Doing M&A in Germany

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How to do M&A in Germany?
M&A in Germany by Chinese investors

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Overview

Germany is the key destination for Chinese enterprises to make investment in Europe. The number of M&A transactions conducted by Chinese investors in Germany increased from 8 in 2010 to 68 in 2016 and fell back to 28 in 2020[1]. In 2021, the number has increased again slightly to 35.[2] Nevertheless, Germany is still the go-to destination for Chinese investors in Europe.

There are two main reasons for the decline in the number of such M&A transactions. On the one hand, China has tightened its foreign exchange control since November 2016, which has affected the investment orientation and investor status of some Chinese enterprises. For example, the Chinese government no longer supports investment in non-technical projects, such as in real estate, entertainment, and sports clubs. It becomes more difficult for purely financial investors (funds) to obtain approval for outbound investment. On the other hand, Germany and the EU are seeking stronger protection for sensitive and crucial sectors. For this end, the Foreign Trade and Payments Act (Außenwirtschaftsgesetz - AWG) has become more rigorous after a series of amendments made in 2017, 2018, 2020[3] and 2021. With the last amendment, the acquisition of important technology companies by foreign investors was put under intensified scrutiny.

The new measures may slow down the trend of M&A and temporarily hinder the progress of individual transactions. Given the interest of Chinese investors in German high-tech companies and the ambition of Chinese companies to expand internationally, however, such measures cannot suppress the keen interest of Chinese investors in German companies and technologies in the long run.

In this article, we will introduce to you the process of M&A transactions (see Part II), the regulatory review and approvals (see Part III) and give some practical recommendations on M&A in Germany (see Part IV).

Process of M&A transactions

Preliminary stage

In general, investment banks and M&A advisors will introduce the target for sale to investors. The seller usually will require the buyer to sign a confidentiality agreement in advance to ensure that the buyer will keep confidential all the information it may be provided with respect to the target. Meanwhile, the buyer will seek a promise from the seller that it will negotiate exclusively with the buyer on the sale of the target.

If the buyer is highly interested in the target, both parties will usually sign a "letter of intent" or "memorandum" as a written agreement of intent, which contains the information of the subject matter, the initially agreed-on consideration, and the timetable for the follow-up process or the main framework for the future M&A agreement. Except for the confidentiality clause and exclusivity agreement, the other terms of the letter of intent are usually not legally binding.

The parties should be careful not to cover all topics in the letter of intent. In that case, important matters may be negotiated twice - once in the letter of intent and the other time in the share purchase agreement (SPA).

Due diligence

During the due diligence process, the buyer will be provided with information on the target so that the buyer can evaluate the risks of the transaction and get information on the target that may affect the transaction price. Due diligence generally covers legal, financial, tax, and commercial matters. Some investors will also conduct due diligence on environment, insurance and pension. The documents required for due diligence are generally stored in an electronic data room. Since the buyer needs to engage external advisors for due diligence, it is necessary to consider in advance which information is most important and confirm the scope of due diligence with its advisors. Chinese buyers generally attach more importance to intellectual property, employment, and pension commitments.

It has to be taken into account that liability for breaches of warranties given by the seller in the SPA will regularly be excluded if the facts underlying the breach of warranty were known to the buyer from the due diligence or should have been known from the data room. This applies in particular if - as has been common in recent years - the seller no longer assumes liability for such risks himself, but transaction risks are to be borne by an insurance policy to be taken out by the buyer.

[1] https://assets.ey.com/content/dam/ey-sites/ey-com/de_de/news/2021/03/ey-chinesische-investoren-in-europa-2021.pdf

[2] https://assets.ey.com/content/dam/ey-sites/ey-com/de_de/noindex/ey-chinesische-investitionen-in-europa-2021-final.pdf

[3] For more details, please read KWM's insight article - Foreign Direct Investment: Changes in Germany | KWM. Please see https://www.kwm.com/en/de/knowledge/insights/fdi-germany-20200724.

Negotiation and execution of SPAs

In the course of due diligence, the parties may start negotiation on the SPA. In the bidding process (see f) below, the seller usually provides the draft agreement, while in the one-to-one process, the buyer's counsel usually prepares it.

A company may be acquired via an "asset deal" or a "share deal". In an asset deal, the target sells its assets and contractual relationship to the buyer, and the buyer also assumes part of its debt. In a share deal, the shareholders of the target sell their shares to the buyer. The assets of an insolvent company are usually purchased by way of asset deal, in which all or part of the assets of the insolvent company are acquired from the administrator by an investment vehicle of the buyer.

