

Germany

P+P Pöllath + Partners

Dr. Matthias Bruse & Dr. Dorothee Landgraf

1. MARKET OVERVIEW

1.1 Types of investors

The common sources from which private equity funds in Germany obtain their funding are corporate investors, private investors, public sector, banks, insurance companies, pension funds, family offices, funds of funds and capital gains for re-investments.

According to the German Private Equity and Venture Capital Association (*Bundesverband Deutscher Kapitalbeteiligungsgesellschaften*), in 2009, the main sources of funding were credit institutions (30.6 per cent), funds of funds (11.0 per cent), private investors (9.0 per cent), insurances (6.1 per cent), pension funds (4.0 per cent) and corporate investors (3.6 per cent).

Due to the German pension system, fewer pension funds exist in Germany than in other countries. Thus, pension funds have a less important role as investors in private equity funds in Germany compared to their roles in other countries.

1.2 Types of investments

According to the German Private Equity and Venture Capital Association, €2.4 billion was invested in German target companies in 2009 which is significantly less than in 2008 (€9.1 billion). Forty-eight per cent of this amount was invested in buyouts. The buyout volume totalled €1.142 billion, clearly less than the 2008 buyout volume of €6.872 billion.

Furthermore, of all transactions in which private equity funds invested in Germany during 2009, 21 per cent were growth capital, 14 per cent start-up capital, 10 per cent later-stage venture capital, two per cent seed capital and five per cent different transactions.

German investment companies invested €1.6 billion, foreign investment companies €0.8 billion of the total investment volume of €2.4 billion in Germany in 2009.

The largest portions were invested in industrial products (23 per cent), communication technology (15 per cent) and life sciences (12 per cent).

In the past, the use of equity in the above-mentioned transactions included 25-50 per cent of the total investment amount. Thus, 50-75 per cent was debt financing. Currently, the use of equity and debt financing is more balanced, about 50 per cent of each.

2. FUNDS

2.1 Fund structures

The domestic legal structure most commonly used as a vehicle for domestic private equity funds is the 'GmbH & Co. KG'. This is a limited partnership (*Kommanditgesellschaft* (KG)) with a private limited liability company (*Gesellschaft mit beschränkter Haftung* (GmbH)) as the general partner and with the investors as the limited partners. In order to establish non-business status of the partnership for German tax purposes, the partnership must have a managing limited partner, who typically is affiliated with the general partner/sponsor. The partnership is formed in accordance with the provisions of the German Commercial Code (*Handelsgesetzbuch* (HGB)).

Occasionally, other legal structures such as a limited liability company (*Gesellschaft mit beschränkter Haftung* (GmbH)), a public limited company (*Aktiengesellschaft* (AG)) or a partnership limited by shares (*Kommanditgesellschaft auf Aktien* (KGaA)) are used as a vehicle for domestic private equity funds. Under German law, a very specific investment company (*Unternehmensbeteiligungsgesellschaft*) exists (*Gesetz über die Unternehmensbeteiligungsgesellschaft*, the UBGG), but due to various constraints it is an unpopular legal form.

Beside domestic legal structures, foreign legal structures are often used as vehicles for private equity funds investing in Germany, such as limited partnerships, in particular based in Guernsey, Jersey or Delaware.

The German limited partnership has certain advantages over other legal entities, eg:

- the assignment of interests in the partnership does not require notarisational;
- the accession of new investors as limited partners is uncomplicated and cost-efficient;
- the partnership agreement is not publicly available;
- usually, no permission of the Federal Financial Supervisory Authority (*Bundesamt für Finanzdienstleistungen* (BaFin)) is necessary, only a notification to operate the partnership is required;
- the rights of the limited partners are restricted by law to certain information rights; and
- there are beneficial tax rules if the partnership is not engaged in business activities for German tax purposes.

2.2 Regulation of fund raising and fund managers

Although there have recently been political discussions in Germany about if and how far private equity funds should be regulated and supervised by the government, there are no specific domestic laws governing private equity funds.

