Matrix Structures

Compliance and Risk Management
in Corporate Groups under German Law

2019

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Editorial

Today, most corporate groups have some kind of a matrix organization. Matrix management means the coexistence of several overlapping reporting lines or – more generally – an organization that is cross-functional and not fully aligned to the group's legal structure. In practice, this basic concept of a matrix structure can have very different forms. It can be that the entire group is deliberately organized as matrix organization, where, for instance, business divisions are organized across the different group entities. Quite often matrix structures are the by-product of management decisions to centralize certain functions within the group, like sales, procurement, HR, IT, legal and tax. Matrix structures also frequently arise when an employee of a certain group entity is assigned to work in the interest of another group entity, e.g. in case of secondments.

A matrix organization can lead to synergies, help the effective management of the group, and facilitate reorganizations within the group. At the same time, legal challenges arise from matrix structures because German law is not particularly suited to deal with them. Legal risks resulting from matrix structures should be mitigated by defining and documenting clear responsibilities and reporting lines and by establishing monitoring tools for the managers who are legally responsible. Agreements between the different group entities and with employees should properly reflect the matrix structure. Problems with matrix structures often arise because they are overlooked and their legal implications are not addressed at all.

This brochure provides an overview of legal issues that frequently arise from matrix structures in the fields of corporate, employment, product liability, product safety, product compliance, tax, and data protection law and demonstrates how those issues can be addressed. We hope this brochure is of interest to you and gives you helpful insights.

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This brochure only provides a general guidance. It must not be relied upon as a substitute for specific legal advice. In the interests of readability, the masculine form has been used throughout, although both sexes are accorded equal importance.

1. Corporate law

Matrix structures and German corporate law – not a perfect match

Matrix structures are an expression of permanently optimized organizational operations. As a result, real business life within a group of companies significantly deviates from the hierarchical legal structure – which in turn often does not reflect the actual hierarchy within the group, but instead has a historical or tax-driven background. German corporate law, however, thinks in entities and corporate bodies, not in business divisions. These discrepancies may result in non-compliance and – in a worst case scenario – in liability issues for managing directors and members of the management board and supervisory board. However, these risks are well manageable with reasonable efforts.

Looking at the most popular legal form in Germany, the limited liability company (*GmbH – Gesellschaft mit beschränkter Haftung*), there are in particular two typical situations in which matrix structures can be inconsistent with applicable law:

- The managing director of a GmbH does not report to and receives instructions from representatives of the GmbH's sole shareholder, e.g. in the group structure for tax purposes a mere holding vehicle in the form of a Dutch B.V., but directly from the US headquarters, which is several levels higher in the group chart.
- The legal counsel employed by the operational German GmbH does not report to and receives instructions from the managing director of the GmbH, but reports to and receives instructions from the European General Counsel who is located at the Swiss European headquarters. The managing director is a physician and does not know what the legal counsel is doing every day.

Looking at the first scenario, an issue arises because – although not explicitly set out in the German Limited Liability Companies Act (***GmbHG*** *– Gesetz betreffend die Gesellschaft mit beschränkter Haftung*) – it is undisputed that the right to issue instructions to the managing directors is incumbent upon the shareholders. The second scenario is problematic because the managing director generally has a duty of oversight and control over the employees working at the GmbH at which he holds the office as managing director – which he does not and obviously cannot exercise in our example as he is not part of the reporting line.

While this will not cause issues as long as everything runs smoothly, liability issues cannot be excluded from this non-compliance in worst case scenarios, for example if the managing director follows an instruction from the US headquarters which disadvantages the GmbH or if an employee implements an instruction from a superior working at another group entity which is not in compliance with German law without the managing director being able to intervene due to lack of knowledge.

While it is not possible for the shareholders of a GmbH to transfer their right to issue instructions to the managing directors fully, permanently and irrevocably, it is recognized that the exercise of such right may be partially delegated if a residual responsibility remains with the shareholders. Therefore, it is possible to partially split and delegate such right from the shareholder(s) in accordance with the actual instruction and reporting lines to the respective function within the group, provided that this is clearly documented and it is stipulated that the shareholder(s) may at any time generally or on a case-by-case basis revoke such delegation and may at any time revoke or change instructions already issued by the respective function within the group. Such regulations should be included in the GmbH's articles of association. The respective authorized function has to be clearly defined, but due to staff turnover individual names should not be included but rather a generic description such as CFO, Global Head of Division X or Senior Vice President Y should be used.

Likewise, the allocation of responsibilities not only between the several managing directors, but also the delegation by them to subordinated employees is generally fine. However, delegation is not limited to persons employed by the GmbH. The managing director(s) may, and upon a lawful instruction from the shareholder(s) are obliged to, delegate certain tasks also to employees of other group entities ("**Authorized Externals**"). Just as in the case of a delegation to one of "their" employees, the delegation to Authorized Externals – and as a consequence the argument that they were unaware of what was happening – does not release the managing director(s) from their responsibility to ensure legal compliance within the GmbH. An external delegation, however, makes it more difficult for the managing directors to comply with this task as they are in principle excluded from the instruction and reporting lines of the respective

employees of the GmbH who are subject to the delegation ("**Excluded Employees**"). Therefore, the delegation of the right to issue functional instructions to the Excluded Employees (the managing directors necessarily remain the disciplinary superiors of the Excluded Employees – a delegation of this function is not possible) and the transfer of the corresponding primary reporting lines will not only have to be clearly documented, but also have to stipulate certain mechanisms to ensure that the managing directors remain able to fulfil their duty of oversight and control.

