START-UP / VENTURE CAPITAL

Dear Reader,

Shortly before the end of the year we would like to get back to you and report on the latest news and ideas from our sector.

We hope you all got through this challenging year smoothly and without problems. Should you find yourself in a situation, though, where we can do something for you on the legal side, just give us a call. One thing has surprised us this year in a particularly positive way: The willingness to help each other; we are pleased to join in.

As terrible as many experiences were in the past months, we have also learned a lot. For instance, that for a founder the "mindset" can be very helpful in phases like these. We had to constantly adapt, change and rethink concepts and come together again to cooperate with each other. It was, thus, hardly surprising to us that most of you are quite laid back in dealing with this crisis.

So *business as usual* – we have the following articles for you in this newsletter:

- "Corona Pandemic – Labour Law Helps Start-ups Save Money", **Dr Michaela Felisiak** and **Dr Erik Schmid**
- Legislative Initiative to Simplify Taxation of ESOPs, **Dr Christian Kalusa**
- Second Closing for Financing Rounds, **Markus Schönherr** and **Dr Sebastian Weller**
- Duty of Notification Under the German Foreign Trade and Payments Act and the German Foreign Trade Act and Payments Regulation, **Benjamin Knorr** and **Robert Schmid**
- Will There Soon Be a New Legal Form for Start-ups? **Dr Gesine von der Groeben**
- Decentralized Autonomous Organizations – Vision and Classification Under Corporate Law, **Julius Weishaupt**

Right at the beginning of the new year we will again start our workshop series and are looking forward to welcoming you – therefore, we further develop our digital offers, and of course we all hope that we can meet face to face again.

Until then we have our work cut out for us. The lockdown phases with their restrictions have to be made up for and numerous projects still have to be completed. The next weeks will be packed with work and very busy.

So let's get to work and not let it get us down.

Best regards,

Your BEITEN BURKHARDT Start-up / Venture Capital Team

Corona Pandemic – Labour Law Helps Start-ups Save Money

The corona pandemic confronts the whole world with major challenges. Companies are also affected in terms of organisation, personnel and above all financially. With the right labour law advice, start-ups in particular can save money. Our experts present their 10 helpful suggestions:

TIP 1: UNPAID LEAVE OF ABSENCE FOR PEOPLE REFUSING TO WEAR MASKS

According to section 106 sentence 1 German Trade, Commerce and Industry Regulation Act (*GewO*), employers have the right to determine the content, place and time of work performance at their own reasonable discretion. Along with the right of direction, the employer also has a duty of care and to avert dangers to its employees. Insofar as there are no other regulations relevant to the employment relationship, the right of direction also includes the implementation of the corona hygiene concept drawn up by the employer, such as the wearing of protective masks, the disinfection of hands, the observance of physical distancing, the prohibition of physical meetings, etc.

BEITEN BURKHARDT

Employees who violate the corona hygiene concept set up by the employer are acting in breach of their duties. The employer can use the usual instruments of labour law to impose sanctions, such as repeated explicit instructions to comply with the hygiene concept, a warning or ordinary termination for conduct and/or extraordinary dismissal.

Since the employee e.g. not wearing a mask violates the hygiene concept and thus offers its work performance in a way that is not fit for work, the employer would also be entitled to release the employee unpaid for this period.

TIP 2: USE MOBILE WORKING TO REDUCE RENTAL COSTS

Financially, it may be worthwhile to have more staff working outside a rented office, thus reducing the rental costs for the start-up. Legally, a distinction is made between the terms telework, home office and mobile working, with a difference both in terms of location (telework and home office: private residence; mobile working: any place outside the premises) and in terms of set-up costs (telework: fixed workplace; home office and mobile working: no fixed workplace).

In Germany there is not (yet) a legal entitlement of employees to a home office. Nor is there – at least in the opinion of the Regional Labour Court of Berlin-Brandenburg – any right on the part of the employer to instruct employees to work from home, if the place of work is contractually specified. However, crisis periods such as the corona pandemic are not covered by this rule. "Normal operation" would therefore require a legal basis. This, too, can save a lot of money with regard to the "issue of cost assumption" (e.g. pro rata assumption of employees' rental costs).

