Jens Kirchner
Pascal R. Kremp
Michael Magotsch
Editors

Key Aspects of German Employment and Labour Law

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Editors
Dr. Jens Kirchner, Attorney
DLA Piper
Westhafenplatz 1
60327 Frankfurt am Main
Germany
jens.kirchner@dlapiper.com

Pascal R. Kremp LL.M., Attorney
DLA Piper
Westhafenplatz 1
60327 Frankfurt am Main
Germany
pascal.kremp@dlapiper.com

Michael Magotsch, LL.M., Attorney
DLA Piper
Westhafenplatz 1
60327 Frankfurt am Main
Germany
michael.magotsch@dlapiper.com

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List of Authors

Dr. Bernd Borgmann, LL.M. (University of East Anglia, Norwich). Bernd is an attorney and partner of the German Employment, Pensions and Benefits practice group of DLA Piper and is based in the Cologne office.

Dr. Kai Bodenstedt, LL.M. (University of Edinburgh). Kai is an attorney of the German Employment, Pensions and Benefits practice group of DLA Piper and is based in the Hamburg office.

Martin Heinsius. Martin is an attorney, tax adviser and partner of the German Corporate/Tax practice group of DLA Piper and is based in the Frankfurt Office.

Dr. Jens Kirchner. Jens is an attorney and partner of the German Employment, Pensions and Benefits practice group of DLA Piper and is based in the Frankfurt office.

Dr. Rolf Kowanz. Rolf is an attorney and partner of the German Employment, Pensions and Benefits practice group of DLA Piper and is based in the Munich office.

Pascal R. Kremp, LL.M. (Wake Forest University). Pascal is an attorney of the German Employment, Pensions and Benefits practice group of DLA Piper and is based in the Frankfurt office.

Michael Magotsch, LL.M. (Georgetown University). Michael is an attorney and partner of the German Employment, Pensions and Benefits practice group of DLA Piper and is based in the Frankfurt office.

Eva Mittelhamm, LL.M. (University of Stellenbosch). Eva is an attorney of the German Employment, Pensions and Benefits practice group of DLA Piper and is based in the Frankfurt office.

Dr. Flemming Moos. Flemming is an attorney of the German Intellectual Property and Technology practice group of DLA Piper and is based in the Hamburg office.

Dr. Sascha Morgenroth, LL.M. (University of Texas at Austin). Sascha is an attorney of the German Employment, Pensions and Benefits practice group of DLA Piper and is based in the Frankfurt office.

Dr. Julia Schönbohm, LL.M. (Fordham University). Julia is an attorney and partner of the German Intellectual Property and Technology practice group of DLA Piper and is based in the Frankfurt office.

Abbreviations

AG	Aktiengesellschaft (Stock Corporation Act)
AGG	Allgemeines Gleichbehandlungsgesetz (General Equal Treatment Act)
ArbGG	Arbeitsgerichtsgesetz (Labour Court Act)
ArbnErfG	Arbeitnehmererfindungsgesetz)Act on Employee Inventions)
ATG	Altersteilzeitgesetz (Labour Court Act)
AÜG	Arbeitnehmerüberlassungsgesetz
AVmG	Altersvermögensgesetz (Act on Pension Provisions)
BA	Bundesagentur für Arbeit (Federal Employment Agency)
BaFin	Bundesanstalt für Finanzdienstleistungen (Federal Financial Supervisory Authority)
BAG	Bundesarbeitsgericht (Federal Employment Agency)
BDSG	Bundesdatenschutzgesetz (Federal Data Protection Act)
BEEG	Bundeselterngeld- und Elternzeitgesetz (Federal Parental Allowance and Parental Leave Act)
BetrAVG	Gesetz zur Verbesserung der betrieblichen Altersversorgung (Act for the Improvement of Company Pension Plans); also: Betriebsrentengesetz (Company Pension Act)
BetrVG	Betriebsverfassungsgesetz (Works Constitution Act)
BGB	Bürgerliches Gesetzbuch (Civil Code)
BGH	Bundesgerichtshof (Federal Labour Court)
BSG	Bundessozialgericht (Federal Social Court)
BUrlG	Bundesurlaubsgesetz (Federal Vacation Act)
D&O	Directors and Officers
DBA	Doppelbesteuerungsabkommen (Double Taxation Treaty)
DGB	Deutscher Gewerkschaftsbund (German Association for Labour Unions)
DrittelbG	Drittelbeteiligungsgesetz (One-Third-Participation Act)

ECJ	European Court of Justice
EEA	European Economic Area
EFZG	Entgeltfortzahlungsgesetz (Continuation Payment of Salary Act)
EU	European Union
EuGH	Europäischer Gerichtshof (European Court of Justice)
EWR	Europäischer Wirtschaftsraum (European Economic Area)
GbR	Gesellschaft bürgerlichen Rechts (Civil Law Partnership)
GewO	Gewerbeordnung (Trade Regulation Act)
GG	Grundgesetz (German Constitution)
GmbH	Gesellschaften mit beschränkter Haftung (Liability Company)
GmbH & Co. KG	Gesellschaft mit beschränkter Haftung & Co. Kommanditgesellschaft (Unlimited Liability Partner)
GmbHG	Gesetz betreffend die Gesellschaft mit beschränkter Haftung (Limited Liability Company Act)
HGB	Handelsgesetzbuch (Commercial Code)
ILO	International Labour Organization (Internationale Arbeitsorganisation)
KG	Kommanditgesellschaft (Limited Partnership)
KonTraG	Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (Act on Control and Transparency within Companies)
KSchG	Kündigungschutzgesetz (Dismissal Protection Act)
LAG	Landesarbeitsgericht (Labour Court of Appeal)
MgVG	Gesetz über die Mitbestimmung der Arbeitnehmer bei grenzüberschreitenden Verschmelzungen (Act on the Co-Determination of the Employees in Cross-Border Mergers)
MitbestG	Mitbestimmungsgesetz (Co-Determination Act)
Montan-MitbestG	Montan-Mitbestimmungsgesetz (Co-determination Act for the Coal and Steel Industry of 1951)
MuSchG	Mutterschutzgesetz (Maternity Protection Act)
NLRB	National Labour Relations Board
OHG	Offene Handelsgesellschaft (Partnership)
PSV	Pensionssicherungsverein (Pension Insurance Association)
RIF	Reduction in Force
RVG	Rechtsanwaltsvergütungsgesetz (Attorneys' Fees Act)
SE	Societas Europea
SEEG	Gesetz zur Einführung der Europäischen Gesellschaft (Act on the Introduction of the European Company)
SGB	Sozialgesetzbuch (Social Security Code)
StGB	Strafgesetzbuch (Criminal Code)
StPO	Strafprozessordnung (Criminal Procedure Act)

TKG	Telekommunikationsgesetz (Telecommunication Act)
TVG	Tarifvertragsgesetz (Collective Bargaining Agreement Act)
TzBfG	Teilzeit- und Befristungsgesetz (Part-Time and Fixed-Term Employment Act)
UmwG	Umwandlungsgesetz (Company Transformation Act)
VVaG	Versicherungsverein auf Gegenseitigkeit (Mutual Insurance Company)
ZPO	Zivilprozessordnung (Civil Procedure Act)

Part I
Employment Law

Chapter 1
Executive Summary: German Employment and Labour Law

Jens Kirchner and Sascha Morgenroth

A. Background

As a civil law country, Germany's legal system is mainly based on written law, including constitutions, codes and statutes. In addition to the federal constitution and statutes, each state has its own laws and constitution. However, the main areas of law, such as criminal law, civil law and commercial law, are regulated by uniform federal codes, such as the Criminal Code (*Strafgesetzbuch, StGB*), the Civil Code (*Bürgerliches Gesetzbuch, BGB*), and the Commercial Code (*Handelsgesetzbuch, HGB*). German employment and labour law is also largely governed by federal statutes. Historically, however, there is no unified employment and labour law code. The relevant law is contained in several statutes. Statutory gaps are filled by case law, which is particularly important in this field of law. In practice, this makes the understanding and application of German labour and employment law quite difficult for both employers and employees.

German employment and labour law is, to a large extent, influenced by European Union (EU) law, as the German legislature and judiciary have to comply with regulations and directives of the EU and their interpretation by the European Court of Justice (*Europäischer Gerichtshof, EuGH*). For example, the EU Employment Equality Directive 2000/78/EC prohibits discrimination against employees because of their religion, disability, age, or sexual orientation. Germany implemented this EU Directive in 2006 with the German General Equal Treatment Act (*Allgemeines Gleichbehandlungsgesetz, AGG*).

In Germany, there are strict federal procedural rules for the different jurisdictions, such as the Labour Court Act (*Arbeitsgerichtsgesetz, ArbGG*), the Criminal Procedure Act (*Strafprozessordnung, StPO*), or the Civil Procedure Act (*Zivilprozessordnung, ZPO*). These procedural rules apply to all courts at all levels of the respective subject matter jurisdiction. The courts must apply this statutory law. Although there is no doctrine of precedent, the lower courts tend to follow the rulings of higher courts. The highest courts have the constitutional right and

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duty to apply the law equally. In labour and employment law, case law has greater importance than in other areas, as the German labour courts often have to fill statutory gaps.

Employment law covers the relationship between employers and individual employees, whereas labour law governs the relationship between the collective parties, namely employers, employers' organisations, works councils, and trade unions. Labour court proceedings are regulated by the Labour Court Act (*ArbGG*), which often refers to the provisions of the Civil Procedure Act (*ZPO*). In Germany, there is no designated state agency which deals with labour law claims (as compared with the United States, which has a National Labor Relations Board (NLRB)). There is also no binding arbitration in labour or employment cases in Germany, except in disputes between employers and works councils before a conciliation board (*Einigungsstelle*). Instead, labour and employment law disputes go directly to the court with special jurisdiction for labour and employment law. In employment law court proceedings there is a mandatory conciliation hearing (*Güteverhandlung*) during which the parties will attempt to settle the case prior to the presiding judge considering the case on its merits. Further, the court may, and in most cases will, set a conciliation hearing in collective labour law proceedings in order to assess whether the parties are willing to settle the case without a verdict. However, conciliation hearings are not obligatory in labour law matters.

B. Company Perspective

I. Legal Entities

Generally, the laws affecting companies are federal laws, which are commonly applied in all parts of Germany. Most companies are treated as so-called "incorporated companies," meaning that they can be parties to a lawsuit. This is the case for German as well as for foreign companies. However, there are several forms of legal entities, each with its differences. The most common forms of legal entities are limited liability companies (*Gesellschaft mit beschränkter Haftung, GmbH*), stock corporations (*Aktiengesellschaft, AG*), civil law partnerships (*BGB-Gesellschaft*), and limited partnerships (*Kommanditgesellschaft, KG*).

II. Co-Determination

Employers of operations with an established works council need to observe significant co-determination rights of the works council.

Companies with more than 500 employees must establish a supervisory board (*Aufsichtsrat*), one third of which must consist of representatives directly elected by the employees pursuant to the One-Third Participation Act (*Drittelbeteiligungsgesetz, DrittelbG*). However, according to the Co-Determination Act (*Mitbestimmungesetz, MitbestG*), limited liability corporations, stock corporations, and partnerships limited by shares with more than 2,000 employees must install a supervisory board consisting of an equal number of employees and shareholders.

III. Managing Director and Management Board Member

Limited liability companies have one or more managing directors (*Geschäftsführer*) who manage and represent the company. The managing directors are appointed and can be removed by simple majority at a shareholders' meeting pursuant to the Limited Liability Company Act (*Gesetz betreffend die Gesellschaft mit beschränkter Haftung, GmbHG*). However, the legal act of appointing or removing managing directors from office by shareholders' resolutions must be distinguished from the company's employment relationship with them. Managing directors are bound by the decisions made at shareholders' meetings and may be liable for damages caused by a breach of their duties towards the company.

Under the Stock Corporation Act (*Aktiengesetz, AktG*), stock corporations are represented by management board members (*Vorstandsmitglieder*) who are appointed by the supervisory board. Management board members can only be removed from their office for specific reasons (e.g., gross breach of duty or inability to manage the company properly). As with managing directors, the legal act of appointing or removing a management board member from office must be distinguished from the contractual employment relationship and its termination. The management board (*Vorstand*) is not bound by directives issued by the supervisory board. However, the supervisory board approves the annual financial statement of the management board. The management board is liable for damages resulting from a breach of his office duties (sec. 93 *AktG*).

Statutory Managing Directors and Management Board Members are usually not considered "employees". Consequently, they can only bring claims against a company in civil courts. They have no redress against a company in labour courts. In contrast, executive employees (*leitende Angestellte*) are usually considered employees; however, they are not covered by some of the general rules of labour and employment law. Particularly, they are afforded less protection under the Wrongful Dismissal Protection Act (*Kündigungsschutzgesetz, KSchG*) and are not covered by the Works Constitution Act (*Betriebsverfassungsgesetz*, *BetrVG*). However, executive employees may elect a representative under the Spokespersons Committee Act (*Sprecherausschussgesetz, SprAuG*), if the business operation has at least ten executive employees.

IV. Small Business Operations

One factor that leads to differences in the treatment of employees is the size of the employer's organisation. Employees of smaller operations are less protected. Since a statutory reform in 2004, the Wrongful Dismissal Protection Act (*KSchG*) is only applicable to business operations with more than ten employees (sec. 23 para. 1 *KSchG*). The previously applicable threshold was more than five employees. This has been changed to protect smaller business operations, allowing them greater flexibility to deal with economic changes. Moreover, the right to elect a works council under to the Works Constitution Act (*BetrVG*) only arises in business operations with at least five permanent employees who are entitled to vote. Moreover, three of these five permanent employees must be eligible to be elected (sec. 1 para. 1 *BetrVG*).

V. Companies Abroad

These rules are also basically applicable to foreign companies. However, the provisions of the Wrongful Dismissal Protection Act and the Works Constitution Act usually will not extend to companies abroad if there is no operational organisation in Germany and all the employer functions are completely exercised abroad.

C. Employment Law

The most common issues arising in labour and employment law are cases of wrongful termination, works council co-determination rights, and transfers of business operations (asset deals).

I. Employment Contract

Employment contracts drafted entirely by the employer are subject to the provisions of the Civil Code on General Contractual Terms and Conditions (*Allgemeine Geschäftsbedingungen*). Therefore, such contracts must be sufficiently transparent and must not contain any substantial disadvantage to the employee.

II. Protection from Dismissal

German law does not recognise employment "at will." In principle, a person's employment can only be terminated where there is a reason to do so.

There are in principle two ways to terminate employment
Termination for good cause (sec. 626 BGB)
Regular termination observing statutory/contractual notice periods *In business operations with more than 10 employees, if an employee has been employed for more than 6 months in the same business operation or company, additionally only for person-related, conduct-related or urgent operational reasons (sec. 1 KSchG)*

If a works council is in place, the employer must inform it of any proposed terminations and consult with it before any decision to terminate a person's employment is made. If the works council is not consulted, any decision to terminate will be invalid (sec. 102 *BetrVG*).

If the employee succeeds with dismissal protection proceedings before the labour court, the employee can ask to be reinstated, returning to work with the same working conditions. Moreover, the employer must pay the employee for the period between the end of the notice period and the court's verdict.

To avoid any such cases, the employer must abide by the statutory regulations, consult with the works council, and carefully consider the employees whose employment could potentially be brought to an end. If the layoff is caused by operational changes, e.g. rationalisation, the employer must show the significance of the underlying entrepreneurial decision. In business operations with more than 20 employees, employers are obliged to negotiate a balance of interests (*Interessenausgleich*) and social plan (*Sozialplan*) with the works council. The balance of interests is intended to determine the particular measures of the operational change of business. The social plan attempts to compensate or mitigate the economic disadvantages to the employees as a result of the operational change. In any event, an employer and employee can end the employment relationship by signing a contractual termination agreement. However, the employer is not allowed to force the employee to sign such an agreement.

1. Termination for Good Cause

A termination for good cause usually ends the employment relationship immediately without notice. The employer has to show good cause, i.e. an important reason (e.g. significant breach of contract, constant inability to work, severe defamation of the employer), which is hard to prove at trial. Once an employer has received knowledge of the alleged conduct, it must terminate the employment of the person in question within two weeks. This is a mandatory deadline that the employer must observe.

Termination for good cause must fulfil a two-prong test
There must be good cause for termination
Notice must be given within 2 weeks of the employer's knowledge of the good cause

2. Regular Termination and Wrongful Dismissal Protection

a) Regular Termination

In the case of regular termination, the employer has to continue the employment relationship until the end of the statutory notice periods, pursuant to sec. 622 BGB, or the end of the contractually agreed notice period. The normal statutory minimum notice period is four weeks to the 15th or the end of the calendar month. The statutory minimum notice period applicable where employment is terminated by the employer gradually increases according to the employee's length of service (sec. 622 para. 2 *BGB*).

The statutory minimum notice period applicable where employment is terminated by the employer increases according to the employee's length of service as follows
After 2 years of service, 1 month to the end of the calendar month
After 5 years of service, 2 months to the end of the calendar month
After 8 years of service, 3 months to the end of the calendar month
After 10 years of service, 4 months to the end of the calendar month
After 12 years of service, 5 months to the end of the calendar month
After 15 years of service, 6 months to the end of the calendar month
After 20 years of service, 7 months to the end of the calendar month

However, where an employer terminates a person's employment, this will be subject to the "favourability principle" (*Günstigkeitsprinzip*). This means that where the contractual notice period is longer than the statutory minimum notice period, it is the contractual notice period that will apply because it is more beneficial to the employee.

It should be noted that the parties may initially agree on a probationary period of up to six months during which the employment relationship may be terminated with a two week notice period without cause (sec. 622 para. 2 *BGB*).

b) Wrongful Dismissal Protection

Where an employee facing dismissal has been employed in the same business or company for more than six months and the business employs more than ten employees, the proposed dismissal requires social justification under the Wrongful Dismissal Protection Act (*KSchG*).

The Wrongful Dismissal Protection Act applies to
Every business with more than 10 employees
Employees facing dismissal who have been employed in the same business or company for more than 6 months

c) Lack of Possibility of Continued Employment

In order to prove the social justification of the dismissal, the employer has to show that it is not possible to continue employing the employee, even in another position or another part of the company.

d) Statutory Grounds for Termination

Where the Wrongful Dismissal Protection Act (KSchG) applies, only three statutory grounds may socially justify the termination
Conduct-related reasons
Person-related reasons
Urgent operational reasons

aa) Conduct-Related Reasons

Prior to termination on this ground, the employer will often have to issue a warning letter to the employee due to a new misconduct for similar reasons.

bb) Person-Related Reasons

Typical person-related issues include cases of long-term or frequent short term illness. However, in order for the termination to be socially justified on this ground, the prognosis of the employee's health condition must be negative and it must be shown, on a balance of the parties' interests that the employee's expected health related absences will result in an detriment to the employer's business interests.

cc) Operational Reasons

If an employee is dismissed for operational reasons, such reasons must be proven by the employer, and a "social selection" (*Sozialauswahl*) among comparable employees needs to be carried out. The employer has to compare the social data of comparable employees before selecting the employees whose employment will be terminated.

The crucial social selection criteria are
Age
Length of service
Obligations to pay family support
Disability

The employer has to carefully consider whether there are comparable employees working in the business whose work could also be performed by an employee threatened with termination. In this case, the employer has to examine which of the comparable employees merits greater social protection. The social selection extends to all similar employees in an entire business operation. However, the social selection

will not extend to other business operations of the company or the group. Further, the employer is free in his basic entrepreneurial decision to reduce the workforce in response to certain economic or internal situations. Finally, the employer may exclude from the social selection employees whose retention is in the legitimate interest of the business. In practice, however, this exception is not often used as such legitimate interest is difficult for the employer to prove.

In summary, the social selection process must be carried out in the following three steps
First, the employer must determine the categories of comparable employees within the business operation.
Second, the employer has the opportunity to exclude from the social selection process the employees whose retention is in the legitimate interests of the business. However, the employer carries the burden of proof for such legitimate interest, and therefore, in practice, this exemption is not often used.
Finally, the employer must – after having complied with the first two steps – carry out a social selection of the remaining employees in accordance with the above mentioned criteria of length of service, age, obligations to financial support and severe disability.

e) Mass Dismissals

Where dismissals and other terminations of employment by the employer reach a certain threshold within a period of 30 calendar days, the employer must notify the Employment Agency (*Agentur für Arbeit*) prior to effecting the dismissals (sec. 17 *KSchG*). These are known as "mass dismissals".

The relevant dismissal/termination thresholds for notification of the Employment Agency of so-called mass dismissals are within 30 calendar days	
In business operations with usually more than 20 and less than 60 employees	More than 5 employees
In business operations with usually 60 or more and less than 500 employees	10% of the employees regularly employed in the business operation or more than 25 employees
In business operations with usually 500 or more employees	30 or more employees

According to the European Court of Justice (*EuGH*) the competent state authorities must be notified, not only before the actual termination date, but 30 days before notice to terminate the employment is given to the employee.

f) Termination with Change of Terms of Employment

If the employer's goal is merely to change working conditions, he might choose a termination with change of terms of employment (*Änderungskündigung*), i.e. a termination by the employer connected with an offer to continue the employment relationship under changed conditions. However, the employee can file a complaint with the labour court against the dismissal under to the Wrongful Dismissal Protection Act (*KSchG*). Moreover, termination with change of terms of employment are

only advisable in individual cases. They are usually not recommended to change working conditions in cases of mass dismissals.

3. Special Dismissal Protection

Moreover, special protection against dismissals applies to certain groups of employees.

Special Termination Protection applies to certain groups of employees, including
Women during pregnancy and 4 months after childbirth pursuant to sec. 9 of the Maternity Protection Act (*Mutterschutzgesetz, MuSchG*)
Employees on parental leave (*Elternzeit*) and 8 weeks prior to parental leave pursuant to sec. 18 of the Federal Parental Allowance and Parental Leave Act (*Bundeselterngeld und – Elternzeitgesetz, BEEG*)
Severely disabled persons pursuant to sec. 85 et seqq. of the Social Security Act IX (*Sozialgesetzbuch IX, SBG IX*)
Members of the works council pursuant to sec. 15 of the Wrongful Dismissal Protection Act (*KSchG*)

The special termination protection particularly requires the employers to obtain the consent of the competent administrative agencies prior to the dismissal of a protected employee.

III. Anti-Discrimination

1. Discrimination Criteria

The General Equal Treatment Act, which implements the EU Employment Equality Directive 2000/78/EC into German law, prohibits discrimination on grounds of race or ethnic origin, religion or belief, sex, disability, age or sexual orientation (sec. 1 *AGG*).

The General Equal Treatment Act (AGG) prohibits discrimination based on
Race or ethnic origin
Religion or belief
Sex
Disability
Age
Sexual orientation

Discrimination on the basis of these criteria is particularly prohibited in relation to selection procedures and recruitment conditions, employment and working conditions, conducting employment relationships and promotions (sec. 2 *AGG*).

2. Protected Persons

The *AGG* protects all employed persons. In addition to employees, apprentices, temporary employees, freelancers, persons similar to employees (*arbeitnehmerähnliche Personen*) and home workers (sec. 6 *AGG*) are also protected. Limited to engagement or promotion matters, the *AGG* also covers members of executive bodies (such as statutory Managing Directors and Members of the Management Board).

3. Discriminatory Behaviour and Justified Discrimination

Under the *AGG*, discrimination is an unjustified difference in treatment on one of the grounds set out above in sec. 1 *AGG*.

The General Equal Treatment Act (AGG) prohibits the following discriminatory behaviour
Direct discrimination
Indirect discrimination
Harassment (this includes "bullying")
Sexual harassment
Employer instructions to discriminate

Instructions to discriminate a person on one of the grounds listed in the *AGG* constitutes prohibited discrimination (e.g. instruction to the HR-Department not to hire disabled people). However, not every difference in treatment constitutes discrimination. In exceptional cases, a difference in treatment may be justified under certain conditions depending on the ground of discrimination. Particularly, discriminatory treatment on the basis of race or ethnic origin, sex, religion or belief, disability or sexual orientation may be justified if a substantial and vital work-related requirement can be demonstrated. However, this will only be the case where the requirement is mandatory for performing the professional activity.

4. Legal Consequences/Rights of Persons Concerned

The *AGG* provides for liability for material damages depending on fault (sec. 15 para. 1). The employer is responsible for his own fault, i.e. intent and negligence. In relation to works agreements and collective bargaining agreements, liability is, however, limited to intent and gross negligence. The employer is also liable for the fault of his legal representatives and of his vicarious agents (i.e. his management employees in relation to the general workforce). Fault is assumed and so the burden of proof is on the employer to show that he is not at fault. Furthermore, there is liability for immaterial damages. The amount of compensation for immaterial damages has to be appropriate. In the context of hiring of employees any compensation is limited to a maximum of 3 months' salary, except for the best-qualified applicant. If the best-qualified applicant has not been hired due to discrimination, the amount of compensation is unlimited.

The employees have the right to complain to the company's competent department (usually a complaints department) if they feel discriminated against by the employer, the management, other employees or third parties in relation to their employment. If the employer does not take any steps, or takes obviously inappropriate measures to prevent harassment or sexual harassment, the employee concerned is entitled to cease working while still receiving wages, provided this is required for his or her protection and will have the right to injunctive relief. Where an employer has committed a gross breach of the prohibition on discrimination, the works council or the competent union are permitted to assert the rights mentioned above (particularly a claim to injunctive relief). They are not, however, entitled to assert claims of the discriminated person.

Under the *AGG*, the burden of proof is on the employer. An employee bringing a claim only has to show that, on the facts, it may be inferred that the treatment in question is unjustifiably discriminatory. The employer then has to prove that no discrimination occurred and that the treatment is in fact justifiable. Employers should therefore ensure that there can be no presumption of possible discrimination before taking personnel measures.

IV. Part-Time and Fixed-Term Employment

1. Part-Time Employment

The Part-Time and Fixed-Term Employment Act (*Teilzeit- und Befristungsgesetz, TzBfG*) is intended to help establish part-time employment relationships. Employers are obliged to give their employees the opportunity to work part-time under certain conditions.

Employers are obliged to give their employees the opportunity to work part-time if
The employee has been employed for more than 6 months
The employer has more than 15 employees
There are no operational reasons for opposing the reduction in the employee's working hours

The employee must inform the employer at least three months before the proposed reduction in working hours will take effect. If an employee delays in providing the information, this will result in the start of their part-time working being postponed retrospectively.

Once an employee's request for part-time working has been received, the employer must inform the employee of its decision in writing at least one month prior to the intended start of part-time work. If the employer does not do this, under the Part-Time and Fixed-Term Employment Act (*TzBfG*) it will be assumed that the request for part-time work has been granted by the employer.

Under the Equal Treatment Principle (*Gleichbehandlungsgrundsatz*) contained in the Part-Time and Fixed-Term Employment Act, part-time employees must be

treated in the same way as full-time employees in relation to wages and other working conditions.

2. Fixed-Term Employment

Pursuant to the Part-Time and Fixed-Term Employment Act (TzBfG) a fixed-term employment contract is lawful
Where there is cause (e.g. temporary need for employees, substitute employment)
Without cause but for a total period of up to 2 years. Employment contracts for a shorter period can be extended by agreement up to three times for a total period of 2 years. Breaches of these limitations result in employment contracts for an unlimited time period. In effect, it is possible to "test" new employees for a period of 2 years

V. Employee Leave Entitlements

Under the Federal Vacation Act (*Bundesurlaubsgesetz, BUrlG*) all employees are entitled to 20 days' paid vacation, based on a 5-day working week. Vacation days that have not been taken by employees during a calendar year usually remain valid for 3 months in the following year. The Continuation of Remuneration Act (*Entgeltfortzahlungsgesetz, EFZG*) entitles employees to up to six weeks' paid time off in case of illness. A new 6-week-period commences if the employee gets sick again due to the same underlying illness and six months have passed since the end of the last sick leave, or if one year has passed since the beginning of the first sick leave. If the underlying reason for the sickness is a new one, the 6-week period automatically begins again.

VI. Employee Liability

Employee liability for damage caused to the employer during the course of their work, or activities initiated by their work, is limited according to principles established by the jurisdiction of the Federal Labour Court (*Bundesarbeitsgericht, BAG*). According to these principles, where an employee has been slightly negligent, liability will be excluded. In contrast, an employee who has been grossly negligent will be obliged to compensate for all of the resulting damage. However, except for particularly severe gross negligence, labour courts may decide differently if the risk of damage is considered disproportionate when compared with the employee's salary. If the employee caused damage as a result of "average" negligence, labour courts will divide the damages between employer and employee in accordance with equity and the circumstances of the individual case.

The liability limitations, in principle, do not apply to damage caused to third parties. However, the employee has a right to demand that he be indemnified by the employer if he would not have been liable according to the principles explained above, or only liable to a limited extent. If the employee injures a colleague,

liability will be excluded (sec. 105 para. 1 Social Security Act (*SGB*) VII), and the injured colleague may only refer to the statutory accident insurance (*Unfallversicherung*) for redress. However, if the employee causes damages to a colleague's property, the employee will be liable, but may also demand to be indemnified by the employer according to the liability principles applicable in the employment relationship.

D. Labour Law

I. Works Council

The Works Constitution Act (*Betriebsverfassungsgesetz, BetrVG*) provides works councils (*Betriebsrat*) with participation and co-determination rights in relation to managerial decisions involving personnel, social, and operational matters. However, the act is only applicable if a works council actually exists in the business operation.

Works councils can be elected in business operations
With more than five permanent employees who are eligible to vote Three of which must be eligible to be elected

The employer cannot prevent the election of a works council. The size of the works council depends on the size of the operation. Large operations have mandatory works council members who do not perform their normal duties, but are still paid by the employer.

The Works Constitution Act distinguishes between the business operation (*Betrieb*), a part of the business operation (*Betriebsteil*), and the company (*Unternehmen*). The business operation is a unit of material and personnel under common management. Parts of these business operations have their own operational leadership with directive authority, but are mostly regarded as belonging to the business operation of which they are a part. The company forms the legal entity to which the business operation belongs. Employee co-determination is exercised by works councils on an individual business operation level, and by supervisory boards (*Aufsichtsräte*) on a company level.

Employees may also establish a central works council (*Gesamtbetriebsrat*) for an entire company, a group works council (*Konzernbetriebsrat*) for a group, and a European works council (*Europäischer Betriebsrat*) for companies with at least two operations located in different European member states.

In business operations with more than 100 permanent employees, an economic committee (*Wirtschaftsausschuss*) can be elected to discuss economical issues with the employer. The economic committee has no co-determination rights, but consultations with the employer will still take place.

II. Co-Determination Rights

1. General Principles

The works council has a general right of information (*allgemeiner Unterrichtungsanspruch*) and co-determination rights (*Mitbestimmungsrechte*) concerning social, personal, and economic matters. Employer and works councils can conclude works agreements (*Betriebsvereinbarungen*) in relation to working conditions that are binding on the employer and all employees in the business operation. A breach of the works council's rights of participation and information may lead to losing a trial.

2. Operational Changes

Under the Works Constitution Act, where a company has more than 20 employees, the employer must inform the works council in a timely and comprehensive manner about significant planned operational changes, and discuss such changes with the works council (sec. 111 *BetrVG*).

Operational changes include
Reduction in and closure of the entire business operation or of significant parts
Relocation of the entire operation or significant parts
Mergers with another business operation or the spin-off of the business operation
Fundamental changes to the operation's organisation, to the subject of the business operation, or to its facilities
Introduction of fundamentally new working methods and manufacturing processes

The most common operational change is the reduction in or closure of a significant part of the business operation. The labour courts interpret the mere reduction of staff as reduction of significant parts of the business operation, if at least 5% of the workforce is affected by changes.

In cases of operational changes, the employer must inform the works council and consult its members. The employer must also conclude a social plan (*Sozialplan*) with the works council, and usually also negotiates a balance of interests (*Interessenausgleich*). The balance of interests covers the operational changes proposed and the details of their implementation. If the parties cannot reach an agreement on a balance of interests, either the works council or the employer can call a conciliation board to make a decision. The works council cannot force the employer to negotiate but the employer should try to reach an agreement on a balance of interests in order to prevent possible claims from employees for compensation of disadvantages (*Nachteilsausgleich*). In contrast, it is mandatory for the employer to put together a social plan in cases of operational changes. The social plan is intended to reduce the economic disadvantages employees will face as a result of the employer's decisions. They therefore usually include compensation payments. If the parties cannot agree

upon its contents, a conciliation board will decide on the details of the social plan. If the parties cannot agree on the size of the board and the identity of the chairman, it will be for the labour court to determine.

In principle, it is crucial that the employer and the works council reach an agreement on the implementation of operational changes. Where no agreement can be reached, the conciliation board will usually decide on the contents of the social plan. As a general rule, employers and works councils should try to avoid conciliation board proceedings, because they could be disadvantageous for either party. Moreover, there is only limited possibility to appeal the conciliation board's decision.

Until an agreement has been reached, the employer cannot usually implement the intended measures and must continue the business operation unchanged. Some district labour courts (e.g. in the states of Hesse, North-Rhine Westfalia, and Berlin) have granted preliminary injunctions to works councils preventing employers from dismissing employees until the parties find a balance of interest, or the employer initiates and completes conciliation board proceedings.

As a result, employers and works councils are advised to be well prepared throughout the planning and negotiating of operational changes. Convincing arguments and a detailed plan are the keys to success.

III. Business Transfer

Employee rights on a transfer of a business/undertaking (asset deal) are dealt with under German law in sec. 613a *BGB*, which was implemented in response to European Union Directives relating to the transfer of business, e.g. 77/187 EC.

1. Transfer of Employment Relationships

Where there is a transfer of a business, the buyer of the business "steps into the shoes" of his predecessor and assumes all of his rights and duties relating to the existing employment contracts. The parties to a transfer of business need to be aware that, according to sec. 613a para. 1 *BGB*, any rights and duties arising from a collective bargaining agreement or works agreement usually become part of the employment contract between an employee and the buyer.

2. Employees' Right to Information

Prior to the transfer of a business, either the seller or the buyer must fully inform the affected employees about certain aspects of the transfer in writing, e.g. letter, email, fax (sec. 613a para. 5 *BGB*).

The employees' right to information in writing includes
The date or proposed date of the transfer
The reason of the transfer
The legal, economic and social consequences of the transfer for the employees
The measures proposed in respect of the employees

3. Employees' Right to Object

Employees have the right to object to the transfer of their employment relationship. They must do so in writing, within one month upon the receipt of the written information about the transfer from the employer (sec. 613a para. 6 *BGB*). However, the one month period does not begin to run where the information given to the employees by the employer is insufficient. Therefore, the written information given to employees requires careful drafting. If an employee objects to the transfer of his employment, the employer may be able to terminate the employee's employment for operational grounds where there is no possibility of employment with the previous employer. However, if the employee does not object to the transfer, all rights and duties of the employment relationship are transferred to the new employer.

4. Special Termination Protection

Employees who are part of the transferred business operation cannot be dismissed because of the transfer (sec. 613a para. 4 *BGB*). They can, however, be dismissed on other grounds.

5. Liability

After the transfer, the buyer becomes liable for all employment obligations, except for those relating to employees who left the business before the transfer, for which the seller remains liable. The seller will also be jointly and severely liable for obligations which arose before the transfer of business and become due within one year after the transfer date (sec. 613a para. 2 *BGB*). Employees who suffer economic loss because of a failure or delay in provision of the written information under sec. 613a *BGB* may be able to bring a claim for damages.

6. Business Transfer and Operational Changes of Business

A business transfer may be connected with operational changes to the business. Often restructuring plans result in the relocation of part of a unit, fundamental changes in the structure of a unit, or the reduction in and/or closing down of part of, or the entire, business operation. Because of this, works councils have rights to

information and consultation under sec. 111 of the Works Constitution Act (*BetrVG*).

There are two issues that arise under sec. 613a BGB and sec. 111 BetrVG where a transfer of business includes operational changes
Information of and negotiations with the works council
Protection of and the obligations towards the employees whose employment relationships are transferred to the buyer

It is therefore necessary to be thoroughly prepared by having a detailed action plan, time plan, and backup plan for each individual measure proposed.

IV. Collective Bargaining Agreements

Where an employee is a member of a trade union, it will be bound by any collective bargaining agreements entered into by that union. An employer may be bound by a collective bargaining agreement in two ways: if the employer enters into a collective company agreement (*Haustarifvertrag*) directly with the trade union or if the employer is a member of an employer's organisation which enters into a collective association agreement (*Verbandstarifvertrag*) with the trade union. Typical contents of collective bargaining agreements are working conditions, particularly remuneration and working hours, overtime, bonuses, holidays, and notice periods. So far the Federal Labour Court (*BAG*) has held that there can only be one collective bargaining agreement for every operation, and only the parties (or members of the contractual parties) are bound by the agreement. However, it remains to be seen whether the Federal Labour Court will continue to stand firm on this decision.

Chapter 2
Recruitment

Sascha Morgenroth

A. Introduction

Although the recruitment process precedes the formation of an actual employment relationship, certain duties and rights nonetheless apply to the prospective employer and candidate during this process.

B. Recruitment Practice

I. Diversity Issues

Prospective employees are protected from discrimination during the recruitment process in much the same way as actual employees are during their employment. Under the General Equal Treatment Act (*Allgemeines Gleichbehandlungsgesetz, AGG*), which came into force on 18 August 2006 (see Chap. 11 for further details), a person must not be directly or indirectly discriminated against on grounds of race or ethnic origin, religion or belief, gender, disability, age or sexual orientation. Employers cannot be forced to hire certain candidates, but discrimination during the course of the recruitment process or during employment may lead to claims against employers for damages or compensation. Claims for pecuniary losses could include wages that a candidate could have earned (possibly until the first potential termination date) had they not been discriminated against and had been employed. In some cases, candidates would not have been employed anyway (e.g. because another candidate was better qualified), and so compensation for non-pecuniary losses is limited to three months' salary. If a candidate wants to bring a discrimination claim, they must do so within two months of receiving a rejection letter from the employer.

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II. Pre-Contractual Duties

Certain pre-contractual duties apply during the recruitment process under the German Civil Code (*Bürgerliches Gesetzbuch, BGB*). Where an employer misleads an employee to believe that they will be given employment, and the employee leaves his current job in reliance upon this, an employer may be liable for damages. Further, an employer may also be liable if it fails to keep proper application documentation, or if it fails to inform applicants that an advertised vacancy is no longer available. Where a candidate decides they do not want to accept a position, in order to avoid liability they must inform the employer in good time. Neither an employee nor employer will be liable where contract negotiations are abandoned.

C. Recruitment Process

I. Job Advertisements

In Germany, the recruitment process usually begins with employers advertising vacancies in newspapers or on the internet. Employers also recruit through the Federal Employment Agency (*Bundesagentur für Arbeit, BA*) or through professional recruitment agencies.

Job advertisements must not be directly or indirectly discriminatory. Particularly, job advertisements must be drafted as gender and age neutral. As a basic rule, employers are not allowed to ask candidates for their age or date of birth, marital status or photographs. Even though asking for a photograph of a candidate could give rise to a claim for indirect discrimination, it is still common practice for candidates to send a photograph with their application.

II. Application Documents and Applicant Data

1. Application Documents

Job applications in Germany usually consist of a covering letter, CV, copies of reference letters from former employers, and certificates from schools, apprenticeships and universities. The candidate pays for the usual application documents and the shipping costs. The potential employer is not obliged to respond to unsolicited applications or to return them. Any application documents that are sent to an employer in response to an advertisement must be kept. If the candidate is later employed, the application documents form part of their personnel file (*Personalakte*). Where a candidate is unsuccessful in their application, all of the application documents must be returned to the candidate in good condition. The employer will be liable for any loss or damage to the application documents.

2. Applicant Data

In Germany, there is no obligation on employers to retain data relating to job candidates. However, companies should keep relevant applicant data until the period during which that applicant could bring a discrimination claim has passed. Under German anti-discrimination law, candidates must bring a claim within two months of the receipt of a rejection letter. Relevant data on an unsuccessful candidate should therefore be retained for at least two months from the date of service of the rejection letter. A candidate could potentially bring a claim outside of the two month period where there is a discrepancy over the date of receipt of the rejection letter, and the candidate claims it was received at a later date. Because of this, employers may decide to hold candidate data for longer than two months. The courts have not yet decided what the permissible time period for holding candidate information would be in this situation. Based on the regular statute of limitation, it has been argued that this data could legally be stored for up to three years. An employer would only continue to hold information for this long in cases where it reasonably expected that a candidate would bring a discrimination claim against it.

a) Obligation to Delete Data

Under German data protection law, employers can only keep personal data while it is required for justified interests (which includes for legal protection against discrimination claims). Once the retention of this data can no longer be justified, it must be deleted (see Chap. 12 for further details).

b) Aspects of Cross-Border Transfers of Applicant Data

Usually applicant data for positions in Germany remain in Germany. However, foreign multinational companies with an international matrix structure may have reasons to process and store employee and job candidate data centrally in foreign headquarters. The cross-border transfer of candidate data will not be permitted if the candidate concerned can show a legitimate interest that prevents their data from being transferred. Such candidate interest is assumed where the data recipient cannot guarantee an "adequate level of data protection" (*angemessenes Datenschutzniveau*). An adequate level of data protection is only deemed to exist within the European Union (EU) and in countries the EU Commission has declared as providing an adequate level of data protection, such as Canada, Switzerland etc. The US, generally, are not considered to provide an adequate level of data protection. However, US companies that have agreed to the "Safe-Harbour-Principles" of the EU Commission and the US Department of Commerce have been acknowledged as providing an adequate level of data protection. It is also possible to achieve an adequate level of protection by using the standard contractual clauses for the transfer of data as approved by the EU Commission.

III. The Selection Process: Vetting and Screening

When a job candidate is invited to an interview, employers usually ask questions in order to obtain further information.

1. Procuring Information from Applicants/Job Interviews

a) Asking Questions

An employer can only ask the candidate questions that are reasonable, legitimate, and do not amount to a disproportionate invasion of the candidate's privacy. It is reasonable for an employer to ask questions relating to the vacancy.

It would be unreasonable and unlawful for an employer to question a candidate on the following issues:

- planned or current pregnancy,
- illness (however, questions may be permissible if the illness is particularly severe or infectious and may affect the candidate's ability to carry out the position for which they are applying),
- criminal convictions (provided they are not formally recorded on a candidate's criminal record, or are not relevant to the position for which the candidate is applying; however, for example, a current criminal record of embezzlement by a cashier would be relevant),
- union membership,
- religion,
- membership of a political party,
- personal circumstances (e.g., marriage, partnership, sexual orientation).

If an employer asks a candidate a question relating to the above issues during the recruitment process, the candidate is entitled to lie (*Recht zur Lüge*) to the employer. If the candidate is subsequently employed and it is revealed that they lied in response to a question on the above issues, the employer cannot bring any claim against the employee. On the other hand, if the candidate gives a false answer to a permitted question, the employer may challenge the validity of the employment contract for fraudulent misrepresentation.

b) Employee Questionnaires

Employee questionnaires must not ask questions relating to any of the above issues. They may only be used to enquire about those issues that an employer has a reasonable and legitimate interest in and are related to the position in question. Furthermore, where a works council is in place, employee questionnaires must be approved by the works councils pursuant to the Works Constitution Act (*Betriebsverfassungsgesetz, BetrVG*).

c) Assessment Tests, Medical Examinations and Screenings

An employer can require a candidate to undergo a medical examination (*Einstellungsuntersuchung*) and drug screening, provided a candidate has given valid prior consent and the examination relates only to the candidate's suitability for the position and does not violate their personal rights.

Other tests, such as assessment centers, psychological tests or financial background screenings will only be lawful if a candidate has given their prior informed consent and they are conducted by qualified institutions/personnel. The employer must have a reasonable and legitimate interest for obtaining this information. The test/screenings must be sufficiently related to the requirements of the position, must not violate the candidate's personal rights, and the information must not be acquired by other means. Financial background screenings usually require that the position for which a candidate is applying is an executive position or a position of trust.

d) Compensation of Travel Expenses

Candidates that have been expressly invited to an interview with an employer can claim back their reasonable travel expenses.

2. Procuring Information from Third Parties

Usually, an employer can only obtain information about a candidate by approaching that candidate. However, third parties can be contacted where the potential employer can show that it has a reasonable and legitimate interest in particular information that cannot be obtained from the candidate. For example, a previous employer could be contacted where further information is required in relation to previous professional activities, or where an employer has evidence suggesting that a candidate has provided false information. Global companies increasingly make use of professional agencies to undertake a full assessment of at least the candidates that have been short listed. For example, German subsidiaries of major US companies tend to use professional interviewers or request references to get a clearer picture of the candidate. A candidate is entitled to be notified where information relating to them is being gathered. In practice, any secret exchange of information is difficult to prove.

IV. Concluding Employment Contracts

Once an employer has decided which candidate to employ, it will make an offer of employment by way of a signed employment contract. The accompanying covering letter should specify the deadline by which the candidate has to accept the employment agreement. The candidate can then decide to accept or reject the offer before

this deadline. Standard offer letters are not common in Germany and should not be used.

For an employment contract to be concluded, there needs to be agreement between the parties as to the work the employee is to carry out and how much they are to be paid by the employer. Employment contracts can be oral as well as in writing, although it is advisable to have a written contract within which the terms of employment are clearly set out. Under the Part-Time and Fixed-Term Employment Act (*Teilzeit- und Befristungsgesetz, TzBfG*), the agreement on the fixed-term must be in writing; if it is not, the employment is assumed to be for an indefinite period. The employer must confirm the main employment terms to the employee in writing within one month of the start of employment as set out in the Documentation Act (*Nachweisgesetz*).

V. Unsuccessful Job Applications

Employers must not make a decision to reject an applicant directly or indirectly based on their race or ethnic origin, sex, religion or belief, disability, age or sexual identity. A decision to reject an applicant must be based solely on their suitability for the role. As a general rule, a short, clear covering letter should be sent to the applicant when returning their application documents in order to avoid a claim of discrimination.

VI. Works Council Co-Determination Issues

Where requested by a works council, an employer must first advertise any vacancies within the business. Where a business has more than 20 employees eligible to vote for the works council, an employer must provide the works council with the proposed application documentation and obtain its approval prior to starting the recruitment process. This is set out in the Works Constitution. A failure to obtain this approval could result in any subsequent employment contract being invalid, for example, in the situation where the employer has not advertised the vacancy internally. If the works council does not give its approval of the process, it must inform the employer within one week of their consultation. If it does not inform the employer of its decision, then it is assumed that the process has been approved. Where the works council informs an employer that it has not approved the process, the employer can apply to the labour court for its approval, substituting the works council's consent. The employer does not need the works council's approval before entering into an employment contract with a new employee.

Where an employer uses applicant questionnaires and general abstract selection policies (*Auswahlrichtlinien*) during its recruitment process, these must be

approved by its works council. Where there are more than 500 employees, the works council can request the use of certain selection policies.

D. Reference Letters

Reference letters from former employers form an important part of the recruitment process in Germany. These are important for employers and employees, as they provide useful information relating to previous employment, such as dates and duration of employment.

In Germany, all full time and part time employees have the right to receive a qualified reference letter (*qualifiziertes Zeugnis*) when they leave employment. Employees can request an interim reference letter (*Zwischenzeugnis*) in certain circumstances, e.g. where an employer has announced that it plans to dismiss certain employees at a future date, where a change in job position, area of work or supervisor has been suggested, or where a transfer of business is proposed.

Qualified reference letters must be issued on paper bearing the employer's letterhead and must be entitled "*Zeugnis*" (reference). The reference letter must be in the proper form, i.e. typed, dated and signed by the employer. There must not be any defects, for example, stains, crossing-out, corrections, accentuations or underlining. The letter must set out the employee's details, the duration of the employment (including start and finish dates), the employee's position and a description of the employee's role, covering the tasks the employee performed. The letter must also address the performance of the employee, as well as their behaviour. This is different from the basic reference letter (*einfaches Zeugnis*), which does not require an assessment of the employee's performance. The labour courts have held that reference letters must be benevolent (*wohlwollend*) but also truthful. An employer does not have to specifically grade each aspect of the employee's employment in a reference letter but it must not hinder an employee's future employment prospects without cause.

When giving details of employee performance, it is common practice for employers to use the following grading system:

Performance evaluation Overall grade	*Die übertragenen Aufgaben wurden . . . erledigt.*
Very good (*sehr gut*)	*stets zu unserer vollsten Zufriedenheit*
Good (*gut*)	*stets zu unserer vollen Zufriedenheit*
Satisfactory (*befriedigend*)	*stets zu unserer Zufriedenheit*
Non-satisfactory (*ausreichend*)	*zu unserer Zufriedenheit*
Poor (*mangelhaft*)	*im allgemeinen zufrieden stellend*

There is also a similar grading system relating to an employee's behaviour.

Behaviour evaluation Grade	*Das Verhalten gegenüber Vorgesetzten und Mitarbeitern/Kunden . . . .*
Very good (*sehr gut*)	*war stets hervorragend*
Good (*gut*)	*war stets gut*
Satisfactory (*befriedigend*)	*war einwandfrei*
Non-satisfactory (*ausreichend*)	*gab keinen Anlass zu Beanstandungen*
Poor (*mangelhaft*)	*war im allgemeinen einwandfrei*

Sometimes an employee will ask for the reasons for their departure to be included in the reference letter. Some employers include closing words, thanking the employee for their contribution and wishing them well for the future. However, employees cannot force the employer to include such closing words.

Employees may have claims for correction and/or damages where an employer has provided an incorrect, incomplete or delayed reference letter, or where it has refused to provide one. A current employer could bring a claim against a former employer for issuing a false reference letter, but these cases are very hard to prove and do not occur often in practice.

E. Key Aspects

- An employer will be liable where, during the recruitment process (covering advertising, selection process, rejection of applications and conclusion of employment contracts), it discriminates, directly or indirectly, against a candidate on grounds of race or ethnic origin, religion or belief, disability, age or sexual orientation.
- Where there is a works council in place, there may be co-determination rights which need to be observed in relation to the recruitment process.
- Application documents must be securely kept and candidate data must be stored and dealt with in accordance with statutory data protection law requirements. Limitations on the cross-border transfer of candidate data must be observed.
- Employment contracts must contain the main details of employment and should be in writing.
- Employees have a right to receive a benevolent and truthful qualified reference letter (evaluating their overall performance and behaviour) when leaving employment.

Chapter 3
Employment Contracts and Further Legal Sources

Sascha Morgenroth

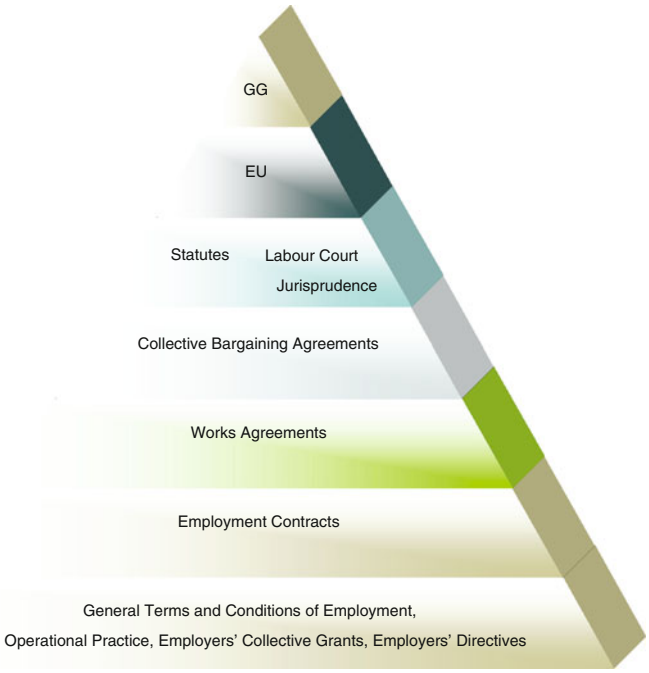
A. Introduction

Employment relationships and labour relations in Germany are governed by a complex system of different legal sources. Relevant regulations are provided by: EU law; German national constitutional law (*Grundgesetz, GG*) and statutory law; collective bargaining agreements; works agreements; individual employment contracts; general terms and conditions of employment; employers' collective grants and employers' directives; operational practices; the equal treatment principle; and, to a large extent, by labour court decisions.

Conflicts among the legal sources of German employment and labour law are resolved by certain legal principles, which determine the hierarchy and relationship between the different sources. According to the general superiority principle (*Rangprinzip*), higher ranked norms generally override lower ranked norms. For example, constitutional law has priority over statutory law whereas statutory law overrides unwritten legal principles. The pyramid below illustrates a simplified version of the hierarchy of legal norms.

The superiority principle is overruled by the principle of favourability (*Günstigskeitsprinzip*), which provides that lower ranked norms will still apply if they are more favourable for the employee. However, the principle does not apply if another legal source states otherwise, such as collective bargaining agreements which basically block the provisions of works agreements. Where norms are of the same rank, the more specific norm will override the more general norm (*Spezialitätsprinzip*) and the more recent norms will replace the older norms (*Ablösungsprinzip*).

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B. Employment Contracts

I. Content

Employers and employees are generally free to agree on the content of individual employment contracts. However, the agreed terms and conditions will only be valid if they comply with the extensive system of employee protection rules which are superior to employment contracts, in particular mandatory statutory law, collective bargaining agreements and works agreements. Contract provisions which conflict with superior law are generally null and void. Moreover, employment contract provisions drafted entirely by the employer (e.g. where the employer uses a standard contract document for all employees) are subject to the protection provisions of the Civil Code on general contractual terms and conditions (*Allgemeine Geschäftsbedingungen*). Basically, if such contract clauses differ from these provisions and are to the detriment of the employee, e.g. contain unreasonable disadvantages for the employee or surprising or unclear regulations, they may also be null and void.

The main duties arising from employment contracts are the duty of the employer to pay the employee's salary and the duty of the employee to personally perform his work. There are further implied duties, like the employer's obligation to protect the life, health and safety of its employees, or the employee's duties to observe

the employer's instructions, to keep business secrets confidential, to protect the employer's property and not to compete with the employer during the course of the employment relationship.

II. Form

Generally, employment contracts do not need to be in a special form and therefore may also be concluded orally. However, it is advisable to have a written contract clearly setting out the terms and conditions of employment. In practice, most employment contracts (approximately 90%) are concluded in writing. However, the employer must, in any case, confirm the main employment terms to the employee in writing within 1 month of the start of the employment according to the Documentation Act (*Nachweisgesetz*). Under the Part-Time and Fixed-Term Employment Act (*Teilzeit- und Befristungsgesetz, TzBfG*), the fixed-term must be agreed in writing; otherwise the employment is assumed to be for an indefinite period.

C. Further Legal Sources

I. European Union Law and International Law

1. European Union Law

German labour and employment law is largely influenced by European Union (EU) law. EU law distinguishes between primary and secondary legal sources. The primary law consists of the European Community (EC) treaties which provide for some basic employee rights such as the equality of remuneration of women and men and the freedom of movement of employees within the EU. The secondary law consists of decrees (*Verordnungen*) and directives (*Richtlinien*). Decrees contain directly applicable law. There are, for example, directly binding EU decrees in the area of workplace health and safety. Directives on the other hand are the main tool of the EU to harmonize the national laws of the member states. EU directives oblige the member states to implement their binding rules into national law (e.g. the General Equal Treatment Act implemented the EU anti-discrimination directives). The directives' rules will only apply directly to employment relationships after implementation into the national law. The European Court of Justice (*Europäischer Gerichtshof*) in Luxembourg is responsible for the interpretation of EU directives upon submission by the national labour courts. It has jurisdiction to decide whether or not the national laws implementing the directives are in accordance with EU law. Decisions of the European Court of Justice on the interpretation of EU law create precedents. Therefore they are binding upon the national court making the submission as well as other courts dealing with the same matter.

2. International Law

Germany ratified most of the important international charters and conventions of the international organisations it is member of, particularly those of the Council of Europe, United Nations and International Labour Organization (ILO). Therefore, the most significant principles of international employment and labour law, such as those of the European Social Charter and the European Convention for the Protection of Human Rights and Fundamental Freedoms, are binding on employment relationships in Germany.

II. Constitution and Statutory Law

The German Constitution and the statutory law contain regulations on employment and labour law. The statutory law must be in accordance with the constitution in order to be valid.

1. Constitutional Law

The German Constitution guarantees basic rights (*Grundrechte*) to individuals, particularly human dignity and personal freedom, freedom to choose profession and workplace, equality and equal treatment, freedom of speech, freedom of religion and protection of marriage and family. The freedom of coalition guarantees employees and employers the right to freely decide to join or not to join associations and the right to raise labour disputes, and for labour unions in particular, the right to call strikes. The constitution grants these rights (except the freedom of coalition) against the state but not directly against individuals due to the principle of freedom of contract. However, the basic rights of the constitution have an indirect effect on private law relations, like employment relationships, through the interpretation of employment law statutes. Furthermore, the basic rights constitute an objective system of social values that applies to all employment relationships.

2. Statutory Law

In Germany, there is extensive labour and employment law legislation which provides employees with a comparatively high level of protection. There is no comprehensive unified code on employment and labour law; rather, the regulations are historically contained in the Civil Code (*Bürgerliches Gesetzbuch*), Commercial Code (*Handelsgesetzbuch*) and numerous specific acts, like the Dismissal Protection Act (*Kündigungsschutzgesetz*), Maternity Protection Act (*Mutterschutzgesetz*),

Part-Time and Fixed-Term Employment Act and the General Equal Treatment Act (*Allgemeines Gleichbehandlungsgesetz*).

In principle, lower ranked regulations, e.g. employment contracts, can provide employees with higher levels of protection (principle of favourability). However, they must not deviate from the mandatory provisions of statutory law (e.g. minimum annual vacation entitlements according to the Federal Vacation Act) to the employee's disadvantage.

III. Labour Court Jurisprudence

Although many fields of employment and labour law are codified in specific acts there are large areas of labour and employment law which are not codified (e.g. the law of labour conflicts). In addition, there are regulatory gaps in the statutory law and statutory language which needs to be interpreted. Therefore, the jurisprudence of the German labour courts, particularly of the Federal Labour Court (*Bundesarbeitsgericht*), has an enormous influence on the establishment and development of German labour law by filling these gaps. Labour courts render decisions on specific matters but have the effect of legal precedence.

IV. Collective Bargaining Agreements

Collective bargaining agreements (*Tarifverträge*) can be concluded between a labour union (*Gewerkschaft*) and a single employer or an employers' association (*Arbeitgeberverband*). Pursuant to the Collective Bargaining Agreement Act (*Tarifvertragsgesetz*), the regulations of such agreements are mandatory and immediately binding on the members of the contracting parties. Therefore, in principle, an employee is only subject to a collective bargaining agreement if he is a member of the respective union. It should be noted, however, that in specific industrial sectors collective bargaining agreements are generally binding (*allgemeinverbindlich*) and mandatory for all employees and employers in the sector, irrespective of union membership or membership of the employers' association. The parties to an employment contract can only deviate from the terms of a collective bargaining agreement to the advantage of the employee (principle of favourability). Collective bargaining agreements can regulate anything that might possibly be covered in an employment contract, e.g. remuneration, working time, holiday entitlements or termination notice periods. In these areas collective bargaining agreements basically block regulations by works agreements. If the employment contracts of non-union member employees make express reference to the provisions of collective bargaining agreements, the respective collective bargaining agreements referred to become part of the individual employment contracts.

V. Works Agreements

The conditions of employment relationships can also be regulated by a works agreement (*Betriebsvereinbarung*) concluded between an employer and a works council. In contrast to collective bargaining agreements, works agreements apply to all employees of the business operation whether they are union members or not. However, certain conditions (e.g. wages and working hours) can only be regulated if this is explicitly allowed by an applicable collective bargaining agreement.

VI. Employer Directives and Operational Practice

1. Employer Directives

The employer may generally determine the time and place of the employee's work, provided it exercises its discretion reasonably. However, the employer's powers to issue directives are relatively weak since they are subject to strict limitations imposed by superior legal sources such as the express restrictions in employment contracts, collective bargaining agreements, works agreements and constitutional and statutory law.

2. Operational Practice

Employee rights to certain conditions of employment may arise from so-called operational practice (*betriebliche Übung*), i.e. the unconditional, regularly repeated grant of benefits from which the employees may conclude that the benefits will also be granted permanently in the future. This may, for instance, be the case if an employer granted unconditional benefits, like a Christmas bonus or reimbursement of transportation costs, at least three times in three consecutive years. As a consequence, employers should grant any benefits with the express reservation that they are voluntary without creating any future rights to the benefit. According to a recent decision of the Federal Labour Court, existing business practices may not simply be replaced by the fact that employees repeatedly not objected to changes to the benefit criteria (so-called negative company practice), but only with employees' consent or by respective termination notice.

VII. Equal Treatment Principle

Employees may base claims to certain employment conditions (e.g. remuneration) on the so-called equal treatment principle (*Gleichbehandlungsgrundsatz*), which is

one of the basic legal principles of German labour law. The principle has also been codified in some specific labour law acts, such as the Works Constitution Act (*Betriebsverfassungsgesetz*) and the Part-Time and Fixed-Term Employment Act which provides that part-time and limited-term employees may not be placed at a disadvantage when compared to full-time permanent employees. The most recent codification on equal treatment is the General Equal Treatment Act, providing protection rights for employees in cases of discrimination based on race, ethnical origin, gender, religion or belief, disability, age or sexual identity.

According to the equal treatment principle, employers granting certain voluntary employment conditions (particularly remuneration) to the entire workforce of their business, or to employees of individual business parts or to employee groups, instead of agreeing them with the individual employees, are bound by these common employment regulations. Therewith, respective employers are generally prevented from arbitrarily deviating from such common regulations to the detriment of individual employees or employee groups. However, different treatment may be objectively justified, e.g. due to internal employee hierarchy levels.

D. Key Aspects

- German employment and labour law is based on a broad system of different legal sources. Higher ranked norms have priority over lower ranked norms, e.g. constitutional law over statutory law. Lower ranked regulations which are more favourable for the employee may still apply. Among norms of the same rank the more specific or more recent norms have priority.
- Precedents of German labour courts are of particular importance for the establishment and development of German employment and labour law.
- EU Law has an ever increasing influence on German employment and labour law. Many German statutes on labour and employment law implement EU directives.

Chapter 4
Employee or Freelance Worker

Jens Kirchner and Eva Mittelhamm

A. Introduction

Under German law the distinction between employees and freelance workers is of particular importance in determining the application of employment and labour laws, as well as the payment of social security contributions and the obligation upon the employer to deduct income tax. In practice, the courts have interpreted the meaning of "employee" widely, often finding that relationships which were intended to be construed as freelance were in fact one of employer and employee. Consequently, such relationships fall within the scope of German employment law. Employment law offers greater protection to an individual who is an employee in comparison with a freelance worker. As an illustration, the termination of an employment relationship must be in compliance with restrictive employment law provisions which would otherwise not apply to a freelance relationship. Furthermore, employers are responsible for the payment of social security contributions and the deduction of income tax from an employee's salary. In order to avoid any doubt as to the status of a relationship, all parties are well advised to carefully analyse whether their relationship truly qualifies as freelance.

B. Definition Employee and Freelance Worker

A "Freelance Worker" (*Freier Mitarbeiter*), is someone who performs services on an independent basis, and assumes the sole risk for his business. The "services" of a freelance worker may cover a project completed under a so-called *Werkvertrag*, which could be a specific works contract, or work performed within the scope of a so-called *Dienstvertrag*, i.e. a contract for services.

The term "Employee" (*Arbeitnehmer*) describes someone who performs services under a contract of employment. Often, an employee is distinguished from a freelance worker as an employee will be required to perform services under the

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direct instructions and supervision of his employer. A freelance worker will usually be under no such obligation or duty.

C. Distinction Employees and Freelance Workers

Decisions of the Federal Labour Court (*Bundesarbeitsgericht, BAG*) have helped in understanding how the employment status of an individual will be assessed. For example, one of the major differences between an employee and a freelance worker concerns the degree of independence an individual has within the scope of his contract, as far as his duty to perform services is concerned.