In addition to regulating the parties and the subject matter, the SPA should also contain provisions on the following topics:

- Consideration: The consideration can be set as a fixed purchase price based on the value of the target on an effective date. In this case, it must be ensured that there have been no cash outflows and that the business has been conducted in the ordinary course, all between effective date and closing date. As an alternative, the parties can determine the preliminary purchase price at the time of signing, and then adjust such price according to accounts prepared on the closing date.

- Representations and Warranties: In the SPA, the seller will usually give the buyer certain warranties regarding the target, that relate to corporate, financial and operating conditions of the target. In case of breach of warranty, the seller regularly has the opportunity to remedy the damage. If seller fails to do so, monetary damages are due. The buyer's claims are usually limited to a maximum amount. In more and more cases, sellers limit their warranties to a very small amount, and even exclude their liability completely and request the buyer to buy warranty & indemnity insurance for damages. With respect to the purchase of an insolvent company, the administrator in general does not provide any kind of warranties.

- Closing: The SPA also specifies how and under which conditions precedent (such as merger control, foreign direct investment (FDI) review in Germany, and outbound direct investment (ODI) approvals in China) the transaction is to be completed.

- Collaterals: When executing the agreement, it is quite common for the seller to require the buyer (especially a Chinese buyer) to make a down payment (see IV.a below). If the SPA is not executed by a Chinese buyer but by its German subsidiary, the seller will often request the Chinese investor to provide guarantees.

- Covenants and Indemnities: The SPA may also provide for covenants on the conduct of business between signing and closing as well as indemnities regarding taxes and environmental law compliance.

The above does not cover all aspects of the SPA, and other matters may need to be agreed upon as the case may be.

If the parties reach an agreement on the terms after negotiation, they may execute an SPA, which, in general, shall be notarised (see IV.e).

Closing and relevant preparation

After execution of the SPA, closing needs to be prepared. In addition to the approvals required for closing (see Part III), it is also necessary to prepare the required documents, such as closing memorandum, shareholders' resolution on replacement of the managing director, or - if not agreed in the SPA already - the share transfer agreement. If the target belongs to a group, then the parties must also negotiate on agreements between the target and other group companies to ensure the continuance of normal business operation of the target during the transition period with respect to centralised functions such as HR and accounting. On the closing date, the buyer is required to pay the purchase price and execute the closing memorandum.

Integration

Although the parties and their advisors will celebrate the completion of the transaction after a successful closing, this does not mean that no further efforts are required. Whether the target can integrate into the buyer's group is a major challenge. This requires a review of the existing structure of the target and the alignment of its future development with the requirements of the buyer's group. Cooperation between companies from different cultures requires more sensitivity and cultural awareness from all parties.

Particularity of bidding process – do not miss the deadline!

Corporate M&A deals are often negotiated between the seller and more than one buyer, and thus the seller often sets up a bidding process. Even for the sale of small businesses, such bidding process is also quite common. The seller hopes to get the highest possible price through a competitive mechanism. In addition, the bidding process also allows the seller to control the whole process from getting to know the buyer's intent to buy and to eventually executing the agreement subject to a fixed timetable. In the past, Chinese bidders often underestimated the time requirement. Due to the complexity of internal processes, Chinese SOE in particular face great challenges in a bidding process. More and more German sellers become aware of this problem and some sellers allow Chinese buyers to enter the process earlier.

Administrative procedures

FDI review in Germany

Introduction to German FDI Law

Any transaction, in which a Chinese investor directly or indirectly acquires a certain percentage of shares in a German company, is subject to a review by the Federal Ministry for Economic Affairs and Energy (the "Ministry"). The relevant threshold triggering such review right depends on the specific business operations of the German target. In case the company is active in so-called highly critical business sectors, any transaction concerning 10 % or more of the shares suffices for an investment to be reviewable whereas a threshold of 20 % applies if a "mere" critical business sector is affected. In case there are no critical business activities, a review is possible in case 25 % or more of the shares shall be acquired. There are no other criteria which need to be considered for the implementation of a review, i.e., there is no size of the transaction test, no requirement of a certain level of control or no exception of certain business sectors.

As a result, an analysis of the FDI situation should be included in the structuring of any foreign investment, in particular since the investment environment has grown more and more complex over the past five years following multiple adaptions of applicable law, as Germany is trying to find the right balance between its political interests, aspects of national security as well as providing a clear and transparent legal framework for the implementation of mutually beneficial foreign investments.