In 2008, the Law on the Modernisation of Framework Conditions for Venture Capital and Equity Investments (*Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungsgesellschaften* (MoRaKG)) came into force. But on 30 September 2009, the European Commission concluded that parts of this law are in conflict with the freedom of establishment under

Article 43 of the EU treaty and also with the European guidelines on risk capital.

The EU commission in Brussels recently drafted a uniform European Directive of Alternative Investment Funds Managers (AIFM) dated 30 April 2009; a preliminary compromise proposal was issued last on 26 August 2010 by the Belgium Presidency of the EU council. According to the proposal, the rules of this Directive shall apply – with some exceptions – to: (i) all EU AIFM, who manage one or more alternative investment funds (AIFs) irrespective of whether the AIF is an EU AIF or a non-EU AIF; (ii) all non-EU AIFM, who manage one or more EU AIFs; and (iii) all non-EU AIFM, who market one or more AIFs to professional investors in the European Union, irrespective of whether the AIF is an EU AIF or a non-EU AIF. Under the envisaged AIFM Directive, private equity funds and their managers are likely to become subject to detailed regulations such as the authorisation of the manager, capital requirements, conduct of business, issues of valuation, instalment of a custodian, restrictions to delegate functions to third parties, transparency requirements, special disclosure and reporting requirements and requirements for managers acquiring controlling stakes in the company. It appears to be possible that the Directive will be implemented into national law in the course of 2010 or 2011.

There are currently some general regulations that can impact the marketing and operating of private equity funds. Under certain circumstances, private equity funds have the duty to publish a prospectus in accordance with the German Securities Prospectus Act (*Wertpapierprospektgesetz* (WpPG)) or the German Law on the Prospectus for Securities offered for Sale (*Verkaufsprospektgesetz* (VerkProspG)). However, since interests in private equity funds are usually not fungible securities, the Securities Prospectus Act rarely applies. It is in dispute whether a private equity fund is subject to the VerkProspG when the shares are offered to private investors. Since most of the private equity funds publish a prospectus anyway, there are usually no legal conflicts in this regard.

Domestic private equity funds and their managing partners are usually not subject to any law that requires state supervision or authorisation by any relevant financial services authority. Since 2009, due to a change in section 2 paragraph 1a no. 11 of the German Banking Act (*Kreditwesengesetz* (KWG)), a licence is required for investment administration (*Anlageverwaltung*). Investment administration is the discretionary acquisition and sale of financial instruments for a group of retail customers, provided this is the fund's main purpose and the customers participate in the instruments' performance. However, the lawmakers' explanations (*Gesetzesbegründung*) contain a clarification as to private equity funds not being subject to any licence requirements, also, if they invest in stock corporations (ie, financial instruments). It is explained that the investment strategy of a private equity fund does not consist of mere participation in the performance of financial instruments, but in particular of the monitoring of the management and the participations in the management of the target company.

Although no specific statutory law might apply to domestic private

equity funds, the funds' partnership agreements often contain provisions concerning their marketing, operation and management. For instance, the transfer of interests in the partnership may typically be conditional on the approval of the general partner.

2.3 Customary or common terms of funds

The customary or common terms of German private equity funds are similar to those in other jurisdictions. German partnership agreements typically address the same issues that investors know from, for example, Guernsey-, Jersey- or Delaware-based partnership agreements.

3. DEBT FINANCE

3.1 Restrictions on granting security

German law contains several provisions that restrict financing banks of the purchaser to use the assets of a target company to collateralise debt financing. In particular, stock corporations and private liability limited companies established under German law are subject to provisions dealing with the raising and maintenance of capital.

In a stock corporation, the contribution of a shareholder must not be returned (section 57 paragraph 1 of the Stock Corporation Act (*Aktiengesetz*, AktG)). Therefore, stock corporations are prohibited from giving any benefit to the shareholder unless it is from the profit retained or exceptionally permitted by law. Consequently, the stock corporation must usually not give any loans to shareholders or other securities to collateralise loans of a shareholder for the purpose of acquiring shares of the stock corporation by such shareholder.