An individual's independence is determined by the extent to which he has to comply with instructions, and stipulations relating to hours of work, place of work and the nature and extent of the services provided for in the employment agreement.

Additionally, an individual's integration into a business is a further relevant consideration. The degree of integration within a business will be a particularly important consideration when the duty to comply with instructions (as explained above) is limited. It may be for example, that an individual apparently working for a business independently and on his own initiative will still be sufficiently integrated within the business to be classified as an employee.

D. Evaluation of Employment Status

In order to identify if an individual is an employee or a freelance worker, an evaluation of the relevant criteria developed from decisions of the BAG is essential.

I. Duty to Comply with Instructions

According to the case law of the BAG it is unclear under which conditions an individual is bound by instructions from a business' managing director. Even in cases in which an individual has unlimited freedom to make decisions in his own professional field (for example, a head surgeon of a university hospital), the BAG has confirmed the existence of an employment relationship, deciding that an individual's freedom to make decisions – within his professional capacity should not automatically preclude an employment relationship. In a case concerning whether the head surgeon of a university hospital was an employee, the fact that he had unlimited freedom to make decisions within his professional capacity did not preclude an employment relationship. However it is important to note in this case that the head surgeon was bound by instructions from hospital management regarding organisational, disciplinary and commercial decisions,

which resulted in a classification as an employee. Consequently, situations can also be envisaged in which the existence of an unlimited freedom to make decisions in an individual's professional capacity would not automatically preclude the existence of a freelance relationship.

An individual's freedom to independently decide what tasks to undertake within the range and scope of his ability/expertise will not be sufficient to reject the existence of a duty to follow instructions.

II. Observance of Fixed Working Hours/Working Schedules

An essential factor to consider is whether the individual is under an obligation to attend work on a regular basis and is bound by fixed working hours and working schedules. Should this be the case, it is likely that the services to be performed by an individual are services which qualify as employment services under an employment contract. This is primarily because the individual is under an obligation to follow the specific instructions of their superiors.

III. Place of Work

A further question is whether an individual is required to perform services at a location specified by the employer. Any further integrational measures, whether operational, organizational or otherwise will also be relevant, as they will point towards an employment relationship.

IV. Permission to Work for Others

It is also important to consider if the individual is exclusively working for the business or alternatively is free to carry out professional activities for other businesses without prior approval. If the latter is true, this could assist in demonstrating a freelance contractual relationship.

V. Term of Employment

A key issue is if an individual has worked for the business over an extensive period of time, as this would potentially indicate an employment relationship. However, there may be exceptional cases in which freelance services have been provided to the same business over a significant period of time.

VI. Tax and Social Insurance Contributions

Another crucial issue is whether an individual invoices the business for its services and adds VAT to the figure. If so, this will assist in asserting that a freelance relationship exists. Any payment of salary during sickness or disability related absence will be relevant as evidence of an employment relationship. If tax and social benefit contributions are deducted from an individual's monthly salary or other payments, this will clearly prove the existence of an employment relationship.

VII. Entrepreneurial Activity

Any entrepreneurial activity on the part of the individual is a typical sign of a freelance relationship. In particular, if an individual hires and employs his own personnel, uses his own financial capital for his activity, uses his own equipment for his work, decides on the volume and timing of any such activity and advertises his activity, this will be evidence indicating entrepreneurial activity, which would potentially classify him as a freelance worker. Where there is no evidence of entrepreneurial activity, this will be a persuasive factor in deciding that an individual is an employee.

VIII. Integration/Hierarchy

This consideration concerns who the individual must report to and whose instructions he must follow. In the event that a managing director is not the only superior who gives an individual instruction and less senior employees also have such authority, then this subrogation would lead to the presumption that an employment relationship exists.

IX. Form of Payment and Vacation

On the one hand an employment relationship is likely to exist if a salary is paid to an individual on a monthly basis. On the other hand, an individual submitting invoices based on fees will not alone be sufficient to argue that a freelance relationship exists. Where, however, an individual consultant submits an invoice for a specific project after its completion, this might point towards a genuine freelance arrangement.

Granting vacation is also an indication of an employment relationship, as is a requirement that any vacation must first be approved by the business. Furthermore, if an individual is paid during vacation this also leads to the presumption that an employment rather than a freelance relationship exists.

X. Intentions of the Parties

The parties' intentions are basically secondary. In order to evaluate whether a freelance or an employment relationship exists, it is of crucial importance to evaluate how the relationship works in practice.

Only when there are very few or no indications that an employment relationship exists, the intentions of the parties and any written terms of agreement will be of importance as a final indicator. Parties should always expressly draft an agreement as freelance if it is intended that an individual will not be an employee.

If a business is in doubt as to whether an individual performing services for it will be considered as an employee or a freelance worker by the local authorities, it can request a status clearance (*Anfrageverfahren*) in advance to provide an answer.

E. Typical Factors Indicating Employment Status

The following factors are typically incorporated within contracts of employment and will therefore lead to the presumption that no freelance contract exists:

- Integration within an existing hierarchy
- Duty to report to employees in addition to the managing director
- Observation of fixed working hours and schedules
- Observation of regular attendance at work
- Prohibition on working for other businesses
- Provision of services at the business' premises or a specific location
- Payment of salary via payroll
- Entitlement to vacation
- Provision of working equipment and facilities by the employer
- Keeping personnel records
- Prohibition on any entrepreneurial activity

F. Legal Consequences

In the event that a relationship intended to be freelance is classified as one of employment then there are important implications for a business under Germany's employment and labour, social security, and tax laws.

I. Employment and Labour Law

In the event that a labour court finds that a relationship was declared as freelance simply to circumvent social security or other laws, an employment contract will be

presumed. Consequently, the freelance worker will – from the point of view of the labour court – be considered an employee from the beginning of his contract. In this situation the individual presumed to be an employee would fall under the protection offered by the Wrongful Dismissal Protection Act (*KSchG*). An employee can only be dismissed under the Act for business – or person-related reasons, or for his misconduct.

II. Social Security Law

It is important to note that local social security authorities are entitled to conduct audits of businesses, which will include an assessment as to the employment status of any individuals engaged by a business. If any relationship treated as freelance by a business is considered as an employment relationship by a local social security authority, the business will be liable to contribute both employer and employee social security contributions for the last 4 years. More seriously, in the event that social security contributions were not paid and the business knew (intentional conduct) that the relationship was an employment rather than freelance one, the business is liable for up to 30 years of unpaid social security contributions. It is worth noting that a business can only claim an employee's outstanding social security contributions from the employee for a period of 3 months, by deducting the respective amount from the employee's salary. Any outstanding liability for social security contributions must be paid in entirety by the employer, and may not be requested from the employee.

III. Tax Law

Under German law the employer is under an obligation to deduct tax from its employees' salaries. If the employer fails to fulfill this obligation, either by failing to deduct tax or by not deducting the correct amount, it is liable to pay 4 years of its employees' tax. A business is not responsible for the payment of any tax relating to any freelance workers it engages, as they are responsible for the payment of their own taxes. If the local tax authority considers that a freelance worker should be classified as an employee, the business is liable for any tax which the individual has failed to pay or has paid incorrectly.

In principle, the employee is the taxpayer which means that any money the employer pays to fulfil tax obligations on its employees' behalf can be reclaimed from each employee. This does not apply, however, to cases in which a circumvention of the obligation to pay social security contributions was intended by an employer. As such, if a local tax authority subsequently considers that a relationship intended to be freelance is instead an obvious employment relationship, it is usually very difficult to claim money back from an employee.

G. Status Clearance

In cases where there is uncertainty as to whether the relationship will be classified as an employment or a freelance relationship, businesses have the possibility of requesting an opinion, by filing a request for clearance status (*Anfrageverfahren*) to the Federal Pension Insurance Department (*Deutsche Rentenversicherung Bund*). The parties involved will get an opportunity to comment on any proposed decision of the Federal Pension Insurance Department. The parties may also appeal any decision before a court. A clearance status request is therefore highly advisable in cases where the true nature of the contractual relationship is questionable. In practice, businesses are well advised to file such a request at the outset of a relationship, rather than years later, in order to avoid any unwanted consequences, whether financial or otherwise.

H. Key Aspects

- A business may be faced with a situation in which certain facts speak for or against the existence of an employment or a freelance relationship.
- Any circumstances which contradict the relationship intended by the parties should be changed as soon as possible to ensure that no court or authority can be in doubt as to the status of the relationship.
- Any ambiguity will most likely lead to a finding that an employment relationship exists, which could involve very unpleasant surprises for both the individual and the business (e.g. liability for social security contributions and income taxes).
- Attention should be paid to whether the terms of the freelance contract differ from its performance in reality. Even the best freelance contract cannot prevent a labour court or local authority from presuming that an employment contract exists if this conclusion mirrors the actual practice between the parties.

Chapter 5
Agency Workers

Rolf Kowanz and Pascal R. Kremp

A. Introduction

Agency work (also called "leasing of employees") is quite common in Germany and allows the client to be more flexible with its head count, e.g. during peaks in production. Agency workers are often provided by professional agency businesses, but may also be provided by employers (e.g. within a corporate group or joint venture from one group company or joint venture partner to another).

Agency work was legalised in Germany in 1972 by the Regulating Commercial Agency Work Act (*Arbeitnehmerüberlassungsgesetz, AÜG*). This Act allowed commercial agency work to be carried out for a period not exceeding 24 months. Due to this, agency work played only a limited and slowly increasing role in Germany in comparison with other European countries.

As of 1 January 2003 the law changed and allowed agency work to continue for an indefinite period meaning the agency (*Verleiher*) now has the right to contract out an employee for an indefinite period of time, whereas the client (*Entleiher*) can now engage an agency worker like an employee of his own without becoming his actual employer. However, agencies who wish to commercially contract employees to clients for work are required to obtain a permit from the state authorities.

The law on agency work is based on the principles of "Equal Pay" and "Equal Treatment". According to these principles agency workers are entitled to the same remuneration and benefits as comparable permanent employees of the client. Lower remuneration of agency workers is only permissible on a collective wage scale basis.

The consequence of the new legislation was that as of 2003 the number of collective wage agreements (*Tarifverträge*) concluded in this sector increased rapidly. All agency businesses have signed up to relatively cheap collective wage agreements. With only a few exceptions, these collective agreements offer a comparably low level of remuneration for agency workers carrying out unskilled work.

In November 2008 the European Parliament and the European Council passed the EU-Directive on Temporary Agency Work (*EU-Zeitarbeitsrichtlinie*). According

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to Art. 2 of the Directive, its purpose is "to ensure the protection of temporary agency workers and to improve the quality of temporary agency work by ensuring that the principle of equal treatment is applied to temporary agency workers, and by recognizing temporary work agencies as employers, while taking into account the need to establish a suitable framework for the use of temporary agency work with a view to contributing effectively to the creation of jobs and to the development of flexible forms of working". EU countries are now required to incorporate the Directive into national law. Therefore, in March 2009 the Federal Ministry of Labour and Social Affairs (BMAS) made a first proposal to amend the AÜG in accordance with the requirements of the Directive. The Directive must be incorporated into national law until 5 December 2011.

B. The Law on Agency Work

I. Permission to Contract Employees to Other Companies

Agency work is permitted in all sectors except the main construction trade.

1. Issue and Withdrawal of the Permit

Agencies must request an agency work permit from the state authorities before an employee can be contracted out. The agency work is "commercial" and therefore a permit is required if the work is not merely taking place on an occasional basis but is anticipated to last for a period of time and aims to achieve direct or indirect economic benefits. It should be noted that case law has construed the term "commercial" very broadly.

The permit is relatively easy to obtain. It is issued by the Regional Office of the Employment Agency (*Regionaldirektion*) for a temporary limited period. However, after 3 years the permit can be granted for an unlimited period of time. Every business which, due to its organisational structure, is able to manage the agency process can apply and obtain a permit in exchange for a fee (currently EUR 750.00 for a temporary limited permit and EUR 2,000.00 for an unlimited permit). Foreign agencies who contract employees in Germany may also be subject to the restrictions of the Posted Workers Act (*Arbeitnehmer-Entsendegesetz*).

The Regional Office of the Employment Agency may also check the employer's adherence to legal regulations after the permit has been issued, e.g. by requesting relevant information and asking for access to business files (especially personnel files). In cases where legal regulations or valid collective agreements have been breached the Regional Office of the Employment Agency has the right to withdraw the agency permit.

2. Illegal Agency Work

The operation of agency work without a permit can have has considerable legal consequences. The Act states that in the absence of a permit the service contract between the agency and the client as well as the employment contract between the agency and the agency worker are not legally binding. Instead, an employment relationship between the client and the agency worker is established. As a consequence, in cases where illegal agency work occurs, the client as the "new employer" also becomes fully liable for submitting the employee's social security contributions (including the employee's part of the contributions) as well as his income tax.

Moreover, both the illegally operating agency and the client will have to pay a fine of up to EUR 25.000,00 for every individual case of illegal agency work.

In order to avoid these considerable legal risks of illegal agency work the client should ask the agency for a copy of the valid permit for agency work before taking on an agency worker.

II. Structure of the Contractual Relations

Agency work is carried out within a triangle of contractual relationships involving the agency (employer), agency worker and client. Thus, there are two contracts which need to be entered into:

- A service contract (so-called temporary hire contract) between the agency and the client and
- An employment contract, which regulates the employment relationship between the agency worker and the agency.

1. Contractual Relations Between Employer and Client

The contracting out of the employee is regulated by the temporary hire contract which is entered into by agency and the client. This contract needs to be in writing and state, for example, the number and qualifications of the agency workers provided by the agency, the period of time of the temporary hire and the remuneration which the agency receives for the contracting out of its employees. Furthermore, this temporary hire contract often covers issues concerning liability and warranty between the agency and the client as well as the legal consequences in cases where the employer does not hold a valid permit for agency work.

2. Contractual Relationship Between Employer and Agency Workers

The employment relationship between the agency and the agency worker forms the legal basis for the employee's obligation to provide his services. The obligation to

provide services involves carrying out work for the respective client according to their instructions.

III. Labour Protection of Agency Workers

German labour law protects agency workers to a similar extent as other employees. They are protected against dismissal in accordance with the Dismissal Protection Act.

During the period of agency work, the employment relationship with the agency is continuing. Consequently, the agency remains the agency worker's employer. Nevertheless, the client exercises the rights of an employer during the period of agency work. In line with the right to give instructions, the client determines the tasks/work the agency worker has to carry out during that period.

The agency worker is paid by the agency, even during the period of agency work. It is also the agency who is obliged to pay the employee's social security contributions and income tax. Thus, the client has limited liability for any unpaid social security contributions.

The agency is responsible for terminating the employment relationship. If there is an intention to dismiss the employee, the legal requirements have to be fulfilled. A dismissal is only possible if the agency is no longer able to employ the agency worker due to operational reasons, i.e. being unable to contract out the employee. The termination of a contract with a client is not always a reason for dismissal. Other reasons for dismissal, such as violation of the employee's duty and permanent disablement, also enable the agency to dismiss the employee.

The client has no right to dismiss the agency worker. However, the client does have the right to force the agency to take back an unsuitable worker and, if necessary, provide a suitable worker. The client can enforce this right if the agency worker is unable to perform the agreed work or does not carry out the work as efficiently as agreed.

A limitation of the employment relationship between the agency and the agency worker is only permitted within the general limits. The general rules of the Part-Time and Fixed-Term Employment Act apply. Thus, a temporary employment relationship can be limited to a maximum of 2 years when the employment relationship is established for the first time, but it is possible to extend the employment relationship three times within this period. Some collective wage agreements, however, stipulate that the limitation period may be extended to a maximum of 3 years and that four extensions are possible within this period.

IV. Health and Safety Regulations

Due to the division of the functions of the employer between agency and the client, which is characteristic for the situation of an agency worker, both the agency and

the client are responsible for the agency worker's health and safety in the working environment.

1. Responsibility of the Client

The actual provision of occupational safety can, of course, only be effected by the client. Therefore, they bear the so-called "local responsibility" (*Vor-Ort-Verantwortung*), i.e. they must make sure that occupational safety regulations are adhered to during the period of agency work. In particular, the client must train the agency worker accordingly before work commences and, in the event of changes in his working environment, make him aware of the health and safety dangers to which he may be exposed in the course of the work, as well as measures and facilities for averting such dangers.

2. Responsibility of the Contractual Employer/Agency

On the other hand, the agency as the contractual employer bears the so-called "final responsibility" (*Letztverantwortung*); he must monitor the client's adherence to occupational safety regulations and ensure they are complied with.

V. Collective Employee Representation

A distinction must be made between the works constitution, the representation of interests and the codetermination of labour.

In the agency's company agency workers have the same right as other employees to take part in electing a works council responsible for the representation of their interests in accordance with the Works Constitution Act. Since a majority of agency workers are employed in unskilled work and have periods of unemployment they have a limited choice of who can represent their interests. Collective representation is rarely used where employment is temporary and few agencies have a works council. Along with this, only very few agency workers are members of trade unions.

However, since the agency workers provide services in the client's company it is the obligation of the works council in that company to represent their interests there, as far as they concern work and performance. Moreover, the agency workers are allowed to make use of the works council's consultation hours, attend staff meetings and exercise individual grievance rights at the client company.

If the agency worker's term of assignment lasts for more than 3 months, he is entitled to vote in elections for the client's works council. Agency workers do not have the right to stand for election into the client's works council.

It should be noted that the works council of the client must be consulted before an agency worker is taken on.

C. Key Aspects

- Agency work is a way of allowing a company to be more flexible with its head count. In Germany, a permit is required for agency work.
- Companies should carefully review agencies, in particular they should ask the agency for a copy of the valid permit for agency work before taking on an agency worker.
- The relationship between the agency and the client is based on a temporary hire contract. This is distinguished from the employment relationship which exists between the employee and the agency.
- Agency workers are legally entitled to the same employment conditions as comparable permanent employees in the client's business (equal pay and equal treatment). Agencies do not operate on the equal pay principle but on the basis of various area and company wage tariffs, which are tailored specially towards the agency business and which usually provide for comparatively low wages.
- The agency remains the agency worker's contractual employer throughout the term of the contract with the client. The agency therefore bears the risk of employment and must continue to pay the agreed remuneration even when the employee is not contracted out.
- Aspects of occupational health and safety must be observed by both the agency and the client.
- During the agency worker's assignment with the client, the client's works council (if there is one) is responsible for representing the agency worker's interests. If the agency worker's term of assignment lasts for more than 3 months, he is entitled to vote in elections for the client's works council. He is, however, not eligible to stand for election.

Chapter 6
Immigration

Sascha Morgenroth

A. Introduction

Foreigners intending to take up employment in Germany usually require a residence permit (*Aufenthaltstitel*) permitting the employment. Nationals of European Union (EU) member states as well as nationals of the other countries of the European Economic Area (EEA), Iceland, Lichtenstein and Norway, and also Swiss nationals, are usually entitled to take up employment in Germany without any residence and/or work permit. For a transitional period, however, nationals of states which joined the EU more recently, in 2004 or 2007, may require a specific work permit.

B. Residence and Employment

I. EU Nationals and Equally Treated Nationals

1. Residence

Nationals of EU member states are generally treated equally to Germans. Due to the EU law principle of freedom of movement within the EU, nationals of EU member states are entitled to enter Germany with a valid identity card (*Personalausweis*) and to take residence without any residence permit. However, in order to reside in Germany for longer than 3 months, they must register with the German Registration Offices (*Einwohnermeldeamt*) in the same way as German residents. They receive a so-called certificate of freedom of movement (*Freizügigkeitsbescheinigung*) if they can prove sufficient health insurance and funds throughout their stay. Basically the same applies to nationals of the other countries of the European Economic Area, Iceland, Lichtenstein and Norway, as well as Swiss nationals.

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2. Employment

a) Nationals of the First 15 EU Member States

Nationals of the first 15 EU member states (besides Germany: i.e. Austria, Belgium, Denmark, Finland, France, Great Britain, Greece, Ireland, Italy, Luxemburg, Netherlands, Portugal, Spain, and Sweden) enjoy unrestricted freedom of movement within the EU, which includes the freedom of employment. They are therefore able to take up self-employment or dependent employment without obtaining a work permit.

b) Nationals of the More Recent EU Member States

During a transitional period, employees of the EU member states that joined the EU on 01 May 2004 (Estonia, Latvia, Lithuania, Poland, Slovakia, Slovenia, Czech Republic, and Hungary – except Malta and Cyprus) require a specific EU work permit (*Arbeitsgenehmigung*-EU) issued by the Employment Agency (*Agentur für Arbeit*) prior to taking up employment in Germany. This transitional period is limited until 30 April 2011. Nationals from Bulgaria and Rumania that joined the EU on 01 January 2007 require a specific EU work permit for a transitional period which may be extended until 31 December 2013.

EU work permits are usually only granted for employment requiring qualified professional training. In practice, such permits are restricted to a specific job position and limited to 12 months (*Arbeitserlaubnis-EU*). Thereafter an unrestricted and unlimited EU work permit (*Arbeitsberechtigung-EU*) is granted. Permits for employment not requiring qualified professional training are only granted in exceptional cases (e.g. secondments for certain maintenance work).

Companies domiciled in one of the recent EU member states may offer cross-border services with their own employees without an EU work permit. During the transitional period, however, cross-border services such as construction work, cleaning services for buildings, inventory, modes of transport as well as interior decoration are excluded.

II. Non-EU Nationals

1. Residence

Non-EU nationals (except, of course, nationals of Iceland, Lichtenstein and Norway, and Switzerland) usually require a valid residence permit *prior* to entering Germany.

Residence permits are issued as
Visa (Visum)
Restricted residence permit (Aufenthaltserlaubnis)
Unrestricted settlement permit (Niederlassungserlaubnis)
EU long-term residence permit (Erlaubnis zum Daueraufenthalt EG)

2. Employment

Work permits are usually granted together with and as part of the residence permit. Non-EU nationals intending to take up employment in Germany must indicate this when applying for the residence permit with the competent authorities (i.e. German embassies, consulates abroad or the aliens offices in Germany). The German authorities forward the application to the competent local aliens office at the intended place of residence in Germany for approval (so-called "one-stop-government").

3. Types of Residence Permits

a) Visa

aa) Competent Authorities

Visas are issued by the German embassies or consulates abroad. Prior to issuing visas for stays longer than 3 months, for employment in Germany or for nationals of certain countries (e.g. Turkey), the embassies and consulates consult the local aliens office (*Ausländerbehörde*) at the place of intended residence in Germany.

bb) Visa Waivers

Nationals of certain countries, however, do not require a visa prior to entering Germany for tourist visits of up to 3 months. This applies to nationals of Australia, Israel, Japan, Canada, New Zealand, South Korea, and the US. If nationals of these countries intend to take up employment in Germany or want to stay for a longer time period in Germany, they may apply for the required residence permit with the competent aliens office in Germany. However, they must not start to work until they have obtained the required residence permit. Certain activities such as consultations and negotiations during time-limited business travel or attending trade fairs are usually not regarded as taking up work in Germany.

Practical advice
If in doubt as to whether the intended activity requires a permit, it is advisable to consult the German authorities in advance. Required residence permits should be obtained prior entering Germany.

cc) Schengen-Visa

Tourist visas and visas for business travel are usually issued as so-called "Schengen-Visas" valid for up to 3 months per calendar half year and for all 24 member states of the Schengen Treaty. Schengen-Visas particularly require proof that the foreigner has sufficient funds to last throughout his stay in Germany (e.g. a current bank statement of the foreigner or confirmation of a host in Germany), of sufficient health insurance (with an insured sum of at least EUR 30,000.00), a passport which is valid for at least 6 months from the date of application for a Schengen-Visa, and payment of a fee (in 2009 this was EUR 60.00).

Member states of the Schengen Treaty
Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Latvia, Lithuania, Luxemburg, Malta, Netherlands, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, and Switzerland

dd) National Visa

Visas for longer time periods than 3 months or for employment in Germany may only be issued as national visas.

Upon submission of all required documents (additional documents will normally be needed beyond the Schengen-Visa requirements, e.g. a signed employment contract) and payment of the fee (in 2009 this was EUR 60), the application will be forwarded for approval of the competent local aliens office at the intended place of residence in Germany. The aliens office will in most cases consult the local employment agency for its consent. In particular it reviews whether German or EU citizens are available to fill the position (so-called "priority review", *Vorrangprüfung*), and ensures that the foreign employee will not be employed under less favourable conditions than comparable domestic employees. The entire application process usually takes about 1–3 months.

b) Restricted Residence Permit

Non-EU citizens that entered Germany with or without a visa (depending on their nationality, intended purpose and duration of their stay) must apply for a residence permit with the aliens office if they decide to extend their stay or to work while in Germany. Residence permits are only granted for specific purposes (e.g. university studies, self-employed work or dependent employment, or for spouses and children of foreign residents) and for a limited time period of up to 3 years. Residence permits may involve further restrictions and conditions (e.g. geographical restraints, time limitations, restrictions to a specific job position).

The aliens office reviews whether the general legal prerequisites for a residence permit are fulfilled (e.g. valid passport, sufficient means to live, no reasons for expulsion, German interests not jeopardized). There are further different requirements if the foreigner intends to take up self-employment or dependent employment.

aa) Self-Employment

Residence permits for self-employed work may be granted if all of the following prerequisites are met:

- Superior economical interest or special regional need
- Positive effect on the German economy can be expected
- Secure funding through own capital or a loan commitment

The first two requirements are generally assumed to be fulfilled in case of a minimum investment of EUR 250,000.00 and the creation of at least five job positions. Otherwise, the prerequisites are examined in terms of the viability of the business idea, the business experience of the foreigner, the amount of invested capital, and the effects on employment and training as well as the contribution to innovation and research. Foreigners who are older than 45 years will only receive a residence permit for self-employed work if they have an adequate old age pension.

After 3 years, the foreigner might be granted an unrestricted settlement permit if the planned business was successfully implemented and if his and his family's livelihood is secured by sufficient income.

bb) Dependent Employment

In most cases of dependent employment, the aliens office must request approval from the employment agency. Certain employment activities, however, do not require the consent of the employment agency (e.g. executive employees with proxy or general power of attorney; executive employees on management board level of companies with businesses located abroad; shareholders; or university internships). In principle, approval by the employment agency may only be granted if all of the following requirements are fulfilled:

- The foreigner has a concrete job offer
- No detrimental effects on the German job market
- The job position cannot be filled by a German or EU citizen (so-called "priority review")
- The foreigner will not be employed under less favourable conditions than comparable German employees

The law distinguishes between qualified and non-qualified employment:

Qualified Employment Consent for employment in job positions requiring at least 3 years professional training may be granted without priority review to certain

groups of qualified foreigners (e.g. executive employees of a joint venture of a German and a foreign company; executive employees and specialists of a company which is domiciled in Germany; specialists with a German or comparable university degree or comparable qualification in the area of information and communication technology).

Non-Qualified Employment Residence permits are generally not issued for the purpose of taking up employment which does not require at least 3 years professional training. Exceptions can be made (1) for nationals of certain countries (Andorra, Australia, Canada, Israel, Japan, Monaco, New Zealand, San Marino, and USA), (2) for very restricted areas of employment (e.g. secondments for certain maintenance work), and (3) based on bilateral agreements (e.g. for contractors, *Werkvertragsarbeitnehmer*, or fixed quotas of guest workers, *Gastarbeitnehmer*).

c) Unrestricted Settlement Permit

Settlement permits grant permanent and unrestricted residence in Germany and generally entitle the foreigner to take up any self-employment or dependent employment without approval by the employment agency. They are granted if all of the following prerequisites are met:

- Possession of a restricted residence permit for 5 years
- Sufficient means to live
- Social insurance contributions paid for at least 60 months
- No threat to public security
- Foreigner permitted to work in Germany (if applicant is an employee)
- Sufficient knowledge of German language and basic knowledge of the German legal and social system (e.g. successful attendance of an integration course)
- Sufficient accommodation for the applicant and his family members

Highly qualified foreigners may, in certain cases, immediately be granted a settlement permit. This applies to scientists with special expert knowledge, teachers or scientific assistants with special functions, or specialists and executive employees with special professional experience and a certain minimum salary (equivalent to the contribution assessment ceiling for statutory pension insurance; in 2009 this was a monthly salary of EUR 5,400.00 in Western Germany).

d) EU Long-Term Residence Permit

Non-EU member state nationals that possess a long-term residence permit in another EU member state can obtain an EU long-term residence permit in Germany. The EU long-term residence permit provides basically the same rights as the national unrestricted settlement permit and has similar prerequisites. Once the EU

long-term residence permit is obtained in Germany, the long-term residence permit of the other EU member state ceases to exist.

III. Administrative Offences

Working without required residence permit or work permit or employing foreign employees without required residence or work permit is an administrative offence. Fines of up to EUR 5,000.00 for employees and of up to EUR 500,000.00 for employers may be imposed.

Practical advice
In order to avoid liabilities, employers should only allow nationals of non-EU and the more recent EU member states to work for them upon proof of a valid residence permit and/or a sufficient work permit valid for the term of employment.

C. Employment Relationships with Foreign Employees

I. Principles of Conflict of Laws

Employers and employees may, in principle, freely agree on the law applicable to their employment relationship. Foreign law may generally be agreed to govern employment relationships in Germany but may not result in any unreasonable changes. Particularly if the employment has only links to one country, e.g. only Germany, the choice of law may not exclude mandatory provisions under German law. In order to prevent circumvention of mandatory employee protection laws, the rules of the country where the employee usually performs his work (or if the employee performs his work in several countries without focus on a specific country, the mandatory law of the domicile of the company branch office) may not be waived (e.g. national employee protection laws on dismissal protection, working-time, holidays, transfer of undertakings). Further, internationally mandatory principles (e.g. the law applicable to mass dismissals) must not be excluded.

If there is no agreement on the applicable law, the applicable law is of the state in which the employee usually performs his work (or if the employee performs his work in several countries without focus on a specific country, the law of the domicile of the branch office). However, a closer link to a different country may be indicated by the circumstances of the employment (e.g. the parties' nationalities or domiciles; contract language; currency of remuneration; place of conclusion of the contract). If this is the case, the law of that country would apply.

German collective labour law, social security and tax law, in principle, apply to employees working in businesses in Germany and residing in Germany (so-called "territoriality principle").

II. Social Security Insurance

1. General Principles

Employees permanently working in Germany are generally subject to German social security contributions. Consequently, employer and employee have to each pay about half of the mandatory social security contributions which total approximately 40% (i.e. employer and employee each pay about 20%) of the employee's gross salary. The employee's share is deducted from his gross salary and the employer pays his share on top.

2. Citizens of the European Economic Area

With respect to EU citizens and citizens of the other countries of the European Economic Area, Iceland, Liechtenstein, Switzerland and Norway, EU law provides for regulations coordinating the various national social security schemes of the member states in order to avoid paying double national insurance in several member states. These regulations are directly applicable and, in principle, have priority over German law. The main subject of the regulations is to regulate the applicable national social security scheme. Generally, the law of the place of employment applies. In case of secondments from abroad of up to 12 months, employees may remain subject to the social security law of their home member state. The competent home state social security administration issues a secondment certificate (form E-101) which is binding upon all other member states. It may be extended for further 12 months upon application (with form E-102) if the required extension was not foreseeable. The competent authorities of the member states (which in Germany is the *Deutsche Verbindungsstelle Krankenversicherung-Ausland, DVKA*) may agree on further exceptions.

3. Citizens of Other Countries

Germany has concluded bilateral social security treaties (*Sozialversicherungsabkommen*) with several countries on the applicable national social security law to prevent double insurance.

Bilateral social security treaties exist between Germany and
Australia, Bosnia-Herzegovina, Brasil (presumably by the end of 2010) Canada and Quebec, Chile, China, Croatia, India, Israel, Japan, Kosovo, Macedonia, Montenegro, Morocco, Serbia, South Korea, Tunisia, Turkey, and the USA

According to the social security treaties, the employee may remain subject to foreign social security laws. This may be the case if the employee is only seconded for a limited term (in case of secondments from the US to Germany: fixed time periods of up to 60 calendar months, i.e. 5 years) by his foreign employer from his home state to Germany in order to perform work for the foreign employer and on his cost. The secondment agreement must clearly stipulate that the employee returns to his employer in his home country after the expiry of the fixed term. The competent home state social security administration issues a respective secondment certificate on the applicability of the social security scheme abroad.

The social security treaties may apply to all or only certain branches of the national social security schemes (e.g., the treaty between Germany and the USA applies only to statutory old-age pension insurance, but not to health insurance, nursing insurance, unemployment and accident insurance). If certain social security branches are not covered by such treaty, or if no bilateral treaty exists at all (e.g. with Indonesia, or South Africa), in principle, the employee might be subject to social insurance abroad and in Germany, i.e. double insurance is generally not excluded.

Practical advice
In each case the competent social security administration (of the foreign employee's home state or in Germany) should be consulted early in advance in order to obtain reliable information on the national social security scheme applicable to the employee

III. Tax

1. General Principles

Taxation of the employee's income depends on his domicile or usual residence, irrespective of his nationality. In principle, if the employee is domiciled or has his usual residence in Germany, his income for his activities physically performed in Germany is subject to taxation in Germany.

2. Double Taxation Treaties

Germany has concluded bilateral so-called "double taxation treaties" (*Doppelbesteuerungsabkommen, DBA*) with several (EU- and non-EU-) countries, in order to avoid the same income being taxed in both countries. Most of the treaties are based on the OECD model treaty.

According to the double taxation agreement between the US and Germany, in principle, if the employee is a resident in the US or Germany and working in Germany, he has to pay income taxes in Germany. However, if the employee is

a US resident he may be exempt from income taxes in Germany if all of the following three requirements are fulfilled:

- He is present in Germany for one or more time periods not exceeding in the aggregate 183 days in the respective calendar year
- The remuneration is paid by, or on behalf of, the employer who is not a resident in Germany
- The remuneration is not borne by a permanent establishment or a fixed base of the employer in Germany

The last two requirements may be fulfilled if the remuneration will be paid by (or on behalf of) the company residing in the US and will be borne by that company. As a result, only if the employee is a US resident and present in Germany for a time period not longer than 183 days per calendar year, he is generally free from income tax obligations in Germany; however, if the employee stays more than 183 days per year in Germany, he is generally subject to German tax law. Of course, if the employee is a German resident, he is subject to German tax law and the exception explained above does not apply.

D. Key Aspects

- Foreigners intending to work in Germany usually require a residence permit containing a work permit prior to entering Germany. This generally does not apply to EU citizens and nationals of other countries in the European Economic Area, Iceland, Lichtenstein and Norway, or Swiss nationals. However, nationals of the more recent EU member states that joined the EU in 2004 or 2007 may require a work permit EU.
- Working without a required residence permit or work permit, or employing foreign employees without a required residence or work permit is an administrative offence (fines are of up to EUR 5,000.00 for employees and up to EUR 500,000.00 for employers).
- Foreign employees working in Germany are usually subject to German social security and income taxes. However, exceptions may apply, particularly where bilateral treaties have been concluded.

Chapter 7
Employee Secondments

Jens Kirchner and Pascal R. Kremp

A. Introduction

It has become common for employees to be seconded to foreign countries. Germany, as an export nation, has traditionally had close links to foreign markets, and foreign companies often second their employees to Germany. There are many different reasons for such secondments, for example, where the company has entered into a new market and the employee is tasked with setting up a local branch office or entering into a joint venture to establish a presence the new market. Sometimes, an employee is seconded to a foreign office to coordinate development and expansion, or to bring specific expertise into the new market. In all cases, however, both employer and employee face many issues that should be addressed in advance of the secondment. Consequently, the terms and conditions of the secondment contract should be carefully drafted in order to avoid disappointment or dispute among the parties in the event of termination of the secondment as well as in cases where the employment itself terminates.

B. Cultural Awareness and the Appropriate Secondee

To ensure that the secondment will be successful, both for the company and the employee, it is crucial to provide cultural awareness training before its commencement In many cases secondments fail because of the significant cultural differences.

Surprisingly, companies often fail to place sufficient focus on the language skills of secondees. If the purpose of the secondment is merely to broaden the employee's experience it might be acceptable to a company that a secondee is not fluent in the local language. In other situations, however, particularly if the purpose of the secondment is to expand the business to the foreign market, it is extremely helpful if the secondee is familiar with the local language and market. The individual will not only need certain language skills, but also a very good understanding of local

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culture, customs and business practice. In addition, whether to post an employee to the foreign country, or, alternatively, to hire a local person who is acquainted with the foreign market, but has not yet developed close ties to the company needs to be carefully considered.

C. Employment Law Issues

I. Contractual Structure

The contractual structure of the secondment depends very much on the purpose of the secondment. On one hand, if the employee is only posted for short time (e.g. only a few weeks for a short term project), this will not usually result in any relevant amendments to the existing contract of employment. On the other hand, if the employee is posted for an indefinite period of time, it is strongly recommended that an agreement is entered into with the local subsidiary, while the contract with the original company is terminated.

Most secondments fall into one of these two basic categories. Usually the employee will be seconded to the foreign country for several months or years, but it is planned that he or she will return to the original employer at some point. In this situation, the parties may agree on a supplemental agreement to the initial employment agreement alone, to cover the temporary employment abroad.

Alternatively, the employee may enter into a new contract of employment with the foreign entity, suspending the operation of the contract with the original employer, for the duration of the secondment. In this case, the original contract would revive upon the employee's return.

Furthermore, and particularly in the case of longer term secondments (e.g. upwards of 3 years), it is often advisable to enter into a separate secondment agreement that replaces the original contract of employment. Moreover, often the employer will be uncertain whether the same or a similar job position will be available upon the employee's return. Therefore, it is usually advisable to end the original employment rather than suspending it for the duration of the secondment. The parties should take the length of the employee's absence and the potential for his replacement into account when drafting the basic terms of return from secondment.

Typical contract models of secondments
Employee receives a supplemental agreement or
Local employment agreement with foreign entity, suspending the operation of the original contract of employment for the duration of the secondment
Local employment agreement with foreign entity while a separate secondment agreement replaces the contract with the original employer

In evaluating the best structure for the secondment agreement, consideration should be given to the documentation required to obtain a work permit for the employee. In some countries it will be necessary for an employee on secondment to possess a local contract of employment.

Moreover, it should be noted that, in all cases, harmonization of the essential terms of employment of the original and new contracts must be ensured. In particular, this applies to notice periods, terms of post-contractual non-competition clauses, non-solicitation clauses and so-called "garden leave" provisions. Secondment terms that deviate from the terms of an additional agreement with the foreign entity, often result in major disputes between the parties. By way of example, when a secondee wishes to end the secondment prematurely in order to join a competitor abroad, while the original employer wants to hold him to his non-compete obligations for as long as possible. If the secondee then remains abroad, as in most cases, it will be difficult for the original employer to enforce a preliminary injunction against him.

II. Content of the Secondment Agreement

In all cases, several areas should be addressed in the contract in order to ensure a sound legal basis for the secondment and to avoid disappointment on the employer's and the employee's side. Typically the areas covered in this type of agreement are:

1. Job Description/Reporting Structure

The job description, purpose of the secondment (e.g. setting up a production site abroad) and reporting structure (e.g. to someone locally or to his company of origin) of the secondee should be clearly described in the agreement. This will allow any misunderstandings to be avoided from the outset.

2. Duration of the Secondment

The duration of the secondment should be clearly specified in the agreement. In practice, however, many agreements omit to stipulate the duration of secondment creating the potential for legal disputes between the parties. Additionally, the parties may stipulate whether the secondment may be extended mutually or unilaterally and set the length of such an extension in the contract.

Furthermore, the agreement should regulate whether either party may terminate the secondment prematurely and, if so, whether this will result in the termination of the general employment relationship with the original employing entity. In this context in particular resignations from management positions which the secondee may hold within the company or any associated company should also be addressed.

3. Expenses for Preparatory Training

Preparatory courses (e.g. cultural awareness, language skills) are expensive and this expense is usually borne by the company. The company should ensure that the employee is obliged to reimburse the company for these expenses if the employee does not begin the secondment or terminates the secondment prematurely.

4. Remuneration

In general, the employee will draw a higher remuneration during the term of the secondment. Whilst the base salary and bonus payments may change, the company usually provides an allowance to cover a higher cost of living. Depending on the position the employee holds within the company, the employer may provide for tuition childcare or similar benefits.

Further, the parties should agree on the currency in which the remuneration will be paid (and therefore, who will bear the risk of fluctuating exchange rates) and the bank account into which it will be paid (i.e. either to the employee's bank account in his country of origin or to his account in the foreign country).

The costs of the employee's relocation to the foreign country and of his return to his home country are usually borne by the employer. However, in circumstances where the employee terminates the employment during the secondment, the contract may stipulate that the employer will not be responsible for the costs of his return to his home country.

If the employment agreement with the original employer is dormant during the secondment, the employee's salary following his return should be agreed upon in advance. Typically, parties agree that the employee will be entitled to the same increase in salary as comparable employees receive during the term of their secondment.

5. Vacation and Holidays

Under German law an employee is entitled to a minimum of 20 working days annual leave, based on a 5 day working week. Depending on the individual circumstances, this rule may also apply to inbound secondments to Germany or may not apply to outbound secondments. It should be clarified at the outset whether the employee will be subject to the same terms as local employees or employees in his country of origin. With regard to public and bank holidays it will be necessary to clarify whether the employee will observe local public holidays or the public holidays applicable in the country of origin.

6. Travel Expenses

While business travel expenses are usually regulated by the company's travel policy, the company might also provide for reimbursement of private expenses

for non-business related flights home. If the employee is entitled to be reimbursed for private travel, the conditions of such trips (e.g. their frequency, whether they will be by economy or business class) should be agreed upon. A decision should also be reached as to whether travel costs for family members (e.g. spouse, partner, marital/non-marital children) shall be covered by the company.

7. Emergencies

It is quite common to provide flights home in case of an emergency within the employee's immediate family. The agreement should specify who falls within the scope of the immediate family and what constitutes an emergency. In addition, it should be stipulated that the employee is obliged to consult with the employer regarding travel expenses before commencing the journey.

In cases of political unrest (e.g. riots), natural disasters (e.g. earthquakes), health hazards (e.g. epidemic dangers), or risk of detention, the employee should be contractually obliged to leave the country of his secondment.

8. Return of the Employee

Many companies and employees do not give sufficient consideration to the return of the employee after termination of the secondment. In practice, the terms and conditions of return are often of crucial importance, both for employee and employer. The employee will usually seek maximum job security upon return from secondment or a generous severance package, where no suitable alternative position can be offered. The employer will often require a long term commitment by the employee, which offers the company sufficient flexibility to withstand shifts in the economic landscape. Post-contractual non-compete clauses can provide a certain level of security for the company and allow it to protect its interests. At the same time, however, the cost of compensation for non-compete clauses needs to be taken into consideration. Another problem faced by many companies is a failure to reintegrate former secondees, resulting in their leaving their jobs shortly after their return. The reasons for this vary but may include changes to management and business environment during the period of secondment or the fact that the employee has been demoted following his secondment. The fact that many employees are promoted for the duration of their secondment often adds to the feeling of having been downgraded upon return. Crucially, this failure to reintegrate will see the company losing out on a return on their investment in the employee's know-how and experience during the secondment.

In order to ensure the employee's successful reintegration the parties should discuss the issue honestly and well in advance of his return. It may be stipulated in the relevant agreement that the employee will be offered the same level of job that he had prior to the secondment. Due to the frequently lengthy duration of secondments, however, it will be difficult for the employer to guarantee a specific position for the employee, upon his return.

9. Other issues

In addition to the above, the following issues are often relevant and should be considered in the drafting of the secondment agreement:

- Confidentiality
- Intellectual property
- Non-competition
- Employee's share options

10. Governing Laws

Whether the individual employment relationship is governed by German law or the law of the foreign country shall be determined on a case-by-case basis. A review of the international conflict of laws rules of the respective country are sometimes necessary. It is strongly recommended that the governing law is identified in the secondment agreement. If the contract with the original employer has been suspended for the duration of the secondment, the original contract usually continues to be governed by the laws of the country of origin and the secondment contract by local laws.

D. Social Security

As a general rule, every country has the power to regulate its social security system and its participants. Therefore, under German law and in accordance with the territoriality principle (*Territorialitätsprinzip*), both German nationals and non-nationals, working on a permanent basis in Germany, will be subject to Germany's mandatory social security system, i.e. public pension insurance, health insurance, unemployment benefits, and nursing insurance. However, there are exceptions to the territoriality principle by supranational law, these are, basically, European Union (EU) law (I), and bilateral social security treaties (II). With regard to secondments to/from countries outside the EU or the European Economic Area (*Europäischer Wirtschaftsraum, EWR*) exceptions to the territoriality principle may also arise due to the principles of "inward/outward radiation" (*Einstrahlung/Ausstrahlung*) (III).

I. European Union Laws

Provided that the anticipated duration of their work does not exceed 12 months, European Union (EU) citizens or foreign citizens with legal residence within the EU who are seconded to countries in the EU or the European Economic

Community, fall exclusively under the social security system of their country of origin. In this case, the employee should apply to their insurance provider to issue them with a secondment certificate (Form E 101) (*Entsendebescheinigung*) regarding the social insurance coverage of the employee. The effect of the certificate may be extended, for a further 12 months, to a maximum of 24 months, upon application by the employer (form E 102) to the employee's social insurance provider. This application must be made within the first 12 months of the secondment, on the basis that the extension could not have been foreseen at the outset of the secondment.

II. Bilateral Social Security Treaties

In order to avoid duplicating the employee's insurance from his country of origin in where he meets the requirements for local social security, Germany has entered into bilateral social security treaties with:

Bosnia-Herzegovina	Macedonia
Canada and Quebec	Montenegro
Chile	Morocco
People's Republic of China	Serbia
Croatia	Switzerland
Finland	Tunisia
Israel	Turkey
Japan	United States
Korea	–

These treaties may not cover all social security subjects. For example, the treaties with Japan and Korea only cover public pension insurance, whereas the treaty with China also addresses unemployment benefits. Thus, if no treaty at all exists or the treaty does not cover all forms of insurance, the risk of duplicating insurance still exists. In such cases, it is important to review at an early stage whether the employee will be subject to both countries' security systems. Often, there is a possibility for an exemption by the public authorities if the secondment is for a fixed-term, e.g. the Croatian authorities will allow exemptions for secondments up to 24 months and the United States will allow exemptions for secondments of anywhere up to 5 years. This also applies to inbound secondments, to Germany.

III. Principles of "Inward/Outward Radiation"

In relation to secondment to/from non-EU countries with which no bilateral treaties have been concluded, an exception to the territoriality principle applies if, in the

course of a continuing employment relationship with a foreign employer, employees are temporarily seconded to Germany. The employee must

1. Be seconded for a fixed-term only
2. Have entered Germany in course of his secondment alone
3. Continue receiving instructions from his employer abroad

In these cases the employees are subject only to the foreign social security system, due to the principle of inward radiation (*Einstrahlung*). In contrast, employees seconded from Germany to a foreign country, basically, remain subject to the German social security system, according to the so-called principle of outward radiation (*Ausstrahlung*). If they are seconded to the foreign country

1. Only for a fixed-term only
2. Continue receiving instructions from the German employer
3. It is intended that he will return to the original employer upon termination of the secondment

The prerequisites of outward radiation are met.

E. Tax Laws

Generally, the employee is subject to the tax laws of his country of residence. In case of a secondment there is a risk that the employee will be deemed to be resident in both countries, i.e. the country of origin and the foreign country. In order to avoid double taxation Germany has entered into double taxation treaties (*Doppelbesteuerungsabkommen*) according to the OECD Model Convention With Respect To Taxes On Income And On Capital (OECD Model Tax Convention) with many countries.

Algeria	Kirgizstan	Philippines
Argentina	Korean Republic	Poland
Armenia	Iran, Islamic Republic	Portugal
Australia	Ireland	Serbia
Austria	Island	Singapore
Azerbaijan	Israel	Slovakia
Bangladesh	Italy	Slovenia
Belarus (White Russia)	Jamaica	South Africa
Belgium	Japan	Spain
Bolivia	Kazakhstan	Sri Lanka
Bosnia-Herzegovina	Kenya	Suisse
Bulgaria	Kuwait	Sweden
Canada	Latvia	Tadzhikistan
China (without Hong Kong and Macau)	Liberia	Thailand
	Lithuania	Trinidad and Tobago
Côte d'Ivoire	Luxembourg	Tunisia

(*continued*)

(continued)

Croatia	Macedonia	Turkey
Cyprus	Malaysia	Turkmenistan
Czech Republic	Malta	Ukraine
Denmark	Mauritius	United Arab Emirates (since 1.01.2009
Ecuador	Mexico	no treaty in force; new treaty is
Egypt	Moldova	initialled and is planned to be set
Estonia	Mongolia	into force retroactively)
Finland	Morocco	United Kingdom
France	Namibia	United States
Georgia	Netherlands	Uruguay
Ghana	New Zealand	Uzbekistan
Greece	Norway	Venezuela
Hungary	Pakistan	Vietnam
India	Rumania	Zambia
Indonesia	Russia	Zimbabwe

In principle, where a double taxation treaty applies, the employee will be taxed in the country where he actually works, if he

1. Works there for more than 183 days in the calendar year
2. Is paid by the local employer in whose business he works

Otherwise, the employee is only taxed in the country of his origin.

Usually, the company provides for a tax advisor who will assist the employee for at least the first year of the secondment. However, it should be stipulated in the secondment agreement that income tax payments are the responsibility of the employee alone. In countries where fiscal administration authorities are not organized very efficiently or where cases of tax fraud are frequent, it is often advisable to appoint a tax advisor for the income tax of the employee throughout the duration of the secondment. This will allow the employee to retain control over the proper taxation of his income and to provide the fiscal authorities with evidence of that taxation, where necessary.

F. Key Aspects

- In order to guarantee a successful secondment thorough preparation is essential.
- The secondment agreement must be carefully drafted to reflect the laws of the country of origin as well as those of the country of secondment.
- Reference must be made in advance of the secondment to relevant social security and tax laws.
- The terms of the original contract and the secondment contract must be harmonized to ensure the avoidance of subsequent legal disputes.

Chapter 8
Pay and Benefits

Jens Kirchner and Sascha Morgenroth

A. Remuneration

I. Agreements

Remuneration of employees can be regulated by individual contract of employment as well as by collective bargaining agreement. Salary can be negotiated between employer and employee. However, an agreement on salary may be deemed to be null and void if the work performed and the salary made-over are grossly disproportionate (i.e. salary extortion) (*Lohnwucher*). A salary will be found to be grossly disproportionate if the employee is paid less than two thirds of the amount agreed by way of collective bargaining or of the comparable customary remuneration. In cases of salary extortion the employee has a right to receive the customary remuneration.

II. Remuneration for Overtime Work

There is no statutory obligation for employers to pay employees for overtime worked. Many collective bargaining agreements, however, contain comprehensive rules in relation to overtime, and according to respective case law, employers have to pay employees for overtime worked if they work in excess of their contractually agreed working hours. In practice, employers are sometimes unaware of overtime worked. To avoid disputes about such overtime it is advisable to implement comprehensive overtime regulations. The employer could, for example, provide payment for overtime only in circumstances where the work had been previously approved by him.

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III. Minimum Wage

There is no national minimum wage (*Mindestlohn*) in Germany. However, many collective bargaining agreements establish minimum wages for their business sector. Moreover, the Posted Workers Act (*Arbeitnehmerentsendegesetz*) obliges employers in certain industries, particularly the construction industry, to pay minimum wages for employees domiciled in Germany or abroad, who are working in Germany. In the years 2007/2008 the Posted Workers Act was extended to the building cleaning industry and postal services. Consequently, the relevant collective bargaining agreements determine the applicable minimum wages. Since 2007, the Act provides that, in addition to the contractor, (i.e. the employer) the person who has commissioned the work shall be liable to ensure payment to the employee of the minimum wage. In addition, the Act states that administrative fines of up to EUR 500,000 may be imposed on the person commissioning the work and/or the contractor.

IV. Operational Practice

Rights of employees to certain payments may arise due to their being made-over on a so-called operational practice (*betriebliche Übung*). An operational practice may develop if the employer has granted similar benefits repeatedly (usually three times) to the employee and this has lead to the employee's developing a reasonable expectation, in all the circumstances of the case, that the employer intended to continue to grant the benefit in the future. Thus, a right for the employee may arise from the behaviour of the employer, even if he did not intend to constitute such a right. An operational practice could therefore develop, if the employer granted, for example, a Christmas bonus for three consecutive years around Christmas time to the same employees.

The employer may, however, avoid the development of an operational practice by designating the payment as having been made on a voluntary basis. In doing so he must clarify that the payment is not legally binding for the future, but discretionary (*Freiwilligkeitsvorbehalt*). If an operational practice exists, it may be eroded over the years by the development of a new practice. This would, however, require that the employee repeatedly accepts the change in benefits (three times). If, in the first instance the employer reserved the right to revoke the benefit, he may cease the practice, where certain valid grounds exist (e.g. economic reasons, performance or conduct of the employee) and where the benefit constitutes no more than 25–30% of the employee's remuneration.

V. Bonus Payments

Employers may grant their employees bonus payments in addition to their fixed basic remuneration (1). They may, however, consider awarding bonus payments on

a voluntary basis alone or subject to the condition that the right to revoke the benefit is reserved (2).

1. Types of Bonus Payments

There are numerous different kinds of bonus payments, for example, commission (*Kommission*), gratuity (*Gratifikation*), profit sharing (*Tantieme*), and supplemental pay (*Zuschlag*).

a) Commission

Commission is a payment based on the employee's performance and is commonly applied to sales staff. According to the statutory regulation model of the German Commercial Code, commission is generally paid upon the conclusion or the procurement of a contract.

b) Gratuity

Gratuities are one-off payments by the employer granted for specific reasons in addition to the employee's basic remuneration. Common examples are Christmas gratuities or anniversary bonuses. Gratuities can have the purpose of awarding the employee for his length of service to the business (*Betriebstreue*) and/or to supplement the employee's remuneration on the basis of their performance.

c) Profit Sharing

Profit sharing bonuses allow the employees to benefit from the company's results. They are usually granted to executive employees (*leitende Angestellte*). In practice, profit sharing bonuses are often implemented in cooperation with and with the consent of the company's shareholders.

d) Supplemental Pay

Supplemental pay to the basic remuneration may be granted by the employer for specific reasons, e.g. to compensate the employee for taking on a particular burden at work (e.g. Sunday work or night shifts), or, more generally, in order to increase the employee's income to meet the terms of a relevant collective bargaining agreement.

2. Reserving Discretion and Revocation Rights

In order to avoid establishing a right to remuneration, the employer may consider making certain payment discretionary (a) or reserving a right to revoke them (b).

a) Making Payments Discretionary

By making certain payments discretionary (*Freiwilligkeitsvorbehalte*) the employer seeks to prevent the employee from establishing a legal right to future monetary claims. The employer does not have to expressly make each payment discretionary and it is sufficient to include a relevant clause in the contract of employment. In order to be valid and effective the clause must be transparent. Therefore, clear and unambiguous wording is required (*Transparenzgebot*). Merely declaring a payment to be discretionary is insufficient as this does not clearly stipulate if the initial payment alone or also subsequent payments are intended to be discretionary. Additionally, it is insufficient to establish a payment as discretionary if the employer explicitly grants a gratuity in the contract of employment, whilst at the same time declaring that no right to the gratuity shall arise. Rather, it should be clearly expressed that the payment is discretionary and that no right to future payment is established.

Following the jurisprudence of the Federal Labour Court, the reason for the gratuity is not decisive in determining the validity of an employer's assertion that such a payment is discretionary in nature. Instead, it is essential that the gratuity is in fact an "additional" payment to the regular salary. Still, the Federal Labour Court decided that monthly supplemental payments may not be paid on a discretionary basis, but may be paid under the condition that the employer retains the right to revoke them. The Court further decided that a clause seeking to make a payment discretionary which is held to be void may not generally be interpreted as, for example, a revocation right.

b) Revocation Rights

In contrast to seeking to make a payment discretionary in nature, revocation rights provide the employer with the possibility of ending further payment of sums which have become routine in practice. According to the Federal Labour Court the revocable part of the remuneration, (i.e. the relevant bonus payment) may only amount to a maximum of 25–30% of the employee's total remuneration. Thus, bonus payments constituting more than 25–30% of the employee's total remuneration are – despite express stipulation in the contract of employment – not freely revocable. Moreover, the Federal Labour Court has ruled that revocation clauses must specify objective grounds for revocation, for example, employee performance, conduct related or economic reasons. Also, the extent to which a payment may be revoked must be as clear as possible to ensure that the clause meets the requirements of being sufficiently transparent and valid. Hence, contract clauses

on revocation rights should be drafted in clear language with simple parameters, for example, economic reasons referring to revenue/losses of a certain percentage.

According to the German Federal Employment Court it is not transparent and therefore impermissible to combine a contract clause making a payment discretionary with a revocation right, since the employee may not be able to foresee which of these regulations is applicable in the circumstances.

VI. Sick Pay

The Continuation of Remuneration Act (*Entgeltfortzahlungsgesetz*) grants employees 6 weeks of mandatory paid time-off in the event of sickness, unless the employee has materially contributed to his own sickness. Where an employee subsequently falls ill due to the same underlying illness, the 6 week-period will recommence if 6 months have elapsed since the end of the last sick leave, or if 1 year has elapsed since the beginning of the first sick leave. If the underlying cause of illness is a new one, the 6-week period automatically commences anew.

B. Benefits

I. Social Insurance Scheme

1. Overview

In Germany, most employees are subject to the mandatory statutory social insurance scheme.

Freelance workers are, generally, not subject to the mandatory statutory social insurance scheme. Persons contracted as freelancers but, in fact, working under the same or similar circumstances as employees, may however be subject to the mandatory statutory social insurance scheme (see Chap. 4).

2. Social Insurance Branches

The mandatory social insurance scheme consists of the state pension insurance (*Rentenversicherung*), unemployment insurance (*Arbeitslosenversicherung*), health insurance (*Krankenversicherung*), nursing insurance (*Pflegeversicherung*), and accident insurance (*Unfallversicherung*).

a) Pension Insurance

The German state pension insurance, regulated in book VI of the Social Security Code (*SGB VI*), is compulsory for all employees, apprentices, persons in civil or

military service *etc*. The carrier of the state pension is the German Pension Insurance Office (*Deutsche Rentenversicherung Bund*), which consists of federal and regional divisions and divisions for certain industries. It is financed according to the "generation contract" concept, meaning the actual state pensions of the generation of retirees are mainly paid by the contributions of the current generation of employees, with the exception of an additional sustainability surplus fund (*Nachhaltigkeitsrücklage*). Hence, due to disadvantageous demographic developments, particularly with regard to the imbalance between the growing numbers of retirees entitled to pension payments and the decreasing numbers of employees paying into their pensions, the whole system has been placed under increasing strain. It has recently been the subject of several reforms; however, further reforms are necessary in order to adapt the state pension scheme to the realities of the last decades' demographic developments. As a consequence of the strain on state pension insurance, the importance of company pension schemes has increased significantly in the last few years.

b) Unemployment Insurance

The statutory unemployment insurance is codified in book II and III of the Social Security Code (*SGB II and III*). The Federal Employment Agency is the carrier for unemployment insurance. In principle, the insurance requires the cooperation of the unemployed person with the employment agency. The insurance is mandatory for employees, apprentices and others who are committed to work. Freelancers, generally, do not have to sign up for unemployment insurance; nevertheless they may to insure themselves voluntarily.

The unemployment insurance offers a wide range of benefits. Amongst others, employees fulfilling the respective statutory requirements can receive unemployment payments, short-term working benefits, payments in case of insolvency and payments for vocational training. Unemployment benefits are limited in time and may be suspended if, for example, the employee does not properly cooperate with the employment agency or declines offers of employment. When the unemployment benefit period expires the unemployed person is entitled to basic social insurance benefits.

Under certain conditions, employers can apply for benefits for employing new workers, benefits for employees who are, for example, disabled or un-trained and benefits due under the Partial Retirement Act.

c) Health Insurance

About 90% of the German population have statutory health insurance, regulated in book V of the Social Security Code (*SGB V*). Statutory health insurance is organised by health insurance companies (e.g. *Allgemeine Ortskrankenkassen*, *Betriebs- und Innungskrankenkassen*, *Ersatzkassen)*. Membership is generally

compulsory for employees, students and apprentices. Currently, however, employees, whose regular annual salary has exceeded a certain limit (in 2008: EUR 48,150.00) for three consecutive years, are free to choose private health insurance or to volunteer to retain their statutory health insurance.

Health insurance is intended to cover medical services necessary for rehabilitation following illness, as well as services for the prevention of illness. In the case of the latter, individual insurance companies slightly differ in their coverage. Furthermore, insurance companies provide sickness benefits (*Krankengeld*) if the employee has been sick for more than 6 weeks, since usually, the employer will then suspend payments if not otherwise agreed in contract of employment or any relevant collective bargaining agreement. Sickness benefits usually amount to approximately 70% of the employee's previous basic salary.

d) Nursing Care Insurance

Nursing care insurance, governed by book XI of the Social Security Code (*SGB XI*) covers nursing care benefits. Nursing care insurance funds are supporting organisations, which are attached to each statutory health insurance company. Consequently, those who are mandatory members of the statutory health insurance are, in general, also subject to compulsory nursing care insurance. Those who are voluntarily insured under a statutory health insurance scheme may be exempted from nursing care insurance under certain circumstances. Members of private health insurances schemes must join private nursing care insurance schemes.

The benefits are scaled in relation to the different levels of care (*Pflegestufen*) required. Benefits of the nursing care insurance may include, for instance, home care, cash benefits and benefits for the education and social protection of the person in need of care.

e) Accident Insurance

Statutory accident insurance, regulated in book VII of the Social Security Code (*SGB VII)*, covers benefits in case of accidents involving employees in the workplace, occupational diseases and accidents on the way to or from work. The carriers are professional associations (*Berufsgenossenschaften*). Benefits may involve, for example, treatment of the illness or injury, rehabilitation and payment of compensation and pensions.

Contributions to statutory accident insurance are made exclusively by the employer. The calculation of the amount of contribution (*Umlageverfahren*) depends on several criteria, particularly, previous expenses for damages in the past year, the level of risk of the company's working environment and the total remuneration paid by the company in the relevant time period.

Within statutory accident insurance employers are highly privileged, as they can only be held liable by employees for insured personal injuries, caused by intentional

acts. Employers are however liable to social insurance funds for expenses arising from insured injuries caused by gross negligence and intentional conduct, up to the amount of a possible claim for damages.

II. Social Insurance Contributions

1. Obligations of the Employer

According to the general provisions applicable to all social security insurances, stipulated in book IV of the Social Security Code (*SGB IV)*, the employer is obliged to register employees in a social insurance scheme with a competent institution of statutory health insurance. He must report the beginning and end of employment and must give annual status reports.

2. Obligations of the Employee

The employee has to provide the employer with the information necessary to report to the health insurance scheme (*SGB IV*). In particular, at the beginning of the employment, the employee must present the employer with his social insurance identity card (*Sozialversicherungsausweis*), issued by a competent state pension insurance institution.

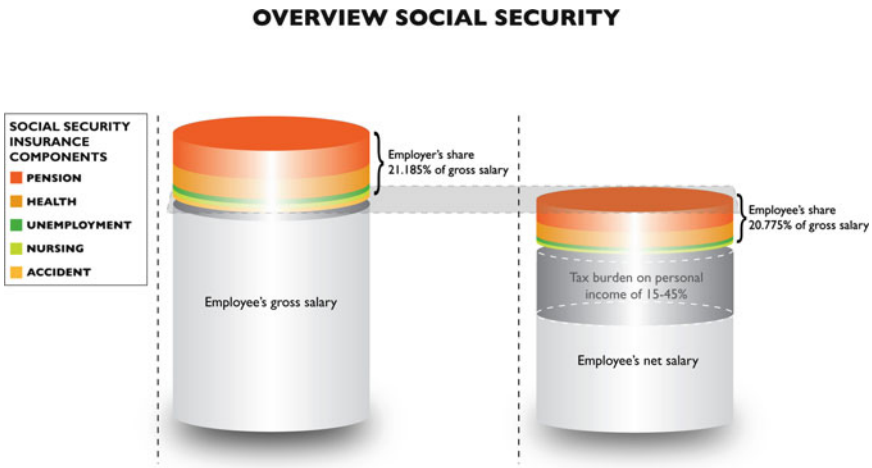
3. Composition and Calculation of Contribution Payments

Contributions to social security schemes, with the exception of accident insurance, are made by the employer and the employee in equal (50%) shares.

