



Private Equity

in 33 jurisdictions worldwide

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1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction?

As the developments in the international credit markets remain disappointing, we saw very few private equity transactions in the German market throughout 2009. As a large number of private equity sponsored companies did not meet the financial covenants agreed prior to the credit crunch, most private equity funds tried to stabilise their portfolio company through a variety of instruments as injection of new capital, stand-still agreements with lenders and restructuring arrangements. Where such efforts failed, insolvency proceedings were initiated (sometimes by management even without approval of the shareholders) resulting in sales to – most often – strategic investors. Consequently, there are currently increasing numbers of transactions targeting distressed debt. However, venture capital investments seem to be nearly unaffected by the banking crisis, as they are independent from debt capital.

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or become public companies?

German companies that may be the target of private equity transactions are usually organised as stock corporations (AG), limited liability companies (GmbH) or limited partnerships (usually with a GmbH as its general partner). Companies organised as limited partnerships on shares (KGaA) remain an exception.

Corporate governance rules only directly affect listed companies and consequently only AGs and KGaAs as only shares in an AG or KGaA can be listed on a stock exchange. Indirectly, however, corporate governance rules have an influence on private equity transactions involving other companies as lending banks or private equity sponsors might have to comply with the corporate governance codex. In addition, compliance with the applicable law and the Corporate Governance Code becomes essential if an exit via IPO is intended.

A prime objective of going private is to change the corporate format of a company from an AG to a GmbH, thereby allowing greater flexibility (including with respect to financing and granting securities) and tighter control by the new owners over management. In addition, costs incurred for complying with stock exchange requirements can be avoided.

Companies that remain or become public companies following a private equity transaction will incur these additional costs plus accounting costs for large companies within the meaning of German accounting rules. Additional disclosure requirements include directors' salaries and directors' transactions in shares of the company.

3 Issues facing public company boards

What are the issues facing boards of directors of public companies considering entering into a going-private or private equity transaction? What is the role of a special committee in such a transaction where members of the board are participating or have an interest in the transaction?

If a public company (in general, an AG; see question 2) is the seller of a target, management will represent it in all negotiations with the buyer, but, owing to internal regulations, will usually need supervisory board approval to finalise the transaction. In rare circumstances, a transaction might require shareholder approval according to case law. Management will need to carefully orchestrate any disclosure of sensitive information, including standard precautions regarding confidentiality, compliance with stock exchange regulations and avoidance of insider trading.

If management is to receive additional compensation for the successful execution of the transaction, such remuneration must be approved by the supervisory board (or a special committee thereof) and must be adequate.

If a public company itself is the target of the transaction, management will first have to closely review what information can be disclosed without infringing company interests or shareholder rights. Management is well advised to coordinate all measures with the supervisory board and to obtain approving resolutions. In a takeover transaction, management (and the supervisory board) have to comment on the takeover offer and have to specifically address the following issues:

- the amount of the offer and its nature;
- the foreseeable consequences for the target, its employees and their representatives, the employment conditions and the sites of the target;
- the objectives pursued by the bidder (ie, the potential buyer); and
- the intention of management (and members of the supervisory board) to accept the offer, provided such persons hold shares in the target.

As discussed below (see question 7), all advantages offered or to be offered to management (and the supervisory board) must be disclosed. There is little actual guidance on how management has to handle potentially conflicting interests; however, disclosure of any conflicts is essential.

Under German law, management is generally precluded from taking active defensive measures against a takeover, which excludes the use of 'poison pills', etc.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

In 2008, an Act to Limit Risks Related to Financial Investments came into effect. Against the background of the increasing importance of

financial investments in capital markets, the Act aims to counteract economically undesired activities of financial investors by way of increasing transparency and improving the legal framework without affecting financial and entrepreneurial transactions that enhance efficiency. For example, the Act states that the holders of essential participations – derived from reaching or exceeding a threshold of 10 per cent of the voting rights – shall be required to disclose the purposes pursued by the acquisition of voting rights and the origin of funds used in the acquisition. However, this shall only apply if the articles of association of the target company do not provide otherwise. Further relevant disclosure issues are addressed in question 7.

Additional requirements follow from the Securities Trading Act and the Stock Corporation Act: whoever reaches, exceeds or falls below 3, 5, 10, 15, 20, 25, 30, 50 and 75 per cent of the voting rights in a listed company must notify both the company and the competent financial supervisory authority. Detailed provisions address persons acting in concert. On the other hand, if an enterprise (to be broadly interpreted) holds more than 25 per cent or more than 50 per cent in the capital of a non-listed stock corporation or whenever an enterprise falls below such thresholds, the enterprise must notify the stock corporation, otherwise the enterprise loses its rights resulting from the shares.