In a private limited liability company, the regulations of raising and maintaining capital are less strict. However, according to section 30 of the Limited Liability Company Act (*Gesetz betreffend die Gesellschaft mit beschränkter Haftung* (GmbHG) the stated share capital (*Stammkapital*) must not be paid out to the shareholders. Thus, loans to the shareholders are forbidden if the redemption claim is not fully adequate and the stated share capital is affected by it. These capital maintenance rules, however, do not apply to shareholders with whom the GmbH has entered into a domination and profit and loss transfer agreement.

Section 30 of the Private Limited Liability Company Act also applies analogue to a GmbH & Co. KG.

If the target company is a general partnership (*offene Handelsgesellschaft* (OHG)) or a limited partnership, the use of the assets of the target company as collateral for debt of a partner is not directly addressed by law but may be limited under the provisions of the partnership agreement

3.2 Inter-creditor issues

Similar to other jurisdictions, inter-creditor agreements determine the ranking of claims of different creditors. Such an agreement may, *inter alia*, address the following issues:

- declarations of some creditors to subordinate their claims to other creditors' claims;

- prohibition for junior creditors to amend or change their loan agreements with the banks to the detriment of the senior creditors;
- declarations by junior creditors not to satisfy their claims unless the senior creditors' claims are executed – usually, the accruing interest is exempt from this provision;
- suspension of some rights of junior creditors until the fulfillment of the senior creditors' claims, such as the termination of credit contracts, the prohibition of an offset or a debt settlement, or to file for insolvency;
- warrant of special rights to the senior creditors in the case of insolvency of the debtor or the guarantor;
- duty of senior creditors to sweep payments wrongly received; and
- sole power of enforcement of the security trustee and the use of the proceeds by the security trustee.

When formulating inter-creditor agreements, section 489 paragraph 4 of the German Civil Code (*Bürgerliches Gesetzbuch* (BGB)) should be considered. According to this provision, the debtor's right of termination may not be excluded or impaired by contract.

3.3 Syndication

Credit institutions commonly syndicate their loans during or after a transaction.

The legal structure of syndication with a third party is usually the partial assumption of rights and obligations under a facility agreement from the old creditor to the new creditor. The assignment of loan claims to a new creditor is permitted by law, but might be limited by the terms of the loan agreement.

In the case where the loan is assigned to another credit institution that already participates in the consortium, this is legally considered an amendment of the agreement and thus needs the permission of all parties. Often the agreement already provides the permission for these types of syndications.

To simplify syndications, many loan agreements between banks and debtors are drafted in accordance with the standards of the Loan Market Association (LMA). The LMA developed a sample loan agreement in accordance with German law. This results in loans which are subject to German law being more fungible.

3.4 Alternative means of financing

Most transactions include a great variety of debt instruments: senior loans provided by banks, second-lien loans, mezzanine instruments provided by banks or specialised lenders in general with equity kickers or similar remunerations, and payment in kind (PIK) instruments.

If the financial structuring is only possible after the transaction, senior loans can be provided as working capital facilities or bridge loans.

Mezzanine finance is usually structured as a junior loan. Alternatively, other forms of mezzanine finance are used, such as vendor loans, usufruct rights (*Genussrechte*), silent participations and bonds, including high-yield bonds in large transactions.

In general, since the credit crunch hit in September 2008, German banks have been rather restrictive in granting debt financing for private equity transactions.

4. EQUITY STRUCTURES

4.1 Role of management

Managers typically enter into individual service agreements with the target company. In their individual service agreements, and frequently also in the shareholders' agreement, restrictive covenants on non-compete, non-solicitation and confidentiality, both contractual and post-contractual are imposed on the management. Target company managers additionally owe non-contractual, fiduciary duties (*Treuepflichten*) to the company, for example confidentiality and non-compete obligations. In general, managers must act in the best interest of the company.

The managers' service agreements often provide for variable payments. The payments usually depend on the performance of the target company or the individual performance of the manager. For determining these payments, the payments may be related to key financial figures such as earnings before interest, taxes, depreciation, and amortisation (EBITDA) or the economic value added, or to the fair market value of the target company.

In order to ensure that the target company managers and the investors have a parallel interest in the target company, the target company managers are often granted equity participations in their target company (management participation programme).