The total (employer and employee) social security contributions are determined on the basis of the gross amount of the employee's monthly salary and are currently approximately 40% of the employee's gross salary.

Contributions to the various branches of social insurance constitute the following percentages of the employee's gross salary: state pensions insurance (19.90%), health insurance (until 2009 the contribution depended on the individual employee's insurance company, whereby the average was 14.00% (2008) plus 0.9% additional employee contribution; since 2009 there is a uniform contribution rate for all insurance companies of 14.6% plus 0.9% additional employee contribution), unemployment insurance (3.30%), and nursing insurance (1.95%).

However, the level of contribution is limited by the employee's monthly gross salary (*Beitragsbemessungsgrenzen*). The maximum monthly contribution for the state pension and unemployment insurance schemes in 2010 amounts to EUR *5500.00* gross in the Western German states and EUR *4650.00* gross in the Eastern German states. The maximum contribution for health and nursing care insurance schemes is uniformly EUR *3750.00* gross.



4. Employer's Civil and Criminal Liability

The employer is responsible for making all of the contributions to the employee's health insurance scheme as such acting as a so-called "collecting centre" (*Einzugsstelle*). He is liable to pay all the contributions for 4 years if he fails to pay them accurately and in case of intentionally withheld contributions he will be liable for 30 years, from the end of the calendar year in which the social insurance contributions fell due. The employer must determine, whether the employment is subject to the statutory social insurance scheme and calculate the contributions (e.g. with help of a pay-roll provider). In case of doubt, if the employee is subject to the German statutory social insurance scheme, the employer can request a binding decision by the collection centre. In case of incorporated companies, the companies as the employers and their governing bodies, for example, managing directors of a limited liability company (*Gesellschaft mit beschränkter Haftung, GmbH*), may be held liable. In practice, employers often forget that the intentional withholding of social insurance contributions is a criminal offence according to the German Criminal Code (*Strafgesetzbuch, StGB*) for which the governing bodies may hold the employer responsible. Therefore, in all cases of doubt if an individual person is self-employed or an employee of the company it is advisable to seek a decision by the collection centre.

5. Employers' Claims Against Employees

In principle, the employer has a claim against the employee for the employee's social insurance contributions. However, the employer may only enforce his claim

by way of deductions from the employee's salary, usually in the same month as the employee's salary payment. If the employer omits to deduct the employee's social insurance contributions from the employee's salary for the respective month, he may only compensate for this omission with the next three monthly salary payments. The employer may only exceed this period if he did not contribute to the failure to deduct the correct amount. This limitation does not apply if the employee breached his obligation to provide the employer with the necessary information for the health insurance scheme and intentionally or negligently failed to pay the social insurance contributions.

C. General Tax Law Aspects

Germany imposes income tax (*Einkommenssteuer*) on salaries, wages, and other remuneration of dependent employment under the Income Tax Act (*Einkommenssteuergesetz*). The employer is obliged to subtract the income tax from the employee's gross salary after deduction of social security contributions and to pay it to the tax authorities on behalf of the employee. Nevertheless, the employee himself is the legal debtor of the tax. Income tax currently ranges from 15 to 45% of the employee's gross income.

The payment of a car allowance by the employer is taxable employee income. Tax savings may be achieved by providing a company car to the employee that the employee may be permitted to use also for private purposes. The private use of a company car constitutes a benefit with monetary value, which the employee must declare as income. The taxable monthly benefit resulting from permitted private use of a company car may, however, be calculated as a flat-rate percentage of around 1% of the manufacturer's listed gross purchase price. This flat-rate amount is usually considerably lower than the actual cost of the car.

Employees working and living in different jurisdictions are generally protected by Double Taxation Treaties between Germany and other countries. The majority of these treaties are based on the OECD Model Tax Convention (see Chaps. 6 and 7 for further details). According to these treaties, salaries, wages, and other remuneration earned from dependent employment by a resident of a contracting country are usually taxable in the country of residence. However, if the employment is carried out in the other contracting country, the income is taxable in that country, if the employee has spent more than 183 days during a 12 month period in that country, or if the salary has been paid by or on behalf of an employer domiciled in that state. Thus, under the Double Taxation Treaties, in order to be subject to German income tax, a non-resident employee actually has to work for more than 183 days in Germany or his income tax contributions are borne by the employer's permanent establishment in Germany or an employer who is resident in Germany. Where there is lower income tax in the employee's country of residence, the employee would usually seek to avoid exceeding the 183-day period; the employee's income would usually then only be taxable in his country of residence.

D. Example Calculation for Social Security Contributions

The following is an example for the calculation of social security contributions and income tax for an unmarried person in the year of 2008 with a fictitious gross salary of EUR 3,000:

Insurance	Percentage of Gross Salary	Assessment Ceiling (EUR gross/month)		Share of Employer	Share of Employee
		West	East		
Pension	19.90%	5.300,00	4.500,00	9.95%	9.95%
Health	15.5%	3.600,00	3.600,00	7.3%	7.3% (+0.9%)
Unemployment	3.30%	5.300,00	4.500,00	1.65%	1.65%
Nursing	1.95%	3.600,00	3.600,00	0.975%	0.975%
Accident	1.31%*			1.31%	0%

* Average figures

E. Key Aspects

- Employee salaries can be based on individual employment contracts between employer and employee or on collective bargaining agreements.
- Germany does not have a general statutory minimum wage; however, in a few industrial sectors a minimum wage for employees working in Germany has been agreed.
- Employers are not obliged to pay employees for overtime worked, unless this is provided for in a collective bargaining agreement or individual employment contract.
- Employers may grant bonus payments, such as a gratuity, supplementary pay, profit sharing and commission. In order to avoid an operational practice, the employer should consider either reserving to himself the voluntary nature of the payments or a implementing a right of revocation in specific circumstances, in the employment contract.
- In Germany there is a mandatory statutory social insurance scheme, covering pension, unemployment, health, nursing care and accident insurance, which applies to most employees and apprentices. With the exception of accident insurance, which employers alone pay, the contributions are equally shared between employer and employee.
- If the employer does not pay or incorrectly pays, the social insurance contributions to the collecting centres, he is liable for the payment of the entire (employer and employee) contribution payments for 4 years. He may also be held criminally liable if he intentionally withholds social insurance contributions.
- The employer must deduct income tax from the employee's gross salary after the subtraction of the social insurance contributions.

Chapter 9
Working Hours, Holidays and Health and Safety

Sascha Morgenroth and Eva Mittelhamm

A. Introduction

Under German law the employee's working time is regulated by several legal sources such as the German Working Hours Act (*Arbeitszeitgesetz*), collective bargaining agreements, works agreements, business practices or individual employment contracts. The same applies to holidays. A minimum statutory standard with regard to holidays is regulated by the Federal Vacation Act (*Bundesurlaubsgesetz*) but collective bargaining agreements and individual employment contracts usually provide for regulations regarding holidays that go beyond the statutory minimum. In addition, there are several public holidays in entire Germany and extra Christian holidays in certain German states. With regard to health and safety a complex system of regulations provides for protection of employees at the workplace in Germany. It is complemented by measures and provisions of the mandatory public Accident Insurance (*Unfallversicherung*).

B. Working Hours

I. Working Hours Act

1. Purpose and Applicability

The Working Hours Act (*Arbeitszeitgesetz*) is intended to protect the safety and health of employees regarding the organization of their working time. It implements the EU Working time directive 2003/88/EC.

The Act generally applies to all employees in Germany, except particularly executive employees (*leitende Angestellte*).

Any regulations violating the protective provisions of the Working Hours Act are null and void. Employers that have employees work in excess of the

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permissible working hours may be punished with fines in the amount of up to EUR 15,000.00.

2. Working Hours

According to the Act, the employee's working time may generally not exceed 8 h per work day. Working time is the time from the beginning until the end of the work excluding rest breaks. Work days are the days from Monday until Saturday. As a consequence, employees may work 48 h on a 6 day work week. The working time may be extended to up to 10 h per work day, if it does not exceed 8 h per work day on the average within six calendar months or within 24 weeks.

Work on Sundays and public holidays is generally prohibited. There is, however, an extensive statutory catalogue of exceptions. Nevertheless, employees must have at least 15 Sundays per annum off work. Further, work on Sundays must be compensated by an alternative day off within a period of 2 weeks (within a period of 8 weeks in case of work on public holidays that fall on work days).

3. Rest Breaks

Employees must not work for more than 6 h without a rest break (*Ruhepause*). Thus, working time must be interrupted after more than 6 h of work by a previously determined break of at least 30 min, which may be split into two periods of 15 min each. In case of working time of more than 9 h, the break must amount to at least 45 min.

4. Rest Period

At the end of the work day, the employee must have an uninterrupted rest period (*Ruhezeit*) of 11 h. During this period, the employee must not be subject to any obligations towards his employer impeding him to freely enjoy his time off.

5. Records

The Act obliges the employer to record employees' working time in excess of eight daily working hours. These records have to be kept for at least two years. Violations of this recording duty may be punished with fines of up to EUR 15,000.00.

II. Collective Bargaining Agreements

Collective bargaining agreements may regulate the duration of working time. They may permit extending daily working time to more than 10 h without compensatory time off, if the working time usually consists mainly of "readiness to work"

(*Arbeitsbereitschaft*) or on-call time (*Bereitschaftsdienst*). The entire working time must, however, not exceed 48 h per week on average over 12 months. Furthermore, collective bargaining agreements may allow employers to reduce the rest period by up to 2 h, if required by the kind of work and if the reduction will be compensated within a determined time period.

III. The Role of the Works Council

In the event that a works council exists in the business operation, the employer may not allocate the working time unilaterally. The works council has a mandatory co-determination right regarding the regulation of the beginning and the end of the daily working time with respect to the individual work days, including breaks and their allocation. The co-determination right also applies to a temporary reduction or extension of the customary working time of the business. However, the determination of the duration of the general working time of the business operation is not subject to the works council's co-determination, if not provided otherwise by collective bargaining agreement. Further, there is no works council co-determination concerning the duration of working time agreed with individual employees in their employment contracts.

C. Holidays

I. Applicability and Amount

According to the Federal Vacation Act (*Bundesurlaubsgesetz*) every employee is entitled to a minimum of 24 paid days of vacation based on a 6 day working week (Monday to Saturday). Most employees nowadays have 5 day working day weeks (Monday to Friday), resulting in 20 days of paid vacations. Many collective bargaining agreements or individual employment contracts grant holiday entitlements between 24 and 30 days based on a 5 day working week.

Holidays
Entitled to holidays are
Full-time employees
Part-time employees
Temporary employees
Persons similar to employees (i.e. who are economically dependent on the employer)
Low budget employees (e.g. students with an in-definite employment contract)

Part-time employees must not be discriminated against due to their part-time employment. However, if part-time employees work fewer days per week than full-time employees, their holiday entitlements are pro-rated. In case of regular allocation of their working time, the annual holiday entitlement is determined by dividing the mandatory minimum of 24 annual holidays by a reference period of six working days per week and multiplied by the number of actual working days per week. For example: if a part-time employee works 3 days per week, his holiday entitlement is 12 holidays per calendar year ($24/6 = 4 \times 3 = 12$ days). Extended reference periods may be required if the working time is allocated irregularly.

Employees only qualify for full annual vacation if they completed a six months waiting period or leave the company in the second half of the calendar year (i.e. later than June 30). Employees are not entitled to full annual vacation if they do not complete the waiting period, or leave the company in the first half of the calendar year (i.e. before June 30). In these cases the entitlement is 1/12th of the annual holiday for each calendar month worked.

II. No Waivers

Employees must take their annual holiday during the calendar year and employers must generally grant employees their holiday. Employees cannot waive their statutory holiday entitlement. Collective bargaining agreements may also not contain holiday waivers. Further, any agreement providing the employer with the right to recall the employee from holidays under certain circumstances will be invalid.

Statutory annual holiday entitlement generally expires at the end of the respective calendar year. The holidays can only be carried forward to the end of the first quarter (31 March) of the following calendar year if the employee was not able to take the holidays for operational reasons (i.e. the employer did not grant the employee vacations he applied for, e.g. because of particularly labour intensive periods in certain industry sectors) or personal reasons (e.g. incapacity for work due to sickness).

The European Court of Justice (*Europäischer Gerichtshof, EuGH*) has ruled that statutory holiday an employee is not able to take during the calendar year or before the end of the transfer period due to sickness cannot be forfeited. Therefore, statutory minimum holidays must generally be financially compensated if the employee stays sick until the end of the employment relationship. This does, however, not apply to any vacation days granted in addition to the statutory minimum holidays by individual employment contract or collective bargaining agreement.

III. Obligations of the Employee

Employees are not permitted to take up paid work during their holidays. They may only perform permitted secondary employment as well as work on their own

property. A violation of these rules by an employee may lead to disciplinary action up to dismissal if the respective prerequisites are fulfilled (see Chap. 15).

IV. Holidays in Case of Termination

Employers should explicitly specify when outstanding holiday is to be taken in a termination notice letter. If untaken holiday cannot be taken due to the end of the employment relationship, employers have to pay in lieu of the untaken holidays. The compensation amount is calculated based on the employee's average income received during the 13 weeks prior to the end of the employment.

Employers should be aware that, if employees are suspended prior to the termination date, holidays are not automatically set off against release periods. Further, holidays may only be set off against periods of irrevocable release. Therefore, employment contracts and/or separation agreements should explicitly state that holidays are set off against days of irrevocable release.

V. Public Holidays

There are nine public holidays in Germany (their expected dates for 2010 until 2012 are listed below), and additional Christian holidays in certain German states. Public holidays as well as Sundays are generally mandatory free time. In some sectors employees may work Sundays and holidays, but are entitled to corresponding time off on other days of the week.

Public holidays

Public holidays	2010	2011	2012
New Year's Day	1 January	1 January	1 January
Good Friday	2 April	22 April	6 April
Easter Monday	5 April	25 April	9 April
Labour Day	1 May	1 May	1 May
Whit Monday	24 May	13 June	28 May
Ascension Day	13 May	2 June	17 June
Reunification Day	3 October	3 October	3 October
First Christmas Day	25 December	25 December	25 December
Second Christmas Day	26 December	26 December	26 December

D. Health and Safety

In Germany there exists a complex system of regulation protecting employees' health and safety at the workplace. It is complemented by measures and provisions of the mandatory public Accident Insurance (*Unfallversicherung*) (see Chap. 8).

I. Protection Regulations

The regulations on the protection of the employee's health and safety consist, in particular of the general Workplace Protection Act (*Arbeitsschutzgesetz*) and further specialized acts (e.g. on work in front of monitor screens) and supplementing ordinances of particular practical importance. The Act is based on EU directives and contains general rules and prohibitions. It applies to all private and public employees.

Pursuant to the health and safety protection regulations, the employer must ensure appropriate measures of workplace health and safety protection, must monitor respective measures and make required adjustments. The responsibilities of employers include for example:

- Ensuring appropriate business organizations and appropriate work equipment
- Taking measures enabling supervisors and employees to comply with their duties of care (e.g. instructions)
- Avoiding hazards for employees by analyzing potential hazard risks and appropriate protection measures (e.g. non-smoker protection) and remedies
- Recording hazard analyses and safety measures. Small businesses with ten or less employees are released from these duties; this exception, however, violates EU law according to the ECJ
- Bearing the burden of costs of required protection measures

The Trade Supervisory Department (*Gewerbeaufsicht*) is responsible for monitoring compliance with health and safety protection provisions. It may inspect businesses without prior notice, remedy violations and impose fines.

II. Health Examinations

Voluntary medical examinations may be required, e.g. if employees handle hazardous materials, perform heavy physical work, are exposed to heavy noise or shift or night work. In certain areas of work that involve particular health risks, there are mandatory special medical examinations required by law (e.g. work with cancer-producing hazardous materials). If employees refuse such mandatory medical examinations, the employer will generally be prohibited from employing them.

III. Employee Duties

Employees are obliged to comply with safety measures and regulations in the workplace. They are obliged to report to their employer if they discover significant immediate hazards or damages to the employer's safety systems.

IV. The Role of the Works Council

The employer is obliged to inform an existing works council about compliance with workplace protection measures in a comprehensive and timely manner. The works council has the right to co-determine health and safety protection measures to which the employer is obliged by law. Measures by the employer without proper consideration of the works council co-determination rights are void.

E. Key Aspects

- Working hours
  - Employee's working time must, in principle, not exceed 8 h per work day.
  - Working time may be extended to up to 10 h per work day, if it does not exceed 8 h per work day on the average. Collective bargaining agreements may provide for further extensions under certain conditions.
  - The employer is obliged to record overtime hours.
  - Working time must be interrupted after more than 6 h by a previously determined rest break (of at least 30 min; 45 min in case of 9 h work day).
  - At the end of the work day, there must be an uninterrupted rest period of 11 h.
  - Work on Sundays and public holidays is generally prohibited. There are, however, extensive exceptions.
  - Works councils have co-determination rights regarding the regulation of the beginning and the end of the daily working time, including breaks and their allocation.
- Holidays
  - Every employee with a 5 day working week is entitled to a minimum of 20 paid holidays per calendar year.
  - Holiday entitlement is pro-rated for part-time employees working fewer days per week than full-time employees.
  - Employees only qualify for full annual vacations if they completed a 6 month waiting period or leave the company in the second half of the calendar year (i.e. later than June 30). Otherwise, their entitlement is pro-rated.
  - Statutory annual holiday entitlement generally expires at the end of the respective calendar year. Holidays can usually only be carried forward to the end of the first quarter (31 March) of the following calendar year if the employee was not able to take the holidays for business or personal reasons.
  - There are at least nine public holidays per calendar year. In certain German states there are additional Christian holidays.
- Health and safety
  - The employer is obliged to protect his employees against hazardous conditions at the workplace.
  - The Trade Supervisory Department (*Gewerbeaufsicht*) monitors compliance with health and safety protection provisions.
  - Works councils have information and co-determination rights regarding employer's health and safety protection measures.

Chapter 10
Partial Retirement

Jens Kirchner and Eva Mittelhamm

A. Introduction

Partial Retirement (*Altersteilzeit*) aims to facilitate the smooth transition from working life into retirement of older employees and is codified in the Partial Retirement Act (*Altersteilzeitgesetz, ATG*). However, in most significant economic sectors collective bargaining agreements have been concluded to regulate partial retirement.

B. Prerequisites of Partial Retirement

I. Qualifying Employees

To qualify for partial retirement, the employee must have reached the age of 55. Further, the employee shall have been employed for at least 1,080 calendar days during the previous 5 years, and must have paid social insurance contributions. This minimum period does not necessarily have to be completed with the same employer. During this time, the employee may have taken up to 1 month unpaid leave without losing continuity of employment. Periods of employment in other EU member states and periods during which the individual is entitled to unemployment benefits are also included in this calculation.

II. Agreement on Partial Retirement

Employer and employee must both agree in writing to reduce the employee's working hours. The agreement must run until the employee reaches statutory

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retirement age and is entitled to a state funded pension, subject to deductions if his pension is drawn early.

The employee's previous weekly working hours must be reduced by 50%. The employee's previous weekly working hours are those which were agreed between the parties before partial retirement commences or, if the employee does not work regular hours, his average weekly working hours over the last 24 months. Partial retirement working hours shall remain subject to social insurance contributions. This means that the reduction in working time must not result in a reduced salary which falls short of the minimum income threshold for social insurance contribution purposes. As a result, only employees whose monthly salary is at least double the minimum threshold for social insurance contributions (EUR 400.00) may agree on partial retirement.

The employee has no statutory right to partial retirement. However, such a right may be established by a collective bargaining agreement or works agreement.

C. Models of Partial Retirement

The Partial Retirement Act provides for two different models of partial retirement: the so-called "block model" (*Blockmodell*) and the so-called "continuity model" (*Kontinuitätsmodell*).

I. Block Model

The block model is the most common in practice. It may be extended to up to 6 years under a collective bargaining agreement, and consists of two blocks of usually equal time periods: in the first block, the so-called "working phase" (*Arbeitsphase*) the employee continues to work his usual hours, and in the second block, the so-called "release phase" (*Freistellungsphase*), the employee is released from work.

The block model as described above may generally only be agreed by collective bargaining agreements or works agreements if this is permitted by exemption clauses (*Öffnungsklausel*) in collective bargaining agreements. If the employer is not bound by a collective bargaining agreement or if there are no collective bargaining agreements which cover partial retirement, works agreements on partial retirement may be concluded. However, if no works council exists in the business, employer and employee may also conclude an individual written agreement. Therefore, if an employee is not bound by a collective bargaining agreement the block model may be introduced by a works agreement or by individual agreement with his employer.

II. Continuity Model

The continuity model allows the employee to work reduced working hours during the entire partial retirement period. However, working continuously may include, for example, working half-days, working 2-day weeks, or alternating between full-time work and rest periods on a weekly, monthly or half-yearly basis.

D. Prolonging the Partial Retirement Period

The partial retirement may exceed 6 years so as to last until the employee reaches statutory retirement age. Partial retirement agreements without block time periods can be agreed individually between employer and employee. However, if both parties wish to agree extended partial retirement block time periods of longer than 3 years until the individual retirement age of 65 or 67 years, the requirements of the block model as explained above apply. This means that the terms of any collective bargaining agreements or works agreements must be complied with prior concluding individual agreements.

E. Employer's Obligations

I. Payment of Salary

The employer has to pay the employee's salary during the entire partial retirement period in both models. The payment has to be made continuously for the whole period, even during the release phase of the block model. The *ATG* assumes that as the employee's working hours are reduced by 50%, his salary is also reduced by 50%. Remuneration for overtime working may be rewarded immediately, irrespective of the employee's salary.

II. Payment of Increase Amounts

During partial retirement, the employer has to pay such employees an increase amount (*Aufstockungsbetrag*) which amounts to at least 20% of the standard salary (*Regelarbeitsentgelt*), in addition to the employee's income.

The standard salary is the monthly salary (reduced to reflect part-time hours during partial retirement) which is subject to social security contributions and which is paid by the employer on a regular basis.

The portions of the salary which are subject to social security contributions are explained in Table.

Bonuses and extra pay
Payments in kind and other benefits in money's worth
Capital forming payments

The standard salary is only taken into consideration up to the social insurance assessment ceiling (*Beitragsbemessungsgrenze*), which in 2010 amounts for the statutory old age pension to EUR 5,500.00 per month in the western German states and to EUR 4,650.00 per month in the eastern German states.

III. Additional Contributions

The employer also has to make contributions to ensure the employee's entitlements under the statutory pension insurance. This contribution amounts to at least the basis of 80% of the standard salary with a restriction of 90% of the difference between standard amount and the assessment ceiling. As such, the assessment ceiling may not be exceeded.

Collective bargaining agreements, works agreements and individual agreements will commonly include an obligation to contribute increase amounts.

In respect of contributions to statutory health insurance, care insurance and unemployment insurance, the employee's basic reduced salary during partial retirement is decisive and no increase amounts have to be paid by the employer in this regard.

IV. Insolvency Insurance

A special problem that may potentially arise in the block model is that the employee may fulfil his previous obligations under the employment relationship in full during the working phase, and yet receive only a reduced salary plus any increase amount. This will be remedied during the release phase when the employer pays a reduced salary in return for no work on the part of the employee. Accordingly, the employer will have kept this money on account (*Wertguthaben*) in favour of the employee when commencing the release phase. Since 2004 the Partial Retirement Act contains a mandatory obligation for the employer to insure this money on account against the possibility of insolvency of the company during the release phase.

Any "work time bonus" accrued over more than 3 months also needs to be insured by the employer against the risk of his insolvency. The increase payments

made by the employer can not be offset against this. The employer's obligation to insure exists from the first month of the working phase and he is required to confirm to the employee in writing that the insurance is in place on a regular basis every 6 months. If the employer fails to comply with this obligation the employee can claim the insurance at labour courts.

The following schemes are appropriate insurance schemes:

- Bank guarantees
- Insurance by way of collateral securities (e.g. pledge of securities, especially funds) in favour of the employee
- Specialist insurance schemes of the insurance industry
- The scheme of double side trust

The following schemes are inappropriate for insolvency insurance:

- Financial accruals
- Obligations to assume liability
- Lieus within a group company, especially bonds, comfort letters and collateral promises

F. Tax Privileges

If the personal prerequisites are met and if the agreement between employer and employee is valid, the increase amount and the additional payment to the pension scheme are tax-free. However, these payments are relevant in relation to the taxable amount of yearly income. For the determination of the rate of taxation within the progression, the tax-free increase amount is incorporated.

G. Special Issues

I. Vacation

If the employee's partial retirement follows the continuity model, his vacation must be granted as usual. Difficulties might arise in case of the block model: if vacation is granted during the working phase the employee has the right to claim full salary. Vacation that has not been taken during the working phase expires at set intervals in accordance with the Federal Vacation Act (*Bundesurlaubsgesetz, BUrlG*) and the employee will not be compensated for any unused holiday entitlement later in the release phase.

II. Sickness

In case of sickness of the employee during the working phase, in the block model or the continuity model, the employer is obliged to continue to pay the employee his salary in accordance with the Continuation of Remuneration Act (*Entgeltfortzahlungsgesetz*). If the employee is sick during the release phase of the block model his entitlement to remuneration continues irrespective of his ability to work.

H. Equal Treatment Aspects

Attention should be paid to the general principle of equal treatment. Regulations providing for different treatment for those employees taking partial retirement are invalid if there is no factual justification for such different treatment.

I. Financial Support by Federal Employment Office

The current Partial Retirement Act requires partial retirement to commence on or before 31 December 2009 in order to receive financial support from the Federal Employment Office (*Bundesagentur für Arbeit*). The financial support for partial retirement by the Federal Employment Office depends on the fulfilment of the following prerequisites.

I. Payment of Increase Amount

The employer must fulfil his obligation to pay the increase amount on top of the standard salary to the employee, as explained above.

II. Payment to Statutory Pension Insurance

The employer is obliged to pay the additional contributions to the statutory pension insurance.

III. Filling Released Position

The part-time job from which the employee is released shall be filled with an unemployed person, or if the employer usually employs not more than 50 people,

with an apprentice. The new employee needs to be employed due to the partial retirement of the older employee. The independent creation of new positions is not sufficient to qualify for the financial support of the Federal Employment Office. The duty to fill the released position is on the employer. If the reoccupation occurs within 3 months after the release in the block model or the reduction of working time in the continuity model the Federal Employment Office also grants financial support for the time of vacancy.

IV. Prevention of Excessive Demands

To ensure that the employer is not overstrained by the requests for partial retirement the financial support depends on the fact that the collective agreement that entitles the employee to partial retirement does not grant this legal position to more than 5% of the employees in the business operation. Therefore, financial support is only paid if the employer is not forced to grant partial retirement to more than 5% of his employees.

In summary, the prerequisites for the financial support by the Federal Employment Office are

Payment of increase amount
Additional payment to statutory pension insurance
Filling the released position
Prevention of excessive demands

V. Scope of Financial Support

The Federal Employment Office compensates the employer for the minimum amount of the increase amount, i.e. 20% of the employee's standard salary, and the additionally paid contributions to the statutory pension insurance.

The payments are made monthly ex post, for those months in which the prerequisites for the support are fulfilled. If the parties have chosen the block model, the payments are made solely during the release phase when the released position is filled with an unemployed person or an apprentice. In this event the monthly payment also comprises the respective time periods dated back from the working phase. The maximum time period for the support is 6 years.

The financial support is only granted for employees who commence their part-time work due to partial retirement on or before 31 December 2009 and by doing so enable the employer to hire an otherwise unemployed person. Thereafter employers, in principle, have no right to financial support by the Federal Employment Office.

VI. End of Financial Support

The financial support ends when the employee returns to full time employment or reaches the statutory retirement age and is entitled to draw his state pension, and will be subject to deductions if he draws his pension early. If the employee takes up a secondary employment which is not marginal in addition to his part-time partial retirement role the financial support will come to an end. Any secondary employment may therefore not exceed the minimum threshold for social insurance contributions. The same applies if overtime work is performed; financial support ceases if the amount of overtime work is such that it exceeds the minimum threshold for social security insurance contributions. Additionally, if the employer does not fill the released position the entitlement to payments of the Federal Employment Office expires.

J. Key Aspects

- There is no statutory entitlement to partial retirement, but there can be entitlements under collective bargaining agreements or works agreements.
- Partial retirement requires the fulfilment of prerequisites by the employee and a prior written agreement between the employee and the employer.
- There are two models of partial retirement, namely the block model and the continuity model.
- If using the block model, employers are obliged to insure employees' money on account against insolvency.
- Financial support is granted by the Federal Employment Office, if the following prerequistiess are fulfilled
- Employers have to pay an increase amount and additional contributions to the statutory pension insurance.
- Financial support is granted by the Federal Employment Office, if the following prerequisites are fulfilled:
  1. Payment of increase amount
  2. Additional payment to statutory pension insurance
  3. Filling of the released position
  4. Prevention of excessive demands
  5. Partial retirement commences on or before 31 December 2009

Chapter 11
Diversity and Discrimination

Pascal R. Kremp and Sascha Morgenroth

A. Introduction

Diversity and discrimination is a relatively new development in German labour and employment law. The general concept of equal treatment and a prohibition against gender discrimination have existed in German statutory law for a long time. Most other discrimination laws were only introduced on 18 August 2006 in the General Equal Treatment Act (*Allgemeines Gleichbehandlungsgesetz, AGG*) which implemented three European Union (EU) anti-discrimination Directives (2000/43/EC, 2000/78/EC and 2002/73/EC). Since then, there have been some discrimination cases making the headlines, but in general discrimination legislation does not yet play such a significant role in Germany as it does in the US or in the UK. This might be partly due to the fact that German courts are traditionally very reluctant to grant substantial compensatory awards. Furthermore, dismissals and company pensions have been explicitly excluded from the scope of discrimination laws in Germany. It is likely that these exemptions are in breach of EU law. If the European Court of Justice (ECJ) confirms this position in future, this might be the catalyst for discrimination law to play a larger role in German employment law. For the time being, diversity remains a rare marketing tool for German companies striving to attract candidates with high potential.

B. General Equal Treatment Act

Discrimination is predominantly governed by the General Equal Treatment Act.
Under the Act illegal discrimination occurs if:

- The discrimination is based on one of the eight discriminatory grounds prohibited by the General Equal Treatment Act
- The individual falls within the scope of the Act
- The discrimination is not justified

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I. Grounds of Discrimination

The Act prohibits discrimination based on race or ethnic origin, religion or belief, gender, disability, age or sexual identity.

The grounds of discrimination in the Act and key issues which arise are considered below.

1. Race and Ethnic Origin

The Act reflects the general position that all races are equal and are treated as such in the eyes of the law. This principle was therefore primarily included for clarification and political reasons.

The definition of ethnic origin covers discrimination based on nationality (for example, against Turkish people even though they have a German passport and history etc.). No case law currently exists regarding the question as to whether Bavarians, Prussians, Eastern/Western Germans (i.e. local German groups) qualify as an identifiable ethnic origin under the Act.

2. Religion or Belief

Obviously, religion includes e.g. Catholics, Protestants, Muslims, and Jews. German case law is ambiguous with regard to whether Scientology qualifies for protection under the Act. No settled case law exists within the EU in this respect. This question will not be settled until a relevant case is brought to the ECJ. Membership of a political party or a union is not covered by the definition of belief, but general beliefs in political systems, such as communism do come within the ambit of the Act. Union membership is, however, protected by the German Constitution.

3. Gender

Gender discrimination protects both men and women. Under German law, gender discrimination may also occur if a woman is treated less favourably than other women because she is pregnant or on maternity leave.

4. Disability

Until recently, German employers have usually only been concerned with severely disabled employees (i.e. with a degree of disability of at least 50%). Discrimination law also protects employees with minor disabilities. Under German law, a condition qualifies as a disability if it affects an individual's mental or physical status for

a period of at least 6 months. The question is whether employees on long term sick leave are covered by the Act. To date, employers can dismiss employees on long term sick leave (usually more than 18 months) if it is unlikely that they will return to work. It is nevertheless understandable that once dismissals fall within the scope of the Act, this will cause some concern for employers. However, although it is likely that there will be some form of discrimination in most cases, it will generally be capable of justification.

5. Age

Under German law employers must not discriminate on the grounds of age. German law protects both "old" and "young" age. It is, for example, unlawful to refuse an employee close to retirement continued education because of his or her old age. Equally it would be unlawful to refuse to consider an employee for promotion based on stereotypical assumptions about his or her perceived youth.

Age discrimination is likely to play a major role in future. Many pay and benefits schemes are based on age or years of service (involving indirect age discrimination). Therefore, employers should carefully consider whether granting certain benefits to employees on the basis of age or years of service is capable of being justified.

6. Sexual Identity

Unlike the EU anti-discrimination Directives, German law prohibits discrimination against sexual identity, not against sexual orientation. Germany's legislators intended to prohibit not only discrimination related to homosexuality, but also transsexual and intersexual discrimination.

In summary, the General Equal Treatment Act prohibits discrimination based on
Race or ethnic origin
Religion or belief
Gender
Disability
Age
Sexual identity

II. Factual Scope of Application

Discrimination is specifically prohibited in relation to selection procedures, recruitment conditions, employment and working conditions, conducting the employment relationship and promotion.

The Act does not apply to company pension schemes, which are exclusively regulated by the Company Pension Act (*Betriebsrentengesetz, BetrAVG*), and to dismissals which remain subject to general and special employment protection laws, in particular the Dismissal Protection Act (*Kündigungsschutzgesetz, KSchG*). However, these exceptions might be unlawful and in violation of the EU anti-discrimination Directives and the rulings of the ECJ as any discrimination surrounding dismissals and pension schemes is prohibited. Thus, in order to avoid unnecessary risks, in particular in dismissal procedures, employers should avoid any unequal treatment which is incapable of justification on objective grounds.

III. Protected Individuals

German discrimination law protects all employees. In addition to employees (including executive employees (*leitende Angestellte*)), apprentices, contractors who are similar to employees (*arbeitnehmerähnliche Personen*) as well as home workers are protected. Likewise, job applicants and those who have had their contracts of employment terminated are protected. German discrimination law also extends protection to freelance workers and members of executive bodies (such as statutory managing directors and management board members), but only where issues of engagement or promotion are concerned.

Protected individuals
Employees
Apprentices
Executive employees
Contractors who are similar to employees
Home workers
Job applicants
Ex-employees
Limited protection
Freelancers
Members of executive bodies (managing directors, management board members)

Example: Whilst it would be discriminatory to refuse promotion to a managing director because of old age, it is likely to be lawful to pay the younger managing director a lower salary than the older managing director because of his age.

IV. Discriminatory Behaviour

According to the Act, discrimination is defined as unequal treatment on one or more of the grounds of discrimination in the Act, which cannot be justified. The

Act explicitly prohibits direct and indirect discrimination, harassment (this may include "bullying"), sexual harassment, instructions to discriminate and retaliation.

The General Equal Treatment Act prohibits as discriminatory behaviour
Direct discrimination
Indirect discrimination
Harassment (this may include "bullying")
Sexual harassment
Employer instructions to discriminate
Retaliation

1. Direct Discrimination

Direct discrimination occurs if a person experiences, experienced or would experience less favourable treatment than another (hypothetical) person in a comparable situation. Here, an actual disadvantage is required (e.g. a woman is not employed purely because of her gender); the mere risk of a disadvantage is not sufficient.

2. Indirect Discrimination

Indirect discrimination occurs when a business imposes apparently neutral provision, criteria or practices which particularly disadvantage a class of people qualifying under one of the protected grounds of discrimination under the Act when compared to other persons. For example, unlike full-time employees, part-time employees do not receive a Christmas bonus. As most part-time workers are female, indirect gender discrimination is an issue. No indirect discrimination occurs if the discriminatory treatment is objectively justified by a legitimate aim and the means of achieving this aim are appropriate and necessary.

3. Harassment

Harassment is discrimination within the meaning of the Act, if unwanted conduct relating to one of the protected discriminatory grounds occurs with the purpose of violating the dignity of a person and creating an intimidating, hostile, degrading, humiliating or offensive environment. Systematic "bullying" by colleagues, i.e. acts against another person with the purpose of mentally and even physically injuring him or her over a sustained period, also constitutes harassment if it relates to one of the protected grounds of discrimination.

4. Sexual Harassment

Sexual harassment is discrimination if an unwanted, sexually motivated act is committed which is intended to or results in the violation of a person's dignity, particularly where this creates an intimidating, hostile, degrading, humiliating or offensive environment. Sexually motivated conduct includes unwanted sexual practices and demands, sexually intended physical contact, remarks with sexual content as well as unwanted illustrations and displays of pornographic material. In comparison with the law of harassment generally, a single act may be sufficient to constitute sexual harassment (e.g. sending one "fun" e-mail with sexual content at work).

5. Instructions to Discriminate

The instruction to discriminate against a person on one of the grounds of discrimination is also prohibited and constitutes an act of discrimination. For example, a managing director's instruction to the HR-Department not to hire any disabled persons would constitute discrimination even though the HR-Department does not follow the instructions. This form of discrimination will also be shown if it is established that someone appointed a person to behave in a manner which is deemed to be discriminatory or may be discriminatory towards an employee under the Act. An actual act of discrimination is thus not required; rather a potential act of discrimination is sufficient.

V. Justified Discrimination

Not every instance of unequal treatment constitutes discrimination. The Act tolerates unequal treatment under various conditions depending on the type of discrimination in issue:

Discriminatory treatment on the basis of race or ethnic origin, gender, religion or belief, disability or sexual identity can only be justified if a substantial and vital work-related requirement can be demonstrated. Such discriminatory treatment must be mandatory for performing an activity, for example the exclusive employment of women as models for lingerie is admissible. It is, however, not admissible to exclusively hire female flight attendants as this job may equally be performed by men. Considerations of mere expediency or advantageousness are not sufficient.

Unequal treatment based on age is less difficult to justify. It is sufficient, if the employer can demonstrate that the unequal treatment is impartial, appropriate and justified by a legitimate aim. The resources needed to achieve this objective have to be appropriate and necessary. The Act contains a non-exhaustive list of examples of admissible unequal treatment on the grounds of age. The following examples are particularly worth noting:

- Special conditions for access to employment, terms and conditions of employment (remuneration, etc.) for an occupationed integration of adolescents and older employees
- Minimum requirements with respect to age, work experience, or seniority upon recruitment, or regarding certain benefits associated with an occupation
- Age limits for recruitment on the basis of specific educational requirements or due to the necessity of an appropriate period of employment before retirement
- An agreement providing for the termination of the employment relationship without dismissal at a time when the employed person may apply for a state pension because of his age

VI. Rights of Persons Concerned

Discrimination law provides for the following remedies.

1. Voidness of Discriminatory Act

The discriminatory act or behaviour is null and void. Thus, no employee has to follow such behaviour (in particular discriminatory instructions by the employer).

2. Compensation for Damages

The employer may be liable for material damages for which it is deemed responsible. The employer is responsible for its own acts, whether caused intentionally or negligently. If works agreements and collective agreements are applicable, any liability is limited to intended acts and gross negligence. The employer is also liable for the acts of his legal representatives and of his vicarious agents (i.e. his executive employees in relation to the general workforce). Employer fault is assumed and the burden of proof is on the employer to show that he is not liable.

3. Compensation

Furthermore, there is potential liability for immaterial damage. Pursuant to the EU anti-discrimination Directives, this liability is presumably not dependant on any act of negligence, although this is not clearly expressed in the Act. The amount of compensation for immaterial damage has to be appropriate. Again, the Act does not provide guidance on what is considered as appropriate. The EU Directives, however, demand that the amount of the compensation should be effective, proportionate and sufficient to act as a deterrent. In this respect, it has to be assumed that

labour courts will measure the amount of the compensation according to the economic status of the respective employer. In the context of recruitment, any compensation is limited to a maximum of three months' salary, except for the best-qualified applicant. In cases where the best qualified candidate has not been hired for reasons which are discriminatory under the Act, the amount of compensation is unlimited.

4. Right to Complain

Employees have the right to complain to the company's complaints department (*Beschwerdestelle*) if they feel discriminated against by their employer, its management, other employees or third parties in relation to their employment.

5. Right to Refuse Performance

If the employer does not take any action or takes obviously inappropriate measures in order to prevent harassment or sexual harassment, the person concerned is entitled to cease working whilst still receiving his or her wages, provided this is required for his or her protection.

6. No Claim to Employment or Promotion

An employer's breach of the Act does not entitle an employee to claim for reinstatement/re-engagement or promotion.

7. Injunctive Relief

An employee discriminated against has the right to apply for injunctive relief. In cases of an employer's gross breach of the Act, a works council or competent union are permitted to legally assert the rights mentioned herein (particularly a claim to injunctive relief). They are, however, not entitled to bring claims of discrimination on behalf of individuals.

VII. Burden of Proof

The burden of proof in any claim under the Act is in favour of the employee who has allegedly been discriminated against. The claimant only has to make out facts sufficient to form a presumption that an act of discrimination occurred under the Act, i.e. the employer then has to prove that no discrimination occurred and that the

specific treatment is in fact justifiable. Thus, employers should ensure, before taking personnel measures that no circumstances exist from which it could be presumed that a prohibited act of discrimination is involved. Documents released in to the public domain such as job advertisements, should be treated with caution and worded carefully, in order to avoid any automatic presumption of discrimination sufficient to shift the burden of proof to the employer. As a basic starting position, job advertisements should always adopt gender-neutral wording. Minimum and maximum age limits should be avoided in such advertisements and no issues which could be associated with discrimination should be mentioned in interviews or assessment centres. Staff that is conducting job interviews should therefore be well trained.

VIII. Practical Consequences

As a result of the Act employers should pay attention to the following.

1. Prevention

The employer has to take preventive measures to comply with his duty of protection and to organise the business in accordance with the laws. Employees, particularly senior employees, should receive equality and diversity training. Furthermore, a complaints department must exist for all employees. A full text version of the Act as well as sec. 61b of the Labour Court Act (*Arbeitsgerichtsgesetz, ArbGG*), containing the relevant procedural regulations, particularly on the complaints procedure, should be communicated to the entire workforce and displayed in a suitable place, whether that be the company's intranet or a staff notice board.

It is advisable that companies provide codes of anti-discrimination and diversity to its employees. Such codes should effectively set out the company's complaints policy and procedure, with particular reference to complaints concerning discrimination. The company's complaints policy and procedure could be incorporated within a works council agreement or alternatively, in an employee manual. Furthermore, it is advisable, to check for any potential pre-existing facts or circumstances which could amount to discrimination under the Act. Particular attention should be paid to gender-neutral wording in employment contracts, works agreements and codes of conduct etc. Further, the company's current salary scheme should be examined for discriminatory practices (e.g. on grounds of age).

2. Investigations

In response to a potentially discriminatory situation, it is advisable to accurately understand the circumstances by holding interviews with all persons involved (i.e.

offender, victim and witnesses). Any interviews should preferably be held with an employee representative present, and all evidence should be carefully recorded.

3. Sanction

Sanctions should not be imposed against an individual accused of discrimination under the Act until the facts have been established and verified. Any sanction must be appropriate, necessary and reasonable. Under the Act, potential sanctions could include a warning, relocation or dismissal. Further feasible measures are if third parties are involved, a ban on that third party entering the business premises. In theory, the employer might be obliged to terminate a contract e.g. with a supplier or a customer if they do not stop acting discriminatory against the employer's employees.

C. Key Aspects

- Discrimination and diversity do not yet play a vital role in Germany.
- German discrimination laws protect against discrimination based on race and ethnic origin, religion or belief, gender, disability, age and sexual identity.
- Discrimination law basically covers the entire employment relationship, from the initial job application, through to pay, benefits and promotions.
- Dismissals and company pensions do not yet fall within the scope of German discrimination laws, which is likely to violate EU law.

Chapter 12
Data Protection and Monitoring

Flemming Moos and Jens Kirchner

A. The Employee's Right to Privacy

In Germany, no specific "Employee Privacy Act" exists. Still, there are several sources of law in Germany which result in rather strict protection of personal employee data. First of all, the provisions of the Federal Data Protection Act (*Bundesdatenschutzgesetz – BDSG*) apply to the collection, processing and use of personal data of employees. As of 1 September 2009, a new sec. 32 has been added to the BDSG which explicitly governs the collection, processing and use of employee data. Secondly, specific data protection obligations might follow from applicable Works Agreements.

Moreover, the employees' privacy is further protected by their respective personal right (*allgemeines Persönlichkeitsrecht*), which is enshrined as a fundamental right in the German Constitution. In particular, the fundamental right on informational self-determination and the fundamental right on confidentiality and integrity of IT systems are significant constitutional guarantees for employment relationships in Germany. The employer, like the works council, is obliged to safeguard and promote the free development of the personality of the employees in the company (sec. 75 (2) Works Constitution Act). Starting out from the aforementioned rights enshrined in the German Constitution, the extensive case law of the labour courts has developed principles for information and data protection in the German labour law framework.

B. Lawfulness of Utilizing Personal Data of Employees

According to the BDSG, the collection, processing and use of personal data shall be lawful only if a statutory provision permits or prescribes it or if the data subject has consented.

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I. Statutory Provisions

The Federal Data Protection Act permits the employer to utilize personal data of employees if the usage of the respective data is necessary for the establishment of an employment relationship or – after its establishment – for its performance or termination (sec. 32 para 1 s. 1 BDSG). "For the purpose of an employment relationship" means the collection and processing of all personal information which is relevant for the establishment and administration of the employment relationship (e.g. name, address, bank details, sex, works council membership), for personnel planning (e.g. language skills, schooling, family status) and for job performance measurement (e.g. times absent, sickness).

II. Works Agreement

It is also generally held, that a works agreement (*Betriebsvereinbarung*) qualifies as a statutory provision in terms of the Federal Data Protection Act. Therefore, a works agreement might allow the utilization of personal data of employees which is to the benefit of the employer. In practice such works agreements are often used as the legal basis for processing employee data. It must be borne in mind that the data protection safeguards of the works agreement can also differ from the statutory provisions, however, they should not considerably fall below the statutory standard.

III. Consent of the Employee

Personal data can also be legally utilized by obtaining the employee's consent to such use. Such consent shall only be effective if it is the data subject's free decision. Moreover, the data subject shall be informed of the purpose of the collection, processing or use of the data and in so far as the circumstances of the individual case require, or at his request, the data subject should be informed of the consequences of withholding consent. Consent shall also be given in writing unless special circumstances allow for any other form of communication. If consent is given in writing simultaneously with agreement to other matters, the employee's attention must be drawn, in particular, to the declaration of consent. Finally, where special categories of personal data are collected, processed or used, the consent shall explicitly include a reference to these types of data.

With respect to the consent given by employees (in particular as standard terms in the employment contract), the following points are relevant:

- Some commentators in legal literature and also the data privacy watchdogs in Germany generally doubt the voluntariness of data privacy consents in an employment contract due to the relationship of subordination between employer

and employee. Therefore, a declaration of consent is recommended as a proper basis for the utilization of personal data only in specific cases.

- If the data privacy consent is included in a larger document which also comprises other declarations (e.g. the employment contract), special prominence must be given to the consent, (e.g. by typing the declaration of consent in bold).
- As to the language of the declaration of consent, no specific requirements are enshrined in German data protection laws. However it is a mandatory requirement of an informed consent that the data subject is informed properly of the scope and purpose of the data processing steps he is being asked to consent to. Accordingly, the information, and also the declaration itself, shall be drafted in a language that the data subject is capable of reading and understanding. If all German employees are capable of reading and understanding English, no German translation is necessary.

C. Data Uses with Relevance for the Employment

I. Monitoring of Employees

Monitoring mechanisms in the workplace affect the privacy rights of employees. For a legal appraisal of surveillance in the workplace (in particular video surveillance), we have to distinguish between the surveillance of premises that are open to the public and the surveillance of premises with restricted access.

1. Surveillance of Premises Open to the Public

Under the Federal Data Protection Act video surveillance of premises that are open to the public (which may include salesrooms and restaurants) is only allowed if (1) there is no indication of prevailing legitimate interests of those affected and if (2) it is necessary for the purpose of

- Enabling public agencies to fulfill their tasks
- Keeping out trespassers or
- Achieving justified interests in certain defined situations (e.g. suspicion of crime).

If these prerequisites are met it must be made clear in advance that surveillance is going to be conducted and who is going to be included. Clandestine surveillance is not permissible. The data must be deleted as soon as it is no longer needed for the defined purpose.

2. Surveillance of Premises with Restricted Access

More relevant in practice is the surveillance of premises with restricted access. According to case law of the Federal Labour Court the relevant provision of the

Federal Data Protection Act does not apply to workplaces which, unlike sales-rooms, are not open to the general public. In these cases, the admissibility of surveillance evidence by video cameras or other technical devices follows from the general provisions protecting the privacy of employees.

The personal rights guaranteed by the constitution include the right to one's own image. The right to self-determination implies that individuals can freely decide whether they may be videotaped and whether the pictures can be used against them. Moreover, there is also protection for the spoken word, i.e. the right to determine oneself whether the spoken word is available to the partner of the conversation only or also made accessible to third parties or even the general public and whether it may be recorded by electronic or other means.

The assertion of the overriding legitimate interests of the employer may justify interference in the privacy rights of the employee. When there is a conflict between the general privacy rights of the employee and the employers' interests, the legally protected interests have to be weighed against the employers' interests to determine on a case by case basis whether the general right to privacy merits priority.

According to the Federal Labour Court clandestine surveillance by technical devices is only permitted if there is a:

- Specific indication of a criminal offence or other serious misconduct at the expense of the employer;
- Less drastic means to clear up the suspicion have been exhausted;
- Covert surveillance is practically the only remaining means;
- The surveillance is proportionate, e.g. a cash deficit that cannot be cleared up in any other way.

Surveillance measures are not permitted to invade the employee's private sphere. Therefore, video surveillance is never permitted in rooms such as changing rooms and toilets. Even if the employees have been informed that a video camera or a similar technical device is to be installed at the workplace, this does not mean that surveillance is automatically admissible. Continuous surveillance will, in most cases, not be permissible because the pressure on employees caused by the feeling of being under constant observation could constitute a considerable infringement of their personal right. This applies particularly in situations where the employer has potential to use undetected surveillance. Again, in this case the interests of the employees have to be weighed against the legitimate interests of the employer.

The above-mentioned principles to safeguard the employee's privacy also apply to other surveillance measures by employers; e.g. eavesdropping on phone calls of employees at the workplace. If such calls are to be intercepted, employees must be notified in advance.

3. Data Processing Steps in Order to Reveal Criminal Conduct

With respect to monitoring measures which are intended to reveal criminal conduct by employees, it must further be noted that as of 1 September 2009, a new sec. 32

has been inserted into the BDSG which sets an explicit framework for such data processings. This provision has been adopted in the wake of several "privacy secondals" in Germany over companies spying on their employees.

Mostly the surveillance operations had been justified by the attempt to fight corruption.

According to the new law, any kind of processing and using employee data for purposes of unveiling criminal actions by employees is only lawful if:

- There is actual evidence which causes suspicion that the employee has committed a criminal offence in the framework of the employment relationship;
- The processing and use of the data is necessary for the prosecution of the crime; and
- There is no overriding legitimate interest of the employee in his data being excluded from such processing and use (in particular the data usage must not be excessive).

4. Involvement of the Works Council

Additionally, the monitoring of employees triggers a co-determination right by the works council (sec. 87 para 1 no. 6 of the Works Constitution Act). The works council has a right of co-determination especially in the event of the introduction and application of technical systems which are suitable for monitoring the conduct or performance of the employees. According to the rulings of the Federal Administrative Court automatic time recording systems are for example technical monitoring systems within the meaning of the Works Constitution Act.

II. Internet/E-Mail Use by Employees in Workplace

In the last few years, employees' private internet and e-mail use in the workplace has become a privacy issue. It is generally held, that by allowing the private use of internet and/or e-mail in the workplace, the employer qualifies as a telecommunication service provider in terms of the Telecommunications Act (TKG), so that he is principally bound to the telecommunication secrecy obligation enshrined in sec. 88 of this Act. Moreover, the data protection law provisions of the TKG apply with respect to permitted private e-mail and internet communication. As a matter of fact, these provisions hardly allow the employer to access the content of such e-mails or the continuous monitoring of private e-mail and internet use. Since it is not always possible to ascertain, whether a certain e-mail is of a private or business nature, conflicts with data protection laws are bound to occur. In order to avoid such conflicts it is recommended to either disallow private e-mail use or to put in place a clear policy which determines if and the extent to which private communications

may be subject to monitoring and may be forwarded to third parties (e.g. holiday replacements, successors).

III. Sharing Employee Information within Groups of Companies

Many German companies have IT-based systems in place for administrating their employee relationships. Apart from the storage of employees' basic data (e.g. name, address), such databases often serve additional purposes for example the recording of the times worked by employees, reviewing their performance etc. In groups of companies, such databases often are centralized and access to the data is granted not only to the local HR department but also to individuals who are formally employed by sister or parent companies in order to make a centralized budget possible and fee calculations or coordinated salary and bonus assessments. Such practice might give rise to data protection concerns because as a general rule, groups of companies enjoy no privilege under German data protection law as regards intra-group transfers of personal data.

IV. Outsourcing Employee Data Processing Operations

The outsourcing of data processing operations also has data protection law implications for employers. The Federal Data Protection Act provides for a so-called data processor privilege. According to this data processor privilege the communication of personal data to a data processor and the processing and use of this data by the processor do not require a specific legal basis. The data controller (i.e. the body which transfers the data to the processor) remains responsible for the data processor's compliance with the data protection rules. Yet, the establishment of a valid data processing agency (and accordingly the enjoyment of the privilege) requires certain arrangements:

- In particular, a written agreement establishing the data processing agency must be in place. Moreover, in this agreement, the technical and organizational measures to be taken by the data processor, the scope, purpose and type of data processing as well as other contractual terms such as inspection and control rights of the data controller etc. must be specified in detail.
- Moreover, the outsourcing of operations must be mainly restricted to data processing operations and must not be tantamount to a transfer of functions (*Funktionsübertragung*). Where there is such a transfer of functions, the data processor privilege will not apply with the effect that the transfer of personal data to the recipient will require a separate legal basis. In practice, it is often very difficult to determine whether an outsourcing of certain services should be regarded as a data processing agency or rather a transfer of functions. While

an outsourcing of IT services (e.g. hosting of systems, storing of data) and functions such as the operation of a call-center can generally be structured as a data processing agency to a third party they will most likely exceed the scope of such data processing agencies and be regarded as a transfer of functions. Therefore, if for example the complete HR functions and their respective employee data were to be outsourced it would most likely not benefit under the data processor privilege and would be considered a transfer of functions. In case of a transfer of functions it would be necessary to assess whether a different valid legal basis for the data processing operations that are inherent to the transfer (e.g. sec. 28 BDSG) could be found.

V. Transfer of Employee Data Outside the EU

For the assessment of the lawfulness of transferring employee data to third party recipients, the place of residence of the recipient is of particular relevance. In the event that the data are transferred within the European Economic Area (EEA) only, no particularities have to be observed. For legal purposes, the transfer of data within the EEA is treated in the same manner as a domestic transfer of data. However, there is a difference if the data is transferred to a recipient outside the EEA. Such data transfers are only permissible subject to the additional requirement that an adequate level of data protection is guaranteed by the body receiving the data (sec. 4b para 2 s. 2 BDSG).

Thus far, the EC Commission has confirmed in a general manner the adequacy of the data protection levels in Switzerland, Hungary, Canada, Argentine, Guernsey and the Isle of Man. With regard to the USA, the EC Commission has acknowledged the adequacy of the data protection level subject to the reservation that the company to which the data is transferred must have joined the so-called Safe Harbour. If a US group company obtaining the data is unwilling to sign the Safe Harbour Agreement or if the data transfers are to be made to other jurisdictions which are not officially recognized by the EC Commission, the transfer of data can nevertheless be organized in a manner that is in accordance with the law. According to the relevant provision, personal data may be transferred even if an adequate level of data protection is not guaranteed by the recipient of the data if the person concerned has consented or if the competent supervisory authority has permitted the data transfer because the recipient of the data furnishes sufficient guarantees for the protection of the transferred data. In particular, such guarantees may result from contractual clauses or binding corporate rules.

D. Appointment of a Data Protection Officer

If a certain number of people are concerned with personal data in the company, the employer shall appoint an internal Data Protection Officer. The officer is obliged to

ensure that the company complies with the applicable data protection laws. In particular he shall monitor the proper use of data processing systems and take suitable steps to familiarize the employees with the applicable data protection rules. The threshold for the number of people concerned with the automatic processing of personal data that triggers the obligation to appoint such an officer has recently been increased from 5 to 10 people (in the unlikely case of a manual and not automatic processing of personal data, the threshold is 20 people).

Eligibility for the appointment as Data Protection Officer is restricted to those who possess the necessary expertise and reliability. Therefore, in practice the CIO and/or head of IT are usually not eligible for this post due to possible conflicts of interest.

E. Key Aspects

- Ensure sufficient documentation and internal control of collection and processing of employee data.
- Appointment of internal data protection officer (if required).
- Ensure that each time the personal data of employees is collected it is either permitted by law or by a valid consent of the individual.
- Be aware that if an employee does not voluntarily consent, a declaration of consent by the employee might not be a valid basis for the processing of personal data in some cases.
- Be aware that transfers of the personal data of employees outside the EEA will require the implementation of model clause contracts or other means to safeguard an adequate level of data protection by the recipient.
- Be aware that appropriate outsourcing agreements that meet the legal requirements shall be in place when appointing data processors.
- Ensure the proper involvement of the works council with respect to the automated processing of personal data.

Chapter 13
Employee Inventions and Copyrights

Julia Schönbohm and Pascal R. Kremp

A. Introduction

Contrary to most other jurisdictions, under German Law inventions and technical improvement proposals belong to the employee. The employer may, however, be able to claim these rights. Following such a successful claim, the rights belong to the employer and the employee will be entitled to a financial compensation. The rules governing inventions and technical improvement proposals are provided for under the German Act on Employee Inventions (*Arbeitnehmererfindungsgesetz*).

Employee's products of work that enjoy copyright protection are governed by the German Copyright Act (*Urheberrechtsgesetz*). Under German law, the copyright as such always belongs to the author. The author is not limited to moral rights as in several other jurisdictions. It is, however, possible to grant the right to exploit and use a copyrighted work. Following his or her employment relationship, the employee is required to transfer the rights to use and exploit a copyrightable work to his employer without being entitled to an additional financial remuneration. For software, the rules are slightly different. If software that enjoys copyright protection is created during the employment, the rights to use and exploit the software are automatically transferred to the employer by virtue of law.

B. Employee Inventions and Technical Improvement Proposals

The German Act on Employee Inventions addresses the mutual rights and obligations of employers and employees relating to inventions and technical improvement proposals. This act aims to protect the employee and to ensure that he is adequately compensated for inventions and technical improvement proposals. The provisions are mandatory and cannot be excluded to the employee's disadvantage. Any agreement on the remuneration of an employee for an invention is invalid unless it is concluded after the invention was made and further provided that the remuneration

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agreed upon is adequate. Whether the remuneration agreed upon is adequate is subject to review by a special arbitration panel located at the German Patent and Trademark Office and the German civil courts.

I. Scope of Application

The German Act on Employee Inventions applies to employees who make an invention or a technical improvement proposal. The provisions only apply to employees but not to

- Managing Directors or board members who are part of the executive body of the company
- Freelancers, being persons who perform services on an independent basis and who bear the commercial risk of their business (see Chap. 4)

Considering that neither Managing Directors nor freelancers are subject to the rules on employee inventions, contracts with such persons should ensure that the company has been granted sufficient rights over the inventions and technical improvement proposals. Thus, Managing Directors and freelancers should be bound to an obligation to inform the company about inventions and technical improvement proposals and provide for a transfer of the rights. In the alternative, such contracts can also provide for the applicability of the German Act on Employee Inventions, if one wants to avoid the quite complicated rules on the remuneration of employee inventions or exclude an additional remuneration.

II. Employee Inventions

The German Act on Employee Invention entitles the employer to get access to inventions and technical improvement proposals that are made during the employment.

Employee inventions are inventions that an employee makes to fulfil his obligations under the employment contract or using specific know-how of the company. All other inventions are “free” inventions. The employer cannot secure access to free inventions.

To qualify as invention, the subject matter must be eligible for patent or utility model protection. This is, in principle, the case for technical inventions that are new and require an inventive step. Excluded from protection are mere discoveries, scientific theories, mathematical methods, aesthetic creations, schemes, rules and methods for performing mental acts, three dimensional structures of semiconductors (topographies), design rights and computer programs, unless they are incorporated into hardware components in a certain manner. Computer programs are usually covered by the German Copyright Act, which is outlined below.

III. Technical Improvement Proposals

Technical improvement proposals are suggestions for technical improvements that are not eligible for patent or utility model protection but which are nevertheless new creations. The requirements are met if a technical improvement proposal provides the employer with the possibility to exploit it in a way similarly to an intellectual property right.

C. Rights and Obligations of the Employer and the Employee

The German Act on Employee Inventions contains detailed requirements that the employer and the employee must follow to ensure the transfer of rights relating to the invention to the employer.

I. Notification

The employee is required to notify the employer about an invention in text form (for example in writing, via email or via fax) immediately after having made the invention. If several employees contributed to the invention, all of them can prepare a respective report. The purpose of the report is to enable the employer to understand the nature of the invention and to have its patentability assessed by an expert. It is thus necessary to provide the details that allow the employer to get a comprehensive picture of the invention that was made to enable the employer to exercise its duty to seek patent or utility model protection, if the invention turns out to be protectable. Moreover, it should provide the basis for the employer's decision whether to claim the invention or not. The report must therefore contain the following information:

- Description of the technical task including the technical outcome that is achieved by the invention.
- The technical solution, which requires mentioning the technicalities which are needed for the technical task to be solved. This does not only require outlining the main idea of the invention but also potential variations, particular embodiments and alternative solutions, to the extent the employee knows about them.
- A description of how the invention was made including any instructions the employee received from the employer or guidelines and any experience the employee gained while working for the employer. Moreover, the report should state which other employees were involved and what they contributed.

II. Obligations of the Employer

After having received a proper report about the employee invention, the employer needs to decide whether to claim the invention in order to be granted rights over it. In this regard, the employer has the following obligations:

- The employer needs to confirm the date on which it received the report in text form.
- If the report is incomplete or unclear, the employer must request the missing information within 2 months after having received the initial report.
- Within 4 months of having received a proper report about the invention, the employer needs to decide whether to claim the invention or not (see below). The employer is required to seek protection after having received a notification of the invention without undue delay to secure the priority date. The employer has to bear the costs of the application, even if it subsequently decides not to claim the invention. If the employer does not comply with this obligation, the employee is entitled to file an application on behalf of the employer and can claim the costs it incurs in connection therewith from the employer.
- The employer needs to inform the employee about the status of the application.

III. Transfer of the Rights Relating to the Invention

The employer can decide whether to claim the invention or not. By claiming the invention, all rights relating to the invention transfer to the employer by virtue of law.

The invention is deemed to be validly claimed if the employer does not waive its rights to the invention within four months upon receipt of the invention disclosure. In consequence, any failure to explicitly claim the invention within the period has not negative effect on the ownership of the employer. If the employer on the contrary explicitly refrains from claiming the invention within this period, the invention will be considered free. In that case, all rights relating to the invention will remain with the employee who is free on how to dispose of the invention.