5 Timing considerations

What are the timing considerations for a going-private or other private equity transaction?

The Takeover Act provides for a rather detailed schedule for going-private transactions, as follows.

- Once a bidder has decided in favour of a public takeover offer, such decision must be immediately notified to the boards of any stock exchange where shares in target or derivatives thereof are listed and the competent federal office and published in designated media.
- Within four weeks of the publication of the decision, the bidder must submit a comprehensive draft offer to the competent financial supervisory authority. The offer must be published immediately once the federal office has approved the publication or once 10 working days – with a possible extension of another five working days – have expired without objections to publication by the federal office.
- The acceptance period is at least four weeks and should not exceed 10 weeks after publication. The ultimate closing will depend on clearance of the antitrust authorities.
- A bidder holding at least 95 per cent of the share capital in a target can initiate a squeeze-out through a shareholder resolution. The minimum notification period for a shareholder meeting is 30 days; however, the drafting of required documents, specifically the report on adequate cash compensation, usually takes a few months. A squeeze-out resolution can be challenged by shareholders only within a one month period (but not for inadequacy of the cash compensation); in the absence of such challenge, the squeeze-out will be registered after the expiry of this period. Any disputes on the cash consideration will be addressed by special tribunals and will not delay registration of the squeeze-out.

In other private equity transactions, timing considerations are primarily driven by financing and antitrust issues. If a seller is not willing to accept ‘subject to financing’ clauses, signing will be delayed until at least a next-to-final term sheet has been agreed upon with the lead financing banks. On German antitrust issues, the closing of the transaction must not occur prior to the expiry of one month after a required notification to the federal cartel office has been made. Within this month, the federal cartel office can initiate a full review of the transaction, to be completed within four months after notification. On European antitrust issues, the European Commission has 25 working days (35 working days in certain scenarios) to decide on the

initiation of proceedings and 90 working days (up to 110 working days in certain scenarios) to make a decision.

6 Purchase agreements

What purchase agreement issues are specific to private equity transactions?

Purchase agreements in private equity transactions do not materially differ from other purchase agreements, with the exception of ‘subject to financing’ clauses (if acceptable to seller) and material adverse change (MAC) provisions that usually tend to cover the same scope as MAC provisions in the financing documents. If the seller itself is a private equity fund (as in secondaries), the seller is not likely to give representations and warranties other than as to title. The buyer will then put greater emphasis on management giving representations and warranties (or similar instruments) on business issues. The concept of a reverse break-up fee, which forces the purchaser to pay a penalty if the transaction fails to close, is not unknown in private equity transactions in Germany. However, this concept is commonly implemented by a rescission right of the seller if the purchaser does not fulfil the conditions precedent for the closing (eg, application for antitrust clearance).

The concept of limitations on remedies for breach is two-fold: the cap for breaches of certain ‘legal’ representations and warranties (for example title, payment of stated capital) is set at 100 per cent of the purchase price, unless there are fraudulent acts committed by the seller where German law does not provide for a cap at all; and with regard to ‘commercial’ representations or warranties, we currently see a return to the previous position. While in the seller market prior to September 2008 the cap was set at anything between 15 per cent of the purchase price (rarely) to 50 per cent, the current thresholds are more likely to be anywhere between 40 per cent and 100 per cent. A separate issue are breaches of tax representations and warranties: while these were virtually uncapped in the past, the notion to include such breaches in the commercial cap gains momentum.

7 Participation of target company's management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues?

In a going-private transaction, management will usually be offered new employment agreements. Private equity sponsors try to receive shorter termination periods (which can be up to five years in an AG) in exchange for increased salaries plus substantial bonus schemes, both fixed and discretionary. In addition, management will be offered equity participation in the target or (more often) in one of the special purpose vehicles (SPVs) used in the transaction. In our experience, banks will not be willing to provide leverage without at least a term sheet being signed that specifies the basic terms of the intended management participation for key management. Provisions on (negative) time and performance vesting are standard, as well acceleration clauses. If the management participation is correctly implemented, a subsequent sale of the participation can be effected under a favourable tax regime (half of regular income tax).

Compensation of AG directors must always be adequate (to be established with a view of the best interests of the company, not its shareholders or directors; the violation of such principle might qualify as a criminal offence by the members of both the supervisory and management board). In addition, the provisions of the takeover act prevent offering unjustified advantages (in cash or in kind) to members of the management or supervisory board of the target. All advantages (including justified advantages) offered or to be offered to members of the management and supervisory board of the target must be disclosed in the takeover offer documents.

8 Tax issues

What are the basic tax issues involved in private equity transactions? Can share acquisitions be classified as asset acquisitions for tax purposes?

The most important tax issues are deductibility of interest payments on debt financing; minimising tax exposure of target; and providing for a tax-optimised exit.