TIP 3: UNILATERAL REDUCTION OF VOLUNTARY OR REVOCABLE SPECIAL PAYMENTS

A rapid savings effect can be achieved by eliminating gratuities or other one-off payments. This requires, however, that a so-called reservation of voluntariness or revocation has been agreed in the employment agreements.

In the case of an (effective) reservation of the voluntary nature, the special payment can be suspended for the future. The reservation of the voluntary nature of the payment prevents the employees' claim for payment from arising. The prerequisite is that the employer must point out each time this special payment is granted that it is voluntary and that no legal claim arises from repeated payments.

In the case of a reservation of revocation, the employer must declare the revocation in good time before the due payment is made. The revocation must be made for the reasons stated in the reservation of revocation and must be at the employer's reasonable discretion.

TIP 4: POSTPONING THE PAYOUT DATE BY MUTUAL AGREEMENT

Should Tip 3 not be feasible because the relevant requirements are not met or if a unilateral reduction of special payments is not desired with regard to employee motivation, it is also possible to postpone the due date of the special payment in agreement with the employees. This will spare liquidity and can help to bridge shortages.

TIP 5: WAIVING SALARY IN EXCHANGE FOR A DEBTOR WARRANT (*BESSERUNGSSCHEIN*)

In the short term, money can be saved by a – mutually agreed – salary waiver. A mere salary waiver saves money but also leads to a lower motivation and willingness to perform on the part of the employees. With a so-called debtor warrant, employees keep the incentive to perform well.

Salary waiver with a debtor warrant is an option that is often neglected, if not forgotten. Employees waive part of their remuneration in order to maintain the employer's liquidity. This way, employees also secure their own jobs. If the economic situation has improved within a certain period of time or on a certain date, the employees will be reimbursed the waived remuneration or part of it.

TIP 6: LETTING FIXED-TERM CONTRACTS EXPIRE

Should it become apparent that further measures need to be taken, it need not always be a wave of dismissals. There are also alternatives that can reduce costs.

One possibility is to let fixed-term employment agreements expire. This has the advantage that there is no need to give notice and the employment relationship ends automatically when the fixed-term contract expires – at least if the fixed-term contract has been effectively agreed.

TIP 7: EXTEND SHORT-TIME WORK

An extension of short-time work beyond the period initially forecast and agreed requires a regular supplement to the employment agreement with the employees affected by short-time work.

The complete and proper documentation of the work actually performed is also of great importance as the basis for the application for short-time allowance for the respective month. The incorrect provision of data when applying for short-time allowance generally not only represents a serious breach of duty for the person responsible but can also lead to comprehensive claims by the Federal Employment Agency (*Bundesagentur für Arbeit*) against the company.

TIP 8: DISMISSAL DESPITE SHORT-TIME WORK
It may turn out that the predicted loss of employment is not only temporary but permanent. In this case, the question arises as to whether dismissals are even possible despite short-time work.

The answer is: YES. Dismissals are also possible during short-time work, not only for personal and behavioural reasons, but also for operational reasons. However, special principles apply here.

A characteristic feature of short-time work is the temporary loss of employment. A dismissal for operational reasons, on the other hand, presupposes a permanent loss of employment. If short-time work is performed in a company, this is an initial argument against a permanent reduction in the need for employment. A merely temporary lack of work cannot justify a dismissal for operational reasons. Start-ups should thus examine and document the extent to which the forecast has changed between the time when the decision was made to introduce short-time work and the time when it was decided to announce layoffs.

If the employee affected by the termination is still on short-time work at the time of the termination, the entitlement to short-time allowance ends when the termination takes effect.

TIP 9: TERMINATION DURING THE PROBATIONARY PERIOD
Insofar as the German Dismissal Protection Act (*KSchG*) applies, it may make sense to make use of the simplified options for giving notice of termination during the probationary period. Hence, start-ups should keep an eye on expiring probationary periods.

