Gleiss Lutz

CLIENT UPDATE

Frankfurt = Bankfurt

Looking at the opportunities of setting up in Frankfurt in the run up to Brexit

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Almost six months have passed since the referendum decision in favour of Brexit. While the political discussion in the UK revolves around when to initiate the process and how "hard" or "soft" it should be, affected financial industry players must plan their response. If they intend to continue operating in the EU/EEA, these plans must include setting up a new basis from which to continue their European operations. Although a "soft" Brexit may still include some form of substitute for the EU passport regime, companies must also be prepared for a scenario where EU passport privileges fall away entirely.

1. Who is affected?

Any bank, financial services provider or asset manager licensed in the UK and providing financial services in the EU or the EEA under the EU passport regime is potentially affected. Whether the services in the EU/EEA are provided through a local branch or cross-border without any local presence is irrelevant. If the EU passport privileges fall away, any such services would no longer be permitted without a local license.

2. What can you do?

In order to obtain a local license, the UK entity could either set up a branch or a subsidiary in the jurisdiction in which it intends to provide financial services and apply for the necessary license(s). Using a subsidiary would have the advantage that the license could be passported into all other EU/EEA Member States. A subsidiary could provide financial services in all other Member States either by setting up local branches or cross-border without any local presence. This would not be possible if the UK entity were to set up branches of its own. The licenses granted to these branches would not qualify for passporting. This means that separate licenses would have to be obtained for each Member State in which the UK entity intends to provide services.

What would no longer be possible is providing cross-border services to the EU/EEA without a local presence. For institutions from non-EU/EEA states, it is compulsory to set up a local presence, be it in form of a branch or a subsidiary.

3. What can be done to mitigate the effect on personnel?

Irrespective of whether a license is applied for through a subsidiary or a branch, the company may wish to try to mitigate the effects on its existing structure and personnel. In particular, it may wish to seek to move as few personnel as possible to the EU/EEA jurisdiction.

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In order to achieve this, there are theoretically various options: If the EU/EEA operation is set up as a subsidiary, it could set up a branch in the UK for the sole purpose of employing the UK personnel and holding and maintaining any assets or contracts necessary to operate from the UK (such as lease agreements and IT operations). Alternatively, the new EU/EEA subsidiary or branch could also enter into an outsourcing agreement with a UK-based group company and this UK-based group company would employ the necessary personnel and hold the relevant assets/contracts. If the EU/EEA operation is set up as a branch of the UK entity, the personnel could also be employed in the UK. In this case, however, under supervisory law the branch would be treated like a separate legal entity for certain purposes - for example it would have to enter into an outsourcing agreement with its headquarters and this outsourcing agreement would have to comply with the requirements applicable to outsourcing arrangements under supervisory law.

4. Frankfurt – Future hub for EU/EEA operations

Many companies potentially affected by Brexit are contemplating using Frankfurt as a hub for their EU/EEA operations in the future. Frankfurt is considered the best possible choice for various reasons. To the extent institutions are subject to supervision by the ECB, they would gain easy and direct access to their supervisory authority. To the extent institutions are supervised by the competent national authority, they would become subject to supervision by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*), which has a very high reputation for its competence, pragmatism and responsiveness. Germany further has a highly developed legal system and Frankfurt offers a perfectly developed infrastructure.

If a UK entity considers setting up a subsidiary or opening a branch in Frankfurt or anywhere else in Germany it should consider the following:

4.1 Supervisory laws

Supervisory laws in Germany are very similar to the corresponding UK laws. As Germany is an EU Member State, the CRR is directly applicable and Germany has implemented the CRD. Companies considering operating their German and EU business with UK personnel would be subject to the restrictions that apply to outsourcing arrangements. Under these restrictions certain functions must be carried out in Germany. It would not be possible to set up a German bank as an empty shell that is entirely operated out of the UK. The scope of functions that have to be carried out in Germany depends on the type of business and may also become the subject of German or EU Brexit implementation acts.

4.2 Data protection

It is not only because of the absurdly high fines that can be imposed for violations of the new EU General Data Protection Regulation (which can amount to EUR 20 million or 4% of annual global turnover) that data protection should rank very high on the list of legal issues that need to be considered when it comes to deciding whether to set up a new branch or subsidiary in Frankfurt or elsewhere in the EU. Post- Brexit the UK will be a “third country” in terms of EU data protection laws. Transferring personal data of customers or employees from the EU to a parent company or headquarters in the UK will therefore be subject to the same restrictions that apply to transferring data to other third countries like the US today and which aim to ensure that personal information concerning European citizens enjoys the same level of protection abroad as it does within the EU. The UK government recently announced that it plans to pass the new EU data protection regulatory framework into national law by May 2018, well before Brexit is likely to take effect. As long as the UK sticks to this framework, after Brexit it can expect to be recognized by the EU Commission as a country that ensures an adequate level of data protection in accordance with Article 45 GDPR. This would make businesses in the UK eligible to receive personal data from the EU under the same conditions as apply to data transfers within the EU. However, the moment UK lawmakers decide to drop EU data protection legislation (or the UK regulator stops enforcing these laws properly) the UK will lose its status as a “safe harbour” for personal data from the EU. In that case UK banks will have to apply “appropriate safeguards” for personal data in accordance with Article 46 GDPR on their own if they want to still be able to share personal data with their branches or subsidiaries in the EU. This can be accomplished, for instance, by entering into intra-group data protection agreements based on standard contractual clauses which will be published by the EU Commission. Alternatively, banks could implement binding corporate rules pursuant to Article 47 GDPR which, however, must be approved by the data protection supervisory authority in the EU.