This can be achieved as follows:

- Clear definition of the Excluded Employees and the corresponding Authorized Externals;
- Establishment of a secondary reporting line from the Excluded Employee to the managing director who is technically most suited, pursuant to which such managing director is at least informed about important instructions which the Excluded Employee receives from the Authorized External and important activities which the Excluded Employee performs;
- Implementation of an escalation mechanism which enables the managing directors to temporarily veto instructions from Authorized Externals which they consider unlawful or otherwise improper and to present them to the shareholder(s) for discussion and final decision;
- Making sure that the Excluded Employees are informed about and comply with such mechanisms and their obligations resulting therefrom.

The analysis should always extend to the question of whether specific functions exist which are excluded by law from inclusion in the matrix structure (e.g. pursuant to Sec. 8 (2) of the German Occupational Safety Act (***ASiG*** – *Arbeitssicherheitsgesetz*) company physicians and occupational health and safety specialists are directly subordinated to the plant manager) or whether the GmbH is subject to specific regulations (in particular if it is active in a highly regulated industry sector) which preclude a delegation in the individual case or require modifications of the above principles. Apart from that there may be further circumstances which require specific attention in case of a matrix structure, for example if the GmbH has a supervisory board, is party to a domination agreement or to a group-wide cash-pooling.

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Conclusion

Matrix structures are common practice within many international groups of companies. However, implementing the legal basis for the required delegation of instructions and transfer of reporting lines under German corporate law is often forgotten. This may in worst cases result in liability risks for the managing directors of a GmbH included in such structure, as they are no longer in the position to fully monitor what the employees of the GmbH are doing. It is recommendable to take action in such cases to "legalize" what is actually practiced. With reasonable efforts it is in our experience possible to include mechanisms which at the same time help to ensure compliance in the German part of the group and protect the managing directors from potential liability risks while keeping the burden in the day-to-day business at a minimum.

Checklist

- Check which entities are part of the matrix structure;
- Assess which instruction and reporting lines deviate from applicable legal principles;
- Review the relevant corporate law specifics of the entity (e.g. GmbH vs. stock corporation (AG), domination agreement, supervisory board);
- Review other relevant specific provisions applicable to the entity (e.g. regulatory provisions resulting from the entity's industry sector);
- Implement legal documentation establishing the relevant delegation of instruction rights and transfer of reporting lines as well as appropriate tools for the managing directors to monitor the employees of the German subsidiary.

Employment law

Matrix organizations in employment law

The digitalization of our society also has effects on the internal organization of companies. Structures in corporate groups have changed significantly. This applies, in particular, to multinational groups. In the past, the top management of a company or of the group decided on important matters, regardless of the respective business unit. Today, many companies follow a "modern management approach". They are no longer organized hierarchically, but have a functional structure. Therefore, more and more decisions are being made separately by the business units for the business units. In these structures, it is common that support units such as HR, finance and IT operate group-wide, which is easily possible thanks to modern methods of communication.

2.1 Matrix organizations – A short definition from an employment law perspective

Modern management with a functional approach as described above leads to a so-called matrix structure. One characteristic of matrix structures is the separation of functional and disciplinary management of the employees. The employer role is carried out by different companies within a group. A typical example is that the disciplinary supervisor of an employee works for the same group company as the employee whereas the functional supervisor works for a different group company – often abroad. This leads to several questions which are not that easy to answer under German employment law as it does not yet reflect these modern practices.

2.2 Works constitution law

From an employment perspective, matrix structures have to be carefully evaluated with regard to German works constitution law. In particular, the competences of the works council and its co-determination rights when hiring or reassigning employees have to be determined.

2.2.1 Competent works council

In matrix organizations, it is difficult to determine the competent works council for a measure the employer wants to implement which is co-determinable under German law. The implementation of a group-wide matrix organization does not automatically result in the sole competence of the general or group works council for questions related to the matrix organization. The competence of the local works council is replaced only by the competence of the general or group works council if a company or group-wide regulation is necessary. This has to be analyzed on a case-by-case basis. When decisions affect more than one group company, it is possible but not inevitable that the group works council is competent.

2.2.2 Functional supervisors and their operations

As regards functional supervisors, it is necessary to determine which operation(s) they belong to. The relevant operation is of particular importance with regard to the co-determination right of the works council when hiring or reassigning employees (including the functional supervisor). Several German lower courts have ruled already that an employee can belong to more than one operation. Therefore, a functional supervisor who belongs to operation A can also belong to operation B if he supervises employees in operation B. This means that the works council of operation B has to be informed about the appointment of the functional supervisor and can either grant or refuse its consent. According to the lower courts, the rights of the works council exist regardless of the place of work of the functional supervisor and regardless of the reporting line the functional supervisor himself is subject to.

No higher court has yet ruled on this issue.

2.3 Dismissal law

When dismissing employees for operational reasons, a review must be carried out to ascertain whether there are any open positions which the affected employees could be assigned to. Within the scope of this, the entire company has to be considered. However, when conducting the required social selection for the dismissal, only the other employees within the operation, and not within the whole company, have to be considered.

This principle also applies in matrix organizations. However, before conducting the social selection, it must be ascertained which operation the affected employee belongs to. The relevant operation might have changed due to the implementation of a matrix organization.