TIP 10: EMPLOYMENT DURING PROCEEDINGS (*PROZESSBESCHÄFTIGUNG*) IN DISMISSAL PROTECTION LAWSUITS
Employment during proceedings, in particular to avert the judicial execution of an enforceable general claim (*titulierter allgemeiner Anspruch*) for further employment by the first instance, is not an employment relationship, not even a de facto employment relationship. The employee only receives remuneration for the work actually performed. If it is subsequently established that the termination is effective, the employer may retain the remuneration for the work performed. However, no other claims arise from an employment relationship, such as holiday or continued remuneration in the event of illness or continued remuneration on public holidays. This means that the basic principle of "no work, no pay" applies without exception to such employment during proceedings.

Dr Michaela Felisiak
Lawyer | LL.M.
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Dr Erik Schmid
Lawyer | Licensed Specialist for Labour Law
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Legislative Initiative to Simplify Taxation of ESOPs

The European country with the most experience in employee participation is the United Kingdom. Here, as far back as the 1950s, conservative intellectuals and politicians sought an answer to the threat posed by the rise of the communist movement and the increasingly strong Labour Party. This gave rise to the concept of "*owner democracy*". The concept's objective was and is to create a legal framework that enables as many citizens as possible to share in the increase in value of assets in a country. The central instrument for this is employee participation.

If we are to believe the statements in the press, we can expect the *modernisation of the legal framework for employee participation* in Germany before Christmas. If we compare the concepts that were discussed in Britain over 70 years ago with those that prevail in Germany, it is clear that the reform is long overdue. And at least in one respect this reform could also bring about a fundamental change in social policy.

The key points of discussion for improving the framework conditions for employee participation are as follows:

- **1.** Adjustment of the framework conditions under corporate law; to this end, creation of a separate category of shares for employees, whose confirmation, issue and transfer should be possible in digital form and without notarisation to the maximum extent conceivable.
- **2.** Creation of legal certainty in the valuation of shares; to this end, procedures are to be set up to enable young growth companies to be valued appropriately and cost-effectively.
- **3.** Creation of incentives for reinvesting payouts from employee participation schemes, e.g. by creating allowances (*Freibeträge*).

- **4.** Equal tax treatment of employees vis-à-vis founders and Investors.

The key points of the reform are No. 3 and 4. Although a separate share class (**No. 1.**) would be a real *nice-to-have*, the existing ESOP (Employee Stock Ownership Plans) at least functions on a purely contractual basis. The shortcoming which has always been inherent in these programs, namely that they are "*not genuine shares*" and therefore do not function to the same extent as an incentive for employees, has been somewhat put into perspective due to the strong market penetration of these programs. Today it is standard practice for most start-ups to have a virtual employee participation scheme. A restriction is to be made here for foreign top executives who are used to the allocation of genuine shares from other legal systems; greater persuasion is still required here.

Also the evaluation of the start-ups (**No. 2.**) does not play a major role in the implementation of the employee participation programs or the signing of the *allotment offer* by the beneficiary employee. The programs are designed in such a way that there is no *dry income* in any scenario, which would be the case if taxes were incurred with allocation and not with inflow of exit proceeds. There is also usually little discussion when it comes to defining the strike price as the underlying asset, from where the employee participates in the increase in value of the company. Either the valuation agreed with the investors is taken as a basis here or some other minimum valuation, which is however more oriented to the scope of the employee participation program and the (virtual) share of the program than to the actual value of the company.

No. 3. would be a real improvement for Germany as a business location. It is true that in a functioning start-up ecosystem, successful founders often become important investors after an exit, often showing much greater foresight than other VC investors; at least this is the experience with regard to the USA and Silicon Valley. Today, the very large number of founders is themselves involved in their start-up through a founder holding company. If exit proceeds flow into the holding company, these can also be reinvested without incurring taxes. Since the ESOPs are usually concluded directly with the employees, the employees here are in a worse position in relation to the founders, without any apparent reason for this. An exemption for re-investments from the ESOP beneficiary would therefore be very welcome.

No. 4. however, would represent a shift in paradigm that can only be welcomed. It has never been evident why an employee has to tax any proceeds from a virtual employee participation scheme as income from employment while founders and investors who at least de facto generate the same proceeds from the same transaction have to tax them via the much lower capital gains tax. Also in this respect a reform is urgently needed.

In summary, it becomes obvious that for Germany as a location for start-ups, the reform would in any case not be a Christmas present but simply a measure long overdue.

