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Foreign Investments in Germany

Legal and Tax Aspects
of
M&A and Real Estate Transactions

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A. Introduction

I. Germany = the World's Third Largest Economy

After the United States and Japan Germany is ranked the world's third largest economy (head-to-head with China), is seen as the largest economy in Europe and considered the world's leading exporter of merchandise with exports accounting for more than one-third of the national output. Germany influences the world economy in beginning, managing or ending crises including the European Monetary Union. And “*Made in Germany*” is a worldwide renowned brand of quality.

II. Efficient Legal Framework

Germany has tried harder: The reunification process was managed and the modernization and integration of the East German economy was pushed, domestic structural problems in the labor market were addressed by gradual deregulation and bureaucratic regulations were set to be simplified. German law is more efficient, cost-effective and predictable than commonly reported since statutory law (instead of case law) provides legal certainty. The Global Competitiveness Report 2008-2009 of the World Economic Forum even shows Germany to be top-ranked in the category of “*Efficiency of legal framework*”.

III. Investment Opportunities

Around 3.5 m businesses and 2,393,839 sqm of real estate in Germany provide for countless investment opportunities. Compared to the Anglo Saxon countries M&A activities in Germany may not have even reached their peak. This brochure intends to provide an initial overview what to expect for those who want to seize the opportunities. Individuals, entrepreneurs, corporations, financial investors, managers and others will find the major issues, challenges, risks and business habits tackled from a German perspective which are involved in the acquisition of businesses and real estate.

IV. The Contents of the Brochure

The guide starts with a description of the various types of companies that may be acquired and what legal issues are encountered in buying real estate or leveraged loans. German transaction procedures including but not limited to financing very much resemble the Anglo Saxon ones; specific issues are highlighted like tender offer rules. Taxes are tackled from each point of view, be it at the start or at the exit. Management plays a key role in a German acquisition and of course other third party involvement has to be considered. After having acquired a company or a piece of land the investor is informed about the current legal situation in the area of human resources, environment, subsidies and IP rights. In times of a financial crisis the specialties of buying distressed assets are marked. This brochure also describes common exit scenarios.

B. Investment Possibilities

I. Share Deal vs. Asset Deal

When investing in German companies one can choose either to buy shares of a certain target company or its assets. Generally speaking, it is more common to buy shares as it is much easier. On the other hand, there may occur situations when it is more recommendable to buy assets, e.g. if the target company has filed for insolvency or if the purchaser only wants to buy a certain business unit by way of spin-off.

Similarly, in real estate transactions the question arises whether to carry out the deal as an asset deal or as a share deal. Under various aspects, which are often connected with tax advantages, a share deal could be the right choice, e.g., to escape property transfer tax. Therefore, in particular large real estate portfolios are very often purchased by way of a share deal. However, apart from such transactions, an asset deal is still rather common in German real estate transactions. One main disadvantage of a share deal is the preparation stage, which requires more legal advice and is therefore more expensive than a real estate asset deal. One important advantage of a share deal is that the transaction can instead be carried out much faster because no time-consuming registrations in the land register are required. The purchaser will therefore benefit from the real estate and the seller will receive the purchase price much more quickly. No costs for the land register are incurred and notary costs can be kept rather low. A further advantage of the share deal is that existing loans can be used for financing and no prepayment penalties will become due. In case the acquisition has been carried out by way of a share deal, the exit will typically be carried out thus too. The existing book values will be adopted in a share deal; since the real estate property will continue to be subject to depreciation an exit by way of an asset deal will only be beneficial in case the book value has increased for some reason.

II. Acquisition of Various Share Types

1. Private Limited Liability Company (*GmbH*)

a) General

The form of a *GmbH* is by far the most frequently used corporation form in Germany. The foundation of a *GmbH* and share transfers require notarization by a notary public. Provided that the nominal share capital is fully paid in after the foundation of a *GmbH*, the shareholders are not personally liable for the company's debts. The nominal share capital must be determined in the articles of association and amount to a minimum of EUR 25,000. The German Limited Liability Company Act provides for the maintenance of the nominal share capital in-so-far that it is not permitted to repay the nominal share capital to shareholders.

b) Commercial Register

It is important to know that only such shareholders who are registered in the shareholders' list are deemed to be shareholders of the respective *GmbH*. A copy of such shareholder's list must therefore be filed with the competent commercial register and is publicly available to anyone who is interested.

c) Management

A *GmbH* is led by one or more managing directors. Contrary to the legal concept in a German stock corporation the applicable law allows shareholders of a *GmbH* to appoint and remove managing directors relatively easy any time they wish to. In general, the managing directors are responsible for business management as well as the representation of the *GmbH*. A legal entity is not allowed to serve as managing director. For some business transactions the managing directors need to obtain prior consent of the shareholders' meeting. Usually, such business transactions are described in detail in the articles of association.

d) Advisory Board / Supervisory Board

Further, the shareholders of a *GmbH* can opt to implement an advisory board or a supervisory board. If a *GmbH* (together with its subsidiaries) has more than 500 employees, the foundation of a supervisory board is required by mandatory labor law, whereby the employees are entitled to appoint at least 1/3 of its members. In case a *GmbH* has more than 2,000 employees, half of the members of the supervisory board are appointed by the employees. In cases of doubt the chairman of the supervisory board, who is appointed by the shareholders, has a casting vote.

e) Recent Amendments to the German Limited Liability Company Act

aa) Administrative Seat Abroad

After [recent amendments](#) to the German Limited Liability Company Act it is now possible for a *GmbH* to have the administrative seat abroad while its registered office remains in Germany. This allows a very flexible handling of a *GmbH*.

bb) Low Share Capital

Further, German lawmaker allowed to set up a special form of *GmbH* with an initial share capital of EUR 1.00. Such company is called entrepreneurial company (*UG*) and is more or less a *GmbH* with the special characteristic that 1/4 of the annual profits must be put into the capital reserves until the share capital amounts to EUR 25,000.

2. Stock Corporation (AG)

a) General

Alongside the *GmbH*, the second major type of German corporate entity is the *AG*. The shares in an *AG* may be, but must not necessarily be, publicly listed. In fact, most of the German *AG*s are not listed but are privately held by a small number of shareholders.

The legal regime that applies to an *AG* is considerably stricter than the one that applies to a *GmbH*. As a rule of thumb, the articles of association of an *AG* may only contain provisions that deviate from those contained in the German Stock Corporation Act, when this is expressly permitted, whereas the articles of a *GmbH* may contain any provision unless such provision is prohibited under the German Limited Liability Companies Act. As a consequence, the flexibility in structuring an *AG* is quite limited, in particular with respect to its corporate governance.

b) Corporate Governance; German Corporate Governance Code

The three mandatory corporate bodies of an AG are the management board, the supervisory board and the shareholders' meeting.

aa) Management Board

The management board is responsible for the management of the company. The authority of the management board to represent the company may not be restricted vis-à-vis third parties. In addition, the management board is not subject to instructions from the shareholders' meeting or the supervisory board. However, certain restrictions on their powers of representation (internally vis-à-vis the company) may be imposed by the articles of association, by decision of the supervisory board or the shareholders' meeting, and by the rules of procedure of the management board, if any.

The members of the management board are appointed by decision of the supervisory board for a term not to exceed five years, with dismissal only possible for cause.

[The German Corporate Governance Code](#), adopted in 2002, does not constitute statutory law. It contains both recommendations and suggestions for German listed companies, aimed at making the German corporate governance system transparent and understandable, and at promoting the trust of international and national investors, customers, employees and the general public in the management and supervision of listed AGs. The management board (and the supervisory board) shall declare yearly that the recommendations of the Code have been and will be complied with, and state which of the Code's recommendations have not been or will not be followed ("comply or explain"). The most relevant recommendations of the Code relate to, *inter alia*, the overall compensation of members of the management board, the shareholdings in the company held by individual members of the management board and the supervisory board, as well as the informing of shareholders and third parties during the fiscal year by means of interim reports.

bb) Supervisory Board

The members of the supervisory board are elected by the shareholders' meeting, unless employee representatives are required by mandatory law. If the AG employs, as a rule, more than 500 employees, one third of the board is to consist of employee representatives. If the AG employs, as a rule, more than 2,000 employees, half of the supervisory board members are elected by the employees (see B.II.1.d)). The supervisory board shall in particular supervise the management board and is competent for the (internal) consent to certain operative measures (see B. II. 2. b) aa)).

cc) Shareholders' Meeting

The shareholders' meeting shall resolve on all matters expressly attributed to it by law or the articles of association. The shareholders' meeting is not permitted to instruct the management board with respect to the operative management of the company, unless the management board has itself requested that a decision shall be made by the shareholders' meeting. However, according to a doctrine established by the German Federal Supreme Court in the so-called "*Holz Müller*" decision, the shareholders' meeting shall grant its consent to matters relating to the

management of the company which materially affect the membership rights of the shareholders, in particular upon the intended sale and disposal of material assets.

c) Share Capital, Shares, Sale and Transfer of Shares

The minimum stated share capital of an *AG* amounts to EUR 50,000. The minimum nominal amount per share is EUR 1.00. The creation of preference shares is possible. The shareholders' meeting may resolve upon an authorized or conditional capital.

In contrast to the law governing the *GmbH*, the sale and transfer of shares in an *AG* does not require a specific form. According to the articles of association, however, the transfer of registered shares - as opposed to bearer shares - may be subject to the consent of the company. Consent is generally granted by the management board under consideration of the best interests of the company.

Any actions with respect to the shares in a listed *AG* must comply with insider law. The violation of insider trading directives regularly constitutes a criminal offence.

As set out in G. III. 1, certain notification requirements must be met for shareholdings in both listed and non-listed companies. A violation of these rules results in suspension of the respective shareholders' rights.

3. Participations in Limited Partnerships (KG)

a) General

A German *KG* consists of at least one general partner and one limited partner. Provided that the limited partner has paid in fixed contributions, which must be registered with the commercial register, he is not liable for the partnership's debts. The liability of the general partner is unlimited but it is permitted to implement a *GmbH* as general partner. After all, this affords a good opportunity for investors to limit their liability. Therefore, a *KG* with a *GmbH* as general partner is very common in Germany (this structure is called a *GmbH & Co. KG*).

b) Partnership Limited by Shares (KGaA)

Moreover, participations of limited partners can also be appropriate for public trading via stock exchanges. Such *KGs* are called *KGaA*. Although the legal form of a *KGaA* is rarely used in Germany, it is well-suited to a family-owned business with minority shareholders, since it allows the general partner to exercise control. Nevertheless, the transfer of the limited partner shares is still very uncomplicated and cost efficient.

c) Rights and Duties of the Partners

If not otherwise stated in the articles of association, the general partner is responsible for the business management and representation of the partnership. Limited partners, on the other hand, are entitled to receive all relevant information and, of course, to participate in profits.

4. Other Partnerships (including Silent Partnerships)

a) Public Private Partnerships

Public private partnerships in Germany are not subject to any specific statutory law. In public private partnerships, investors and certain public bodies co-operate to develop or operate or

maintain public infrastructures. Traffic projects like toll charge systems, waste management or waste water disposals are typical examples of public private partnerships. In many cases, the private investor is responsible for planning, establishing and financing the project. In return he obtains valuable licenses and is able to gain access to new business areas. The establishment of public private partnerships requires detailed written joint venture contracts bearing similarities to a *KG*.

b) Silent Partnerships

Silent partnerships are advisable if an investor wants to invest in a certain business without attracting any attention. In relation to third parties, the business is run only by the non-silent partner. However, the internal relationship between the silent partner and the non-silent partner provides for certain funding obligations of the silent partner against profit sharing. To establish a silent partnership the parties usually conclude a written agreement although such form is not generally required by law.

5. European Companies

In addition to the aforementioned national legal entities for the incorporation or establishment of a business, several legal forms based on European law have or will soon become available in the member states of the European Union and the European Economic Area including Germany, notably the *SE* and the *SPE*.

a) European Stock Corporation (*SE*)

The European Company (denoted by its Latin name *Societas Europaea*, abbr. "*SE*") is a European *AG*. The legal framework of the *SE* is based on [Community law](#) directly applicable in all EU member states and the member states of the EEA Convention and the respective relevant national legislation enacted to implement the *SE* in the different jurisdictions. The *SE* allows for a more flexible corporate governance and more flexibility with respect to employee participation (see below).

Furthermore, a *SE* can be used as a vehicle for cross-border mergers, since a *SE* may, *inter alia*, be established by way of merger of two or more companies in different EU/EEA member states. However, since [the European Directive on Cross-Border Mergers](#) was implemented in Germany in 2007, certain corporations existing under German law may also directly be merged with entities in other EU/EEA member states.

The *SE* has the following main features:

- Once registered, the *SE* has legal personality.
- A *SE* is required to have a minimum amount of subscribed share capital of at least EUR 120,000.
- The shares of a *SE* can be traded on a stock exchange.
- The registered office of the *SE* and its head office, meaning the place where effective control of the *SE* is exercised and the management of the *SE* is situated, must be in the same EU/EEA member state, but may be moved from one to another member state without the *SE* being dissolved or wound up.

- A *SE* is not subject to national employee participation or co-determination law. Instead, employee participation and/or co-determination is – subject to certain limitations – governed by an agreement between the management and the employees, which is a mandatory part of the process of establishing a *SE* and a prerequisite for its registration.
- A *SE* must be treated by the EU/EEA member states as if it were an *AG*, i.e. all laws applicable to an *AG* in the member state where the *SE* is registered are applicable to the *SE*, unless the EU Regulation or the national implementation laws provide otherwise.

The administration and management, shareholder rights and corporate governance of a *SE* are essentially governed by its statutes and less by statutory laws – at least in theory because, as stated above, the national laws applicable to *AGs* in the member state where the *SE* is registered shall also apply – in Germany in particular the Stock Corporation Act (see B. II. 2.).

The statutes of a *SE* can either provide for a one-tier system of administration with one administrative board which is responsible for both the management, including the election of managing directors, and the supervision of the affairs of the company, or a two-tier structure consisting of one management board and one supervisory board like an *AG*.

b) Outlook: European Private Company (*SPE*)

In June 2008, the European Commission has published [draft legislation on a European GmbH](#) (denoted by its Latin name *Societas Privata Europaea*, abbr. "*SPE*"). Contrary to the *SE*, with only few exceptions, the *SPE* will be entirely governed by European Community law directly applicable in all member states. This is expected to significantly facilitate cross-border business and reduce the costs and complexity normally associated with setting up and maintaining a business in another member state. However, since June 2008, the legislative process on this matter has been stalled, in part due to resistance to the proposal in some member states, which fear that the traditional national legal forms of a *GmbH* (see B. II. 1.) might become irrelevant, in part because some issues (in particular employee participation and co-determination rights applicable to a *SPE*) are still under discussion. It is therefore not currently clear if and when the *SPE* will, in fact, become available.

6. Joint-Ventures (*JV*)

Two or more enterprises can cooperate in form of a *JV*. Reasons for the establishment of a *JV* can be that a participant of the *JV* is seeking access to a new market or has very special know-how which is of great interest to the other *JV*-partner. Usually, both *JV*-partners benefit from the *JV*.

JVs can appear in various forms. In the case of a contractual *JV*, the cooperation is only based on bilateral agreements without forming an independent organization. In the case of an equity *JV*, the partners of the *JV* set up a single purpose vehicle for their collaboration. Such entity often adopts the legal form of a German *KG* or a *GmbH*.

III. Acquisition of Real Estate

1. Description of and Title to Real Estate

a) Cadastral Map

In Germany, land is registered both with the cadastral office and the land register. Therefore, a title search is quick and reliable.

Every piece of land is divided up into cadastral plots. Each piece of land consists of at least one cadastral plot but may consist of several. Each cadastral plot is given a corresponding plot number and registered with the cadastral office. The cadastral map contains valuable information on the exact boundaries, the cut and the location of the cadastral plots. It is also important to examine the cadastral map to ensure the property is accessible by public roads. In addition, the cadastral maps contain information on the existing development and superstructures, i.e. buildings crossing the boundaries.

b) Land Register

The cadastral plots are also registered in the land register. The land register is kept at the district courts. It is divided up into an inventory and three sections. The inventory contains the plot number. Sec. 1 contains information on ownership of the plot of land, i.e. the owner or, in case of several co-owners, the shares of the co-owners, and sometimes notes of registrations of easements in favor of the plot of land. Sec. 2 contains encumbrances including easements, limited personal easements, usufructs, priority notices (of conveyance) and restraints on disposal such as heritable building rights (see B. III. 2. d)). Sec. 3 contains the liens such as mortgages, land charges and annuity land charges. The rights registered in the land register have different priorities/ranks. Generally, the priority of the rights depends on the time of their registration, i.e. the older right is ranked higher than the more recent right.

c) Good Faith

Anyone may rely on the content of the land register in good faith and is protected to the effect that the content of the land register is considered to be correct, regardless of its actual correctness. Therefore it is possible to acquire land from the owner registered in the land register even if he is not the true legal owner. Further, encumbrances that are not registered in the land register are generally deemed as nonexistent *vis-à-vis* a purchaser. This leads to great transparency and makes real estate transactions reliable and safe.