In addition, the managers' service agreements or a shareholder agreement usually provide for certain exit scenarios such as drag-along rights, tag-along rights, lock-up and good leaver/bad leaver provisions.

4.2 Common protections for investors

A private equity fund commonly seeks to receive statutory and contractual control over the activities of the target company.

Since the private equity fund is typically the majority shareholder of the target company, it controls the target company and its managers. If the target company is structured as a GmbH, the shareholders can largely instruct the managing directors to take or refrain from taking certain measures. The shareholders can also remove the managing director at any time.

The management of the target company is often bound by rules of procedure. These rules subject certain business activities to the prior consent of the shareholders' meeting or, if any, the shareholder's committee.

If contractually agreed, delegates of the private equity funds can take seats in the target company's body, such as in the supervisory board, the advisory board or the shareholders' committee.

Due to German corporate law, the corporation's articles must be filed with the commercial register and are open to the public. Thus, protective provisions are often inserted into a confidential private shareholders' agreement and not into the articles of association itself. For example, drag-

along rights are a typical device used by a private equity fund to secure its exit options *vis-à-vis* management.

4.3 Common protections for management

The management usually benefits from an equity participation in the target company as mentioned above. Such equity participation may be direct or indirect through a common vehicle which pools the interests of management and which is controlled by the private equity investor.

The shareholder rights of managers are typically limited. Their shares in the acquisition vehicle may be non-voting. If they have voting shares, they may typically have little or no veto position with regard to substantial decisions to be taken by the private equity investor.

However, certain protection may be granted, eg, with regard to anti-dilution protection of management, in particular with respect to future financing and/or refinancing (recaps).

Furthermore, the management will typically be granted a take-along right as the corresponding right to the drag-along obligation *vis-à-vis* the private equity investor.

4.4 Management warranties

Private equity funds usually request comprehensive protections from the sellers and management through warranties which cover all relevant aspects of the target company. While sellers' warranties usually include information about the past and the current business, management warranties may also refer to the future development of the target company.

The management of the target company usually develops a business plan prior to the transaction. Therefore, the investors may expect that the management guarantees that the business plan was prepared thoroughly and in due manner. However, it is typically not expected to be warranted to reach the goals of the business plan. Besides the business plan, manager warranties can also reference other information provided by the management such as management presentations, due diligence documents, vendor due diligence reports or buyer due diligence reports if known to the management.

By receiving these management warranties, investors attempt to obtain complete and correct information prior to the purchase of the target company. The damage compensation in the case of a breach of such warranties is usually limited to the amount of the participation of the respective managers in the company, and the private assets of the manager are usually not affected or only affected to a limited degree. Claims based on a warranty breach are usually subject to the statute of limitation, typically 12 to 24 months following the transaction. Legal proceedings concerning the breach of management warranties are rare.

Furthermore, investors can request the management to give warranties in the case of an exit. For example, investors can oblige the management to give a list of concrete warranties related to the actual conditions of the target company at the time of the exit. In the case of a breach of such warranties,

the partnership agreement usually limits the liability of the management to a certain amount of the exit revenues of the responsible management.

Investors can also impose other obligations on the management such as prohibitions of competition or lock-up agreements and selling restrictions.

4.5 Good leaver/bad leaver provisions

Investors generally intend to financially associate the management with the company. Hence, the management participation programmes often provide provisions concerning the compulsory transfer of the manager's shares if the manager ceases to be active for the company. In this case, the investors or other managers receive a call option for the manager's shares limited to a certain period after the manager leaves the company. Call options are usually installed for the possibility that the manager terminates their service contract or their actual position in the target company but they can also be determined in the case that the manager becomes insolvent or execution measures are taken against them.

It is debated whether such a call option is valid. An arbitrary right of squeeze-out may be void. However, the German Federal Court (*Bundesgerichtshof*) decided that a squeeze-out can be effective if it is justified in specific circumstances. Thus, it is recommended to include the reasons for the time limits of the manager's position as shareholder in the articles of association or in the manager's service agreement. The manager's acquisition of shares in the target company would be defined to be in connection with their position as manager, and without the employment relationship, no shares of the company would have been acquired.