The first objective requires careful review of the German thin capitalisation rules. Owing to the implementation of an earnings stripping rule, the deductibility of interest payments on debt financing has been severely limited. In general, only 30 per cent of interest expenses exceeding the interest income are deductible.

The second objective is usually achieved by tax consolidation through creating the German version of a fiscal unity between target and SPV that incurs the interest expenses. Alternative routes involve debt pushdowns, merger scenarios or both.

As capital gains trigger at least a 2 per cent tax burden, the third objective implies the interposition of a non-German corporate entity which ultimately sells the shares in the German top company (in most cases a Luxembourg entity is used).

In addition, general tax considerations consist of:

- interest on shareholder loans (the interest must be at arm's length, any excessive interest is not deductible, but qualifies as a dividend);
- non-deductibility of dividend payments, both on ordinary and preference shares;
- tax-related transaction costs like real estate transfer tax (even in share deal transactions if at least 95 per cent of the shares are united in the hands of the buyer or buyer and affiliates); and
- preservation of loss carry-forwards of target.

Because of changes in the German corporate tax rules, step-ups are almost impossible and share transactions cannot be classified as asset acquisitions for tax purposes. If, however, the target company is transparent for tax purposes (like the *Kommanditgesellschaft* – limited partnership), an acquisition of interests in the partnership always qualifies as an asset deal for tax purposes.

With regard to management participation, it is essential to minimise taxation as regular income or salary since such income is subject to full taxation. If correctly implemented, management might benefit from taxation at 50 per cent of the regular tax rates.

9 Existing indebtedness

What issues are raised by existing indebtedness at a potential target of a private equity transaction? How can these issues be resolved?

As most private equity transactions are on a 'cash or debt-free' basis, existing indebtedness is a prime factor in the calculation of the ultimate purchase price.

In addition, the buyer usually intends to repay existing debt with collateral provided by the target upon repayment (usually by granting second-tier collateral ranking behind any existing creditor). Premature repayment of existing debt might trigger penalties, however, and existing creditors rarely invoke rights of first refusal. These issues are usually settled in negotiations between the buyer, existing creditor and new creditor.

10 Debt-financing structures

What types of debt are used to finance going-private or private equity transactions? Do margin loan restrictions affect the debt-financing structure of these transactions?

Most transactions before the credit crunch included a great variety of debt instruments: senior loans provided by banks (usually in two or three tranches); mezzanine instruments provided by banks or specialised lenders, in general with equity kicker or similar remuneration;

PIK instruments; and working capital. As additional debt instruments, bonds, vendor notes, or both (or other instruments for deferred compensation) have been used. For tax reasons and subject to German thin capitalisation rules, the equity sponsor might have also provided shareholder loans. On the other hand, management participation programmes and thin capitalisation rules sometimes required the equity sponsor to provide 'debt financing' through equity instruments (preference shares).

However, since the credit crunch in September 2008, German banks have been extremely restrictive in granting any debt for private equity transactions. Hopes that the funding of private equity transactions would improve in the second half of 2009 were not fulfilled.

In going-private transactions, if the public offer contains a cash component, the offer must include the confirmation of a third-party bank that the necessary funds will be available to the bidder.

11 Debt- and equity-financing provisions

What provisions relating to debt- and equity financing are typically found in a going-private transaction? What other documents set out the expected financing?

Going-private transactions in Germany increased during the years prior to the credit crunch. As in other private equity transactions potential purchasers required a certain share of equity capital as a prerequisite for obtaining bank financing. Furthermore, the lending institutions demanded adequate securities such as share pledges and security assignments. Those securities were usually granted by the target company itself. In the course of the financing process the following documents were executed, starting with a term sheet summarising the corner stones of the financing. The negotiations of the finance agreement and conclusion of the security agreements were followed by execution of those documents together with the closing of the transaction.

As soon as the granting of loans by banks is back to normal, it is expected that the financing process will be fairly similar.

12 Fraudulent conveyance issues

Do private equity transactions involving leverage raise 'fraudulent conveyance' issues? How are these issues typically handled in a going-private transaction?

Although in theory fraudulent conveyance issues may arise in any transaction, such issues require careful review of the specific facts and circumstances. Most often, such issues are addressed in light of the rather strict German capital preservation rules protecting the stated capital and certain reserves of a company. These rules can limit the ability to grant securities to lenders. In addition, certain cash-pooling regimes have been scrutinised in light of these rules, the violation of which might result in management and shareholder liability.

13 Shareholders' agreements

What are the key provisions in shareholders' agreements covering minority investments or investments made by two or more private equity firms?