Unlike the commercial register, the land register can only be inspected online by a notary public. Furthermore, to receive information from the land register a valid interest has to be demonstrated. However, the purchaser of a real estate property generally has such valid interest. Cadastral maps are publicly available (and in some municipalities available online).

2. Types of Ownership in Real Estate

Every person and every public or private legal entity (e.g. German federal states, cities, municipalities, AGs or limited liability companies as well as partnerships or civil-law partnerships) may be the owner of land. There are different types of real estate ownership.

a) Sole, Co- and Joint Ownership

The most common form of ownership is sole ownership, i.e. one person or company owns a piece of land. Where land is owned by several persons or companies, they are co-owners or joint owners. In the former, more usual case every co-owner has a share of the property to a certain fraction, e.g. 1/2. Each co-ownership share can be sold and encumbered separately and generally without the consent of the others. In case of joint ownership, each owner owns the whole land jointly with the other owners and is therefore restricted by the rights of the other owners. The whole piece of land can only be sold and encumbered by all joint owners, but not separately.

b) Buildings and Other Components

Ownership of land includes all objects firmly attached to the land, e.g. buildings and garages. The premises attached to the land consist of all components used for their construction. This can under certain circumstances include the fixtures and fittings of a building, if they were customized to the building structure, if they form a unity with the building and they have considerable impact on the appearance of the building as a whole. The sale of real estate thus always includes the building located on it. By contrast, in the newly-formed German states (Brandenburg, Mecklenburg-Pomerania, Thuringia, Saxony, Saxony-Anhalt) and the eastern part of Berlin ownership only was procured before 1990 buildings, whereas the property on which it was located was simply leased. This regulation was continued after reunification of the German states, so this concept of independent ownership of buildings still exists in East Germany.

c) Condominiums**aa) General**

German law also acknowledges the individual ownership of condominiums, which can also include the right to the exclusive use of parking spaces, cellars or balconies. The individual ownership of the condominium itself includes the co-ownership of all commonly used spaces in the condominium building. This co-owned common property embraces the land itself as well as all those sections and facilities of the building that are not subject to individual ownership. A fund for maintenance work is created for the maintenance of the common property which is not refunded upon the sale of the condominium.

bb) Conversion into Condominium

To convert a property into condominiums and common property a notarized partition deed must be drawn up containing a description of each apartment and colored plans of the building illustrating the individually owned condominium space. Generally the ratio of co-ownership of the common property corresponds with the ratio of the individually owned condominium space in relation to the whole building, but may alter due to subsequent expansions within the building, e.g. in the attic. Such conversion requires a governmental certificate confirming separated units. Each condominium is individually recorded in a separate folio in the land register (condominium land register) and is henceforth with respect to the applicable law independent of other condominium property on the same land.

cc) Transfer

Like land, a condominium is independently transferrable and can be independently charged or otherwise encumbered. Likewise, a foreclosure sale does not affect other condominiums. The sale of the condominium can, however, under certain circumstances require the approval of other condominium owners on the same land or of the building administrator.

d) Heritable Building Right

Finally, heritable building rights can be created under German law. A heritable building right entitles one to build and own a building on a piece of land (or below ground, e.g. underground parking) for a certain period of time, e.g. 99 years. The building is considered an integral part of the heritable building right and not of the land. Heritable building rights are often used by municipalities or the Church in order to retain ownership of land while receiving an annual ground rent, usually 4 to 5 % of the value of the land per year. Like rent, ground rent can be subject to indexation, i.e. increase in accordance with a certain index such as the consumer price index. A heritable building right is created by way of a contract between the owner of land and the beneficiary and has to be registered in the land register (see B.III.1.b)). Moreover, a separate folio, the heritable building right register, is created in which the beneficiary of the heritable building right is registered as the owner of the heritable building right. Like land, the heritable building right can be sold and purchased and may be encumbered with easements and charged with land charges. However, the owner of the land will usually reserve the right to approve such transactions, i.e. prior consent is required for any transaction. Upon the expiration of the heritable building right, the owner of land automatically becomes the owner of the building and therefore has to pay compensation to the beneficiary. Lease agreements concluded by the beneficiary automatically devolve to the owner of land. It is also possible to agree on a right to acquire the land in favor of the beneficiary.

3. Encumbrances and Charges

a) Priority Notice

A priority notice secures the enforcement of a claim relating to a property, e.g. the right of conveyance. It is recorded in the land register (see B. III. 1. b)) and has at that point in time the immediate effect of invalidating any subsequent transaction concerning the same plot of land to the extent that the beneficiary's claim would be impaired. It thus preserves the priority of the beneficiary's position over any right with respect to the estate which was created subsequent to the beneficiary's own claim. Any dispositions by way of a foreclosure, distress warrant or insolvency proceedings as well as any contractual dispositions made by the seller are invalid vis-à-vis the beneficiary to the priority notice. In case of an insolvency of the seller, such priority notice will entitle the purchaser protected by such priority notice to claim performance despite the insolvency proceedings without being subject to an insolvency quota. In consequence, German purchase agreements regularly stipulate that the purchase price shall not become due before the priority notice of conveyance has been registered in the land register.

b) Easement

An easement obliges the owner of the encumbered plot of land to tolerate specific conduct of someone else (the beneficiary of the easement) on his or her plot of land or to refrain from

specific conduct on the plot of land for the benefit of someone else. The easement may be registered in favor of and restricted to a certain person/company, a limited personal easement, e.g. a tenant's right to run a retail store or a permanent right of residence. More often, easements are registered in favor of the respective owner of a plot of land, e.g. to secure a right of way or a pipe way leave. Since easements have a material impact on the value of a property because they restrict the right of use or secure an adequate use of the property, all existing or required easements should be reviewed in the course of due diligence.

c) Usufruct

A usufruct in a plot of land entitles the beneficiary to possess the land and to take the emoluments of the land and accessories, e.g. rent payments.

d) Charge on Land

Also, a plot of land may be encumbered in such a way that recurring acts of performance are to be made from the plot of land to the person in whose favor the encumbrance is created (charge on land). It is possible to agree as the content of the charge on land that the acts of performance to be made are adjusted to changed circumstances without notice if, based on the requirements stipulated in the agreement, the type and scope of the encumbrance of the land can be determined. The charge on land may be created in favor of a certain person/company or the respective owner of another plot of land. Often, a charge on land is created to ensure that credit facilities are repaid, which were concurrently agreed upon between the parties.

e) Other Land Charges

German law provides for a number of security interests in real estate. The most important security interests are mortgages and land charges, the difference being that the mortgage secures a specific debt and the land charge does not, for which reason the land charge is the preferred security interest in most transactions. They both give the beneficiary (mostly bank) the right to collect a specific sum of money by way of a forced sale or forced management of the encumbered plot of land. The transferability of a mortgage/land charge can be increased by the creation of a certificate.

4. Transfer of Title and of Leases

a) Transfer of Title

A peculiarity of German law is that in addition to the purchase agreement, a special agreement regarding the conveyance itself is required. Usually this agreement is included in the purchase agreement, i.e. seller and purchaser agree that the title of property shall pass from the seller to the purchaser (see C. IV. 4., 5.).

If the agreement regarding conveyance is concluded separately from the purchase agreement, it must be notarized like the purchase agreement itself. However, the agreement regarding conveyance must be concluded before a German notary in the physical presence of both parties, whereby either party may be represented by an agent. It can only be unconditional and must not contain any sort of time limit (however, this stipulation does not apply to the purchase agreement). The entire agreement, including the agreement regarding conveyance is valid only if the seller is the owner with unrestricted authority to dispose or a third person with authority

granted by the unrestricted owner. If the seller does not have the authority to dispose, the purchaser can only acquire the title if the seller is registered as owner in the land register and the purchaser acts in good faith (see B. III. 1. c)).

The conveyance will only become effective upon its registration in the land register, which may take a long time. However, the parties will intend to enable the purchaser to use the property as soon as possible. It is thus common practice in real estate transactions to agree that the economic ownership (transfer of possession) will be passed on earlier, irrespective of the registration of ownership in the land register but generally not before the registration of a priority notice of conveyance (see B. III. 3.) and the payment of the purchase price. This includes, *inter alia*, the right to collect rent.

The legal transfer of the lease agreements from the seller to the purchaser, however, will occur by operation of law upon the registration of the purchaser in the land register. However, this automatic transfer only applies in case the seller, owner of the real estate and landlord under the lease agreement are identical. If not, it is not sufficient to agree upon the transfer in the purchase agreement. Rather, an agreement between all three parties involved - purchaser, seller and tenant - is required. In case a lease agreement has been concluded but the premises have not yet been handed over to the tenant, the purchaser has to assume all obligations of the landlord in the purchase agreement in order to ensure a transfer of the lease. As the purchaser assumes all obligations of the landlord including the liability for any deposit made by the tenant, it should be ensured that all deposits are in fact handed out to the purchaser.

IV. Acquisition of Leveraged Loans

1. Attractiveness

Lately, portfolio companies of private equity investors are suffering from the credit crunch as the economy slows; they are prepared to breach the financial covenants of the facility agreements and struggle to find new lenders for necessary refinancing. As a consequence, the prices of leveraged loans of these companies fall well below par. This, on the other hand, attracts investors to acquire leveraged loans.

2. Necessity of Banking License

According to the German Banking Act, the acquisition of a leveraged loan does not necessarily require a banking license, so that even private equity funds may generally purchase the loans of their portfolio companies. A banking license is only needed if an entity carries out 'credit business', i.e. *inter alia*, the professional granting of loans. The acquisition of leveraged loans, the facility repayment and/or the enforcement of claims as such do not constitute 'credit businesses'. However, this might be different in the case of refinancing a loan or if a facility agreement gives the lenders certain ancillary rights, e.g. determination of new interest rates. Therefore, it is recommended to examine in each individual case whether a banking license is required for the acquisition of a leveraged loan.

3. Transfer of Loans

Under German law the transfer of a loan does not have to meet any form requirements, i.e. a loan transfer agreement can be signed on the parties' private capacity without notarization. The

transfer of a loan, however, should always be indicated to the borrower in order to avoid him making payments to the transferor with debt discharging effect.

4. Assignment Clause

Another legal aspect concerning the acquisition of a leveraged loan is the assignment clause in the facility agreement. Does the assignment clause permit the assignment of the lender's rights arising from the facility agreement to the respective acquirer of the leveraged loan? In this respect, some facility agreements restrict the potential circle of acquirers to banks and financial institutions and expressly exclude any funds or other such entities. Further, many facility agreements require the consent of the company to the change of lender which, however, may not be unreasonably withheld.

5. Specialties

If the acquirer of a leveraged loan is simultaneously the shareholder of the borrower and the lender, two main issues arise from a German legal perspective: first, the subordination of any repayment claims of the acquirer arising from the facility towards other creditors in case of borrower's insolvency and, secondly, the conflict of interests as the shareholder will be both owner of the borrower and its creditor.

a) Subordination

According to German insolvency law any outstanding shareholder loan or similar contribution is always a subordinated insolvency claim and the repayment of any shareholder loan or similar contributions within the time period of one year before filing or after filing of insolvency proceedings can be reclaimed by the insolvency administrator. Since any loan for which a shareholder is (or has once been) the creditor is treated as a shareholder loan and is therefore subject to these rules an investor must always be aware of his subordinated position in case of an insolvency of the portfolio company. However, the aforementioned rules do not, *inter alia*, apply to shareholders holding less than 10 % of the registered capital of the borrower.

b) Conflict of Interest

If the leveraged loan was granted by a syndicate and the shareholder only acquires a part of the facilities granted to the portfolio company, the shareholder might encounter a significant conflict of interest to the possible disadvantage of other creditors: On the one hand, the shareholder represents the owner of the borrower and, on the other hand, he is a part of the syndicate. Due to this conflict of interest there is a material risk that under German law the shareholder's voting rights in the lenders' syndicate might be withdrawn.

C. Transaction Procedures

I. Acquisition Procedures

Sales processes in Germany are typically set up as a private sales process or an auction process. In both cases, the seller must be well-prepared prior to starting a transaction process with one or more potential purchasers. This includes the prior identification of risks and opportunities, as well as the feasible repair of already identified deficits. Sometimes the seller decides to carry out its own vendor due diligence to get the aforementioned information about the target company in preparation for the upcoming transaction and to speed up the intended sales process.

1. Private Sales Process

a) Typical Procedures

A private sales process is characterized by a sales process with only one potential purchaser. In Germany a private sales process typically begins with a letter of intent/memorandum of understanding between seller and purchaser with respect to the intended purchase of the company, which is essentially non-binding (see C. II. 2. a)). However, the potential purchaser is interested in negotiating a binding exclusivity period prior to starting its costly due diligence work. After signing of a separate confidentiality agreement respectively a confidentiality clause within the letter of intent or the memorandum of understanding, the potential purchaser obtains the possibility to execute due diligence, including an interview with the management of the target company. After scrutinizing the company, the parties negotiate a sale and purchase agreement on the basis of the terms “agreed” upon the letter of intent/memorandum of understanding, appropriately modified by the findings from the due diligence process and the management presentation.

b) Disadvantages for Seller

The option of the seller to sell its company through a private sales process bears two major disadvantages for the seller: On the one hand, the acquisition process is necessarily terminated if the potential purchaser decides, for whatever reason, to terminate the negotiations with the seller. On the other hand, the seller is typically not in the position to facilitate the sale of its business at the highest price on the best possible terms.

c) Advantages for Seller

However, a private sales process may be less expensive than the execution of an auction process with respect to the generated transaction costs. Furthermore, only one potential purchaser will receive confidential information on the target company.

2. Auction Processes

a) Typical Procedures

An auction process is quite common to achieve a higher price by generating a higher demand with multiple potential purchasers. Consultants (e.g. an M&A consultant or an investment bank) provide its business contacts to many potential financial and/or strategic bidders and prepare a company teaser describing the company to be sold in general without any individual information identifying the target company. In case potential bidders are interested in getting more information about the target company through receipt of an information memorandum, they must first sign a separate confidentiality agreement/non-disclosure agreement. At the same time, the seller and its consultants have completely assembled the (in most cases virtual) data room with all available information on the target company (see C. III. 1.). All potential bidders who are interested in purchasing the company are invited to submit a non-binding offer letter containing a first proposal for the purchase price and answers to specific questions requested by the seller. The seller is particularly interested in how the respective bidders are financed and how they can secure the purchase price. The seller decides to grant a limited group of potential purchaser access to the already prepared data room and to the management of the target company in this second phase of the process. After execution of the due diligence and the interviews with the management, all further interested potential bidders are invited to submit a final (but also typically non-binding) letter. After evaluation of all final offer letters and comments on the sale and purchase agreements, the seller decides which potential bidder will proceed to the third phase of the auction process. Those potential purchasers will get the chance to negotiate the respective sale and purchase agreements with the seller. Sometimes, bidders request an exclusivity period in this last phase to enhance their position.

b) Disadvantages for Seller and Purchaser

The auction process is a very time-consuming and costly process. Often, the seller has to negotiate two sale and purchase agreements simultaneously at the end of the last phase of the auction process. Due to the existing demand among the potential purchasers each purchaser has to figure out which purchase price and which amendments of the sale and purchase agreement are essential to obtaining the target company.

II. Getting Started

1. Information Memorandum

In an auction process potential bidders will the first detailed information on the target company upon receipt of an information memorandum. The information memorandum generally contains business, financial, legal and tax-related facts on the company. The business description and the organization of the target company are the most important information for the purchaser. Typically, the information memorandum will be prepared by the seller together with its consultants (e.g. M&A consultant or investment bank).

2. Preliminary Agreements

a) Letter of Intent/Memorandum of Understanding

The letter of intent and the memorandum of understanding are instruments to bring together the seller and potential purchaser in a private sales process. Those (sometimes only one-sided) declarations are typically the first written documents in which the seller and potential purchaser announce their initial intention with regard to the execution of the transaction and their current negotiation results. Most statements in a letter of intent or memorandum of understanding are non-binding, unless explicitly stated otherwise.

Often such letter of intent or memorandum of understanding contains a few explicitly binding clauses regarding the granting of a period of exclusivity including legal consequences in case of a breach, a confidentiality clause, clauses dealing with the payment of costs in case of a broken deal (e.g. break up fees or reimbursement of expenses) and non-solicitation and non-competition clauses.

b) Confidentiality Agreement/Non-Disclosure Agreement

Irrespective of whether it is a private sales process or an auction process the seller is interested in having an extensive confidentiality agreement with the potential purchaser or bidder. The confidentiality agreement shall protect seller and the target company against any transfer of information resulting from the potential purchaser's access to all transaction documents (in particular to the documents in the data room). Within this context, it is important for the seller to define special terms for the confidential information, the purpose of the disclosure, as well as the disclosure and receipt of information.