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Conclusion

Matrix structures lead to several questions which are not easy to answer under the “not-yet-modern” German statutory employment law.

Checklist

- Keep the right to lead the employee disciplinarily;
- Evaluate carefully if it is necessary to include reassignment clauses in employment contracts which enable the employer to reassign the employee group-wide;
- Review carefully which works council is the competent one for each measure you want to take;
- Check to which operation an employee belongs in case you consider a dismissal for operational reasons.

3. Product liability, product safety and product compliance

Product liability, product safety and product compliance in light of matrix structures

3.1 Introduction

Typically, various company departments and subsidiaries are involved in the design, production, advertisement, sale and distribution of a product. Where matrix structures are concerned, an allocation of responsibilities and tasks generally leads to certain product liability, product safety and product compliance implications. There are legal risks for the companies, its brands and its decision-makers.

Companies with matrix structures should familiarize themselves with the German Product Liability Act (***ProdHaftG*** – *Produkthaftungsgesetz*) implementing the EU's Product Liability Directive 85/374/EEC (**PLD**) as well as with the German Product Safety Act (***ProdSG*** – *Produktsicherheitsgesetz*) implementing the EU's General Product Safety Directive 2001/95/EC (**GPSD**).

Under product liability law, "*the producer shall be liable for damage caused by a defect in his product*". A product is defective "*when it does not provide the safety which a person is entitled to expect*". Moreover, under product safety law, "*producers shall be obliged to place only safe products on the market*". In this context, "*safe*" generally means "*any product which, under normal or reasonably foreseeable conditions of use […] does not present any risk or only the minimum risks compatible with the product's use […]*".

Within matrix structures, potential risks become particularly obvious when looking at the role of the "*producer*". According to the PLD, the term "*producer*" means "*the manufacturer of a finished product, the producer of any raw material or the manufacturer of a component part and any person who, by putting his name, trade mark or other distinguishing feature on the product presents himself as its producer*". Moreover, the PLD can also apply to departments or entities that are responsible for product imports. In particular, according to the PLD, "*without prejudice to the liability of the producer, any person who imports into the [EU] a product for sale, hire, leasing or any form of distribution in the course of his business shall be deemed to be a producer within the meaning of [the PLD] and shall be responsible as a producer*".

According to the GPSD, the term "*producer*" means "*the manufacturer of the product, when he is established in the Community, and any other person presenting himself as the manufacturer by affixing to the product his name, trade mark or other distinctive mark, or the person who reconditions the product*". Also, it means "the manufacturer's representative, when the manufacturer is not established in the Community or, if there is no representative established in the Community, the importer of the product" as well as "*other professionals in the supply chain, insofar as their activities may affect the safety properties of a product*". Hence, depending on the specific allocation of responsibilities and tasks, certain departments or entities within a matrix structure might be subject to particular product liability risks as well as product safety obligations and requirements.

Please find below an overview of typical product compliance cases and risks, together with guidance on internal processes and structures to address these product compliance topics.

3.2 Typical challenges

The following categories outline the most typical product compliance issues:

- **Design**: Products should have a proper design. Hence, a company and its decision-makers should ensure that a product meets reasonable safety expectations, especially by applying a state-of-the-art test. A company with matrix structures should have internal processes and structures that ensure compliance with all applicable mandatory legal design requirements (e.g. CE Directives like the Low Voltage Directive 2014/35/EU or the Machinery Directive 2006/42/EC or type-approval requirements, etc.) as well as technical standards (e.g. ISO, EN, DIN, etc.). As part of this compliance process, companies should typically implement structures that allow the R&D department to cooperate with the legal team to ensure a proper and reliable interpretation of legal requirements and technical standards. Design defects can cause significant legal risks, in particular because design issues may affect the entire product population.

- **Approval, certification, labeling and marking**: Products should comply with all applicable approval, certification, labeling and marking requirements. Even if a product is (technically) safe, approval, certification, labeling and marking shortcomings can jeopardize a product's marketability, particularly because the law typically categorizes these kinds of shortcomings as safety issues. Hence, they might be of a purely formal nature (e.g. a missing marking), but they might nevertheless affect the entire product population causing a product crisis (for example because all affected products were placed on the market illegally).
- **Manufacturing**: Products should be manufactured in line with their respective design. In contrast to design defects, production shortcomings might only affect isolated units (instead of the entire product population).
- **Instruction**: Products should have proper instructions. Even if designed properly, products pose certain remaining risks. Instructions should be clear, sufficient and suitable to outline these risks.
- **Product monitoring**: Even after successfully placing (safe) products on the market, a company will still have certain monitoring obligations. To meet these obligations, companies generally need reliable and suitable sensors to detect potential product issues. This can be done by either passive or active product monitoring, or both. For passive product monitoring, a company with matrix structures needs sensors (e.g. a centralized hotline, a dedicated mailbox, etc.) to receive reports on (alleged) product issues. For active product monitoring, a company with matrix structures needs sensors (e.g. a defined research team) that actively search for potential issues, particularly if there are certain indications. In this context, both passive and active product monitoring can apply to reports from internal sources (e.g. from R&D, Production, Quality, Sales, Service, etc.) and external sources (e.g. authorities, customers, end-customers, media, users, etc.). Product monitoring also requires proper reporting lines (particularly to avoid silos).