IV. Exceptions to the Obligation to Apply for a Patent or Utility Model

The employer may abstain from filing for a patent or utility model if he has a legitimate interest not to disclose the invention to competitors and to the general public. In case of a dispute between the employer and the employee as to whether the employer has a legitimate interest to disclose the invention or not, the mediation

panel, which is a specialised body of the German Patent and Trademark Office, has jurisdiction to resolve such a dispute.

The employer is not obliged to seek protection outside Germany. If it decides, however, that it does not want to secure protection outside Germany, the employer is required to release the invention for those countries and to allow the employee to obtain rights abroad. The invention should be released early enough to allow the employee to benefit from the priority date that applies for seeking patent protection abroad, in particular the 12 months period provided for in the Patent Cooperation Treaty.

D. Abandonment of the Rights

The employer is required to maintain patent or utility model protection and has to bear all costs in relation thereto. The employer may only abandon the rights after the employee has been fully compensated for the invention. This is rarely the case. Thus, the employer is usually required to inform the employee of its intention to abandon certain rights relating to an employee invention. The employee has 3 months after having been informed of the employer's intention to abandon a patent and can request the retransfer of the rights at his own costs. The employer may only abandon the intellectual property rights if the employee does not request a transfer of the rights within this period or does not react at all. If the employer violates its obligation to inform the employee, the employer will be liable for damages.

E. Remuneration

The German Act on Employee Inventions aims at ensuring that the employee gets a fair share of the value of the invention. In exchange for the possibility to get access to all rights relating to an employee invention, the employer is required to compensate the employee for the invention.

I. Extent of the Obligation to Compensate the Employee

If the employer claims the invention, it is required to remunerate the employee until the expiration of a registered patent or utility model. The obligation to remunerate the employee does not require that the patent or utility model is registered. If the employer has already used the invention before registration, it has to pay a preliminary compensation. As a general rule, the employee is entitled to a certain percentage of the final compensation, depending on the likelihood that a patent or utility model will be issued for the underlying invention. If it later turns out that no patent or utility model will be granted, the employee is entitled to keep the remuneration already obtained.

II. Calculation of the Remuneration

The employer and the employee are required to agree on an adequate compensation. If they cannot reach an agreement, the employer is required to determine the remuneration at an adequate level. Such remuneration is usually calculated according to the Guidelines of the Ministry of Labour and Employment (see below).

1. Procedure

The statutory deadline to reach an agreement on adequate compensation is 3 months after a patent or utility model has been registered or the underlying invention is used. If the employer and the employee do not reach an agreement, the employer will determine the remuneration and inform the employee accordingly in text form. The employee then has 2 months to object to the compensation that the employer determined. In that case, the employer is still bound to his own determination and required to pay this amount as minimum compensation to the employee.

2. Calculation Method

If the employer and the employee cannot agree on an adequate remuneration, the remuneration is usually calculated according to the Guidelines on the Compensation for Employee Inventions in the Private Sector (*Richtlinien für die Vergütung von Arbeitnehmererfindungen im privaten Dienst*). The Ministry of Labour and Employment issues these guidelines. They contain detailed provisions and calculation methods to determine adequate compensation for an employee invention. Even though these guidelines are not binding, the courts usually refer to them to determine adequate compensation. According to the guidelines, the value of the invention and the contribution of the employee to the invention are the critical factors to determine the adequate compensation.

3. Value of the Employee Invention

There are three calculation methods to determine the value of an employee invention:

- Licence analogy
- Calculation according to the use for the company
- Estimate of the value

The most common calculation method is the licence analogy. This method must be used if turnover is generated from the invention. The turnover generated is the best indicator for the market value of the invention. The value of the invention is

determined by multiplying the turnover with the usual licence fee. The turnover is the remuneration that the employer made by selling the products covered by the invention. In practice, the most difficult part is to determine the adequate licence fee and the calculation basis. German courts usually look at what reasonable parties would have agreed on as royalty.

If an invention is only used internally within the company, the value is determined by the use of the invention for the company. In that case, the possibility to use the invention is relevant. The internal advantages and benefits of the application of the invention are the relevant factors to determine the value of the invention. If this method is not possible either, the value must be estimated.

4. The Employee's Involvement

The guidelines consider it unfair to treat an employee inventor similarly to an independent inventor, since the latter has to bear the risk of the development and the exploitation of the invention and does not benefit from the employer's contribution to obtaining the invention. Thus, the employer's contribution to the invention reduces the value of the invention. This consists of three sub-factors, namely who was asking the technical task, the contribution to the solution and the duties and the position of the employee inventor within the company.

The guidelines also provide further details to determine the value of the employee's involvement. The smaller the employer's contribution in respect of the technical task and its solution, and the lower the previous knowledge and the position of the employee is within the company, the higher is the part to which the employee inventor is entitled. The average factor of the employee's contribution ranges between 10 and 25%.

F. Litigation

In case of a dispute between the employer and the employee as to the employee's adequate remuneration, either party is entitled to consult the mediation panel (*Schiedsstelle*), which belongs to the German Patent and Trademark Office. This consultation is free of charge and neither party can claim its expenses. The mediation panel will try to reach a settlement. Only after consulting the mediation panel it is possible to file a lawsuit before a civil court.

G. Copyrights

Unlike for employee inventions and technical improvement proposals, there are no specific provisions that govern works which an employee may create in the course

of his employment and which are protectable under copyright. Such works are covered by the German Copyright Act. The German Copyright Act expressly includes computer programs and therefore is of growing importance.

The rights relating to copyrightable works created by an employee depend on whether the works were created to fulfil the main obligations under the employment contract or whether they were developed without any connection to the employment. Works created without any connection to the employment are free works and not subject to any restrictions.

Copyrightable works created in the fulfilment of the obligations under the employment contract are called "works on duty." The rights to use and exploit such works belong to the employer. The employee is required to grant the employer the exclusive rights to use and exploit "works on duty." For software developments it is not necessary that the employee grants the employer a licence to exploit such software. The exclusive rights to use and exploit software created in the course of an employment are automatically granted to the employer by virtue of law. Whether the employee author of a copyrightable work on duty is entitled to compensation in addition to his remuneration under the employment contract is still subject matter of controversies. The case law varies and this has to be checked for each individual case. Only in exceptional cases may the employee claim an additional compensation according to the general provisions applying to authors of copyrightable works under the German Copyright Act.

H. Key Aspects

- Unlike in most other jurisdictions employee inventions and technical improvement proposals belong to the employee.
- The employers can claim access to those rights following a detailed process, including the determination of the employee's compensation.
- Copyrights (which include computer programs) created in performance of the employment, may be used and exploited by the employer.

Chapter 14
Non-Competition Clauses

Michael Magotsch and Pascal R. Kremp

A. Introduction

In Germany the law in relation to non-competition clauses is contained in the German Commercial Code (*Handelsgesetzbuch, HGB*) and applies both during the term of the employment relationship and after its termination (where there is a contractual post-employment non-competition provision). The relevant provisions of the Commercial Code are mandatory and must be observed.

The provisions contained in the Commercial Code are different from those found in most other countries, since they provide for a compensation payment (*Karenzentschädigung*) for the period of a post-contractual non-competition clause. Such clauses can consequently become a heavy financial burden for an employer, especially during periods of economic crisis when major downsizing is necessary. Therefore, it is advisable for the employer to carry out an audit of its contracts to establish whether the non-competition clauses are in fact necessary or whether the majority of them can be waived. Usually, post-contractual non-competition clauses are advisable only for key employees with knowledge of company's business secrets (e.g. R&D employees) or with very close client relationships (e.g. Head of Sales)

Employers should be aware that for employment contracts dated on or after 1 January 2002, general terms and conditions (*Allgemeine Geschäftsbedingungen*) that are drafted solely by the employer e.g. on the employer's standard terms, will be subject to the provisions of the German Civil Code (*Bürgerliches Gesetzbuch, BGB*). This will include post-contractual non-competition clauses. Where such clauses deviate from the provisions of the Civil Code to the disadvantage of the employee, they might be invalid and void. As a basic principle, any ambiguities concerning contract clauses are solved to the advantage of the employee. Therefore, it is advisable for the employer to draft non-competition clauses very carefully.

It is the established legal practice of the Federal Court of Justice (*Bundesgerichtshof, BGH*) that the principles laid down in the Commercial Code do not apply directly to executives such as managing directors and board members. However,

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the court has ruled that post-contractual non-competition clauses for executives need to comply with the principles of public policy and should not unreasonably affect a person's freedom to choose and carry out their career, pursuant to art. 12 of the German Constitution (*Grundgesetz, GG*).

B. Post-Contractual Non-Competition Clauses

Post-contractual non-competition clauses for employees must comply with the provisions in the Commercial Code, whereas the strict regulations of the Code do not necessarily apply to executives/managing directors as officers of the company.

I. Employees

The Commercial Code sets out detailed requirements for the validity of post-contractual non-competition clauses for employees, as follows.

1. Form

Post-contractual non-competition clauses must be in writing and signed by both parties, otherwise they are null and void. It is sufficient for such a clause to be contained in the employment contract if the contract itself is in writing and signed by both parties.

2. Compensation Payment During Non-Competition Period

The clause must make provision for a compensation payment in relation to the whole length of a non-competition clause, regardless of the extent of its application to the branch or business of the employer. If the compensation payment as stipulated in the contract does not meet the minimum statutory requirements, the employee has a choice whether or not to comply with the non-competition clause. If the employee chooses not to comply, the clause is not enforceable by the employer. If the employee decides to comply, the employer must pay the compensation payment as stipulated. If the clause does not contain a provision for a compensation payment at all, the clause is null and void.

Case law has prohibited any attempts to bypass the requirement to make a compensation payment by drafting very extensive client protection clauses. The courts treat extensive customer protection clauses as non-competition clauses which should therefore provide for a compensation payment in order to be enforceable.

3. Calculation and Payment of the Compensation

The employee should receive a monthly payment of at least half of his former gross earnings. In detail, compensation payments are calculated as follows:

- The compensation payment is calculated by reference to the gross salary, including bonus, incentive payments, payments in kind and/or other elements of pay. Only the employer's contributions to social security schemes are excluded. Where the amount of bonus and incentive payments change over a year, the average of the last 3 years must be taken into account. The Federal Labour Court has not yet had to decide whether the calculation should be based on the last annual gross salary or on the gross salary earned in the last month of employment. The lower courts tend to refer to an annual period. However, the matter is subject to controversial discussions so careful attention should be paid to future court decisions.
- The employee will receive at least 50% of the total for the year.
- This amount is then divided by 12 and payment to the employee must be made monthly.
- It does not make any difference if parts of the employee's salary, e.g. bonuses or stock options, are paid by a third party as long as it is paid to compensate the employee for his performed services. This might be the case if the employee works for a company which is part of an international group.

Note that even if the employee is not in a position to compete, for example in the event of illness, or the employee is undertaking a further qualification course, the employer is still obliged to pay the compensation payment for the whole length of the non-competition clause.

4. Further Requirements: Legitimate Interest of Employer – Sector, Geographical Area and Duration

A non-competition clause can only have effect to protect the legitimate interests of the employer. The courts have developed the following criteria from this requirement:

- Sector and geographical area: Case law has shown that a non-competition clause that is extended beyond the sector of the employer is too broad, as is a worldwide clause. In such cases, the courts will adjust the clause. The adjusted clause will still be enforceable and the employer will therefore still have to pay the compensation payment.
- Length of non-competition clause: Non-competition clauses can only be binding for a period of up to 2 years. If a longer period has been agreed between the parties, after 2 years the employee will have the choice of continuing to comply with the non-competition clause and receiving a compensation payment, or ceasing to comply and entering into competition.

5. Set-Off of Employee's Earnings Against Compensation Payment

If the employee works during the length of the non-competition clause, any earnings from his new job must be set off against the compensation payment if the compensation payment plus the earnings from the new job together exceed 110% of the salary used to calculate the compensation payment. If the new earnings and the compensation payment exceed 110% of the old annual salary, the compensation payment can be reduced by the amount exceeding the 110%-level.

Average of last 12 salaries	3,000
Compensation	1,500
New salary	2,500
110% of old salary	3,300
Amount to be deducted	700 [(1,500 + 2,500) − 3,300]
Compensation payment can be reduced to	800 (1,500 − 700)

In such a situation, the employer has the right to ask for disclosure of the employee's new salary.

If the employer has agreed on a compensation payment which is higher than 50% of the average of the last 12 salaries, the 110% limit will not be increased to take account of this.

In the event that the employee is forced to move location in order to obtain new employment, the threshold that has to be exceeded by new earnings and compensation payment is increased to 125% of the old salary.

6. Rights of the Employer in the Event of Breach

If the employee breaches the non-competition clause, different options are available to the employer, as follows:

- Claim damages from the employee
- Apply for an injunction to restrain the employee immediately from the competing activity (Cease and Desist Order) or
- Immediately stop paying the compensation payment and demand reimbursement of the compensation already paid during the period the employee has been competing

Under German law it is almost impossible to prove that the employer has been damaged by the breach of a non-competition clause. It is therefore advisable to include in the employment contract a penalty clause applicable to breaches of the non-competition clause.

7. Choice of Employee

Even if the clause is valid under the statutory provisions of the Commercial Code, the clause may not be enforceable in all cases. The Code provides for the employee to have a choice of whether to comply with the clause or not in the following cases:

- In the event of dismissal due to business reasons
- In the event of summary resignation of the employee following a breach of contract by the employer

In such cases, the employee can either choose to comply with the non-competition clause and claim the compensation payment, or choose not to comply with the competition clause which will then become unenforceable. In the latter case the employee has to give written notice that he is not bound by non-competition clause within 1 month of the date of dismissal.

8. Waiver by the Employer

Non-competition clauses can become a substantial financial burden so the employer will often want to waive the clause on the basis that any potentially competitive activity of the employee will be less harmful to the business than having to make the compensation payment.

Where the employer decides to waive the non-competition clause, the obligation to pay the compensation payment will continue for the period of 1 year following the waiver. As the compensation payment is only payable after the end of the employment relationship, it is only worthwhile waiving the non-competition clause at a point in time considerably prior to the end of the employment relationship.

II. Executives

Executives of the company such as the managing director of a limited company (*GmbH-Geschäftsführer*) or a board member of stock corporations (*AG-Vorstand*) are generally not considered to be employees. Thus, the rules set out above do not apply automatically. Case law has developed rules based upon the Commercial Code and the reasoning that a non-competition clause is only justified if it protects a legitimate interest of the company, and that it should not hinder the executive unduly in his professional development, as follows.

1. Legitimate Interest of the Company

A non-competition clause must be intended to protect the confidential information and client connections of the business.

If a non-competition clause merely aims to prevent a competitor from employing a certain executive, it will not be valid since this is not recognized by case law as a legitimate interest of the company.

2. Geographical Scope of the Non-Competition Clause

In order for a non-competition clause to validly apply to an executive, such clause has to contain a geographical limitation. If the clause applies worldwide, or if a geographical limitation is omitted, the clause will be considered too broad and will be null and void and therefore unenforceable under German law.

3. Term of the Non-Competition Clause

Generally, clauses prohibiting a certain activity or activity in a certain geographical area or in a specific business sector can only be applicable for a period of up to 2 years. However, a shorter term may be required depending on the circumstances.

4. Compensation Payment

The rules laid down by the courts in relation to compensation payments in non-competition clauses for executives are not as clear or precise as they are in respect of employees. Whether a compensation payment is required will depend upon the particular circumstances, i.e. the nature and sector of the business or the geographical scope. It is usually advisable to provide for a compensation payment to ensure the validity of the clause. However, it is not possible to give general guidance as to whether to include a compensation payment and for what amount, because the courts tend to evaluate each case according to its specific circumstances.

5. Set-Off of Earnings of the Executive During the Period of the Non-Competition Clause Against Compensation Payment

In contrast to the provisions applicable to employees in the Code, there is no automatic set-off of an executive's earnings. A set-off provision must be included in the non-competition clause from the outset.

6. Waiver

If provided in the contract, the company may waive a non-competition clause before the end of the contract relationship, but it will then be bound by the obligation to pay the compensation payment for the period of 1 year from the date of the waiver.

In contracts with executives it may generally be agreed that the non-competition clause can be waived subsequent to the end of contract and with a shorter remaining non-competition period, (e.g. 6 months). However, the company will in any case have to respect the notice period for the termination of the service contract as well as for the waiver of the non-competition clause.

7. Executive's Choice

If the executive resigns due to the employer's breach of contract, the executive has the choice of whether or not to comply with the non-competition clause.

8. Breach of Non-Competition Clause: Options of the Company

If the executive breaches a non-competition clause, the company has a number of options:

- Claim damages from the executive
- Seek an injunction requiring the executive to cease the competing activity immediately
- Cease making compensation payments and demand reimbursement of the amount of compensation paid during the period the executive has been competing

As previously mentioned, in respect of employees, in German law it is virtually impossible to prove that the company has suffered damage as a result of the breach of a non-competition clause. It is therefore advisable to include provision for a penalty payment in the event of breach of a non-competition clause.

C. Contractual Non-Competition Obligation During Employment

I. Employees

The Code imposes a legal obligation on employees to refrain from competing with their employer's business during the employment relationship.

1. Scope of Prohibition

The obligation not to compete prohibits the employees from setting up their own business, working as an employee or contractor for a competitor, and acting occasionally as a competitor within the field of the employer's business. This is not an exhaustive list but all activity which may be considered to be competition, is prohibited.

2. Steps Available to the Employer in the Event of Breach

The employer may:

- Claim damages
- Demand disclosure of the employee's profits made while competing
- Demand that the employee hands over the profits made while competing
- Demand the transfer of the rights and duties under ongoing contracts entered into by the employee and in this way, take over the employee's ongoing competing business
- In the case of a substantial breach, dismiss the employee without notice on the grounds of misconduct

II. Executives/Managing Directors

Managing directors (*Geschäftsführer*) have a legal obligation not to compete even in the absence of particular provisions in their contracts, as this is part of their fiduciary duty to the company.

1. Scope of Prohibition

Executives must refrain from any action, which could be seen as competitive e.g. setting up their own businesses and becoming managing directors or major shareholders of the company's competitors. The reasoning behind this rule is that executives should not benefit or profit personally from knowledge they have acquired as a result of their positions with their employing companies.

2. Steps Available to the Company in the Event of Breach by the Executive

The company may:

- Claim damages
- Claim disclosure of information relating to sales and profits made while competing and demand payment of profits made while competing
- Apply for an injunction
- Dismiss the executive without notice

D. Key Aspects

The following lists the basic requirements for post-contractual non-competition clauses for employees and the options open to an employer in the event of breach.

Requirements for a non-competition clause:

- The non-competition provision must be in writing.
- It must provide for a compensation payment during the entire time period covered by the clause.
- The compensation must amount to at least 50% of the employee's total earnings in the last year.
- The clause must be limited to 2 years.
- The clause must be justified by the legitimate interests of the employer, and cannot be extended beyond the employer's sector and can only on very rare occasions be extended worldwide.
- In the event of breach of contract by the employer, the employee can choose whether or not to comply with the clause. This applies also to a dismissal for business reasons.
- Options to an employer in case of a breach of contract by the employee:
  - Apply for a cease and desist order (injunction)
  - Claim damages
  - Demand disclosure of profits made while competing
  - Demand the employee hand over the profits made while competing;
  - Dismissal
- Last but not least, any employer should carefully consider initiating an audit to verify whether unnecessary non-compete clauses should be waived and thereby contractually cancelled.

Chapter 15
Termination of Employment

Michael Magotsch and Pascal R. Kremp

A. Introduction

At a first glance, terminating an employee's contract of employment seems to be more complicated in Germany than in other jurisdictions. If someone is familiar with the practice, however, this is not the case. One main difference in comparison to most other jurisdictions, is that employees are entitled to reinstatement if the dismissal is not supported by sufficient reasons. In all other situations, the employee is not entitled to any severance at all. Usually, courts cannot award a severance payment. Due to this situation – all or nothing – employer and employee mutually agree in more than 80% of all cases on a termination of the employment relationship in consideration of a severance payment. Negotiating the severance payment may be troublesome and time consuming, but will result in a fair severance payment in most situations.

German law does not recognise employment at will. In principle, employees can only be dismissed if the termination is supported by specific reasons and by observing the applicable notice period. Only in rare circumstances, e.g. expense fraud or other gross misconduct, is the employer entitled to dismiss with immediate effect (so called summary dismissal).

There are in principle two types of employment termination
Regular termination by observing the applicable notice period *Such termination has to be supported by sufficient person-related, conduct-related or operational reasons in operations with more than 10 employees*
Summary dismissal for cause with immediate effect

Prior to any dismissal the employer has to inform and consult an existing works council. Otherwise, the dismissal is null and void.

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B. Notice Period

The parties to an employment contract may agree on a specific notice period. The notice period for termination by the employee must not exceed the notice period for a termination by the employer. For key employees, the contract often provides for an extended notice period of 3–6 months, sometimes even longer.

Most employment agreements, however, provide for the statutory notice period. The German Civil Code provides for minimum notice periods for a dismissal by the employer. Only if the parties are subject to an applicable collective bargaining agreement, may the statutory notice period be reduced.

The statutory notice period depends on the duration in years of service.

The statutory minimum notice periods for terminations by the employer are (after 2 years of service always effective to the end of the calendar month)
During first 2 years of service, 4 weeks effective to the 15th or to the end of a calendar month
After 2 years of service, 1 month
After 5 years of service, 2 months
After 8 years of service, 3 months
After 10 years of service, 4 months
After 12 years of service, 5 months
After 15 years of service, 6 months
After 20 years of service, 7 months

The minimum notice period for a termination by the employee is 4 weeks effective to the 15th or to the end of a calendar month. Since many employers want to avoid that employees, in particular employees with important know-how, can resign with such short notice period, the employment agreement often provides for the same notice period that is applicable to a termination by the employer.

Most employment contracts provide for a probationary period which may not exceed 6 months. During the probationary period both parties may terminate the employment relationship by giving 2 weeks notice if the contract does not provide for an extended notice period.

C. Termination Notice

Any termination of an employment agreement – either a notice or a severance agreement – has to be in writing. Otherwise, the termination is null and void and the employment relationship continues.

The termination notice has to be signed and must be served to the other party in original form with the original signature. Copies, faxes, emails, computer signatures

etc. do not meet the statutory requirements. The dismissal would be null and void. Employers should assure that the dismissal is signed by an individual that is registered in the commercial register (e.g. managing director, proxy holder). Otherwise, the employee might be able to reject the dismissal letter without undue delay (usually 1–2 weeks) arguing he or she would not have knowledge if the person who signed the dismissal letter is authorised to do so. In this case, the dismissal would again be null and void. The employer would have to repeat the dismissal, but the notice period would start anew.

Usually, the termination notice does not need to provide for the reasons for the termination. There are certain exceptions for termination of employees on maternity leave and for trainees.

D. Service of the Termination Notice

The notice becomes only effective upon service to the other party. Only then, the notice period will be triggered.

The burden of proof that the notice has actually been served on the employee is on the employer. Therefore, the employee should be asked to confirm receipt of the notice (as original letter) on a copy of the original letter. If the employee refuses to confirm receipt the employer should call for another person who witnesses the service. However, managing directors or board members are not permissible witnesses since they are considered as the employer himself. If the notice is not served in person, but to the employee's home, the employer again needs to make sure he can prove the services and on what date (and time) the letter was served. Best way is to use a courier who again confirms on a copy that he dropped the original termination notice in the mailbox of the employee and the date and time of service. Registered mail is not recommended. If the employee is not at home, the service would only occur once the employee picks up the letter at the post office (if at all). Only then, the notice period would be triggered.

E. General Termination Protection by Social Justification

Under German Law, employees are protected against termination of their employment by the Dismissal Protection Act (*Kündigungsschutzgesetz – KSchG*). According to the Act the termination of the employment contract of an employee will be legally effective only if "socially justified." Social justification means that there is one of three statutory grounds that support the dismissal, i.e. that there is either a conduct-related, person-related or operational reason for the termination.

I. Scope of Application

The Act is, however, only applicable to employees who have been employed for more than 6 months and if more than ten employees are employed in the business (*Betrieb*).

The Dismissal Protection Act basically applies to
Every business operation with usually >10 employees
If the respective employee to be dismissed has been employed in the same business operation or company for >6 months

1. Size of the Business: Small Business Exemption

The Dismissal Protection Act applies only to businesses (*Betriebe*) usually employing more than 10 employees in Germany.

Part time employees count pro rata. Employees working not more than 30 h per week count 0.75, employees not working more than 20 h per week count 0.5.

Students or cleaning services may also be considered as employees depending on the circumstances.

Due to a subsequent amendment, the Act also applies to employees of a business, with not more than 10 employees, who were already employed on 31 December 2003, provided that there are more than 5 employees that have been employed since then.

Example: A company has 8 employees. 6 of them have been employed at least since 2003. Those 6 would enjoy protection under the Act, the other 2 would not. If only 5 employees had been employed at least 2003, any of the 8 would enjoy protection.

2. Term of Employment

The Dismissal Protection Act applies only to employees who have been employed for more than 6 months. According to case law, this is even true if the employment agreement does not explicitly provide for a probationary period.

It is sufficient, to serve the dismissal letter on the very last day of the 6 months period even though the notice period would expire only after 6 months of employment.

3. Reasons for Termination

If the Act does not apply, the employer does not need a specific reason to terminate an employment relationship. Thus, the risk that the employee will challenge the effectiveness of the termination in the courts resulting in a severance payment, which would be mutually agreed, is very low. The termination would only be

deemed null and void if it is found violating public policy (e.g. if on discriminatory grounds).

Therefore, employers should carefully review newly hired employees during the first 6 months and take a decision during this time whether to continue the employment relationship or not. Once the employee has been employed for more than 6 months a dismissal will become significantly more expensive.

Also, in small businesses employers should carefully consider whether to hire more than 10 employees. Passing this threshold of 10 employees will immediately provide these employees with protection under the Dismissal Protection Act.

II. Reasons for Termination

Social justification of a termination requires that the employee's termination is on grounds related to the employee's conduct, for person-related or for operational reasons.

The Dismissal Protection Act (*KSchG*) sets out 3 statutory reasons which may socially justify a termination
Person-related reasons
Conduct reasons
Operational reasons

1. Person-Related Terminations

Generally speaking, a termination for person-related reasons will be considered socially justified if the employee has lost his ability to perform his contractual duties. Pursuant to case law, such a termination has to meet a 3-prong test:

First, at the time the termination is served, it can be presumed that the employee will not regain his ability to perform the working duties in the foreseeable future (negative prognosis).

Second, due to the inability of the employee to work the employer has to suffer a serious detriment to his business interests. Such a detriment may be assumed, e.g. from a loss of production, machinery breakdowns, loss of customers, inability to find adequate substitute staff.

Finally, the interests of the employer must outweigh the interests of the employee. The employer has to consider on behalf of the employee, e.g. his or her age, number of dependents, years of service. As the termination has to be *ultima ratio* the employer is also required to consider relocating the employee to another vacant position within the same business or to take any other appropriate action to avoid the termination.

Since person-related reasons are not due to the employee's own fault, no prior warning is required.

Typical personnel related termination issues are illness and alcohol or drug addiction. Since it is up to the employer to prove before court that the employee is in fact incapable of working, it is nevertheless often advisable to issue a warning letter first to also meet the requirements for a conduct-related dismissal. Often, the employer may not be able to provide convincing evidence for the addiction of an employee.

a) Illness

Illness may be sufficient reason for a person-related termination. Key issue is whether it can be expected that the employee will not come back to work for the foreseeable future. Reason for such a termination is not to punish the employee for past illness.

aa) Long Term Illness

Long term absence from work may justify a termination for person-related reasons. There is no settled case law on the length of such illness before it can be assumed that the employee will not return for the foreseeable future and that this would result in a significant detriment to the business. This obviously depends on the individual circumstances of the case at hand. Certainly, an absence of 6 weeks is not sufficient since this equals the period for statutory sick leave. Case law has ruled that in the event an employee has been off work for 18 months and his return is not foreseeable, a detrimental impact on the company's business might be assumed, thus, a dismissal could be justified.

bb) Frequent Short Term Absences

Frequent short-term absences may be sufficient reason for a termination if it is very likely that the employee will be absent due to illness in the future. According to case law only absences of about 15–25% in total within the last 3 years will be regarded as frequently. Absences of not more than 6 weeks per year (equals maximum sick pay leave) are unlikely to be sufficient for a termination.

b) Alcohol or Drug Addiction

If an employee is addicted to alcohol or other drugs, this may be sufficient for a termination, in particular if his disease results in poor work performance or absences. A negative prognosis is more likely since there is an empirical experience that alcoholism or drug addiction is difficult to cure. Employees, however, are not obliged to participate in breathalyzer or alcohol blood tests.

c) Work Permit

Losing a work permit may justify a termination if it is not likely that the employee will be reissued a new work permit within due course.

2. Conduct-Related Termination

The employer may respond to a breach of the employee's contractual duties by termination on conduct-related grounds. The social justification of such a dismissal is to be determined by 4 criteria:

- First, there has to be an objective reason, meaning that the employee has significantly breached the contractual duties.
- Second, it must be likely that the employee will breach the working duties again in the future (negative prognosis). The aim of a conduct-related termination is not to punish the employee for his past conduct, but to avoid future breaches of the contractual duties. Subsequently – and unlike a termination based on person-related grounds – the employer is obliged to issue a warning to the employee prior to a dismissal. A dismissal without prior warning is void. But a warning is not required if it is evident that the employee does not behave in compliance with the contract of employment.
- Third, the employer's interest to terminate the relationship outweighs the interest of the employee. The social data (e.g. age, number of dependents, seniority) have to be considered on behalf of the employee.
- Finally, the termination must be *ultima ratio*. No less restrictive means may be available. Hence, the employer has to consider, e.g. to reallocate the employee to a different job position.

The burden of proof is on the employer with regard to the objective reason constituting a breach of contract. The employer has to introduce evidence that, e.g. the employee was absent from work and at what time. Thereafter, the burden of proof shifts to the employee. He must come up with evidence that he was absent for good reason, e.g. he was sick.

a) Typical Issues of Misconduct

Typical issues arising out of conduct-related dismissals include:

aa) Alcohol or Drug Use (Not Addicted)

Usually, employees are not allowed to drink at the work place or to work under the influence of alcohol or drugs, if there is the possibility of harming themselves (e.g. working at dangerous machines) or others (e.g. drivers). In such a case, it might even not be necessary to issue a warning letter prior to a dismissal. The employer may

generally prohibit any alcohol or drug use with the consent of the works council. As a matter of fact, the employer has to provide evidence before court that the employee consumed alcohol or drugs. Since alcohol or drug tests are not permissible without the consent of the employee, this can be difficult. It can be useful to have witnesses reporting that the employee had alcohol on his or her breath.

bb) Unexcused Absence

Repeated unexcused absences constitute a breach of the employment contract. A typical situation includes one where the employee unilaterally "extends" vacations. In fact, in most cases employees provide a medical certificate which is quite easy to obtain in Germany. It is nearly impossible for the employer to show before court that the employee was in fact not sick.

cc) Misconduct Off-Work

Off-work misconduct may only justify a termination if the misconduct has an impact on the employment relationship. This may be the case, for example, if a truck driver loses his driving license because of a private drive under the influence of alcohol.

dd) Union Activities

Union activities are protected by the constitution and do not justify a termination.

ee) Poor Performance

Surprisingly, it is rather difficult to terminate an employee based on poor performance. The case law is very strict. The reason is that employees only have a duty to perform their job to the average kind and quality and based on their individual abilities. Otherwise, there will always be someone in the workforce who does not perform to the required standard. Thus, it may only be permissible to terminate a low performer if the work performance is significantly lower than comparable average employees – case law has often discussed a requirement of at least 30%. The key issue is to determine which employees are really comparable. E.g. if sales employees are responsible for different territories, the employee might argue that it would be much more difficult to create new business in his particular territory since the region has a weak economy. Also, the employee could provide evidence that he is working to the best possible standard under the circumstances. In fact, employers are well advised to better manage low performers by giving clear working instructions, e.g. a specific number of cold calls or customer visits per week. If the employee fails to follow such instructions, the employer may give a warning and then later terminate the employee's contract if there is a continuing failure to follow the instructions.

ff) Inappropriate Conduct Towards Employer and Co-Workers

Employees denunciating and treating co-workers inappropriately may be terminated for conduct-related reasons. However, like in cases of sexual harassment, the employer could face difficulties to prove the allegations.

b) Warning

Terminations based on conduct-related reasons usually require a prior warning to request the employee to stop his misconduct in the future. Without such a warning a conduct related termination usually will be null and void. Unlike a conduct related dismissal a person-related dismissal does not require a warning because the employee is typically not able to change his characteristics or inability to perform the contractual duties.

A warning must not be in writing. However, in order to give evidence in a subsequent law suit for wrongful dismissal, it is advisable to state warnings in written form.

Also, warning letters have to include specific content to be effective. In particular, they have to describe the shortcomings of the employee and set out how the employee should have performed his job. Also, the warning letter has to emphasise that should the employee repeat his misconduct, this may result in a dismissal.

3. Terminations for Operational Reasons

A dismissal for operational reasons has to meet a 3 prong test:

- First, the dismissal must be based on compelling operational or business reasons. The employer has to show why a specific job position ceases to exist.
- Second, the employer has to carry out a so-called "social selection" between employees who are comparable to each other.
- Third, there should be no other available job position which could be offered to the employee in question.

a) Compelling Operational Reasons

The dismissal must be based on compelling operational or business reasons. The employer has to provide evidence for why a specific job position should cease to exist. Case law distinguishes between so called internal and external business reasons. Usually, it is much easier to argue on the basis of internal reasons.

A termination for operational reasons may be on the basis of on a commercial decision by the business – perhaps a decision by which the employer is trying to react to a certain economic, possibly industry wide situation. Thus, the demand for a product might drop, sales may fall, or profits shrink. The Federal Labour Court recognises such grounds as external business reasons.

Moreover, based on an analysis of the business' situation within the economy, the business may set goals and make plans, which lead to particular commercial decisions. The Federal Labour Court recognises such commercial decisions as internal grounds for a termination for operational reasons. Examples of such commercial decisions include modifications of production methods or the introduction of new ones, changes within the organization (such as the introduction of lean management or group labour), operational shutdowns, closure of a business unit or a department, or outsourcing of work to other companies.

The employer must prove and substantiate the internal or external reasons for the business decision which has led to the elimination of the employment position. Labour courts are limited to the extent to which they can assess commercial decisions. Such decisions are subject to review only to the extent to which they may be considered arbitrary and totally discretionary in nature.

The loss of the employee's position must be a consequence of the commercial decision. Therefore, it is often easier to argue a dismissal was based on internal reasons. If, e.g. profits or sales decrease (i.e. an external reason) the employer would have to provide evidence why such decrease resulted in the elimination of specific number of job positions. The employer would have to show why, for example, 200 employees were made redundant, and not only 180 or 50. Usually, the employer can provide such evidence only if he has analysed the working capacity in detail. But if the employer makes a commercial decision to shut down an entire business unit (i.e. an internal reason), regardless of whether the business is making a profit, it is obvious that this decision results in all job positions in the particular unit to be made redundant. Having said this, it is also much easier to implement a vertical head count reduction (i.e. closing units or departments) instead of a horizontal reduction in force (e.g. 10% reduction in all departments).

Given the large number of possible situations, only a few typical examples for terminations for operational reasons shall be listed below.

aa) Operational Shutdowns (Fully or in Part)

If a business is shut down, this will, in general, justify a termination for operational reasons. The necessity of shutting down a business is a commercial decision, which cannot be judicially reviewed in wrongful dismissal actions. In these situations, the employer does not have to wait until the business has actually been shut down before issuing termination notices. The dismissal can be served once such business decision to shut down has been taken. But if a works council is in place the company might have to consult with the works council first prior to terminating employees (see Chap. 21).

bb) Downturn in Sales and Orders

Downturns in sales and orders may justify a termination for operational reasons if the volume of work is reduced to such a degree that there is no longer any need for the continued employment of one or more employees. The requirements set forth

by case law in this respect must not, however, be underestimated. The employer will have met the labour courts' requirements only if, for example, he can prove that a lower total number of working hours to handle the remaining orders is necessary as a result of the downturn in sales.

In these cases, employers may have particular difficulties showing that the downturn in turnover and orders has led to a specifically reduced work volume in various departments. The Federal Labour Court (*BAG*) requires that the decrease in work volume be expressed numerically. In addition, these numbers must be presented in such a way as to show that any remaining tasks can, in fact, be assumed by other employees without working overtime.

cc) Outsourcing

Many employers decide to outsource individual aspects of their business. Such a decision will be based on commercial reasons, which, in effect, cannot be reviewed by the labour courts. Outsourcing measures, however, may result in the transfer of parts of the business to a third party. The employment relationships of all employees dedicated to this part of business would be assumed by the third party in accordance with sec. 613a of the Civil Code (*BGB*).

b) The Social Selection Process

The social selection is one of the key issues in the area of terminations for operational reasons.

aa) Criteria for Social Selection

Before the employer issues a termination for operational reasons, he must examine whether there are comparable employees working in the business whose work could also be performed by the employee at risk. If this is the case, the employer must examine whether the employee at risk requires greater social protection than the other employees. Statutory law sets forth as social criteria the year of service with the company (seniority), age, family support obligations and disability. The employer must adequately account for these criteria in making his selections.

The crucial social selection criteria are
Age
Seniority
Obligations to pay family support
Disability

None of the 4 criteria generally has priority over the others. The employer has a certain amount of leeway (which is in practice very limited) when taking the decision. He must, however, carefully weigh the social criteria.

It can be difficult to establish whether someone should enjoy more protection if he has 2 years more of service, but is 5 years younger than another colleague. Therefore, it might be helpful to get a better overview of the social selection by applying a point scheme by giving each of the above named criteria certain amount of points (e.g. seniority – 1 point per year of service, age – 1 point per year, married – 5 points, children – 4 points per child, disabled – 5 points). There are certain point schemes which have been approved by case law in the past. If a works council has been established, however, the employer would need the approval of the works council to implement such a point scheme.

bb) Employees to be Included in the Social Selection

The extension of the social selection depends on the wording of the individual employment agreement. Only those job positions to which the employee at risk of termination could be relocated, have to be included in the social selection. Most employment contracts provide that the employee is obliged to also accept other appropriate work he is qualified for. While this provision is advantageous for the employer during the employment relationship, it has a disadvantage in the event of social selection. Due to this provision the social selection would have to extend to all job positions the employee at risk could perform. However, only those job positions have to be reviewed which are on the same hierarchy level.

Even if the employment agreement provides for such a provision, the social selection has to include the entire operation (*Betrieb*) and is not limited to the department or business unit only. The social selection would not, however, include comparable job positions in other operations of the same legal entity.

In practice, it is often difficult to thoroughly establish what job positions have to be included in the social selection. This is usually the key dispute when employees challenge the dismissal before court.

cc) Exemptions from the Social Selection

Employees who enjoy specific protection against dismissals are usually not included in the social selection. But the employer could include severely disabled persons or an employee on maternity or parental leave, but would then need the approval of the authorities to terminate such employees.

Employees statutorily excluded from ordinary termination are not to be included in the social selection procedure. This applies in particular to
Severely disabled persons
Pregnant employees and mothers after childbirth
Parents on parental leave
Works council members

Employees whose employment, according to a collective bargaining agreement, cannot be terminated are not to be included in the social selection.

The employer may also exempt certain employees whose retention in employment is in the legitimate interests of the business. This could, for example, be employees with very specific knowledge which is difficult to obtain or with very close customer relationships. The employer carries the burden of proof for such legitimate interest. The exemption should therefore be applied only when necessary.

dd) Social Selection Step by Step

When conducting a social selection, the employer has to follow certain steps.

In summary, the social selection process must be carried out in the following 4 steps
Determine the categories of comparable employees within the business operation (check employment agreement, same hierarchy level only)
Exempt employees with specific dismissal protection (maternity leave etc.)
Exempt specific employees whose retention in employment is in the legitimate interests of the business
Conduct social selection between the remaining employees

ee) List of Names in Restructuring Measures

Significant operational changes of a business (e.g. operational shutdowns, mass dismissals) have to be consulted with the works council. In this event employer and works council may agree on a list of names of employees to be terminated. Such list has the effect that the labour court will review the termination only for evident faults which have to be proved by the terminated employee.

This provision is a great improvement from the employer's point of view. But works councils are usually reluctant to such list or may agree only in consideration of significant increased severance payments to the employees who will be terminated.

c) No Open Job Positions

Before terminating an employee the employer has to review whether another job position is vacant within the company and if the employee to be terminated would be qualified for such position. If so the employer would have to give notice but offer at the same time the opportunity for the employee to relocate to the different job. The employee can then decide within 3 weeks whether to accept such offer, to deny it or to start working on the new job position, but ask a court to review whether the termination of his current job position was justified.

The employer, however, is only obliged to offer job positions which are on the same or on a lower hierarchy level than the current job position of the employee. The employee has no right to promotion. The new position might result in a lower

salary or even be at a different site of the same legal entity within Germany. Usually, employers are not obliged to offer a vacant job position with another group company in Germany or a job position outside of Germany.

The new job position has to be reasonable. Given the currently high unemployment rate in Germany, courts construe "reasonable" very widely. Thus, employees might face the risk to accept a job position with significant lower salaries or on a significant lower level. Employers are usually well advised to always offer a lower vacant job position as long as it is not obvious that this position is not reasonable at all. Otherwise, if the employer failed to offer this job position (while terminating the employee at the same time) the dismissal might be null and void.

d) Mass Dismissal

In the event of mass dismissals the employer has to notify the employment agency (*Agentur für Arbeit*) prior to give notice to the individual employees. Otherwise, the dismissal would be null and void.

This rule applies if employer's terminations exceed a specific threshold (depending on the size of the business) within 30 days. Employer's notice or separation agreements initiated by the employer are considered as termination in this meaning.

The relevant dismissal/termination thresholds for notification of the Employment Agency of mass dismissals within 30 calendar days are

Size of operation	Intended layoffs
21–59 employees	More than 5 employees
60–499 employees	More than 25 employees or 10%
500 or more employees	At least 30 employees; additionally at least 5% of the employees

For more details see Chap. 21.

F. Severance Payments

As a general rule, if the dismissal is supported by sufficient reasons (social justification) the employee is not entitled to any severance payment at all. Courts usually cannot issue a severance award. If the dismissal is not supported by sufficient reasons, the dismissal is null and void and the employee would have to be reinstated and is also entitled to back pay.

To avoid such "all or nothing" situations, employers and employees agree in most cases on a mutual termination in consideration of a severance payment. The severance payment has to be negotiated. As a general rule, employers should expect severance payments of about 0.5 monthly salaries per year of service. But the amount might be significantly higher, e.g. 1 or even 2 or more monthly salaries if the legal position of the employer is rather weak.

In the event of a dismissal for business reasons, the employer may offer a severance payment of 0.5 monthly salaries per year of service up front in the termination letter. If the employee does not challenge the effectiveness of the dismissal before court within the statutory 3 weeks deadline, the dismissal would be effective, but the employee would nevertheless be entitled to this severance payment. If the employee goes to court, he loses this severance entitlement even if the court rules that the dismissal had been effective.

In case of a significant restructuring measure which is subject to consultation rights of the works council, the works council and the employer have to agree on a social plan. Such plan provides for severance payments to the employees. In such a case, employees are entitled to a severance payment according to the plan. Employees might nevertheless review the effectiveness of the dismissal before court.

G. Termination with the Option of Altered Conditions of Employment/Modification Dismissal

If the employers' goal is to change certain working conditions, the employer might use a "modification dismissal" (*Änderungskündigung*), i.e. a termination together with an offer to continue the employment relationship under altered conditions. As aforementioned, the employee may accept such changes, deny them or – what most employees do – accept the changes, but ask the court to review if the changes are justified.

Such modification dismissals are only advisable for individual cases. They are usually not recommended in cases of mass dismissals for the purposes of changing working conditions.

If the purpose of such dismissal is only to reduce the salary of the employee or of all employees, case law is very strict. Usually, this is only permissible in circumstances where the company is trying to avoid insolvency. In fact, under German case law it is easier to terminate employees than reduce their salary.

H. Special Termination Protection

In addition to the general termination protection, there are also special protection provisions against termination for certain groups of employees.

Special Termination Protection applies to certain groups of employees, including
Women during pregnancy and 4 months after childbirth
Employees on parental leave (*Elternzeit*) and 8 weeks prior to parental leave
Severely disabled persons
Members of the works council, candidates and members of the election board

I. Special Termination Protection for Pregnant Employees and Mothers After Childbirth

The dismissal of a woman during pregnancy and for up to 4 months following childbirth is not permitted. If the employer has not been aware of the pregnancy when giving notice, the woman has to notify the employer within 2 weeks. The dismissal would then be null and void.

In exceptional cases, the competent state authority may permit termination for reasons which are not related to the woman's condition during pregnancy or her situation through the term of 4 months after childbirth. Typical examples are criminal acts of the employee or if the entire business is shut down. In the event of a partial closure of business, the employer generally must continue the pregnant employee's employment in another department. In any case, a termination notice issued without the relevant authority's prior consent is null and void.

II. Special Termination Protection for Employees on Parental Leave

The employer may not terminate the employment of an employee who has requested parental leave – which request may not be more than 8 weeks prior to the commencement of parental leave – or during the parental leave. In exceptional cases, a termination may be permitted by the relevant state authority (e.g. shut down of business).

III. Special Termination Protection for Severely Disabled Persons

Disabled employees with a minimum grade of disability of 50 (i.e. severely disabled employees) may not be terminated without the prior consent of the competent authority. This also applies to employees with a grade of disability of 30–40 and who have been officially recognised as "equal to severely disabled employees."

The authority has complete discretion in deciding such cases. Usually, the authorities consent if the dismissal is not related to the disability, e.g. terminations for business reasons or criminal acts.

IV. Special Termination Protection for Members of the Works Council

Members of the works council enjoy strong protection against dismissals and may be terminated only for cause. In addition, the works council has to give its prior

consent to such dismissal or, if they refuse to, the employer has to ask a court to give such consent. Only once a court ruling has been obtained – which might take 2 years if someone appeals all instances – the member of the works council can finally be dismissed. During this period of time the works council member is entitled to full salary pay.

An ex-council member's employment within 1 year from the end of his term in office can also only be terminated for cause. However, the prior works council's approval is no longer required during this phase.

Vice-works council members will also enjoy this special 12 months protection every time they replaced a prime works council member, even if it is just in 1 works council meeting.

Members of the election committee for the works council from the time of their appointment until the results are published can also only be terminated for cause and again only with the consent of the works council. The termination will not be permissible within 6 months following publication of the results unless for good cause; the consent of the works council is no longer required. The same applies to candidates for the works council.

Employees requesting an election committee or employees running for election to a works council may be terminated only for good cause until the results of the elections have been published.

If the entire business is shut down, then also the aforementioned individuals may be terminated, but only with effect to the time of the closure.

If only 1 department, for which the works council member is working, will be shut down, the employer has to offer the works council member a reasonable job position in another department. If no open job positions are available, the employer might even have to terminate another employee and move the works council member to this position. Only if the works council member is not qualified for another job position or the employee to be terminated enjoys significant more protection than the works council member, the employer may terminate the employment of the works council member.

I. Works Council Consultation Prior to Termination

Prior to giving notice, the employer has to inform the works council of the termination and its reasons (if a works council exists). This also applies to terminations during any probationary period.

The information can be provided verbally. But since the employer has to prove before court that he informed the works council sufficiently, written information is strongly recommended.

Employers should not underestimate the importance of giving such information. Often, employees win a lawsuit challenging the effectiveness of the dismissal because the employer did not provide sufficient information to the works council. It is therefore worth to prepare such information thoroughly. Reasons which are not

originally provided to the works council may not later be relied on as grounds for the termination.

In addition to the employee's personal data and business details, the grounds for termination must be provided. In the case of a termination for operational reasons, this includes showing the commercial decision, which has led to the elimination of the position. If a social selection procedure has been conducted, the works council must also be informed in detail about the group of comparable employees and which criteria influenced the decision. Finally, the works council must be informed about the type of termination, namely regular termination or a summary dismissal, the notice period, and the termination date.

In the case of a regular termination, the works council has 7 days to process the termination of the employee's employment. In the case of a termination for good cause without notice, the works council will be granted a period of 3 days. The works council may consent to the termination, reserve its opinion, or object to the termination. Even if the works council objects, the employer nevertheless can give notice to the employee.

If the works council objects in a proper and timely manner to the dismissal and the employee files an action for unfair dismissal he has to be further employed, under the same conditions as before, until the final judgment is delivered.

J. Summary Dismissal

A summary dismissal (also called termination for good cause) ends the employment immediately instead and there is no notice period. The employer has to show a significant reason (e.g. significant breach of contract, severe defamation of the employer). Additionally, the employer has to give notice within 2 weeks upon gaining knowledge of the reasons justifying the summary dismissal.

A summary dismissal must meet a 2-prong test
There must be good cause for termination
Notice must be given within 2 weeks of knowledge of the good cause

I. Good Cause

Generally speaking, good cause exists if it would be unreasonable for the employer to employ the employee until the end of the notice period. The threshold for terminations for cause is very high. Examples of effective terminations for cause are:

- Any kind of theft of employer's property (a famous court case ruled that a summary dismissal was justified when a shop assistant in a bakery ate a piece of cake)
- Expense fraud

- Severe defamation of the employer if this was not committed in a mere private conversation with a third party or a colleague
- Working for a competitor of the employer

II. Two Week Deadline

Notice must be given within 2 weeks of receiving knowledge of the facts qualifying for "cause." Otherwise, the notice for cause is void but may be construed as a regular termination without cause terminating the employment at the end of the notice period.

Within this 2 week timeframe the employer must have provided the necessary information to the works council. Since the works council has 3 days to review its reply the employer is well advised to speed up once he found a reason for a summary dismissal.

III. Suspicion of Criminal Acts

Often, the employer is not able to prove that an employee committed a criminal act. If there is nevertheless a strong suspicion, this might justify a summary dismissal. In any event, the employer has to give the employee the opportunity to justify his doing. Theoretically, the 2 weeks deadline will only be triggered once the employer has thorough knowledge of the wrongdoing, thus, the deadline might only start once the employee has replied. However, to avoid any discussions before court if the 2 weeks deadline has been met, employers should, if at all possible, try to conduct the hearing of the employee and the information of the works council within the first 2 weeks since the employer gained knowledge of the wrongdoing of the employee.

K. Wrongful Dismissal Claims

If individual employees want to challenge the effectiveness of a dismissal they have to file a complaint before the labour court within 3 weeks upon service of the termination notice – not upon expiration of the notice period. Otherwise, the dismissal will be effective.

If the dismissal requires the prior consent of the authorities (employees on maternity leave, parental leave or disabled employees) the 3 week deadline will only be triggered after the authorities consented to the dismissal.

L. Termination Agreements

As an alternative to risky termination notices, entering into a termination agreement represents a quick and suitable means of ending an employment relationship. Termination agreements require neither a prior hearing by the works council, nor the consent of a government authority. Termination agreements stipulate in particular the termination date, often provide for a severance payment and a release of either party's claims. The employer will generally give the employee a written offer, which may be accepted by signing the termination agreement. However, the employer may not force the employee to sign such a termination agreement.

But the main issue of a termination agreement is that the employee is likely to suffer a so-called 12 week blocking period, i.e. the employee will not receive unemployment benefits (between 60 and 67% of the net salary) for this period of time. Thus, an employer should always inform an employee of such consequences prior to the conclusion of a termination agreement in order to exclude possible liability claims.

According to internal guidelines from the employment agency, such blocking period can be avoided if (1) the employer would otherwise have given notice for operational reasons, (2) the parties observe the applicable notice period (even if the employment may be extended) and (3) the employee receives a severance payment of 0.25 to 0.5 monthly salary per year of service.

A blocking period will also not be imposed if the employer had given notice, but the parties later on agree on a settlement before court.

M. Key Aspects

- German law does not recognize employment at will.
- Generally, employment relationships may be terminated for person-related reasons, a reason related to conduct or operational reasons by giving the applicable period of notice.
- If the employee is in severe breach of the employment agreement (e.g. expense fraud) the employer may terminate the employment relationship with immediate effect, provided the termination takes effect within 2 weeks of the employer gaining knowledge of the facts warranting summary dismissal.
- If the termination is not supported by sufficient reasons, the employee has to be reinstated and obtains back pay. If the dismissal is effective, the employment ends usually without any severance payment. In significant restructuring cases a social plan between employer and works council may provide for mandatory severance.
- No specific reason is required for termination of employees with not more than 6 months' service or in small business with usually not more than 10 employees.
- In fact, most terminations are settled before court.

- Prior to giving notice, the employer must inform and consult an existing works council, otherwise the termination is null and void.
- The main issues which arises in cases of termination for operational reasons are demonstrating why a specific work place should cease to exist and conducting a social selection between comparable employees.
- Be aware of special termination protection for certain groups of employees such as severely disabled, pregnant employees, parents on parental leave and works council members.
- There exists no compulsory statutory severance claim under German employment law.
- Be aware of the relevant thresholds for notification of the employment agency for mass dismissals which will all take place within a 30 day window.

Chapter 16
Family Friendly Rights

Kai Bodenstedt and Sascha Morgenroth

A. Introduction

German constitutional law emphasises the duty of all public authorities to protect the family institution. German statutory employment law reflects this with two main aspects of family friendly rights: special protection against dismissals and leave entitlements. The German legislator has repeatedly confirmed that employees in special family-related circumstances shall not have to bear existential worries while having to cope with the family-related situation.

The statutory family friendly rights involve provisions giving special protection against dismissals, regarding the termination of pregnant employees and employees on parental or nursing care leave. However, the protection of employees during these times is not limited to protection against dismissal. Furthermore, employees may be entitled to periods of leave. Since the notice periods for these leave entitlements are relatively short, employers may face situations in which they have to re-organise their staff on short notice. This requires employers to be flexible with respect to labour utilization.

B. Statutory Family Friendly Rights

German statutory law provides special protection for employees during maternity, parental leave and nursing care.

I. Maternity Protection

During pregnancy and for a certain period after childbirth any termination of employment is principally considered invalid. Furthermore, the employer has to

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respect certain provisions of the German Maternity Protection Act (*Mutterschutzgesetz*) which limit the types of employment available for pregnant employees during and after pregnancy.

1. Special Protection Against Dismissals

During pregnancy and until 4 months after childbirth any termination of employment is invalid, unless the competent public authorities have granted their prior consent. However, in practice, the public authorities only grant such consent under exceptional circumstances.

a) Term of the Special Protection

The special protection against dismissal starts with the employee's pregnancy. If the exact date of the beginning of the pregnancy is in doubt, it is determined by deducting 280 days from the anticipated day of childbirth as calculated by a physician or a midwife. The employer is entitled to ask for a certificate of pregnancy at its expense.

The special protection against dismissals ends 4 months after childbirth. E.g., if childbirth takes place on 25 September, the respective employee falls under special protection against dismissal until the end of 25 January.

Childbirth is determined by labour courts considering the latest state of medical analysis. The Federal Labour Court recently ruled that childbirth only occurred if the child developed a stadium in which it is in principle able to exist independently without the mother. This is generally the case, if the child weighs at least 600 g at the time of childbirth. Otherwise, the special protection against dismissal ceases to exist.

From the legal point of view, a stillbirth is considered to be a childbirth. The 4-month period of special protection against dismissal remains unaffected if during this term the child dies or is given away for adoption by the mother.

In cases of so-called uniform employment agreements – e.g. for a janitor and his wife – the special protection against dismissal applies to both employees.

b) Scope of Protection

Pregnant employees enjoy special protection against all kinds of dismissal – terminations with or without good cause, terminations for conduct, person-related or operational reasons.

Even if it is undisputed that the employee's conduct would justify a termination for cause without notice, the employment relationship may only be validly terminated with the prior consent of the competent public authority.

However, termination agreements may validly be agreed upon during the special dismissal protection period. In these cases the employment must end due to a mutual agreement between the employer and employee and not because of an employer's unilateral decision.

The special protection against dismissal applies during insolvency proceedings, strikes and operational shutdowns of businesses.

In case of terminations held invalid by the labour courts, the employer will be obliged to continue to employ the employee after the intended termination date. Further, if the employee stopped working after the intended termination date, the employer will be obliged to reimburse the employee for the remuneration, which would have been due between the termination date and the date of the court's decision.

c) Employer's Knowledge of Employee's Pregnancy

The termination of the employment of a pregnant employee is invalid if (1) the employer had positive knowledge of the employee's pregnancy at the time the termination notice was served or (2) the employer was informed about the pregnancy within 2 weeks after the service of the termination notice. The employee does not expressly need to claim special protection against dismissal due to her pregnancy. It is however necessary that she informs the employer that the pregnancy existed when the termination notice was served.

If the employer is a legal entity (e.g. a corporation), the entity's legal representative needs to be informed about the pregnancy. If the employer consists of different people, knowledge of one of these people will be sufficient to trigger the special protection rights. However, knowledge of co-employees or even the company physician will not trigger the employee's special protection unless they inform the employer accordingly.

In case of a transfer of business the purchaser of the business is the statutory successor of the seller of the business. This means that he assumes all legal positions of the seller in respect of existing employment relationships. Therefore, the seller's knowledge of the pregnancy transfers to the purchaser of the business and, hence, the special dismissal protection applies to the pregnant employee.

The special protection laws apply if the employer has positive knowledge of the pregnancy. Gross negligent lack of knowledge is not sufficient; neither are mere suspicions of the employer or rumours at the employee's workplace.

If more than 2 weeks have passed since the service of the notice of termination, the employee may only benefit from special dismissal protection, if she (1) proves that she missed the 2 week deadline without fault and (2) notifies the employer about the pregnancy immediately after the reason preventing her from informing the employer elapsed.

The employee will be unlikely to prove absence of fault if she has positive knowledge or gross negligent ignorance of her pregnancy. However, mere negligence does not trigger the 2-week period (e.g., in case of temporary absence of menorrhoea).

Failure to meet the 2-week deadline will not be a problem for the employee if she can prove that she mailed a notification letter within the deadline. Further, the employee is entitled to wait for a medical certificate of the pregnancy, issued by a physician before she informs the employer.

The employee needs to inform the employer "immediately" after the obstacle has elapsed which prevented her to meet the 2 week period. There is no general rule as to the meaning of "immediately" in these circumstances. However, if the employee waits another 4 days she may have to explain the further delay.

2. Other Protection Rights of Pregnant Employees

Other protection rights of pregnant employees refer mainly to prohibitions to work (*Beschäftigungsverbote*) before and after childbirth. The employee may however be entitled to remuneration.

If employers intentionally violate employment prohibitions and order employees to work, they might be subject to criminal charges, which can result in fines or even prison sentences.

a) Prohibition from Work Prior to Childbirth

Employees are prohibited from working 6 weeks prior to childbirth, as calculated by a physician or a midwife, regardless of the nature of the work or any threat to life and health. However, the employee may waive this protection. Such waiver needs to relate expressly to the fact that the employee intends to continue working regardless of her entitlement to stay at home.

b) Prohibition from Work After Childbirth

Under German law, there is a prohibition from work until 8 weeks after childbirth. In cases of premature birth or twin or multiple childbirths the 8-week period is extended to 12 weeks. In case of premature birth, the period is further extended by the 6-week period before childbirth, which could not be taken advantage of due to the premature birth. Under German law premature birth is considered as any birth which involves a child with a birth weight of less than 2,500 g.

The prohibition from work after childbirth is mandatory and may not be waived by the employees. Violations might lead to the (criminal) consequences described above. However, if the child dies during or after childbirth, the employee may upon her explicit request start working before the 8/12-week period has elapsed. The purpose of this is to help the employee cope with the death of the child.

However, if the employee prefers to stay away from work until the end of the protection period, the employer has no legal means to force the employee to return to work.

Furthermore, it is important to note that the employee is entitled to nurse her child during the lactation period at least twice a day for half an hour each time. If the working time exceeds eight consecutive hours the nursing time is statutorily extended to 45 min each time. The employer is obliged to continue paying the employee's remuneration during nursing time.

c) Alternative Work or Suspension from Work

Further to the maternity protection periods explained above, when an employee is pregnant or is breast-feeding, the employer must assess the particular risks which the employee faces in the workplace and take measures to avoid them. Further, the employment of pregnant employees may generally be prohibited by law or if a medical certificate states that the individual life or health of the mother or the unborn child would be endangered by the continuation of the particular occupation. In these cases the employer is obliged to offer suitable alternative work or to suspend the employee from her work with full pay.

The employer must suspend a pregnant employee on full pay if a medical certificate states that the life or health of the expectant mother or the unborn child would be endangered by continued employment. Such danger can arise from the nature of work or the woman's state of health. Even if this suspension is related to health problems, it is not considered sick leave. Thus, the employee does not receive sick pay allowance by the statutory health insurance; rather, the employer has to continue to pay the employee's remuneration.

Further, pregnant employees are prohibited by statute to work e.g. in the following cases:

- Work involving exposure to hazardous materials or radiation, dust, gases or vapours, heat, cold or moistness, vibrations or noise
- Regular hand-operated handling of loads of more than five kg or occasionally loads of more than ten kg without mechanical equipment or machine-operated handling of heavier loads
- After the fifth month of pregnancy, work requiring the employee to stand continuously for more than 4 h per day
- Work requiring the employee to frequently significantly stretch or bend or to permanently crouch or to stay ducked
- Jobs requiring the operation of equipment and machines of all kinds with high stress for the feet, particularly by feet-operated machines
- Work by which the employee is particularly exposed to the risk of occupational diseases due to her pregnancy or by which the employee or the foetus are particularly endangered
- Beginning from the end of the third month, work on vehicles of any kind
- Work in which the employee is exposed to a greater risk of accidents, in particular the danger of slipping and falling

- The pregnant employee is not allowed to work more than 8.5 h per day or over 90 h during 2 weeks, and pregnant employees under age 18 are not allowed to work more than 8 h per day or 80 h per 2 weeks
- Piecework or any other kind of work in which the employee can achieve higher earnings by working faster
- Assembly line work

If necessary, the employer may ask for the consent of the competent administration for an exception to the last two prohibitions, if the kind of work and the work place do not indicate negative effects on the health of the expectant mother or the child.

d) Remuneration During Maternity Protection

aa) Remuneration During Suspension from Work

During suspension from work, as explained above, employees are entitled to full pay. The remuneration entitlement is calculated on the average remuneration of the last 13 weeks or of the last 3 months prior to the beginning of the month of pregnancy. The employer can essentially choose between these two methods of calculation.

In order to calculate the remuneration during the protection periods (*Mutterschutzlohn*) the employer has to take into account an evaluation of the average remuneration which consists of normal salary, commission, overtime pay, capital-forming payments (*vermögenswirksame Leistungen*), and extra pay. Temporary increases of the remuneration that become effective after 13 weeks or 3 months have to be included in the calculation. However, reductions of the earnings due to short-time work, shortage of work, or sick leave or reimbursement of expenses are not considered in the calculation. The employer may not take into account one-off payments as emoluments, bonuses or profit sharing because they are considered to be paid for the entire year and not only for time of suspension for maternity protection.

bb) Maternity Allowance During Protection Periods

During the protection periods before and after childbirth of usually 14 weeks in total (see above) the employee is entitled to receive maternity allowance (*Mutterschaftsgeld*) from the statutory health insurance scheme provided that she has been a member of the statutory health insurance scheme between the tenth month and the fourth month before the childbirth for at least 12 weeks. The maternity allowance is paid by the health insurance scheme up to a maximum amount of EUR 13.00 per calendar day.

The employer has to pay the difference between the maternity allowance and the employee's net remuneration. The average daily pay has to be calculated as

described above for the remuneration during the suspension for maternity protection. After the evaluation of the daily average pay the compulsory deductions and the EUR 13.00 have to be subtracted in order to calculate the supplementary maternity allowance that the employer has to pay.