III. Due Diligence

1. Purpose of Due Diligence

Generally, due diligence is a procedure in which an investor considering an investment is comprehensively provided with relevant information on and documentation of the potential target. Although sellers sometimes undertake a form of due diligence prior to a sale of assets or shares (*vendor due diligence*), most due diligence processes are conducted from a purchaser's perspective.

The major purpose of due diligence is to give the purchaser the information he needs to learn about the target and to structure the transaction. Purchasers and - in case of leveraged transactions - the financing banks need to be provided with a certain degree of comfort that material information accurately reflects the assets, liabilities and the other relevant aspects of the target. Therefore, due diligence supports the risk management of the purchaser. The seller will usually have knowledge of and information on special risks and legal issues resulting from the target, whereas a purchaser is not properly informed without due diligence. Hence, a purchaser will conduct due diligence to compensate the knowledge imbalance between seller and purchaser. Pursuant to German case law, seller is obliged to make full disclosure of all essential facts having an effect on the decision of the purchaser. Otherwise purchaser is entitled to claim for damages arising out of any violation of such disclosure obligations. If risks have

been identified, purchaser and seller usually negotiate which party is to bear these risks and the potential purchaser can decide on which terms he wants to proceed with the transaction.

2. Components of Due Diligence

Different parts of a due diligence process are usually distinguished from one another. In many cases financial, legal, tax and environmental examinations form an integral part of the due diligence. On occasion, the purchaser undertakes special due diligence investigations, for example with respect to technical matters, human resources or insurance matters. In general, the due diligence is carried out by the purchaser himself and by his legal, tax and commercial advisors.

3. Focus of Legal Due Diligence

Legal due diligence is defined as the process of gathering information and evaluating liabilities, risks and opportunities in terms of the target and its business. The topics of a legal due diligence may vary from case to case. However, the scope of a legal due diligence usually includes the following:

- corporate and commercial legal documentation of the target company,
- financing of the target company,
- material contracts (in particular leases and agreements with suppliers and customers),
- human resources,
- real estate,
- intellectual property and IT,
- litigation,
- public affairs,
- environmental issues
- insurance policies.

4. Focus of Tax Due Diligence

Tax due diligence is meant to obtain information on tax risks at target level which might result in a tax burden on the side of the purchaser, e.g. in the course of a subsequent tax audit conducted by German tax authorities. Such tax issues are not only relevant in the course of a share deal, but also in an asset deal where the purchaser may, under certain circumstances, become liable for business taxes of the assets. Moreover, tax due diligence provides details on the target with respect to a tax-efficient acquisition structure as well as post-acquisition reorganization.

5. Due Diligence Process

The due diligence process is usually conducted in cooperation with several participants, such as the management of the target company, external financial advisors, lawyers, tax advisors and other consultants. In auction processes it is quite common to provide only basic information in the beginning and to disclose more confidential information at a later stage, when some bidders

have lost interest and one of the few remaining bidders is likely to execute the transaction. However, regardless of whether the transaction is executed as a private sales process or an auction process, successful due diligence always requires close cooperation with everyone involved, including the management and the key personnel of the target.

In general, the consultants, especially tax advisors and lawyers, prepare tailored request lists and due diligence questionnaires which are delivered to the management of the target company. The requested material is usually presented for review in a data room. Especially in the case of a major transaction, due diligence is conducted in virtual data rooms presented on special internet platforms. The major advantage of a virtual data room is that many different advisors from all over the world can review the relevant documents at the same time. This is essential, in particular if a target company has important subsidiaries abroad and lawyers specializing in the relevant foreign jurisdictions must be involved in the due diligence process.

6. Due Diligence Report

The results and findings of a due diligence investigation are summarized in a report for the client. The purpose of the report is, firstly, to provide the client with detailed information about the prospective target and, secondly, to concentrate on the major findings and issues. The due diligence findings may therefore affect the preparation and negotiation of the share purchase and transfer agreement (see C. IV.). Moreover, identified risks and legal issues may impact the structure of the transaction. Therefore, it is advisable from a purchaser's perspective to complete the due diligence process before drafting the SPA, especially before drafting any representations and warranties.

In principle, due diligence reports are primarily prepared for the client. In particular, the report may only be used for the intended transaction and may not be circulated to third parties without prior approval of the advisors. The report usually contains a limitation of liability in favor of the advisor in relation to his client. The amount of this limitation depends on the volume of the transaction.

In the case of leveraged transactions, a due diligence report is normally required for the financing banks in order to receive the necessary funds for payment of the purchase price. Commonly, the permission to forward the due diligence report to financing banks is provided in a special reliance letter concluded between the advisors and the financing banks. Normally, the reliance letter contains the same liability cap in favor of the advisors which applies in relation to the client.

IV. Sale and Purchase Agreement

1. "German" vs. "Anglo-Saxon" Contracts

Traditionally, commercial contracts under German law are substantially shorter than those Anglo-Saxon investors are used to in their own jurisdictions. To a certain degree, this also applies to sale and purchase agreements (SPAs) in the mergers and acquisitions context, although the influence of Anglo-Saxon legal culture has been significant over the past two decades. "Anglo-Saxon style" SPAs are most frequent (and have become the market standard) in large and mid-cap private equity transactions, where the need for international syndication of

debt or equity instruments has a strong impact on market practice. On the other hand, comparatively short "German style" documents continue to prevail in many all-equity-financed transactions (even very large ones) and in many transactions involving typical German medium-sized companies, as well as most transactions involving insolvency receivers. Or, as the CEO of a German corporation wishing to make a mid-cap acquisition stated when confronted with the seller's five-page "German style" SPA draft: "This type of contract we use only for the very small and for the very big acquisitions."

2. Relevance of Statutory Law

The brevity of German-style documentation should not be misread as sloppiness. Rather, it should be noted that most key areas of German corporate and contract law are dominated by extensive statutes such as the German Commercial Code, first enacted on 10 May 1879, and the 2,385 sections of the German Civil Code, most of which date back to 1 January 1900. Statutory law makes many of the definitions and much of the explanatory language of Anglo-Saxon style contracts redundant (or in many cases even misleading) under German law. On items like remedies for violation of warranties, calculation of damages, contributory negligence and the like, German contracts often rely on statutory law (including long-standing case law interpreting it). On the one hand, this makes German contracts shorter and easier to read than Anglo-Saxon counterparts; on the other hand, the wording of the contract sometimes gives little guidance on practical handling issues as the wording is to be understood within the context of statutory law and general legal principles (which may or may not be known to the person actually dealing with the execution of the contract).

3. Interpretation of Contracts; Substance over Form

Principles of interpretation of contracts under German law differ substantially from common law principles. In particular, the purpose and intention of a clause is often predominant in interpretation (with results which may even be contrary to the wording, if taken literally). This explains why "boiler plate" language such as headings being for reference only, masculine terms including the feminine, plural including the singular, etc. are missing in typical German SPAs. In many cases, the parties choose German law but use English as the language of the contract. This requires great care by the lawyers involved because many standard terms in English-speaking M&A practice, such as "representations and warranties", "best knowledge" and the like, are by no means identical to the usual German counterparts or are ambiguous under German law. Such terms need to be clearly defined in the agreement in accordance with categories of German law.

4. Notarization Requirements and Fees

A peculiarity of German law is the importance of notaries public in transactional practice. Any German law agreement involving the transfer of *GmbH* shares or real property must be notarized. This means that the entire document, including any ancillary agreements related thereto and including any exhibits, which are substantially part of the agreement (other than lists and tables, as to which an exception applies) must be read aloud by or in front of the notary. Therefore, allow a whole day for "signing" of a detailed German law SPA containing many exhibits! Foreign investors often avoid this by sending their German lawyers with a power of

attorney. Note that for some purposes (such as capital increases in *GmbHs* and real estate purchases) the power of attorney itself needs to be notarized.

German notary fees are governed by a mandatory, non-negotiable fee schedule and are calculated on the basis of transaction value. Accordingly, they range from EUR 10 (e.g. for the notarization of a 200 page SPA involving the purchase of a heavily indebted *GmbH* for EUR 1) to a maximum amount of approximately EUR 55,000 (at a transaction value of EUR 60,000,000 or more, even if the SPA is only five pages long). Notary fees are customarily borne by the purchaser. In order to avoid the costly German notary fees, parties frequently "flee" to Switzerland to have SPAs notarized by Swiss notaries (who are allowed to negotiate fees in accordance with the actual work load and usually charge only a fraction of the German fees). Note that this practice is impossible for real estate transactions (for which notarization by a German notary is mandatory for the transfer of ownership) and has come under increased scrutiny with regard to *GmbH* shares following [amendments](#) of the Limited Liability Companies Act in November 2008.

5. Substantive Standards and Market Practice

In substance (although often not in style and wording) German law SPAs are similar to standards used elsewhere. When reading German SPAs, foreign investors may be confused by the distinction between the sale and the transfer which are described as two separate transactions. The "sale" constitutes the obligation to transfer the share while the transfer constitutes the actual passage of title. The same applies for the sale and the conveyance of property (see above B. III. 4.). The transfer (but not the sale) is usually subject to the condition precedent of payment of the purchase price. In cases in which antitrust filing requirements apply, the transfer (but not the sale) must be subject to antitrust clearance. A typical German SPA contains the sale as well as the transfer but the transfer may be subject to certain closing conditions. A "German closing" therefore consists of mutual acknowledgements regarding satisfaction of such conditions but no actual instrument on the transfer of title is executed upon closing.

Note that, under German law, only an *AG* may issue share certificates; titles to *GmbH* shares or *KG* interests pass by virtue of the agreement only (which is unusual for many foreign investors and makes them feel somewhat uncomfortable given that as a matter of law, neither entries in the commercial registry nor a chain of previous transfers evidenced by notarial deeds inspected in legal due diligence constitutes conclusive evidence of share ownership in a *GmbH*). [Amendments to the Limited Liabilities Companies Act](#) enacted in November 2008 have improved the status of *bona fide* purchasers relying on the share register, which can be inspected online in the commercial registry, but the recent amendments have created new legal problems with regard to possible encumbrances or seizures of shares by third party creditors between closing and publication of the transfer in the electronic commercial registry.

As in any jurisdiction, purchase price and adjustment clauses are core elements of the SPA. Since the beginning of the subprime crisis in 2007, net financial debt and working capital adjustments as of closing have become more frequent and "locked box" schemes (with fixed purchase prices determined on the basis of past figures and purchasers being protected only by restrictive covenants between signing and closing) are on the retreat.

Representations and warranties are usually as detailed and comprehensive as in most other jurisdictions. With purchasers becoming more cautious in recent months, market standards have changed; comprehensive warranty catalogues have again become standard practice (note that this is substantially different in purchases from insolvency) and liability caps are on the rise again.

V. Public Tender Offers

1. General

A particular way of acquiring control over a listed AG is through the issue of a public tender offer. In cases in which a controlling position cannot be reached merely by the purchase of block holdings in off-market transactions, a public tender offer will often be the only viable way of acquiring a majority stake in a listed company without purchases on the open market. In addition, if a private transaction or purchases on the open market cause the acquirer to reach or exceed the threshold of 30 % of the voting rights, an obligation to make an offer will result from these transactions (so-called “mandatory offer”, see G. III.). As a consequence, the acquisition of a listed company is in practice often structured as a combination of purchases on the open market, the acquisition of one or more blocks of shares in private transactions, and the issue of a public tender offer.

2. Types of Public Tender Offers

Public tender offers can be made by way of two main types of offers, namely voluntary offers and mandatory offers. Voluntary offers aiming at the acquisition of control over a company are so-called “takeover offers”. As opposed thereto, a “mandatory offer” must be made to the outside shareholders upon the acquisition of control in any way other than by a take-over bid, e.g. through an off-market purchase of shares, by way of purchase on the open market, subscription in a capital increase or a merger.

“Control” is established by directly or indirectly holding 30 % or more of the voting rights. To determine whether the 30 % threshold has been met, the voting rights directly held by a shareholder and certain voting rights imputed to him must be combined. For example, voting rights which are owned by a subsidiary of the shareholder, or voting rights which are owned by a third party for the account of the shareholder, shall be deemed to be voting rights of the shareholder. In particular, the voting rights of a third party with whom a shareholder coordinates his conduct with respect to the company are imputed to the shareholder, with the exception of agreements in individual cases ([“acting in concert”](#)). “Coordination” between the shareholder and a third party shall be deemed to exist in cases in which they agree on the exercise of voting rights or otherwise act together with the purpose of an effecting permanent and significant change to the company’s entrepreneurial approach.

3. Making the Offer and Pricing

a) Offer Procedure

Once the bidder has decided to make a takeover offer, or once the 30 % control threshold has been met, the bidder must immediately publish the decision or announce the fact that the control threshold has been met. Such publication must be made via internet and via an electronic data

dissemination system widely used by credit and financial institutions. Thereafter, as a rule, the bidder has a period of four weeks to prepare an offer document containing the full terms of the offer, and to submit the document to the German Financial Supervisory Authority ("*Bundesanstalt für Finanzdienstleistungsaufsicht*" - "*BaFin*") for verification. Upon approval of the document by *BaFin*, the bidder must immediately publish the offer. The publication marks the beginning of the acceptance period. The acceptance period may generally not be less than four and not more than ten weeks. At certain intervals during and after the expiry of the acceptance period, the bidder must publish the respective acceptance level. In the event of a takeover offer, in order to protect those shareholders, who have not accepted the offer within the regular acceptance period, there is an "extended acceptance period" of a further two weeks during which the offer can still be accepted, provided that the bidder has successfully obtained control over the company or a certain percentage of voting rights has been reached. Upon expiry of the acceptance period or, if applicable, the extended acceptance period, the transaction is settled by way of payment of the respective consideration.

b) Pricing

For both a takeover and a mandatory offer, the bidder generally has the choice between either offering to the other shareholders an adequate consideration in cash or in liquid shares which have been admitted to trading on an organized market. The consideration must at least be equal to the higher of (i) the highest consideration which the bidder, persons acting in concert with the bidder or their subsidiary undertakings have, during a period of six months preceding the publication of the offer document, granted or promised for the acquisition of shares, or (ii) the weighted average domestic stock market price of the shares during the three month period preceding the publication of the bidder's decision to make a takeover offer or of the bidder's attainment of the 30 % threshold. However, the consideration will be adjusted to a higher price if the bidder, persons acting in concert with the bidder or their subsidiary undertakings acquire further shares either during the acceptance period or, by way of an off-market transaction, within one year after the acceptance period, in case the consideration promised or granted for such shares exceeds the value of the consideration specified in the offer. An exception thereof exists for the acquisition of shares in connection with a statutory obligation to grant compensation to shareholders of the target company, e.g. after the implementation of a domination agreement or a profit and loss transfer agreement, or in the case of a squeeze-out of the remaining shareholders.

4. Typical Takeover Strategies in Germany

Both takeover offers and mandatory offers basically follow the same legal regime. An important deviation, however, is that a mandatory offer may not be made subject to conditions, whereas for voluntary offers - and thus also for takeover offers - conditions are generally permissible. In particular, a takeover offer may be made subject to the achievement of a certain acceptance level. As a consequence, in order to ensure that a certain percentage of voting rights is obtained, bidders will usually make their offer conditional upon the tender of the relevant number of shares. Most bidders try to reach a percentage of at least 75 % of the voting rights. Such majority is required for decisions with major consequences for the company, such as changes to

the articles of association, mergers, conversions, domination agreements and profit and loss transfer agreements.

Based on the fact that a mandatory offer cannot be made subject to conditions, bidders will typically try to avoid reaching the 30 % threshold. The combination of a private transaction of 30 % or more with a takeover offer, - subject to a certain acceptance level - is typically achieved by signing the private transaction *prior* to the announcement of the offer and closing the transaction *after* the announcement. In so doing, one ensures that the offer is not a mandatory offer but rather a takeover offer with conditions being thereby permissible. In addition, the offer price can be based on the price agreed upon in the private transaction, whereby the risk that the offer may become more expensive due to rising stock prices is mitigated.

As an alternative to a private transaction, it would also be possible for the seller and the purchaser to enter into an agreement in the form of a so-called "irrevocable undertaking". The seller hereby undertakes vis-à-vis the purchaser - the future bidder - to tender its shares in an upcoming takeover offer. The main commercial difference from a private transaction is that, in so doing, the seller will be amongst the shareholders tendering their shares and will thus be protected by all rules which are applicable to the offer, most importantly those with regard to any potential price adjustments as set out above.

After a successful takeover with at least 75 % of the voting rights is reached, the bidder will be able to take full control over the company, e.g. by way of implementation of a domination agreement and a profit and loss transfer agreement, by merger or - if the threshold of 95 % has been met - by way of a squeeze-out of the remaining shareholders.