As soon as the law is passed, we will again provide you with information here and offer a workshop on how employee participation programs should be structured in future.

Dr Christian Philipp Kalusa
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Second Closing for Financing Rounds

AN INSTRUMENT FOR OPTIMISING THE TIMING OF A VENTURE CAPITAL INVESTMENT PROCESS IN THE SEARCH FOR INVESTORS FOR A GERMAN GMBH

Irrespective of the current Covid-19 pandemic situation, the most essential factor in the search for new investors and / or business angels is the time: only the time determines when and if money flows at all. Time-related uncertainties can prevent the required investment, or at least (seriously) delay it. This delay will inevitably worsen the negotiating position of the *Venture*, as potential investors will know the required financial requirements.

INRODUCTION

Despite numerous advantages, the inflow of funds through the creation of so-called *authorized capital* (*cf.* section 55 German Limited Liability Companies Act (*GmbHG*)), should the required financing volume of the "first" financing round not yet be reached, is still rarely seen in the German *venture capital* sector.

In the context of a *venture capital* participation of investors already involved as well as in the search for new investors up to a certain deadline, it is advisable to reserve the right for additional investors to join the participation agreement and thus the company. In the case of the GmbH, this is done by a so-called *Second Closing* which is implemented through authorized capital. Here the GmbH is provided with the necessary liquidity and in return a simplified form of share issue is made to the (new) investor.

Although this results in a simplification of the time frame for all parties involved, the first step requires a careful and accurate contract drafting excercise.

AUTHORIZED CAPITAL IN A NUTSHELL

Basically, the shareholders of the first financing round (Closing) agree that further investors or those from the existing shareholder base can subscribe new shares without the need for further shareholder resolutions at a later date. As a result, the management of the GmbH is (usually) authorised to increase the share capital of the company by a maximum of 50 percent of the previous share capital within the next – maximum – five years, subject to the conditions initially set by the shareholders. Said shareholders' resolution amending the articles of association (notarisation and

majority required to amend the articles of association, cf. section 53 para. GmbHG) is filed with the commercial register and consequently becomes a new component of the then applicable articles of association.

The creation of authorised capital in venture capital financing is being flanked by the placement of further provisions in the entire investment documentation, including the *Investor Agreement* and / or the *Shareholders Agreement*. The entire content sought by the shareholders should finally be included in the investment documentation. This requires a careful approach to contract drafting in order to avoid later changes (in the articles of association).

What should thus be definitely arranged and stipulated – in advance – without fail?

- Maximum increase amount (maximum 50 percent of the share capital already subscribed);
- Number and nominal amount of the maximum number of shares to be issued (if necessary, by mentioning the ranking (keyword: *Preferred Shares*));
- Clarification of the issue of gradual authorisation, i.e. repeated exercise until the maximum amount of the increase is exhausted;
- Collateral duties of the investor, including joining the Investor Agreement / Shareholder's Agreement in the case of a (new) investor;
- Provisions regarding the obligation to make contributions (*Einlageverpflichtung*), such as payment or overpayment (free capital reserve in accordance with section 272 para. 2 no. 4 German Commercial Code (*HGB*));
- Exclusion of subscription rights of existing shareholders;
- Catalogue of approval (*Zustimmungskatalog*) of individual existing shareholders, if applicable.

CLOSING OF THE SECOND CLOSING

Second Closing is then executed by the management or nominated investors. The takeover of the new shares is based on the notarised takeover declaration (*Übernahmeerklärung*) of the (new) investor and a declaration of acceptance (*Annahmeerklärung*) of the company (informal). Subsequently, the management registers the capital increase with the commercial register and submits a list of the transferees and a new list of shareholders to the commercial register. At the same time, this registration also leads to an amendment in the articles of association, as the share capital is increased as a result.

ADVANTAGES AND DISADVANTAGES

ADVANTAGES

The creation of the possibility of a *Second Closing* at economically identical or already determined conditions leaves founders and their investors the necessary time to select and negotiate with (new) investors. Since the decisive parameters are already carved in stone, there is planning security and the founders have the opportunity to make their selection of the new investor without the participation of the entire shareholder group. The (new) investor would have to renegotiate or refrain from participation if it did not agree with the conditions of the authorized capital. The chances of saving (notary) costs compared to the *venture capital* investment process of a normal investment round are enormous.

