

Slow recovery

Philipp von Braunschweig of P+P Pöllath+Partners on how the German M&A market is coming out of the financial crisis

In late spring of 2010, the German M&A environment continues to be dominated by the aftermath of the financial crisis, although M&A (and even leveraged buyout activity) is picking up at least in selected industries.

The fourth quarter of 2008 saw an almost complete collapse of M&A activity and during 2009, most private equity funds and even many industrial players were engaged in restructuring their existing portfolios rather than pursuing opportunities for new transactions. Many market participants had expected, for 2009, a wave of forced sales and foreclosures of share pledges by banks which had financed an unprecedented number of buy-out transactions (many of them at excessive valuations) during the boom years of 2005 through 2007.

Many private-equity-sponsored companies had to report breaches of covenants to their financing banks after the first or second quarter of 2009 which gave banks the opportunity to call due their acquisition facilities and force equity sponsors into disposals of their shareholdings. Depressed market prices and the almost complete absence of private equity players on the buy-side during most of 2009, have, however, significantly limited the ability of banks to recover their senior loans through M&A processes. The fear of 2009 book losses has increased banks' willingness to grant waivers for the second half of 2009 and postponed their foreclosure decisions into 2010. With price levels slowly increasing, many expect an increase of forced sales in the second half of 2010.

While restructuring, forced sales and sales from insolvency continue to play an important role, the general buy-out market is beginning to recover. Many auction processes, most notably disposals by private equity funds as well as sales of family-owned *Mittelstand* companies in the context of succession scenarios, have been interrupted or put off due to the crisis and many of these entities can be expected to be put to the market as price-levels start to increase.

Observers see, however, two limiting factors to this development. Many sellers continue to delay auctions because they hope for a return to pre-crisis valuations in 2011. In addition, the 2009 operating results of many companies have been severely affected by the crisis and non-recurring restructuring expenses. Therefore, exit transactions for such companies are more likely to occur when (audited) 2010 financials become available.

Changes in insolvency laws

Leveraged acquisition vehicles in particular, but also many operating companies, continue to be exposed to insolvency risks. Under German law, a company's management must file for insolvency proceedings (and will become liable to criminal prosecution in case of violation of such filing obligation) if the company is illiquid (*zahlungsunfähig*) or over-indebted (*überschuldet*). Over-indebtedness means that the company's liabilities (excluding certain subordinated debts) exceed the fair market value of the company's assets. As part of an emergency legislation package to avoid a wave of insolvencies, the German Insolvency Act (*Insolvenzordnung*) was amended in October 2008 with respect to over-indebtedness.

An over-indebted company does not have to file for insolvency if there is a "preponderant likelihood" (*überwiegende Wahrscheinlichkeit*) for the business to continue as an operating concern. The relevant forecast period is not defined by statute but is generally believed to equal at least twelve months. As a practical matter, the new statutory rule has been used by many companies during 2009 and continues to be used in 2010. It should be noted, however that the new provision has increased conflicts of interest between owners and management: insolvency filing requirements now depend on a forecast being provided by management. While management is frequently exposed to pressure from equity sponsors to avoid premature insolvency filings, management often takes a conservative approach to

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the forecast in order to avoid risks of personal (including criminal) liability.

Tax uncertainties

Restructuring transactions designated to avoid insolvency frequently involve the need for waivers of loans or other receivables by shareholders and third party creditors. Such waivers can have disastrous tax consequences if the book profits of the company are subjected to corporate income and municipal trade tax. After an amendment in the 1990s, there is no longer any statutory rule to exclude taxation of book profits in restructuring situations. The tax authorities have, however, issued a ruling pursuant to which tax relief on book profits from a waiver shall be granted in a restructuring situation if certain criteria are met.

Most notably, there must be a comprehensive restructuring plan involving waivers by substantially all groups of creditors (not only one or two individual creditors). In many cases, these narrow criteria cannot be met. Especially when a shareholder or a third party buys loan tranches from banks and wishes to waive them (partly or in total) but does not want to include trade creditors in the restructuring, there is a substantial tax exposure. In view of certain uncertainties in the published ruling, it has become common practice to obtain an individual advance ruling from the local tax office prior to executing any waiver transaction (this can substantially delay the restructuring process).