D. Acquisition Financing from a German Perspective

I. Introduction

A German acquisition structure of institutional investments, as well as of strategic investments on a stand-alone-basis, regularly requires an acquisition vehicle in the legal form of a German *GmbH* purchasing the target group. Since an acquisition vehicle does not dispose of essential assets, it has to be funded with (quasi-) equity by the shareholders (i.e. equity in the form of capital reserves as well as in the form of shareholder loans) and with bank debt (i.e. senior debt, second lien loans, mezzanine debt, as well as high yield bonds) in order to be able to pay the purchase price to the seller.

The debt-to-equity-ratio mainly depends on (i) the overall market situation, (ii) the strategy of the investor, as well as (iii) the cash flow of the target group as the subsequent debt service has to be generated from the target group's operational business. In addition, banks require the granting of sufficient security by the acquisition vehicle, the target group and – so far mostly in cases of a strategic investor – by the investor.

II. Financing Process

The financing process can be generally divided into three phases: The process usually starts with a term sheet summarizing the (economic) corner-stones of the financing. The term sheet is followed by negotiations of the credit agreement and its final conclusion. On the closing date, the security agreements are executed and the funds are made available to the borrower.

III. Documentation

1. Term Sheet

If a bank is potentially willing to fund a transaction, it would provide the purchaser with a proposed structure of the acquisition financing detailed in a term sheet. The term sheet contains usually a determination of the debt- to-equity-ratio, the amount of the facilities and the essential conditions, the maturity date of the facilities, as well as the financial covenants.

2. Facility Agreements

Facility agreements throughout Europe are generally based on the standard facility agreements issued by the Loan Market Association (LMA) in London. Since 2007 the LMA is even publishing a special German law version of the LMA documents, i.e. the standard LMA documents are specifically adapted to the requirements of German law and banking practice (see D. IV.) whilst otherwise retaining the form and substance of the LMA English law documents.

In the past the acquisition financing of a German target group was – except for the security agreements – mostly governed by English law. Lenders intending to syndicate the credit facilities insisted on English law since English LMA documents were routinely used across Europe and were therefore regarded as inevitable for a smooth syndication process. As a consequence of the availability of the version of the LMA standard that is compliant with German law, more and more acquisition financing agreements are facing German law as substantive law if the target group has its headquarters in Germany. Only the largest transactions (exceeding

EUR 1 billion) are still commonly governed by English law. However, the English language continues to be the major drafting language of finance documents.

A bank or a consortium of banks financing an acquisition is normally also interested in (re-) financing the working capital of the target group. In this way, the acquisition financier can avoid other institutional lenders of the target group and hence the risk of draining money or subordinated enforcement rights. A so-called 'revolving facility' is therefore often also part of the senior facility agreement.

3. Securities

Naturally, lenders expect security for the granted facilities. In the facility agreements the security is usually only briefly mentioned, referring to the details in the security agreements. The security documents themselves provide very exhaustive documentation.

The following security structure is normally implemented for the benefit of the lenders: The acquisition vehicle usually pledges only its shares in the holding company of the target group since these are its only essential assets. The target group pledges any shares in any material subsidiary, as well as any bank accounts, and assigns all receivables, intellectual property rights, as well as current assets. So far only in the context of strategic investors, but as a consequence of the credit crunch nowadays also in the context of a financial investor, lenders also more frequently expect security in the form of payment guarantees from the respective investor itself. This, however, might have a negative tax consequences for a financial investor domiciled in Germany.

If an acquisition financing has several levels, e.g. a senior and a mezzanine facility, the loans are typically linked through so-called 'cross defaults' clauses. Once a borrower breaches any facility agreement, an event of default in the other credit agreements occurs and all lenders may accelerate – given certain grace periods – the credit lines. Therefore, the relationship of lenders and especially their ranking with regard to the proceeds from the enforcement of security generally need to be governed by an inter-creditor agreement.

IV. Specific Issues under German Corporate Law

In the case of an investment in a target group incorporated in Germany and finance documents governed by German law, acquisition financing faces – apart from tax implications, which are not discussed in this Part C. but in E– specific issues under German law as follows:

1. Prohibition of Compound Interest

According to German law, the contracting parties must not agree on any compound interest nor on the accrual of any default interest on overdue interest. Such agreements are invalid. However, creditors may claim compensation for any damages resulting from a delayed payment of interest. If therefore a borrower fails to pay interest on the due date, lenders shall claim lump sum damages on the overdue amount from the due date up to the date of the actual payment. The damages usually comprise the loss of profit the bank would have made if it had invested the amount due in the market. The borrower, however, shall be free to prove that no damages have been incurred or have not been incurred in the relevant amount.

2. Prohibition of Financial Assistance by an AG

A German AG may not give upstream or cross-stream guarantees or security to assist in the acquisition of its shares. According to German corporate law any financial assistance of an AG (or its subsidiaries) in the acquisition of shares in itself by granting security, providing a loan or making an advanced payment is – without exception – prohibited. Even the refinancing of loans used for the acquisition of shares constitutes undue support. Any assistance in acquisition of stock in a German AG by the respective target is therefore, as a rule, null and void. As a consequence, a security such as the pledge of shares of the respective target group, i.e. shares in the AG itself as well as shares in any subsidiary, or the liens on real estate for any liabilities resulting from the acquisition financing must not be granted to the lenders.

However, since the prohibition is limited to the support of the acquisition financing, a payment guarantee or an upstream security may be – subject to the ‘maintenance of capital rules’ (see D. IV. 3.) – granted by a target in the legal form of an AG for any working capital loan such as a revolving facility. For this reason, the separation of the acquisition financing from the financing of the working capital is regularly seen if the target company is an AG.

Other types of German business entities than a German AG and the rarely used KGaA, such as a German GmbH, by the way, do not fall within the scope of the prohibition of financial assistance.

3. Maintenance of Capital Rules and Limitation Language

Any corporate entity that provides upstream or cross-stream guarantees or security must comply with the German ‘rules on maintenance of capital’. These rules (indirectly) limit the financial assistance of target groups. Since they are considered to be relatively strict compared to international standards this is the most important legal issue in acquisition financing from a German perspective.

The rules on capital maintenance for an AG are more far-reaching compared to those which apply to a German GmbH or a limited partnership with a GmbH as general partner. An AG is prohibited to distribute any assets to its shareholders, unless a regular distribution is concerned or the AG and its shareholder have entered into a [domination and profit and loss agreement](#). In other words, when granting upstream and cross-stream guarantees or security, an AG must receive an equivalent benefit or a guarantee fee at the fair market value or must be the dominated company of a domination and profit and loss agreement.

Different maintenance of capital rules apply to the German GmbH or German GmbH & Co. KG. These business entities do not comply with the maintenance of capital rules, if they distribute any assets to shareholders and do not provide for the preservation of the registered share capital of the GmbH. Therefore, managing directors may not provide any upstream or cross-stream guarantees or security, if the granting or enforcement of such guarantees or security causes the net assets of the company to fall below the registered share capital. However, the German capital preservation rules only apply if the borrower, i.e. the acquisition vehicle, is a direct or indirect shareholder or an affiliate of the shareholder of the German GmbH or German GmbH & Co. KG granting the upstream or cross-stream guarantees.

Since a breach of the maintenance of capital rules of the German *GmbH* and German *GmbH & Co. KG* can potentially give rise to personal or criminal liability of the management and/or shareholders of the company (see D. V.), it is standard practice to face these rules with so-called 'limitation language' in the security documents. In view of the risk of personal liability, the lenders are prepared to accept contractual limitation language on the guarantees and security in order to limit the subsequent enforcement of upstream or cross-stream guarantees and security to the extent these are not covered by the strict rules on capital maintenance. However, the German LMA standard has not included any such language. The contracting parties must therefore negotiate the terms and conditions of the limitation language on a case-by-case basis. While a certain practice has been established in the past, there are uncertainties regarding whether this practice is still adequate in view of the latest amendments to the German Limited Liability Company Act.

4. Over-Collateralisation

According to German civil law, the granting of security is invalid by reason of acting against public policy if the lender is over-collateralized. Therefore, German standard security agreements include a clause concerning the release of security: At any time when the total value of the aggregate security granted by the borrower and/or the target group which can be expected to be realized in the event of enforcement of the security exceeds 110 % of the secured claims, the lender shall, on demand of the borrower, release such part of the security as to reduce the realizable value of the security to 110% of the secured claims.

V. Liability Risks

1. Investors

Investors may be liable for endangering a company's existence. If an investor intentionally causes the insolvency of a direct or indirect subsidiary by draining the assets of the respective subsidiary, e.g. by payments of management fees or by granting upstream securities, and the occurrence of an insolvency was reasonably likely as well as noticeable to the investor, this may result in shareholder liability for any damages of the insolvent company.

2. Management

The management of a borrower (about to breach the financial covenants of a facility agreement) faces an essential risk of (personal) liability due to the breach of a director's duty such as

- forbidden payments of (a part of) the registered capital of the company to a shareholder;
- violation of bookkeeping requirements, e.g. misleading bookkeeping;
- insufficient risk controlling concerning the business of the company;
- failure to promptly inform other cash pool parties of a negative material impact on the financial position of the company;
- failure to convene a shareholders' meeting upon the loss of 50 % of the share capital of the company.

If (due to an event of default) the insolvency of a company occurs, the management might be personal liable, especially for

- payments of the company to its shareholders that noticeably and inevitably caused the illiquidity of the company;
- careless payments of the company made after the event of illiquidity or the identification of over-indebtedness of the company;
- losses of creditors due to a delayed filing of insolvency proceedings or due to other tortuous actions.

In the very challenging situation of the occurrence of an event of default under a facility agreement, the management shall be – in order to avoid criminal liability - especially aware of the elements of a crime as follows:

- fraud, e.g. by confirming false financial covenants in a compliance certificate, especially if the company has a revolving credit line;
- violation of bookkeeping requirements or misleading financial statements;
- failure to promptly inform the shareholders of the loss of 50 % of the share capital of the company;
- delayed filing for the commencement of insolvency proceedings.

E. Taxation

I. **Basic German Tax Parameters**

The German tax system is commonly known to be complex; however, German tax rates are competitive in comparison with other developed countries. Foreign investors generally discover that the effective tax burden in Germany is lower in various cases, as individuals and entities can benefit from numerous exemptions and depreciation provisions.

Individual income tax and corporate income tax, both supplemented by a so-called “surplus charge”, are levied with respect to German residents on their worldwide income and with respect to foreign investors on their income from German sources only. Generally speaking, the German income of foreign investors includes, e.g.

- business income to the extent the business activities can be allocated to a domestic permanent establishment or a permanent agent
- rental income from domestic real estate
- (if not already included in business income:) capital gains resulting from the disposal of domestic real estate except the real estate does not qualify as business asset and was held by individual or non-business partnership for more than ten years
- income from personal services which are utilized in Germany and provided by individuals (self-employed or employed) or entities
- capital gains resulting from the disposal of shares in a German corporation (minimum share holding of 1 % at one point of time within the last five years required)
- dividends and liquidation proceeds received from German corporations
- performance-related interest income paid by German debtors and capital gains derived from the disposal of such instruments
- certain other (non-performance-related) interest income (including capital gains) if the debt instrument is registered in Germany or secured by domestic real estate.

Double taxation in Germany as well as in a foreign jurisdiction is mitigated by double tax treaties which are in place with more than 70 countries. According to the standard rules of such double tax treaties, business income and rental income is taxed in the jurisdiction in which the permanent establishment or real estate is located; capital income (interest, dividends and capital gains from the disposal of financial assets) is generally taxed in the jurisdiction of the foreign investor’s residence. In some cases of capital income, Germany has the right to levy a withholding tax.

Business income which is allocated to a German permanent establishment is also subject to a municipal trade tax at a rate of 7 % to 17.2 % (average rate approx. 14 %) depending on the location of the business.

The applicable rate in Germany for value-added tax rate is 19 %, although a reduced rate of 7 % applies to certain basic products (such as food and books), while other transactions are value-added-tax-exempt (such as transfer of shares or transfer of real estate) or non-taxable (such as

the transfer of an entire business unit via an asset deal). Input value-added tax on purchases is generally refundable if and to the extent that it is not related to value-added-tax-exempt turnover. Exports are tax-exempt, whereas input value-added tax related to such transactions can still be claimed by the entrepreneur.

1. Taxation of Individuals

a) Rates

Income of individuals generated personally or via participation in a partnership is currently (2009) taxed at a rate (including surplus charge) starting at 14.8 % (taxable income from EUR 7,835 to EUR 13,139) and proportionally increasing up to 44.3 % (taxable income from EUR 13,140 to EUR 52,551). The marginal rate for taxable income from EUR 52,552 to EUR 250,400 is 44.3 %; for taxable income of more than EUR 250,400 it is 47.5 %.

b) Flat Tax Rate

For certain categories of interest income, dividend income and capital gains [a flat tax rate](#) of 26.4 % (including surplus charge) applies ("*Abgeltungsteuer*" – "definite" tax). Expenses and costs effectively connected with such capital gain are not deductible from the flat rate tax base. The flat rate taxation is not applicable but the standard taxation applies in the following circumstances:

- The financial assets generate business income and are thus qualified as business assets.
- With respect to interest income: the borrower is a corporation and the lender holds at least a 10 % shareholding or is a related party of the borrowing corporation.
- With respect to capital gains: the shareholder has a shareholding in a corporation of at least 1 %.

The taxpayer can opt for standard taxation instead of flat rate taxation concerning dividend income in cases of

- a shareholding of at least 25 % or
- a shareholding of at least 1 % and employment by the corporation (typical MBO structure)

c) Certain Tax Exemptions

If the standard taxation applies, dividend income and capital gains resulting from a disposal of shares in a corporation are 40 % tax-exempt and 40 % of related costs are non-deductible. Interest income is not tax-exempt and related costs are fully deductible.

d) Trade Tax

Business income of an individual (sole proprietorship) is subject to trade tax, however, the trade tax burden can largely be offset from the personal income tax liability.

2. Taxation of Partnerships

a) Transparency

A partnership like a *KG* is transparent for income tax / corporate income tax purposes, thus profits and losses are taxed at the partner level. From an income tax / corporate income tax

point of view, assets, liabilities and income of a partnership are allocated to the partner in proportion to its partnership interest. However, the utilization of losses generated by a *KG* at the level of a limited partner is generally restricted to the amount of the respective committed equity.

b) Trade Tax if Business Income

If the partnership conducts business activities, the entire income of the partnership is qualified as business income (i.e. also the income from non-commercial activities) and is thus subject to trade tax on its income derived from German permanent establishments. The trade tax burden can basically be offset to a large extent from the personal income tax liability of an individual partner in proportion to its equity interest in the partnership.

c) Trade Tax Exemption in Case of Private Asset Management

Partnerships that solely conduct private asset management (generating income, dividend income, lease income and capital gains) are typically not subject to trade tax. However, a *KG* with only corporations acting as general partner and no limited partner appointed as manager is qualified as a deemed business and is therefore qualified as a commercial activity and subject to trade tax. In such a case, a deemed business designation can be avoided by appointing a limited partner as manager of the *KG*.

3. Taxation of Corporate Entities

a) Corporate Income Tax

German corporations (such as *GmbHs* and *AGs*; see B. II. 1. and 2.) are subject to corporate income tax with respect to their entire income, whereas all income qualifies as business income. Foreign corporations are subject to corporate income tax only with income generated in Germany (unless their place of management is in Germany, in this case, the foreign corporation is subject to unlimited taxation). The corporate income tax rate is 15.8 % (including surplus charge).

b) Trade Tax

Trade tax is also levied to the extent that a German or foreign corporation generates income in a German permanent establishment, regardless of the type of income.

c) Overall Rates

The overall combined tax rate for corporations is approx. 29.8 % for corporate income tax and trade tax.

d) Certain Tax Exemptions

Dividend income and capital gains from the disposal of shares held in another corporation are 95 % tax-exempt at the level of the shareholding corporation for both corporate income tax and trade tax purposes, resulting in an effective tax burden of only approx. 1.5 %. However, the exemption of dividends for trade tax purposes requires a minimum shareholding of 15 % at the beginning of the fiscal year.

e) Withholding Tax

A distribution of dividends by a German corporation generally triggers withholding tax of 26.4 % which is creditable at shareholder level (standard taxation) or equals the flat tax that is due at shareholder level. In case of a foreign corporation subject to limited tax liability in Germany, the withholding tax is reduced to 15.8 %. An exemption from withholding tax applies for distributions to a foreign EU-corporation (minimum shareholding of 10 % required). Moreover, the withholding tax can be reduced to a lower percentage or be avoided / reclaimed according to a respective double tax treaty. However, in these cases the foreign shareholding corporation needs sufficient substance to be able to benefit from of such favorable rules (for further details please see below E. III. 1.).