The management participation programmes in Germany usually determine the amount payable to the leaving manager dependent on fault. A 'good leaver' is commonly a manager who leaves the company because of retirement, death, disability or termination without fault of the manager. A 'bad leaver' departs because of termination through the company with good cause or termination by the manager themselves during a specified initial period.

The calculation of a manager's compensation often depends on the acquisition costs and the market value of any shares acquired by the manager as part of the transaction or management contract. A good leaver usually receives the market value of their shares; a bad leaver typically receives the lower of acquisition costs of the shares and fair market value. Under German corporate law, compensation clauses that do not consider the market value of the shares are not always enforceable. In particular, courts have decided that clauses may not be valid if they provide compensation only in the amount of the book value of the company. Such jurisprudence should be considered when formulating good leaver/bad leaver provisions. Furthermore, compensation clauses could be found to be void if, at the time of the agreement, the market value of the shares clearly exceeded the amount of the compensation. If compensation clauses are valid at the time of the agreement but invalid at the time of the departure of the manager, courts may also adjust the compensation clauses.

For the determination of the amount of the compensation, other parameters than the good leaver/bad leaver provisions may be taken into account such as time vesting or performance vesting.

4.6 Public to private transactions

Public to private transactions are still uncommon in Germany, although the number of such transactions in Germany had slightly increased before the credit crunch in 2008. The complexity of public to private transactions is often perceived to be disproportionate to the commercial benefits for the investors.

Going-private transactions often involve a transformation of the legal form from a stock corporation to a limited liability company and thereby permitting greater flexibility and tighter control by the new owners over management. Additionally, costs for complying with stock exchange requirements can be avoided.

Another important device for a public to private transaction is the domination and profit and loss transfer agreement. This instrument allows the majority shareholder to control the management of a publicly listed stock corporation, including the right to give specific instructions to management regarding certain business transactions. In deviation from the standard model, the management of the stock corporation loses its relative independence *vis-à-vis* its shareholders. Both a transformation, as well as a domination and profit and loss transfer agreement, require a mandatory tender offer to acquire the shares from minority shareholders under corporate law rules.

Prior to the above, public to private transactions are typically affected by the Takeover Act of 2002 (*Übernahmegesetz* (WpÜG)). This Act regulates all public offers whereby a bidder wishes to acquire substantial stakes in a publicly listed target company. Thus, it provides a detailed schedule for the going-private transaction, for example, provisions such as how a bidder can make an offer to acquire shares of a target company, what requirements a bidder must comply with (providing offer documents, securing sufficient financial resources, etc) or when a bidder must give a mandatory offer.

There are also disclosure issues in connection with going-private transactions. The requirements of the Securities Trading Act (*Wertpapierhandelsgesetz* (WpHG)) and the Act to Limit Risk related to Financial Investments (*Gesetz zur Begrenzung der mit Finanzinvestitionen verbundenen Risiken* (*Risikobegrenzungsgesetz*)) must be complied with. According to the Securities Trading Act, whenever an investor ownership reaches, exceeds or falls below three, five, 10, 15, 25, 30, 50 and 75 per cent of the voting rights in a listed company, a notification to both the company and the Federal Financial Supervisory Authority is required. The Act to Limit Risk related to Financial Investments aims to counteract economically undesired activities of financial investors by way of increasing transparency and improving the legal framework without, however, affecting financial and entrepreneurial transactions that enhance efficiency.

5. EXITS

According to the German Private Equity and Venture Capital Association, exits of German target companies in 2009 amounted to a volume of €1.595 billion of which 34 per cent were trade sales, 33 per cent total loss, 12 per cent buy-backs of the management, 11 per cent secondary sales, 5.2 per cent repayments of silent participations and 1.4 per cent repayment of shareholder loans. In total, 689 companies were affected. Due to the credit crunch in 2008 and the accompanying volatility in varying share prices, there were no initial public offerings (IPOs) in Germany.

In comparison, the exit volume in 2008 of German target companies amounted to €2.261 billion, of which 42 per cent were trade sales, 29 per cent were secondary sales, 9.6 per cent were IPOs/purchase of shares, 4.3 per cent were management buy-back, 4.2 per cent were repayments of silent participations and 3.5 per cent repayment of shareholders loans.