For example, as a preventive measure or in a product crisis, a company with matrix structures can successfully assess and resolve potential design, approval, certification, labeling, marking, production, instruction and monitoring issues by conducting an audit or internal investigation. An internal investigation is particularly helpful (i) to identify all applicable legal requirements, (ii) to verify actual product compliance with all identified applicable legal requirements, (iii) to narrow down potentially affected products and the involved risk, (iv) to identify key figures and (v) to find and eliminate potential flaws in existing internal processes and structures.

3.3 Civil law risks

In the event of a product issue, particularly a product crisis, a company with matrix structures may face significant civil law claims. In particular, claimants might attempt to seek compensation based on contract/warranty, general tort and strict liability law:

- **Contract/warranty**: Non-compliant and/or unsafe products can be defective, triggering a breach of contract or warranty claim. In such cases, claimants might attempt to seek some kind of replacement or even payment of damages. In certain jurisdictions, for example under German law, there is a statutory presumption that the seller of a defective product acted negligently. Therefore, companies should have sophisticated internal processes and structures in place to be able to demonstrate that a potential defect was not linked to any negligence.
- **General tort:** Non-compliant and/or unsafe products can also trigger claims under general tort law. Under tort law, courts often accept a certain relaxation of the burden of proof in favor of a claimant, i.e. assuming a company's fault once there is evidence for a defect. Hence, to avoid liability, a company would have to prove that it, in principle, did everything necessary and reasonable to avoid the defect. As with contractual or warranty claims (above), companies should have sophisticated internal processes and structures in place to be able to demonstrate that a potential defect was not linked to any negligence.

- **Strict liability:** Furthermore, non-compliant and/or unsafe products may trigger claims based on strict liability under product liability law (i.e. regardless of any negligence or intent on the producer's side). The German Product Liability Act implementing the PLD is basically applicable in parallel to contract/warranty as well as general tort law. It provides that "*the producer shall be liable for damage caused by a defect in his product*". In Germany, most consumer claims are brought under the German Product Liability Act (particularly because of its strict liability regime).

3.4 Public law risks

In the event of a product crisis, companies may be obliged to notify market surveillance authorities and to take certain corrective actions. When doing so, companies with matrix structures need to be aware of the market surveillance authorities' powers.

- **Notification obligation**: Under German law, there is an authority notification obligation for consumer products. Companies that "know or ought to know […] that a product that they have placed on the market poses risks to the consumer […] shall immediately inform the competent authorities […]". Hence, companies generally need to conduct a risk assessment to assess potential product safety risks, in particular to decide whether they are under an immediate obligation to notify the authority.
- **Power to investigate**: Under German law, market surveillance authorities have various powers to investigate (alleged) product compliance issues. For example, they have the power to enter business premises (during business hours), to inspect products and their production as well as to ask for samples and technical documentation (e.g. conformity assessment documentation). In contrast to public prosecution, market surveillance authorities generally do not need a warrant or any other form of prior consultation with a judge. Hence, for companies, these kinds of authority investigations can be particularly challenging. As an example, in addition to "dawn raid guidelines", certain companies might also want to consider having corresponding guidelines for the event of a market surveillance authority investigation.
- **Power to take corrective action**: As a general rule, market surveillance authorities have the power to order corrective action such as product recalls or withdrawals. In addition, they have the power to disclose certain product issues, particularly by warning the public.

3.5 Criminal law risks

In the case of product compliance issues, the public prosecution might initiate criminal investigations. Such criminal law risks may not just affect the company but also its decision-makers, particularly in light of existing matrix structures.

- **Fraud allegations**: In the event of a product issue, a company and its decision-makers might face certain fraud allegations (see Sec. 263 of the German Criminal Code (***StGB*** – *Strafgesetzbuch*). The public prosecution might argue that fraud was committed by (allegedly) deliberately placing a product on the market while knowing about the product's (allegedly) missing marketability. The public prosecution might seek to argue that customers were misled and tricked into buying an (allegedly) defective/unsafe product and thereby suffered financial harm.
- **Allegations of negligently causing bodily harm or manslaughter:** In the event of an accident involving personal injury and/or fatalities, a company and its decision-makers might face certain criminal allegations, particularly linked to negligently causing bodily harm (see Sec. 229 StGB) or negligent manslaughter (Sec. 222 StGB). The public prosecution might argue that an (allegedly) defective/unsafe product was placed on the market while knowing about the product's (allegedly) missing marketability. In particular, (and these are the most common cases in practice), the public prosecution might argue that the company (allegedly) omitted to launch corrective actions, such as a recall.
- **Product safety law allegations**: A company and its decision-makers might also face certain criminal allegations directly linked to product safety law violations. For example, a person who persistently repeats certain intentional product safety law violations can commit a crime (see Sec. 40 ProdSG).

- **Corporate criminal liability under administrative offence law**: As a general rule, German criminal law does not apply to companies (only to natural persons like the decision-makers). However, in certain circumstances, for example, if a company failed to implement proper internal compliance processes and structures, the public prosecution might have a right to order disgorgement of the company's profits under administrative offence laws (see Secs. 130, 30, 17 and 29a of the German Administrative Offence Act (***OWiG*** – *Ordnungswidrigkeitengesetz*). In doing so, the public prosecution might typically try to punish the company by disgorging its profits from selling non-compliant products (for example that were not allowed on the market in the first place due to a lack of marketability). The disgorgement of profits is generally unlimited and the amounts can therefore be significant.