4. Taxation of German Real Estate Investment Trusts

As in many other countries, the establishment of Real Estate Investment Trusts is now also available in Germany. [The German Real Estate Investment Trusts Act of 2007](#) created significant opportunities for real estate holding entities and investors in German real estate. Real Estate Investment Trusts are real estate holding companies in the legal form of an AG listed at a stock exchange. The business purpose of a Real Estate Investment Trust is limited to acquiring, holding, managing by renting out and leasing, and selling real estate (or rights of use of real estate), and acquiring, holding, managing, and selling shares in real estate business partnerships. Sale-and-lease-back structures are also permitted.

a) Income Tax

Income of Real Estate Investment Trusts is exempt from income tax / corporate income tax at the entity level if certain requirements are met (such as a minimum float rate of 15 % [25 % at the time of listing] maximum individual shareholder participation of 10 %, minimum profit distribution of 90 %). However, distributions of a Real Estate Investment Trust are fully subject to taxation on the investor level (without tax exemptions) and trigger a withholding tax of 26.4 %.

b) Tax Benefits

The Real Estate Investment Trust Act provides attractive conditions for real estate owners to transfer German real estate to Real Estate Investment Trusts (under certain requirements, only 50 % of the hidden reserves are subject to taxation). This attractive exit tax is limited to transfers of real estate until the end of 2009. Thereby, Real Estate Investment Trusts may help to unlock built-in gains and to invest the proceeds tax-efficiently in the investor's core business. In any case, Real Estate Investment Trusts are an important tool available to foreign investors active in the German real estate market.

5. Real Estate Transfer Tax

a) Direct Acquisition of Real Estate

The direct acquisition of real estate (and certain rights in real estate, e.g., heritable building rights) located in Germany is subject to real estate transfer tax. Real estate transfer tax is already triggered by the legally binding agreement between the seller and the acquirer to transfer title of the real estate (i.e. the sale and purchase agreement, see C. IV. 5.).

In case of an asset deal, for real estate transfer tax purposes the taxpayers are the parties involved in such a taxable transaction, i.e. the seller as well as the acquirer owe the tax according to the wording of law. Typically, however, the parties contractually agree among each other on only the acquirer bearing the real estate transfer tax.

b) Acquisition of Shares in a Real Estate Holding Company

Real estate transfer tax also becomes due if 95 % or more of the shares in a real estate holding entity (corporation or partnership) are held in "one hand" e.g. obtained directly and / or indirectly by *one* acquirer or by controlling and dependent entities or by dependent entities only (tax group for real estate transfer tax purposes). However, partnership interests are counted by the number of partners and not by the percentage of equity interests held by the partners.

Shares in a real estate holding entity which are owned indirectly via an interposed corporation can only be allocated to an acquirer if the latter holds 95 % or more of the shares in the interposed corporation (indirect investment).

If more than 95 % of the shares in a real estate holding entity are acquired by one acquirer, such acquirer is liable for real estate transfer tax.

Depending on the circumstances, a share deal of a real estate holding corporation may be structured specifically to avoid the triggering of real estate transfer tax. For example, this could be achieved through an interposed partnership and a third party minority investor in the partnership.

c) Acquisition of Interests in a Real Estate Holding Partnership

Furthermore, real estate transfer tax becomes due if 95 % or more of the equity interests in a real estate holding partnership are transferred directly and / or indirectly to *new* partners within a five year period. For purposes of this rule, partnership interests are counted by the percentage of equity interests held by the transferring partner. In the case of an entity holding an equity interest in a partnership, this equity interest is deemed to be transferred to a new partner if 95 % or more of the shares in the entity are acquired by new shareholders (indirect investment).

The real estate holding partnership is liable for real estate transfer tax.

A share deal of a real estate holding partnership may be structured without triggering real estate transfer tax by a deferred transfer of a minimum partnership interest of at least 5 %.

d) Tax Rates and Tax Bases

Generally, real estate transfer tax is levied at a rate of 3.5 % on the tax base. However, for real estate located in Berlin or Hamburg, the tax rate is 4.5 %. In case of a sale and purchase agreement, the tax base is the agreed consideration, i.e. the purchase price. Any part of the purchase price paid for buildings is included in the tax base.

The base for real estate transfer tax levied on taxable transfers relating to real estate holding companies is a certain tax value of the real estate as determined according to the Tax Valuation Act. The tax value is usually lower than the fair market value of the real estate.

e) Acquisition Cost

For income tax / corporate income tax and trade tax purposes, real estate transfer tax is treated as part of the acquisition costs of the acquired assets and must be capitalized. Like other capitalized acquisition costs, real estate transfer tax is amortized over the standardized life of the buildings to the extent that the tax is allocable to buildings, which qualify for depreciation, and not to land.

II. Tax Structures

1. Basic Considerations

As set forth under B. I., there are generally two possibilities for the acquisition of a business:

- the purchase of (all) targets' assets (asset deal) or
- the purchase of the shares in the target (share deal).

The question of share deal versus asset deal has to be determined by taking into account all interests of both sellers and purchasers. Therefore, the identification of an appropriate transaction structure is certainly a challenge. However, usually even more challenging is the design and implementation of an optimized acquisition structure that takes into account the annual tax burden for the purchaser, as well as appropriate taxation of a subsequent exit.

From the purchaser's point of view, the following goals regarding taxation are crucial:

- tax-effective depreciation of the purchase price (step-up)
- efficient exit taxation
- utilization of loss carry forwards of the target
- deductibility of interest expenses for acquisition debt from the tax base of the target
- minimization of transaction costs (real estate transfer tax).

2. Asset Deal / Share Deal of Partnership Interests

a) Asset Deal

The acquisition of a business by a German acquisition vehicle via an asset deal is mostly more advantageous for the purchaser with respect to current taxation than to a share deal. The purchaser can directly convert the purchase price into a tax-efficient depreciation (step-up) to the extent the assets are depreciable. The purchase price is allocated to the acquired assets which are entered in the balance sheet as of the acquisition date at their fair market value including goodwill -if any- and is amortized over the useful time of life (goodwill: 15 years) of the assets: However, land can be written off only to the extent that the fair market value is permanently lower than the purchase price.

b) Acquisition of Partnership Interests

The acquisition of a partnership interest (see B. II. 3.) is basically equal to the acquisition of the assets from a seller. The same principles apply to the acquisition of partnership interests as the entity is transparent for tax purposes.

The acquisition of partnership interests permits the inclusion of certain investors' expenses in the tax calculation of the partnership income, e.g., interest expenses which arise on the partner level from the acquisition financing. From a German tax point of view, such interest expenses are allocable to the partnership. In the foreign partner's jurisdiction, however such interest expenses might be allocated to the business on the partner level and thus provide for a "double dip" of the interest expenses in Germany as well as in the foreign investors' jurisdiction. However, case law and tax authorities challenge such structures under certain circumstances.

c) Exit Scenarios

An exit from a German business investment is subject to income tax / corporate income tax at seller level and in most cases, is also subject to trade tax. For individuals selling an entire business or partnership interest a tax relief (lower income tax rate) may apply if certain requirements are met. Trade tax is not triggered if

- an individual or a partnership disposes of its entire assets or a separate business unit (the sale of the business by a corporation is subject to trade tax);
- an individual disposes of its entire partnership interest.

Due to the tax impact for the seller upon exit (taxation at full tax rate), an asset deal is often disadvantageous when compared to a share deal and therefore investments are thus more likely to be transferred by way of a share deal than by an asset deal.

With respect to a tax-efficient exit from an investment in a partnership, a tax neutral conversion of the partnership into a corporation might be favorable; however, to take full advantage of a subsequent transfer of shares in a corporation, a "cooling off" holding period of seven years must be observed.

3. Share Deal of a Corporation

The capital gain resulting from a transfer of shares in a German corporation is 95 % tax-exempt if the seller is a corporation and 40 % tax-exempt if the seller is an individual which holds at least 1 % of the shares or holds the shares as business assets. If the seller is a partnership, the taxation for income tax/corporate income tax purposes takes place on the partner level and tax exemptions depend on the status of the partner (individual or corporation); trade tax becomes due on the partnership level (if the shares are attributable to a domestic permanent establishment). However, with respect to foreign investors, a capital gain might be fully tax-exempt in Germany according to the respective double tax treaty (if the shares do not belong to a domestic permanent establishment). Thus, a transfer of shares in a corporation is preferable for the seller (also for the investor with respect to a subsequent exit from the investment).

By acquiring shares in a corporation, a step-up of the assets of the corporation does not take place, but the shares have to be capitalized at the acquisition costs (*no step-up*). Shares in a corporation are not depreciable; an extraordinary write-down is only possible if the fair market value of the shares is continuously below the acquisition costs. Such write-down is 60 % tax-effective only if the shares are held by an individual (or to the extent that an individual is partner in a partnership holding the shares) and the shares belong to German business assets.

Otherwise, a write-down is not tax-relevant. Therefore, the share deal has the result that the purchaser cannot utilize hidden reserves in the acquired business assets through depreciation.

As the acquired corporation qualifies as a separate taxpayer, additional considerations are required to match operating profits of the target corporation with acquisition debt financing costs at the purchaser level (see below E. II. 5.).

4. Loss Carry Forwards

According to German rules, tax losses in a financial year can be carried back to the previous year up to an amount of EUR 511,500 for income tax / corporate income tax purposes (not for trade tax purposes) and can further be carried forward ("*loss carry forwards*") without time restrictions (income tax / corporate income tax / trade tax). However, the utilization of loss carry forwards is limited to the "minimum taxation rule". According to this rule, a base amount of EUR 1,000,000 loss carry forward can be utilized annually without restrictions and in excess thereof only to the proportion of 40 % of the remaining positive tax base of the respective financial year.

Such loss carry forwards are of value to a legal entity, if it generates taxable profits in a subsequent financial year. However, in the course of a sale transaction, loss carry forwards usually cease to exist (or will at least be reduced). The most important rules for a forfeiture of loss carry forwards through a change of ownership are as follows:

- Asset deal: loss carry forwards cannot be transferred.
- Direct transfer of a partnership interest: trade tax loss carry forwards at the partnership level will be forfeited in proportion to the transferred percentage of the partnership equity interests. If not all partnership interests are transferred the remaining loss carry forwards can be utilized only to the extent a partner remains in the partnership (loss carry forwards for trade tax purpose are "personalized").
- Transfer of shares in a corporation: If within a period of five years more than 25 % and up to 50 % of the corporation's shares are transferred to one purchaser, related parties of such purchaser or a group of purchasers acting in concert, then the corporation's loss carry forwards (corporate income tax / trade tax) will be proportionally forfeited. In case such transfer exceeds the 50 % threshold within five years, the entire loss carry forwards will be forfeited. Both rules shall apply, irrespective of a direct or indirect transfer of the shares in the corporation.
- The same rules apply to trade tax loss carry forwards of a partnership which is held by a corporation in case the shares in the corporation are (directly or indirectly) transferred.
- Reorganization: For most reorganization procedures, such as a merger of entities, a spin-off, a contribution of a business unit in kind, a change of legal form from a corporation to a partnership and vice versa, the loss carry forwards of the transferred business unit respectively legal entity will be forfeited.

There is neither an exemption for companies to be recapitalized nor for groups. As there are no special rules for groups, the direct change of shareholders can be harmful, even if there are no indirect changes in the structure of the upper level shareholders. Consequently, restructuring

and reorganization measures within a group might negatively affect the utilization of loss carry forwards.

To avoid this consequence, the seller may realize hidden reserves before carrying out the transaction by utilizing loss carry forwards and then selling a business via a share deal with increased tax book values of the assets. Minimum taxation rules need to be considered.

A tax-efficient utilization of losses is also possible by establishing a tax group (for the requirements of a tax group please see E. II. 5.): Within a tax group profits and losses are taxed at top entity level and can thus be balanced. However, it must be taken into consideration that losses of a tax group entity (subsidiary) incurred before the time of the group taxation (loss carry forwards from former financial years) cannot be balanced with profits within the tax group. Such loss carry forwards are “frozen” at subsidiary level as long as the tax group exists.

5. Acquisition Structures

The deductibility of interest expenses for acquisition debt financing is a crucial issue in the tax structuring of acquisitions via a share deal. If the acquisition vehicle is financed with respect to the purchase price for the acquisition of the shares of the target entity, bank loans and/or shareholder loans will be provided in addition to equity capital of the investor to achieve a leverage effect. Interest expenses on the acquisition debt shall be deducted from profits of the operating target in order to reach a tax base in net terms that is as low as possible. Generally, a German acquisition vehicle is implemented to ensure that both the target entity and the acquisition vehicle, are subject to German taxation. In particular, the following tax structures are usually recommended:

- *Merger*: The acquisition vehicle and the target entity will be merged in a tax-neutral way. As a result, the interest expenses occur directly at target level.
- *Tax group*: Between the acquisition vehicle and the target a tax group (“*Organschaft*”) will be established. This requires – inter alia - that (i) the target entity is a corporation, (ii) the majority shareholder (acquisition company) is an individual or partnership conducting business activities or a corporation and (iii) a profit and loss transfer agreement for a period of at least five years is concluded. In a tax group the taxable profit of the subsidiary (tax unity corporation) is transferred and taxed at shareholder level (tax unity parent).
- *Target entity is a partnership*: The target is a business partnership or will be transformed in a tax-neutral way into a partnership (change of legal form). Interest expenses for debt financing to acquire the shares of the target partnership are then allocated to the taxable income of the partnership (see E. II. 2.). Accordingly, the interest expenses are part of the tax base of the target partnership.

6. Interest Deduction

Interest deduction for business income in Germany is limited by thin capitalization rules, especially from 2008 onwards by the so-called “[interest barrier](#)”.

As a general rule, the net interest expenses (after balancing of interest income) are deductible in the financial year of expenditure only up to 30 % of the company’s tax accounting-based EBITDA (earnings before interest, tax, depreciation and amortization).

Non-deductible interest expenses are carried forward to subsequent financial years and can be deducted, only within the limits of the interest barrier rule. Basically, the interest carry forwards will be forfeited according to the rules for a forfeiture of tax loss carry forwards (see E. II. 4.).

The interest barrier is not applicable if

- the net interest expenses (excess of interest expenses over interest income of a financial year) of a business unit are less than EUR 1,000,000 (threshold), or
- the business unit (whereby a tax group qualifies as one single business unit despite the fact that separate legal entities are included) is not (or only partially) consolidated in the consolidated financial statements of a group (IFRS, German GAAP, other EU-GAAP or even US-GAAP can be applied), or
- the business unit is fully consolidated in the consolidated financial statements of a group, but the equity ratio of the business unit on a stand-alone basis is not lower than 1 % of the equity ratio of the group in the consolidated financial statements (certain tax-related adjustments of GAAP to tax equity must be considered).

With respect to a corporation or a partnership subsidiary of a corporation, the two last exemptions above only apply if no harmful shareholder financing is in place. The financing of a stand-alone business entity is harmful if a shareholder with more than 25 % shareholding, a related party of such shareholder or a third party (e.g., bank) with recourse (back-to-back financing) to such shareholder or related party grants loans to the entity and the interest for these loans exceeds 10 % of the net interest expenses of the entity. Concerning a group entity (3 above), financing is harmful if a non-consolidated but more than 25 % shareholder of *any* group entity, or a related party or a bank with recourse to such shareholder or related party grants loans to *any* (domestic or foreign) entity belonging to the group and the interest for these loans exceeds 10 % of the net interest expenses of this specific entity.

From a practical point of view, the requirements for an escape are difficult to meet and careful tax planning is recommended.

To the extent that interest expenses are deductible for income tax / corporate income tax purposes, a 25 % add-back to the trade tax base is applicable.

7. Debt Push-Down to Foreign Subsidiaries

In some cases the interest barrier rule might limit the interest deduction in Germany. In this situation, one should consider whether a debt push-down of financing costs to foreign group entities could be beneficial. This can be achieved by cross-border intercompany loans, as well as via distributions and third party debt recapitalization of the foreign group entities.

III. Cross Boarder Aspects

1. Dividends

a) General Rule: Withholding Tax

Dividends distributed by a German corporation are generally subject to 26.4 % withholding tax which is creditable to the German income tax / corporate income tax liability of the shareholder. The withholding tax rate is reduced to 15.8 % for foreign corporations receiving dividends if the

three tests described under b) are fulfilled). Furthermore, most double tax treaties provide that (i) such dividend income is subject to taxation in the jurisdiction of the shareholder's residence only and (ii) the withholding tax is limited to a lower rate of typically 15 % or (iii) the withholding tax is even reduced to 0 % if certain conditions are met (basically, the shareholder must be a foreign corporation holding a certain minimum shareholding in the German corporation). Moreover, withholding tax does not occur if the shareholder is a non-domestic EU-based corporation with a minimum shareholding of 10 %.

b) Treaty Shopping

According to the 2007 [Tax Act](#) enacted by the German parliament, withholding tax still applies at the full rate if the shareholding corporation does not have sufficient substance (treaty override). Under these German anti-treaty- / anti-directive-shopping rules, a foreign shareholder of a German corporation will not be entitled to a reduced or zero percentage withholding tax rate upon receiving a dividend distribution if and to the extent that the foreign shareholder itself is owned by shareholders who would not be entitled to a corresponding benefit under a tax treaty or the EU directive if they would receive the dividend directly and if, in addition to this, one of the following three tests applies:

- *Business purpose test:* There is no material economic or other relevant non-tax-related reason for interposing the foreign direct shareholding entity.
- *Gross receipts test:* Not at least 10 % of the direct shareholders' aggregate gross revenue for the relevant financial year is generated from own economic activities. Dividends usually do not qualify as such own income, except the shareholding company is an active holding (involved in the business of the subsidiaries).
- *Substance test:* The foreign company does not have its own adequate business substance to engage in its trade or business.