DISADVANTAGES

On the other hand, there is the concern that the conditions in the first round were not correctly assessed or simply poorly, if not wrongly drafted. The authorized capital and the wording of its terms and conditions require extreme care in contract drafting and also estimation of the valuation, as the economic parameters cannot be changed later or only with greater effort.

RECOMMENDATION FOR ACTION

Although the factual requirements for authorized capital seem to be clear by law, the exact intentions of the shareholders must be reflected in the creation of such capital. This requires sound advice in advance and, as a consequence, proper and thorough contractual implementation. Furthermore, the formal requirements associated with a possible amendment of the articles of association must be observed even before the authorized capital is created. Only if all this is observed can the Second Closing be a chance to save time, money and nerves.

Dr Sebastian Weller
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Dusseldorf

Markus Schönherr
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Dusseldorf

Duty of Notification under the German Foreign Trade and Payments Act and the German Foreign Trade Act and Payments Regulation

In accordance with section 67 para. 1 of the German Foreign Trade and Payments Regulation (*Außenwirtschaftsverordnung* – "*AWV*"), notification of foreign payment transactions to the *Deutsche Bundesbank* (Central Bank of Germany) has been mandatory since September 2013. This is often disregarded or not known at all, particularly by young companies in the start-up phase, especially

if, due to the company's field of business, sales are at first essentially made in Germany only. However, the duty of notification can already be triggered if, for instance, online advertising measures are assigned on search engines or social networks, as the companies concerned are usually not based in Germany. The violation of the duty of notification constitutes an administrative offence and can be sanctioned with a fine of up to EUR 30,000. Hence, at an early stage of business development, attention should be paid to corresponding foreign payment transactions and action should be taken accordingly.

This contribution is intended to provide an overview of the mandatory notification duty in foreign trade and the consequences of a violation as well as the possibilities for its remedy in the past in the form of a voluntary disclosure, or its avoidance for the future.

DUTY OF NOTIFICATION

According to section 67 para. 1 AWV, German nationals must notify the *Deutsche Bundesbank* of payment transactions which they receive from foreigners or on their behalf from German nationals (incoming payments), or make to foreigners or on their behalf to German nationals (outgoing payments). According to section 2 para. 15 no. 2 AWG, German nationals within the meaning of this standard are also legal entities domiciled in Germany. Thus, compliance with the duty of notification should be part of a company's corporate housekeeping.

Section 67 AWV already defines exceptions to payment transactions that are not subject to the duty of notification. Accordingly, the following payment transactions are exempt from the duty of notification under section 67 para. 2 AWV:

- Payments not exceeding the amount of EUR 12,500 or the equivalent in another currency ("exemption limit");
- Payments for the import, export or shipment of goods;
- Payments which involve the granting, borrowing or repayment of credits, including the creation and repayment of balances, with an originally agreed maturity or period of notice of not more than twelve months.

VIOLATION OF THE DUTY OF NOTIFICATION

Anyone who intentionally or negligently fails to submit the notifications pursuant to section 67 para. 1 AWV, or fails to submit the information correctly, completely or on time, is acting in breach of regulations pursuant to section 19 para. 3 no. 1b of the German Foreign Trade and Payments Act (*Außenwirtschaftsgesetz* – "*AWG*") in conjunction with section 81 para. 2 no. 19 AWV. The administrative offence can be sanctioned with a fine of up to EUR 30,000 (section 19 para. 6 AWG) although prosecution is at the discretion of the competent authority pursuant to section 47 para. 1 German Administrative Offences Act (*Gesetz über Ordungswidrigkeiten* – "*OWiG*"). It should be noted that not only the company subject to reporting can be prosecuted, but also the management and the employees responsible for reporting, if the appropriate conditions are met. Under certain circumstances, this may also apply to all former members of the management, provided that the notifications have also not been submitted during their employment. Rules on the statute of limitations set out in the *OWiG* are also likely to be of particular importance in this respect.