If the employee is not entitled to a maternity allowance either because she does not comply with the conditions or because she is not member of the statutory health scheme, she is only entitled to a maternity allowance provided by the Federal State. This is limited to a maximum total amount of EUR 210.00 plus the difference between the maternity allowance and the average daily net salary for the entire period of maternity leave. The supplementary payment by the employer to the maternity allowance and the average daily net salary are calculated as if the employee received the maternity insurance allowance which amounts to EUR 13.00.

The Federal Constitutional Court (*Bundesverfassungsgericht, BVerfG*) held that the employer's duty to pay the difference between the maternity allowance and the net pay of the employee violates the employer's constitutional rights. Therefore, the German legislator passed a regulation under which, from 1 January 2006, the employer may make a claim for reimbursement from the employee's statutory health insurance scheme for the contribution which they have paid to the maternity allowance and for the remuneration paid during the period of protection.

II. Parental Leave

German statutory law on parental leave (*Elternzeit*) enables parents to spend time with their child within the first years after the child was born without having to carry existential risks. This is similar to statutory law on the protection of pregnant employees and in the view of the legislator this goal may only be achieved if the employee in question enjoys special protection against dismissal during parental leave. Hence, generally a dismissal will be considered invalid during parental leave. Only on rare occasions, the competent public authority might grant its prior consent to a dismissal. In this context there has been a recent amendment to the statutory law, according to which employees might be eligible to parental benefits for the first 14 month after childbirth.

1. How to Qualify for Parental Leave

a) Scope and Prerequisites

Pursuant to the Federal Parental Allowance and Parental Leave Act (*Bundeselterngeld- und Elternzeitgesetz*) both female and male employees are entitled to take parental leave up to the third birthday of each child of the employee. The employee and employer may also agree to transfer up to 12 months of parental leave to a point

in time before the child's eighth birthday. Under certain conditions, employees may also be entitled to parental leave in respect of children who are not their biological children. However, if an employee wants to take parental leave to take care of a child not in his legal custody, the employee needs to obtain the biological parent's consent to qualify for parental leave.

Parents may unilaterally decide how to split the 3 years parental leave between them. Theoretically, it is possible that each parent can take 3 years leave. However, since the employer is not obliged to pay the employee's salary during parental leave this is a rather unlikely scenario because one parent will usually have to provide an income.

An employee intending to claim parental leave needs to inform the employer at least 7 weeks prior to the contemplated parental leave about the date and duration of the leave. A shorter notice period may only be acceptable under special circumstances, e.g. if the person usually taking care of the child has fallen ill. The employer is not entitled to reject the employee's claim for parental leave. Therefore, e.g. even if the employee in question is not dispensable for a certain project, the employer does not have any (legal) means to deny the employee parental leave. However, the parental leave may be ended prematurely only with the employer's consent.

b) Maternity Protection and Parental Leave

In case of female employees who take parental leave directly after the protection period for pregnant employees, this period will be deducted from the term of the parental leave.

c) Part-Time Work During Parental Leave

It is not mandatory that the employee stays at home throughout the whole term of parental leave. In fact, the legislator allows employees to work up to 30 h per week during parental leave.

The employee is entitled to claim that his working time shall be reduced during parental leave. The employer may only deny such claim for urgent operational reasons. German case law has identified that costs connected with the training of a different employee on the position of the employee on parental leave is not sufficient to qualify as such an urgent operational reason. Similarly, the employer may not deny a reduction of the working time just because the operations in the business are effected by the reduction of the working time. However, if the employer can prove that in fact the purpose and nature of the business are threatened by the reduction of the working time or if there is a need to substantially change the working organisation the employer might be entitled to deny the reduction of the working time.

The employee needs to claim the reduction of the working time at least 7 weeks before the commencement of the reduced activity.

d) Several Children and Multiple Births

In case of multiple births or the birth of several children within a short period, the employee is entitled to take 3 years parental leave for each child. This means that it is legally admissible to transfer 12 months of the parental leave for each child to a point in time before the eighth birthday of each child.

This allows the employee to take advantage of his entitlement to parental leave in a very flexible way. E.g., if twins were born on 1 February 2008 the employee would be entitled to take 2 years of parental leave for child A until his second birthday and transfer the third year of parental leave with the consent of the employer e.g. to 1 February 2011 until 31 January 2012. In respect of child B the employee might transfer 12 months of the 3-year leave with the employer's consent e.g. to 1 February 2012 until 31 January 2013. In respect of child B's third year the employee could claim parental leave e.g. for the period commencing after the 2-year leave period in respect of child A. This would have the consequence that the parental leave of the employee would last from 1 February 2008 until 31 January 2013 (5 years). During this time, the employee would fall under the special statutory dismissal protection.

2. Special Dismissal Protection

The statutory special dismissal protection applies from the time the employee claims parental leave, but not earlier than 8 weeks prior to the commencement of the parental leave. The dismissal protection applies also to dismissals served during the parental leave.

According to German case law, a termination will even be invalid if it was served because the employee simply stopped coming to work after he claimed parental leave. However, this might be a case where the public authority should consider granting its consent to such a dismissal.

If the employee takes advantage of the option to split the parental leave into different periods the law on special protection against dismissals will still take effect no earlier than 8 weeks before the commencement of the first period of parental leave. The special protection will not apply again 8 weeks prior to the second term of parental leave. Thus, in this case, a termination will be valid as a result of the special dismissal protection not applying before the beginning of the second term of parental leave.

The special protection against dismissal ends effective with the end of the (last term of) parental leave. However, it is important to note that German case law has proved to be rather generous in favour of the employee in the past. The Cologne labour court of appeal ruled that an employer, who was aware of the date of birth of

the employee's child, implied his consent to a split term of parental leave, just because the child was (at the time the employee claimed parental leave) one and a half years old. This had the consequence that a termination that was served after the child's third birthday was held invalid by the court.

A termination which is served despite the special protection against dismissal, is invalid. Pursuant to German law the notice of termination may not be interpreted as only taking effect after the special protection has ended. Similar to the legal situation in case of maternity protection, in rare cases a termination may be valid if the competent public authority had granted its prior consent.

3. Parental Benefits

Since 1 January 2007, employees who are parents of a newborn child may be entitled to a substantial public parental allowance (*Elterngeld*) of 67 % of the last net income up to an amount of EUR 1,800.00 per month for a term of 14 months. The biological parents of the child are entitled to such benefits. However, if both parents decide to take advantage of these benefits each parent will only be entitled to payment for a term of 7 months.

These benefits will be borne by the state alone. The employee remains eligible for the benefits even if he works part time and less than 30 h per week. In this case, he is entitled to a payment of 67% of the difference between a full salary and the part-time salary.

It is also important to note that the employee is entitled to claim unused holidays for the year the parental leave commenced in the year following the parental leave. The Federal Labour Court recently ruled that an employee, who takes parental leave for two children consecutively, is still entitled to unused holiday claims arising from a term before the first term of parental leave. It may still be claimed after the second term of parental leave has elapsed.

III. Nursing Care

On 1 July 2008 the Nursing Care Leave Act (*Pflegezeitgesetz*) came into force. The act was part of the legislator's initiative to emphasise the importance of domestic care. The new law entitles employees and persons similar to employees (*arbeitnehmerähnliche Personen*) to short-time release from work to care for close relatives in urgent need of care or to take nursing care leave, both on relatively short notice. During nursing care, persons may only be dismissed if the competent authority has granted its prior consent. The Nursing Care Leave Act does not however provide an obligation for the employer to pay the employee's salary during the nursing care leave however such obligation may well arise from other provisions.

1. Applicability

The Nursing Care Leave Act has a rather wide scope of applicability. For the first time in German legal history, persons who are only similar to employees enjoy the benefits of employee protection law. This is a clear contradiction to decades of jurisprudence and legislation.

Persons who are only similar to employees, are not part of the business organisation of the employer and are – contrary to employees – largely free in dividing their working and spare time. However, these persons usually work only for one person; hence, there is an economic dependence, which makes them comparable to employees. Persons similar to employees are usually people working from a home office or, like distribution agents, travel for most of their working time.

2. Special Dismissal Protection

Employees and persons similar to employees enjoy special protection against dismissals from the moment they claimed short-term release from work or nursing care leave until the end of these periods.

a) Short-Term Release from Work

If there is an urgent need to care for a close relative, the employee or person similar to employees may inform the employer that he intends to take up to 10 days off to organise care for the close relative. There is no period of notice in which the employee must inform the employer of the leave.

The term "close relative" is defined very broadly under the Nursing Care Leave Act and includes siblings, parents, grandparents, grandchildren, husband or wife, children, life partners, children of life partners.

Whether or not there is in fact urgent need for care will be determined in accordance with the statutory provision on the public nursing insurance (*Pflegeversicherung*). If its prerequisites are met, the employee or person similar to employees is entitled to stay at home for up to 10 days. During this time and starting from the announcement of the release from work, a termination of the contract will be invalid unless the competent authority has granted its consent.

b) Nursing Care Leave

Employees or persons similar to employees are entitled to nursing care leave of up to 6 months for each close relative in need of care. However, only employers who usually employ more than 15 employees and/or persons similar to employees are subject to nursing care leave entitlements. The number of employees and/or persons

similar to employees will be determined upon calculating the average number of persons that are necessary to run the business.

The employee or person similar to an employee needs to inform the employer in writing that he intends to take nursing care leave at least ten working days prior to the commencement of the nursing care leave. This information needs to specify the period of the contemplated nursing care leave, which may be up to 6 months for each close relative in need of care. Again, whether or not a close relative is in need of care will be determined along the lines set out by the statutory law on the public nursing insurance.

As previously discussed, the definition of a "close relative" is rather broad under the Nursing Care Leave Act. Since the entitlement to nursing care leave covers a period of up to 6 months for each close relative in need of care this might have the consequence that an employee or person similar to an employee may not be terminated for a rather long period of time.

The special protection against dismissal is triggered at the point in time the employer receives the written notification of the nursing care leave and ends upon the end of the leave.

C. Key Aspects

- Maternity protection
  - Dismissal during pregnancy and until the end of 4 months after childbirth is only permissible for reasons not related to the pregnancy and only in exceptional cases with prior consent of the competent supervisory authority.
  - Maternity leave starts 6 weeks prior to assumed childbirth and normally ends 8 weeks after childbirth, altogether 14 weeks.
  - During maternity leave, the Employer has only to pay a contribution to the maternity allowance usually paid by the employee's health insurance.
  - Beyond maternity leave, if life or health of mother or child is endangered, or in the event of certain kinds of work generally prohibited by the law, the employer has either to offer suitable alternative work or to suspend the employee from work.
  - If an expectant mother is suspended from work due to her pregnancy, she receives full pay. However, the employer has a claim for reimbursement against the statutory health insurance.
- Parental leave
  - Parental Leave may be taken for a time period of up to 3 years. Two years have to be taken until the child's third birthday. The remaining year can – with the consent of the employer – be taken until the child's eighth birthday.
  - The employer does not have to pay remuneration during parental leave except one-off loyalty payments.
  - Employee must notify the employer in writing of the decision to take parental leave.

  - During parental leave, the employer cannot dismiss the employee unless in exceptional circumstances with prior consent of the competent supervisory authority.
- Nursing care
  - Employees may request a short-term release from work for up to 10 days in order to organize or assure required nursing care for a close relative in an urgent situation of need of care.
  - If the employer usually employs more than 15 employees, employees are entitled to unpaid nursing care leave of up to 6 months to provide nursing care for close relatives. The request must be announced to the employer at least ten working days prior to the beginning of the leave period.
  - During short-term release or nursing care leave special dismissal protection applies. A termination of employment during these periods requires prior approval of the competent supervisory authority.

Chapter 17
Managing Directors and Management Board Members

Michael Magotsch and Jens Kirchner

A. Introduction

Unlike in common law jurisdictions, managing directors (*Geschäftsführer*) of German Limited Liability Companies (*Gesellschaften mit beschränkter Haftung, GmbHs*) as well as Management Board Members (*Vorstände*) of German stock corporations (*Aktiengesellschaften, AGs*) are not considered employees. On the contrary, they work under "service agreements" which in addition to their office and role as organ of the company stipulate the terms and conditions of their contractual relationship. This chapter deals with the specific role and office of these key managerial employees, their respective duties and obligations under German law as well as their liability. This includes cases of alleged mismanagement and the respective personal liability of managing directors or board members in Germany. In connection with the personal liability of managing directors we will also briefly cover the issue of Directors and Officers ("D&O") insurance coverage for top management.

B. Managing Directors

I. Appointment

The shareholders of a *GmbH* have the power to appoint managing directors. Managing directors are appointed by shareholders' resolution, passed by a simple majority of the votes cast, unless the articles of association ("the articles") of a company provide otherwise or the applicable co-determination regulation assigns the appointing authority to the supervisory board (*Aufsichtsrat*) of the company. According to the One-Third-Participation Act (*Drittelbeteiligungsgesetz, DrittelbG*) *GmbHs* with more than 500 employees must establish a supervisory board consisting of 1/3

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of employee representatives. Further, by virtue of the Co-Determination Act (*Mitbestimmungsgesetz, MitbestG*) *GmbHs* with more than 2,000 employees must establish a supervisory board composed equally of employee and shareholder representatives (see Chap. 26).

1. Qualification for the Position as Managing Director

Both shareholders and non-shareholders may be appointed managing directors. Managing directors are therefore not required to hold shares in the *GmbH*. However, only individuals, not legal entities, are eligible for the position of managing director.

Corporate law does not require that any or all managing directors be German citizens or have their domicile or residence in Germany. Managing directors are not legally required to perform their duties within Germany. If none of the managing directors permanently or temporarily stays in Germany, or at least is legally allowed to enter Germany to perform his duties, the courts may however hold that the company does not have its corporate offices in Germany, as required by law, and thus cannot be registered.

Corporate law imposes only two requirements regarding the personal reliability and professional qualification of managing directors. First, a person convicted of certain criminal offences in the course of insolvency is precluded from becoming a managing director for a period of five years from the date of his conviction. Second, a person prohibited by court judgment or administrative order to perform a specific profession or business cannot, while the judicial or administrative prohibition is in effect, become a managing director of a GmbH which is partially or totally involved in that profession or trade.

A managing director cannot at the same time be a member of the supervisory board if the company has such a board. Furthermore, a managing director cannot be an authorized signatory, i.e. a holder of a proxy (*Prokura*) on behalf of the company.

2. Service Agreement

Despite the fact that the typical managing director is not an employee by virtue of case law, a managing director may be considered to be comparable to an executive employee under particular circumstances. However, there are important labour law statutes that explicitly exclude managing directors (e.g. Dismissal Protection Act, Works Constitution Act, Labour Courts Act).

The service agreement of a managing director is an agreement with the company and not with the shareholders, unless the agreement provides otherwise. However, the service agreement is concluded and terminated on behalf of the company by the shareholders, unless a co-determination act requires otherwise.

II. Representation of the Company

1. The Managing Directors

The managing directors represent the company in and out of court. If several managing directors have been appointed, they represent the *GmbH* jointly.

The company's articles may require or permit the shareholders to pass separate shareholders' resolutions, in order to deviate from the statutory principle of joint representation. The power of representation of each managing director, or of one or several specific managing directors, may be extended so that they are empowered as follows:

- To represent the company acting singly
- To represent the company acting jointly, with one or several other managing directors
- To represent the company acting jointly with one or several managing directors or holders of a proxy

2. Publication of Representation Rights

The right of representation of the managing directors, and any extension thereof, must be entered in the commercial register and must then be published in the appropriate publications.

3. Limitation of the Authority of Managing Directors

In contrast to an extension, a limitation of the statutory authority of the managing directors to represent the company will have no effect vis-à-vis third parties.

However, internally, the articles or a shareholders' resolution may limit the authority of the managing directors to represent the *GmbH*. For instance, it might be resolved that the managing directors must not engage in activities not included in the purpose of the company or that all, or several, or one managing director shall require the consent of the shareholders to engage the *GmbH* in specific transactions.

Should such a limitation be violated, the *GmbH* cannot invoke it against third parties to defeat a commitment made to such a third party by managing directors. The *ultra-vires*-doctrine is unknown to German law. However, the violation of such a limitation constitutes a breach of the service agreement with the *GmbH*, which in turn gives rise to a claim by the company against the managing director for damages and may also justify a dismissal for cause.

III. Internal Management Structure

The affairs of a company are managed by its managing directors. The management responsibility of the managing directors relates only to matters within the field of

activities defined as the purpose of the company in the articles. Even within this field, certain matters of major importance are reserved for decision by the shareholders. The shareholders may, either through the articles or by shareholders' resolution, extend or restrict the managing directors' scope of responsibility.

The statutory management concept is one of joint management of the company by all managing directors. Under this concept, management decisions require the consent of all managing directors. It is possible to deviate from the concept of joint management. The shareholders might assign specific fields of responsibility (e.g. accounting, finance, production, distribution) to one or more managing directors.

IV. Summary of Main Duties and Responsibilities

1. Diligent Management

In all matters concerning the company, the managing directors must employ the diligence of an orderly businessman. Each year the managing directors have to submit a list of shareholders to the commercial register. In the event that shares are assigned, the managing directors must notify the commercial register of the assignment.

This general obligation of diligent management is owed to the company and not to the shareholders, the creditors of the company or third parties. If a managing director negligently or intentionally violates his obligations, he is liable to the company for damages, jointly and severally with any other managing director who also violated his obligations in this way. However, no liability for damages arises if the conduct of the managing director was approved by a shareholders' resolution, unless such shareholders' resolution was illegal.

Because of the particular emphasis of the German Act on Limited Liability Companies (*GmbH-Gesetz*) upon ensuring the contribution and preservation of the share capital of the company, special obligations and liabilities are imposed upon managing directors with respect to these matters.

a) Liability for Incorrect Statements

If incorrect statements were made for the purpose of forming the company or increasing its share capital, managing directors who acted negligently or intentionally are jointly and severally liable to the company to contribute the missing sums, reimburse money to the company which should have been included in formation expenditures but were not, and to make good any other damage they have caused.

b) Liability to Shareholders

If an illegal disbursement of share capital contributions has occurred that cannot be recovered from the recipient, the other shareholders are proportionately liable for the refund owed to the company. Such a sum becomes due to the company from the shareholders if that sum is needed to satisfy creditors of the company. The

managing directors who negligently or intentionally made the disbursement are jointly and severally liable to those shareholders who are required to refund the sum to the company.

c) Liability in Case of Liquidation of the Company

Finally, if the company is liquidated, managing directors who act as liquidators are jointly and severally liable to reimburse the company for amounts negligently or intentionally distributed to the shareholders before such a distribution should have been made. In these situations, the managing directors cannot defend themselves by asserting that they acted in accordance with a shareholders' resolution.

d) Duty to Inform Shareholders

If the annual or interim balance sheet of the company shows that half or more of its share capital has been lost, the managing directors must call a shareholders' meeting as soon as possible. Managing directors, who negligently or intentionally fail to do so, are jointly and severally liable for damages to the company and are also subject to criminal penalties.

e) Commencing Insolvency Proceedings

Insolvency proceedings are commenced against the assets of a company if it is either over-indebted or insolvent. The petition to commence insolvency proceedings can be filed by any creditor of the company or by anyone of its managing directors or liquidators.

In case of overindebtedness or insolvency, each managing director, whether authorized to represent the company singly or jointly with others, is obligated to file a petition for the institution of composition proceedings (*Vergleichsverfahren*), or an insolvency petition without undue delay but in no event later than three weeks from the date on which the overindebtedness was asserted or the insolvency arose. Managing directors who negligently or intentionally fail to meet this obligation commit a criminal offence and are liable for damages in respect of both the company and its creditors.

2. Special Responsibilities Regarding the Preparation of Annual Accounts, the Payment of Taxes and Social Insurance Contributions

a) Annual Accounts

The managing directors have to prepare annual accounts that have to be submitted to the shareholders and the commercial register. The shareholders have to give formal approval to the actions of the managing directors and have to approve the profit distribution by resolution.

b) Compliance with Tax Laws

Pursuant to their general obligation to ensure that the company is in compliance with the law, the managing directors must ensure that the company is in compliance with tax law. They become liable to the company for damages if they negligently or intentionally fail to ensure such compliance. The managing directors have to file monthly VAT returns, the corporate income tax return as well as the trade tax return, which must be filed by May of the following year. In addition to this obligation of the company, the tax laws impose on the managing directors a direct responsibility to the government to ensure the company's compliance with its obligations. Managing directors, who by intent or gross negligence fail to carry out such responsibility, are personally liable for payment of relevant taxes and subject to administrative sanctions and even to criminal penalties.

c) Payment of Social Insurance

Similar obligations and liabilities are imposed upon managing directors to ensure payment of the statutory social insurance contributions owed with respect to compensation paid to the company's employees. These contributions are owed in part by the company directly and in part by its employees. To the extent that contributions are owed to the company's employees, the company is obligated to withhold such contributions from the employee's compensation and pay it to the appropriate social insurance institutions.

d) Liability for Damages

The managing directors are obliged to ensure the company's compliance with these obligations. If they fail to do so, they may become liable for damages to the company, subject to dismissal for cause, and exposed to administrative fines. Furthermore, they can become personally liable to the relevant insurance institutions for the payment of the part of the contributions owed by the company's employees, which should have been withheld and paid by the company.

e) Compliance with Instructions of Shareholders

In addition to complying with the articles and the service agreements with the company, the managing directors are obliged to comply with the instructions given to them by the shareholders, unless those instructions are illegal. Negligent or intentional violations of this obligation render the managing directors liable to the company for damages and may in certain circumstances justify their dismissal for cause.

V. Removal and Resignation

The removal and resignation of managing directors are corporate acts governed by corporate law and must be distinguished from the termination of service agreements between the company and its managing directors.

1. Removal by the Shareholders

Managing directors are removed from office by shareholders' resolutions passed by a simple majority of the votes cast, unless the articles provide otherwise or a co-determination law assigns the authority to remove managing directors to the supervisory board.

Notwithstanding their claims for compensation under their service contracts, managing directors can be removed from office at any time with or without cause, unless the articles or a Co-Determination Act provide otherwise. The articles can restrict the right to remove managing directors without cause but cannot restrict the right to remove them for cause.

The removal of a managing director must be entered in the commercial register and the remaining managing directors must apply for registration of the removal. While the removal does not have to be registered to be effective, registration should not be delayed. This is because as long as someone is registered in the commercial register as managing director, the fact that that person is no longer a managing director is no defence against third parties who were not aware of the managing director's removal. Therefore the company will be bound by any act of a former managing director towards such third parties if his removal has not been registered.

2. Resignation

Resignation, whether for cause or not, is a unilateral act which becomes effective when the resignation is declared, even if it is a violation by the resigning managing director of his contractual duties and therefore creates a claim by the company for damages. Resignations must be registered on the commercial register. Registrations should not be delayed unduly for the same reasons given above concerning registration of the removal of a managing director from office.

3. Service Agreement

Either the company or the managing director may give notice with respect to the service agreement. In this case, the notice period is to be determined according to the German Civil Code (*BGB*).

However, in many cases a termination with notice (*ordentliche Kündigung*) is not permitted. In particular, if the service agreement is concluded for a fixed term and does not explicitly provide for a termination with notice, the service

agreement may be terminated only for cause (*wichtiger Grund*). If the service agreement is not for a fixed term, such agreements will, in practice, provide for long notice periods between 6 and 18 months. Summary dismissals for cause are also required if the company falls within the scope of the Co-Determination Act.

In general, duration of the service agreement can be connected with the position as managing director. This can be achieved through a contract clause stipulating that the resignation of the managing director shall constitute a cause for termination of the service agreement. Such clauses might however be invalid, if the managing director himself is bound by a long-term duration of the contract or a long-term notice period whereas the company is able to cancel the contract at any time.

VI. Personal Liability

It used to be an unwritten rule that in the event of alleged mismanagement, directors were simply removed from their offices without any further consequences. Now, however, increasing internationalisation and globalisation, concepts of shareholder value and return on investment and the company's increasing pressure to commence actions and claim damages against their former directors result in more German directors requiring D&O insurance coverage in their role.

Moreover, recent German legislation such as *AnSVG* 2004, *BilKoG/BilTeG* 2004, *APAG* 2005, *KapMuG* 2005 and the *UMAG* 2005 and respective central decisions of the Federal Civil Court (*BGH*) have resulted in increasing damages claims against directors by the supervisory bodies. While US style D&O insurance policies do not cover "internal claims," i.e. claims from the company against its own officers and directors, German insurance polices in general cover such claims (*Innenverhältnisdeckung*) provided there was no gross negligence or intent nor gross violation of contractual obligations (*Nichterfüllung vertraglicher Pflichten*). It is therefore advisable to obtain expert advice on this topic when concluding service agreements with directors.

VII. Application of Labour Laws

As previously mentioned, managing directors are generally considered not to be employees. As a consequence, managing directors do not fall under the scope of the Dismissal Protection Act and severance payments in case of a termination of a managing director are not common in Germany (may be with the exception of change of control clauses). At the same time managing directors often benefit from longer contractual termination notice periods and/or individual company pension promises. However, due to case law, some labour laws may also apply to managing directors if the managing director is in need of protection like an executive employee (*leitender Angestellter*). This may be especially true for managing

directors who are neither major nor minor shareholders of the company (so-called *Fremdgeschäftsführer*).

Whether a managing director is in need of protection is to be determined by the degree of their economic dependence of the company on a case-by-case basis. If a managing director is considered to be comparable to an executive employee, provisions regarding the statutory notice period or the right to reference letters may apply.

According to a decision of the Federal Labour Court (*BAG*), the service contract of a managing director is not transferred to the buyer in the course of a transfer of business, as would be the case with employment contracts. In case of a transformation of the company according to the Company Transformation Act (*Umwandlungsgesetz*) the service contract of the managing director remains valid. However, in most of the cases the position as managing director will be void. The consequence would be that the company's duty to employ the managing director (not the obligation to pay him) will cease, and the managing director will have a reason to terminate the service agreement for cause.

C. Management Board Members

Most of the legal principles described above regarding managing directors of *GmbHs* apply also to management board members (*Vorstandsmitglieder*) of stock corporations (*Aktiengesellschaften, AGs*). However, certain particularities exist with regard to management board members. Therefore, the following shall be restricted to explain some basic legal principles and the main differences to managing directors of *GmbHs*.

The composition of the management board is regulated in the company's articles (*Satzung*). The management board may consist of one or several members. If the company's basic capital (*Grundkapital*) amounts to more than three million Euro, the management board must consist of at least two members, the articles may however provide that it consists of only one member. In companies with regularly more than 2,000 employees, a labour director (*Arbeitsdirektor*), essentially responsible for personnel and social matters, must be appointed as equal member of the management board by the supervisory board. The German Corporate Governance Codex recommends management boards with several members.

I. Appointment

1. Supervisory Board Resolution

Appointing a member of the management board is a corporate act requiring a resolution of the supervisory board by a simple majority of the votes cast. This is mandatory and the supervisory board may not delegate its appointment authority to the supervisory board committee.

2. Term

The supervisory board may appoint management board members for a time period of up to five years. This time limitation is intended to avoid the company being bound by long-term appointment commitments. Management board members may however be reappointed for a further term or their term may be extended for a maximum of further five years. Only if the management board member has been appointed for a term of less than five years, may his term may be extended to a total term of five years without new resolution.

3. Deputies

The supervisory board may appoint deputy management board members (*stellvertretende Vorstandsmitglieder*) besides the regular board members. In principle, these usually have the same rights and obligations as regular management board members.

4. Chairmen and Spokesmen

If the management board consists of more than one member, the supervisory board may appoint a chairman of the management board (*Vorstandsvorsitzender*) by a simple majority of the votes cast. In case the supervisory board has not appointed a chairman, the management board may appoint its own spokesman of the management board (*Vorstandssprecher*). The German Corporate Governance Codex, however, recommends the appointment of a chairman.

5. Service Agreement

Like with managing directors of *GmbHs*, the corporate act of appointment must be distinguished from the service contract. In principle, both are legally independent from each other.

At the conclusion and the termination of the management board member's service contract, the stock corporation is represented by its supervisory board.

6. Qualification for the Position as Management Board Member

Only individuals, not legal entities, are eligible for the position as management board member. Members of the management board are not necessarily required to be German citizens, and therefore may be foreign citizens. Further, members of the management board do not have to be shareholders of the stock corporation; rather, they are appointed by corporate act and obliged by service agreement, even where they are, in fact, shareholders. The company's articles may provide for further qualifications (e.g. professional experience).

In principle, management board members may not simultaneously be members of the supervisory board, if one exists, which oversees the activities of the management board.

II. Representation of the Company

According to the stock corporation act, the stock corporation is legally represented by the management board both in and out of court. The members of the management board are usually only authorized to represent the company jointly. However, the articles of the corporation may provide otherwise.

III. Internal Management Structure

The management of the company is monitored by the supervisory board. Management tasks may not be assigned to the supervisory board. In principle, the management board is independent from the instructions of the supervisory board. The company's articles or the supervisory board must provide that certain kinds of business activities may only be conducted with the consent of the supervisory board. If the supervisory board denies its consent, the management board may instead request that the shareholders resolve to grant their consent by a majority of at least three-fourth of the votes cast.

IV. Duties and Responsibilities

1. Duties and Responsibilities of Management Board Members

The management board is responsible for the entire management of the stock corporation. If the management is subdivided among the management board members, the members still have a duty to exchange information and to intervene in the case of undesirable developments.

The management board prepares and executes shareholders' resolutions. It must inform the shareholders immediately where there is a loss of half of the basic capital and file for bankruptcy in case of insolvency or over-indebtedness. The annual statement of accounts (*Jahresabschluss*) and the status report (*Lagebericht*) are also established and presented by the management board.

2. Violation of Duties

The members of the management board must act in accordance with their duties, otherwise they may be held liable for damages. In comparison to managing

directors of *GmbHs*, a rather strict liability scheme corresponds to the broad authorities of the management board. Particularly, management board members are held jointly liable for damages to the company due to violations of their duties, if they cannot prove that they acted without fault (reversed burden of proof).

Management board members are not liable to the company if their actions are based on a lawful shareholders' resolution. Their liability is however not excluded by mere approvals of the supervisory board. Further, stock corporations may only waive claims for damages against management board members at least three years after accrual of such a claim. Such waivers require the consent of shareholders holding at least 90% of the basic share capital. Where the managing director is subject to bankruptcy proceedings, the time restriction for waivers of damage claims does not apply.

V. Removal and Resignation

1. Removal

Management board members of *AGs* can only be removed from office by the supervisory board for cause. This is different from managing directors of *GmbHs*, and is intended to increase the management board member's independence and motivation to carry out his duties in a responsible way. Removal for cause may particularly be considered in cases of gross negligence (*grobe Pflichtverletzung*), inability to manage in an orderly way (*Unfähigkeit zur ordnungsgemäßen Geschäftsführung*) or where there is a vote of no confidence (*Vertrauensentzug*) by the shareholders. Votes of no confidence will only constitute cause if the confidence was withdrawn on objective grounds. Such shareholders' resolutions do not oblige the supervisory board to remove the respective management board member, instead, the supervisory board decides this by a resolution in its own right.

Causes for removal are gross breaches of duty, lack of fitness for proper management or withdrawal of confidence by a general meeting (*Hauptversammlung*) of the shareholders, if the withdrawal is not based on obviously unreasonable grounds.

Where a management board member has been removed by a supervisory board resolution without cause, the management board member may file a claim for a determination of invalidity of the removal. The removal remains valid and effective until a final court decision renders it invalid.

2. Resignation

In principle, management board members may resign from their office. The legal requirements for their resignation are however not yet resolved. In particular, it is disputed whether a management board member needs cause to resign (e.g. in case

of his denied discharge). Some assume that management board members may resign without cause, in a way similar to managing directors of *GmbHs*. Insofar, resignations are held to be void only under special circumstances constituting abuse of right (e.g. in a company crisis or in order to achieve a changed service agreement or an early reappointment).

3. Service Agreement

Like a managing director, the management board member's service contract is legally independent from the corporate acts of appointment and withdrawal (or resignation). Particularly, in case of resignation or revocation of office, usually only the corporate position as management board member ends. The service agreement may persist, due to the fact that a cause for withdrawal does not necessarily form sufficient cause for the summary dismissal of the service agreement. The service agreement may provide differently although high thresholds regarding the required cause apply to terminations of service agreements before the end of their term.

VI. Application of Labour Law

Since the management board member is executing employer functions, his contractual relationship to the employing stock corporation is not strictly an employment relationship, but rather a service contract on business management functions. Therefore, statutory employee protection provisions of German labour law (e.g. the Dismissal Protection Act) do not apply to management board members. Service relationships of management board members may, however, show similarities with employment relationships, particularly those of executive employees. As far as this is the case, certain labour law provisions may apply accordingly.

The ordinary civil courts and not the labour courts have jurisdiction in relation to disputes between management board members and the stock corporation.

D. Key Aspects

- Managing directors and management board members are not considered employees of the company.
- Service contracts of managing directors and management board members are generally legally independent from the corporate acts of their appointment and removal.
- Appointment and removal of managing directors require shareholders' resolutions by simple majority of the votes cast.

- Management board members are appointed and removed by the supervisory board by a simple majority of the votes cast. Different from managing directors, they may only be removed for cause.
- Appointment and removal of managing directors and management board members must be registered with the commercial register, particularly in order to be legally effective towards third parties.
- Since managing directors and management board members execute employer functions for their companies, in principle, the statutory employee protection provisions of German employment law do not apply to them.
- Ordinary civil courts are competent for legal disputes regarding the service contract relationships of managing directors and management board members.

Part II
Labour Law

Chapter 18
Unions and Collective Bargaining

Jens Kirchner and Pascal R. Kremp

A. Coalitions

I. Background

From the times of early capitalism employees in Germany started to form trade unions in order to improve their working conditions. Employers responded by creating employers' associations. These associations act as a counterbalance to the trade unions, forming a negotiating partner for conflicts with the unions. Both trade unions and employers' associations fall under the generic heading of "coalitions."

II. Definition of the Term "Coalition"

A coalition exists where the following conditions are met:

- It is a voluntary and private body of employees or employers, which has been established for a certain period of time, has a corporate organisation and is democratically administrated
- Independence (especially independence from employers and employers' associations from the State and from other social groups, such as political parties)
- The primary purpose is the protection and promotion of working and economic conditions

In order to conclude collective bargaining agreements, the coalition must be willing to be part of respective agreements, must accept the current law concerning labour conflict and arbitration and must have so-called "social power," which

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means that it must be able to put pressure on its employer and the employers' association.

III. Freedom of Association

The basic right of the so-called "Freedom of Association" is codified in Art. 9 sec. 3 of the German Constitution. The purpose of freedom of association is the protection and promotion of working and economic conditions. It is a basic right, encompassing rights for individuals as well as for coalitions themselves.

Freedom of association allows individuals to found coalitions and to participate in or refrain from them. This basic right is highly protected under German labour law. Thus, clauses in employment contracts preventing the freedom of association are void, as are dismissals based on an employee's participation in a coalition. Further, clauses in collective bargaining agreements which oblige the employer to employ members of a specific union are not valid.

Moreover, it is freedom of association which assures the existence and activity of the coalition itself, including the right to advertise for new members, the right to decide freely on its activities, the right to take part in labour conflicts and particularly the right to conclude collective bargaining agreements.

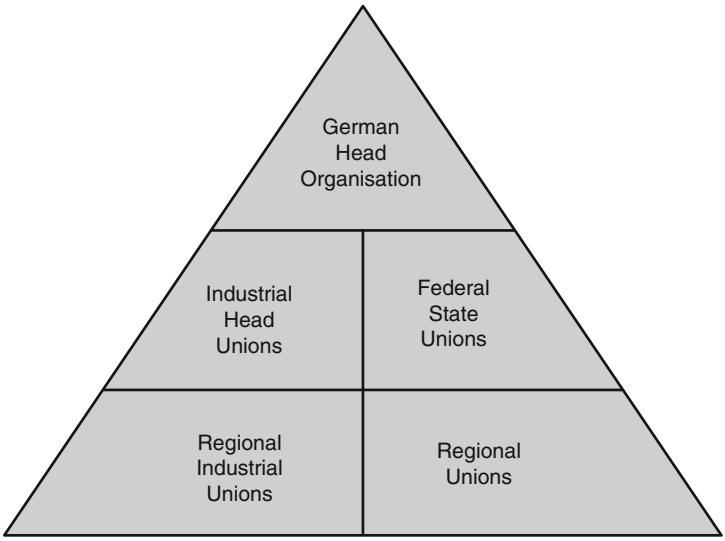
IV. Employers' Associations and Trade Unions

1. Employers' Associations

About 80% of employers in Germany are represented by employers' associations. The associations are organised either in the form of industrial unions or in the form of regional unions. Industrial unions encompass employers within the same industry, while regional unions encompass employers from the same region, regardless of which industrial sector they belong to.

Nevertheless, it is also possible for both types of unions to be combined into a regional industrial union, (e.g. the union *Hessen Metall*, which is open to all employers of the metal industry in the region of Hessen). Regional industrial unions regularly belong to industrial head unions (*Bundesfachverbände*) and regional unions to the respective federal state union (*Landesvereinigungen*), such as the *Vereinigung der hessischen Unternehmerverbände, V.h.U.* For example, the aforementioned *Hessen Metall* is a member of the industrial head union, *Gesamtmetall*.

Industrial head unions and federal state unions, on the other hand, usually belong to the Head of the German State Union (*Deutsche Arbeitgeberverbände e.V.* (*BDA*)) and/or to other head organisations such as the *Bundeverband der Deutschen Industrie e.V.,* (*BDI*).



Example of the structure and relationship between employers' associations

2. Trade Unions

Trade unions are organised either as industrial or as professional organisations. Industrial organisations operate on similar principles to the employers' industrial unions: they are associations of employees working in the same industrial sector. The *IG Metall* union, for example, represents employees working in the metal, electronics, textiles and clothing, wood and synthetics sector, as well as employees in the information and communication technology sector.

Professional unions, on the other hand, are unions for members of the same profession, such as *Marburger Bund*, the union for medical doctors.

At the head of the trade unions is the German Association for Trade Unions (*Deutscher Gewerkschaftsbund* (*DGB*)), to which the majority of trade unions belong. In 2008, the German Association of Trade Unions had 6,371,475 members from eight different Employees' Associations. Usually trade unions are organised as associations without legal capacity.

V. Coalition Rights in Companies

Trade unions have numerous rights in companies in which they are represented. This is the case if at least one employee of the company, excluding the managing director, is a member of the trade union, and if the trade union is responsible for the

company according to the terms of its own statute. Coalition rights in companies can be divided into three categories:

- The trade union has a controlling function in respect of the formation of works councils and compliance with the Works Constitution Act. The union has, for example, the right to appeal against the election of a works council because of its violations of law, or to file an application against the formation of a works agreement with the labour court.
- The trade union has a supporting function in relation to the activities of the works council. A representative of the trade union may participate in meetings of the works council as a consultant, if ¼ of the members of the works council make an application.
- The trade union acts as the counterpart to the employer. The union has the right to recruit new members within the company. For this purpose, the trade union is allowed to mobilise union members who are not employed by the company. And these union members have the right to access the company.

B. Collective Bargaining

I. Background

The right to collective bargaining agreements overcomes the weakened position of the employee in relation to the employer, allowing for a balanced negotiation about working conditions. Thus, a collective bargaining agreement guarantees a minimum standard of working conditions, such as remuneration, working hours and holiday entitlement.

II. Forms of Collective Bargaining Agreements

A collective bargaining agreement is a contract between an employer or employers' association and one or more trade unions. It can be concluded in different forms.

1. Collective Association Agreement

A collective association agreement (*Verbandstarifvertrag*) is a contract between two coalitions. On the one side, there is the trade union, representing the employee; on the other side there is the employers' association, representing the employer or numerous employers.

2. Collective Company Agreements

In collective company agreements (*Firmentarifvertrag*), the trade union and the employer are directly involved. Instead of an employers' association, the employer itself is the contracting partner.

III. Preconditions for Collective Bargaining Agreements

There are certain preconditions, set out by the Collective Bargaining Agreement Act, which have to be met in order to conclude a collective bargaining agreement.

1. Written Form

The agreement must be concluded in writing and must be signed by the contracting parties.

2. Capacity for Collective Bargaining

Only trade unions, their head unions, employers' associations and their head associations and the individual employer itself have the capacity to be a party to the contract. Making collective bargaining agreements is part of the statutory duties and responsibilities of trade unions and employers' associations.

3. Competence for Collective Bargaining

Finally, the parties to the contract must have the competence to conclude collective bargaining agreements. The competence of trade unions and employers' associations is regulated by their own statute. The individual employer, however, is always competent for its own business.

IV. Scope of Application

The parties to the agreement must stay within their regional and factual competencies when setting the scope of the agreement. Thus the parties can regulate whether the agreement will be applied regionally or nationwide and so on. The parties also define the companies to which the contract will apply. Often the agreement is narrowed to a specific sector (e.g. all businesses in the construction sector).

If both parties to the contract are organised according to the industrial association principle, the collective bargaining agreement is usually concluded for all businesses in the relevant industrial sector. Such a collective bargaining agreement is a contract applied to the whole industry (*Branchentarifvetrag*).

Furthermore, the parties have to decide upon the agreement's scope with regard to personnel. In this respect the agreement can be limited to certain positions, such as employees, apprentices and so on. Usually, the collective bargaining agreements stipulate that key employees do not fall in the scope of agreement.

Finally, collective bargaining agreements often include regulations concerning the beginning or ending of the contract.

V. Effect of Collective Bargaining Agreements

Collective bargaining agreements combine two legal components which have different effects: on the one hand, they form legal obligations, giving rights and duties to the contracting partners. On the other hand, they have a normative component, meaning that such legal have an immediate and direct legal effect for employers and employees ("statutory effect").

1. Obligatory Effect

Collective bargaining agreements place the contracting partners under legal obligations.

The following legal obligations always arise:

- During the term of the collective bargaining agreement the contracting parties may not call for labour disputes (e.g. strike).
- The obligation to ensure compliance with the provisions with statutory effect of the contract. Note, however, that it is for the employers and employees to enforce the provisions with statutory effect.
- The obligations on employers' associations to ensure their members respect the provisions with statutory effect.

Another obligation which may arise is the duty to have arbitrational proceedings after the expiry of the contract.

2. Statutory Effect

The agreement has a statutory effect for individual employment contracts. It overrides the terms of the employment contract, even if the employer and employee did not have knowledge of the collective bargaining agreement.

The statutory effect of collective bargaining agreements has several practical consequences.

a) Priority Over Contractual Terms

The collective bargaining agreement overrides less advantageous terms of an individual employment contract. As the provisions of the collective bargaining agreement with statutory effect apply directly, the employment contract does not have to be amended for this to take effect. It is not even essential that the affected employer or employee is aware of the provisions contained in the collective bargaining agreement.

Due to the statutory effect of a collective bargaining agreement, a deviation from its terms is generally not allowed. However, there are two exceptions to this:

- More favourable terms
  Where a term in a contract of employment differs from the collective bargaining agreement to the benefit of the employee, it will still be valid. The more beneficial rule will apply.

  The evaluation of whether a term in the employment contract is more favourable than a term in the collective agreement is made by an objective comparison of matters such as the number of holidays, remuneration during holiday, and the notice period.
- Exemption clauses
  The collective bargaining agreement may provide for permissible exemptions by individual agreement or – which is common – by works agreement with the works council. In such a situation, the individual agreement of the works agreement will overrule the collective bargaining agreement, even if it is to the detriment of the employee. Collective bargaining agreements often, for example, allow increasing the weekly working time for a limited number of employees by individual or works agreement.

b) Waiver, Exclusionary Periods

The waiver of collective rights is only permissible if the waiver is authorized by the parties to the collective bargaining agreement. However, many collective bargaining agreements provide for a specific deadline the employee has to bring forward his/her claim; otherwise the claim will forfeit.

VI. Binding Effect of Collective Bargaining Agreements

Collective bargaining agreements can generally apply to an employment relationship in the following situations:

- Immediate application since employer and employee are members of the respective association and union or the employer itself is a party of the collective bargaining agreement
- Reference clause in the employment agreement
- The collective bargaining agreement is generally binding (*allgemeinverbindlich*)
- Operational practice

Collective bargaining agreements can be declared to be generally binding. In this case, employers and employees who were not previously bound by the agreement will now covered by it.

1. Immediate Application

A collective bargaining agreement applies to an employment relationship on one side if the employer is either a member of the employers' association which has entered into a collective bargaining agreement or the employer itself is a party to the company agreement. On the other side, the employee has to be a member of the respective union which has entered into the collective bargaining agreement. Only if both sides, employer and employee, are bound to bargaining agreement, the collective bargaining agreement applies to the employment relationship of the respective employees.

The provisions of the agreement are binding on the parties until it expires. It is important to note that termination of membership of the union or association will not end the responsibilities imposed by the agreement. As the agreement may last for years, commentators often consider this to be unconstitutional. However, the Federal Labour Court upholds this principle, considering it important to promote the stability of associations and to protect employees.

In this context, the consequences of a transfer of business (German implementation of the EU Acquired Rights Directive) are of high practical importance. According to sec. 613 of the German Civil Code, rights and obligations set out in a collective bargaining agreement will become part of the individual employment contract in the event of a transfer of business. This process is called transformation. All provisions set out in the agreement must not be changed to the disadvantage of the employee until at least 1 year after the transfer of business. The 1 year period is irrelevant, however, if the agreement expires or if the acquirer's business falls under a different collective bargaining agreement. If the acquirer is part of another collective bargaining agreement which governs the same matter, those terms displace the old contract and the old agreement is no longer binding.

2. Contractual Application

In order to ensure that the benefits of a collective bargaining agreement apply to employees who are not automatically bound by it ("outsiders"), individual working

agreements often have referring clauses (*Bezugnahmeklausel*). Employers usually put such reference clause in all employment agreements in order to avoid administration of two different salary schemes and to avoid that all employees would immediately join the union to get the benefits of the collective bargaining agreement. Under a referring clause, the provisions of a collective bargaining agreement apply to those employees who are not member of a trade union. The question of which agreement will be applied depends on the wording of the referring clause.

The clause may make reference to a specific version of a collective bargaining agreement. In this case, under a so-called static referring clause, only provisions of that specific collective bargaining agreement are binding. If the bargaining agreement is modified (e.g. salary increase), the "new" collective bargaining agreement is not covered by the referring clause.

The referring clause may make reference to the collective bargaining agreement for a specific region and industry effective from time to time (e.g. to the collective bargaining agreements of the metal industry in Bavaria). This is called a "small dynamic referring clause." If the employment agreement only states the collective bargaining agreements applicable to the business and effective from time to time, such clause is known as a "large dynamic referral clause." In the case of dynamic clauses, employees will participate in the modification of the collective bargaining agreement over time.

- Jurisdiction of the Federal Labour Court

As dynamic referral clauses mainly have the purpose of treating all employees as if they were union members, the Federal Labour Court has interpreted dynamic referral clauses in the past as equal treatment clauses. As a result, if the employer's membership of the association ended, the referral clause lost its dynamic effect and only the current collective bargaining agreement was binding on the employees.

The Federal Labour Court has changed its position on this issue. Employment contracts signed after January 2002 are no longer interpreted as equal treatment clauses. Now it must be explicitly mentioned in the referral clause if it is to have the purpose of equal treatment. Otherwise, dynamic clauses are interpreted literally, in other words, as having dynamic effect. As a result, modifications of the contract, whether to the benefit or to the detriment of the employee, are binding.

- Consequences of the Jurisdiction

The impact of legislation with regard to the transfer of businesses is interesting. In the event of a transfer of business, dynamic clauses guarantee that collective norms referred to in the individual employment contract will continue to apply.

Dynamic referral clauses entered into before 2002 are interpreted as equal treatment clauses. Therefore the specific collective bargaining agreement that was binding on the seller at the time of the transfer of business will apply. However, if a new collective bargaining agreement in the acquirers' business is binding on the employees who are union members, the same agreement will be binding on the "outsiders" due to the interpretation of the clause as an equal treatment clause. This holds true, even if the new contract differs to the detriment of the employee.

Dynamic referral clauses in employment contracts signed after 1 January 2002 are not automatically interpreted as equal treatment clauses. The clauses are taken literally as dynamic clauses. Therefore, future modifications of the collective bargaining agreement will be binding on employees. As a result, different collective bargaining agreements may be applied in the same company depending on the date of the employment contract.

The question of the interpretation of dynamic referral clauses is also interesting where the employer resigns from the contracting association. The Federal Labour Court had to decide a case where an employment contract concluded in May 2002 included a dynamic referral clause. The employer resigned from the contracting employers' association and was not willing to continue to apply the collective bargaining agreement. The Court ruled that the employer was obliged to apply the collective bargaining agreement referred to in the employment contract, even though it was no longer a member of the contracting employers' association. The reasoning of the Court was that there was no evidence that the clause had the sole purpose of an equal treatment clause. Thus resignation from the employers' association does not result in the non-application of the relevant collective agreement.

3. General Binding Effect

Collective bargaining agreements can be declared to be generally binding. In this case, the agreement is directly and compulsorily binding on all employees. The Federal Ministry of Labour and Social Affairs may only declare the agreement to be generally binding if one party to the contract has applied for such a ruling, and if a commission of three members of each head association of employers and employees gives its consent to the declaration.

An exception exists for the construction and building cleaning industry, postal services, nursing services, security services, laundry services, the coal mining industry, the waste industry and trade union institutions for further education. Under the Posted Workers Act, all minimum employment conditions contained in collective bargaining agreements which have been declared to be generally binding are applied to employment relationships between employers which have their head office in one country and employees working for them in a different country. The collective bargaining agreement about a minimum wage for the electronics industry is one such agreement, whereby all employees of that sector are granted a specific minimum wage.

4. Operational Practice

A collective bargaining agreement may also be applicable to the employment relationships, if the employer has applied such bargaining agreement over an extended period of time as a matter of fact. However, future changes to the

collective bargaining agreement will not apply based on this theory of operational practice (*betriebliche Übung*).

VII. Termination of Collective Bargaining Agreements

Collective bargaining agreements come into force either by the signing of the contract, or within a specific date set out by the contracting parties. Retrospective implementation is possible and quite common. The publication of the agreement is not a precondition for its effectiveness.

A collective bargaining agreement may end by way of expiry date, the triggering of some condition in the agreement, regular termination, termination for good cause or by means of a cancellation agreement. The agreement also ends if one party to the contract resigns from its association. Normally, however, the agreement ends on its expiry date. In this case, how ever the agreement comes to an end, the post-termination effects must be considered.

VIII. Post-Termination Effects

As a period of time without the implementation of a collective bargaining agreement must be avoided, collective rules continue to exist, even if the agreement expires, until the norms are displaced by a new arrangement. As a result, the content of the negotiations which led to the original agreement will be protected.

Nevertheless, the Federal Labour Court has limited post-termination effects to those employment relationships which were in force during the term of the collective bargaining agreement. Employment contracts which are concluded after the expiration of the collective bargaining agreement will not be covered by the post-termination effects.

As mentioned above, a new arrangement will override the effects of the previous agreement with post-termination effect even if it is to the detriment of the employee. A new arrangement may be in the form of a collective bargaining agreement, works agreement or individual agreement.

For example, an individual agreement granting 28 days of annual leave will override the term of an expired collective bargaining agreement which granted 30 days of annual leave.

IX. Concurrency and Plurality

If an employment relationship is covered by multiple collective bargaining agreements, the agreements apply alongside each other, insofar as they differ in their

content. If one matter is covered by more than one collective bargaining agreement, however, the concurrency of agreements, or the question of which agreement is to be applied, arises (*Tarifkonkurrenz*). As a result of overlapping agreements, the legal rules applying to an employment contract often conflict. According to the Principle of Uniformity, only one collective bargaining agreement, the one which is most specific, will be applied to the relevant employment contract. Whether one contract is more specific than another is decided by examining the geographical, factual and personal connection to the business. For example, a company agreement will be more specific than an association agreement, a regional agreement will be more specific than a nationwide agreement, and so on.

Another situation where collective bargaining agreements conflict is the case of plurality of agreements (*Tarifpluralität*). This arises where numerous collective bargaining agreements would apply to employment relationships in the same business, i.e. one employer would have to deal with different unions. So far, the Federal Labour Court has ruled that also in this case only the most specific agreement applies which is usually the collective bargaining agreement which would apply to most employees in the business.

C. Key Aspects

- Employers form employers' associations, whereas employees may represent themselves in trade unions. The generic term for both associations is a coalition.
- The right to join a coalition is guaranteed by the German Constitution. This so called freedom of association also includes the right to refrain from joining a coalition.
- Employers' associations are based on industrial sectors and regional areas. Trade unions are categorized by industrial sectors and professions.
- Trade unions have special rights in businesses, such as being able to supervise the cooperation between a works council and the employer.
- Trade unions and employers' associations, or trade unions and employers, may regulate working conditions jointly through a collective bargaining agreement.
- Collective bargaining agreements form legal rules which apply directly and are binding to the individual employment relationships, just like ordinary statutory law.
- Collective legal rules are only binding upon members of the contracting unions and the contracting employer by making reference in the individual employment agreement or by a decision of the Federal Ministry of Labour and Social Affairs.
- The scope of application of the collective bargaining agreement is defined by the parties to the contract themselves.
- If a collective bargaining agreement expires, the collective provisions will stay in force until they are overridden by a new agreement (so called post-termination effect).
- If two collective bargaining agreements apply to the same employment relationship, the more specific agreement will be applied.

Chapter 19
Labour Conflicts

Jens Kirchner and Eva Mittelhamm

A. Introduction

The German legal system does not explicitly regulate rights relating to labour conflicts. As a result, these rights are predominantly developed by jurisprudence and are mainly based on the guaranteed constitutional right of coalition. In addition, further rules concerning aspects of labour conflicts and freedoms within business derive from customary law and the European Social Charter. Labour conflicts are an admissible tool in negotiations concerning collective bargaining agreements, particularly in order to adjust the agreement to modified operational circumstances or to the general business environment. Therefore, if negotiations fail, the parties to the contract may try to achieve the conclusion of a new collective bargaining agreement by putting pressure on the other party through labour conflict. Labour conflict means that usually the employees, but sometimes also employers, collectively and purposefully exerting pressure on the other party by disturbing the employment relationship. Most of the conflicts between employers and employees are related to salary issues or job retention.

B. Labour Conflict Practice

I. Principle of Parity

The aim of a labour conflict is to regulate working conditions in collective bargaining agreements. In order to achieve this, the principle of parity (*Prinzip der Kampfparität*) ensures the balance of powers between the parties. By virtue of this principle, labour conflicts are only admissible if they are appropriate and necessary to secure the balance of powers between employers and employees.

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II. Employees' Instruments

1. Strike

The strike is the most effective and most important instrument for employees in labour conflicts. A strike is defined as the temporary, planned work stoppage of a large number of employees in order to achieve a collective aim. The aim of a strike must be the achievement of a collective bargaining adjustment, as the strike is an implementation of tariff autonomy. Therefore, the following requirements have to be fulfilled for the strike to be lawful.

a) Formal Requirements

A lawful strike has to be organised by a trade union and can only be carried out by, and against, parties who are able to be parties to the collective bargaining agreement. This is frequently the case, where the employer is part of an employers, association and the employee is a member of a trade union.

Generally, single employees are not allowed to strike by themselves. An exception to this principle can be made for an employee holding a key position. However, if the trade union makes use of the employee's extraordinary position in order to put pressure on the other party (for example to close down the entire business) this would have a disproportionate impact on the balance of powers. This would therefore lead to violation of the principle of parity.

So-called 'wildcat' strikes, (strikes which are not organised by the trade union) are generally illegal.

A further formal requirement is the holding of a strike ballot, in which a certain majority of members of the trade union must support the execution of the strike. Employees who are not members of the trade union are entitled to participate in a strike.

b) Purposeful Action

Another requirement for a lawful strike is that the strike must be aimed at a change that can be achieved by collective bargaining agreements.

Demonstration and protest strikes are unlawful if the purpose is to criticise or influence the employer, i.e. the aim is not to achieve a conclusion of a collective bargaining agreement.

Political strikes are illegal, as the aim is to gain concessions from public authorities and to put pressure on the parliamentary legislative procedure. Participants in political strikes may even be accused of assaulting constitutional bodies.

In 2007, the Federal Labour Court (*Bundesarbeitsgericht, BAG*) ruled that 'supporting strikes' are considered legal. Strikes whereby one trade union supports

another in the latter's labour conflict are lawful if a certain economic closeness exists between the businesses organised by the different trade unions. Nevertheless, the supporting strike itself needs to be lawful.

c) No-Strike Clause

If the trade union is bound by a no-strike clause in a collective bargaining agreement, all labour conflicts concerning issues governed by that agreement will be invalid until the agreement terminates. For the duration of a collective bargaining agreement there is a 'relative peace' obligation, meaning all measures of labour conflict must be refrained from, as long as the crucial issue is regulated in the agreement.

d) Principle of Proportionality

The strike itself is governed by the principle of proportionality. This implies that the strike is only admissible after all other options for solution of the problem are exhausted, which in turn means that all negotiations must have failed (the so-called 'ultima ratio' principle). The ultima ratio principle is of high importance in constellations, where employees refuse to work for 2–3 h during negotiations in order to put pressure on the employer. According to case law of the Federal Labour Court such so-called warning strikes are also restricted by the ultima ratio principle and are therefore unlawful, if negotiations have not failed at the time of the warning strike. However, the warning strike itself implies that negotiations have failed and the failure does not have to be announced specifically to the employers.

Due to the principle of proportionality the trade union has to respect the principle of fair labour conflict measures. Therefore, certain methods may be unlawful and can lead to claims for compensation. As an example of this principle it is unlawful to prevent non-striking employees from getting to their workplace and fulfilling their duty to work. It is also a violation of the principle of fair labour conflict measures if the trade union does not ensure a minimum of emergency and conservation measures.

Emergency measures are necessary measures in order to ensure the minimum supply of basic personal and public necessities.

Conservation measures are essential measures, which are necessary at the end of the labour conflict to ensure the functionality of the business and the immediate resumption of work.

e) Collective Social Plan

Over the last few years it has been noticeable that conflicts have increasingly shifted from an association level to that of the companies themselves. So-called

collective social plans (*Tarifsozialplan*) are concluded more often after strong pressure from the unions. Such plans regulate in particular if and how a company will achieve a change in operations and the question of compensation for employees who have been disadvantaged. The collective social plan therefore regulates issues which are usually subject to a balance of interests or social plan between the individual employer and the local works council. These collective social plans can be concluded with the employer alone as a collective company agreement or between the employers, association and the trade union as a company related collective association agreement.

In the event of imminent closure of businesses or relocations of operations, trade unions increasingly turn to such collective social plans. In 2007 the German Federal Labour Court (*BAG*) explicitly affirmed the possibility of enforcing a collective social plan through strikes. According to the court ruling, matters of a typical social plan are collectively regulatory matters, i.e. can be subject to a collective social plan.

f) Overview of Strike Days in Europe

The number of working days lost in Germany because of strikes is, in comparison to other European countries, considerably moderate (*source: Eurostat*).

Country	Amount of lost working days per 1,000 employees in the year		
	2006	2007	Average 2006/2007
1. Slovakia	0.01	0.00	0.005
2. Sweden	0.47	3.20	1.84
3. Switzerland	2.00	2.00	2.00
4. Netherlands	2.00	4.00	3.00
5. Ireland	4.30	3.45	3.88
6. Lithuania	0.00	8.00	4.00
7. Hungary	2.00	10.00	6.00
8. Poland	3.25	18.66	10.96
9. Germany	12.00	12.00	12.00
10. Malta	19.00	5.00	12.00
11. United Kingdom	28.00	38.00	33.00
12. Norway	64.91	1.68	33.30
13. Denmark	32.60	34.33	33.47
14. Finland	30.00	42.99	36.50
15. Italy	29.50	47.30	38.40
16. Romania	3.80	75.32	39.56
17. Spain	47.00	58.00	52.5
18. Turkey	42.00	502.00	272.00
19. France	116.00	Not available	–
20. Portugal	16.00	Not available	–

2. Further Instruments of Labour Conflict

Further tools utilised by employees in labour conflicts include reduction of work (slowdown strike), 'sit-in's', boycotts and so-called flashmobs.

In slowdown strikes, employees offer performance of their work but intentionally do not perform the work as they are supposed to. This method of action is unlawful.

'Sit-in's' have been held to be illegal in the jurisprudence and this is supported by academics. The same applies to business blockades. Such measures affect the employer's rights regarding the business establishment, domestic authority and the sole ownership of the production facilities.

It is necessary to differentiate in the case of boycotts. If the only reason for the boycott is to ensure the effectiveness of a strike – without applying additional pressure on the employer – the boycott is legal. Other legal measures include the trade union appealing to employees of businesses which are on strike not to work and to also appeal to employees to not perform work that is not required during a strike. However, it is generally illegal to require a client of an employer to call for a boycott if the intention is to reject the employer's services. Such appeals constitute a violation of the principle of proportionality.

Recently labour conflicts have also been carried out by so-called 'flashmob' actions. The retail sector has been especially affected by such actions. Trade unions instruct their members to block retail stores by filling shopping carts with goods and leaving them standing in the alleys or proceeding to the checkpoint and noting that they cannot pay after the cashier has scanned all goods. The Federal Labour Court (*BAG*) ruled in 2009 that such flashmob actions can be lawful labour conflict tools as long as the principle of proportionality is preserved.

III. Employers' Instruments

1. Lock-Out

The employer's most important instrument in labour conflicts is the lock-out. A lock-out involves the exclusion of employees from work. A lock-out is declared by one or more employer without obtaining the employees' consent and by refusal of payment of remuneration.

The aim of a lock-out is to shorten a strike in order to reduce its economic consequences. Like the strike, the lock-out is only admissible after the employer has made use of all negotiation measures and must be approved by the consent of the association. As a consequence a 'wild' lock-out is unlawful.

In practice, the lock-out is most often a 'defensive' lock-out as a reaction to an offensive strike. With regard to the principle of proportionality a quotation rule has to be respected regarding the quantity of employees affected in the course of lawful strikes:

- If less than 25% of employees of the respective collective bargaining area are asked to participate in the strike, at the most 25% on top of these employees are allowed to be locked-out.
- If 25% of the employees (or more) are asked to participate in the strike, the total sum of striking and locked-out employees in the respective collective bargaining area may be 50%.
- If 50% of employees (or more) are called to strike or are affected by the lock-out, a further lock-out is unlawful.

2. Further Tools of Labour Conflict

Additionally, employers have further tools in labour conflicts such as shut down of (or part of) the business and the provision of supplementary benefits, for example the granting of premiums to employees who do not participate in the strike (*Streikbruchprämie*).

- The employer whose business is subject to a strike, may close down the business provided the non-striking employee's contracts have been suspended. It is not decisive in this regard whether a further employment would be possible and reasonable. Those employees who are willing to work must be adequately informed about the fact that their work performance is abandoned during the labour conflict.
- Granting a supplementary benefit for those employees who are not striking and willing to work is another tool for the employer in labour conflicts. To avoid the shut down of the business the employer may grant benefits to those employees who break the strike declaring that they will not participate in it.

C. Legal Consequences

The end of the labour conflict will have different legal consequences for those who were involved and third parties who were not.

The legal consequences of the strike also depend on whether the strike was lawful or not. This is especially true for the possible claims that the employer may have against striking unions and/or striking persons for omission and/or for compensation and the right to extraordinary termination.

I. Parties of the Employment Contract

As mentioned above the dimension and content of the legal consequences of a labour conflict will depend on its lawfulness.

1. Lawful Labour Conflict

The participation in a lawful strike leads to the suspension of the main obligations of the employment agreement. The striking employee is not entitled to employment and remuneration during that period of time. However, trade unions pay so-called strike benefits (*Streikgeld*) to the striking employees for the duration of the strike.

The suspension of the main obligations begins with the participation of the employee in the strike and ends with the offer to take up employment again.