According to these rules, foreign direct shareholders who solely perform "pure" asset management or whose business activities are conducted by related or third parties can generally not take advantage of the withholding tax relief in Germany.

The restrictions do not apply to a direct foreign shareholding corporation whose shares are publicly traded or that qualifies as an investment fund.

In order to take advantage of the withholding tax relief, the substance and activities of the foreign shareholder need careful consideration.

2. Transfer Pricing

a) General Aspects

Transfer pricing in the following refers to the pricing of transactions (tangible and intangible assets, services, funds, etc.) between affiliated companies or related parties across national boundaries. The valuation of such a transfer is of special interest for tax purposes, since the affiliated companies or related parties are separately subject to taxation in different jurisdictions. In case of such transactions, the typical market mechanisms that establish prices at arm's length between third parties may not apply.

b) Arm's Length Principle

Hence, according to the arm's length principle, *transfer pricing methods* have become the accepted approach in dealing with cross-border intercompany transactions. The arm's length principle requires that consideration for any intercompany transaction shall conform to the level that would have applied had the transaction taken place between unrelated (third) parties under similar conditions. However, different countries may accept different methods (e.g., "comparable uncontrolled price method", "resale price method", "cost plus method" or "profit split method") of calculating appropriate transfer prices.

If and to the extent that the arm's length principle is not met with respect to (national as well as international) transactions, the tax base of the respective German entity might be adjusted (at the latest in the course of a tax audit) resulting in an additional income tax / corporate income tax / trade tax burden (adjusted tax base) and additional withholding taxes (hidden profit distributions) as the case may be. Moreover, penalty charges may result.

German tax authorities basically accept the most common intercompany transfer pricing standards, in particular the comparable uncontrolled price method, resale price method and cost plus method.

c) Latent Restrictions

In 2008, significant changes to Germany's transfer pricing legislation were introduced: A "*relocation of functions*" will be deemed to have taken place when a function performed by one entity is transferred cross-border to another group entity, even if the transfer is partial or temporary. In this context, "*functions*" are defined as the aggregation of similar operational tasks, including corresponding opportunities and risks, executed by certain departments of the enterprise. Moreover, the term "*relocation of functions*" also includes the duplication of functions. Under certain conditions, an appropriate transfer price will be established based on the supplier's minimum price and the recipient's maximum price.

d) Transfer Pricing Documentation

German tax law requires that the taxpayer maintains proper transfer pricing documentation in case of intercompany cross-border transactions with regard to the type and content of his business relationships with related parties, including details on the calculation of transfer prices. For material business transactions the entity must fulfill the documentation requirements in a timely manner (6 months after end of the financial year), in other cases upon request by the tax authorities only. If no or insufficient documentation is available, the tax authorities are authorized to assume (estimate) a higher tax base at the German entity's level and, in addition, penalty payments will be assessed.

F. Management

I. **Conflicts of Interest within M&A-Transactions**

Whatever a manager does, whether he abstains from an action or tolerates certain measures, he or she must apply due care. Managers must identify and weigh pros and cons and balance conflicting interests. In this area, [German law](#) differs from general Anglo-American legal principles and practice in a distinct way. Shareholder primacy does not exist as a rule of law – the manager of a company may not only take the interests of the company’s shareholders into account. Rather, as the target’s manager is obligated to the target itself, he must consider the legitimate interests of the target and of all its shareholders (i.e. not only the interests of the shareholders) – that is employees, creditors and the general public. Even in public tender offer situations (see C. V.), the managers of the target company are arguably not strictly obliged to act like auctioneers to achieve the highest price possible for the shareholders. Managers have broad discretion, and this discretion is protected by the business judgment rule. As long as the managers decide on an entrepreneurial issue and can reasonably assume that, based on an appropriate basis of information, they are acting in the best interests of the company, the judge will not second-guess the managerial conclusion. However, a judge would consider whether a manager lawfully determined the best interests of the company, i.e. whether the interests of all corporate constituencies were taken into account and that the manager was not erroneously driven only by shareholder interests (or, worse, by his or her own interests as a present or future participation holder).

From the perspective of the managers, M&A-transactions often entail the loss of a lucrative position, either by being laid off or by being forced to work under worse conditions. This “end game” situation induces managers to evaluate alternative employment scenarios and give up some of their loyalty to the target company. Eventually, this shift of loyalty may even result in an obstruction of the entire transaction. For this reason, members of management can often be regarded as the “third party” of the transaction. From the perspective of the remaining parties, it seems reasonable to contract for the [management's loyalty](#).

II. Management Incentives

1. Transaction Bonuses by Target Company

In an M&A transaction, the management of the target company is typically granted a bonus upon exit. The amount of the bonus is between one and two annual gross salaries, on occasion it might increase dependent on the achieved purchase price. The bonus is generally paid upon closing. The bonus payment might be granted on a fully discretionary basis or may be dependent on the achievement of certain steps in an M&A transaction, e.g. establishment of an info memorandum and data room, preparation of due diligence or management presentations. In return, the management is often asked to deliver a “directors certificate” or “warranty deed”. In such declaration, management has to guarantee the seller that the management is not aware of any facts which are incorrectly stated in the vendor due diligence reports or which would lead to a breach of representation in the share purchase agreement with the potential purchaser. The liability under such certificate might be limited to the anticipated bonus payment.

In general, transaction bonuses paid by the employing company must be in an appropriate relationship to the duties of such manager and the target company’s condition. Moreover, these bonuses only have a sound legal basis if they are stipulated in the employment agreement in advance. Without such contractual basis, the bonus payments are only justified if they are paid in the interest of the company. This is deemed to be the case if, by receiving the bonus, the manager is bound to the company or if the recipient or other employees are incentivized to work for the company to achieve similar bonus payments.

With a view on the current financial crisis, salary caps must be considered. In German AGs, the supervisory board is competent to reduce payments during financial crises, while managing directors of German limited liability companies might be required to renegotiate their service agreements. If investments are made in companies which obtain governmental subsidies in accordance with the Act on the Stabilization of the Capital Market, additional restrictions apply. For instance, an annual salary exceeding EUR 500,000 may be deemed unreasonable per se. Apart from executive remuneration in general, these principles may also affect transaction bonuses.

2. Transaction Bonuses by Seller

Under German law, the supervisory board of a company is responsible for the appointment, revocation and compensation of members of the management board. Nevertheless, there are situations in which a shareholder intends to grant [financial benefits to members of the management board](#) in accordance with milestones to be achieved by the managers with respect to the company’s conduct of business. Due to the fact that such benefits are not directly granted by the employing company, they are generally called “third party bonuses“. The performance-related milestones of these bonuses enable the alignment of the manager’s conduct of business with the objectives of the third party providing the benefits. Therefore, from an economic point of view, bonuses granted by a shareholder within an M&A transaction coincide with the manager’s interest as well as the interest of the relevant shareholder, to achieve a high enterprise value for the company. However, it is disputed whether it is permissible under German law for a third

party to grant transaction bonuses to the management instead of the company. It seems reasonable to demand approval by the supervisory board or at least require that it be informed.

3. Incentives within Public Tender Offers

In public tender offer situations (see C. V.) a manager's remuneration shall also be in an appropriate relationship to the duties of such manager and the target company's condition. Transaction boni by the seller to the management arguably require approval by the AGs supervisory board or that the board must be informed of such measures. A bidder might be inclined to offer or grant benefits to managers, only for the purpose of winning the management's favor in order to gain ground in competitions among several bidders. Without good reason, the acceptance of these benefits is a violation of the manager's fiduciary duty owed to the target company and is therefore invalid pursuant to the German Takeover Act. Certain benefits, however, are allowed, provided they are "justified". While the exact meaning of "justification" in this context remains rather vague, it is acknowledged that benefits allowing for the continuation of the management's services can be permissible.

In public tender offer situations, the management is obliged to make a statement on the offer to the target company's shareholders. If an incentive causes a conflict of interest for the management, it seems reasonable to ask this manager either not to join the management's statement or to explain the nature of the conflict and to hire an expert witness. Moreover, the bidder has to state in his bidding documents details of any monetary or cash equivalent benefits for the management or the supervisory board, even if the benefits might be justified under the aforementioned terms.

4. Taxation and Social Security Contribution of Transaction Bonuses

Bonus payments are fully taxable as ordinary income at the manager's individual tax rate the maximum tax rate being 45 % (plus church taxes and surplus charge). Provided that managers are above the maximum limits by virtue of their ordinary income, no social security contributions should arise with respect to these arrangements (maximum limits are currently EUR 64,800 (West Germany) and EUR 54,600 (East Germany)).

III. Management Participation

The private equity investor aims at [aligning its own and concurrent interests](#) of the management with the interests of the target company. For this reason, the implementation of an up-to-date [Management Equity Program \(MEP\)](#) is of utmost importance in management buyouts and became a *conditio sine qua non*. For this reason, the following principles address investments of private equity investors in particular. Nevertheless, if strategic investors implement management participation programs, in general these participations follow similar rules and, to a certain extent, the following policies can be applied accordingly.

1. Structuring

a) Participation Ratios and Amounts

Management will typically invest alongside the investor via an interposed trust vehicle or partnership in the acquisition vehicle. The quote depends upon the type and size of the deal and might vary from 3 % to 25 %. 1st line managers are requested to invest one to two gross annual

salaries in addition to any potential transaction bonuses. 2nd line managers are allowed but not requested to invest between EUR 10,000 to EUR 100,000 also depending on the size of the deal and on the investment amount available to the management. In a secondary transaction management is asked to reinvest at least 50 % net of taxes of their sales proceeds.

In a typical investment scenario management could expect a money multiple of 10 and an envy ratio of 3. Money multiple means that management shall be able to receive 10 times their invested money if the business plan for the next 5 years is met and the company is sold on the same multiple as the entry multiple. Envy ratio is the ratio between the money multiple anticipated for the management and the one for the investor.

The envy ratio is accomplished by leveraging the acquisition of those shares that are acquired by the management. This leverage effect can either be achieved by a disproportionate subscription of shareholder loans or preference shares or a non-recourse loan for the managers.

b) Shareholder Agreement

The rights and obligations of the managers and the investor are stipulated in a shareholders or co-investment agreement. Such agreement includes – among others – provisions on the exit and the so-called leaver scheme. In case of an exit management is obliged to co-sell its shares with the investor (“*Drag-Along-Right*”). Vice-versa management is entitled to request to co-sell its shares if the financial sponsor partially or in total sells its shares (“*Tag-Along-Right*”). In case of corporate actions the rights of the management (subscription right, retention of the capital structure etc.) can be protected by anti-dilution-protection clauses. The allocation of any exit-proceeds follows the allocation of the shareholding in the acquisition vehicle. However, alternative liquidation preferences can be agreed upon by the parties.

c) Leaver Scenarios

Upon termination of the manager’s employment contract or upon the manager’s cessation as managing director with the target company, as well as under other specifically stipulated circumstances, the private equity investor can request the respective manager to sell and transfer his shares (call option). The manager, respectively his heirs might request upon the occurrence of certain events e.g. death, disability, retirement) the acquisition of his shares (put option). In both cases the repurchase price depends on the specific termination event. Parties distinguish between good-leaver-cases (e.g. death, invalidity, occupational disability, manager’s termination for good cause) and bad-leaver-cases (e.g. manager’s breach of duty, termination of manager’s contract by the employing company for good cause). In good-leaver-cases, the repurchase price is equal to current fair market value of his shares, subject to vesting schedules. In bad-leaver-cases the manager is only entitled to the lower of the fair market value and his acquisition costs for his shares. Vesting of the shares might be subject to time (e.g. 25 % p.a.) or performance of the target company (e.g. achievement of certain EBITDA / free cash flow targets). Payment of the repurchase price might be made upon exercise of the respective option or deferred until the occurrence of an exit.

In addition, the management’s participation might be subject to money-multiple- (e.g. 2.5 times the invested money) or IRR- (e.g. 25 % p.a.) hurdles set by the financial sponsors (*ratchet*).

2. Tax Aspects

Structuring of management incentives in Germany is, to a considerable extent, tax-driven: stock option schemes are taxed like bonus schemes, i.e. the gain recognized by management upon exit is fully taxable as ordinary income. In contrast, MEPs can be structured in order to generate favorable capital gains for managers.

For shares acquired prior to 1 January 2009 the former tax regime applies. If a manager holds less than 1 % of the stated share capital of the company, the shares can be sold free of taxes after a holding period of at least 12 months. For shares acquired after 1 January 2009 the new capital gains flat tax of 25 % (plus church taxes and surplus surcharge) applies if the shareholding is less than 1 %. If the shareholding is above 1 % the capital gain is subject to the partial income procedure, i.e. only 60 % of the gain is subject to the personal tax rate (plus church taxes and surplus surcharge).

The acquisition of shares below fair market value will trigger fully taxable ordinary income. The same applies to the whole MEP gain if the beneficial ownership in the acquired shares is denied by the tax authorities due to intensive restrictions of shareholder rights of managers, e.g. vesting, claw backs, transfer restrictions.

IV. Personal Obligations and Liability Risks of Managers in M&A-Scenarios

Managers in M&A transactions have personal obligations, the breach of which creates personal liability. This is relevant not only in private equity situations (with management participations on either one or both sides), but also between the target and its managers. Seller's or purchaser's managers and their advisors might have their own obligations and liabilities if they, for example, cause or induce a breach by the target company's managers, or if they otherwise participate in that violation (which might constitute fraud or another tort or criminal offence) or because they fail to detect or to disclose the breach.

A manager may breach his obligations by making [disclosure](#). Any disclosure of a company's data or secrets to another person might constitute a breach of confidentiality. Disclosure to a competitor is certainly a breach, and even a financial sponsor might be, or become, a competitor through another investee company. Releasing information may be a breach of third party rights, such as express or implied confidentiality obligations to customers, suppliers or employees. Disclosure can also constitute a breach of data protection laws – either industry-specific ones such as those in the financial and telecommunication industries, or general ones such as the Federal Data Protection Act.

Non-disclosure can also constitute a breach of a manager's obligations and expose the manager to liability. Generally speaking, conflicts of interest must be disclosed. For instance, direct contact between management and bidders (or contact in the absence of the seller's representatives) is forbidden, even without a special agreement to this effect, unless it is disclosed to the target and the seller.

G. Third Party Involvement

I. Antitrust Issues

1. Restraints of Competition

German competition law has undergone remarkable changes aimed at moving national law closer in line with European legislation.

The German Act Against Restraints on Competition not only covers classical cartels between competing companies (horizontal agreements) but also other anti-competitive agreements between companies which are in a supplier-customer relationship with one another (vertical agreements). Anti-competitive agreements between companies are exempted or can be exempted from the general prohibition if certain conditions are fulfilled, i.e. specific co-operation facilities of small or medium-sized enterprises may be permitted in order to equalize disadvantages in competition with powerful large-scale enterprises. Agreements which do not comply with applicable EC block exemption rules may be void altogether or with regard to specific clauses, and are in any case not enforceable.

Otherwise, there are two possibilities for the authorities to act against anti-competitive agreements. Either the authority imposes an order to end the conduct objected to in administrative proceedings or it imposes fines within the framework of administrative offence proceedings. For so-called regular fines, the maximum is ca. EUR 1,000,000. Instead, certain violations can now be punished by a fine of up to 10 % of the annual turnover of the relevant undertaking. Depending on its contribution to uncovering the cartel, a cooperative cartel member can be granted a reduction of up to 100 % of the fine imposed.

2. Merger Control

a) German Merger Control

German merger control will only apply where certain turnover thresholds are exceeded. In detail, the combined aggregate worldwide turnover in the preceding financial year must be higher than EUR 500,000,000 and at least one company must have a turnover within Germany of more than EUR 25,000,000 and a further company must have a turnover within Germany of EUR 5,000,000 or more. In this respect, the turnover includes the amounts derived from sales of products and provision of services gained by target and its affiliated subsidiaries, as well as by purchaser and its affiliated companies. If the operations of a company consist of trade in goods, only 3/4 of the turnover is taken into account. For companies operating in the media business (newspapers, magazines, broadcasting, etc.) 20 times the amount of the turnover is taken into account.