VOLUNTARY DISCLOSURE EXEMPTING FROM SANCTIONS

Section 22 para. 4 AWG provides for the possibility of a voluntary disclosure that exempts the company from sanctions. Accordingly, prosecution as an administrative offence is not required if the following conditions are cumulatively fulfilled:

- Negligent violation within the meaning of section 19 para. 3 no. 1b AWG;
- The violation must have been discovered by way of internal monitoring;
- The violation must have been reported to the competent authority;
- Appropriate measures must be taken to prevent a violation for the same reason;
- The authority must not yet have started an investigation into the violation.

CONCUSION

A violation of the duty of notification according to section 67 AWV can be sanctioned with substantial fines. It is thus all the more noteworthy that this duty of notification is often not known in practice or is only treated negligently. The voluntary declaration exempting the company from sanctions can therefore be an important instrument to counteract high fines. We will be pleased to advise and support you in the event of possible violations of the duty of notification and any consequences for the past and the future.

Benjamin Knorr
Lawyer | LL.M. Eur.
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Berlin

Robert Schmid
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Berlin

Will There Soon Be a New Legal Form for Start-ups?

In addition to the "classic" GmbH, the GbR (*Gesellschaft bürgerlichen Rechts or BGB-Gesellschaft*, [partnership under the German Civil Code]) which is not particularly popular and the somewhat younger UG (actually: *Unternehmergesellschaft (haftungsbeschränkt)*, [entrepreneurial company with limited liability]), there might be another legal form in the future which could be suitable for young companies in their early stages: the GbR with legal capacity.

On 19 November 2020, the Federal Ministry of Justice and Consumer Protection (*BMJV*) published a draft law for a modernised partnership law. The draft law is intended to structure the partnership under German civil law as the basic form of all partnerships with legal capacity and, on this occasion, to adapt the law of the partnership as a whole, which in part dates back to the 19th century, to the needs of modern economic life.

The German Federal Minister of Justice commented: "The draft law for a modernised partnership law is the third major reform of corporate law since 1949. The partnership under German civil law will be oriented towards a new model and made fit for the 21st century: Away from the betting pool towards the start-up. Founders can start up in an uncomplicated and legally secure way and develop their company step by step with the new extended transformation options".

Up to now, the GbR has usually not been the legal form of choice for start-ups: On the one hand, the partners (i.e. the founders) are personally liable to creditors (for example: landlords, freelancers, etc.). On the other hand, in contrast to the GmbH or UG, due to the absence of a corresponding register, the GbR does not allow the contractual partners of the company to identify the participation regulations made internally.

The legal model of the GbR has so far been the occasional company (e.g. the Lotto betting pool) without legal capacity. However, in contrast to this, today a considerable proportion of GbRs are set up on a long-term basis and founded for the purpose of participating in legal transactions with the company, e.g. group practices of physicians or GbRs owning real estate – or simply the founders who start "just like that" and initiate the implementation of their start-up idea without founding a GmbH or UG. Attempts by the courts to find solutions for these companies that are in line with their interests have not been able to completely eliminate legal and other uncertainties. This is now to be resolved by the draft law: In the German Civil Code, the variant of the GbR with legal capacity, which is the basic form of all partnerships with legal capacity, is now to be placed alongside the GbR without legal capacity. It is based on the new legal model of a company structured for a long term perspective and equipped with its own rights and obligations.

According to the draft law, a voluntary, public register of companies is also to be introduced. Customers and business partners of GbR will thus obtain reliable knowledge about liability relationships and representation of the companies. In future, partners will be able to have their company entered in the register but they will not have to do so. With the registration, essential key data of the company can be retrieved from the company register in a legally secure way for the public.

The draft was sent to the German federal states and associations and published on the BMJV's website. Interested parties now have the opportunity to submit their comments by 16 December 2020. The comments will also be published on the website of the BMJV.

Whether the planned amendments will actually increase the attractiveness of a GbR for start-up founders depends on further developments in the legislative procedure and thus remains to be seen. In particular does the personal liability of the founders not cease to apply even in the case of a GbR with legal capacity. However, the increased publicity resulting from the (voluntary) entry in the company register could lead to an improved perception of the start-up organised as a GbR to the outside world, and thus somewhat reduce the pressure that often exists on the part of the contractual partners to establish a corporation, and thus to take on the corresponding financial and organisational effort. This, in turn, could possibly reduce the risk of a quick set-up, make it less discouraging and encourage more young people to at least try to set up a start-up. This would be welcome in view of the still cautious start-up culture in Germany.