Additional uncertainty has been created by recent lower tax court decisions stating that the published ruling of the tax authorities has no sufficient basis in statutory law and, therefore, the governmental practice of waiving the relevant tax claims is illegal. Practitioners are putting increasing pressure on the government to enact an amendment of the statute in order to achieve clarity for transactional practice.

In any event, even under the published ruling, loss carry forwards must be offset against the amount of the waiver. Many financial restructurings may therefore result in a disappearance of a loss carried forward and can therefore have a substantial negative impact on value.

Voluntary sales

In many cases, equity sponsors refuse to make additional cash contributions in order to effect a financial restructuring within the existing shareholder structure. In order to achieve a solution outside insolvency, financing banks

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either push for a conversion of their loans into equity or for a sale of the company.

As a matter of law, shareholder loans are generally subordinated to the claims of third party creditors in case of insolvency. This would normally be an impediment to debt to equity swaps. There are, however, two exceptions to the rule on statutory subordination. Shareholders holding less than 10% of the shares are generally exempt from subordination. An additional exception exists for shareholders who have acquired their shareholdings “for purposes of restructuring” (*zum Zwecke der Sanierung*; so-called restructuring privilege). Notwithstanding the “Restructuring Privilege”, banks are typically reluctant to take equity positions in German companies, especially if less than all of their loans are being converted, because the remaining loans may then be exposed to risks of statutory subordination. Typically, therefore, a sale of all of the shares in the respective company to a third party investor would be the preferred route for the banks if the existing shareholders are not prepared to increase their equity investment in a restructuring.

If all of the shares in the debtor company have been pledged to the banks, the banks can technically force a 100% sale. A technical foreclosure process under mandatory rules of the German civil code may, however, be time-consuming and burdensome. In most cases, purchase prices generated in statutory foreclosure proceedings are far less than optimal. Therefore, the preferred route for a sale would be a voluntary transaction managed by an M&A or corporate finance advisor. In order to obtain the consents of the equity sponsors to such a sale, banks will in most cases have to offer the equity holders a certain share in the proceeds. In order to incentivise equity holders to support the process, banks and shareholders often agree on a sliding scale pursuant to which the equity holders’ percentage share in the proceeds increases depending on the total purchase price received.

However, such incentives may not be enough for shareholders to actively support a transaction (rather than just sitting back and hoping for a recovery of the operating business). Therefore, banks are interested in exercising additional leverage to accelerate and control the process by obtaining irrevocable powers of attorney from the shareholders with respect to a sale or, preferably, requesting an outright share transfer by the old shareholders to a trustee selected by the bank. Banks themselves are not interested in taking the position of trustee



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because this would expose their claims to the aforementioned risks of statutory subordination. Therefore, the role of trustee is typically played by special purpose entities set up by insolvency law firms and the trustee companies are typically managed by partners of such law firms. Recently, some M&A advisors have also started to offer trusteeship services for restructuring sale scenarios.

The legal framework for such voluntary sales consists of two separate documents. On one hand, the banks and the company must enter into a standstill agreement (or even an agreement on additional working capital facilities) for a specified, limited period of time in order to avoid insolvency. On the other hand, the banks, the shareholders and the trustee must enter into an agreement governing the transfer of shares to the trustee (or alternatively an irrevocable power of attorney by the shareholders). Such agreements also contain rules on the conduct of process by the trustee, the distribution of proceeds to the various stakeholders as well as fees and liability of the trustee.

From the banks' perspective, their natural desire to control the process is limited by the risks of being treated as quasi-shareholders for purposes of the laws on statutory subordination. In order to avoid quasi-ownership status, banks are not interested in formal instruction rights; rather, the trustee typically appoints an advisory body with consulting functions consisting of representatives of the various stakeholders.

The fees of the trustee (who usually charges a retainer plus a time-based fee at hourly rates customary for legal advisors) as well as third party fees (most notably fees of M&A advisors appointed by the trustee) are a frequent topic of negotiation between shareholders and banks. The discussion regarding the fees of M&A advisors is less difficult because they are typically paid on a success basis and only from the sales proceeds. The situation is more difficult, however, with respect to retainers and the fees of the trustee itself. Shareholders are typically reluctant to accept liability for such fees (even though they formally give instructions to the trustee with respect to the sales process). Capital adequacy laws may limit the legal ability of the company to pay such fees. Although there would be a valid argument to permit such payments because the company is benefiting from the waiver agreement which, in turn, is conditional on the shareholders entering into the trusteeship agreement. Therefore, it can be argued that the payment of fees to the trustee is in the best interest of the company.