All mergers which have an effect within Germany are covered by German merger control, regardless of where the merger will be accomplished geographically.

A merger is not subject to control

- if it takes place between one company and another non-controlled company which had a world-wide turnover of less than EUR 10,000,000 (de minimis clause), or

- if a market is concerned in which goods or commercial services have been offered for at least five years and each of the product markets had a sales volume of less than EUR 15,000,000 in the last calendar year

Even the acquisition of a single built-up or undeveloped property by way of an asset deal may principally meet the merger requirements of a so-called acquisition of assets, the Federal Cartel Office, however, upholds the opinion that – for the time being – acquisitions of real property, the total value of which stays below the threshold value of EUR 5,000,000 within the business year relevant under merger law, do not constitute such an acquisition of assets, provided, however, that the total turnover achieved by the buyer from sales, leases, rental payments etc. within radius of 20 km around the acquired real property did not exceed the turnover threshold of EUR 30,000,000 during the last business year.

In case the respective legal requirements are fulfilled, the parties must file a pre-merger notification. Hereafter, the authorization of the Federal Cartel Office in Bonn either interdicts or allows the merger (limited by the imposition of obligations if necessary). After a deadline of four months, the approval is deemed to be given. Mergers must not be completed within a certain deadline.

b) European Merger Control

The procedure under the European Control Merger Regulation, comparably to German merger control, is set up as a preventative procedure. If certain turnover thresholds are met, the German companies involved in the transaction are exclusively subject to the respective EC rules.

The merger is governed by the European Control Merger Regulation if the combined aggregate worldwide turnover of the companies (as defined above) is higher than EUR 5,000,000,000 and the aggregate EU-wide turnover of each of at least two companies involved in the merger is higher than EUR 250,000,000.

Furthermore, the European Control Merger Regulation is applicable if the combined aggregate worldwide turnover of all companies involved is higher than EUR 2,500,000,000 and the following terms are complied with simultaneously:

- the aggregate EU-wide turnover of each of at least two of the companies involved in the merger is higher than EUR 100,000,000;
- the aggregate turnover of each of at least two companies involved in the merger in each of at least three of these member states is higher than EUR 25,000,000;
- the combined aggregate turnover of any company involved in the merger in each of at least three member states is higher than EUR 100,000,000.

A merger is not subject to European merger control if 2/3 of the EU wide turnover of all involved companies is made in one member state.

After filing the notification, the Commission will either make a decision to interdict the merger or declare it to be compatible with the Common Market (limited by the imposition of obligations if necessary).

As a rule approval or clearance from the merger control authorities is a condition precedent for closing in the acquisition agreement.

II. Foreign Investment Approvals

The acquisition of companies with offices or places of business in Germany is partly restricted with respect to investors with their seats or management outside the European Union (EU)/European Free-Trade Area (EFTA) on the one side and the acquisition of German war-related industries on the other side.

1. General Investment Approvals

Since 2009 each direct or indirect acquisition of at least 25 % of the voting rights of a German company by an acquirer with its seat or management outside the EU/EFTA may be [reviewed by the German Ministry of Economics \(GMoE\)](#) within three months, beginning upon conclusion of the obligation to acquire a company (see C. IV. 5.), respectively upon publication of the decision to make a takeover bid or publication of obtainment of control. If the GMoE requests the delivery of documents relating to the acquisition, it has an additional two months to issue orders or prohibit the acquisition in case the acquisition endangers the public order or security of the Federal Republic of Germany.

If no concerns exist, each acquirer has a right to issuance of a clearance certificate vis-à-vis the GMoE. The application for a clearance certificate requires a description of the scheduled acquisition and information about the acquirer and its business. The clearance certificate is considered to be granted if the GMoE has not instituted review procedures within a period of one month beginning upon receipt of the application.

2. Approvals for Acquisitions of Defense-Related Industries

In case of the acquisition of a German company which manufactures or develops military weapons, cryptographic systems or other defense-related goods the transaction must be announced to the GMoE. The notification requirement also applies in case of an indirect acquisition if a foreigner holds 25 % or more of the voting rights of the German parent acquirer.

The GMoE can prohibit such acquisition within one month after receipt of the announcement, if the prohibition is essential to protect the security interests of the Federal Republic of Germany.

III. Public Financial Control

When investing in German companies, investors are subject to various regulatory requirements, depending in particular on the kind and amount of their investment and the type of company in which they are investing. As a general rule, these requirements are applicable in cases of companies incorporated in Germany; however, in some cases they may also apply to companies whose shares are admitted for trading on a regulated market in Germany.

1. Acquisition of Shares: Notification Requirements

When acquiring or selling shares in companies admitted for trading on a regulated market as well as warrants or financial instruments which give an unconditional right to acquire shares in such companies and, in so doing, exceeding or falling below certain thresholds in voting rights (3 %, 5 %, 10 %, 15 %, 20 %, 25 %, 30 %, 50 %, 75 %), any investor has to notify the company

and the German Financial Supervisory Authority (“*Bundesanstalt für Finanzdienstleistungsaufsicht* - “*BaFin*”) without undue delay, at the latest within four trading days. Voting rights may generally not be exercised if the notification requirement is not complied with.

With effect as of 31 May 2009, any purchaser of listed shares reaching or exceeding the threshold of 10 % or any higher threshold must disclose to the issuer within 20 trading days the objects of the purchase and the source of financing, i.e. whether and to what extent means are debt or equity. Public tender offers are exempt from such disclosure, as well as purchases by investment companies regulated under the UCITS directive. The issuer is required to publish any information thus disclosed and information on all cases in which the disclosure requirement has been violated. Issuers may exclude application of the disclosure requirement in their by-laws.

When acquiring shares in AGs not listed on a regulated market and which exceed the threshold of more than 25 % of the shares, the purchaser has to notify the company, and the company has to publish such notification. No similar notification requirements apply to purchases of shares or interests in companies of other legal types, such as *GmbHs*.

2. Public Tender Offers

Any bidder making a public tender offer (see C.V) to purchase shares as a whole or in part in a company admitted to trading on a regulated market is subject to certain notification and publication requirements. An offer document in the German language must be submitted to and approved by BaFin. Additional requirements apply to takeover bids and mandatory offers in case voting rights reach or are intended to reach at least 30 %. Upon written application by the bidder BaFin may grant an exemption from the mandatory offer requirements in certain circumstances. In case of conflicting foreign rules, reliefs may be obtained with regard to cross-border purchases.

3. Control of Banks or Financial Institutions

When acquiring shares in a bank or other regulated financial services provider subject to the supervision of BaFin and, in so doing, exceeding certain thresholds in capital or voting rights (the minimum is 10 %), BaFin and the German Federal Bank (*Bundesbank*) have to be notified by the purchaser who is classified as controller of its intention to do so, including provision of evidence of the purchaser’s trustworthiness. BaFin may prohibit such purchase within three months, and may later on impose restrictions on the controller’s exercise of voting rights or require it to sell its participation.

4. Miscellaneous

With regard to listed shares, the prohibitions of insider trading and market manipulation should be observed as general rules of conduct.

The granting of loans to portfolio companies based in Germany may be subject to license requirements depending on the amount and quantity of the loan(s) granted.

Depending on the type of transaction and portfolio company there may be further regulatory requirements, such as anti-money laundering checks on investors.

IV. Pre-Emption Rights

1. Pre-Emption Rights concerning Shares

In many cases, the articles of association of certain companies contain pre-emption rights in favor of the remaining shareholders. Usually, the articles of association set out a specific time frame for the exercise of the pre-emption right. Beneficiaries must be informed prior to an envisaged transaction or immediately after the share purchase agreement has been concluded. Therefore, provisions relating to pre-emption rights must be reviewed very carefully in a due diligence process. Further, it is advisable to address this issue with the respective pre-emptors in a timely manner. In many cases, it is easy to negotiate a waiver of the respective pre-emption rights.

2. Pre-Emption Rights concerning Real Estate

The land register is only allowed to register the purchaser of a property as new owner if confirmation is provided that the municipality does not execute its pre-emption right. A municipality may have a statutory pre-emption right, e.g. in case the real estate property is located in a redevelopment area or if the property is required for other public purposes. Therefore, all purchase agreements regarding German real estate (asset deal) stipulate that the purchase price shall not fall due before the respective waiver has been issued by the municipality.

Further statutory and contractual pre-emption rights may exist, i.e. the statutory pre-emption right of a tenant to purchase his apartment in case it was converted into a separately owned condominium (see B. III. 2. c)) during the term of his lease and is now being sold for the first time. Furthermore, pre-emption rights can be freely created by contract with any third party, including municipalities. Please note, however, that the pre-emption right must be registered in the land register in order to affect a transaction. Pre-emption rights which are not registered in the land register and are therefore not obvious to a potential purchaser will only allow entitlement to damages *vis-à-vis* the other party. If registered, the pre-emption right is enforceable not only against the owner of the estate, but also any of his or her successors.

H. General Legal Frame for Investments

I. Labour Law

1. General Employment Conditions

A uniform labor law codex does not exist in Germany. The provisions of German labor law derive from different laws and are supplemented and overlaid by provisions of the employment contract, European legislation, collective labor agreements and bargaining agreements. Protection of the employees is of high importance and a multitude of acts exist concerning, e.g. working hours, maternity protection, protection against chemicals in the workplace etc. In a nutshell, one can say German labor law is highly regulated and predominantly employee-friendly.

2. Employment Contracts, Temporary Work and Social Protection

a) Employment Contracts

The majority of employment contracts are concluded for an indefinite period of time. However, employers are free to offer fixed-term contracts. German labor law stipulates several restrictions on this right. In general, a fixed term employment contract can be entered into for duration of up to two years. If the duration exceeds two years, the employer needs a special reason to justify the time limitation. Without such reason, the employment contract is valid for an indefinite term.

b) Temporary Work

Temporary work is allowed in Germany and available in nearly all industrial sectors and all kinds of jobs. A significant advantage of temporary work for the hirer is the greater flexibility compared to regular employment. The termination of temporary work contracts is independent from labor law restrictions and only subject to the contract between the hirer and the temporary work agency.

c) Social Protection

German employees are insured against illness, invalidity, age and unemployment by statutory social insurance. In general, employees and employer bear the costs in equal parts. Apart from such mandatory law the employer is free to grant additional benefits, mainly occupational pension schemes, funded only by the employer or funded by employer and employees.

3. Termination of Employment

a) Dismissal Protection and Reasons for Termination

Employees working for an employer with more than five regular employees enjoy dismissal protection: The employment contract can only be terminated for specific reasons. Therefore, termination is only admissible for personal, conduct-related or operational reasons. Dismissal for personal or conduct-related reasons requires a previous warning and is supposed to be a last resort option. Dismissal for operational reasons is based on an organizational business decision. Labor law courts are not entitled to examine this decision.

b) Social Selection

Dismissal for operational reasons is only admissible if there are no other vacant jobs within the company which the employee is capable of doing. Finally, a social selection has to be executed which means that the personal needs and social situation of potentially affected employees have to be taken into consideration. The social selection is under the control of the labor law courts.

c) Notice Period

Notice periods for termination can be found in the employment contract, in collective labor agreements or in statutory law and normally depend on the length of employment of the employee with the employer.

4. Collective Labor Law

Unions are of great importance in the German working world, especially for the determination of remuneration and other working conditions. During the last several years, German unions have become more and more willing to conclude flexible collective labor agreement to consider specific economic conditions. As a general rule, there is one union for each major sector of economy, usually mirrored by a corresponding employers association. The two sides represent the employers and employees in the periodic negotiations on collective labor agreements. Employment conditions set out in the collective labor agreement are binding for the employer, if the employer and employees are members of an employers federation or union. Some collective labor agreements allow deviations from provisions set forth therein, if the employer faces economic difficulties or other circumstances which jeopardize jobs. Employers which are not members of an employers' federation are free to agree with the employees on deviating working conditions.

5. Co-Determination of Employees

a) Workers' Council

Employees of business units of an undertaking with more than five regular employees are entitled to set up a workers' council. In case an undertaking operates more than one business unit, more than one workers' council may be established. The size of the workers' council depends on the number of employees. Workers' councils have considerable consultation and information rights, e.g. relating to such issues as dismissals, organizational changes, conditions of employment, vacation schedules etc. Further, the workers' council must be briefed by the management of the target company in the preliminary stages of the conclusion of a sale and purchase agreement, if hereby a minimum of 30 % of the voting rights of the target company are acquired. The briefing must occur in due time, namely before any decision on the deal is made. The obligation to inform does not exist if operation and business secrets of the target company are thereby endangered.

b) Supervisory Boards

Co-determination in bigger corporations is additionally realized by the election of supervisory boards. The proportion of shareholder and employee representatives depends on the branch and the number of persons employed by the company. The proportion of employee

representatives ranges between 1/3 and 1/2 (see B. II. 1. c)). The chairman of the supervisory board provided with a casting vote is always a shareholder representative.

6. Employee Transfer in Case of an Asset Deal

In case of an asset deal the employees who belong to the sold unit are automatically transferred to the purchaser if they do not object the transfer of their employment. The question of under which circumstances an employee belongs to the sold unit is not answered by law and is subject to extensive case law of the German Federal Labor Court and the European Court of Justice. A careful assessment on an individual basis is necessary to identify those employment relationships which will be transferred to the new owner.

II. Public Law Issues

1. Building and Planning Law

The general compliance of a real estate property with building and planning law has to be reviewed in the course of the due diligence of a property. Of course, any investor has to ensure that no risks with regard to building and planning law exist. In particular, there may be restrictions on the use of a property which have an impact on the investment decision, e.g. restrictions on the conversion into “luxury” real estate or on the permitted amount of rent charged in certain “underprivileged” areas. However, some aspects of planning law may not constitute a risk but may nevertheless have a material impact on the process of the transaction itself (such as the pre-emption right of a municipality, see G. IV. 2.) or even on the pricing.

a) (Re)Development Areas

Municipalities may decide that a certain area needs to be developed for the first time or that an older area needs to be redeveloped. The aims of such (re)development will be set out in a (re)development plan which is binding in nature. In the land register of the affected real estate properties, respective notice of (re)development will be registered (and may therefore be identified in course of the due diligence). The effect of such a (re)development area is that certain transactions require the prior consent of the municipality, *inter alia*:

- erection, demolition or change of use of a building, as well as material investments in a building;
- sale of a real estate property or the creation or sale of a heritable building right (see B. III. 2. d));
- creation of encumbrances, e.g. a land charge for a financing bank or easements;
- conclusion of lease agreements or other usages for a fixed period of more than one year.

Therefore, basically all transactions of interest for an investor require the prior consent of the municipality.

As all urban (re)development measures aim to improve a certain area, such measures will most likely result in an increase of the value of the affected real estate properties. This increase in value, however, is collected from the owners of the real estate properties by way of a so-called compensation payment. The amount of such payment equals the amount of the increase of the

value of the real estate property. An investor should therefore consider these costs in his investment decision.

b) Energy Performance of Buildings Directive and Green Building

Energy efficiency of buildings and the integration of renewable energies in modern architecture are becoming more and more important. There are both compulsory rules and voluntary standards.

Upon the erection or alteration of a building, an energy pass is to be issued according to the Energy Performance of Buildings Directive (EnEV 2007). EnEV 2007 is part of German building law and stipulates technical requirements for the efficient use of energy in residential and office buildings as well as in some industrial buildings.

Since 1 January 2009 owners of a building generally have to provide an energy pass for their building to potential purchasers. In case a sale or lease agreement is concluded without respective documentation the owner may be fined up to EUR 15,000. However, in case the owner does not intend to sell or lease the property, an energy pass is not required.

The German Federal Government has enacted an amendment to the EnEV 2007 on 18 March 2009 (EnEV 2009) which is reported to diminish the energy demand of buildings by 30 % in comparison to EnEV 2007. EnEV 2009 will enter into force in autumn 2009.

Besides these statutory requirements so-called “green buildings” are *en vogue*. Green buildings are generally recognized as having lower energy consumption and less environmental impact than standard buildings and combine particular design features with special materials und utility systems (ventilation, heating, water, etc.) to obtain a structure with a very low to no impact on the environment. The exact definitions may vary, but the growing number of possible green solutions and approaches that emerged led to the development of national standards for green buildings such as the Leadership in Energy and Environmental Design, Green Building Rating System developed in 2000 by the U.S. Green Building Council, the Green Star Rating System developed by the Green Building Council Australia launched in 2002 and the BREEAM in the UK provided by the United Kingdom Green Building Council launched in February 2007.

Similarly, in Germany the German Sustainable Building Council was founded in 2007 and started to certify buildings in 2009. German Sustainable Building Council has developed a German standard, also with view to EU requirements. It provides three certificates: “bronze”, “silver” and “gold”.