Dr Gesine von der Groeben
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Frankfurt am Main

Decentralized Autonomous Organizations – Vision and Classification Under Corporate Law

"*The 50 Million Robbery*" is the headline of FAZ newspaper. The magazine Wired speaks of "*The Biggest Crowdfunding Project Ever – the DAO – Is Kind of a Mess*".

Thus, the so-called Decentralized Autonomous Organization (DAO) first became known in July 2016, at a time when it was in the most unfavourable situation conceivable. The initiators of the project, the Canadian-Russian software developer Vitalik Buterin and his German companion Christoph Jentzsch were convinced that they had created something unprecedented. According to their vision, the DAO should be a self-governing legal entity that automatically executes decisions on the basis of a decentralized voting process among its members. The latest digital instruments should replace any human administration. Enthusiasm about a

virtual company led to the first foundation and the successful issue of shares worth a total of approx. USD 152 million. Only a few weeks later, however, the DAO became the target of unknown criminal hackers who stole USD 50 million from the investors. This criminal act, which has not yet been fully resolved, led to considerable doubts about the vision, the initiators and ultimately the underlying technology.

But what is behind the technological vision of a DAO, how can it be legally classified and what relevance does this concept still have today?

TECHNICAL BACKGROUND

A DAO is a structure of various smart contracts, which relate to each other and which carry out measures, when previously defined conditions arise (for further details on this topic, see *Dr Christian Philipp Kalusa* "*Special Topic Blockchain: The Use of Smart Contracts*").

The structure of smart contracts is embedded in a blockchain, a digital database that stores information transactions in a decentralized, publicly accessible and tamper-resistant manner. Investors can acquire tokens issued by the DAO, which grant them membership rights such as voting rights or profit sharing rights. These tokens are called equity or utility tokens depending on the respective weighting of their functions.

EQUITY OR UTILITY TOKEN

Tokens are software protocols that grant the owner certain rights. They are issued in so-called Initial Coin Offerings (ICOs) and can be acquired against payment of a recognised currency or crypto currency. Utility Tokens allow access to certain services or products, similar to an admission ticket or voucher. According to BaFin, this category includes the majority of the crypto tokens known to date issued in Germany within the framework of an ICO. In principle, utility tokens do not constitute securities in the sense of the German Securities Prospectus Act (*WpPG*) or investments in the sense of the German Investment Act (*VermAnlG*). In many cases, such tokens are also not financial instruments according to the German Banking Act (*KWG*). Equity tokens, on the other hand, grant membership rights or claims under the law of obligations to assets which are comparable to those of a shareholder or holder of a debt instrument (e.g. claims to dividend-like payments, co-determination, repayment claims, interest). In general, they are securities as defined in the German Prospectus Regulation (ProspektVO), the WpPG and the German Securities Trading Act (WpHG) and are also financial instruments as defined in the KWG.

In the case of the DAO, for instance, it is defined in advance which quotas are required for a particular resolution among the members. A smart contract, which provides for a specific transaction to a real bank account, is introduced as a resolution template. Each member then exercises his or her voting right via the token. If the appropriate quota is given, the transaction is automatically executed. An executive board or a supervisory board is not required in this scenario.

LEGAL CLASSIFICATION

The first problem with a virtual organization is the question of the applicable legal statute. The smart contracts on which the DAO is based are operated via a worldwide server network. Membership is also international and people generally only meet online. Hence, the administrative headquarters cannot be the basis for determining the applicable legal regime. Such point of reference is simply not identifiable. What is of relevance must be the so-called *lex fori*, i.e. the law applicable at the place of the court invoked in the individual case which is decisive. It is obvious that this can lead to different results of the legal classification.

Furthermore, the conclusion of a contract between the parties may raise questions. In order to acquire a membership token via the blockchain, the investor must use a pseudonym. This results in attribution difficulties. Voices in the legal profession, however, consider this problem to be solvable, because pseudonymisation must be clarified with the corresponding calculation effort.