4.3 Employment

If a UK entity considers setting up a subsidiary or opening a branch in Frankfurt or anywhere else in Germany must bear in mind that German employment law will apply. Under German law, for example, in all companies with more than ten employees termination of employment is subject to strict rules, and employers can only dismiss employees on operational, conduct-related or personal grounds. In smaller businesses, i.e. ones with ten or fewer employees, the employer is free to dismiss employees on any grounds, provided that they are not arbitrary or in abuse of legal rights or ethical considerations. In order to avoid unfair termination litigation, employers very often enter into termination agreements with employees they want to release.

A mutual termination agreement usually sets out the conditions under which employment will end and includes a severance payment. Employees do not have a statutory claim to severance and there is no statutory formula for calculating severance payments. It is a matter for negotiation, though severance payments are often calculated as follows: Factor x gross monthly salary x years of service. The factor applied in the banking industry in Frankfurt usually ranges between 0.75 and 1.5.

Another important aspect of German employment law is that in operations with five employees or more, employees can elect a works council, an employee representative body with a four-year tenure. The size depends on the number of employees in the firm. For example, firms with 201 to 400 employees will have a 9-strong works council. The works council has its own rights vis-à-vis the employer regarding certain decisions to be taken within the company. In some areas the works council only has information and consultation rights; in other areas, e.g. weekly duty rotas, it has actual co-determination rights. The works council exercises its main co-determination rights by concluding works agreements with the employer. Agreements of this kind have an immediate and binding effect on the individual employment relationships.

In a scenario where a German subsidiary of a UK corporation sets up a UK branch for the sole purpose of employing the UK personnel and holding and maintaining any assets or contracts necessary to operate out of the UK, German employment law would not apply to persons employed at this branch, irrespective of the fact that the German subsidiary is the (contractual) employer. In particular, UK employment law and social security law would apply.

If the German subsidiary or German branch were to enter into an outsourcing agreement with a UK-based group company and the latter were to employ the necessary personnel and hold the relevant assets/contracts, the personnel structure would not be mitigated that much. However, in order to avoid a situation where the outsourcing could be considered as (illegal) personnel leasing, the outsourcing agreement should not include any clause allowing the German subsidiary to directly issue work instructions to the UK personnel. Nor should the German subsidiary actually directly issue work instructions to the UK personnel. In situations where applicable supervisory regulations require to directly issue working instructions to the UK personnel, it should be checked if alternative solutions such as the application for a license for personnel leasing are necessary.

4.4 Tax

If the German subsidiary were to be set up as a corporation under German law, it would be subject to unlimited taxation in respect of all profits generated through business activities in Germany at an aggregate income tax rate of app. 32% (in the City of Frankfurt). The same would generally be true for a German branch of a UK entity operating as a fixed place of business (*Betriebsstätte*) in Germany. The repatriation of profits from a subsidiary may attract withholding taxes in Germany (with a possible reduction of the relevant tax rate), while no such withholding taxes apply to the repatriation of profits from a branch.

Generally speaking, a UK branch of a German subsidiary would be subject to applicable UK taxation on the profits and expenses attributable to the UK business, provided the UK branch constituted a fixed place of business (*Betriebsstätte*) in the UK. However, please note that the German business and the UK businesses would have to be viewed separately for taxation purposes. As a consequence, losses accruing in the UK branch cannot be set off against profits arising in Germany and vice versa. The UK branch could therefore in particular not offset employment expenses incurred in the UK against profits realized (or deemed to be realized) by the German subsidiary.

In the case of a German subsidiary entering into an outsourcing agreement with the UK (parent) entity for services to be rendered in Germany, the letting of UK-based employees to this German subsidiary (as well as other services rendered from the UK to Germany) might be subject to German VAT, which is 19% at present. This VAT is not recoverable by the German subsidiary (being an entrepreneur performing banking services/financial services), so that an additional tax burden of 19% could arise compared to a scenario where the employees are employed directly by the German subsidiary (or its UK branch). In addition, sending employees across the border has to be monitored closely with respect to wage tax issues (as well as social security issues) that may arise in this context.

4.5 Corporate law

Under German banking supervisory law, a financial institution can be organized in any legal form. Nonetheless, most of the private banks operating in Germany (other than *Volksbanken* which are organized on a cooperative basis) are organized either as stock corporations (*Aktiengesellschaft, AG*) or as limited liability companies (*Gesellschaft mit beschränkter Haftung, GmbH*), as opposed to limited or general partnerships.

A German limited liability company is a very flexible corporate form which allows its (usually a small number of) shareholders to shape the company to best suit their requirements, in particular with respect to corporate governance. The limited liability company is, therefore, the most popular corporate form in Germany and frequently used by small and medium-sized banks.

However, the vast majority of private banks in Germany and also most of the German subsidiaries of international banks are traditionally organized as stock corporations. This is due in particular, on the one hand, to the fact that stock corporations have a higher reputation within the financial sector and, on the other hand, the fact that they are more easily able to comply with the complicated and time-consuming formal procedures that are mandatory for stock corporations.

Apart from the legal form they are considering adopting, UK banks willing to move will also have to consider how to get there, options being, e.g., cross-border mergers into German corporations as provided for by the European Merger Directive or a cross-border migration under the Vale doctrine, i.e. a transfer of the seat of the company combined with a conversion of the legal form. Banking supervisory law would in principle allow either. Tax implications would need to be reviewed in this context.

Gleiss Lutz is one of the leading independent law firms in Germany. For many years, we have assisted international clients setting up operations in Germany. In order to assist companies affected by Brexit, the firm has set up a 25-strong task force bringing together lawyers from all relevant practices and industry groups. The task force lawyers are at your disposal under: brexit@gleisslutz.com.

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