2. Environmental Law

a) Operating permits

It is important to clarify whether the business has obtained all operating permits that are required now and, if applicable, in the future. If the investment is to be made by way of an asset deal (see B. I.), the situation in the business with regard to permits should be examined with due care. In almost all cases, the operating permits entitle the business owners to operate the facilities and must be obtained again after the transaction. The most common permits are permits pertaining to pollution control, water rights and waste legislation, as well as such for storing and

discharging hazardous substances. The permits issued by the authorities mostly include supplementary provisions such as, for instance, limit values or deadlines that must be complied with. The business management should also pay attention to the compliance with such supplementary requirements. Otherwise, the authorities can withdraw the permit and stop operations. The operation of particular facilities may even be liable to prosecution if they are operated without the permits required by law.

b) Environmental Liability

In case of damages inflicted on the environment, there are a number of laws regulating liability. Liability for inherited pollution is the type of liability with the most practical significance. Both the user and the current and former owner of the contaminated site can be held liable for soil exploration, decontamination and protection at their own expenses. Soil contamination may result in cost-intensive excavation work and ground water impairment requiring longsome measures of protection and monitoring.

In case of business transactions it is often advisable to involve specialized companies which follow standardized procedures in the examination of environmental issues. In an initial phase, required documentation will be reviewed, the site will be inspected and persons in charge will be interviewed. Should these activities result in indications for environmental risks, technical and environmental examinations will be made in a second phase.

3. Public Procurement Law

Due to the German history, the state is the owner of a great deal of land, in particular in East Germany. Therefore, the state often appears as the seller of real estate properties. In case the state is involved, certain contracts have to be put out to tender. The violation of the public procurement law would render any respective contract void. Generally, this obligation exists only for contracts regarding the procurement of goods, building work and services. Therefore, the sole sale of land was and continues to be generally not subject to tender. However, the conclusion may change in cases where the purchaser assumes further obligations, e.g. an obligation to build. In this case, the entire transaction may be legally regarded as constituting a building order or a building concession – and thereby be subject to the obligation to put out to public tender. Recent court decisions have applied these rules inconsistently. It is therefore not entirely clear which transactions have to be, in fact, put out to tender. This causes concerns within the real estate market and many transactions involving the state are on hold. A decision of the European Court of Justice is still pending. Although the German legislator has passed a clarifying amendment of the respective German law which will presumably enter into force on March 2009, there remains a certain degree of legal uncertainty until such a decision by the European Court of Justice.

III. Investment Grants and Subsidies

Investors in Germany can benefit from numerous publicly offered incentives to all investors – regardless of whether they are from Germany or not. Funds are provided by the German government, the individual federal states, and the European Union. The support ranges from cash incentives to labor-related incentives, as well as incentives for research and development.

Cash incentives provided in the form of non-repayable subsidies make up the main components of this package. Various forms of funds may be combined.

The level of grants available depends principally on the size of the enterprise and the number of new employees. It must be taken into consideration that schemes are subject to alteration. Grants and subsidies in Germany are generally approved or allowed under certain conditions, e.g. retaining in supported industry sector, minimum number of employees for a definite period, all associated assets must remain in the manufacturing facility. The intention of these conditions is to preserve the purpose of the subsidy.

1. Subsidies in the EU

The legal and financial framework of public funding throughout Europe is provided by the European Union, meaning that public funding must meet certain criteria applicable to all EU member states. The East German states (Brandenburg, Mecklenburg-Western Pomerania, Saxony, Saxony-Anhalt, and Thuringia as well as special areas of Berlin) are supported as a “convergence region” on a high level of public funding.

2. Subsidies in Germany

Grants and subsidies from the German federal and regional governments are generally provided in the following ways:

- subsidies (some of which are repayable under certain conditions),
- loans at low interest rates (granted by various public credit institutions; maturities of between ten and twenty years; maximum amount of between EUR 500.00 and EUR 10 million, depending on the subsidy scheme),
- capital resources aid (also available from various public institutions) and
- guarantees (provided for investments in projects and equity holdings).

If the target of an investment is subsidized by any public grant or subsidy, the aid will not be granted automatically after the sale of the company. Furthermore it has to be considered that grants or subsidies must be paid back in certain cases. In case of subsidies which breach the EU framework of public funding the subsidies can be reclaimed for an unlimited period. It is possible that the investor is obliged to reimburse grants or subsidies. Hence, grants and subsidies are a considerable subject of due diligence, because reclaimable payments could be crucial risk for an investor in various scenarios.

If the development or restructuring of real estate is subsidized by any public grant or subsidy, the aid is commonly dependent on the fulfillment of specified conditions. The nature of the conditions is determined by the nature of the investment. The conditions can lead to restrictions on the permitted amount of the rental fees. They have to be met for a fixed period of time (between 5 to 30 years). Any violation of the conditions may cause the obligation of the investor to reimburse grants or subsidies. In case of the purchase of existing subsidized real state during the fixed period of time, the existing conditions commonly also apply to the purchaser. Failure to meet these conditions may cause the obligation of the purchaser to reimburse grants or

subsidies or may cause the imposition of penalties. Therefore, careful review in the due diligence process is absolutely necessary.

IV. Intellectual Property

1. Situation of Intellectual Property Rights

Germany is a member of all important international intellectual property treaties and its IP system complies with international standards concerning the types of protectable IP and the enforcement of IP rights. The German legal framework is said to be highly efficient, predictable and reliable. The protection of intangible assets has always enjoyed great importance in Germany which is, for instance reflected by Germany's ranking as no. 6 (of 134 nations) for protection of intellectual property in the [Global Competitiveness Report 2008 - 2009](#) as well as by the fact that the European Patent Office is based in Munich, Germany.

Most intangible assets enjoy protection only after registration. Technical inventions are protectable as patents (max. 20 years), utility models (max. 10 years) or as topographies (max. 10 years); only exceptionally may duration of protection be extended (for pharmaceuticals and petrochemicals for 5 years). Non-technical intangible assets enjoy protection as trademarks (renewable for 10 year terms, indefinite protection possible), designs (max.10 years) or domains (indefinite term).

However, further protection exists for intangible assets without registration, like copyright protection (until 70 years posthumously), protection of secret know-how (for the period of secrecy) and protection of trademarks / trade names by use (i.e. well-known trademarks). As Germany is an EU member, "European" IP rights exist (community trademarks and community designs) which automatically enjoy protection in Germany without a requirement for national registration.

2. Specific IP Issues in Transactions

After having identified all intellectual assets of the target (including the non-registered rights), there are specific issues that need to be observed in its acquisition.

a) Inventions

One German particularity is that an invention principally belongs to the inventor (mostly an employee) and need to be claimed by the employer (target company) *via-à-vis* the employee within a certain period to be transferred to him and the employer is obliged to remunerate the inventor under the Employee Inventions Act.

b) Copyrights

Another particularity is that the copyright as such cannot be transferred under German law (moral right) but the author may only grant rights of use and exploitation rights to the purchaser. There is no work-for hire principle in Germany, except in case of software works.

c) Transfer of rights and availability

For registered IP rights, the transfer of rights should be filed with the relevant registers even if it is not mandatory for validity of transfer (but necessary for later enforcement of rights). Another

issue is to assure availability of the relevant technology or know-how after acquisition. With regard to software, respectively IT, the crucial points are to safeguard access to and availability of customized software, as well as to assure IT disposability and data access and accordingly data protection after closing of an asset deal or sale of a separate business division.

d) Licenses

With respect to license agreements, no permit or registration is required but there are certain anti-trust issues that merit attention as they could affect validity of the agreement. Transfer of the agreement by the purchaser requires the approval of the other contractual partner.

V. Product Liability

In Germany, the manufacturer respectively the first importer to the EU, can be held liable for defects of its products that cause death or physical harm or damage other products. The German Product Liability Act is based on EU law and provides for a strict liability independent of default or a contractual relationship. Three types of product defects cause liability: design defects, manufacturing defects, and defects in marketing (improper instructions, failure to warn of latent dangers). Liability for personal harm is limited by law to EUR 85,000,000; any further limitations of liability (e.g. in T&C's) are invalid. Thus, due diligence mainly serves to identify potential liability risks that require proof of insurance coverage and can be reflected in the purchase price or in the acquisition agreement through indemnifications.

I. Acquisition of Distressed Companies

I. General

The acquisition of a distressed company is usually structured as an asset deal. In principle, this structure enables the purchaser to acquire the valuable assets only and to leave behind the liabilities.

In case of an acquisition of a distressed company, one major goal of the purchaser is to avoid legal risks. Important for this aspect is the fact of whether the transaction takes place outside or in an insolvency proceeding.

II. Acquisition outside Insolvency Proceedings

1. Challenges by the Insolvency Administrator

An asset deal transaction may be challenged by the insolvency administrator if either

- (i) the sale precedes the filing for insolvency proceedings by three months or less, (ii) the seller was unable to pay its debt when due at the time of the sale and (iii) at that time the purchaser was aware thereof; or
- (i) the sale is concluded subsequent to the filing for insolvency proceedings and (ii) at the time of the sale, the purchaser was aware of seller's inability to pay its debt when due.

Moreover, the transaction has to result in direct damages for the creditors. A challenge by the insolvency administrator is excluded if the purchaser paid fair market value by way of immediate available funds (cash transaction). In this case, purchaser must immediately pay the full purchase price to seller; in particular, no part of the purchase price must be held back by purchaser because of an escrow agreement.

In exceptional cases the insolvency administrator may challenge the asset deal transaction if the sale is concluded either within the last ten years prior to the filing of insolvency proceedings or after such filing provided that the other party had knowledge at that time of the seller's intention to harm the seller's creditors.

2. Statutory Assumption of Liabilities

In principle, the liabilities of the distressed company remain with the selling company because of the asset deal structure. However, the liabilities of the seller may pass to the purchaser by operation of law in the following cases:

- If the purchaser acquires a business and continues such business under its previous name, he assumes, by operation of law, all liabilities of the seller which have been created in the conduct of business. This assumption of liabilities can be excluded by an agreement between seller and purchaser. However, such an exclusion will only be binding on creditors (i) if they have been notified thereof, or (ii) if it has been registered in the commercial register and was officially published. If the liability of the purchaser is not effectively excluded, it is unlimited.
- Under German law, the purchaser of an entire business or of a business division becomes, by operation of law, liable for all business and withholding taxes accrued from

the beginning of the last calendar year prior to the acquisition. Purchaser's liability is limited to the acquired assets. However, the assumption of liabilities cannot be excluded by an agreement between seller and purchaser.

- If purchaser acquires a business or a part of a business, he automatically assumes all rights and obligations under the existing employment contracts.
- The acquisition of real estate can render the purchaser responsible for existing contamination and clean-up costs.
- The purchaser may be liable to repay unlawful subsidies granted to the distressed company by the European Union.
- The purchaser may be liable for a violation of competition rules of the European Union committed by the seller.

As a rule, the statutory assumption of liabilities cannot be excluded in the acquisition agreement. Nevertheless, purchaser may demand warranties or indemnifications from seller concerning the assumed liabilities. In practice, purchaser must be aware that these representations and indemnifications might be valueless, if the distressed seller is effectively unable to pay. If necessary, purchaser may look for securities, for example in form of a bank guarantee or retention of the purchase price.

III. Acquisition after Commencement of Insolvency Proceedings

In the case of insolvency the power of disposal over the property of the debtor is in the hands of the insolvency administrator. The insolvency administrator has various methods of utilization for the real estate property. These are forced sale or forced management or the open-market sale. An investor has the opportunity to acquire real estate property in the course of a forced sale or an open-market sale.

In the course of a forced sale, the property is sold to the highest bidder; consent of the debtor is not required. The costs of the forced sale are subtracted from the auction proceeds. The rest of the proceeds are distributed between the creditors which have claimed in accordance with the rankings of their respective claims. Upon the acceptance of the highest bid by the acting judicial officer, ownership of the property is transferred to the highest bidder at that point in time. All encumbrances and rights to the real estate property also terminate at that point in time; exceptions exist.

In case of an open-market sale, the property is sold by the insolvency administrator in the form of a "regular" real estate transaction. Due to the specifics of the insolvency, certain rules have to be incorporated into the property purchase agreement. In addition, an agreement with the creditors has to be drawn up in which such issues as the distribution of the proceeds and cancellation of land charges is regulated. In both cases described above, the purchaser obtains a right of termination for the existing lease agreements; exceptions exist.

1. No Risk of Challenges by the Insolvency Administrator

One of the major advantages resulting from an acquisition after the commencement of insolvency proceedings is that there is no legal risk with respect to a potential challenge of the transaction by the insolvency administrator.

2. Statutory Assumption of Liabilities

Another major advantage resulting from an acquisition after commencement of insolvency proceedings is that the pre-insolvency liabilities, including those resulting from employment contracts accrued prior to the commencement of insolvency proceedings, usually stay with the insolvent company and do not have to be assumed by the purchaser. Even the liabilities for the continuation of the business under the previous business name and the liabilities for business taxes are excluded. However, the other above-mentioned assumption of statutory liabilities (see I. II. 2.) remains unaffected from the commencement of insolvency proceedings.

With respect to the acquisition agreement, it is very difficult for the purchaser to get warranties or indemnifications. The insolvency administrator may argue that his knowledge of the insolvent business is only limited and that the existing risks are already covered by the low purchase price. One major goal of the insolvency administrator is to avoid his own personal liability. Such a personal liability may accrue if the amount left in the insolvent company is not sufficient to cover claims for warranties or indemnifications in the acquisition agreement.

J. Exit Scenarios for Investors

I. Scenarios

The scenarios of an exit can be manifold. Shares in a publicly traded company may be sold on the stock exchange or by way of a bulk sale. Shares in a privately held company can typically be sold by way of a private agreement subject to certain limitations of the articles for associations and/or a shareholders' agreement of the company.

Potential alternatives to a sale may be a true merger of a company by way of general legal succession, typically in exchange for the issuance of new shares.

An exit from an investment basically triggers capital gains tax at seller level. The tax consequences are described in E. above.

The following outlines certain provisions of typically privately held companies dealing with exit scenarios in the articles of association and/or a shareholders' agreement.

II. Management of the Exit Process

A lead investor typically wishes to agree with minority shareholders in a shareholders' agreement that the majority shareholder is in control of the exit process. Important feature is, *inter alia*, the decision on which advisors of the shareholders shall be retained in the exit process, in particular investment banks, corporate finance advisors, lawyers, accountants, etc.. The majority shareholder typically desires that "his" advisors take the lead in the process.

III. Initial Public Offering (IPO)

In times of efficient capital markets, the IPO may be a preferred exit device and the parties may contractually agree on this preference. The IPO allows the investors to behave differently with regard to their respective shareholding. Whereas certain investors seek to finally dispose of their investment within a certain time frame (e.g. private equity investors) their strategic partners may be interested in a long-term ongoing shareholder relationship with their joint target company.

It is common that the parties agree on the time horizon with regard to an intended IPO. The parties may simultaneously with the preparation of the IPO also pursue the exit by way of a trade sale ("dual track"; see J. IV.).

If the IPO happens, the shareholders will typically be subject to certain lock-up obligations, e.g. for a period of 6 to 12 months, vis-à-vis the issuing banks and/or the stock exchange. The shareholders may internally also agree on certain rules on how they may limit and prioritize any sales if any if they are not being made by way of a bulk sale, but rather through the stock exchange. Obviously, the main concern of all parties is to protect the stock purchase price in case of substantial disposal pressure.

IV. Trade Sale

The standard alternative to the IPO is the so-called trade sale, i.e. a sale of all or almost all outstanding shares in the target company, typically by way of an organized sales/auction process. Alternatively, the assets of such company and/or its subsidiaries may be sold in a third party transaction ("asset deal"). A further exit alternative may be a recapitalization by which

shareholders seek a return on their investment through one or more jumbo dividends which may be financed by the assumption of further debt by the target company. (For tax consequences please see E.).

In case of a trade sale, the minority shareholder will typically request a take-along right vis-à-vis the majority shareholder which allows the minority shareholder to co-sell its shareholding together with the majority shareholder.

The reverse side to the tag-along right is the drag-along right. The drag-along right shall secure the majority shareholders' position to sell 100 % of the target company shares, thereby generally achieving a higher purchase price. The drag-along right is typically an undertaking of the minority shareholder vis-à-vis the majority shareholder. The majority shareholder may possibly seek to protect his drag-along right by obtaining a proxy from the minority shareholder in order to smoothly effectuate the trade sales process.

The minority shareholder may seek to obtain protection regarding the drag-along rights by the majority shareholder by agreeing that the disposal

- is being made at the same conditions for the minority shareholder as the conditions agreed upon the majority shareholder;
- (in certain scenarios:) contains a minimum price (e.g. EBIT or EBITDA related) and
- may not be an intra-group transaction of the majority shareholder.

V. Other Disposals

Other disposals of shares in a privately held company are often subject to consent requirements, e.g. by the board or the shareholders and rights of first refusal of the other shareholders.

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