3.6 Internal processes and structures to handle product compliance topics

As outlined above, companies with matrix structures should have sophisticated internal product compliance structures and processes. In practice, companies typically implement an incident management system which ensures the detection, investigation, assessment, decision-making and execution linked to (alleged) product compliance issues. Companies – particularly those with matrix structures – often implement a five-step-approach: (1) Sensors to receive and detect potential issues; (2) Reporting lines to the competent person(s) within the company; (3) A proper investigation and preparation of the facts of the case; (4) A sophisticated assessment and decision-making process; (5) Proper remediation.

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Conclusion

Product non-compliance may trigger severe civil, public and criminal law consequences for the company, its brands and its decision-makers. To mitigate risks – especially in the event of a product crisis – companies with matrix structures should establish sophisticated internal processes to meet all applicable product liability, product safety and product compliance requirements.

Checklist

- Create and raise awareness of the role of the "producer" within the matrix structure, particularly in connection with civil, public and criminal law risks for the company, its brands and its decision-makers linked to product liability, product safety and product compliance;
- Implement a proper and robust internal incident management system to safe-guard certain matrix structures (incl. sensors to receive and detect potential issues, clear reporting lines, an effective investigation of the facts of the case, a sophisticated assessment and decision-making process as well as reliable execution);
- Create an internal database for all responsible entities and decision-makers within a matrix structure with all applicable product requirements (e.g. CE marking, type-approval, etc.) incl. technical standards (e.g. ISO, DIN, EN, etc.);
- Within matrix structures, cooperation between the R&D department and legal team to ensure proper interpretation of product compliance requirements;
- Install internal processes and structures to ensure product compliance covering all relevant decision-makers and entities within the matrix structures (i.e. before placing a product on the market);
- Ensure product monitoring process (i.e. after a product has been placed on the market).

4. Tax

4.1 Place of management/ permanent establishments

4.1.1 Place of management and unlimited tax liability

Tax residency is an important economic factor for companies, as it determines states' rights to tax them. It may come as a surprise that the implementation of a matrix structure can have an influence on this.

Germany's corporate income tax code assumes an unlimited tax liability if a corporation has a) its management and/or b) its seat in Germany. While a corporation's seat is determined by the relevant provisions in the articles of association, i.e. by *legal* circumstances, its place of management is dependent on *factual* circumstances and is deemed to be where the main business decisions are made, i.e. where the company's most important day-to-day management takes place.

If the matrix structure is such that these decisions are mainly made by matrix managers rather than the appointed managing directors of the company in question, it is vital to pay attention to where the matrix managers perform their work.

If they are based abroad and day-to-day management is thus conducted outside of Germany, this may – depending on the foreign country's national tax law – give rise to an unlimited tax liability of the company in that other country in addition to the unlimited tax liability in Germany brought about by the company's seat here. Which state (or states) has (or have) the right to tax the company depends on the circumstances of the individual case, in particular on the applicable double tax convention, if there is one. The OECD's model tax convention stipulates that, in such cases, a corporation should be deemed to be a resident *only* of the state in which its place of effective management is situated. As a consequence, the implementation of a matrix structure may cause profits to become subject to tax in a different country than before. It is important to note, however, that any profits attributable to a permanent establishment (e.g. a factory which produces goods) remain taxable in the state in which the permanent establishment is situated, regardless of the residence of its head office.

Conversely, a corporation with its seat abroad becomes subject to an unlimited corporate tax liability in Germany if the most important day-to-day management is conducted by matrix managers based in Germany. Here, too, whether and to what extent profits become subject to tax in a different country than before, depends on the circumstances of the individual case and, in particular, the existence of permanent establishments abroad as well as the applicable double tax convention, if one exists.

4.1.2 Permanent establishments and limited tax liability

If a matrix structure is implemented in a corporation with its seat in Germany, where the corporation's main (i.e. most important) day-to-day management remain in Germany, no additional *unlimited* tax liability is triggered in another state. However, a *limited* tax liability may be caused by the (often unexpected and unwanted) creation of a permanent establishment.

Such permanent establishments can come into existence by accident in seemingly innocuous cases. For example, a matrix manager may be hired by the German head office but actually perform the bulk of his work from another country. If the German head office provides office space abroad, this will in many cases qualify as a permanent establishment of the head office. Generally, this requires that the enterprise to which it is to be attributed has (not only temporary) power of disposal over the establishment (in this example: the office space) and is thus entitled to access it anytime it wishes. In some states, however, it could even be the case that home offices used by matrix managers might also qualify as permanent establishments. What's more, if the matrix manager regularly concludes contracts in the head office's name, this may per se give rise to a (representative's) permanent establishment.

If a permanent establishment can be assumed to exist, profits attributable to it are taxable in the country in which the permanent establishment is located (and not at the tax residence of the corporation to which the permanent establishment is to be attributed). In addition, business transactions between the head office and its permanent establishment must be conducted at arm's length, i.e. at the terms and especially for the consideration for which they would have been conducted between unaffiliated, independent companies. These requirements give rise to, at the very least, a considerable bureaucratic workload and possibly, depending on the countries involved, an increased tax burden, for example due to a higher tax rate in the state with the permanent establishment or because of double taxation that may occur if the company's residence state does not recognize the permanent establishment in the other state or if the involved states cannot agree on the allocation of the corporation's income to the permanent establishment.