Secondary obligations of the parties, for example the obligation of confidentiality or a non-competition covenant remain unaffected during the labour conflict. Moreover, the employment relationship itself persists during a lawful strike. Therefore, the underlying main obligations will revive automatically as soon as the labour conflict ends. Explicit re-employment is not required.

A lawful labour conflict has no implications on the employment relationship with regard to the social security insurance. The membership of the employees will remain intact during the labour conflict. The employer, however, does not have to continue to pay social security contributions because the obligation to pay salary is suspended during the lawful labour conflict,

2. Unlawful Labour Conflict

If an employee participates in an unlawful strike the obligation to perform work is not suspended.

Therefore, the employer is entitled to claim the performance against the employee by enforcing it at court. The employer can instigate a preliminary injunction against the unlawfully striking employee as the participation in an unlawful strike constitutes a violation of obligations under the employment agreement. The employee is not entitled to receive salary during the participation in an unlawful labour conflict. If the employee does not fulfil his contractual obligations after sustained request of the employer, the latter can claim compensation for the violation of the contractual obligations and unlawful conduct in violating the employer's rights relating to his business. A prerequisite for the claim for compensation is default on the part of the employee and damages incurred on the part of the employer.

Further, the employer may consider a conduct-related termination or summary dismissal of the unlawfully striking employee. The termination can only be valid, though, if the employer has repeatedly but unsuccessfully called upon the employee to resume his performance at work. In addition, a prior warning letter has to be issued towards the respective employee. A consultation of the works council is not necessary as the termination originates in the labour conflict.

In respect of terminations due to a labour conflict the termination of single employees is also possible according to the principle of selective dismissal (*Prinzip der selektiven Kündigung*). Otherwise the employer would only have the option to terminate either all or none of the employment agreements. However, the selection

of the employees whose employment relationships are to be terminated may not be discretionary. Instead the decision about the employees to be dismissed has to be based upon factual selection criteria. For instance, continuing participation in the labour conflict can be a good reason. In the case of an unlawful lock-out by the employer, the employer's obligation to pay salary is not suspended. Unlawfully locked out employees, therefore, remain entitled to their remuneration. If the employer violates this right, they are in arrears and may have to pay compensation if the employee suffers financial damage because of the non-payment.

In general, a legal lock-out justifies the summary dismissal of the employment relationship by the employee. Nevertheless, in a few situations a good cause will be missing, for example in the case of a short lock-out or minor default of the employer.

In the event of an unlawful labour conflict the employment relationship regarding social security insurance is initially not affected and memberships will remain intact at first. However, after 1 month, memberships in all parts of the social security insurance end if the labour conflict is illegal. Employer contributions are suspended for the duration of any salary suspension.

II. Parties of the Labour Conflict

Like for the parties of the employment agreement the legal consequences for the parties involved in the labour conflict depend on the legality of the labour conflict itself.

1. Lawful Labour Conflict

In the case of a lawful labour conflict, labour unions and employers' associations are obligated to interact. Because of the principle of fair conflict the parties of the conflict have to assist with the organisation of emergency and conservation measures (see above). According to the principle of proportionality the parties are bound by the obligation to avoid actions which cause an unreasonable burden on the other party.

2. Unlawful Labour Conflict

In the case of unlawful measures, compensation claims and claims for omission may arise on the side of the trade union as well as on the side of the employers' association either because of violation of the collective bargaining agreements or due to the right of coalition activity.

Usually, associations do not suffer any damages in the event of an unlawful strike. Therefore, claims for compensation and omission mainly occur with the employer.

A claim for omission against a trade union because of an unlawful strike can be achieved by preliminary injunction.

III. Legal Consequences for Third Parties

Third parties not involved in the labour conflict can also be affected. Therefore, they are entitled to take action against the parties in conflict.

For companies directly affected by the conflict the special rule of risk of labour conflict (*Arbeitskampfrisiko*) applies. According to this rule the entitlement to remuneration of employees willing to work is dispensed if the employment is technically impossible or economically unreasonable for the employer because of the strike. If this is not the case, the employee is entitled to continued payment of remuneration. If the employer does not comply with this obligation he may be held liable for damages as explained above.

Companies indirectly affected usually cannot assert claims; the legal protection of the business establishment is not that extensive. A company can be, for example, indirectly affected if a labour conflict that occurs at an automobile industry supplier in collective bargaining area A affects the automobile production of an employer in collective bargaining area B because of a lack of vendor parts. A so-called long range effect can develop if the association responsible for the company indirectly affected is identical or closely connected with the association directly involved in the labour conflict. In this case employers and employees bear the respective labour conflict risk, i.e. the employee bears the remuneration risk and the employer bears the operational risk. This results in a loss of the employee's entitlement for employment and remuneration for the duration of the labour conflict.

D. Key Aspects

- Strikes as well as lock-outs are permissible labour conflict instruments for the enforcement of collective bargaining aims as long as the principles of parity and proportionality and compliance with the peace obligation and the principle of fair labour conflict measures are observed.
- Lawful labour conflicts result in the suspension of the main obligations of the employment relationship.
- Unlawful labour conflicts have no suspending effect with the result that claims for performance and for damages can occur on both sides.
- Labour conflicts shift increasingly from association level into companies and shut downs of businesses are affected by trade unions' claims for collective social plans.
- Even employers that are not members of employers, associations can be affected directly or indirectly by labour conflicts.

Chapter 20
Employee Representation

Pascal R. Kremp and Jens Kirchner

A. Introduction

German law provides for employee representation at different levels. The most important employee representative body is the works council (*Betriebsrat*), a body elected by employees for a term of 4 years. The works council has to be consulted on a wide range of subject matters. However, the works council is not usually competent to negotiate salaries and other key terms of employment. This competence rests with the unions. The unions are usually nationwide organisations and do not only exist in a single company. Also, only unions have the competence to call for a strike. Key members of the works council, particularly in larger companies, are, however, often union members and have a say within the union. Employees are also represented in an "economic committee" (*Wirtschaftsausschuß*), a body of employee experts mainly appointed by the works council. The committee has a right to be informed of relevant economic circumstances of the employer. In large companies with significant operations within at least two member states of the European Union (EU) employees may set up a European Works Council, competent for matters affecting several countries.

B. Works Council

Employees in operations with more than five employees may elect a works council. The works council has to be informed and consulted in regard to certain matters; in some instances the employer might even need the consent of the works council, without which the employer would have to ask a mediation committee (*Einigungsstelle*) to make the ultimate decision. Failure to involve the works council may mean that the employer cannot implement a measure, even though an employee might have agreed on it on individual level.

Whilst such participation rights of employee representatives might be unusual for foreign investors, the system has proven successful. The key to such success is

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to build up a trusting working relationship with the works council. This will undoubtedly take effort and patience at the beginning and will depend on the individual characters on both employer's and employees' side. In the long term it is better for the employer to be co-operative than to take a hostile approach. Employers are well advised to take an educated stance and treat the works council with respect. This does not mean that the works council should be permitted to be involved in areas where it does not have a say, but its statutory information and consultation rights (so called co-determination rights (*Mitbestimmungsrechte*)) should be respected. Otherwise, if the relationship between employer and works council is frayed and full of distrust, this will be detrimental to both the employer and the employees.

The works council is the representative body of the employees. Key employees such as managing directors/board members are not represented by the works council and may not participate in the elections of the works council. The works council has no information and consultation rights with regard to these individuals.

Employers should also be aware that hindering the works council members in performing their office or trying to stop elections of a works council can constitute a criminal offence.

I. Elections

Employees in operations with at least five regularly employed employees, who are eligible to vote, may elect a works council. There is no legal obligation to elect a works council and the employer is not obliged to call for elections. In fact, in some industries such as IT, PR or marketing there may not be a works council in place, despite the fact that such operations have several hundreds employees. For a long time a well known German software company did not have a works council in an operation, despite employing several thousand employees.

The costs of the elections, including the time off of all employees to participate in the elections have to be borne by the employer.

1. Operation

A works council may be elected in every operation (*Betrieb*). An operation has to be distinguished from the legal entity (e.g. Limited Liability Company (GmbH)). A legal entity might have several operations.

Usually, every site with management responsible for taking all employee related decisions (e.g. hiring, dismissals) can be considered as an operation which is eligible for a works council.

Sometimes, two separate legal entities run a joint operation (*Gemeinschaftsbetrieb*) together. This is often the case with two companies who are part of the same group; these companies might take all employees related decision together.

In circumstances such as this, only one works council would have to be elected by the employees of both companies at this operation.

2. Eligible Employees

All employees over the age of 18 are eligible to vote, including agency workers who have been employed for at least 3 months.

Generally speaking, all employees over 18 who have been employed in the operation for at least 6 months are eligible to stand for election.

3. Election Process

The election procedure is governed in detail by law. A simplified two step election process can be carried out in operations with less than 50 employees eligible to vote.

a) Regular Election Process

In operations with more than 50 employees eligible to vote a sophisticated election process has to be followed.

If no works council exists three employees or the union may call for the election of a three member election committee in a staff meeting. If a works council exists the works council has to appoint the election committee at least 10 weeks prior to the end of the term.

The election committee has to create a list of employees eligible to vote. Often, there will be discussions as to whether individual employees are key employees (and thus are unable to vote) or not. Six weeks prior to the election date the election committee publishes an official announcement of the upcoming elections. Within 2 weeks of this announcement employees can be nominated as candidates. To be stand as a candidate employees need a certain number of signatures of employees eligible to vote (depending on the size of the operation). Employees then vote on the list of candidates. The voting is done in secret. The election committee counts the votes and publishes the result of the election.

b) Simplified Election Process in Small Operations

In operations with less than 50 employees eligible to vote a simplified election process applies. The employees vote the election committee in a staff meeting. If a works council already exists the election committee is appointed by the works council. During the staff meeting employees may hand in notification that they

would like to stand as a candidate in the elections. The elections take place in a second staff meeting 1 week later. Again, the voting is done in secret.

4. The Timing of Works Council Elections and Term of Works Council Members

The works council is elected for a term of 4 years. Elections take place throughout Germany every 4 years from 1 March through to 31 May. The next elections will be in spring 2010, then 2014 and so on.

If elections take place during the 4 year period (e.g. because no works council has been in existence so far or the works council resigned) if only 1 year is left until the beginning of the next term the elected works council will remain in office until the end of the next term.

Example: The works council is elected in summer 2009. This works council remains in office until spring 2014. If the works council had been elected in 2008, it would remain in office only until spring 2010.

5. Size of the Works Council

The size of the works council depends on the number of employees regularly employed in the operation.

The size of the works council depends on the number of employees in the operation
5–20 employees eligible to vote: 1 member
21–50 employees eligible to vote: 3 members
51 employees eligible to vote to 100 employees: 5 members
101–200 employees: 7 members
201–400 employees: 9 members
401–700 employees: 11 members
701–1,000 employees: 13 members
1,001–1,500 employees: 15 members
1,501–2,000 employees: 17 members
2,001–2,500 employees: 19 members
2,501–3,000 employees: 21 members
3,001–3,500 employees: 23 members
3,501–4,000 employees: 25 members
4,001–4,500 employees: 27 members
4,501–5,000 employees: 29 members
5,001–6,000 employees: 31 members
6,001–7,000 employees: 33 members
7,001–9,000 employees: 35 members
In operations with more than 9,000 employees the number of works council members increases by 2 for every further 3,000 employees (e.g. in operations of 9,001–12,000 employees there are 37 members and so on)

6. Challenging Works Council Elections

If important rules of the election process have been breached the elections can be challenged in court in the 2 weeks following the announcement of the results. The employer, three employees or a union having members in the operation can file such an application. If the court agrees that the process has been breached the elections have to be repeated.

If the rules which have been breached are sufficiently important, so much so that someone might not call it a democratic election process, the elections are null and void. In this case, there is no time limit as to when the elections can be challenged and the 2 week deadline is not applicable.

7. Protection Against Dismissals

To ensure that the employer cannot hinder the election process German law protects employees who are involved in the process against dismissal. Employees who call for elections, members of the election committee and candidates for the works council are generally protected against dismissals until the end of the elections. They can only be given notice to terminate where there is significant cause (e.g. fraud) and if the works council or the labour court consents to the dismissal.

Members of the election committee and candidates may not be dismissed for a further period of 6 months following the official announcement of the results of the elections, except for significant cause. During this period the consent of the works council or the labour court is not required.

Since it takes very little effort to call for works council elections or to become a candidate – and given the protection against dismissal afforded to those involved – employers should carefully review any parallel restructuring measures. There have been cases where 80% of the entire work force have suddenly signed up for candidacy ostensibly for the protection from dismissal that they were then given. A court of appeal has ruled this would not have been an abuse of statutory rights.

II. Role of Members

Members of the works council enjoy wide protection in order to fulfil their office without interruption.

1. General

Members of the works council should not suffer any disadvantages, nor enjoy any additional benefits due to their office. The salary of member of the works council has to increase in accordance with the salary of a comparable employees.

The works council usually holds regular meetings. In order to attend such meetings, and also for other works council related matters, the members have to

be released from their duties on full pay. Indeed, in larger operations a specific minimum number of works council members have to be released from work on a permanent basis (see table below) so as to do works council duties full time. The number might be higher if necessary for the works council to perform its duties.

Every works council member is also entitled to attend external training on how to perform his role as member of the works council. In general, members of the works council can claim at least 3 weeks time off for training per 4 year term. Such training, like all other expenses, has to be financed by the employer.

To perform its duties, the works council may obtain professional advice (e.g. lawyers, consultants) if necessary. Again, such costs have to be borne by the employer.

Number of members of the works council to be permanently released from work (depending on the size of operation)
200–500 employees: 1 member of the works council to be released
501–900 employees: 2 members
901–1,500 employees: 3 members
1,501–2,000 employees: 4 members
2,001–3,000 employees: 5 members
3,001–4,000 employees: 6 members
4,001–5,000 employees: 7 members
5,001–6,000 employees: 8 members
6,001–7,000 employees: 9 members
7,001–8,000 employees: 10 members
8,001–9,000 employee: 11 members
9,001–10,000 employees: 12 members
In operations with more than 10,000 employees, one additional member has to be released per every additional 2,000 employees (e.g. in operations with 10,001–12,000 employees – 13 members, in operations with 12,001–14,000 – 14 members and so on)

2. Protection Against Dismissals

Members of the works council are protected against dismissal during the term of office and for 1 year after the end of term. During this period they may only be dismissed for good cause (e.g. fraud). During the 4 year term the works council has to consent to the dismissal of individual members. If the works council does consent the employer has to apply to court for to its consent.

Works council members can only be dismissed for significant reasons related to their employment relationship and not for reasons related to their office only (e.g. continual refusal to co-operate with the employer in relation to the works council). If a member of the works council is in gross breach of his duties as works council member, 25% of the employees in the operation, the employer or the union may apply to court to withdraw the member from office. Such applications are usually filed in very rare circumstances only.

III. Information and Consultation Rights

The works council enjoys a wide range of information and consultation rights, in some cases even the right to veto decisions of the employer. The veto may only be overridden by a ruling of a mediation committee. Such rights are usually called "co-determination rights."

The works council has general information and consultation rights. The co-determination rights mainly concern three subject matters falling into the categories of personnel matters, so called social matters, and economic matters.

1. Works Agreements

Where the works council has information and consultation rights employer and works council may agree on a so called "works agreement" (*Betriebsvereinbarung*). This is usually the case for social matters (see below). Such a works agreement is binding on all employees (except executive employees). If however the individual employment agreement, collective bargaining agreements or statute provides for terms which are more beneficial to employees, such terms will override those in the works agreement. Employer and employee may not deviate from such works agreement to the detriment of the employee by individual agreement.

A works agreement may usually be terminated by giving 3 months notice, unless otherwise stipulated in the agreement.

In areas where the employer needs the consent of the works council (in particular in social matters) the works agreement will remain in effect even after the expiration of the notice period (so called "after effect" (*Nachwirkung*)). However, employer and employee may then deviate from the works agreement, even to the detriment of the employee, by individual agreement.

2. General Rights

The works council has general participation rights. The works council is, for example, obliged to ensure that all the laws, rules and health provisions are applied correctly and to the benefit of the employees. The works council should also prevent discrimination. In order to perform its job, the works council has to be informed by and provided with information from the employer.

3. Personnel Matters

The works council enjoys certain co-determination rights in relation to personnel matters. The co-determination rights concern three different areas: general personnel matters, continued professional education, and individual personnel matters.

a) General Personnel Matters

The employer has to inform the works council of staff planning, in particular on the current and future need for staff.

Upon request by the works council, an employer has to advertise job positions internally, before looking externally.

Employee questionnaires (i.e. for job candidates or for current employees) and performance review schemes have to be agreed with the works council. If employer and works council cannot come to an agreement, the mediation committee will find a ruling.

Employer and works council may also agree on binding "selection guidelines" particularly for hiring, transferring and dismissing employees. In the event of dismissals for business reasons, such selection guideline may, for example, provide for specific number of points for age, years of service, child and family support obligations and disability. Such social selection may only then be reviewed by a court for gross mistakes.

b) Matters of Continued Professional Education

Upon request by the works council the employer and works council have to consult on continued professional education and development measures for employees. In particular, they have to consult on the need for such measures.

c) Individual Personnel Matters

This is, next to participation rights in social and in economic matters, one of the key areas in which the works council has a right to be involved.

aa) Hiring, Transfer and Regrouping of Employees

In operations with more than 20 employees, the employer has to inform the works council prior to hiring an individual, prior to the transfer of an employee from one job position to another and prior to an employee being moved from one pay grade to another. The works council has to be provided with all necessary documents, including the application form for the employee concerned, in order to make an educated decision.

The works council may only refuse its consent to such measures for specific reasons, e.g. if the measure would be in breach of the law, or it is likely that other employees will suffer a detriment as a result. The works council has to notify the employer of its refusal in writing (including the reasons for the refusal) within 1 week since notification by the employer. If the refusal is too late or is in incorrect form the works councils consent is assumed.

If the works council lawfully refuses the employer may ask the labour court to give consent in its place.

In urgent cases the employer might – despite the refusal of the works council – implement the measure anyway (e.g. hire an employee). However, the employer then has to ask the court for consent within 3 days.

bb) Dismissing Employees

Prior to giving notice to an employee the employer is obliged to inform the works council of the reasons for the dismissal. This can be done verbally. However, for evidential reasons it is recommended that this is done in writing.

The works council has 1 week to provide its comments on the proposed dismissal in writing. In the event of a dismissal for significant cause (e.g. fraud) the works council has only 3 days.

Even if the works council objects to the dismissal, the employer can still serve the dismiss letter to the employee. It is however imperative to wait the 1 week or 3 days period prior to giving notice. Otherwise, the dismissal will be null and void.

The dismissal will also be null and void if the works council has not been duly and sufficiently informed on the reasons for the dismissal. In fact, many wrongful dismissal claims succeed because the employer has failed to thoroughly inform the works council of the reasons for dismissal.

4. Social Matters

a) Catalogue of Co-Determination Rights

Pursuant to sec. 87 of the Works Constitution Act (*BetrVG -Betriebsverfassungsgesetz*) the works council has powerful co-determination rights, particularly in relation to the following.

aa) Policies Relating to the Order and Conduct of Employees

Prior to implementing policies which govern the conduct of the employees the employer has to obtain the consent of the works council. Typical examples of such policies are dress codes, access to premises, and prohibition of alcohol or drug use on the company's premises.

Also, certain provisions of a code of conduct/code of ethics are subject to the co-determination rights of a works council. US companies are unable to implement some types of code of conduct without the consent of the works council, even though they might be able to under US law, in particular under the Sarbanes Oxley Act.

Employers should take care when implementing whistle blowing hotlines. Due to the past history of Germany, employees tend to be very sensitive to such hotlines, particularly if they allow anonymous reports. Such hotlines may be considered a tool of denunciation. However, a recent case which has made the news headlines concerning bribery in a large German company may have improved the public perception of such hotlines. Nevertheless, the implementation of whistle blowing

hotlines is not only subject to the consent of the works council, but also to strict data privacy laws, i.e. multinational companies in Germany must observe the stringent provisions of the Federal Data Protection Act (*BDSG - Bundesdatenschutzgesetz*).

Depending on the content, employee handbooks might also be subject to co-determination rights.

bb) The Start and End of the Working Day and Allocation of Hours on Weekdays

It is up to the individual employment agreement and to collective bargaining agreements to determine how many hours per week employees have to work (e.g. 40 h per week). However, the employer has to agree with the works council a general scheme regarding the allocation of hours on weekdays as well as start and end time for every day. Such schemes include rules on flexible working times, schemes on shift work, and work rosters.

cc) Temporary Increase or Decrease of Operational Working Time

The employer also needs the consent of the works council to temporarily increase or decrease the working hours for the entire operation or a group of employees. Usually, consent is only required if the employer is asking several employees (e.g a department or a business unit) to work overtime or work on a weekend, not if it is only individual employees who are being asked to work overtime.

Also, the employer and works council have to agree on "short time work" (*Kurzarbeit*), i.e. a general reduction of working time with equivalent reduction of salary for a group of employees. Such "short time work" is supported by the unemployment agency as an appropriate mean to overcome a temporary period with a reduced work load due to economic reasons (e.g. loss of customers).

dd) Introducing and Using of Technology to Control the Conduct or the Performance of Employees

The implementation of any technology which may potentially be used to monitor performance or conduct of employees has to be agreed on with the works council. Such systems include video surveillance and the recording of personal internet or email use. Also, computer software used to evaluate performance has to be agreed on with the works council. Depending on the circumstances, video or computer evidence which has been obtained without the consent of the works council may not be used against the individual employee.

ee) Implementation of "Social Institutions"

Employer and works council have to consult and agree on any kind of "social institutions," i.e. institutions which are to the benefit of employees, like a cafe or on-site childcare facilities. Such "social institutions" also include the implementation of a company pension scheme.

ff) Operational Pay Scheme

The implementation of any remuneration scheme has to be consulted on with the works council. If the pay scheme is already governed by collective bargaining agreement – which is often the case – only a remuneration scheme which supplements the collective scheme has to be agreed on with the works council.

Typical issues to be consulted on are the implementation of bonus schemes, stock options or other long term incentive schemes. The works council does not have the ability to determine whether the scheme is introduced nor can it decide the level of remuneration. These decisions remain solely with the employer. However, once the employer has decided to introduce a scheme, the structure of the scheme has to be agreed on with the works council.

In multinational companies there is usually no leeway to change the terms of a stock option or long term incentive scheme since such schemes are implemented on a global basis. When this is the case, it is usually advisable for the employer to make it a "take it as it is or leave it" decision for the works council since the scheme is usually only an additional benefit for the employees, and not part of their contractual entitlement.

b) Mediation Committee

If employer and works council cannot come to an agreement on the aforementioned social matters, either party may call for a mediation committee. This is an internal committee which either may be established permanently or from time to time as and when necessary. The mediation committee consists of an equal number of representatives from the employer and the works council. Both parties have to agree on a chairman, who is usually a judge. The appointment of the chairman itself might take weeks or month if one party is uninterested in coming to a quick resolution. The committee will then come to a final ruling which is binding for both parties and may be reviewed before a court only in very limited circumstances. If the chairman is not able to mediate an agreement between employer and works council, he or she has to take a final decision on the matter in hand.

The costs of the committee are, as all works council related costs, to be borne by the employer.

c) Remedies for Breach of Co-Determination Rights

Where the works council has co-determination rights it may stop the employer from implementing such matters without the agreement of the works council or the mediation committee by injunction. In urgent cases, the works council may even make an application for a preliminary injunction. Also, if the employer is in breach of mandatory co-determination rights of the works council, measures taken with regard to individual employees are null and void. Individual employees would not have to follow such measures or instructions of the employer.

5. Economic Matters

In the event of a significant restructuring – so called changes of operation (*Betriebsänderung*) – the employer is obliged to inform the works council in good time and to consult with the works council on such measures before implementation.

Changes of operations which are subject to the information and consultation rights of the works council are:

- Reduction or closure of operations or significant parts of it
- Relocation of the entire operation or significant parts of it
- Merger or split of operations
- Major changes to the organisation or the purpose of the operation
- Introduction of new working methods

Generally speaking, the employer is only obliged to inform and consult with the works council if a significant number of employees are affected, i.e. dismissed. Case law uses the thresholds for mass redundancies as a rough guide as to when the obligation to inform and consult arises. There is no obligation to consult with the works council in operations of less than 20 employees.

Employers are obliged to inform and consult with the works council if a specific number of employees are affected depending on the size of operation
21–59 employees: more than 5 employees
60–499 employees: more than 25 employees or 10%
500 or more employees: at least 30 employees; additionally at least 5% of the employees

If the threshold is met the employer and works council have to negotiate a so called balance of interests and a social plan. The balance of interests describes the restructuring measure (e.g. relocation to a different city, dismissal of 300 employees). The social plan sets out the compensation for the employees affected (typically severance payments, but may also include other benefits such as commuting allowance, moving expenses).

According to the law the works council has to be informed at an early stage, so that it has the opportunity to influence the business decision of the employer. Ultimately however, the works council cannot prevent the implementation of the restructuring measures as planned by the employer. If the employer is unwilling to reconsider its measures, the works council has the ability to heavily delay the implementation. Employers are well advised to thoroughly prepare any restructuring measures before approaching the works council to avoid lengthy negotiations.

Depending on the competent court, employers might be able to implement the restructuring measures without informing and consulting with the works council or without completing such negotiations. This would, however, be regarded as a highly aggressive approach which might have a negative impact on the reputation of the employer. Individual employees may also be able to claim compensation from court for their economic detriment. In other jurisdictions, courts might issue a preliminary injunction upon request of the works council. Such injunction is very

troublesome for employers and immediately stops the implementation of any restructuring measures; otherwise the employer faces administrative fines of up to EUR 250,000 or 6 months imprisonment.

For further detail on restructuring measures see Chap. 21.

C. Central and Group Works Council

I. Central Works Council

As set out above a company, i.e. a legal entity might well have several operations. If at least two works councils have been created a so called central works council (*Gesamtbetriebsrat*) has to be appointed.

The local works council is only competent for matters at local level. The central works council is competent for matters affecting at least two operations of the same company. For example, if the employer decides to shut down only one site, only the local works council is competent to negotiate a balance of interests and a social plan. If the restructuring measures, however, affect several sites the central works council is likely to be competent.

The central works council, however, is not competent for local matters where no works council exist at all. Thus, if the employer decides to shut down one site where no works council has been set up, it is not obliged to inform and consult with the central works council.

In practice, it is not always easy to establish whether it is the local works council or the central works council who has the competence. It might even be that the two works councils argue about their position. In cases such as this employers are well advised to ask the local works council to give the central works council the authority to negotiate on behalf of the local works council.

II. Group Works Council

Similar to the central works council at company level, the central or local works council may also set up a group works council (*Konzernbetriebsrat*) at group level. The group works council is competent for all matters affecting at least two operations of two different companies (e.g. group wide restructuring measures).

D. Economic Committee

In companies with more than 100 employees the works council has to set up a three to seven member economic committee (*Wirtschaftsausschuss*). The members of the works council have to be employees of the company; this may also include key

employees. At least one member has to be a works council member. The purpose of the economic committee is to be informed and consult with the employer on economic matters, in particular:

- The financial situation of the company
- Production and investing programs
- Reduction, closure or relocation of sites
- Changes of production methods
- Planned takeovers or changes of control of the company

In smaller companies, where no economic committee exists, the works council has to be informed on planned takeovers and changes of control.

The economic committee usually holds meetings on a monthly basis. If the economic committee believe that it has not been informed sufficiently or within due time, it may call the mediation committee, who will then determine the issue. However, the economic committee does not have real power to enforce its rights.

E. European Works Council

Employees in companies or groups with at least 1,000 employees within the European Union and at least 150 employees in each of two member states may set up a European Works Council. The European Works Council is governed by an EU Directive which has been implemented by a national act in each member state. The Directive has recently been reviewed. The purpose of the Directive is to prevent national information and consultation rights being circumvented purely because the ultimate business decision is made by management in another member state.

The main concept behind the Directive is for the company or group and employee representatives to agree on the structure of the European Works Council and its information and consultation rights. If no agreement can be achieved, the European Works Council can be set up based on statute.

Whilst the European Works Council itself does not have a particularly powerful position, employers are nevertheless well advised to respect the information and consultation rights of an existing European Works Council since its members are usually also employee representatives at national level where they might have much stronger participation rights.

I. European Works Council Based on Agreement

At least 100 employees or the employee representatives in at least two member states or the employer itself may call for the formation of a special negotiation committee. Such a committee consists of employee representatives from each state.

The purpose of the committee is to negotiate an agreement on cross border information and consultation of employees with the employer. The agreement on the employee representation is at the full discretion of the employer and the negotiation committee. If employer and negotiation committee come to an agreement, the agreement should be put in written form and include:

- The names of all companies and operations covered
- The composition of the European Works Council
- The competence of the European Works Council and procedure of information and consultation
- The location and periods of meetings of the European Works Council

II. European Works Council Based on Statutory Laws

If the company refuses to negotiate on the European Works Council the employee representation bodies (which may vary from country to country) appoint the European Works Council.

The European Works Council generally consists of one member of each EU member state where the company has operations and, depending on the size of business in a member state the number of representatives may increase. Members are appointed for a 4 year term.

The European Works Council is competent for matters which affect at least two operations or companies in at least two different member states, in particular:

- Information on the development of the business and the perspective of the company (including financial situation, planned reorganisations, mass redundancies) on an annual basis, including providing relevant documents upfront
- Information and, upon request, consultation on unexpected circumstances which may have a significant impact on the interests of the employees, in particular the relocation or closure of companies or operations, and mass redundancies

Failure to inform or consult the European Works Council may result in administrative fines of EUR 15,000.

F. Key Aspects

- Employee representation takes place at different levels: on a business level by the works council, in economic matters by the economic committee, and on European level by the European Works Council.
- Employees in operations with at least five employees may elect a work's council – although there is no legal obligation to do so. Employers are well advised to build a trusting relationship with an existing works council, recognising its rights, but not over-participating with it.

- The works council is fully financed by the employer.
- Members of the works council, the election committee and candidates for the works council enjoy significant protection against dismissal.
- The works council has considerable information and consultation rights, in some instances even the right to veto, which may be overruled by a mediation panel.

Chapter 21
Restructuring

Michael Magotsch and Jens Kirchner

A. Introduction

This chapter shall address the means of restructuring operations in Germany from a labour and employment point of view. It will focus on (1) short time working; (2) reduction in force (RIF) programs including changes of operations in the meaning of sec. 111 of the German Works Constitution Act (*Betriebsverfassungsgesetz*) and issues relating to the transfer of undertakings and three examples of common restructuring scenarios.

B. Short-Time Working

In Germany, short-time working may be an attractive temporary measure for cost reduction in order to avoid lay-offs. As the employees' working hours are reduced they are only remunerated for the reduced hours of work.

I. Preconditions

German law requires a legal justification for the establishment of short-time work. In respect of the change of working hours, German law usually provides that such measures require individual agreement with each employee or modification dismissals (*Änderungskündigungen*) of the individual employment contracts. Businesses with a works councils can implement an agreement with their employee representative body in order to establish short time work for the employees. Collective bargaining agreements setting out preconditions for short-time work (e.g. notice periods for the introduction of short-time work) may also be in place, and if so, these will bind the company.

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In order for employees on short-time work to be entitled to benefits, the employer must file an application with the employment agency. The employer has to demonstrate an unavoidable temporary and significant loss of work (resulting in at least 10% gross salary reduction) and must show that the statutory requirements for the receipt of short-time working benefits are satisfied.

There is a three month exclusionary period for the application of short-time work benefits following the last month of short-time work. Forms for the indication of short-time work and application for short-time work benefits will be provided by the employment agency and need to be followed closely.

II. Incentive One

The German government recently introduced two incentive plans promoting short-time work.

The first incentive plan extended the maximum period for the grant of short-time work benefits. The 12 month period has now been increased to 24 months for employees affected prior to 31 December 2009. These latest changes are effective as of 01 July 2009 and shall be in force and valid until 31 December 2010.

The short-time work benefit amounts to 60% (67% in case of existence of dependent children) of the net salary difference resulting from the reduced working hours during the period of eligibility. It is free of income tax for the employee (the employment agency pays the short-time work benefit to the employer who forwards it to the employees).

III. Incentive Two

The second incentive plan includes measures such as the refund of 50% of social security contributions during short-time work upon application time. The compensation can be increased to 100%, though, if employees participate in professional training programs. After six month of short time work, the employment agency compensates the entire social security contributions for all employees on short time work. This incentive shall be in operation until the end of 2010.

The most significant requirement employees must show in order to receive short-time working benefit is a loss of at least 10% of their monthly gross salary (the additional requirement that at least one-third of the employees working at the business are affected has been suspended until the end of 2010). Until the end of 2010, flexible working time accounts must not be balanced prior to short-time work and time-limited employees and temporary employees may be placed on short-time work.

C. Reduction in Force Programs

RIF programs in Germany are often complex and demand careful advance planning. This is particularly true for companies having a works council and in cases where the number of affected employees exceeds the collective dismissal filing requirement (see Sect. III).

I. Action Plan and Timelines

The time frame and in particular the duration of the information and consultation process with the works council is very difficult to predict. Thorough preparation is the key driver for an efficient consultation process. Also, the motivation or frustration of the work force confronted with potential RIF programs heavily depends on the age and job role profiles of the employees – generally the younger and less senior the employees, the less resistance (e.g. 30 years of age on average).

The length of negotiations with the works council over agreements to balance the interests of the parties and the social plan heavily depend on the support of local German management and staff support from human resources in providing the preparatory work (e.g. draft "story book" for works council information and consultation, notification of works council on each individual dismissal; preparation of mass dismissal filings etc.). The negotiations usually last from a few months up to nine months. In this estimated timescale, mediation and consequential wrongful dismissal cases before German labour courts are not included.

The implementation of RIF programs may for example be divided into three phases.

1. Preparation (Phase 1)

1. Internal preparation
   - Planning of the restructuring measures
   - KEY: Drafting of a "story book" for works council information and consultation
     - Reasons for restructuring measures
     - Units/employees affected
     - Timing for implementation of restructuring
   - Rehearsal with local management of works council presentation
   - Drafting of Q&As (from employer's and works council's perspective)
2. Written resolution to "plan" restructuring measures
   - Resolution by the board/local management to plan restructuring measures; rough description of such planned measures

2. Information and Consultation with the Works Council (Phase 2)

1. Information of works council in Germany on restructuring measure
   - Presentation of "story book" by management
   - Usually preparation of responses to Q&As by works council
   - Agree on fixed meeting schedule
2. Works meeting with all employees to inform on planned restructuring measure
3. Consultation with works council on planned restructuring measure and on compensation of detriments suffered by employees
   - Consultation usually results in two agreements with the works council: a so-called "balance of interests" describing the measure and a social plan providing compensation to employees suffering detriment (e.g. severance payment)
   - Time (information and consultation): may be subject to variation
   - If the consultation on the restructuring measure fails: Mandatory conciliation committee proceeding (*Einigungsstelle*)
     – The committee will consist of representatives of employees and employers, both sides have to agree on a chairman (usually a judge). This process alone might take several weeks. Obtaining agreement between the parties on the appointment of a chairman can often take a considerable amount of time.
     – The chairman may rule on the social plan, but not on the balance of interests.
     – The entire conciliation committee proceeding can take a few weeks or several months.
     – Please note that some labour courts grant preliminary injunctions for the benefit of works councils if employers attempt to implement restructuring measures prior to finalising negotiations with the works council (e.g. preventing employers serving dismissal notices prior to this, or transferring services or assets to other subsidiaries, operations or locations)!
4. Works meeting for all employees on outcome of consultations

3. Implementation (Phase 3)

1. Filing for collective redundancies with local labour agency
   - Dismissal letters should only be served after written confirmation of filing
2. At the same time: Notification of works council on each individual termination
3. Service of termination letter to each employee (usually not prior to one week after notification to works council)
4. Expiration of individual notice period
5. Individual court proceedings with employees challenging the effectiveness of the termination

Generally about 10–30% of employees file a claim to the court; nevertheless, the number might be higher if employees feel that a reasonable severance has not been offered.

Court cases often end up with higher severance payments to be bargained.

The vast majority of cases get settled at first instance.

II. Geographical, Material and Personnel Scope

The German Works Constitution Act (*BetrVG*) applies to all businesses located within the Federal Republic of Germany (so-called principle of territoriality), irrespective of who the owner of the enterprise in question is. It does not apply to any businesses located abroad, even if they are owned by German enterprises. An exception applies to German employees temporarily sent abroad who might still be subject to certain regulations of the Act (*Ausstrahlungswirkung*).

The Works Constitution Act covers any businesses (*Betriebe*), as well as any ancillary plants and units (*Betriebsteile*; see sec. 4 of the Works Constitution Act).

It applies to all employees except for directors and so-called executive employees (*leitende Angestellte*) within the meaning of sec. 5 para. 3 of the Works Constitution Act. This distinction can create significant problems in individual cases. In practice, however, it can often be assumed that only the management level directly below the managing directors (*Geschäftsführer*) of a company may be regarded as executive employees. Moreover, in many cases proxy holders will be deemed executive employees.

In wrongful termination cases it is common for employees to claim that they are not executives. If the employee was considered as an executive in the last works council election, this may be indicative in determining whether an employee is an executive or not. When in doubt, the works council should be consulted as a precaution prior to any termination.

III. Works Council's Rights of Co-Determination

Co-Determination exists in personnel, social and economic matters. This outline concentrates on the latter.

1. Change of Operations

According to sec. 111 of the Works Constitution Act the employer of enterprises generally having more than 20 employees who are eligible to vote must give the works council timely and comprehensive information about any planned operational changes which may result in material detriments to the staff or large sections

thereof. In this case such operational changes have to be discussed with the works council. Operational changes include:

- Reduction and closure of the entire operation or of significant parts thereof
- Re-location of the entire operation or significant parts thereof
- Merger with other operations or the spin off of operations
- Fundamental changes to the organisation of the operation, its purpose, or its facilities
- Introduction of fundamentally new working methods and manufacturing processes

The most common case is the reduction or closure of a large section of the operation. Whether or not a "significant" part of the operation is affected is assessed based on its importance within the organisation of the operation as a whole. However, under case law a "significant" part of the operation is involved if, pursuant to the numbers of sec. 17 of the Dismissal Protection Act, the following staff reduction occurs as in Table.

Threshold Consultation Requirement	
Size of operation	Intended layoffs
21–59 employees	More than 5 employees
60–499 employees	More than 25 employees or 10%
500 or more employees	At least 30 employees; additionally at least 5% of the employees

The governing factor is the number of employees who will be affected, even if it will take place in several "waves." If there are periods of only a few weeks or months between the various "waves," then there is a factual presumption that such measures stem from one overall business plan.

An operational reduction within the meaning of sec. 111 of the Works Constitution Act generally also requires that material operational resources be reduced. Settled case law holds, however, that a mere reduction in personnel while maintaining material operational also includes a reduction in operations. In the case of major operations, this is reflected in the case law, however, only if at least 5% of the employees are affected by the reduction.

Another question to consider is whether redundancies without alteration to material operational resources create an obligation to enter into an agreement for a social plan (*Sozialplan*) with the works council. This is governed by the table of figures set out in sec. 112 a para. 1 of the Works Constitution Act.

2. Balance of Interests

If an operational change is planned, the works council has a right to be given timely and comprehensive notice of it. The works council has the right to discuss the question of the time schedule and the kind of the respective operational change.

The works council may be able to obtain an interim injunction to assert its negotiation rights in several state labour courts. In such cases the employer is prevented from dismissing employees until the conclusion of the discussions concerning the balancing of interests. This type of case law exists, for example, in Hessen, Bremen, Hamburg, and parts of North Rhine-Westphalia. Additionally, recently courts like the court of appeal in Munich have changed their long established jurisdiction, now granting works councils preliminary injunctions in the event that the employer has not reached a balance of interest or a respective mediation award.

Please note that – in the worst case scenario – even if the employer has given the works council comprehensive information, the procedure to balance interests does not automatically end at some fixed term period, but may be extended without any limitation, unless the employer initiates a so-called arbitration procedure (*Einigungsstellenverfahren*) with the Labour Court.

The negotiations with the works council may result in the conclusion of a so-called "Balance of Interests" (*Interessenausgleich*). The Balance of Interests is intended to determine the particular measures of the change in operations, the number or scope of affected employment relationships and the way in which the employment relationships are affected.

The preparation shall start in advance (prior to any meetings with the works council) in order to have a detailed action plan and a back-up plan with respect to the alternative individual measures to be taken.

3. Social Plan

In the event of an operational change within the meaning of sec. 111 of the Works Constitution Act the employer is obliged to conclude a social plan (*Sozialplan*).

The social plan mitigates the economical disadvantages the employees may suffer from the operational change. The means offered in a social plan depend on the alterations leading to the change in operations. A typical form of mitigation is for example the payment of monetary compensation or gratuities in case of termination or the payment of moving costs in case of relocation. The contracting partners are in general free to decide upon the means that shall be granted to the employees.

Nonetheless, the content of the social plan has to be in accordance with other rules. As a consequence, the payment of compensation can for example not be conditioned that the employee waives a wrongful dismissal claim. Additionally, the equal treatment principle has to be observed (see Chap. 3).

Should no agreement be reached, then a conciliation office must be consulted. If the parties are unable to agree on the chairman of the conciliation office and the number of persons sitting thereon, then, upon application by the employer/works council, the conciliation office chairman shall be appointed by the labour court. The court can also rule on the number of people sitting on the conciliation tribunal.

If no agreement on the nature of the social plan can be reached in conciliation either, then the conciliation tribunal will make a decision of its own concerning the plan's preparation. This possibility of enforcement of the social plan by the conciliation tribunal is the decisive difference between the conclusion of a balance of interests and a social plan. Unlike the contracting partners, the conciliation tribunal is bound by certain guidelines stipulated in the Work Constitution Act while forming the social plan. Thereafter, for instance, the social interests of the employees and the economical defensibleness of the decision for the company have to be respected. Additionally, individual cases shall be considered as benefits are evaluated and integrated.

The social plan may be rescinded in limited circumstances only (sec. 76 para. 5, s. 4 of the Works Constitution Act): within 2 weeks the employer or works council can rescind the social plan, claiming that the conciliation tribunal has exceeded its discretionary authority.

Mere redundancies may also require the preparation of a social plan. However, the figures set out in sec. 112a of the Works Constitution must be attained. A social redundancy plan must be prepared, for example, if, in an operation having at least 60 but less than 250 employees, 20% of the regularly employed workers or at least 37 employees are intended to be dismissed for operational reasons. Dismissal includes conclusion of an agreed termination under a settlement agreement triggered by the employer.

Labour unions are – according to recent case law – allowed to increase pressure on the employer to conclude collective social plans which satisfy the demands of the employees. In this respect the labour union may even call upon the employees to arrange a lawful strike. As a strike is regularly followed by enormous costs, employers can be forced to conclude social plans rapidly. Consequently, social plans may – under the pressure of the labour union – strongly benefit the employees.

The strike is only lawful, though, if matters are concerned that are not collectively regulated. It has to be noted, though, that social plans, are often not part of collective bargaining agreements. In order to avoid the costs of a strike, it is often advisable to quickly conclude a satisfactory social plan with the works council before the labour union gets involved.

4. Transfer Company

Transfer companies (*Transfergesellschaften*) often play a major role in larger redundancies and restructurings that involve a large number of dismissals. In such complex scenarios, unions and works councils insist on transfer company schemes being part of any social plan negotiations. The provision of transfer companies shall enable companies to reduce headcount in a "socially reasonable" manner and to allow employees to prepare for new employment challenges and opportunities out of a status of employment for up to 12 months. Further points of interest for the employees to be made redundant are continued insurance in state pension schemes, professional qualification, coaching and training as well as risk free trial employment with potential new employers. The costly introduction of transfer companies

will ultimately delay the point of unemployment of the employees during the term of the transfer company. But also companies may benefit from transfer companies by improving their liquidity, transferring long notice period payroll payments into funding the transfer company and avoiding wrongful dismissal claims.

Please note that not each and every restructuring will justify the establishment of a transfer company. Strategic ideas in connection with the partial sale of assets or units may however be a reason for considering the tool of a transfer company in addition to or as replacement of a social plan. Often potential investors make any transfer depending on a large amount (if not all employees) being transferred to a transfer company prior to any transfer of business. Also please note that the majority of transfer companies have a union background or are run by former union representatives or lawyers who are specialised in representing works councils and/or unions. Therefore time is necessary to carefully analyse the offered set up from transfer companies, their quality as well as all involved costs and administrative responsibilities prior to agreeing to any transfer company.

5. Transfer of Undertaking Related Issues

While it is well established that the transfer of a undertaking (also known as transfer of business) by virtue of contract pursuant to sec. 613a of the German Civil Code (*BGB*) does not as such constitute a change in operations in general, in most of the typical asset deals, any partial transfer of business almost always leads to further measures which are connected with the transfer of a business.

This is particularly true when a restructuring plan results in the relocation of part of the unit, fundamental changes in the organisation of this unit or the restriction and/or closing down of the entire business, or major parts of it.

In the majority of cases it will be difficult to allocate the individual employees to the individual measures which are intended by the restructuring and transfer of the business parts into individual units.

Therefore, in such cases the works council will be in a position to easily construct a scenario that requires the commencement of negotiations for a social plan and a balance of interest under sec. 111 et seq. of the Works Constitution Act. Also in such situations the preparation well in advance (prior to any meetings with the works council) is essential in order to have a detailed action plan, time plan, lay-off plan (if necessary) and back-up plan with respect to the alternative individual measures to be taken (see action plan and timeline above under I.).

D. Examples

I. Reduction of Central Functions

A typical scenario is the plan to reduce overhead services by way of centralising the overhead administrative functions to individual divisions.

Such a plan must be considered a change in the business within the meaning of sec. 111 of the Works Constitution Act. Here, the key issue will be to undertake a social selection (*Sozialauswahl*) among those currently employed as employees, as not all positions will become redundant. There will still be a need for some employees in each unit. A basic approach under German labour law is that any social selection must protect those employees who are more senior, are older, have more family support duties and those employees who have a disability. Therefore, the best course of action will be to agree with the works council on a so-called appendix to the balance of interest (*Namensliste*), which should be an agreed list of those employees that in the view of management and in the view of the works council should be made redundant. A social redundancy plan must then be negotiated only for those employees. Such plans should be thoroughly prepared internally before discussing the restructuring plans with the works council.

II. Outsourcing of a Group of Employees

The fundamental questions are first whether the group of employees who should be outsourced could be considered a stand-alone unit, and second whether all involved employees are to be clearly allocated to this unit only. In such a case the potential outsourcing of this group to a third party could be considered a transfer of a part of a business as discussed above. Therefore, in principle, such an outsourcing project would not automatically be a change in the business within the meaning of sec. 111 of the Works Constitution Act. However, in reality almost any outsourcing project results in a change of the business structure at the operational level at the same time; i.e. triggering the results of mandatory "*Interessenausgleich*" and "*Sozialplan*" negotiations with the works council as described above.

The plan must closely be analysed and it is strongly recommended that a due diligence exercise from an employment law perspective is undertaken with regard to the in-scope employees prior to raising this issue with the works council.

III. Collective Dismissals

Collective dismissals are often part of restructuring measures. In the case of collective dismissals, special rules have to be observed according to sec. 17 Dismissal Protection Act. Hereafter, the employer is for example obliged to negotiate with the works council before the termination. Additionally, the employer is obliged to inform the employment agency about the planned collective dismissals before the declaration of the dismissal.

According to the latest case law there has to be a minimum period of 30 days which has to elapse between providing the information to the agency and the actual end of the employment relationship. During that so called "stoppage period"

(prescribed in sec. 18 Dismissal Protection Act), the employment agency will have the chance to look for solutions for the upcoming problems arising out of the collective dismissals. Consequently, the period set out in sec. 18 Dismissal Protection Act shall not be added to the period of notice that has to be respected in any case. It will only become relevant in situations, where the termination period is shorter than four weeks. The court ruled that it shall definitely not be a period of time, where the employer is not allowed to declare dismissals.

IV. Impact of Special Protection Against Dismissals

The special protection against dismissal, especially for works council nominees, may cause severe problems particularly if terminations for operational reasons are to be conducted or restructuring measures are planned. That is particularly true if a social plan and balance of interests must be negotiated with the works council or even with the labour union in the case of a change of operations (*Betriebsänderung*).

Numerous employees may apply for the works council just to obtain special protection against dismissals. There have been cases where up to 80% of the employees applied for the works council to get special protection against dismissals. Even though there is only a few number of cases concerning this issue, some labour courts have held this collective effort lawful. Thus, all applicants have enjoyed special protection against dismissals.

This may jeopardize the restructuring measure. Therefore, employers should consider waiting to announce the restructuring measure until after the employees have handed in their election proposals and obtained special protection against dismissals. By acting this way, an employer might lose a few months, having to spend additional personnel costs. However, otherwise the employer faces the risk that the restructuring measure might be delayed even more significantly because of the special protection against dismissals.

E. Key Aspects

- RIF programs have to be prepared carefully and ahead of time due to their complexity.
- The implementation of RIF-programs can be divided into three phases:
- Preparation, information and consultation with the works council, and implementation.
- In the case of a change of operation, the works council must be informed and consulted within. The negotiations may lead to a balance of interests.
- In the event of a change of operation, the employer is obliged to conclude a social plan.

- Typical scenarios in respect of restructurings are (1) the reduction of central functions, (2) the outsourcing of a group of employees and (3) collective dismissals.
- In cases of collective dismissals within the meaning of the Works Constitution Act, the employment agency has to be informed about the planned collective dismissals before the declaration of the dismissals.

Chapter 22
Mergers and Acquisitions

Pascal R. Kremp and Jens Kirchner

A. Introduction

M&A transactions often involve many labour and employment issues, which should be carefully considered at the very beginning of the transaction. In fact, a number of transactions fail to complete because of labour and employment issues, particularly in relation to the unforeseeable risk of pension liabilities of the target company. Therefore, a company interested in a business is well advised to conduct thorough due diligence to obtain a full understanding of how to structure the transaction and how to integrate the acquired business into its own business (post merger integration).

B. Overview of a Typical Transaction

Most transactions are structured in a similar way. Typically, at the beginning of the transaction seller and purchaser enter into confidentiality agreements that must be signed up by executives and employees involved in the transaction. After some initial talks on the transaction the parties sign a letter of intent (also called a memorandum of understanding or term sheet). In the letter of intent the parties set out some of the main terms agreed in principle in respect of the transaction. Depending on the wording of the letter of intent and depending on the relevant laws, the letter of intent may sometimes be legally binding and at other times may not be. Then, the purchaser is allowed to conduct a due diligence exercise. This may include many different topics such as financial, tax, environmental and, of course, the legal due diligence. If the purchaser has obtained a better understanding of the target, the parties will then negotiate and sign the purchase agreement. After signing the parties usually have to fulfil certain closing conditions, often including anti-trust clearance procedures. Once all conditions have been fulfilled the closing takes place and the transaction becomes effective. Subsequent to closing the purchaser has

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to integrate the target into its own business. At every step labour and employment law issues are involved. Typical issues are:

- Disclosure of specific information about the employees of the target
- Structure of the transaction: Can the purchaser pick and chose employees?
- Information and consultation rights of the employee representatives
- Stipulations and warranties in the purchase agreement
- Post-merger/transaction integration

C. Due Diligence

In most transactions, the purchaser conducts a due diligence exercise, i.e. reviews the business of the target. Usually, the seller puts some information on the target together and makes it available to the purchaser in a data room (physically or, more common today, in a virtual data room). The purchaser and its advisers review the data within a short time frame and produce a due diligence report which describes the business and highlights the risks involved. Depending on the purchaser's requirements the due diligence report might be very detailed and may show all contracts that the business has entered into. It may however provide only an executive summary or it may even focus only on major issues (red flag report).

Labour and employment rights play a significant role in Germany (and Europe) and it might be difficult to remedy any employment issues later in the transaction. The purchaser should therefore conduct a thorough due diligence of the labour and employment situation of the target company since staff costs may have a significant impact on the future profitability of the business.

The purchaser usually has a considerable interest in receiving as much information as possible on the business, including on all employees. In Germany (and in the European Union) employees enjoy personal data protection which conflicts with the interest of the purchaser. The parties must also therefore address such data protection issues during the course of the due diligence exercise.

I. Issues to Be Addressed in a Due Diligence

The purpose of the legal labour and employment due diligence is to get a full understanding of the terms of employment and often also of the feasibility and the costs of later restructuring measures.

The purchaser usually provides the seller with a questionnaire which covers many labour and employment topics. The seller should either answer those questions or compile the necessary information in a data room accordingly.

Typical questions and requests for information in respect of the acquisition of a German business are set out below. However, this is not a complete list and may

have to be amended or expanded significantly depending on the target and the deal structure.

- Complete lists of all relevant managing directors and employees (indicating white and blue collar employees) with the following details: name, position, date of birth, years of service, remuneration, fringe benefits, notice period, fixed term, remaining holiday, special protection against dismissals depending on status of individual employees (member of works council, disabled, employee on maternity or parental leave etc.) or based on individual or collective rules
- Employees in partial retirement (*Altersteilzeit*), terms of partial retirement
- Employees subject to post-contractual non-competition provisions
- Employees who have given notice or that they intend to give notice
- Identification of key employees (e.g. with special know-how, customer relationships or special skills)
- Copies of employment agreements of managing directors and key employees
- Templates of standard employment agreements for white and blue collar workers; information on employment agreements deviating from standard templates
- Identification of all employees exceeding a specific annual income or with extended notice periods
- List of employees with change of control provisions and other entitlements in case of a change of control
- Copies of consulting and freelancer agreements
- Copies of agreements with staffing agencies and list of agency workers; copies of official licenses of staffing agencies to contract employees to other companies
- Copies of benefits and other remuneration plans (e.g. stock option plans, bonus plans, sales compensation plans, life and accident insurance) and identification of employees with entitlements to such benefits and variable remuneration
- Salary increases in the preceding fiscal year and agreed future salary increases (either based on individual or collective agreement)
- Copies of all company pension plans (including widow or survivor pensions and pensions for invalidity) and all amendments, including pension plans that have been closed in the past and detailed information on the closure of such plans (e.g. agreements with works council, communication to employees)
- List identifying current and former employees (including pensioners) entitled to each plan and vested or non-vested accrued benefits
- Actuarial reports for the last 5 years
- Information on adjustments/increases to pensions in the past as required by statutory law pursuant to the German Company Pension Act (sec. 16 BetrAVG); if no full increases have occurred in the past, detailed information on reasons for omitting such increases
- Agreements relating to pensions that have been outsourced to a third party (e.g. articles of relief funds including information on whether the purchaser can remain a member of such funds post transaction)
- Employee agreements in respect of any insurance policy

- Schedule of costs of pension or retirement benefits (for example insurance premiums, payments to relief or pension funds, contributions to the mutual pension assurance association (*Pensionssicherungsverein*))
- Copy of company policies (e.g. employee handbook, code of conduct, company car or travel guidelines)
- Information on past transfers of business (*Betriebsübergang*) pursuant to the EC Directive on Acquired Rights (implemented in sec. 613a German Civil Code) affecting any employee within the scope of the transaction
- Information in respect of recent disposals of businesses according to sec. 613a German Civil Code (regarding risk of employees objecting to the recent transfers and claiming employment with the target)
- List of employees with loan agreements
- Information regarding the existence of a works council, central works council and/or economic committee or other employee representatives together with a list of all members including substitute members
- Copies of all works agreements (*Betriebsvereinbarung*), even if expired if still taking effect (so called after-effect, *Nachwirkung*) and other agreements with the works council
- Lists of all operational practices (*betriebliche Übungen*) providing legal entitlements to the employees
- Lists of all unilateral collective promises (*Gesamtzusagen*)
- Copies of minutes of the meetings of the economic committee (*Wirtschaftausschuß*) from the last 3 years
- Copies of all collective bargaining agreements which apply to any of the employees within the scope of the transaction (also if based on "after-effect"); information on unions in each business operation; list of employees showing relevant collective bargaining agreements
- Estimated number of union members within the workforce
- Information on membership in employer's organisations or past memberships
- Description of all collective actions and labour disputes (*Arbeitskämpfe*) (e.g. strike) during the last 5 years
- Description of the status of current and/or upcoming negotiation of collective bargaining agreements
- Organisational charts providing an overview of the structure of the company's workforce and (in the event of an asset deal) the relevant unit
- Asset deal: Description of the unit to be transferred and an explanation of why all employees within the scope of the transaction are part of the unit to be transferred and why the employees not within scope cannot claim that they should transfer to the purchaser based on sec. 613a German Civil Code
- List of all agreements or commitments providing for severance payments
- Information on past restructuring measures including amount of severance payments paid, social plan and balance of interests (agreements with works council on such restructuring transactions), number of wrongful dismissal claims before court

- Information in respect of pending or upcoming negotiations with the works council in relation to restructuring measures affecting any relevant employee
- Overview of conciliation committee proceedings (*Einigungsstellenverfahren*) in the last 5 years, including the topic, name of the chairman, and outcome of the proceeding
- Overview of all audits by authorities (in particular regarding social security) during the last 5 years and copies of statements of the authorities
- List and brief summary of all recent (in the last 5 years), pending or threatened labour law court proceedings
- Documentation of employee discrimination training

II. Data Protection

As the aforementioned due diligence questionnaire shows, the purchaser wants to learn as much as possible about the business and its employees. While in larger businesses the purchaser might be happy with some general information on the employees, in the case of a smaller target the purchaser usually wants to have a full understanding of all employee data such as salary, fringe benefits, age, years of service, membership in the works council, employees on maternity or parental leave or disabled employees. In any event, the purchaser will want this information in respect of any key employees who have significant know-how or customer relationships and are important to the running of the business.

All this information is, however, protected under German data protection laws (which is based on European law). The seller is therefore not generally allowed to share this information with a third party without the consent of the individual employees or any other legal basis. In particular American and Asian companies struggle with these obstacles since the data protection level in the European Union is much stricter than in other countries. These issues may, however, be approached in different ways.

If the target is very small, it might be feasible to obtain the consent of all employees so that the business may disclose the personal data to the purchaser. This will usually only work in very small privately owned businesses where the employees are aware of the sales process.

Even in larger transactions it is quite common to obtain the consent from the top level management or selected key employees of the target since they are usually aware of the transaction and are key to running the business after completion.

Large companies with regular divestitures of their business may consider entering into a general works agreement with the works council in order to address the disclosure of personal employee data to potential purchasers. Such works agreement may also be a sufficient legal basis on which to disclose the information. Works agreements, however, usually stipulate that the works council must be immediately informed of any disclosure which might not always be practicable if the parties wish to keep the deal confidential for as long as possible.

In practice it is not unusual, even though it is doubtful as to whether it is legally permissible, to provide the purchaser with a list showing all employee data on an anonymous basis.

Otherwise, the seller may consider providing the purchaser with only some general information on the employees, such as average salary, average years of service and age (or split by certain age groups) which does not allow the purchaser to identify individual employees.

Even though it is questionable whether it is legally permissible, in practice the seller will sometimes provide access to some restricted personal data but only to the purchaser's advisers and not the purchaser itself. The advisers are then allowed to share only general information with the purchaser, but not any detailed personal data relating to individual employees.

In any event, the seller should enter into an agreement with the purchaser in order to ensure that the purchaser may only use the personal data for the purpose of the transaction and to ensure that the purchaser deletes all data if the transaction does not continue. Also, the seller should make sure that the purchaser undertakes to provide access to this data only to its employees and advisers who have signed up to a confidentiality agreement.

D. Structure of the Transaction

From a corporate point of view there are basically two different types of deal structures. Either the purchaser acquires all shares in the target company or the purchaser acquires all or some assets of the company. The German Transformation Act (*Umwandlungsesetz*) provides for some additional structures such as merger, spin-off or split of the company.

I. Share Deal

In a share deal the purchaser acquires all the shares of the target company. Thus, the legal entity the employees are employed by, i.e. the employer, remains the same after the transaction. All employees will continue to be employed by the same employer. Employees do not have the option to object to the transfer. The works council will continue to be in office and the collective bargaining arrangements will usually continue to apply. Generally speaking the terms and conditions remain unchanged. The focus of the purchaser will therefore be on getting an understanding of the current terms and conditions.

If, however, some terms and conditions at the seller had been provided at group level, the purchaser needs to have a close look at the impact of the transaction on these terms and conditions. Typically, stock options (or other equity awards) are provided by the ultimate parent company and not the target company. The same might be true for sales compensation plans, bonus plans and sometimes pension

schemes. If this is the case, the purchaser will usually have to provide equivalent benefits to the employees of the target company after the acquisition.

II. Asset Deal

In the event of an asset deal the purchaser does not acquire the shares of a company, but all or parts of the assets of the seller.

1. Transfer of Business

In many situations the employment relationships dedicated to the relevant business or business unit will be transferred to the purchasing entity by operation of law according to the European Acquired Rights Directive (implemented in Germany in sec. 613a German Civil Code). This is the case if the relevant business (unit) can be considered to be an economic entity, i.e. an entity which retains its identity, meaning an organised grouping of resources which has the objective of pursuing an economic activity, whether or not that activity is central or ancillary. The European Court of Justice interprets the meaning of an economic entity quite broadly.

If all assets are acquired this will usually trigger sec. 613a German Civil Code. Furthermore, if a business unit (e.g. production) or a specific department (e.g. canteen of a department store) is acquired this can be considered to be an economic unit and can therefore result in a transfer of business. The same is true for many outsourcing deals (e.g. outsourcing of an IT department).

2. Assumption of All Employment Relationships by Purchaser

As a consequence of the transfer of business the purchaser assumes all rights and liabilities of the employment relationships dedicated to the business (unit). In Germany, this usually also includes all pension liabilities. The seller and purchaser are generally not able to opt out of the employee consequences of a transfer of business.

If the purchaser does not have collective bargaining agreements or works agreements with the works council in place, the collective bargaining agreements and works agreements applicable at the seller will remain in effect for the transferred employees after the acquisition. They may be changed to the detriment of the employees only with the consent of the individual employees and only after the expiry of 1 year from the date the transfer became effective. The transferred employees will not, however, by affected by future amendments to the collective bargaining agreements or works agreements of the seller (e.g. future salary increases that have not yet been agreed on at the seller). These will only keep the status quo on the day the transfer of business becomes effective.

If the purchaser has collective bargaining agreements or works agreements in place, they will replace the collective bargaining agreements and works agreements

of the seller provided that these collective agreements govern the same topic. For example, the purchaser's works agreement on working time will replace any such works agreement of the seller, but not the seller's other works agreements dealing with different topics.

III. Transactions According to the Transformation Act

1. Corporate Structure

The German Transformation Act (*Umwandlungsgesetz*) provides for different structures of a transaction on a corporate level (besides the aforementioned share deal and asset deal):

- Merger, i.e. company A will be merged into company B and A ceases to exist
- Spin-off (*Abspaltung* or *Ausgliederung*): Assets of A will be spun off and transferred into another legal entity
- Split: All assets of A will be split and transferred into at least two different legal entities

2. Labour and Employment Consequences

In the event of a merger all employment relationships of the transferor company will be transferred to the transferee company in accordance with sec. 613a German Civil Code, i.e. the transfer of business rule. The transferee company becomes the employer of the employees with the same terms and conditions. However, to the extent collective bargaining agreements and works agreements exist at the transferee company, they will usually replace such agreements of the transferor company.

Essentially, the same rules apply in the event of a spin-off or of a split of a company. In such a situation it might, however, sometimes be unclear which employees belong to the part that will form the spin-off and therefore be transferred to the other legal entity. Similarly, in the event of a split it might be unclear who will be transferred to the one entity and who will be transferred to the other entity. In such uncertain cases, the employer and works council may agree on the names that will be transferred. If an employee brings a claim, the labour court would only review this allocation by the employer and works council for significant mistakes.

IV. Pre-Transaction Considerations

In light of the number of different types of possible transactions, the parties should consider how best to structure the transaction in order to achieve the best outcome.