5.1 Secondary sales

The secondary sale is the sale of the target company from a private equity investor to another financial sponsor. A secondary sale may be an exit option if a second stage of development can be started in the development of the target company with another financial sponsor. Consequently, the target company should have enough potential to warrant to the new investor an increase in value by operative improvement. For a successful secondary sale, the management should also be willing to invest a substantial amount of its proceeds received in the exit together with the new investors (roll over).

The volume of secondary sales of German target companies in 2009 amounted to €175 million. In detail, the secondary sales to credit institutions amounted to €35 million, thus 2.2 per cent of all exits. The volume of secondary sales to other investment funds amounted to €140 million, thus 8.8 per cent of all exits. The volume of secondary sales in 2009 dropped significantly compared to the volume of €650 million in 2008.

5.2 Trade sales

A trade sale is the sale to a strategic investor. The purchaser usually expects to benefit from synergy effects. As a result, it is necessary for the purchaser to acquire a controlling interest in the target company. In this case, the private equity investor may make use of its drag-along rights *vis-à-vis* minority shareholders, eg, management.

5.3 IPOs

IPOs in Germany usually command higher costs and more effort than secondary and trade sales, but often create better overall returns. Furthermore, IPOs allow spreading the divestment over time, whereas other sales allow a full immediate divestment.

Thus, IPOs were often the preferred exit channel. But, as noted above, due to the recent credit crunch, the market for IPOs was not very active in Germany in 2009. In 2010, IPOs are slowly coming back. Recently,

companies such as Brenntag, Kabel Deutschland (KDW), Tom Tailor or Joyou performed an IPO in Germany.

For an IPO it is required that the target company is organised in a structure capable of sale of shares in capital markets. A common method is a tax-neutral reorganisation into a stock corporation or a partnership limited by shares according to the German law on the Regulation of Transformations (*Umwandlungsgesetz* (UmwG)). If the IPO involves an increase of capital, a shareholder resolution is mandatory. If the IPO involves only the existing shares and no new shares are issued, a shareholders' resolution might still be necessary. According to a decision of the German Federal Supreme Court, a withdrawal from the stock market requires a shareholders' resolution. It can be argued that a shareholders' resolution is needed for an IPO as well. It is debated if a simple shareholders' majority is sufficient for such a resolution.

To be permitted into the regular market, a prospectus in accordance with the Takeover Act (*Übernahmegesetz* (WpÜG)) approved by the Federal Financial Supervisory Authority has to be issued. Additionally, the requirements of the listing regulation (*Börsenzulassungsverordnung*) and of section 35 of regulation 1278/2006 (EG) must be fulfilled. For instance, the annual financial statements of the last three years need to be disclosed, a sufficient spread of the shares need to be shown, etc. The listing regulation requires a written application for permission with some attachments, eg excerpts from the public register and articles of association.

If the shares should not be traded on the regular market but in the unofficial market instead, the guidelines of the respective stock exchange must be met.

5.4 Refinancings

Refinancing is the new structuring of debt. Recapitalisation (recap) is the repayment of equity in part or in total to the financial sponsor. Recapitalisation and refinancing were often used devices to finance leveraged buyouts in 2005 until 2007.

Since the deterioration of the debt markets in the course of 2008, the new term 'reverse recap' was implemented, meaning that a financially weak target company is recapitalised with equity.

The recapitalisation allows a private equity fund to realise a partial exit from an economic point of view. After a certain time, the private equity fund uses the improved operative results to receive a return financed by debt through surplus dividends, repayment of shareholder loans or repurchase of shares. Important features of the recapitalisation process are the increase of cash flows, the degree of debt relief and the leverage arbitrage.

5.5 Restructuring/insolvency

In the case of insolvency, the Insolvency Code (*Insolvenzordnung* (InsO)) determines the order of priority in insolvency proceedings. Both debt providers and shareholders are insolvency creditors. Debt providers are generally given priority over shareholders unless a creditor agreed to subordinate their claim to all other forms of financing. However, in

insolvency proceedings, the creditors typically only realise a marginal portion of their claims.