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Conclusion

Matrix structures can have unexpected consequences. If the implementation of a matrix structure shifts the main day-to-day management from Germany to abroad, this will generally create an unlimited tax liability in the other state, too. However, double taxation conventions generally assign the taxation rights (only) to the state in which the actual day-to-day management takes place. As a consequence, the corporation's business profits will generally, subject to certain exceptions (most notably permanent establishments, which are taxable in the state where they are located), become taxable in the state in which the main day-to-day-management is carried out – and not in Germany.

If the transfer of management duties abroad is limited so that the main (i.e. most important) day-to-day management stays in Germany, the company's profits remain subject to an unlimited tax liability in Germany. No unlimited tax liability abroad is triggered. Depending on the circumstances, however, the implementation of the matrix structure may bring about a permanent establishment and thus, a limited tax liability abroad.

These possible consequences must be carefully examined when the introduction of a matrix structure is considered.

Checklist

- Are the main day-to-day business decisions made by matrix managers who are based abroad?
- If not: Are any of the matrix managers based abroad? Are their workplace and their legal situation designed in a way as to avoid giving rise to a permanent establishment?

4.2 The tax department in a matrix organization

Most corporate groups have a central tax department which performs tasks for several group companies. In doing so, the tax department fulfills tasks that – from a legal point of view – are individual obligations for every group company. This results in a matrix structure, where the business organization and the legal responsibility do not coincide.

4.2.1 Obligations of the managing directors

The statutory managing directors have to fulfill the tax obligations of their company (Sec. 34 of the German Fiscal Code (***AO*** – *Abgabenordnung*)). In general if there is a breach of tax regulations, for example because a tax return has not been submitted at all or has been filed late, incompletely or incorrectly, it is the statutory managing directors who are responsible. They can delegate the execution of the entity's tax obligations to their own employees or to third parties; however, they still have a duty to select qualified persons and to instruct and monitor them. Those obligations to select, instruct and monitor also arise if the central tax department undertakes tasks that are the legal responsibility of other group companies.

4.2.2 Delegation to the group tax department

How the delegation to the group tax department should be structured depends on the circumstances of each individual case. Generally speaking:

- In most cases, the managing directors of affiliates have hardly any say in the selection of tax department employees and the allocation of tasks. The reason for establishing a central group tax department is to ensure the efficient allocation of resources via centralised management and task distribution. However, in professionally managed groups the central tax departments have the necessary resources to fulfill the affiliate's tax obligations.
- The instructions issued to the tax department must be in written form, specifying which tasks the tax department takes over and how the tax department gets information about tax-relevant facts. Tax errors occur most frequently when people who are in charge of filing the tax returns do not have all the relevant information, e.g. the content of contracts. For instance, tax errors occur frequently at the interfaces of the central tax department with human resources, sales, procurement or IP.
- How the central tax department is monitored and supervised by the managing directors of the individual group entities depends on the circumstances of each case. It can be advisable for the tax department to report to the managing directors on a regular basis. In any event, the managing directors must be informed if tax compliance issues arise, e.g. during a tax audit or if past tax returns have to be corrected because tax was underreported.

4.2.3 Liability risks

In the case of major tax offences, criminal or administrative proceedings are regularly initiated against the responsible managers. A fine may be imposed in the case of grossly negligent non-compliance with the managing directors' obligation to instruct and supervise the central tax department (Sec. 378 AO). A sentence for tax evasion is possible in the case of willful tax evasion (Sec. 370 AO). Additionally, the managing directors may be liable to the company for tax liabilities, for example if VAT that should be a pass-through cost for the company becomes a definitive burden because it was not correctly invoiced to the customers. If managing directors violate the entity's tax obligations intentionally or with gross negligence, the tax authority may hold them liable for the payment of the entity's taxes (Secs. 34, 69 AO); this frequently occurs if an entity becomes insolvent.

The managing directors can protect themselves from personal liability by complying with their selection, instruction and monitoring obligations and by documenting this. Moreover, the German tax authorities have explicitly acknowledged that the establishment of a tax compliance management system can be an indicator against intentional or negligent behavior.

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Conclusion

The establishment of a central tax department within a group of companies does not release the legal representatives of the individual group entities from their duty to ensure their entity's tax compliance. The statutory managing directors must always ensure the effective delegation of the tax obligations and to monitor the tax department.

Checklist

- Ensure that the delegation to the tax department is based on a comprehensive written documentation,
- Be aware that most tax mistakes occur at the interfaces between different departments, and coordinate those interfaces,
- Monitor the work of the tax department and step in if the tax department does not fulfill the assigned tasks properly.

5. Data protection in the context of employment

5.1 Data processing requirements for the exchange of employee data in corporate groups with matrix structures

For the effective use of matrix structures within a corporate group, it is necessary to exchange personal data, in particular employee data, between the legal entities within the corporate group. In this context, companies have to comply with the requirements under applicable data protection laws to avoid fines, claims for damages and other disadvantages.

5.2 Requirements for the transfer of employee data in a matrix structure

In a matrix organization, an employee could have a disciplinary supervisor within the same company while another manager issues the instructions related to the employees' work (e.g. a department manager). The latter could be employed by the group parent company or by another affiliate, and could even be in another country.

As personal data is processed by different companies within the matrix organization, the organizational structure needs to overcome legal barriers under applicable data protection laws. It is for example necessary for both the internal disciplinary supervisor and the external department manager to have access to certain personal data of the employee. Without access to this data, they cannot fulfill their managerial tasks.

The transfer of personal data to the department manager in another group company requires justification under applicable data protection laws. If the company the manager is employed by is based in a country outside the EU/EEA, this cross-border data transfer needs to comply with further requirements.