It should be noted that any transfer to one acquirer of 95% or more of the shares in a German corporation owning real property estate triggers real estate transfer tax. Accordingly, trusteeship structures involving an outright transfer of shares to the trustee and a subsequent sale by the trustee to the third party would be subject to double taxation (each time at a rate of approx. 3.5% of the property value).

Purchase price concepts

As in other jurisdictions, the years of 2006 and 2007 showed a tendency towards more seller-friendly share purchase agreements with narrow warranty catalogues, liability caps of sometimes 10% or less and locked-box purchase price concepts with no post-closing adjustment for net debt and working capital. Unsurprisingly, the tendency towards ever more seller-friendly share purchase agreements has been reversed in the financial crisis, as purchasers have seen an increasing need for protection.

Until early 2008, locked-box purchase price concepts prevailed in German market practice. A fixed purchase price was established on the basis of the latest available annual accounts (or interim accounts) and the purchaser's protection against adverse developments after the latest accounts date was limited to certain covenants (such as prohibitions of distributions to the seller prior to closing and the like). After 2008, locked-box concepts were no longer (with few exceptions) bankable on the German market. In current market practice, the purchasers almost always insist on a customary net financial debt / net working capital adjustment as of the closing date.

Vendor loans and earn-outs

Despite a recovery of the M&A market, bank financing of buy-outs continues to be difficult in many industries. Accordingly, vendor financing has played a substantial role in many recent transactions. As in other jurisdictions, vendor loans are typically subordinated to bank financing and often repayable only after full repayment of senior facilities (or upon an exit transaction), regular interest payments or scheduled repayments are permissible, if at all, only subject to certain covenants. Vendor loans are typically unsecured. In roll-over scenarios where the seller acquires an equity interest in the acquisition vehicle, the rules on statutory subordination apply: If the seller holds more than 10% of the acquisition vehicle or is a managing director of the acquisition vehicle, his or her vendor loan will, in case of insolvency, be automatically subordinated to the claims of third party creditors.

Earn-out structures play an increasing role in German share purchase agreements. In many cases, earn-out structures (where part of the purchase price is contingent on the future performance of the business) are an adequate device to deal with the uncertainty of forecasts. It remains to be seen whether the trend towards earn-out structures will be reversed as business forecasts become more reliable in a more stable economic environment after the crisis. Sellers are typically reluctant to accept earn-outs because they lose control of the business at closing.

Earn-out structures are easier to accept if the seller retains a certain degree of influence over the business, for example, as managing director or as minority shareholder (preferably with a blocking majority of 25.1 % which would, under German statutory law, give the seller the power to veto cap-

ital increases, mergers and the like). In a German limited liability company (GmbH), which is the most popular type of corporation for smaller and medium-sized enterprises, a managing director's position as such does not give substantial protection to the seller. This is because, as a matter of statutory law, the managing director of a GmbH is subject to instructions by the shareholders even with respect to day-to-day business decisions and the appointment of the managing director can be revoked by the shareholders at any time (irrespective of any monetary claims the managing director may have under his or her employment agreement). Therefore, many earn-out arrangements provide that the full earn-out amount becomes due if the purchaser revokes the seller's appointment as managing director without cause.

The German M&A market continues to be dominated by transactions occurring in a restructuring context. Even though the economy is slowly recovering, a significant number of forced sales which had originally been expected for 2009 are anticipated to occur in the course of 2010 as closing banks now find a more stable environment for such transactions. In many of these transactions, independent trustees are used by banks in order to accelerate and facilitate the sales process. In the meantime, the market for buy-out transactions is slowly recovering although LBO bank financing continues to be available in selected industries. Share purchase agreements have generally become more purchaser-friendly over the past two years and can be expected to remain so in 2010/2011. Even after price levels have recovered, there remains a substantial valuation gap in many transactions; vendor loans and earn-out structures may therefore continue to play an important role in the foreseeable future.