Sometimes, financial investors specialising in turnaround situations and restructurings are interested in buying an insolvent target company, either immediately before or during insolvency proceedings.

6. TAX

6.1 Taxation of fund structures

Private equity funds set up as a limited liability partnership allow investors from different jurisdictions to invest in a fiscally ‘transparent’ structure for tax purposes. To be regarded as fiscally transparent, it is required that the activities of the private equity fund are limited to passive asset management rather than to business activities. From a German tax point of view, certain criteria must be met in order to avoid the private equity fund qualifying as a business. The private equity fund is generally not qualified as a business if it is managed, at least partly, by one or more of its limited partners; if it does not hold an interest in a business partnership unless the investment is made indirectly through a corporation; and if it qualifies under the guidelines provided by the German Federal Ministry of Finance (*Bundesfinanzministerium* (BFM)) in its statement dated 16 December 2003. Due to this guideline, a non-business partnership can be expected to:

- not use bank loans (except for short-term bridge loans);
- not have an extensive organisation to administer the fund’s equity;
- use the equity funds’ expertise only for inserting on its own account;
- only administrate and realise investments for its own account;
- not have short-term-holdings;
- not reinvest sale proceeds (except as cover for investors’ capital initially used to pay managing fees);
- not have active involvement in the management of target companies; and
- not have entrepreneurial investments in the target company.

If a private equity fund fulfils these requirements, the German fund vehicle is neither subject to German corporate income tax nor subject to German trade tax. All income is immediately allocated to its partners and taxed at the level of the partners. The taxation of each partner depends on its individual tax status.

Thus, if the partner in the German non-business fund vehicle is a German individual, since 1 January 2009, the income (capital gains, dividends, interest) is subject to withholding tax in the amount of 25 per cent plus a solidarity surcharge thereon at a rate of 5.5 per cent and – where applicable – church tax.

If the partner of a German non-business fund vehicle is a domestic corporation, such as a GmbH or an AG, it is subject to corporate income tax and trade tax, regardless of its shareholders. This implies that 95 per cent of the dividend received and capital gains from the sale of a shareholding of the fund are generally exempt from corporate income tax. In addition, 95 per cent of the dividends are generally exempt from trade tax if the

corporation indirectly holds more than 15 per cent of the target company's stated share capital from the beginning of the assessment period. Special tax rules apply to capital gains realised by companies active in the financial and insurance sectors as well as by pension funds.

If the partner is a foreign individual or a foreign corporation, it is generally not taxed in Germany, but in its home jurisdiction. However, if the foreign individual or the foreign corporation indirectly holds more than one per cent of a German target company's stated share capital, it is subject to German taxation in the same manner as a German individual or a domestic corporation, unless it has protection under an applicable double taxation treaty.

If the private equity fund is qualified as a business, it is subject to trade tax. Additionally, if the partner of the German business fund is a German or foreign individual, according to the part-income tax rule (Teileinkünfteverfahren), 60 per cent of the capital gains and dividends received by the partner are taxable. If the partner of the German business fund is a domestic or foreign corporation, the corporation is subject to corporate income tax as described above, but not to trade tax (with the exception of companies active in the financial and insurance sectors as well as by pension funds).

Private equity funds set up in the legal structure of a German stock corporation are subject to corporate income tax and trade tax in Germany.

6.2 Carried interest

In Germany, it was in dispute for a long time whether carried interest qualifies for tax purposes as remuneration for service or as partnership income. Finally, in 2004, the Act for Promotion of Venture Capital came into force. Under this Act, carried interest is qualified as remuneration for services if the interest is paid by a private equity fund partnership that is not engaged in a trade or business.

Following this, 40 per cent of the carried interest received from such a private equity partnership can be tax exempt from German income tax. For private equity funds set up before the end of 2008, 50 per cent of the carried interest can be tax exempt.

It is debated whether the same rules apply for carried interest that is paid by a private equity fund engaged in business, or structured as a corporation.

In the international context, the qualification of carried interest as remuneration for services can cause double taxation issues.