Assuming an effective conclusion of a contract, a DAO would in any case be regarded as a German civil law partnership (*GbR*) within the meaning of Sections 705 et seq. German Civil Code (*BGB*). Since the parties involved deliberately dispense with the statutory disclosure requirements of corporate law – according to their vision they just wanted to create a completely new organizational form – a DAO cannot be structured directly as, for example, a German stock corporation (*AG*), a German limited liability company (*GmbH*) or a German limited partnership (*KG*). Classification as a GbR then ensues by virtue of the legal form requirement, because German corporate law assigns a legal form even if the parties involved are unaware that they are a company.

If the DAO were to be economically active, unlimited personal liability of all members would result analogously in accordance with Section 128 Serman Commercial Code (*HGB*). This naturally entails high risks.

A different classification of the DAO into the legal forms under corporate law would only be possible, if it were not regarded as the business enterprise itself, but only as a DAO that benefits from the functions of a DAO in the context of financing. The DAO can act as a tool or vehicle for online crowdfunding. However, a GmbH would be "placed in front" of this vehicle, to which the DAO would be affiliated as a silent partnership. The vision of the initiators thus clashes with the matter-of-fact reality of German corporate law. Does this mean that the concept of the DAO is nothing more than a intellectual game?

RELEVANCE AND PROSPECTS

Even if the total number of ICOs has already decreased in 2019, there is still a demand for experimental, especially digital, funding mechanisms and forms of organization. The DAO is an expression of this demand. The latest digital instruments are used to achieve an entrepreneurial objective. Here the traditional forms of organization are called into question. However, the DAO experiment should not be seen as an alternative concept but can rather be

an inspiration for the design of processes. For instance, a virtual general meeting, which is indispensable in times of the Covid-19 pandemic, could make use of tokens and smart contracts as in a DAO.

In this light, the vision of Vitalik Buterin and Christoph Jentzsch is again of relevance today.

Nevertheless, much would still have to change, before their concept could be fully recognised as a proper legal form of its own. Being a company under German law always means having to comply with mandatory law such as disclosure requirements. In civil law, this is the perpetual conflict between private autonomy on the one hand and protection of legal relations and creditors on the other. Ultimately, only the legislator can make this judgmental decision with general binding effect. In the interest of further innovation, it could be useful to decide in favour of a Decentralized Autonomous Organization.

Julius Weishaupt
Research assistant
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Imprint

This publication is issued by
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Ganghoferstrasse 33 | D-80339 Munich
Registered under HR B 155350 at the Regional Court Munich/
VAT Reg. No.: DE811218811

For more information see:
https://www.beiten-burkhardt.com/en/imprint

EDITOR IN CHARGE
Dr Christian Philipp Kalusa | Lawyer

PLEASE NOTE
This publication cannot replace consultation with a trained legal professional.

If you no longer wish to receive this newsletter, you can unsubscribe at any time by e-mail (please send an e-mail with the heading “Unsubscribe” to newsletter@bblaw.com) or any other declaration made to BEITEN BURKHARDT.

YOUR CONTACTS

BERLIN
Luetzowplatz 10 | 10785 Berlin
Tassilo Klesen | Lawyer
Tel.: +49 30 26471-351 | Tassilo.Klesen@bblaw.com

DUSSELDORF
Cecilienallee 7 | 40474 Dusseldorf
Dr Sebastian Weller | Lawyer
Tel.: +49 211 518989-134 | Sebastian.Weller@bblaw.com

FRANKFURT AM MAIN
Mainzer Landstrasse 36 | 60325 Frankfurt am Main
Dr Gesine von der Groeben | Lawyer
Tel.: +49 69 756095-393 | Gesine.vonderGroeben@bblaw.com

HAMBURG
Neuer Wall 72 | 20354 Hamburg
Dr Christian Ulrich Wolf | Lawyer
Tel.: +49 40 688745-124 | ChristianUlrich.Wolf@bblaw.com

MUNICH
Ganghoferstrasse 33 | 80339 Munich
Dr Mario Weichel | Lawyer
Tel.: +49 89 35065-1303 | Mario.Weichel@bblaw.com