1. Carve Out

It might well be that a potential purchaser is only interested in specific assets and related staff (e.g. a specific product line) of the seller company, but not in the entire business. Also, the seller might only want to dispose of specific assets or a business unit which, from a mid or long term perspective, are no longer in the core business of the seller.

However, only those employees who are dedicated to the relevant business unit on an organisational level will be transferred to the purchaser. Thus, employees in administrative functions, which are not part of a business unit, for example shared service centres, will usually not fall in the scope of the transaction. Even if, for example, an employee of the centralised shared service centre works exclusively for the relevant business unit, if that employee is reporting to the head of the shared service functions only, he would not be part of the transaction.

Therefore, to ensure that the relevant business unit is self-functioning, the seller might consider carving out the respective business unit prior to the transaction. It may also change the reporting lines of employees in centralised functions to ensure that they become part of the transaction.

The carve out will often trigger information and consultation rights of the seller's works council. Therefore, if the seller plans to dispose of a business unit on a mid or long term perspective, the seller might be well advised to carve out the business unit at an early stage so that it will be easier to handle the later sale of the unit.

In addition, the seller could transfer the carved out unit into a separate legal entity. This would allow the seller to sell only the shares in this new legal entity and thereby, in many cases, avoid consultation with the works council which otherwise may heavily delay or even jeopardise the transaction.

2. Reduction of Headcount Prior to Transaction

Dismissals of employees in operations with more than ten employees must be justified by specific reasons such as operational reasons. The employer may reduce the headcount even in the absence of an acquisition in order to make the target company "leaner" and thus more attractive to potential buyers. In order to do this the employer must have a specific strategy for the reduced headcount (for example, closing a department or business unit which is not core business).

In the event of an asset deal, however, dismissals "because of" the transfer of business are not permissible. The reasoning behind the transfer of business rule is to ensure that the employment relationships will continue with the purchaser after the acquisition. A company is not able to terminate employment relationships by merely transferring the assets to a different legal entity. This means that the seller must either reduce the headcount in advance based on its own operational needs or the purchaser will assume all employment relationships and it may then reduce the headcount in a second step. Strategic investors often want to avoid the latter in order

to keep the transferred employees motivated and not notify the employees of redundancies as a "welcome gift."

In insolvency situations, however, the seller does not intend to continue the business at all. Nevertheless, the Federal Labour Court has allowed dismissals by the seller in situations where an agreed plan is in place with a purchaser. This enables the parties in an insolvency situation to restructure the business even before the transaction takes place; the parties can therefore avoid employees remaining on the payroll for too long. This case law makes restructurings in insolvency situations much easier.

3. Separation Agreements in Insolvency Situations

As previously outlined above, a dismissal "because of" a transfer of business is null and void. Also, any attempts to circumvent this rule are not permissible. For example, it is not permissible to sign separation agreements with all employees and then offer them employment with the purchaser of the assets on lower salaries. Also, it is generally not permissible to sign separation agreements and then offer employment only to a selected number of employees. Any employees who had not been selected would be able to claim employment with the purchaser of the assets since the separation agreement would be null and void.

The Federal Labour Court has, however, permitted a certain construction for specific situations, in particular for insolvency situations.

In the event of larger headcount reductions or an entire shut down of a company, often the Federal Labour Court will allow employees to transfer in a separate legal entity, a so-called transfer agency. The employees will remain with the transfer agency usually for a period of 6–18 months. The purpose of the transfer agency is to enable the employees to qualify for future job positions and provide outplacement services. The transfer agencies are usually run by third party service providers and are subsidised by the government.

In the event of an insolvency situation, the Federal Labour Court allows a selling employer to ask all its employees to sign a separation agreement and transfer them into the transfer agency provided that there is not yet an agreement with the purchaser on the acquisition of the assets. In this situation, the employees do not know if the purchaser will finally acquire the assets or not. At this point the employees therefore have no guarantee that they will be re-hired by the purchaser. In this specific situation the purchaser may pick and choose employees from the transfer agency.

4. Collective Bargaining Agreements

The purchaser should look carefully at the application of collective bargaining agreements to the relevant employees and the consequences of the transaction. This is particularly true for asset deals (transfer of business according to sec. 613a German Civil Code).

The application of a specific collective bargaining agreement usually depends inter alia on the kind of work the majority of the employees is performing. For example, if a company providing only canteen services acquires only the canteen staff of a large industrial metal company, then often the collective bargaining agreements for the canteen business will apply to the staff after the acquisition. These will usually provide for a lower salary than the collective bargaining agreements for the metal industry.

On the other hand, if the acquired employees exceed the number of staff of the acquiring business, then the entire business of the purchaser might become subject to a more expensive collective bargaining agreement.

E. Information and Consultation Rights of Employee Representatives

Employees are represented on different levels. In the event of a transaction, information and consultation rights might exist on all levels of employee representation. All levels must be considered at a very early stage of the transaction and ideally the parties should agree on a plan in respect of how and when to approach each employee representative. If the transaction is multi-jurisdictional, the information and consultation rights of employee representatives must be considered not only on different levels, but also in different jurisdictions, making the transaction even more complex.

I. European Works Council

In large operations with more than 150 employees in at least two jurisdictions of the European Union, employees may set up a European Works Council. The rights of the European Works Council may be agreed with the company, otherwise statutory laws will apply.

Generally speaking the seller has to inform and consult with the European Works Council on all measures that may have a significant impact on the workforce. In the case of either a share deal or an asset deal this mainly depends on the size of the business to be sold. If the transaction also involves the restructuring or relocation of operations or mass redundancies, the information and consultation rights of the European Works Council will be triggered. The information process must take place in good time prior to the measures.

In practice, many companies have been able to create a good working relationship with the European Works Council, resulting in a reasonable consultation process. In any case, the European Works Council does not currently have any significant leverage to enforce its rights. It remains to be seen whether the revised terms of the EU-Directive enacted in early 2009 will have a significant impact once transformed into national law.

II. Works Council

The German works councils enjoy extended information and consultation rights in the event of restructuring measures such as mass redundancies, split transactions or relocation of operational sites. In many states in Germany the works council can stop the implementation of a restructuring measure by preliminary injunction.

However, the works council has no authority in respect of pure share deals. Also, if the seller disposes of its entire business by asset deal the works council has no consultation rights on this entrepreneurial decision of disposal. In practice, however, the disposal of the business usually implies organizational changes which are subject to information and consultation rights.

However, if the seller splits the operation or sells only part of the business the seller must fully inform and consult with the works council on the acquisition. The information and consultation theoretically should take place if the employer has set up a plan, but has not yet taken any final decision. The works council should be in a position to influence the plan of the company. The negotiations with the works council usually result in two agreements. The first is the so-called balance of interests (*Interessenausgleich*) which describes the measure, and the second is a social plan providing for compensation, in particular, for those employees who might lose their job position or suffer any other detriments. Ultimately however, the works council cannot legally stop the restructuring measure and the sale of the business. But the works council can heavily delay the sale process, with the result that the purchaser might walk away from the transaction.

The purchaser should be prepared that the works council of the seller might ask for certain commitments to the employees to be assumed by the purchaser. Often, such requests include a guarantee that the purchasers will avoid dismissals for operational reasons for a specific period of time, location guarantees for a defined term, guaranteed severances in the event of restructuring measures or guarantees of minimum remuneration or benefits.

In general, the seller and purchaser are well advised to have clear communication with the works council in order to build up a trusting relationship. Without the consent of the works council it will be very difficult to ensure that the transaction will be a success. Also, the works council can in fact often strongly support the transaction and convince employees of the advantages of the transaction.

III. Economic Committee

In operations with more than 100 employees, the works council may set up a so-called economic committee (*Wirtschaftsausschuss*). The economic committee consists of representatives of the works council, employees and the employer. The economic committee must be informed on a regular basis of the financial and economic development of the company. This also includes information on planned disposals of the business or even the entire company. In the event of the latter, if no

economic committee has been set up, the works council has to be informed of the possible sale of the entire company.

Ignoring the information rights of the economic committee may trigger some administrative fines. However, the economic committee cannot stop the transaction.

IV. Timing of Consultation with Employee Representatives and Ad Hoc Notifications to Stock Markets

On the one hand, the European Works Council, the Economic Committee, and, more importantly, the local works councils must be informed in good time prior to the transaction, so that the employee representatives can still take influence of the transaction or restructuring measures involved in the transaction.

On the other hand, the seller and purchaser might be listed on a stock exchange and may therefore be obliged to notify the stock market on the transaction.

Even though the employee representatives are usually subject to strict confidentiality obligations, companies sometimes prefer to notify the stock markets first in order to avoid severe sanctions. The employee representatives might then be informed directly afterwards. When informing the stock market it should be pointed out that possible restructuring measures are at planning stage only, and are still subject to consultation with the competent employee representatives.

In any case, it is important to review the local laws very carefully and to set up a communication plan to ensure compliance with all applicable laws.

In multi-jurisdiction acquisitions it is even more important to set up a clear communication plan at a very early stage since in some jurisdictions the seller or purchaser might even be obliged to consult with the employee representatives on a share deal or sale of the entire business.

F. Purchase Agreement

Typically, the purchase agreement on the acquisition of the shares or assets of the target company is split into several sections. In the "main part" the parties stipulate in detail how to handle labour and employment issues. In a separate section or addendum the seller will give certain warranties, including warranties on labour and employment issues.

I. Employee Related Provisions

From a purchaser's point of view several employee related issues should be addressed in the purchase agreement. In particular in an asset deal the parties often address additional issues. The purchaser who usually assumes the employment

relationships by operation of law according to sec. 613a German Civil Code has a strong interest in having a clear understanding of the allocation of liabilities, since the purchaser will generally assume all liabilities. Matters that are typically addressed in the purchase agreement are:

- Provision on who will notify the employees of the impending transfer of business
  The seller and purchaser are obliged to inform the employees about the impending transfer of business, the date of transfer as well as the legal, social and economic consequences for the employees. Following the provision of thorough and correct information, employees may object to the transfer within 1 month. In this case, these employees would remain with the seller. If the information provided to the employees is not thorough and correct the 1 month deadline is not triggered. Employees may then object to the transfer several months or possibly even years after the transaction. The seller has a strong interest in avoiding employees returning after a long period of time. Therefore, it is in the seller's interests to shift the liability for insufficient information to the purchaser.
- Allocation of costs of employees who object to the transfer or claims of employees who will not transfer
  The parties should also address the allocation of costs of relevant employees who should transfer to the purchaser, but object to the transfer and will therefore remain with the seller. The seller will usually terminate these employees resulting in termination costs to be borne by the seller if not agreed otherwise. If the deal has not been properly prepared and communicated to the employees and employee representatives, a large number of employees might object to the transfer, which would be a significant risk for the seller but also the purchaser since the deal may fail.
- Material adverse effect clause
  Purchase agreements often include a material adverse effect clause (MAC clause) which covers unexpected events. With regard to labour and employment laws, the purchaser might not be prepared to close the deal or may wish to rescind the purchase agreement at a later date if specific key employees do not join or a certain number of employees (threshold) object to the transaction.
- Employee related accruals
  Employers must make provisions in the balance sheet for certain employee entitlements such as pensions (depending on the pension scheme), annual leave and accruals for worked hours. In the event of an asset deal these provisions will obviously not be transferred to the purchaser, but the purchaser will be fully liable for any employee claims which arise. Therefore, the purchaser needs to ensure that a cash amount which corresponds to the amount of the provision, will either be transferred to the purchaser, deducted from the purchase price or somehow negotiated by the purchaser in determining the purchase price.
- Pensions
  Pensions often have to be explicitly addressed whether a share deal or an asset deal is at hand. Pension obligations can create a significant liability for the purchaser and should therefore be very carefully reviewed. A number of transactions fail to

complete as potential purchasers step back from the transaction due to the size of the pension liabilities and the difficulty in estimating such liabilities.

Depending on the pension scheme it should be specified that not only the pension liability, but also the corresponding pension assets (if any) will transfer to the purchaser. This may also apply to a share deal since the pension assets might have been outsourced and will not necessarily be transferred to the purchaser of the target company. In an asset deal close attention should be paid to pension provisions for two reasons. First of all, as set out before, the amount of the accruals will not be transferred to the purchaser if not explicitly stipulated in the purchase agreement. Secondly, if such provisions are made in line with German GAAP rules (according to the German Commercial Code) the provisions will not fully reflect the true pension liability since a depreciation rate of 6% is applied.

II. Warranties

In most transactions, the purchaser will ask the seller to provide certain warranties with regard to labour and employment laws. Usually, the seller is willing to give such guarantees to a certain extent. The seller may provide such warranties with some restrictions, in particular if the seller itself had acquired the business only quite recently. However, in some situations, in particular if the seller is the insolvency administrator, it will be difficult for the purchaser to obtain any warranties at all. Sometimes, the seller might limit the warranty to the knowledge of specific individuals. If the seller gives warranties, such warranties may include:

- Confirmation that all numbers of employees, salaries, years of service, age, fringe benefits, applicable collective bargaining agreements and works agreements are true and complete
- Confirmation that no employees (except as otherwise disclosed) are entitled to bonuses, severance payments or any other benefits in the event of a change of control
- Confirmation that all labour and employment related accruals are correct
- In an asset deal: Confirmation that only the relevant employees can claim employment with the purchaser
- Confirmation that no pension liabilities exist beyond the liabilities set out in the actuarial reports; confirmation that pension liabilities are fully funded
- Confirmation that no freelancers or consultants could claim that they are employees
- Confirmation that all contributions for social security and all withheld taxes have been duly paid

G. Post Merger Integration

Surprisingly, a number of companies still underestimate the importance of integration of the acquired business into its own business. It cannot be emphasised often

enough: post merger integration begins at the beginning of the entire transaction, in particular at the beginning of the due diligence exercise.

The main purpose of the labour and employment due diligence should not only be to get a thorough understanding of the current employment terms and conditions of the target company, but also to get a thorough understanding of how to integrate the business into the purchaser's own business. In many cases, the transaction may not pay off for the purchaser, if the integration costs – and time of integration! – have not sufficiently been considered.

In fact, it is not unusual for a purchaser not to think too much about how to integrate the future business, in particular with regard to labour and employment laws. In many transactions the executives or other key employees are kept busy with the transaction itself and do not have time to think about the later integration. Many companies simply do not have sufficient resources to review the integration in depth.

The post merger integration often, however, involves highly complex issues – ranging from tax, and corporate laws to labour and employment issues (not to mention the integration of different IT systems).

With regard to labour and employment, post merger integration involves for example the merger of existing operations of both companies, the use of synergies, relocation of businesses, and adjustments to headcounts.

In particular in bigger transactions involving several jurisdictions it is of major importance to have a competent team in place that has significant experience in post merger integration since usually works councils and other employee representatives in different jurisdictions must be consulted with in relation to such integration.

H. Key Aspects

- The consequences of labour and employment issues in respect of share deals, asset deals and mergers, spin-offs and split of companies are very different and should be carefully reviewed at an early stage.
- The purchaser is well advised to conduct thorough due diligence of labour and employment issues since staff costs may have a strong impact on the future profitability of the target. In particular pension liabilities can be significant.
- Employee representatives may have significant information and consultation rights with regard to transactions.
- The seller and purchaser should conduct clear and open communication with employee representatives in order to address concerns of the employees so as to make the transaction a success.
- The seller and purchaser should come to a clear understanding of all obligations in the purchase agreement.
- The purchaser should review post merger or transaction integration issues at a very early stage.

Chapter 23
Business Transfers

Jens Kirchner and Michael Magotsch

A. Introduction

Section 613a of the German Civil Code (*BGB*) governs employers' and employees' rights and duties in the case of business transfers (*Betriebsübergang*). In practice, business transfers are also known as transfer of business or transfer of undertaking. Furthermore, outsourcing measures often qualify as business transfers. The spirit and purpose of sec. 613a – which mainly implements the European Community directive 2001/23/EC – is to maintain the employee's social status quo and to grant comprehensive employee protection. In particular, the employee must not suffer any disadvantage as a result of the business transfer. The function and continuity of business operations must be protected alongside the preservation of the employee's job position. Moreover, employees have a comprehensive right to information about the planned transfer of the business as well as a right to object to the transfer of their employment relationship. Thus, sec. 613a BGB is designed to achieve the following 3 key objectives:

- The business transfer should not affect the continued existence of the employment relationships of individual employees and therefore serves as an additional system of protection against wrongful dismissals
- Ensuring the continued existence of the works council in the transferred business
- The acquiring party (transferee) assumes all rights and duties of the seller (transferor), arising from the employment relationships existing at the time of the business transfer

B. Scope of Application

Section 613a BGB is applicable to all employment relationships existing at the time of the business transfer. It applies equally to fixed-term employment relationships and to employment relationships terminated during the notice period. All employees,

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without distinction between normal workers and executive employees (*leitende Angestellte*) or between full-time and part-time employees, are included. However, the Federal Labour Court (*BAG*) has determined that the relationship of statutory managing directors (*Geschäftsführer*) is not in the scope of a business transfer, i.e. the statutory managing director does not get transferred to the acquiring party.

In the case of a transfer of part of a business, only those employment relationships which can be assigned to the transferred business will pass to the transferee. If a concrete assignment is not possible the relevant employment relationship remains with the present employer. Administrative employees are often difficult to assign to the respective part of the business and as a consequence sometimes cannot be included in the business transfer.

C. Mandatory Rule

Due to its intended purpose sec. 613a BGB is a mandatory rule. The parties cannot preclude the legal consequences of sec. 613a BGB prior to the transfer of business. Corresponding agreements are null and void as well as circumventions, for example, dismissals with the agreement of re-employment by the purchaser on less favourable working conditions. However, agreements due to a planned transfer of business may be treated differently. They might relate to rescissions of the employment contract or to the amendment of contractual terms.

D. Business Transfer as a Precondition

I. Transfer of a Business or Part of a Business

1. Definition of the Jurisdiction

The definition of "business transfer" as it is used by the German Federal Labour Court is owed to the European Court of Justice (ECJ), which defines it – consistently with the directive 2001/23/EC – as a change of ownership (employer) of an economic entity maintaining its identity after the transfer. In matters before the German Federal Labour Court, the identity of the economic entity and, hence, the determination of a business transfer is based on an overall assessment of 7 criteria established by the European Court of Justice (March 18, 1986 – C-24/85 – Spijkers, regarding art. 1 para. 1 of directive 77/187).

The German Federal Labour Court generally distinguished between businesses rich in tangible/intangible assets (*betriebsmittelreich*) and those with no or few tangible/intangible assets (*betriebsmittelarm*). In the first case, if such assets

The 7 criteria of the European Court of Justice that determine the identity of the economic entity and, hence, a business transfer consist of an overall assessment of the following
1. The type of business
2. The transfer of tangible assets such as buildings and moveable property
3. Value of intangible assets at the time of the transfer
4. Take over of the majority of the employees by new owner
5. Transfer of customers
6. Degree of similarity of the activities before and after the transfer
7. Period, if any, for which those activities were suspended

basically form the identity of the entity transferred and the transferee takes over and continues the main part of the assets, there will generally be a business transfer within the meaning of the definition. Thus, in the case of a production plant, as a typical business rich in tangible/intangible assets, the transfer of the fundamental utilities within the existing operational organisation is essential.

In businesses with no or only few tangible/intangible assets, i.e. people-intensive service sector businesses (call centres etc.), the workforce usually forms the main part of the entity. Hence, if the transferee does not take over a relevant part of the workforce, usually no business transfer occurs. For complex work tasks, the transfer of all key-employees, even if they form only a small part of the work force, may be a relevant business transfer. If the business involves only simple work then a transfer of three-fourth of the entire workforce may not necessarily qualify as a business transfer.

In the past years, the BAG did not recognize a business transfer for a mere continuation of certain functions, a so-called functional succession (*Funktionsnachfolge*), for example by an independent contractor. The ECJ, however, questioned this constant German jurisprudence when it decided in one of its recent cases Klarenberg ./. Ferrotron (February 12, 2009 – C-466/07) that the determination of the identity of the economic entity would not require maintaining its organisation. Rather, a very broad and in practice difficult to explain "*retention of a functional link of interdependence, and complementarity, between various transferred elements of production*" would already be sufficient. It remains to be seen to what extent this new case law will affect German labour courts in their decision making.

2. Self-Functioning Unit

In the case of a change of the employer, the essential operational means of a self-functioning unit (*Funktionseinheit*) or part of the organisation of the business must be transferred at least. Such a unit must be created in a way that enables an effective execution of composite tasks and the fulfilment of certain operational purposes. Therefore, if a third party intends to continue using the operational means for their former purpose, i.e. maintaining the same facilities and/or continuing to support the same customers, a transfer of part of a business according to sec. 613a BGB might exist.

3. Outsourcing

The applicable law is quite ambiguous with respect to the issue of whether outsourcing is a business transfer (or a transfer of part of a business) or not. The European Court of Justice (ECJ) held that in businesses characterised mainly by manpower (e.g. cleaning companies) a business transfer would not depend that much on the technical means of the business but rather on the employees. Thus, if a company sources out part of its business to another company (supplier), but the supplier employs a substantial part of the employees of the outsourcing company to perform the services, this might be considered a business transfer. The effect would be that the supplier assumes all employment relationships from the respective department by virtue of law. However, the traditional case of outsourcing, namely the simple transfer of a task, formerly done internally, to an external supplier will often not be deemed a transfer of business if the new supplier neither takes over personnel nor working equipment.

4. Change of Ownership

Another prerequisite for the application of sec. 613a BGB is a change in the ownership of the business, i.e. of the person who assumes control of the business and its organisation (asset deal). This prerequisite is not fulfilled by a mere change of the legal form of the owner or by a change of shareholders (share deal). According to a decision of the Federal Labour Court, these principles also apply to a partnership under the civil code (*Gesellschaft Bürgerlichen Rechts, GbR*). For there to be a change of ownership, and thus a business transfer, it is crucial that the new owner actually continues or restarts the business.

II. Leading Cases

Unfortunately the European Court of Justice and the German Federal Labour Court have taken deviating positions once in a while over the last years regarding the prerequisites of business transfer situations. As a consequence, no clear and transparent line of case law exists. The question whether a potential investor is faced with a business transfer scenario or not has become more and more difficult. The following important leading cases of the European Court of Justice (*ECJ*) and the Federal Labour Court provide a helpful view of situations that might be considered business transfers in practice:

1. Dietmar Klarenberg ./. Ferrotron Technologies GmbH

In this case before the European Court of Justice (February 12, 2009 – C-466/07) an employee claimed the transfer of his employment from his insolvent employer after

integration of a few employees and some assets, including a production line, into a third party company. The business operation of the relevant part of the employer, however, was not continued at the acquiring third party company. Nevertheless, the court held that the employment transferred because it is sufficient if the acquirer is in a position to continue to use the business assets for an economic activity. This case extends the scope of possible business transfers to a significant extent. It remains to be seen if the European Court of Justice will uphold this broad definition of business transfers.

2. Temco Service Industries SA ./. Samir Imzilyen

In the case of Temco Service Industries SA ./. Samir Imzilyen (January 24, 2002 – C-51/00), a customer had assigned the cleaning of his business premises to company A, which subcontracted the job. After terminating the contract with company A the customer entered into a new cleaning contract with company B. Company B employed most of the subcontractors' employees. In this case the European Court of Justice considered the contract to be a business transfer, since company B took over a substantial part of the staff of the subcontractor, with emphasis being placed on the number of employees transferred and their expert knowledge.

3. Ayse Suezen ./. Zehnacker Gebäudereinigung

In the case of Ayse Suezen ./. Zehnacker Gebäudereinigung (March 11, 1997 – C-13/95), the European Court of Justice refused to find that a business transfer had occurred. The claimant was working for the cleaning company Zehnacker, which was contracted to clean a school. The school terminated the contract with the cleaning company. As a consequence Zehnacker itself dismissed all employees who were working in the school, including the claimant. The school then contracted with another cleaning company to clean the school. The new company neither inherited any relevant material or immaterial operating facilities nor any substantial part of the staff from Zehnacker. The plaintiff filed the suit claiming that her employment relationship has not been terminated, as a business transfer has taken place. The Court ruled with regard to a business transfer that there is no need for a contractual relationship between the previous owner and the purchaser. However, the mere loss of a customer to a competing company does not constitute a business transfer. The transfer of an organizational entity, which exists on a continuing basis, is the determining factor. This requirement was not fulfilled in this case.

4. Carlito Abler ./. Sodexho MM Catering GmbH

A business transfer might occur even if none of the former employees are transferred, if the supplier performs its services on the premises and in the same accommodation as the company. In November 2003 the European Court of Justice

heard the case of Carlito Abler ./. Sodexho MM Catering GmbH (November 20, 2003 – C-340/01), concerning the change of a hospital catering company. The operator of a canteen kitchen, Sanrest, which was contracted to provide the entire catering facilities at a hospital, was replaced by another company, Sodexho. The hospital provided Sodexho with the complete production facilities Sanrest had previously used. The Court considered the change to be a business transfer even though Sodexho did not intend to employ any of Sanrest's employees. The Court held that the relevant entity preserves its identity if the business is continued or resumed and the subsequent operation operates on the same premises, using the same inventory and production facilities.

5. Güney-Görres and Demir ./. Securicor Aviation [Germany] Ltd and Kötter Aviation Security GmbH & Co. KG

In the cases of Güney-Görres and Demir ./. Securicor Aviation [Germany] Ltd and Kötter Aviation Security GmbH & Co. KG (December 15, 2005 – C-232/04 and 233/04) the European Court of Justice held that it is not decisive for the evaluation of a business transfer whether the transferee continues to use the work equipment for his own economic interest or not. In the second case the security service provider at the Düsseldorf airport changed from the employer Securicor to the company Kötter. Kötter continued to use the same equipment as Securicor, which was owned by the German State, and took over several employees. Two airport security staff members, whose employment contracts were terminated, claimed that a business transfer had taken place. For the evaluation of the transfer the question arose, whether the business transfer was already excluded as Kötter had no economic interest in the equipment. The court ruled that a business transfer is not excluded by the fact that the new company does not have an economic interest concerning the operating equipment.

6. Federal Labour Court

The Federal Labour Court has applied the decision of the European Court of Justice in the cases of Güney-Görres and Demir ./. Securicor Aviation [Germany] Ltd and Kötter Aviation Security GmbH & Co. KG (December 15, 2005 – C-232/04 and 233/04) abandoning some former prerequisite requirements. Thus, the court found a business transfer to have occurred between two printing service companies (April 6, 2006 – 8 AZR 222/04), where the transferee continued to use the machines owned by the same client to perform the same services, even though the use of the equipment for his own economic interest had been excluded in the service contract. However, the Federal Labour Court held in a parallel decision of the same date, that a business transfer is nevertheless negated, if the transferee does not use the transferor's work organisation (the Federal Labour Court calls this "to lay down in a made bed"), but creates a new one or implements the former independent economic entity in his already existing organisation, thereby terminating the separate identity of the entity (April 6, 2006 – 8 AZR 249/04).

The Federal Labour Court also refused to find a business transfer in the case of a womens' refuge, claiming that the transferor only concentrated on providing a shelter house for battered women. The transferee in contrast significantly changed the concept and the organization of the business, by providing a broader concept of consultation. The womens' refuge played only a minor role in his concept, as the former independent business was integrated in a new structure of several consultation centres (May 4, 2006 – 8 AZR 299/05).

E. Impact on Collective Agreements

The main impact of sec. 613a BGB is that the employment relationships existing at the time of the business transfer pass to the purchaser and continue. Legal agreements between the parties concerning the transfer of employment relationships are unnecessary and agreements to the contrary are ineffective. At the time of the business transfer the purchaser becomes the new employer substituting the previous employer. He will be bound by all duties (for example back pay) and has the benefit of all rights based upon the employment relationship. The previous employer is liable for all duties existing prior to the business transfer. Where applicable, this will be on a pro-rata basis.

In principle, the employment relationships and duties continue to exist with the new employer on the same terms. If the terms of employment for a transferring employee are to be qualified or changed, the employee must raise these claims promptly after knowledge of the business transfer with the new business owner. Otherwise, the employee is free to object to the transfer of the employment relationship. As a consequence the employment relationship with the previous employer continues (see below). The continuity of the works council may also be assumed if the business continues as a separate economic entity.

In practice, one of the most problematic areas of a business transfer is the impact of the transfer on collective bargaining agreements and works agreements. In principle, these collective agreements are either incorporated into each employment relationship, continue to be applicable unchanged on a collective level or get replaced by already existing collective agreements at the purchaser of the business. In recent years the Federal Labour Court has changed its legal position on various related topics and it is not yet known if further new jurisprudence will come to surface. Moreover, it is to be noted that exceptions might apply for various reasons and the explanations made below are simplified to make them more transparent.

I. Transformation

As a result of the business transfer (sec. 613a para. 1 sent. 2 BGB) the collective standards become part of the individual contracts by virtue of law. This is usually to the disadvantage of the employer and to the benefit of the employee. The employer

cannot change these standards to the disadvantage of the employee within a period of 1 year. Thereafter, if, for example, the contents of a works agreement are transformed into individual employment contracts, modifications will have to be agreed upon with every single employee.

II. Continuation

In some cases, collective agreements such as collective bargaining agreements (*Tarifverträge*) or works agreements (*Betriebsvereinbarungen*) might remain applicable and unchanged throughout the business transfer. That will be the case if, for example, the purchaser is a member of the employers' organisation that entered the collective bargaining agreement or if a collective bargaining agreement has been generally binding for the respective industry sector. An existing works agreement might stay in effect as a whole if the identity of the transferred business is preserved. As a consequence, where a works agreement stays in effect, modifications can be made on a collective level, i.e. the new employer does not need to negotiate modifications with each individual employee but with the works council only.

III. Replacement

In other cases, the purchaser is already bound by collective agreements on the same subject matter. In this event, so far as is applicable, the collective agreements will be replaced by the existing collective agreements applicable at the purchaser. For example, according to the Federal Labour Court in the event that the new employer already has a company pension plan based on a works agreement, the old works agreement is replaced by the existing one. However, the employees keep their pension entitlements from the old pension plan already earned till the day of the business transfer. Thereafter, the pension plan at the new employer applies even if the entitlements that can be acquired under the new pension plan are lower than under the previous plan.

F. Effective Date of Transfer

The relevant point in time for the legal consequences of sec. 613a BGB is the date at which the change of ownership of the business occurs. A particular assignment of the management is not necessary according to German law. The previous owner merely has to quit his commercial activity regarding the business to be transferred, and the new owner has to start continuing the business. In this respect it is not relevant if the sales agreement demands the complete payment of the purchase price for the ownership to change. If the new owner has taken over the business but the

purchase price has not been paid then the business transfer will still have occurred according to the Federal Labour Court.

G. Liability

The purchaser takes on the employment relationships on terms equal to those existing at the time of the business transfer, that is to say that he is basically liable for existing debts of the previous owner. However, according to the applicable statutory provisions (sec. 613a para. 2 BGB) the previous owner is liable for any liabilities generated prior to the business transfer as well as for those which were generated prior to the transfer and become due up to 1 year after the transfer.

The previous owner and the purchaser are jointly and severally liable. In case of doubt both are liable in equal shares. The respective statutory provisions (sec. 613a para. 2 BGB) are mandatory in favour of the employees and cannot be subject to a contrary agreement between the vendor and purchaser, nor can it be subject to the disposition of individual employees.

If a body corporate ceases to exist following the transfer, however, no joint and several liability occurs. With expiry of the body corporate the former employer ceases to exist and thus no source of liability can exist (e.g. company A merged with company B, company A ceases to exist). All assets are located with the new employer.

H. Dismissal Protection

I. Introduction

The most serious provision for the purchaser is the prohibition against dismissal according to sec. 613a BGB. Under this provision the termination of an employment relationship either by the previous employer or by the new owner on the grounds that a business transfer has taken place is ineffective.

II. Scope of Application

The prohibition against dismissal in business transfer cases applies to regular terminations (*ordentliche Kündigung*) as well as to terminations for good cause (*Kündigung aus wichtigem Grund*). The complaint against the dismissal has to be filed against the employer who gave notice. The business transfer must be the main reason and the ultimate cause of the dismissal. At the time of the dismissal the fact of the business transfer must have been known. The legal consequence is that such a dismissal will be deemed invalid.

The prohibition provision is not applicable to dismissals which are factually justifiable irrespective of the business transfer. Moreover, this provision for prohibition

against dismissals stands independently of the general Dismissal Protection Act (*Kündigungsschutzgesetz, KSchG*). A notice which is given against the prohibition is deemed to be void.

III. Closing Down of the Business

A difficult case occurs if employees are dismissed due to the closing down of a business, but later the business is sold and continued. The Federal Labour Court deals with that difficulty by examining strictly, if facts prove that it was intended to close down the business by the time notice of the dismissals was served. Pursuant to the BAG an intended closing down can be assumed if the operational circumstances and a reasonable business analysis justify the outlook that the business would be closed down and that the employees are thus dispensable. In these cases, dismissals will be valid even if later a transfer of the business takes place. Please note, the dismissals will be invalid, if by the time notice was served, there was an equal likelihood of a business transfer or the closing down of the business.

IV. Claim to Reinstatement

If a business transfer takes place shortly after the notice of termination, the terminated employee has a claim to be reinstated under his previous contractual conditions by the purchaser of the business. According to the BAG this is not true for terminations caused by insolvency (October 28, 2004 – 8 AZR 199/04), in particular if the business transfer occurs after expiration of the individual notice period.

I. Information of the Employees

The provisions regarding business transfer set out the present employer's or the new purchaser's obligation to inform the employees about the transfer of business and the employee's right of objection against the business transfer. Every employee who is employed with the previous employer at the time of the business transfer and who is affected by the business transfer has to be informed.

The purpose of these provisions is to inform the employees about the prerequisites and consequences of the upcoming business transfer and thus enable them to take a decision whether they wish to object against the transfer of their employment relationship or not. The employer's obligation to inform those employees affected by the transfer should at all times exist independently, no matter how large the business is. This also applies in those instances where workers' representatives exist in the relevant business operation.

I. Employee Notification

Employees affected by the business transfer must be notified in writing by the previous employer or the new owner of the time of and reason for the transfer, as well as the legal, economic and social consequences and the contemplated measures to be taken with respect to employees.

II. Issues Concerning the Information of Notification

The notification, whose contents are prescribed, has to be issued prior to the business transfer. Attention should be paid to the accuracy of the information given. The information may be generally formulated and does not need to be drafted on behalf of the individual employee.

1. Time of the Transfer

In cases of corporate restructuring, it is sufficient to set a prospective deadline for the registration of the corporate restructuring, which usually takes between 4 and 8 weeks following the filing of the registration. In case delays in the business transfer affect the content of the notification it is advisable to draft an adjusted version for all employees. The same is true if the business transfer is postponed. The proper date of the transfer is not the date of the legal transaction (for example the asset purchase contract), but the commencement of the new ownership of the business.

2. Grounds for the Transfer

The correct notification will include information about the legal grounds for the business transfer, such as an acquisition, lease or change of corporation form. It is definitely not intended, though, to disclose confidential business information by way of detailed justifications, supported by commercial operating figures. Thus, the economic forces and entrepreneurial motivation leading to the business transfer do in general not have to be explained. In cases where the economic reasons will affect the employees' employment, if for instance, the vendor will close down the business and therefore terminate the employment due to operational reasons, this background has to be part of the information. In this regard it is sufficient to roughly reconstruct the economic reasons that might affect the employment.

3. Legal, Economic and Social Consequences of the Transfer for the Employees

The direct legal, economic and social consequences of the business transfer have to be disclosed in sufficient detail to the affected employees. Please be aware that

a blanket reference to the listed regulations will not be sufficient to satisfy the obligation of providing correct information but individual and impartial legally binding advice to the employees goes further than is necessary. In all events, the notification should comprise an explanation of the main legal consequences of the transfer of the existing employment contracts to the purchaser, the continuity or the transformation of effective provisions of collective agreements, the provisions regarding liability and the prohibition of dismissals. Furthermore, in this context the information about the right to object and potential legal consequences of the exercise of that right are essential in order to notify correctly. The indirect consequences have to be made specific and be easily recognised by the employee. They should have a connection to the employment relationship and in addition, be associated with the business transfer through a factual and temporal context. This limitation applies especially with respect to the social consequences.

It is also necessary to inform about the identity, form of organization and head office of the purchaser. In this respect the BAG held that it is not sufficient to refer to the purchaser as the "new" company. The German labour courts have made various decisions in recent years about whether the information about the solvency of the purchaser is necessary or not. The Federal Labour Court ruled that employees have to be informed if a considerable reduction of company assets will take place. Considering that some consequences of the transfer depend on the plans of the new purchaser and these plans might not be known to the present employer, the obligation to inform about legal, economic and social consequences should not expand beyond the direct legal consequences provided in the statutory provisions for business transfer.

4. Contemplated Measures

According to the explanatory memorandum of the legislator, the measures that need to be contemplated by the employer in respect of the employees include further training concerning the planned reorganisation of production or restructuring and other measures that concern employee professional development. In the event the business transfer involves a change in operations, an indication as to the conclusion of agreements between the employer and it's works council on so-called balance of interests (*Interessenausgleich*) and a social plan (*Sozialplan*) or as to any corresponding negotiations will be necessary.

5. Content of the Notification

The obligation applies to both the previous employer and the new owner. According to the explanatory memorandum of the legislator, both of them have to reach an agreement as to the manner in which they want to fulfil their obligations to give notification. In view of liability issues in respect of the concerned businesses, a concerted schedule of action becomes a necessity. A demarcation of respective

liabilities in the event that inadequate notification is given should become a regular item in an asset purchase agreement.

6. Time of the Notification

The law does not contain any provision regarding the point in time for the notification. In practice the parties often wish to identify at the earliest opportunity those employees that do not wish to transfer to the new owner. Therefore, a notification of the transfer at an early stage forces the employees to decide in advance of the transfer about the exercise of their right to object. Since the employees are entitled to object to their transfer within 1 month of the notification, employers are usually well advised to issue the notification at least 1 month prior to the upcoming business transfer so that they are able to identify the number of employees who plan to exercise their right to object prior to the transfer. This provides for greater certainty when planning the sale, but runs the risk that any essential changes to the terms of the sale will enhance the risk of the employer issuing a defective notification. In each individual case the employer may balance the options before taking a definite decision on the right point in time of notification of employees.

7. Form of the Notification

The notification has to be given in text format, as provided by the German Civil Code. The statement must therefore be in writing, state the identity of the person making the statement and must be capable of being recognized as made by that person (e.g. by being evidenced by their signature or in another acceptable form). It is therefore permissible to give the notification via email or on a notice board. However, in view of the fact that once the notification has been given, the 1-month objection period is triggered, the employer might have to provide sufficient proof that the notification has been received. Therefore, it is advisable that the employee signs an acknowledgement of receipt.

8. Legal Consequences of an Omitted Notification

The legal consequences arising out of an omitted or deficient notification are not fully governed by the law. The respective provision merely stipulates that the objection period of 1 month for the relevant employees does not commence prior to the receipt of the notification. In addition to that, deficiencies regarding the notification may cause claims for damages against both the previous employer and the new owner.

The Federal Labour Court had to decide in 2005 on a wrongful termination case involving an employee who was insufficiently informed about an upcoming

business transfer, objected, and was then terminated by his old employer. The court held that an insufficient notification results in the consequence that the 1 month period to object (see below) does not start to run, but does not lead to the invalidity of a termination (May 24, 2005 – 8 AZR 398/04). That decision relieves a lot of the pressure from old employers, and diminishes the danger of omitted or insufficient notification significantly. Notwithstanding that decision, employers should continue to comprehensively inform their employees, as that will decrease the chance to reach a mutual solution in the course of the transfer.

J. Right of Objection

I. Prerequisites

The employee has the right to object to the transfer of his employment relationship from the vendor of the business to the purchaser of the business within 1 month of receiving complete notification. The objection does not require a statement of reasons. The objection statement has to be in writing and the intention of the employee to object has to be sufficiently apparent. The period of 1 month cannot be shortened unilaterally; it can be extended, though, by a tripartite contract as the extension is to the benefit of the employee.

The party to which the objection has been given should inform the other party. It is quite apparent that the parties involved in the transfer will have to cooperate and reciprocally inform each other about the receipt of any objection. Even when one of the parties fails to inform the other about having received an objection, the other party will be prevented from contesting the omission. In the event that a deficient or inadequate notification has been supplied, the time limit for the objection will not be triggered. But it can be presumed that the employee forfeits his right for objection after a certain time period upon the transfer.

II. Consequences of Objection

An effective objection prevents the employment relationship from being transferred, so that the employment relationship continues with the previous employer. In practice, however, the previous employer often terminates the employment for other reasons than due to the business transfer, in particular for operational reasons since the relevant business was transferred to the new employer.

In principle the effective exercise of the right to object cannot be revoked by the mere commencement of work with the purchaser of the business. Since the right to object is a constitutive right, it cannot be explicitly or implicitly revoked. Provided that the right to object was exercised effectively, the employment relationship will

not be transferred, but continues with the previous employer on equal terms. If the previous employer does not terminate the employment relationship for operational reasons, the employee is entitled to continue the employment contract on equal terms. Potential negative consequences of the objection are namely the possibility that the former employer will have to terminate the employment relationship due to operational reasons.

Admittedly, there are cases of abuse of rights and of forfeiture in which the employee's right to object lapses and becomes irrelevant. In this regard the concept of forfeiture gains importance. A German labour court, for example, has adjudicated that an employee is not entitled to return to his former employer if he has joined the purchaser in the meantime, even though he has objected to the transfer of the business. In that particular case, the employee in question following his objection had worked 3 months for the new owner without any protest and had drawn his salary from the new owner. Therefore, the court excluded the employee's right to object.

Employees may object collectively to a business transfer as long as the employees only exercise their contractual rights and the right to keep their employer. However, if the employees intend to obstruct a business transfer as such and harm the employer, the collective objection might be an abuse of rights.

K. Cross-Border Transactions

Cross-Border M&A Transactions, i.e. transactions involving businesses in different countries, raise a number of questions regarding the applicable labour and employment law.

I. National Transfers

In principle, mergers, spin-offs and transfers of assets as a whole or in part – except mere share deals – may form a transfer of business in the meaning of sec. 613a of the German Civil Code, if there is a change of ownership and if the identity of the economic entity remains the same after the transfer. The new ownership may be obtained by a foreign owner' although his nationality is irrelevant. The German statutory provisions apply, if the transferred business is still located in Germany, i.e. not relocated abroad, and if the employment contracts are governed by German law. However, outsourcing of work tasks to a contractor abroad is not a relevant business transfer if the transferee does not take over a considerable part of the personnel or tangible/intangible assets of the transferor. Thus the transfer of business provision does not apply in cross-border and off-shore outsourcing, if a mere functional succession (*Funktionsnachfolge*) is concerned.

II. International Relocations

The international relocation of a business may also generally involve a business transfer, however, this may only be the case if, preceding or following the relocation, a change of ownership takes place and if the identity of the economic entity remains intact. However, if the business is relocated from Germany to a site abroad, the relocation preceding or following the change of ownership results in a closure of the business in Germany. Further, the termination protection of the employees pursuant to the German Dismissal Protection Act and also the Works Constitution Act (*Betriebsverfassungsgesetz, BetrVG*) are limited to businesses located on German territory. Thus, the employees lose their termination protection pursuant to the Dismissal Protection Act regarding a termination of their employment for operational reasons due to the loss of their work place at the closed business in Germany, and they need not to be offered vacant positions in the relocated business abroad. Moreover, the employees may also experience a considerable modification of their right to establish and keep a works council.

The same will apply to the employees who did not object to the transfer of their employment, if the transferee takes over only parts of a business, e.g. its single branches, but not its local head office in Germany. According to the German Federal Labour Court, a business operation located on German territory requires that the employees are integrated into a operational organisation at least partly managed from Germany. It is insufficient, for example, if independent field employees are managed by a distribution organisation located abroad. However, if a business is relocated abroad from Germany, the employees are not obliged to continue their employment at the relocated site abroad; rather the employees may object to the continuation of their employment.

According to the German Federal Labour Court, although disputed by the Higher Regional Labour Courts, a relevant business transfer may arise in cross-border relocations with simultaneous change of ownership and the continuation of the work abroad, like in businesses with no or only few tangible/intangible assets. However, in such businesses, in which the workforce constitutes the identity of the economic entity, the transferee may avoid a business transfer by employing a new workforce at the relocation site abroad.

L. Stock Option Plans

Employee rights arising from Stock Option Plans may in principle transfer according to sec. 613a BGB from the seller/transferor to the purchaser/transferee of the business, if they are part of the employment relationship. Thus, stock option rights granted by an affiliated/parent company instead of the employer, may only be claimed against the granting company and generally do not become part of the employment relationship with the employer that transfers to the purchaser/transferee

of the business. Forfeiture Clauses (*Verfallklauseln*) for the case of a transfer of business may be deemed invalid.

M. Key Aspects

- The preconditions of a business transfer are dominated by decisions of the European Court of Justice but also by the Federal Labour Court.
- Statutory managing directors do not fall into the scope of the transfer of business provisions.
- In case of a business transfer it is of high importance that the employees receive the correct information.
- The old and the new employer are in principle bound by joint liability towards the employees transferred.
- A dismissal due to the business transfer is invalid.
- Employees, who want to object to the business transfer, should be made aware of all consequences, especially of the possibility that the former employer will have to terminate the employment relationship due to operational reasons.
- Collective agreements in principle either (1) become incorporated into the individual employment contract, (2) continue to be applicable unchanged or (3) get replaced by existing collective agreements at the new employer.
- Cross-Border Transfers might result into the German protective regulations no longer being applicable.
- Outsourcing, insourcing or change of contractorship (*Auftragsneuvergabe*) bear the risk of direct application of transfer of business rules.

Chapter 24
Stock Options

Martin Heinsius and Pascal R. Kremp

A. Introduction

The participation of employees in the company's economic success serves to bring the interests of the employees in line with the interests of the shareholders in increasing the profit of the company. Stock options and other equity awards may help to create an entrepreneurial spirit within the company's workforce increasing the motivation and loyalty of the staff. Since stock options usually cannot be exercised for several years after they have been granted and become void if an employee leaves the company, the options tie employees to their employer. In addition, they enable firms to pay competitive wages without a drain on liquid funds. The stock corporation (*Aktiengesellschaft, AG*) is the most suitable corporate form under German law for participation of the employees in such a scheme as the shares are most interchangeable and marketable. Due to the financial and economic crisis, stock options and other equity incentive awards are under stringent review. It can be expected that in the future stock options will only be permissible if the focus is on long-term incentives. The grant of stock options and other equity awards affects various areas of law, including corporate, labour and employment, insider trading, securities and tax law.

B. Corporate Law

I. Real Equity Capital Instruments

If the company chooses a model where the employee is granted the right to actually acquire shares, the company has the duty to transfer the shares at the time the employee exercises his option. However, at the time of offering employees the opportunity to participate in the programme, the company is obliged to acquire or create sufficient shares to be in a position to fulfil the employees' claims once they

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exercise their options. Under German statutory law, there are different ways for a company to acquire or create those shares. These include:

1. Cost-Free Allocation of Shares from Existing Shareholders

The easiest and cheapest way for the company to acquire or create shares of for the existing shareholders to agree to make their shares available. However, this form is rare in practice and is chosen by companies with only very few major shareholders which are about to go public.

2. Contingent Capital Increase

The most common practice is the creation of shares by contingent capital increase (*bedingtes Kapital*). Here, the stated share capital increases only at the time the employees exercise their options and acquire shares from the company. The contingent capital increase requires a shareholders' resolution in general meeting by a majority of 75% of the capital represented.

The employees' option right to acquire shares from the company usually has one of the two following forms in the case of a contingent capital increase.

a) Simple Preemptive Rights

To facilitate the employees' participation in the company, the legislator created the possibility to grant so-called "simple preemptive rights" ("naked warrants"). Only the so-called strike price has to be paid upon the exercise of the option.

The details and the exercise of the simple preemptive rights are subject to general provisions. A shareholders' resolution adopted at a general meeting with a majority of 75% of the capital represented is required. The resolution must determine the allocation of the preemptive rights to senior executives and employees, i.e. to the groups management board (*Vorstand*) of the company and senior executives of the subsidiaries, as well as the employees. A double allocation to board members who are also executives of subsidiaries should be avoided.

The acquisition period for the preemptive rights must also be determined. The initial exercise period, i.e. the waiting period between the grant of the preemptive right and the first opportunity to exercise the right for each tranche is also significant. A waiting period of 5 years is the norm; a shorter period would appear to be appropriate only in special cases, for example, for very innovative companies with very short product cycles. According to statutory regulations, under no circumstances may the period be shorter than 4 years.

The resolution must define the requirements of the acquisition. That is, restrictions for the exercise of the preemptive right, usually determined by a certain future

price level for the shares of the company (strict performance). An additional tie to a share index is also permissible (relative performance).

The nominal value of the shares related to the "naked warrants" may not exceed 10% of the registered capital at the time of the shareholders' resolution on the contingent capital increase.

b) Convertible Bonds/Warrant Bonds and Option Bonds

In case of convertible and warrant bonds (*Wandelschuldverschreibungen*), the employee grants the company an interest-bearing loan. A convertible bond entitles the employee to request the transfer of a fixed number of shares instead of repayment of the loan. In case of an option bond (*Optionsanleihe*), the employee may acquire a certain number of shares for a fixed price in addition to the repayment of the loan. In view of the right to acquire shares for a fixed price, the interest rate for the loan is below the market rate for both the convertible bond and the option bond.

The issuance of convertible bonds requires a shareholders' resolution by a majority of 75% of the capital represented. This resolution may authorize the board for a period of no more than 5 years to issue the bonds. The shareholders of the company have a preemptive right relating to the convertible and option bonds. Therefore, an exclusion of the preemptive right by shareholders resolution is necessary as well as a report by the board justifying this exclusion of the preemptive rights.

3. Purchase of Own Shares

The company may also acquire its own shares on the market to pass them on to the employees exercising their options. However, this procedure reduces the liquidity of the company. If the strike price is lower than the purchase price, the company will suffer a loss. The acquisition of a company's own shares is subject to strict conditions: The total number of own shares held must not exceed 10% of the stated share capital of the company. The acquisition cost must be covered by the annual profit or the revenue reserve, and the cash contribution on the shares (nominal value plus any agio to be paid) must be fully paid up.

The employees' option right can differ as follows.

a) Employee Stocks

The law provides for the issuance of so-called employee stocks (*Belegschaftsaktien*). Only employees of the company or of affiliated companies within the meaning of German labour law can be beneficiaries, i.e. no members of the management board or of the supervisory board of a stock corporation. The shares

admissibly acquired for this purpose must be fully issued to the employees within 1 year. A shareholders' resolution is not required.

b) Stock Options on the Basis of General Authority to Acquire Own Shares

Generally, companies are allowed to acquire their own shares for any purpose except for the trade of their own shares. Unlike employee stocks, those shares may also be issued to members of the management board of the company and affiliated companies. However, this would be under the condition that the board is authorized by a shareholders' resolution adopted by simple majority to acquire the shares for a maximum period of 5 years. There is no obligation to sell them after the end of a particular time period.

The resolution granting such authority should also specify both the lowest and the highest amount for which the shares may be purchased, the addressees of the stock options, the performance targets, the acquisition and exercise periods, and the waiting period for the first exercise of the right. The law requires a minimum waiting period of 4 years. It should be made clear that there may be a gap between the end of the authorization period for the acquisition of a company's own shares and the time at which the option is first exercised.

Issuing a company's own shares to its employees requires an exclusion of shareholders' preemptive rights as they would otherwise be entitled to own the shares as if they were created in a capital increase. Therefore the shareholders must agree at a general meeting to exclude the preemptive right, and the Board must justify this exclusion of the preemptive rights in a report. This resolution requires a 75% majority of the votes present at the meeting.

4. Authorized Capital

Although the Act on Control and Transparency within Companies (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich, KonTraG*) recognized the possibility of granting stock options by "naked warrants" through a contingent capital increase, it should, nevertheless, be possible to allocate shares to the members of the board, to employees of the company and also to the executives and employees of affiliated companies on the basis of authorized capital. This requires a shareholders' resolution with a majority of 75% of the represented capital. The resolution may authorize the board to increase the capital for a maximum period of 5 years upon registration of the resolution. The amount of the authorized capital must not exceed one-half of the share capital existing at the time of authorization; in the case of a simultaneous regular increase of capital, the higher share capital is relevant. The shareholders have a preemptive right relating to the authorized capital and this must be excluded when authorized capital is created for the stock options of board members and employees. The board must

give reasons for this exclusion of the preemptive right to the general meeting in a written report.

II. Virtual Equity Capital Instruments (Synthetic Options, Phantom Stocks, Stock Appreciation Rights)

Synthetic Options are characterized by option holders never becoming actual shareholders. The company, acting as the seller, offers its employees "custom made" options with the company's own shares or the listed shares of the group parent company as underlying security. In the terms and conditions for the option, the performance of the option transaction by means of delivery of shares is excluded, and instead the option holder receives a cash payment from the company, in principle compensating the difference between the strike price and the stock exchange price on the exercise date.

Phantom stocks differ from stock appreciation rights in that they are subject not only to positive, but also negative developments in share price. They also provide for the payment of dividends.

Usually, the option terms and conditions will determine whether it can only be exercised within certain time periods during the term of the option if certain price targets are met with regard to the underlying security.

III. General Restrictions Concerning Stock Option Plans for Board Members

German law provides for significant restrictions for stock options for board members. The aggregate remuneration of a board member, namely the fixed salary, the reimbursement of expenses, insurance premiums and other fringe benefits, as well as any variable remuneration elements, must be in direct relation to the duties of the board member and to the financial situation of the company.

There are a wide range of variations of stock option plans available, a description of all of which is not possible here. Accordingly, an individual evaluation is necessary for each individual stock option plan to determine which is most suitable.

C. Contractual and Labour Issues of Granting Stock Options

In addition to the question of how to acquire stocks under a stock option plan, another issue which requires consideration is the contractual relationship between the company and the employee regarding the stock options.

I. Stock Corporation Law Aspects

According to the German Stock Corporation Act (*Aktiengesetz, AktG*), any offer to subscribe to new shares may only be made subject to the preemptive rights of the current shareholders. Any contractual obligation made prior to a resolution on the capital increase is invalid in relation to the stock corporation. This applies to a regular capital increase in the same way as to a capital increase with authorized capital or contingent capital. The company should therefore avoid entering into a binding agreement with the employees prior to the shareholders' resolution, as the employees may recover damages from the company or even the board members if the general meeting does not approve the stock option plan.

II. Labour and Employment Law Aspects

The key concerns in respect of stock options from a labour and employment law perspective include the legal basis of the grant to the individual employees and information and consultation rights of the works council.

1. Legal Basis for Granting Stock Options

The grant of stock options to employees is typically based on one of the following legal bases:

- Individual agreement
- Works agreement with the works council (*Betriebsvereinbarung*)
- Operational practice

a) Individual Agreement

Stock options for managing directors and key employees are usually granted by individual agreement – i.e. by a provision in the employment contract, an addendum or a side letter stating that the board may decide to grant a specific number of stock options to the individual employee.

b) Works Agreement

In companies with a works council, the employer has to inform and consult with the works council prior to implementing a stock option plan. This does not apply to individuals who are managing directors or key employees.

It is up to the employer to decide if a stock option plan is to be introduced at all as well as the extent of such a plan. The works council must be consulted and given details about the allocation of the options to individual employees.

In the case of local companies, the works council might have considerable influence on the stock option plan since the board which has to decide on the structure of the plan is located in Germany and the plan is subject to German law.

In foreign companies (i.e. if the parent company issuing the options is located abroad) however, the board usually decides on the introduction of a stock option plan on a global basis. In this case, a local works council will have minimal influence on the structure of the plan and eligible employees. Employers are advised to inform the works council that the implementation of the plan would be a "take it or leave it" decision. Since stock options are an add-on to the remuneration of the employees, the works council will usually sign off such plans.

If the employer ignores the consultation rights of the works council, the works council could theoretically stop the implementation of the plan by injunctive relief or preliminary injunction. In practice however this is very rare since stock options are an additional remuneration for employees which they otherwise would not receive.

If the employer has not consulted with the works council and proceeds to send grant letters to individual employees, the works council could force the employer to renegotiate the stock option plan. This could result in an amendment of eligible employees and then increase the total volume of the plan.

c) Operational Practice

Employers should be aware that employees might be entitled to stock options based on a theory of operational practice (*betriebliche Übung*).

If the employer has voluntarily granted a benefit three consecutive times without a reservation that such benefit is on a voluntary basis, employees may be entitled to receive such benefits in the future.

Employers should therefore always have thorough documentation that the stock option grant is only a one off grant and shall not support any future claims.

2. Typical Labour and Employment Issues

a) Principle of Equal Treatment

When introducing a stock option plan, the employer must respect the principle of equal treatment. According to this principle, employees shall be treated equally unless there is an objective reason for a difference in treatment. Employers should give particular consideration to what groups of employees will be eligible for stock options and whether the distinction between them and other employee groups is justified.

Examples of permissible justifications would include granting stock options to key employees only or choosing to exempt fixed term employees (since stock options are usually a long term incentive).

b) Discrimination

Employers are not allowed to discriminate against employees based on race, ethnic, religion, belief, gender, sexual orientation, disability and age unless the discriminatory behaviour is justified. Nor is such discriminatory behaviour permitted with regard to the introduction and grant of stock options.

In particular, it might be discriminatory not to grant stock options to part-time employees, since most part-time employees are female and this could therefore constitute indirect gender discrimination.

c) Forfeiture Provisions

Stock option plans typically stipulate that the options forfeit or have to be exercised within a specific period of time if the employment relationship is terminated.

According to a recent ruling of the Federal Labour Court, it is permissible that the options cease to exist at the end of employment.

D. Insider Trading

In Germany, insider trading is sanctioned by means of criminal punishment. In principle, the beneficiaries of a stock option plan are persons who, as members of the executive body of a company or because of their profession, activities or work, inevitably obtain insider knowledge. They are prohibited from using such knowledge for the purpose of trading securities. Insider trading issues involved in stock option plans are described in the following according to the time sequence of stock option plans:

I. Introduction of the Stock Option Plan

At the time of introducing a stock option plan, there are, usually no problems under the insider trading laws.

II. Allocation of the Stock Options

Problems may however arise in connection with the allocation of stock options if the beneficiary under a stock option plan is given the right to choose between fixed

remuneration and receipt of option rights. Beneficiaries with insider knowledge who decide to receive the option rights may be criminally liable. Therefore, option rights should only be granted to employees automatically and without the beneficiary getting involved in the events or after the insider facts have been disclosed to the public.

III. Exercise of Stock Options

The exercise of stock options is generally "plain sailing" under the insider trading law. However, in order to be safe, it is advisable to prepare a stock option plan to introduce automatic standards defined in advance that largely reduce the beneficiary's discretion. It should be stipulated that the options may be exercised only during certain time periods (exercise periods), for example within 3 weeks of the presentation of a business or interim report, a balance sheet press conference, or the like, i.e. at a time the up-to-date economic data on the issuer of the options are also available to other market players.

IV. Sale of Shares

A sensitive matter under the insider trading law is the sale of the shares if the seller is aware of negative insider facts. However, there are various ways to limit the possibility to sell the shares acquired by the beneficiary: First, the beneficiary may employ a third person who must not be bound by instructions to manage the shares. Second, the company may give very narrow standardized instructions to the beneficiary for the sale of the shares, providing him with only a very limited discretionary scope. Third, companies are well advised to maintain a degree of transparency beyond the minimum statutory requirements.

V. Harmful Effect on the Company's Reputation Because of the Appearance of Insider Trading

It would be very damaging to a company's reputation for the impression to be given that the beneficiaries enjoyed special advantages in connection with a stock option plan. It is therefore advisable for companies to set clear criteria and fixed standards in the stock option plan.

E. Reporting Obligations Under Securities Regulations

In Germany, persons holding stock options or similar options are subject to reporting obligations under the German Securities Trading Act (*Wertpapierhandelsgesetz,*

WpHG). Reporting obligations apply if such persons' conduct constitutes directors' dealings or if the number of stock options or similar options exceeds certain thresholds as stipulated in the WpHG.

I. Directors' Dealings

According to sec. 15 a of the German Securities Trading Act (WpHG) persons performing executive functions at an issuer of shares are obligated to notify such issuer and the competent German Federal Supervisory Authority for Financial Services (*Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin*), within five business days in writing of any dealings, (i.e. purchase or sale of shares of such issuer or of financial instruments relating to such shares,) if the price of such financial instruments depends, directly or indirectly, on the price of the shares.

BaFin considers, *inter alia*, the following types of financial instruments to relate to shares of the issuer: convertible bonds, convertible participation rights, warrants, call and put-options, stock options, stock appreciation rights and phantom stock plans.

However, sec. 15 a of the German Securities Trading Act (WpHG) applies if the shares of the issuer are (1) admitted to trading at a German stock exchange or (2) admitted to trading at a foreign organized market, provided that such issuer has its corporate seat in Germany, or (3) shares of an issuer with its corporate seat outside the European Union and the European Economic Area if such shares were admitted to trading to an organized market at a German stock exchange.

Persons performing executive functions are considered to be: members of the management board, members of the supervisory board (*Aufsichtsrat*), shareholders underlying a personal liability of such issuer and other persons who regularly have access to sensitive insider information and having authorization to making material business decisions for such issuer, i.e. such person needs to be entitled to making strategic decisions for the issuer either on a stand-alone-basis or as member of a board or other competent body alike (the "Executive").

For the sake of transparency, persons maintaining a close personal relationship with the Executive are also required to notify the issuer and BaFin about dealings accordingly. Persons maintaining a close personal relationship are considered spouses, registered life partners, dependent children and other relatives, who have a common household with an Executive for at least 1 year prior to the dealings to be reported accordingly.

Further, legal entities, including foundations and partnerships, in which a person performs executive functions, who is considered either an Executive or a person maintaining a close relationship with such Executive, are also considered to be a person maintaining a close personal relationship.

In addition, legal entities, companies and institutions which are directly or indirectly controlled by either an Executive or a person maintaining a close personal relationship to an Executive, or which are established for such a person or which economic interests largely correspond to the economic interests of such a person, are covered by the reporting obligations as well.

Finally, however, such reporting obligations do not apply if the total amount of dealings in shares or financial instruments relating to such shares does not reach EUR 5,000 within a calendar year.

II. Holding of Financial Instruments

A second reporting obligation may apply if the number of stock options or similar options held by an individual or a legal person exceeds certain thresholds. Any individual or legal person, whether German or foreign citizen or whether with corporate seat in Germany or abroad, is required to notify an issuer of voting rights in shares and BaFin without undue delay, but no later than four stock exchange days, upon exceeding or going below the thresholds of 3, 5, 10, 15, 20, 25, 30, 50 or 75%, respectively. In general, the above reporting obligation applies only if the shares of such issuer are admitted to trading at a German stock exchange.

An individual or legal person holding, directly or indirectly, financial instruments which in connection with a legally binding agreement unilaterally grant such individual or legal person the right to purchase issued shares carrying voting rights, are obligated to notify the respective issuer of the shares and BaFin in writing without undue delay once the number of such financial instruments upon conversion into shares of such issuer, which are already issued, exceeds 3, 5, 10, 15, 20, 25, 30, 50 or 75%, respectively, of the share capital of such issuer, provided that Germany is the state of origin (*Herkunftsstaat*) for such issuer of shares. Germany will be the state of origin if the issued shares are either admitted to trading at a German stock exchange or at an organized market in the European Union or the European Economic Area, provided that the issuer has its corporate seat in Germany.

The above reporting obligation applies if the unilateral right to purchase issued shares carrying voting rights arises simply from a contract so no claim *in rem* is needed.

However, the fungibility of the issued shares is not a prerequisite for the above reporting obligation. Consequently, the reporting obligation arises if the financial instruments, which provide for a unilateral contractual right for purchase of shares, relate to issued shares, which are not admitted to trading at a German stock exchange or an organized market in the European Union or the European Economic Area.