Companies which do not comply with applicable data protection requirements can be subject to substantial fines and other disadvantages. Under the General Data Protection Regulation (**GDPR**) which applies in Europe from 25 May 2018, fines of up to €20 million, or four percent of the global group revenue, whichever is the greater, can be imposed for every single violation.

5.3 Justification for the transfer of personal data

Generally, the respective employer is considered to be the controller for the processing of the personal data of its employees. The transfer of personal data between companies of a corporate group requires legal justification to be lawful. There is no exemption or privilege for the transfer of personal employee data within a group of companies under European or German data protection law.

The following lawful grounds may justify the transfer of personal data within a matrix organization:

- **Purposes of the employment relationship:** The transfer of personal data can be justified to the extent that it is necessary and proportionate for hiring decisions or, after hiring, for carrying out or terminating the employment relationship (Sec. 26 (1) of the new German Federal Data Protection Act as applicable as of 25 May 2018 (**BDSG** *Bundesdatenschutzgesetz*)).

  According to a common interpretation of the old German Federal Data Protection Act in the version applicable until 24 May 2018, purposes of the employment relationship could be relied upon to justify intragroup data transfer only if the employment contract was related to the corporate group and if such relation was laid down at the beginning of the employment relationship. Such a relation to the corporate group could for example be established if the employment contract provides that the employee can be deployed in another group company. In this case, the transfer of personal data is deemed to be necessary for the deployment within the group.

  However, there are sound arguments that employers in a matrix organization can rely on purposes of the employment relationship to justify the transfer of certain personal data to other group companies in other cases as well. If an employee's supervisor is for example employed by another group company, this supervisor needs to have access to certain personal data of the employee he supervises for example for the purpose of conducting performance review interviews, etc. This managerial task in our view constitutes an admissible purpose of the employment relationship.

- **Legitimate interests:** Companies may also rely on legitimate interests (Art. 6 (1) lit. f) GDPR) to justify the transfer of employees' personal data within a corporate group to the extent that the transfer is not required for purposes of the employment relationship.

  Each data transfer based on legitimate interests requires a balancing of interests test taking into account the interests of the controller as well as of the employee concerned in the particular case. Internal reporting purposes of the corporate group can for example under certain circumstances constitute legitimate interests for the transfer of personal employee data. This data transfer needs to be fair, transparent, proportionate and limited to what is necessary to pursue the legitimate interests, however.

  In practice, group companies with a matrix organization often opt to enter into intra-group data transfer agreements which stipulate additional safeguards and establish joint data protection standards to protect the employees' personal data within the matrix organization. This can be taken into account in favor of the employer in the balancing of interests test and, thus, improve the likelihood that the data transfer operations are regarded as lawful.

- **Declaration of consent:** Consent (Art. 6 (1) lit. a) GDPR) cannot usually serve as a suitable lawful ground to justify cross-border data transfers within a matrix organization. Consent declarations need to be given freely and voluntarily to be valid and can be withdrawn by the employees at any time. The German data protection authorities take the view that employees usually do not have free choice as to whether they consent to the processing of their personal data by their employer due to the imbalance of power within the employment relationship. Due to these restrictions, employers should generally not rely on consent apart from in exceptional situations.

- **Works council agreements concerning data transfer within the matrix organization:** Works council agreements can serve as a lawful ground for the processing of personal employee data within matrix organizations as well. As a prerequisite, the works council agreement needs to provide for a high level of transparency and suitable and specific measures to protect the employees' personal data as required under Art. 88 (1) and (2) GDPR and Sec. 26 (4) BDSG.

  Typically, personal employee data are stored and processed in human capital management (**HCM**) systems such as for example SuccessFactors, Workday, PeopleSoft, etc. Corporate groups have an interest in providing matrix managers with access rights to certain personal data of the employees in their team that are stored in the HCM system. German works councils have mandatory co-determination rights in the implementation and use of such HCM systems. It is, thus, advisable to negotiate the works council agreements in a manner which allows matrix managers and other selected personnel to safely access employee data in the HCM system to the extent this is required for these employees to fulfill their managerial or other tasks within the matrix organization. Such well drafted works council agreements can provide for additional legal certainty for the employers within a matrix organization.

5.4 Data transfer to third countries outside the EU/EEA

Data transfers within the matrix organization from group companies in the EU/EEA to third countries outside the EU/EEA may require the implementation of appropriate additional safeguards in order to be lawful, unless this country is considered to offer an adequate level of data protection based on adequacy decision by the EU Commission. Besides legal justification, this data transfer needs to comply with the additional requirements under Art. 44 et seq. GDPR.

If for example a matrix manager of the US group parent company receives personal data or obtains access to personal data of an employee of an affiliate in the EU/EEA, suitable safeguards need to be in place. This is for example the case for any data transfers from EU member states to the US.

Such appropriate guarantees can be a certification of the data importer under the EU-US Privacy Shield. As a very common alternative, the data exporter and the data importer can also enter into so-called EU Standard Contractual Clauses (**SCCs**). Another option is the self-commitment of all group companies within the matrix organization to so-called Binding Corporate Rules (**BCR**), which are sometimes considered as the "gold standard" for intra-group data transfer. If a corporate group has no or limited data privacy structures in place so far, the conclusion of an intra-group data transfer agreement based on SCCs can be a reasonable first step to provide for suitable guarantees which can be implemented within a timely manner whereas the implementation of BCRs usually takes more time and effort.