6.3 Management equity

The basic tax consideration of the management participation programme is that the management receives capital gains and dividends distributed tax exempt. This requires that the management has economic ownership straight away with its participation, meaning that the managers bear real value risks from the investment. If this is not the case, the appreciation is subject to taxation as ordinary income. Otherwise, the following tax rules apply.

The taxation of capital gains depends on whether the shares were acquired before or after the end of 2008. Concerning the sale of shares acquired before the end of 2008, capital gains are tax exempt if the holding period of the shares is at least 12 months and if the total investment in the target company is less than one per cent. Otherwise, according to the part-income tax rule (*Teileinkünfteverfahren*), 60 per cent of the capital gains are taxable.

Concerning the sale of shares acquired after the end of 2008, capital gains are subject to withholding tax of 25 per cent plus a solidarity surcharge (and – where applicable – church tax) if the management total investment in the target company is less than one per cent. Otherwise, the part-income tax rule as described above, applies as well.

The taxation of dividends depends on whether the dividends are distributed before or after the end of 2008. Dividends distributed before the end of 2008 are subject to the half-income tax rule (*Halbeinkünfteverfahren*). Dividends distributed after 2008 are subject to withholding tax.

Due to a change in the administrative practice of German tax authorities, since the beginning of 2008, the management fees paid by the target companies are subject to value added tax (VAT) regardless of whether such management fee is structured as a priority profit share in the balance sheet profit of the receptive partnership. Thus, the fees are regarded as an additional fee, not as part of the contribution as partner or shareholder.

6.4 Loan interest

The interest payable on non-hybrid loans to the private equity fund is usually not subject to German withholding tax.

Interest expenses of the target company are partly tax deductible. Since 2008, the interest barrier regulations (*Zinsschranke*) limit the tax deductibility of interest expenses of German companies. This rule is complex. In short, the deductibility of interest expenses is capped at 30 per cent of the EBITDA of the relevant company. However, companies are able to build up an EBITDA reserve in business years where 30 per cent of the EBITDA exceeds the negative interest balance. This reserve can be used in the following five business years if the negative interest balance exceeds 30 per cent of the EBITDA in one such business year. The restrictive provisions do not apply if the interest expenses do not exceed the interest income by more than €3 million.

6.5 Transaction taxes

Under German tax law, the sale of all of a company's assets is not subject to VAT. However, in the case of the sale of less than 100 per cent of the company's assets, VAT is applicable.

The purchase of shares of a company is VAT exempt or not subject to VAT at all.

If an asset deal includes the transfer of property, land transfer tax (*Grunderwerbssteuer*) is raised in the amount of 3.5 per cent to 4.5 per cent. The tax is based on the proportional purchase price.

In a share deal, land transfer tax is only raised if the purchaser consolidates 95 per cent or more of the shares of a corporation or a partnership that owns property in Germany. The tax is based on the fiscal property value.

The same tax rules apply if 95 per cent or more of the partners of a partnership that owns property change within five years. To avoid land transfer tax, a purchaser might acquire less than 95 per cent of the partnership shares and receive a call option for the rest of the shares that can be exercised five years' later.

7. CURRENT TOPICAL ISSUES/TRENDS

An increasing number of Private Investment in Public Equity (PIPE) transactions of private equity investors as well as family-owned businesses and family offices is foreseeable. In addition, an increase of minority participations of private equity investors in privately held companies appears to be realistic. This is to some degree a deviation from the classic buyout pattern with the standard majority participation of the private equity investor. On the other hand, it is not really new, since minority participations are usual in venture capital financings.

In general, an equity stake seems to have become a more attractive alternative compared to other forms of financing in the present market environment. Since debt financing in general is still subject to various constraints and hybrid financing may presently be considered to be rather expensive, straight forward equity financing may be the choice. From the perspective of the private equity fund, such private equity financing may presently even be structured as an all-equity financing. However, these transactions are typically structured in such a manner that a future partial debt refinancing by way of a future recap is feasible.

Finally, vendor financing including earn-out structures are becoming increasingly relevant in the overall financing package in an attempt to bridge deviating purchase price expectations of vendors and purchasers.