F. Tax Law Aspects

I. Employee Shares

If shares are issued to an employee for no valuable consideration, or for a price below the market price, (so-called employee shares (*Belegschaftsaktien*)) then on the day the shares are made available a "monetary benefit" arises in the amount of

the difference between the stock exchange price and the price actually paid by the employee. This benefit is subject to income tax because it is an income from non-self-employed work. However, it is worth noting that the German Income Tax Act (*EStG*) exempts benefits not exceeding EURO 135, per calendar year and benefits not amounting to more than 50% of the market price for the shares.

II. Convertible or Option Bonds, Synthetic Options

1. Option Bonds, Synthetic Options

According to case law set by the Federal Finance Court, no monetary benefit arises at the time the conversion or option rights or the "synthetic option" is granted. This is considered not to be a relevant monetary benefit, because the employee is not generally allowed to freely dispose of the option as such rights are usually strictly personal and non-transferable. Therefore only the exercise of the conversion or option right itself is considered to be a monetary benefit. The monetary benefit is the difference between the strike price and the stock exchange price on the exercise day of the option. If the performance of the option rights is limited to payment of the difference (as in case of synthetic options), the monetary benefit is the amount being subject to income tax liability. As the due date to determine the monetary benefit is the exercise of the option, the employee might face very high taxes. If the value of the delivered shares subsequently decreases significantly, the employee might face the problem that the value of the shares is less than this tax liability. The employee's expenses in acquiring the options are tax deductible.

2. Convertible Bonds

Convertible Bonds are generally regarded as constituting a monetary benefit at the date the bonds are acquired by the employee, because they are in general transferable and marketable securities which by law include the right of the bond holder to convert his bonds into shares, provided however, that a market where these instruments can actually be traded exists. In such case, the monetary benefit is the difference between the actual acquisition cost for the convertible bonds and their fair market value at the day of the acquisition. Otherwise, i.e. in case no such market exists, the same principles as described under item (1) apply.

3. Capital Gains

In addition to the taxation at the time of exercise of the option or at the time of the acquisition of the convertible bond, the employee must pay tax on the additional profit realised by selling the shares. When such gains are realized they are, in

principle, subject to a final withholding tax at a rate of 25%, which is withheld by the bank at which the employee holds his securities account. In a situation where the average income tax rate of the employee is lower than 25% he may apply for taxation of such income as ordinary income. In this case the withholding tax will be credited against his income tax liability.

III. Simple Preemptive Rights

In principle, preemptive rights are not transferable. Simple preemptive rights ("Naked Warrants") are only regarded as transferable if they are actually listed and traded at a stock exchange. Naked Warrants used in stock option programs do not meet this requirement, therefore the granting of a preemptive right does not constitute a monetary benefit. Only the exercise of the preemptive right results in a taxable monetary benefit. The decisive day to calculate the monetary benefit is the day the shares are credited on the employer's securities account. The taxable monetary benefit is the difference between the strike price and the fair market value of the shares.

IV. Reserved Shares

If, in connection with an (initial) public offering, shares to be issued to the employees are reserved for subscription for a "preferential price," the difference between this "preferential price" and the actual subscription price is a monetary benefit generally subject to income tax liability, regardless of whether the employee is subject to a restraint on alienation or not. Profits from subscriptions, i.e. the difference between the subscription price and the actual stock exchange price, are subject to income tax as income from employment at the regular income tax rates. This benefit is however income tax free provided that the benefit does not exceed 50% of the fair market value of the share and does not exceed EUR 135 annually.

V. Limitation of German Taxation on Monetary Benefits from Preemptive Rights and Similar Instruments

The above-mentioned taxable monetary benefits are regarded as income for the period between the grant of the preemptive right, (or any other instrument which is treated regarding taxes like a preemptive right), and the exercise of such right. In the case where an employee receives income from employment during this period

which is tax exempt, pursuant to an applicable Double Taxation Treaty, the taxable monetary benefit is subject to German taxation only on a *pro rata temporis* basis. These rules apply even if the employee is not subject to German income tax at the day of the exercise of the preemptive right.

VI. Wage Tax, Capital Gains

1. Wage Tax

As soon as the option is exercised, the difference between the strike price and the actual (higher) stock exchange value of the share constitutes a benefit for the employee, which is subject to wage tax (*Lohnsteuer*) liability. The employer or principal must deduct the wage tax from the wages in the month in which this benefit arises. Although the benefit received by the employee constitutes a part of the wages, this obligation to retain the tax relates only to the cash wages. If this is not sufficient, the employer must demand that the employee himself provides the employer with the amount to be paid as a wage tax. If this is not done, the employer must inform the tax authorities in order to avoid any wage tax liability.

The obligation to retain tax always falls on the employer, even if the wages are paid by a third party. This is frequently the case where employee options are granted, for example, when the employees of a German company participate in a stock option plan of the foreign parent company. If the shares are then actually issued, the German subsidiary must either retain the wage tax or inform the tax authorities. In order to enable the employer to properly perform his obligation to withhold taxes on such monetary benefit, the employee is obliged to inform his (previous) employer about the exercise of such instruments and to provide the relevant data to calculate the taxes to be withheld.

2. Capital Gains

The provisions concerning private sales transactions are applicable when options are exercised and the shares obtained are resold for a profit within 1 year, provided however that the shares have been acquired prior to 1 January 2009. The profit for this purpose is the difference between the sales price and the acquisition costs. Due to the fact that the difference between the strike price and the market price is subject to wage tax liability when the option is granted, the acquisition costs rise to the market value at the time of the exercise of the option. A taxable profit thus arises only if the market price increases after the exercise of the option, and then only in the amount of the price increase. Such capital gain (*Veräußerungsgewinn*) is subject to income tax only with one half of its actual amount.

With respect to shares acquired after 31 December 2008 different rules apply. For these shares any capital gain is subject to tax as income from capital investment

(*Einkünfte aus Kapitalvermögen*) regardless of when such gain is realized. Such income from capital investment is in principle subject to a final withholding tax of 25% on the capital gain. The tax is to be withheld by the bank at which the employee has his securities account. In case the actual average income tax rate of the employee is lower than 25% he may opt for a tax assessment of such income. In such a case the withholding tax will be credited against his income tax liability. The capital gain together with all other income from capital investment would then be subject to income tax at regular rates. Please note that in calculating such taxable income from capital investment, cost relating to such income is not deductible in the calculation of taxable income.

However, as the benefit in this case is not based on the employment or work contract, the employer or the principal is not obliged to retain and pay any wage taxes to the tax authorities. Instead, the profit must be included in the employee's income tax declaration.

If the options granted were actually marketable as defined above (and can be evaluated), a benefit subject to wage tax would arise when the options are granted. Provided that the options have been acquired prior to 1 January 2009, there would be a profit subject to income tax if the option is sold or exercised within 1 year for a price exceeding the benefit taxed at the time of the granting of the option, or if the option is exercised within 1 year after it has been granted and the market value of the shares exceeds the strike price plus the value of the option at the time of its acquisition (the "Capital Gain"). However, the Capital Gain is subject to income tax only on half of its actual amount.

With respect to such options acquired after 31 December 2008 the Capital Gain would be considered to be income from capital investment regardless when the option is exercised or sold. Such income is subject to a final withholding tax of 25%, which is to be withheld by the bank at which the employee has his securities account. In a situation where the average income tax rate of the employee having exercised or sold the option is lower than 25%, he may opt for a tax assessment of income tax on income from capital investment. In this case this income would be subject to income tax at regular rates and the withholding tax will be credited against his income tax liability.

G. Selection of the Most Suitable Model in Practice

In order to select the most suitable model for a stock option plan, it is necessary to compare the needs of the company with the benefits and disadvantages of each model.

I. Contingent Capital Increase

The contingent capital increase is the most common way to back-up a stock option plan. The main advantage is that the company doesn't have to spend money to

acquire shares on the market, but instead creates new shares. Once the options have been exercised the increase in share capital strengthens the company's equity capital. Compared to the authorized capital increase the contingent capital is not limited in time in the absence of a respective provision in the shareholders' resolution. However, the contingent capital increase has the disadvantage that its nominal amount may not exceed 10% of the nominal share capital that is available at the time of the resolution on the contingent capital increase. Moreover, the stake of the existing shareholders is diluted.

II. Authorized Capital

Authorized capital is also cost effective since no shares must be acquired on the market. Nevertheless, authorized capital is less favourable than contingent capital: First, there is a statutory time limitation of 5 years regarding the authorization of the board to create new shares. Hence, the stock option plan must also be limited to 5 years. Otherwise, it might occur that the board is not able to serve the exercised options with shares (absent a new resolution by the shareholders general meeting). Given the minimum statutory waiting period of four years such a plan would not likely be not very attractive. Second, the handling of the capital increase is complex because the board must always use its power to raise the capital whenever options are exercised. Moreover, authorized capital also results in dilution of the existing shareholders' stake.

III. Purchasing Own Shares

Unlike contingent or authorized capital, the value of the existing shares is not diluted if the company acquires own shares for the stock option plan. But depending on the size of the stock option plan, the company's cash flow will be reduced. Moreover, the repurchase of own shares is limited to 10% of the registered share capital. However, if the stock options shall be granted merely to employees (including key employees) but not to board members no resolution of the general meeting is required.

IV. Synthetic Options

The disadvantage of synthetic options is that under German GAAP (Generally Accepted Accounting Principle) they negatively affect the profit and loss account due to the high expenditures necessary to serve the options once they are exercised. However, in principle all stock option programs will have such an effect on the profit and loss account under IFRS (International Financial Reporting Standards),

which became compulsory in 2005 for companies listed on European stock exchanges. The existing shares are not diluted and no shareholders' resolution is necessary.

H. Key Aspects

- The implementation of stock option plans has to be consulted with the works council.
- If only managing directors and key employees are eligible, no consultation with the works council is required.
- When determining the eligible employees, employees should consider the principle of equal treatment and avoid discrimination issues. Options are typically subject to tax at the time the options are exercised, not granted. Stock options also affect various corporate and securities laws.

Chapter 25
Company Pensions

Bernd Borgmann and Jens Kirchner

A. Introduction

A pension is a steady income given to a person, usually after retirement. As in almost all other European countries the German system of retirement pensions consists of three pillars:

- The compulsory German Pension Insurance (*Deutsche Rentenversicherung*) providing for a basic pension financed by employers' and employees' contributions directly deducted from the monthly payroll
- The so-called company pensions, which include certain employees' savings schemes linked to their employment usually referred to as deferred compensation (*Entgeltumwandlung*) as well as schemes that are fully or partly financed by the employer
- The entirely voluntary private pension arrangements, which may contain various elements from private saving accounts to real estate properties

Providing a company pension can have significant advantages for employers as well, if they are designed to reduce staff turnover costs and to encourage staff loyalty, which is particularly important with regard to more highly qualified employees. Long vesting periods combined with a pension plan providing for progressively increasing pensions in line with the length of service can be used as a very powerful retention program.

I. Sources

All pension arrangements provided by the employer or in connection with the employment contract (the so-called second pillar of the pensions system) are covered by the Act for the Improvement of Company Pension Plans (*Gesetz zur Verbesserung der betrieblichen Altersversorgung, BetrAVG*), usually referred to as the Company Pension Act (*Betriebsrentengesetz*).

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The Company Pension Act was passed in 1974 to regulate important aspects of company pension provisions which until then – in the absence of specific legislation – had been ruled by general civil law and the specific jurisdiction of the German Labour Courts. The Act contains provisions for the pension promise and the types of schemes used to provide corresponding pension payments, whether they are organised in-house (direct pension promise or support funds) or externally (direct insurance, pension insurance funds or pension funds). The provisions relate to all important issues such as financing, non-forfeitability, amount of liabilities, the type of commitment, the adjustment of benefits and the protection against insolvency of the principal employer. In the Act's second part, detailed tax rules determine whether company pension costs can be regarded as business expenses. In addition, the Income Tax Act (*Einkommenssteuergesetz*) contains further regulations of considerable importance for company pensions as do several other pieces of legislation, such as the Act on the Supervision of Insurance Enterprises (*Versicherungsaufsichtsgesetz*).

In case of any disputes about company pension issues, the labour court system has sole competence to determine matters relating to occupational pensions or to the Company Pensions Act, including matters relating to disputes between external pension providers or involving the Pensions Insurance Association (*Pensionssicherungsverein aG, PSV*) in the field of corporate insolvencies. Only disputes about the mandatory contributions to the Pension Insurance Association are dealt with at the Administrative Courts. As always in German employment and labour law, jurisdiction also plays a major role in the field of company pension law.

II. Reform of Company Pensions Act

A significant reform of the entire German Company Pension Act was introduced by the Act on Pension Provisions (*Altersvermögensgesetz, AVmG*) which came into force in 2001. The primary aim of the Act was the promotion of private pension plans, but company pension schemes have been included in these promotional measures and have also been given special concessions, particularly in the form of tax and social security contributions relief. Another long awaited measure was the recognition of defined contribution schemes and the introduction of pension funds as a fifth way of providing for company pensions.

B. Contractual Basis of Company Pensions

I. Basic Requirements of a Pension Promise

Company pensions are based on a contractual agreement which determines the details of the pension obligation. The legal definition contained in section 1 paragraph 1 Company Pension Act provides as follows:

If an employer has promised an employee the payment of an old-age, invalidity or survivor's pension in connection with his employment (company pension promise) the provisions of this Act shall apply. The company pension promise may be executed directly through the employer or through one of the pension providers described in section 1b paragraph 2 to 4. The employer shall guarantee the fulfilment of the pension obligations promised by him even if they are not directly executed through the employer.

An existing employment relationship is therefore a prerequisite for a company pension. The term "employment" has a wide meaning in pensions law and covers regular employees as well as managing directors, board members and other persons working for another natural or legal person (e.g. as consultant, freelancer or commercial agent). It does not, however, apply to the sole trader or commercial owner, even if he is engaged in his own business in a formal employment relationship.

II. Individual and Collective Pension Promises

A pension promise can be made as an individual promise or in the form of a collective promise based on an agreement with the works council or provided for in a collective bargaining agreement.

1. Individual Pension Promise

The classic form of an individual pension promise is a contract in which the employer offers the payment of a pension with specified provisions to which the employee then consents. Pension promises do not have to be in written form and can validly be formed by oral agreement; however, they will only be recognized under tax laws if made in writing. The classic form of individual pension contract is commonly used to provide higher management staff, managing directors or board members with a pension entitlement.

a) Standard Contract (*Vertragliche Einheitsregelung*)

An employer can use a standard contract to individually address employees, but provide a uniform pension promise which provides equal benefits to the whole workforce. Unlike the classic form of individual pension contract, the standard contract is characterized by an intention to provide equal promises to a collective group of employees in the specific business, location or company. This is of particular importance if the content of the pension promise is to be amended at a later stage.

b) General Promise (*Gesamtzusage*)

As in the standard contract, a general promise provides employees with a uniform pension promise. For practical reasons the promise is not made in individual agreements with the employees, but through a more general means of communication such as a general notification on the businesses' notice board or a standard letter to all employees. As the pension promise is a benefit without obligations on the part of the employees, the pension promise is binding without requiring a formal consent from employees. Employees are deemed to accept the promise if they do not object, and this is sufficient to make the general promise binding.

c) Operational Practise (*Betriebliche Übung*)

Repeated and similar standard practises of an employer may create a legally recognised expectation on the side of the employees that they will receive a certain level of benefit in the future. Such practises are known as standard operational practises and are mainly related to annual benefits such as a Christmas bonus. For example, employees have been able to claim for a pension promise in a company where it was a standard practise to award a pension to employees at the completion of 10 years' service.

d) Principle of Equal Treatment (*Gleichbehandlungsgrundsatz*)

The principle of equal treatment is a basic principle in German employment law and has been further developed by the adoption of the Act on General Equal Treatment (*Allgemeines Gleichbehandlungsgesetz, AGG*). Employees can claim that they have to be given access to a company pension scheme if a comparable group of employees is collectively provided with such a benefit. A prime example of discrimination is a scheme specifying an earlier retirement age to female than to male employees. Accepted criteria for differentiation in the area of pension plans are hierarchy levels, qualifications of employees or the requirement of permanent employment as opposed to fixed term contracts.

2. Collective Pension Promise

In companies with an established works council, the Works Constitution Act provides for a right of co-determination in issues relating to social benefits or to the form in which remuneration is provided (sec. 87 para. 1 numbers 8 and 10 of the Works Constitution Act). In practise, many companies operate a pension scheme based entirely on collective agreements with the works council, the company works council or even, if applicable, the group works council. Such collective pension

schemes apply to the individual as a direct entitlement and without any further contractual agreement being necessary.

Trade Unions are also able to agree binding pension schemes in collective bargaining agreements, but this option has been used rarely, with notable exceptions in public service, the building industry and the metal and electro industry. A recent example of particular importance is a collective bargaining agreement in the metal and electro industry providing for annual pension contributions of at least EUR 319.08 per employee (Collective Bargaining Agreement on Retirement Related Benefits (*Tarifvertrag über altersvorsorgewirksame Leistungen*)).

III. Commitment to Provide Benefits or Contributions

In most European countries the company pension promise can be arranged as a commitment to provide a defined benefit or as an obligation to make specific financial contributions only. To limit the effects defined contribution schemes can have on the employees' pension expectations, German law does not recognize pure defined contribution schemes as pension plans. They can, however, be recognized as general employee saving schemes. In order to qualify as a company pension promise, German law requires a certain guaranteed benefit from employers operating such a modified defined contribution scheme. Nevertheless, almost all modern pension promises are contribution oriented and avoid promising a defined benefit.

1. Defined Benefit Promises (*Leistungszusage*)

In the past defined benefit plans were very common in Germany. In most plans, benefit portions are fixed or graded according to the length of service or based on a portion of the employee's salary at retirement. For example, a common pension formula for middle management under a defined benefit plan could read as follows:

> *At your retirement, we shall provide you with a monthly company pension which shall amount to*
>
> *a) 1.5 per cent of your last regular monthly salary up to the threshold for general pension contributions;*
>
> *b) 3.0 per cent of your last regular monthly salary exceeding the threshold for general pension contributions;*
>
> *both multiplied with the years of service in our company up to a maximum of 20 years.*

Under such a formula, an employee retiring in 2008 with a monthly salary of EUR 6,000.00 and 20 years employment in the company would be entitled to a pension of EUR 2,010.00.

2. Contribution Oriented Benefit Promises (*Beitragsorientierte Leistungszusage*)

Aiming to reduce the financial risks in the development of pension plans, many employers have changed their pension promises to contribution oriented benefit promises. Below is an example of a common pension formula under a contribution oriented plan:

> *We shall contribute to your company pension account once a month an amount of*
> *a) 1.5 per cent of your monthly salary up to the threshold for general pension contributions and*
> *b) 3.0 per cent of your monthly salary exceeding the threshold for general pension contributions;*
> *The annual total contribution is converted into a pension expectation according to the attached schedule. The total of all pension expectations will form your monthly pension payment at your retirement.*

While the contributions under such plan define the employer's annual costs, the financial uncertainties for the employer remain in the pension conversion formula which requires specific know-how of actuarial and insurance experts.

3. Defined Contribution with Minimum Benefit Promises (*Beitragszusage mit Mindestleistung*)

The option to provide pension promises as a defined contribution with minimum benefit has been introduced by the Act on Pension Provisions with effect from 26 June 2001. The obligation of the employer is limited to the contributions and a guarantee that at the time of retirement at least an amount equal to the aggregated employer's contributions is available to be converted into a pension.

In contrast to the defined benefit and contribution oriented benefit plans the pension expectation in a defined contribution with minimum benefit plan depends solely on the investment performance of the external pension providers.

IV. Deferred Compensation

As already mentioned, the Act on Pension Provisions of 2001 introduced the recognition of deferred compensation schemes as valid schemes in the system of company pensions. The Company Pension Act requires that deferred compensation schemes have to ensure that the pension expectations resulting from the plan will be of equal value to the deferred remuneration itself.

Unlike employer financed company pension schemes, the employees have a legal right to be offered at least one pension scheme for deferring a certain portion of their individual remuneration. The advantage of deferred compensation schemes is that contributions are tax free. Pensions resulting from a deferred compensation

scheme are taxed at the individual tax rate, which for most people is significantly lower in retirement than when in active employment.

For example, in a typical deferred compensation pension scheme the employer agrees with an insurance company to set up a discounted insurance arrangement for his employees and then offers them participation in the scheme. Employees signing up to the scheme have to agree that a certain percentage of their regular salary, annual bonus or a similar benefit is deducted before its payment to the employees and transferred directly from the employer to the insurance accounts. The employer will obtain a life insurance contract from the insurance company for the benefit of the employee, with immediate vesting rights attributed to the employees to secure them against the risk of insolvency of the employer.

C. Five Ways to Arrange Company Pension Schemes

The Company Pension Act provides for five different types of company pension schemes:

- Direct pension promises (*Direktzusage*)
- Support funds (*Unterstützungskasse*)
- Direct insurance (*Direktversicherung*)
- Pension insurance funds (*Pensionskasse*)
- Pension funds (*Pensionsfonds*)

The most common type of the schemes is the direct pension promise which constitutes approximately 40% of all German company pension promises. Direct insurance contracts, pension insurance funds, support funds and pension funds amount to the other 60%, whereby direct insurance has the widest spread and the pension fund, due to its relatively new introduction, has the lowest spread among existing schemes.

All types of pension schemes are subject to special rules regarding administration, accounting, taxation and investment strategy. Therefore the employer's choice of a pension scheme type is an important decision not only for the future liabilities of the employer but also for the beneficiaries. The employer can choose to combine different pension scheme types. He is also legally entitled to change how he arranges administration for his pension promise, although rules providing specific protection for pension rights already acquired have to be observed.

I. Direct Pension Promise

1. Overview and Legal Structure

In the case of a direct pension promise the employee holds a right to receive pension payments directly from the employer (sec. 1b para. 1 Company Pension Act).

Administration of the direct pension promise is easy and cheap, as there is neither an external pension provider nor an external supervisor involved. Both defined benefits and contribution oriented benefits can be provided as direct pension promise, however it is not permitted for the so-called defined contribution with minimum benefit plans. Even though direct pension promises are usually benefits financed by the employer, it is also possible to operate a deferred compensation scheme as a direct pension promise. In the event of the biggest risk for the employee, the employer's insolvency, benefits are safeguarded by the statutory Pension Insurance Association (*Pensionssicherungsverein a.G., PSV*). Contributions to the Pension Insurance Association are provided by the employer in addition to the direct pension promise.

2. Funding and Financial Implications

The other aspect of the employee's right is the employer's future liability to actually make the pension payments to the retired or disabled employee or, in the case of survivors' pensions, to the beneficiaries. This type of pension promise is usually not funded, but the future obligation provisions have to be made in the employer's balance sheet. There is an outflow of cash in the disbursement phase only. Once retirement starts and the pension payments become due, the employer has to provide the payments from his then current cash flow and has to make corresponding adjustments in his balance sheet by releasing the respective provisions.

Most employers only make provisions on the balance sheet and use the corresponding assets for the general financing of their business. Compared to most other European countries this is a quite unusual way to provide for pension obligations. Thus the balance sheets of German companies comprising provisions for unfunded pension liabilities are often misinterpreted by international analysts, which may cause severe detriments on the international finance market. Some companies have therefore created funding vehicles, called Collective Trust Arrangements (CTAs), which allow them to use a separate legal entity called a "trust" (but not being a trust under UK or US law) to accumulate certain assets for the funding of the accrued obligations. The assets under a CTA qualify as plan assets according to international accounting rules and can therefore be used to shorten the balance sheet in line with international practise.

3. Tax Implications

In terms of tax treatment, no income tax is levied on the additional pension entitlement during active employment, as the employee does not receive any direct value (sec. 11 Income Tax Act). The tax effect on the employee's side is that the pension is only taxable when the actual payments are made, i.e. in the retirement phase, at the employee's individual tax rate. The employer is entitled to reduce his taxable profits by the necessary provisions as calculated by an annual actuarial valuation (sec. 6a Income Tax Act).

II. Support Fund Promise

1. Overview and Legal Structure

Instead of making pension payments directly out of his business, an employer can provide that the pension promise shall be arranged through a support fund. Support funds are separate legal entities, often in the form of a registered association (*eingetragener Verein*). They can be operated by one or more employers.

The existence of support funds in German company pension law can only be explained historically. Originally support funds were associations founded by the employer and/or the employees of a company to provide employees in need with a certain financial support. The scope of the funds was then expanded to provide employment related pension benefits. The pension promise can be employer financed or paid for by deferred compensation, defined benefit and contribution oriented benefit plans.

A common variation of the traditional support funds are so-called reinsured support funds, often set up by insurance companies, which offer the administration of pension promises as a business service.

2. Funding and Financial Implications

Sufficient funds must be allocated to the support fund by the operating employers in order to enable the support fund to pay pensions to beneficiaries. However, the employer has a wide discretion to decide on the level and timing of funding.

In the case of reinsured support funds, the employer has to pay the premiums to the reinsurance company which releases annually the necessary contributions to the support fund to meet it's obligations towards the employees. Even though the reinsured support fund's liabilities are fully covered for by the reinsurance agreement, it is also covered by the Pension Insurance Association, albeit on a reduced contribution basis.

3. Tax Implications

The support fund is not subject to corporation tax or trade tax. Contributions made by the employer arranging his pension scheme via the support fund are not considered immediate benefits to the covered employees and therefore not subject to income tax. Employees have to pay income tax on the pension payments received at their then actual tax rate (sec. 11 Income Tax Act). Furthermore, the Income Tax Act provides that contributions to the support fund are only recognised as tax effective operating expenses if the aggregated financial assets do not exceed the equivalent of two average annual pension disbursements for each employee covered by the pension promise.

In the case of the reinsured support fund insurance premiums are recognised as operating expenses without limitation. Therefore, the deduction constraints are irrelevant.

III. Direct Insurance

1. Overview and Legal Structure

A direct insurance pension scheme has a very simple legal structure: the employer arranges for a life insurance contract in favour of the employee to whom the pension promise is made. The employer provides the premiums to the insurance company, so the employee receives a direct legal entitlement.

A direct insurance pension scheme can be applied to any type of pension promise. It can be applied as an additional benefit paid for by the employer or as a deferred compensation scheme. If the employer does not offer another type of deferred compensation plan employees have a legal right to be provided with direct insurance.

2. Funding and Financial Implications

In the case of direct insurance, the financial and funding side of the company pension promise is entirely under the control of the insurance company. In practise, the only obligation of the employer is the timely payment of insurance premiums; the employer's guarantee for the pension payment as stipulated by the Company Pension Act is reduced to a mere theoretical notion. As the whole risk of funding for the pension promise is assumed by the insurance company the overall cost for the same pension benefit tends to be higher than in the case of internal funding.

3. Tax Implications

As employees receive a direct legal entitlement to the life insurance, contributions are subject to income tax, however, an amount of 4% of the threshold for general pension contributions can be provided tax free (sec. 3 number 63 Income Tax Act). Arrangements made prior to 2004 could use a flat tax rate of 20% plus solidarity and church tax (sec. 40b Income Tax Act) up to a ceiling of EUR 1,752.00 per year. Up to this ceiling, contributions are also exempt from social security contributions. The pension payments are subject to taxation of the earnings portion with the individual tax rate of the beneficiary.

On the funding side, premiums paid by the employer to the insurance company are fully recognised as operating expenses.

IV. Pension Insurance Fund

1. Overview and Legal Structure

Similar to direct insurance, a pension insurance fund is when an external pension provider fully assumes the administration and funding side of the company pension. They are non profit entities operated by one or more employers who thereby arrange company pension schemes for their workforce. Participation in the pension insurance fund is restricted to the supporting employers. These employers pay contributions to the pension insurance fund, which invests the assets and funds the pension benefits later paid to the employees. Employees hold a legal entitlement against the pension insurance fund to receive pension payments. Due to the tight system of controls already operating in such funds, there is no duty to contribute to the Pension Insurance Association.

A pension insurance fund scheme can be applied to any type of pension promise. Depending on the internal rules of the pension insurance fund, contributions are often also required from the employees in order for them to be covered under the plan, thereby incorporating deferred compensation elements.

2. Funding and Financial Implications

The funding and financial arrangements for a pension insurance fund are very similar to direct insurance. Investment opportunities of pension insurance funds are limited to specifically safe investments. The pension insurance fund operates independently from the employer and has full control over its own investments. The employer has to pay contributions and is released from all other liabilities except the inevitable guarantee for the pension payment as stipulated by the Company Pension Act.

3. Tax Implications

According to the Income Tax Act the employer's contributions to a pension insurance fund are directly tax effective operating expenses. For the employee contributions are basically considered to be part of the compensation package and therefore subject to income tax. As in the case of direct insurance, an amount of 4% of the threshold for general pension contributions can be provided tax free.

V. Pension Fund

1. Overview and Legal Structure

According to its legal definition, the pension fund is, like a pension insurance fund, a legally independent institution which operates a funded company pension scheme on

behalf of the employer in return for the payment of contributions. Pension funds are, as well as pension insurance funds, subject to supervision by the Federal Financial Supervisory Authority. The main difference is that the pension fund is less restricted in its investment strategies. There is – despite some disputes about this duty – only a very small requirement to contribute to the Pension Insurance Association.

2. Funding and Financial Implications

While the funding side of the company pension promise is basically similar to the pension insurance fund, there is one specific difference. The pension fund can invest relatively free in the capital markets which provide options for higher return on investments, but also carry the risk of loosing funds that are required to meet the pension promises made.

3. Tax Implications

Tax implications are almost identical to those with the pension insurance fund.

D. Legal Protection for Company Pensions

I. Vesting of Company Pensions

Before the already mentioned landmark decision of the Federal Labour Court of 1972 on the vesting of pension rights, it was generally considered that provisions stipulating that the pension right was forfeited if the employee left the employment prior to retirement were valid due to freedom of contract. The Company Pension Act, as amended in 2001, provides that eligibility for a company pension is non-forfeitable from the age of 30 if the commitment has lasted for at least 5 years (sec. 1b para. 1 Company Pension Act). In the case of deferred compensation schemes the Company Pension Act clarifies that the pension rights vest immediately.

The amount of the pension right has to be calculated according to the rate-based assessment method (sec. 2 para. 1 Company Pension Act). The employee leaving the employment prior to retirement age receives a pension which corresponds to the ratio of the actual duration of employment in the company to the potential full service duration up to retirement age.

II. Restrictions Against Set-Offs, Early Payouts and Transfers

As a general rule, the employee may not waive accrued pension benefits, either with or without compensation, if the waiver is agreed in connection with the termination of employment or thereafter until reaching of the retirement age. The Company

Pensions Act restricts the waiver and early payout of accrued company pensions to the payout of minimum pension values. Other pension rights with a higher value cannot be waived and paid out to the employee, even if such a payout would be required by and in be the interest of the employee.

Furthermore, the Company Pensions Act provides restrictions on the transfer of vested pension rights after termination of employment. A transfer shall only be permitted if the pension scheme as such is continued in a new employment relationship or if a new employer provides for an equivalent value of pension rights in another pension scheme. In the case of liquidation of the former employer a transfer of the pension promise to a pension insurance fund or a regular life insurance company is possible, which is a considerable advantage in the liquidation process of companies. All other forms of transfers of pension rights are excluded and will not be legally recognised.

III. Adjustment of Pension Payouts

The Company Pension Act also contains minimum regulations for the adjustment of current pension payments. If no adjustments were permitted inflation would reduce the actual value of the pension in a way that over time would marginalise the intended benefit. Company pensions must therefore be reviewed once every 3 years and increased by at least the inflation rate or by the growth in net wages in comparable groups of employees within the company concerned (sec. 16 Company Pension Act). An adjustment can generally be deferred if the employer's financial situation so requires. However, an employer who claims the right to defer an adjustment has to inform all beneficiaries about the financial situation. Failure to inform the beneficiaries may result in an obligation to make up the adjustments of company pensions at a later time.

IV. Restructuring of Pension Schemes

As employment relationships are generally long-lasting agreements it is important that the conditions and obligations remain flexible over time. It is therefore recognized that company pension schemes are not fully protected against changes and restructuring needs. However, the importance of the company pension for the individual means it requires specific protection. The Federal Labour Court has developed a set of rulings which apply to the amendment and restructuring of company pension schemes made on the basis of a works council agreement.

The most important provision for employers is that any company pension scheme can be closed to new entrants at any time. This enables the employer to avoid accruing more liabilities in a difficult financial situation. Further, reduction of existing company pension rights is possible only if such reduction can be justified. According to jurisdiction, a detrimental change to a pension right already accrued is

only permitted if the employer's solvency is at risk and all other means of restructuring have been exhausted. The reduction of already accrued rights to the future increase of a pension expectation is possible if the employer has compelling reasons. Even less protection is awarded to the expected level of pension entitlements not yet earned (e.g. the continued application of a pension plan without any changes). It will be sufficient if the employer has reasonable, justifying grounds to introduce changes. For pension plans on a different legal basis than a works agreement these rules apply in a similar way.

V. Protection Against Insolvency of the Employer

In the case of insolvency of the employer the employees may lose not only their current employment but also the provider of the company pension promise. The Company Pension Act provides therefore for a compulsory reinsurance scheme which covers the event of insolvency of the employer. The Pension Insurance Association (*Pensionssicherungsverein a.G., PSV*) with its registered office in Cologne, assumes the pension obligation if the employer operating the scheme becomes insolvent. It will guarantee the full company pension entitlement and running pension benefits. As the number of claims has significantly increased in recent years, the contribution system for financing the Pension Insurance Association has been reviewed and shall now cover the fully funded value of all claims in a given year, by contributions to be collected in the same year.

E. Key Aspects

- The employer can grant a company pension promise in individual contracts or in agreements with the works council or trade union. If a works council exists any collective company pension scheme is subject to co-determination.
- Setting up new pension schemes is driven by tax advantages and capital allocation structures. An employer can choose to make a defined benefit promise, a contribution oriented benefit promise or a defined contribution promise with minimum benefit guarantee.
- German company pensions law allows for five different ways to provide for the pension promise:
  - Direct pension promises where the pension has to be paid by the employer.
  - Support funds which provide for an external pension provider under the control of the employer.
  - Direct insurances where the pension is provided by an insurance company.
  - Pension insurance funds which provide a secured and fully funded pension right.
  - Pension funds which are set up to enable investments in the capital markets for company pension purposes.

- Pension schemes can be amended, adopted or restructured according to the business situation of the company; however, the requirements are high and complex.
- In the case of insolvency of the employer the Pension Insurance Association will assume the pension obligation and provide for full pension payments and continued payment of already running benefits.

Chapter 26
Employee Co-Determination at Board Level

Michael Magotsch and Sascha Morgenroth

A. Introduction

German Labour Law provides for works council co-determination rights in accordance with the German Works Constitution Act (*Betriebsverfassungsgesetz, BetrVG*). This form of co-determination can be described as employee participation "from below" and has already been explained in detail above (see Part II, Chap. 4 on Employee Representation). This must be distinguished from co-determination at board level (*unternehmerische Mitbestimmung*), which can be described best as employee participation "from above," meaning monitoring the business management.

Germany has one of the most detailed and developed concepts of board level co-determination. There is a long history of board level co-determination governed by the Co-determination Act for the Coal and Steel Industry of 1951 (*Montan-Mitbestimmungsgesetz, Montan-MitbestG*), the Co-determination Act of 1976 (*Mitbestimmungsgesetz, MitbestG*) and the One-Third-Participation Act of 2004 (*Drittelbeteiligungsgesetz, DrittelbG*).

To the surprise of many foreign companies, employees in Germany may be entitled to up to 50% of the seats on the supervisory board of stock corporations. The employee co-determination laws, however, only apply to corporations, such as stock corporations (*Aktiengesellschaften, AG*), and limited liability companies (*Gesellschaften mit beschränkter Haftung, GmbH*). Around two-third of the workforce in Germany are employed in companies without employee co-determination. In particular, partnerships (*Offene Handelsgesellschaft, OHG*), limited partnerships (*Kommanditgesellschaft, KG*) and sole proprietors are not subject to employee co-determination laws.

The co-determination laws only apply to domestic corporations (the so-called territoriality principle) and not to foreign companies who have their management abroad (e.g. limited companies under UK law). Although controversial, in general the same principle applies to foreign companies that have their management officially abroad but are de facto managed in Germany.

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B. German Co-Determination Law

I. General Principles

1. Two-Tier Corporate Management

In Europe there are two different systems of board level management.

In the UK, for example, corporations have only one management body (the board of directors), and employee representatives are therefore not directly involved in company management (the so-called monistic system).

In Germany, on the other hand, in addition to the management board (*Vorstand* at *AG* or *Geschäftsführung* at *GmbH*) corporations may have a supervisory board (*Aufsichtsrat*) where the employee representatives are positioned (the so-called dualistic system). The basic corporate entity of corporations is the assembly of the stock owners (*Hauptversammlung* at *AG*) or shareholders (*Gesellschafterversammlung* at *GmbH*). It decides on the articles of incorporation and approves the disposal of profits as well as confirms the actions of both the management board and supervisory board.

a) Management Board

The management board (*Vorstand* at *AG* or *Geschäftsführung* at *GmbH*) is responsible for the day-to-day management of the company and coordinates, structures and monitors all company activities.

b) Supervisory Board

The supervisory board (*Aufsichtsrat*) consists of representatives elected by the shareholders and employee representatives elected by the staff, i.e. in most cases works councils and trade union members. The supervisory board monitors the managing directors and has the authority to appoint and withdraw management board members and to enter into and terminate their service contracts.

2. Constitutionality of Co-Determination Laws

Employee participation affects the basic constitutional rights of the companies (freedom of occupation), shareholders (freedom of property), and the employers' associations (freedom of coalition), but has nevertheless been regarded as clearly constitutional by the German Federal Constitutional Court (*Bundesverfassungsgericht, BVerfG*) if there is no unrestricted parity and shareholders in the supervisory boards maintain the right to the final entrepreneurial decision.

II. Co-Determination Statutes

The German statutory law on employee participation on supervisory boards is traditionally divided into three different systems depending on the legal form of the company, number of employees (>500 and >2,000 employees) and – in the case of the coal mining and steel producing (*Montan*) industry – the industry sector of the company.

In companies with 500 or less employees there is no mandatory co-determination. However, one-third participation applies in small AGs with 500 or less employees founded prior to 10 August 1994, if they are not considered mere family businesses.

1. Co-Determination in Corporations of the Coal Mining and Steel Producing (*Montan*) Industry with >1,000 Employees

The first German statute on employee co-determination at board level was the Co-determination Act for the Coal and Steel Industry of 1951. In practice, its scope of application is very limited. Understanding its regulations is, however, important for understanding German board level co-determination.

a) Almost Parity Co-Determination

Since 1951 in the coal mining and steel producing industry, stock corporations and limited liability companies that have more than 1,000 employees due to the Co-determination Act for the Coal and Steel Industry, have "almost parity" co-determination.

The supervisory board usually consists of 11 members ("Elferrat"); equally represented by shareholders and employees plus one "neutral" member. Shareholders and employees each appoint four members and one additional member. At least two employee members must be employed by the company. These are nominated for election by the works council after consultation with the labour union. The additional members must not represent any employers' association or labour union and must not work for the company. The "neutral" member is elected by the other supervisory board members. However, if the members of the supervisory board cannot agree on the "neutral" member, the shareholders have the final say. As a consequence, there is in fact no true parity.

Usual size of the supervisory board
11 members
4 shareholder rep. + 1 member
4 employee rep. + 1 member
1 "neutral" member

In the case of companies with registered capital of more than Euro 10 million, the company's articles of association may provide for a larger supervisory board

of 15 members. In the case of companies with registered capital of more than Euro 25 million, the supervisory board may have 21 members.

Possible size of the supervisory board according to the Company's Articles	
Company capital	*Supervisory board members*
>Euro 10 million	15 members
>Euro 25 million	21 members

b) Scope of Employees

Employees of dependent group companies are not included in the calculation of the required staff size of usually more than 1,000 employees. These employees may only vote for the group's supervisory board if the company, subject, to the Co-determination Act for the Coal and Steel Industry, is controlling the group and has a group works council.

c) Labour Director

According to the Co-determination Act for the Coal and Steel Industry, a labour director (*Arbeitsdirektor*), entrusted with the human resources and social management, must be appointed as an equal member of the management board. The labour director may, however, not be appointed or withdrawn without the support of the majority of the employee representatives on the supervisory board.

d) Company Groups Controlling Corporations of the Coal Mining and Steel Producing Industry

If there is sufficient contact to the coal mining and steel producing industry, parent companies controlling corporations of the coal mining and steel producing industry may themselves be subject to the Supplementary Co-determination Act for the Coal and Steel Industry of 1956. The parent and dependent group companies, subject to co-determination in the coal and steel industry, must accrue at least one-fifth of the revenues and employ usually more than one-fifth of the employees of the group. If controlling companies themselves are not subject to co-determination, they only fall under the Supplementary Co-determination Act if the controlled co-determined companies accrued in the last six business years more than 50% of the group's total turnover.

2. Co-Determination in Large-Scale Corporations with >2,000 Employees

The Co-determination Act of 1976 provides for co-determination in large-scale corporations with more than 2,000 employees. The Act applies to stock corporations

(*AGs*), partnerships limited by shares (*Kommanditgesellschaft auf Aktien, KGaA*), limited liability companies (*GmbHs*), and cooperatives (*Genossenschaften, eG*).

Companies that serve direct or predominant political, religious, charitable, educational, scientific or artistic purposes (*Tendenzunternehmen*) are excluded from the Act; these have so-called tendency protection (*Tendenzschutz*).

a) Parity Co-Determination

The Act provides for parity co-determination (i.e. the supervisory board consists equally of shareholders and employee representatives). In contrast to the co-determination in companies in the coal and steel industry, there is no neutral member in the supervisory board.

The total size of the supervisory board depends on the number of employees as shown in the chart.

Total size of the supervisory board	
Employees	*Supervisory board members*
$\leq$10,000 employees	12 members
$>$10,000 $\leq$ 20,000 employees	16 members
$>$20,000 employees	20 members

The supervisory board elects a chairman and a vice-chairman with two-third majority of its members. If the required majority is not reached by the elections, the chairman is elected by the shareholder representatives and the vice-chairman by the employee representatives, on a majority vote basis. Therefore, in practice, it is common for the chairman to be a shareholder representative. This results in a predominance of the shareholders, since only the chairman has two votes in the case of a deadlock.

b) Scope of Employees

Executive employees (*leitende Angestellte*) are counted as employees; however, they are subject to different election and representation rights. Temporary employees (*Leiharbeitnehmer*) are generally not considered employees of the corporation for co-determination purposes.

In partnership companies with a *GmbH* as unlimited liability partner (*GmbH & Co. KG*), employees of the partnership are counted as employees of the *GmbH*, providing for indirect employee co-determination in the partnership.

In company groups, employees of companies controlled by a corporation are counted as employees of the controlling corporation. This results in group-wide co-determination.

c) Labour Director

As in the case of co-determination in the coal and steel industry, a labour director (*Arbeitsdirektor*), entrusted with the human resources and social management, must

be appointed as an equal member of the board of directors. This does, however, not apply to partnerships limited by shares (*KGaA*). In contrast to co-determination in the coal and steel industry, the employee representatives have no particular influence on the appointment or withdrawal of the labour director.

3. Co-Determination in Other Corporations with >500 Employees

Under the One-Third-Participation Act of 2004 (*Drittelbeteiligungsgesetz, DrittelbG*), which replaced the respective regulations of the former Works Constitution Act of 1952, in corporations with more than 500 employees and up to 2,000 employees, the supervisory board consists of one-third employee representatives. The Act applies to respective stock corporations (*AGs*), partnerships limited by shares (*KGaA*), limited liability companies (*GmbHs*), cooperatives (*eG*), and mutual insurance companies (*Versicherungsverein auf Gegenseitigkeit, VVaG*) that have a supervisory board.

If they are not considered family businesses (i.e., particularly, if a single individual is the sole shareholder) then stock corporations (*AGs*) with less than 500 employees that have been registered with the commercial register prior to 10 August 1994 fall under one-third-participation.

Companies that serve direct or predominant political, religious, charitable, educational, scientific or artistic purposes (*Tendenzunternehmen*) are also excluded from the One-Third-Participation Act; this is so-called tendency protection (*Tendenzschutz*).

a) One-Third Participation

In the scope of the one-third participation, if the company bylaws do not provide for a higher number of members, the supervisory board consists of three members. The number of members must, however, be divisible by three. The maximum number of supervisory board members depends on the company capital.

Maximum size of the supervisory board	
Company capital	*Supervisory board members*
≤Euro 1.5 million	9 members
>Euro 1.5 million	15 members
>Euro 10 million	21 members

b) Scope of Employees

In a company group structure, employees of dependant group companies are counted as employees of the controlling corporation (1) if a control agreement (*Beherrschungsvertrag*) exists or (2) if the dependant company is integrated in the controlling company, resulting in group-wide co-determination.

Overview of German Co-determination Law			
	Co-determination Act for the Coal and Steel (*Montan*) Industry (1951)	Co-determination Act (1976)	One-Third-Participation Act (2004)
Legal forms of companies	AG and GmbH in the coal and steel industry	AG, KGaA, GmbH, eG	AG, KGaA, GmbH, eG, VVaG with supervisory board
Particular industry	Coal mining and steel producing industry	–	–
"Tendency protection"	Yes (particular industry requirement)	Yes	Yes
Registered office in Germany required	Yes	Yes	Yes
Required number of employees	>1,000	>2,000	>500 (and AG's < 500 employees registered prior to 10 August 1994 not considered family businesses)
Group-wide co-determination	Yes (pursuant to Supplementary Co-determination Act for the coal and steel industry of 1956)	Yes	Yes (in case of control agreement or integration of dependant company in controlling company)
Composition of the supervisory board	→ almost parity	→ parity 1/2 shareholder rep. 1/2 employee rep.	→ one-third-participation 2/3 shareholder rep. 1/3 employee rep.
Supervisory board members	Usually 11 members: 4 shareholder rep. + 1 member 4 employee rep. + 1 member 1 "neutral" member	12, 16 or 20 members depending on the number of employees	3 members or higher number in company bylaws divisible by 3; maximum number of members: 9, 15 or 21 members depending on company capital
Number of employees		≤10,000:12 members >10,000:16 members >20,000:20 members	
Company capital	Increase to 15 or 21 members possible in company bylaws: >Euro 10 million: 15 members >Euro 25 million: 21 members		Maximum number of members: ≤Euro 1.5 million: 9 members >Euro 1.5 million: 15 members >Euro 10 million: 21 members

C. EU Co-Determination Law

I. Co-Determination in the Societas Europea

1. Societas Europea

The so-called Societas Europea (SE) is a European company. It can be established (1) by so-called primary foundation, i.e. transformation, merger or establishment of a joint holding or subsidiary company, or (2) so-called secondary foundation of a subsidiary company of an existing SE. The corporate law rules on the establishment of the SE are implemented into German law by the Act on the Introduction of the European Company (*Gesetz zur Einführung der Europäischen Gesellschaft, SEEG*). Prominent examples of SEs established by German companies are *Allianz SE*, *BASF SE* and *Porsche Automobil Holding SE*.

2. Co-Determination

Employee co-determination in SE's in Germany is implemented in the separate German Act on Employee Participation in the European Company.

EU law generally allows companies to decide in their articles of incorporation for either of the two different legal concepts of employee co-determination in the member states: (1) only one management board (so-called monistic system) – like in the UK, or (2) a board of directors and a supervisory board (so-called dualistic system) – like in Germany.

Employee co-determination, however, must be negotiated prior to SE's constitutive registration. The employees of the companies founding the SE establish a Special Negotiation Board (*Besonderes Verhandlungsgremium*) in order to negotiate a company-specific co-determination scheme with the management bodies of these companies. If co-determination has not been waived and negotiations about the co-determination scheme fail then the statutory rules apply. According to the statutory rules, if companies with different national co-determination rules (applying to at least 25% respectively 50% of their employees) merge or establish SE Holdings or SE subsidiary companies, usually the highest co-determination standard amongst the involved companies apply to the SE. However, ultimately the Special Negotiation Board may decide on the applicable co-determination rules.

Therefore, an SE with the participation of German companies that have extensive parity co-determination is, in general, less appealing. Establishing SE companies, however, may help to "freeze" co-determination in order to avoid future application of (stricter) co-determination rules. This might be of particular interest for German companies without co-determination or companies with German one-third participation, which might otherwise fall under (parity) co-determination due to later staff increases.

II. Co-Determination in Cross-Border Mergers

On December 29, 2006, the Act on the Co-determination of the Employees in Cross-Border Mergers (*Gesetz über die Mitbestimmung der Arbeitnehmer bei grenzüberschreitenden Verschmelzungen, MgVG*) came into force, implementing art. 16 of the EU Directive 2005/56/EC of October 26, 2005, on Cross-Border Mergers of Limited Liability Companies. The main objectives of the EU directive are to facilitate cross-border mergers of corporations and to protect employee co-determination rights existing at the merging companies.

As a general principle, the national law – including co-determination law – of the EU member state applies where the merged company has its registered office. Thus, mergers into companies with a registered office in a member state without or with a lower standard of co-determination laws would result in the loss or reduction of the standard of co-determination previously applicable to employees of companies involved in the cross-border merger.

Therefore, the Act provides for a regulatory system similar to the Act on Employee Participation in the European Company. The company management may negotiate with a Special Negotiation Board on a co-determination model for the new company after the merger. If negotiations fail, mandatory statutory rules apply to the new company which follows the highest co-determination rules among the companies involved in the merger. In the 3 years post merger, the resulting co-determination cannot be changed to the employees' detriment. However, different from the SE, the companies involved in the merger may also determine the application of the statutory rules unilaterally without prior negotiations with the Special Negotiation Board, provided that more than 33% of all employees are already subject to co-determination.

D. Key Aspects

- German Co-determination Law
  The German statutory law on employee participation on supervisory boards is traditionally divided into three different systems depending on the legal form of the company, number of employees (>500 and >2,000 employees) and – in the case of the coal mining and steel producing industry – the industry sector of the company.

  Stock corporations and limited liability companies of the coal mining and steel producing industry with usually more than 1,000 employees are subject to "almost parity" co-determination. The shareholder's have the final say in the event of dispute on the determination of the "neutral" member of the supervisory board.

  In large scale corporations with more than 2,000 employees there is parity co-determination, i.e. the supervisory board consists equally of shareholders and employee representatives.

  In corporations with more than 500 and up to 2,000 employees the supervisory board consists of one-third employee representatives.

In companies with less than 500 employees there is no mandatory co-determination. There is, however, one-third participation in small *AGs* with less than 500 employees founded prior to 10 August 1994, if they are not considered mere family businesses.

- EU Co-determination Law
  Prior to constitution of the Societas Europea (SE) employee co-determination must be negotiated with a Special Negotiation Board established by the employees of the founding companies. If negotiations fail, and co-determination rights have not been waived, usually the highest national co-determination standard among the involved companies applies. Similar rules apply in case of cross-border mergers.

Chapter 27
Court Proceedings

Pascal R. Kremp and Sascha Morgenroth

In Germany, unlike many other countries, it is not unusual for an employer and employee to end up in court. In particular, if an employee's employment is terminated by their employer, they may be required to challenge the dismissal before the court in order to obtain a severance payment and avoid detriment in relation to unemployment benefits. The purpose of this chapter is to give an overview of the labour court system and court proceedings in Germany.

A. Labour Court System

I. Jurisdiction

1. Subject Matter Jurisdiction

The exclusive labour court jurisdiction, in principle, extends to all individual legal disputes between employer and employee arising from the employment relationship or its termination. Thus, labour courts are usually not competent to hear legal disputes between managing directors and management board members of incorporated companies or the respective companies. Further, labour courts also hear collective disputes, particularly between an employer and a works council.

2. Local Jurisdiction

Employers may be sued in their country of domicile and, if they are incorporated companies (*juristische Personen*), where their registered office is located. The claimant may also choose to file a claim at the labour court of the district where a branch (*Niederlassung*) is located. Claims may be filed against the employer at the

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place of his business, as this is where the employees usually perform their work. Employees can also sue the employer in the court where the employee lives if they usually work from a home office. Employees may be sued in the place they are domiciled.

If the employer has his domicile or a branch in another EU country (except Denmark) then the employee may, pursuant to regulation 44/2001/EC on jurisdiction and the recognition of judgments in civil and commercial matters, choose to sue the employer in the employer's country of domicile, where the employer has a branch or at the employee's permanent place of work. In cases where the employer has no domicile or branch within the EU, the labour courts will apply the above explained rules accordingly. Hence, the employee will generally be allowed to file a claim against the employer at his permanent place of work.

II. Hierarchy Levels

Cases are heard in the first instance by the Labour Court (*Arbeitsgericht*) This court hears the case and tries to find the facts. Decisions of the labour court can be reviewed by the Higher Labour Court (*Landesarbeitsgericht*) on appeal. Appeals may be based on facts or on legal and procedural grounds. Labour court decisions may, however, only be appealed if the decision of the labour court itself explicitly allowed the appeal because of its fundamental significance, a legal dispute, or if the matter value exceeds EUR 600. Nevertheless, decisions of labour courts may always be appealed if they relate to the (non-)existence or termination of an employment relationship. Appeals must be filed within 1 month of receipt of the labour court decision and have to be substantiated within one further month of filing the appeal. Appeals against the decision of the Higher Labour Court, are reviewed by the Federal Labour Court (*Bundesarbeitsgericht, BAG*). However, appeal to the Federal Labour Court must usually be allowed by the Higher Labour Court's decision and is limited to legal and procedural grounds.

III. Court Composition

There are no jury trials before German labour courts. The first instance labour courts and the second instance Higher Labour Courts are divided into chambers (*Kammern*), each of which are presided over by one professional judge who is supported by two lay judges, one from an employer and one from employee background, who contribute their business experience. The Federal Labour Court (*BAG*) is organised in senates (*Senate*), each presided by three professional judges and supported by two lay judges.

B. Labour Court Proceedings

Legal proceedings in labour and employment cases follow a strict and formal scheme according to the Labour Court Act (*ArbGG*) and the Civil Procedure Act (*ZPO*). A party that intends to go to trial will usually discuss the issue with its legal representative, and provide him with the facts that support the claim. The legal representative then develops a basic pleading and submits it to the court. The basic pleading needs to address the court and parties clearly. It must name the parties' and their legal representatives' places of residence, their profession, and position in the trial. The pleading should also cover the claimant's application for relief, including the sum or content of the anticipated judgment. Furthermore, it must address the cause of action supported by the basic facts on which the alleged claim is based on, with evidence to support the facts. The document must be signed by the party, or if necessary the party's legal representative. There are basically two types of proceedings under the Labour Court Act: individual disputes (I.) and collective disputes (II.).

I. Individual Disputes

The majority of cases relating to termination of an individual's employment go to court. More than 80% of these cases are however settled before the court, and only a minority of employment cases end with a court verdict.

The course of labour court proceedings in cases of individual disputes, particularly in dismissal protection matters, is of special importance in practice and will therefore be explained in more detail below.

1. Filing of an Action

According to the Wrongful Dismissal Protection Act (*KSchG*), an employee has to file an action against the termination of his employment within 3 weeks of the service of the dismissal letter in order to avoid his dismissal becoming effective.

2. Conciliation Hearing

The German Labour Courts Act does not provide for alternative dispute resolution. However, in cases where an action is filed before a labour court, e.g. by an employee based on the allegation of the wrongful termination of his employment contract, the court will determine a date for a compulsory conciliation hearing (*Güteverhandlung*). The conciliation hearing usually takes place within 1 or 2 months of the filing of the complaint. The parties may file written statements to the court

in order to substantiate their pleadings in preparation of the conciliation hearing but there is no requirement for the defendant to do so. At the conciliation hearing the presiding judge will ask the defendant to explain its position and sometimes indicates his view at the case. In most cases, however, the judge asks the parties for options to settle the case.

3. Settlement Negotiations

The negotiation of the terms of a possible settlement, particularly regarding the amount of severance pay, constitutes the most important part of the hearing. In consideration for payment of the agreed amount of severance pay, the employee agrees to the termination of the employment relationship. It should be noted that the amount of severance pay is freely negotiable by the parties but the court may on the basis of its preliminary assessment of the case and its possible result suggest an amount that can serve as a basis for negotiations. The amount of severance pay is usually based on a payment of between 0.5 and 1 month's gross salary for each year of employment. Depending on the risk of litigation, the amount of severance pay may also be lower or substantially higher. However, the employee neither has a statutory claim for severance pay nor is he obliged to accept a severance pay offer by the employer according to the above formula.

4. Main Hearing

If the dispute is not settled or has otherwise ended, the presiding judge will hold a main hearing (*Hauptverhandlung*) to consider the case on its merits (*streitige Verhandlung*). The main hearing usually takes place 2–4 months after the conciliation hearing. The court will also determine a period of at least 2 weeks in which the defendant is required to state his defense in written form. Generally, the party that claims to have a right must prove it; in most cases it will be the claimant. However, in some cases the burden of proof is reversed by the law. There are five kinds of permissible evidence: sensory perception, witnesses, expert witnesses, documents, and examination of the parties. The court is free in its decision as to how to evaluate the evidence.

In practice, the court provides the claimant with a period in which to reply to the defense ahead of the hearing. There is no pre-trial discovery. All the documents required to prove the case are collected in the court file and parties can ask for access to the court file. The parties also receive copies of their opponents' pleadings.

The main hearing itself commences with the filing of motions by the parties and is usually followed by a legal discussion of the case under the direction of the judge. If necessary for the court, in order to prepare its judgment, it will also take evidence on the matter; particularly it will hear witnesses presented by the parties. In practice

this, rarely happens. Throughout the course of the main hearing the parties may still consider agreeing to settling the case without a court judgment.

5. Verdicts in Wrongful Dismissal Proceedings

If the case is not settled during the conciliation or main hearing, the court will deliver a verdict at the end of the hearing, e.g. ruling if a dismissal is valid.

a) Continued Employment

During the dismissal notice period, in principle, the employee is obliged to continue to work and may claim his salary for the work performed. However, the employer may consider releasing the employee from work for a compelling interest, generally, under continued salary payment due to the employer's default in refusing to allow the employee to continue to work. If, however, the employer's dismissal notice appears invalid and the works council previously objected in a timely and proper way to the employee's dismissal, an employee who has filed a dismissal protection action may request continued employment and enforce this claim by filing an action for preliminary injunction with the labour court.

If the labour court finally considers a dismissal invalid, the employment will continue under the previous terms and conditions of employment. Even if the employer appeals the decision of the labour court in the first instance, the employer has to continuously employ the employee on the basis of the verdict of the labour court until the Higher Labour Court reaches a decision.

b) Dissolution and Severance Payment

Save for a few exceptions, labour courts may not order the termination of the employment relationship in consideration for payment of severance pay unless the parties have mutually consented to a specific amount of severance pay. However, if the labour court concludes that the ordinary dismissal is not socially justified and that, therefore, the employment relationship is not terminated at the end of the applicable notice period, the labour court may upon application of the employee dissolve the employment relationship. The labour court at the same time will order the employer to make an adequate severance payment. An application for a dissolution decision requires that the continuation of the employment relationship is not reasonable for the employee, which will only be the case in rare circumstances. The continued employment of the employee, presumably for an indefinite time, must, at the time of the decision of the court about the dissolution, be seen to result in detrimental conditions for the employee. However, the Federal Labour Court does not demand cause like in the case of the employee's summary dismissal notice without notice (sec. 626 para. 1 *BGB*).

In contrast, motions by employers for the dissolution of the employment relationship in return for a severance payment maybe successful if a continued employment relationship beneficial for the purposes of the business can no longer be expected. The Federal Labour Court requires that the employer not only bases his dissolution application on the general perception of lost faith in the employee, but rather substantiates it with concrete facts. Contrary to the employee, the employer may only request the dissolution if the dismissal of the employee has been exclusively not socially justified. If the dismissal has been unlawful for other reasons, e.g. for failing to carry out the required prior consultation with the works council or failing to obtain the prior consent of the integration agency in the case of a severely disabled person; the employer may not apply for dissolution. With regard to key employees, however, the application of the employer does not have to be supported by any reason at all.

The labour court will in cases of dissolution decisions set the termination date of the dismissal notice as the date for the dissolution of the employment relationship.

The severance payment amount to be set by the labour courts is limited by statute: The courts can award severance payments of up to 12 months gross salary, increasing to up to 18 months gross salary for employees aged 55 years and over who have been employed for at least 20 years. If the employee is aged 50 years and over and has been employed for at least 15 years, the court may set a severance payment of up to 15 months gross salary. Within these limitations, the labour courts have discretionary power to determine the amount of severance payment; particularly, the courts are not bound by the applications of the parties. They will set the amount considering the employee's seniority and age, and may also take into account the employee's opportunities in the job market, his family status, the number of persons entitled to maintenance by him, and the employee's health. The gross monthly salary as a basis for calculation includes all remuneration received by the employee for work done. However, supplemental pay, bonus payments, 13th/14th salaries etc. have to be considered on a pro-rata-basis. In most cases the severance will be between 0.5 and 1 month's salary per year of service.

In cases of summary dismissal for cause without notice only the employee may apply for the dissolution of the employment relationship. The employer may only request the dissolution if he also alternatively dismissed the employee with notice.

II. Collective Disputes

The parties to collective disputes proceedings are works councils (*Betriebsräte*), trade unions (*Gewerkschaften*), employers (*Arbeitgeber*), and employers' associations (*Arbeitgeberverbände*). The proceedings cover disputes arising out of the Works Constitution Act (*Betriebsverfassungsgesetz, BetrVG*), the Co-Determination Act (*Mitbestimmungsgesetz, MibestG*), and the Collective Bargaining Agreements Act (*Tarifvertragsgesetz*). A particularity of collective dispute proceedings is that it is for the court to discover the facts relevant to the parties' applications, whereas

in individual disputes it is up to the parties to present the facts to the court. Further, the court may, and in most cases will, set a conciliation hearing in order to assess if the parties are willing to settle the case without a verdict. However, conciliation hearings are not obligatory in these cases. As with individual disputes, if the dispute has not been settled by the parties, at the end of the hearing there is a verdict that may be appealed by complaint (*Beschwerde*) to the Higher Labour Court, irrespective of the value of the complaint. The complaint must be filed within 1 month of receipt of the decision and it must be further substantiated by its grounds within 1 month of filing the complaint.

C. Costs of Labour Court Proceedings

It should be noted that in proceedings before the labour court special rules apply concerning the costs of court proceedings. Collective disputes are generally free of charges in the labour court. In individual disputes before the labour courts of first instance, recoverable costs are very limited. No legal fees are recoverable by the successful party from the losing party and no compensation for loss of salary is recoverable for the time spent before the court. An exception applies if a settlement was reached in which the parties agree to divide the costs differently. Otherwise, very few exceptions apply to this rule. Particularly, this limitation on the compensation of costs is excluded for proceedings before the Higher Labour Court and the Federal Labour Court. There, the losing party has to carry the costs, including the legal fees of the successful party.

Legal representatives are paid according to the Attorneys' Fees Act (*Rechtsanwaltsvergütungsgesetz, RVG*) or on an hourly basis according to an individual contractual fee agreement (*Honorarvereinbarung*). Thus, there are no contingency fees. The losing party pays the prevailing party's attorney fees that arise pursuant to the Attorneys' Fees Act (*RVG*). As already mentioned above, in the first instance at the labour courts, every party has to pay for its own legal fees no matter if they are incurred in accordance with the Attorneys Fees Act or on an hourly basis.

Parties that cannot afford to pay for the trial or their legal fees, can receive financial aid awarded by the courts if the prerequisites of the Labour Court Act or the Civil Procedure Act (*ZPO*) are fulfilled. Particularly, the party has to show that there is sufficient evidence for a rational judge to decide the case in their favour.

D. Key Aspects

- Labour court proceedings are quite common in Germany; in particular, employees who have been dismissed often file a complaint challenging the effectiveness of the dismissal.
- Labour court proceedings usually take about 3–6 months in the first instance.

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