5.5 Joint controllership

Companies within a matrix organization also need to assess to what extent they process personal data as joint controllers (within the meaning of Art. 26 GDPR). Companies are deemed to be joint controllers where they jointly determine the purposes and means of the processing for example of personal employee data. According to the view taken by German data protection authorities, this may be the case where employers within a corporate group jointly maintain databases such as a joint applicant portal. In such cases, the joint controllers need to enter into a joint controllership agreement which determines their respective responsibilities for compliance with the GDPR.
If companies in a matrix organization are obliged to enter into a joint controllership agreement but do not have a respective agreement in place, this constitutes an administrative offence (pursuant to Art. 83 (4) lit. a) GDPR).

5.6 Data processor scenarios

Not every sharing of employee data within the group is based on an exchange of data between two controllers. Where one entity within the group provides services to other entities with the corporate group, such entity may not be a controller with regard to the processing of personal data but qualify as a processor. This will be the case where the group entity does not determine the means and purposes of the processing but processes personal data solely on behalf and in accordance with the instructions of the other group entities to which

it provides the services, such as in potentially in case of centralized IT or business support services. Those data sharing scenarios should be clearly differentiated from other exchanges within the group, as they need to be legitimized based on a data processing agreement reflecting the strict requirements for respective type of agreements under Art. 28 (3) GDPR. Failure to comply may trigger administrative fines (pursuant to Art. 83 (4) lit. a) GDPR).

5.7 Transparency requirements

The GDPR results in increased transparency requirements for employers (Art. 12 et seq. GDPR). For companies in a matrix organization, this means that the respective employer as a controller must inform its employees about a whole range of items, including in particular about which personal data it will transfer for which purposes to which recipients based on which lawful ground(s) within the matrix organization. This information needs to be meaningful and easy to understand. It needs to be provided in a comprehensive and easily accessible manner. This information can for example be part of a general employee data privacy notice.

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Conclusion

Before transferring employees' personal data within the matrix organization to other group companies, the employer needs to ensure that every individual data transfer operation complies with the legal requirements under the EU General Data Protection Regulation and the new Federal Data Protection Act. Data transfers within a matrix organization are not "privileged". Solid data privacy structures within the corporate group can enable data transfer operations and reduce the risks of fines, claims for damages and other disadvantages.

Checklist

- Can the individual data transfer operations within the matrix organization be based on a lawful ground as a justification? Are the data transfer operations for example necessary for purposes of the employment relationship or to pursue other legitimate interests?
- Are suitable safeguards in place, such as SCCs, to provide for suitable guarantees for intragroup data transfer to countries outside the EU/EEA?
- Have the employees been sufficiently informed about the transfer of their personal data to other group companies in a comprehensive and transparent manner?
- Are works council agreements in place which regulate intra-group data transfer operations? If so, do the works council agreements comply with the increased requirements under the GDPR and the BDSG-new?
- Are intra-group data transfer agreements in place which provide for binding standards for the transfer of personal data within the matrix organization?
- Are the companies within the corporate group acting as joint controllers with regard to specific data processing operations? If so, is an appropriate joint controllership agreement in place?

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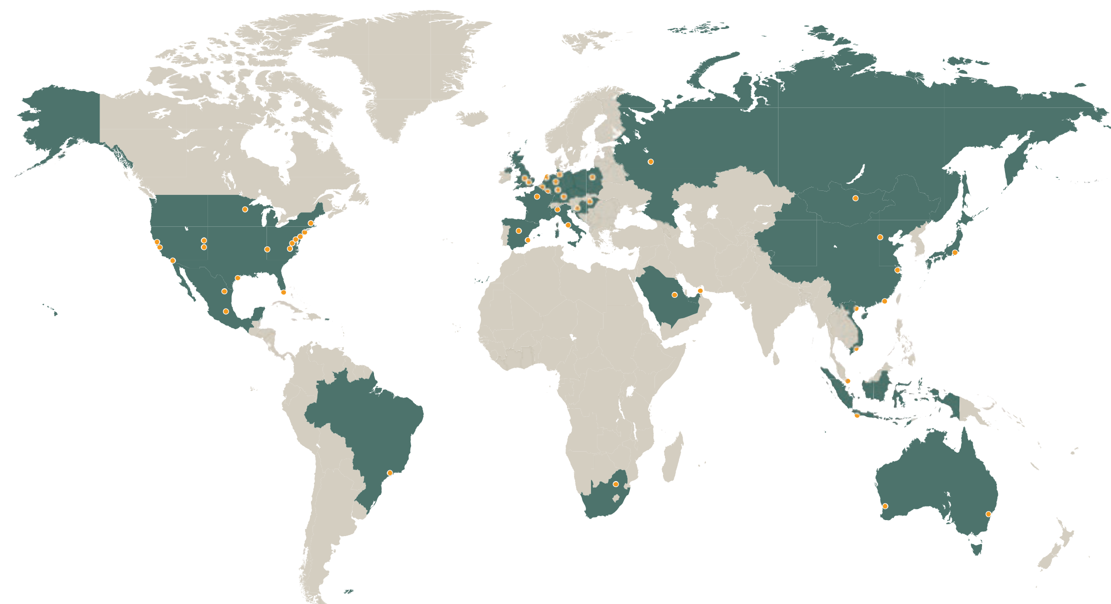

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