Typical private equity firms (as opposed to venture capital firms) rarely accept minority positions. If they do, however, they require board representation (supervisory board in an AG; equivalent board in a GmbH), information rights including full access to accounting documents, certain veto rights (usually against changes in the corporate documents and fundamental changes in the business of target), transfer restrictions for other shareholders, tag-along and drag-along rights and rights regarding an exit (usually the right to trigger an exit after a certain period).

14 Limitations on transaction size

Do private equity firms have limitations on the size of transactions they may engage in?

Any limitations are only based on internal rules of a specific fund. Depending on the size of the fund (or the funds in club deals), transactions of any size are possible.

Since banks are currently not willing to provide any debt and as the overall economic climate (or at least the perception of it) is only slightly improving (if at all), purchase prices have declined steeply during 2009.

15 Exit strategies and investment horizons

How do the exit strategies and investment horizons of private equity firms affect the structuring and negotiation of leveraged buyout transactions?

In general, documentation will allow for an exit through IPO as well as through sale (one-time or in tranches, trade sale or secondary sale). In addition, quasi-exits through recapitalisation are possible and becoming more popular owing to the availability of debt.

On the equity side, exit strategies and investment horizons usually have an impact on management participation programmes (vesting schedule, acceleration). Club deals usually contain provisions allowing one or more members to exit unilaterally after a certain period of time.

On the debt side, exit strategies and investment horizons influence the period of the senior debt tranches and equity kickers on mezzanine debt.

16 Principal accounting considerations

What are some of the principal accounting considerations for private equity transactions?

Accounting considerations focus on the difference between US GAAP, IFRS/IAS and German GAAP, where German GAAP forms the basis of German taxation. However, because of specific tax rules, the tax balance sheet of a German company might nevertheless differ from its German GAAP balance sheet.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

The relatively few going-private transactions do not show a specific industry sector to be the prime target of such transactions.

Other private equity transactions cover all industry sectors. The recent past has seen a significant increase in transactions involving

distressed loans and real-estate portfolios.

No such regulatory schemes would definitely preclude a private equity transaction. However, certain requirements apply in the banking sector and with regard to insurance companies (for example, the buyer must have qualified personnel). The acquisition of certain targets (eg, contractors to the Ministry of Defence) might require specific approval by the competent authorities.

18 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or private equity transaction?

A unique feature of going-private transactions is that an independent third party must confirm the availability of funds for any cash component of the offer. The third party must be a German bank or a German financial service provider, a non-German bank or financial service provider with its seat within the EEA or a non-German bank that maintains a branch in Germany with the approval of the competent federal office.

In other cross-border private equity transactions, minimising German tax exposure is key. This objective requires compliance with the thin capitalisation rules, avoidance of withholding taxes on dividends and taxation of capital gains outside Germany.

19 Club and group deals

What are the special considerations when more than one private equity firm (or one or more private equity firms and a strategic partner) is participating in a club or group deal?

According to the Act to Limit Risks Related to Financial Investments, 'acting in concert' is no longer limited to coordinating the exercise of voting rights in the shareholders' meeting. Likewise, a cooperation apart from exercising voting rights may in the future result in an attribution of voting rights, as far as the cooperation is aimed at a permanent and significant change of the issuer's entrepreneurial approach.

A takeover offer is mandatory once the members of the club or group hold 30 per cent in the aggregate of the voting rights of the target. Since 30 per cent of the voting rights can also be achieved on an 'acting in concert' basis, the Act to Limit Risks Related to Financial Investments might have an essential influence on club deals.

In any club or group deal the respective rights (and obligations) of the members need to be specified. If there is one dominant group member, the other members will seek to obtain the standard provisions necessary to protect minority rights; and the dominant member will try to ensure that, at least to some extent, the other members will vote their shares in line with the dominant member. If club or group members are equally strong, the members should carefully consider how to overcome potential deadlocks; however, private equity funds

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(like almost everybody else) are hesitant to agree on simple, but potentially dangerous devices (like 'shotgun' clauses).

20 Recent credit market disruptions

How have disruptions in the credit markets affected dealmaking?

What specific changes to transaction terms have you seen and do you expect in the future?

Since mid-2008, the private equity sector has been suffering from the credit crunch as investors struggle to find lenders. As a consequence, investors (if any) either make an all-equity deal intending to refinance the deal as soon as the credit market has improved or take

over existing liabilities of the target company, specifically existing bank liabilities at significant discounts. Specific changes to the transaction terms are especially seen in the financing documents. Lenders demand more control and more securities, such as guarantees granted by the private equity funds themselves, which can result in negative tax consequences as such funds might qualify as 'commercial' for tax purposes. The future of private equity remains to be seen. Despite hopes to the contrary, 2009 did not see a significant increase in private equity transactions. If sales were made out of insolvency scenarios, the majority of buyers were strategic investors. Highly leveraged transactions will not be seen in the foreseeable future.

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