Due to the complexity of the legal environment and the fact that each transaction is subject to its own specific circumstances, it is extremely difficult to provide general statements which apply to all foreign investments. Rather, each individual transaction must be assessed on a stand-alone basis. Nonetheless, the overview set out below highlights the general principles for FDI reviews upon which a high-level first assessment of a specific transaction can be made. In addition to such general principles, the following aspects should generally be considered:

- In case the transaction concerns a highly critical or critical business, there is a notification duty for the purchaser and the transaction is subject to a prohibition to close until the Ministry has approved the transaction;
- German FDI reviews can take a considerable amount of time to complete; currently even a standard process takes 3-4 months;
- Information requests can be very comprehensive and the transaction parties will have to allocate considerable resources to such process;
- Information requests can also concern details on indirect shareholders so the parties may have to obtain information from external sources.

General Principles of German FDI Law

Topic	Sector-specific Review	Cross sector Review		
		Highly Critical Business	Critical Business	Non-critical Business
Business sectors	Military/Defence	• Critical Infrastructures (e.g. companies active in the water, energy, medicine & healthcare sector); • Software providers for the above; • Cloud-IT companies.	• Critical products or technologies (medicine, aviation, AI, IOT, certain robots, nano-electronics etc.); • Companies employing people with access to highly sensitive information.	All other business sectors / technologies **Consequence:** Any transaction is potentially reviewable, regardless of size or nature of the deal.
Protected Interests	National security interests	Prevention of likely adverse effects on public security and public order		
First relevant threshold	10% of voting rights	10% of voting rights	20% of voting rights	25% of voting rights
Stake-building thresholds	20%, 25%, 40%, 50% and 75%	20%, 25%, 40%, 50% and 75%	25%, 40%, 50% and 75%	40%, 50% and 75%
Catch-all approach	All alternative structures comparable to an acquisition of voting rights and the control provided by them shall be covered by applicable law, e.g. (i) only partial acquisition of companies or business units (ii) asset deals (iii) combination of acquisition of a non-reviewable number of voting rights with additional rights, such as seats in supervisory boards, special veto rights, special information rights etc. (iv) agreements on the execution of voting rights or execution of control rights between investors.			
Indirect Acquisitions	Any indirect acquisition is reviewable. As a result, even changes in the indirect shareholding structure need to be assessed from an FDI perspective (e.g. foreign investor acquiring a Chinese holding which is a shareholder of a German company)..			
Nationality of investors	Non-German Investors	Non-EU Investors		
Notification Duty	Yes	Yes	Yes	No
Prohibition to close	Yes	Yes	Yes	No

<table>
<tr><th rowspan="2">Topic</th><th rowspan="2">Sector-specific Review</th><th colspan="3">Cross sector Review</th></tr>
<tr><th>Highly Critical Business</th><th>Critical Business</th><th>Non-critical Business</th></tr>
<tr><td>Review periods</td><td colspan="4">Phase I (high-level review based on a limited set of information):
• Fixed two-month period (no extensions).
• Triggered by notification / application for certificate of non-objection / knowledge of Ministry of a transaction.
• <u>Potential Outcome</u>: (i) Approval of transaction (or deemed approval after two-month review period lapses without Phase II being initiated (ii) prohibition or (iii) Initiation of an in-depth review (Phase II).
Phase II (in-depth review of all requested information):
• Flexible four-month period. Beginning of time period depends on provision of all information which Ministry requests, so parties cannot control start of time-period. Potential extension by three months if assessment of the transaction is subject to difficulties (and further extension by one month if national defence interests are concerned and the Ministry of defence requests such extension). Potential additional extension with the consent of the direct purchaser.
• The expiry of the aforementioned time-periods can be suspended in specific situations.
• <u>Potential Outcome</u>: (i) Full approval of the transaction (or deemed approval after review period lapse), (ii) approval in connection with certain decrees or orders, or (iii) initiation of negotiation of a public law contract to which granting of approval is tied.</td></tr>
<tr><td>Group exemption</td><td colspan="4">Yes, but only in case involved companies are 100 % subsidiaries of the same parent and all have their place of management in the same country.</td></tr>
<tr><td>Special Aspects of interest</td><td colspan="4">a) Purchaser is state or military controlled
b) Purchaser is state or military financed
c) IP / know-how drain risk
d) Level of criticality of Business
e) Past activities of Purchaser
f) Subsidies
g) Involvement of Dual-Use goods
h) Business plan after Closing
i) Political motivation</td></tr>
</table>

Summary and Recommendation

The FDI process risk assessment has become a regular part of any cross-border M&A deal in Germany and a proper preparation of such process and its interaction with other milestones of the transaction should be part of the preparation of any international M&A project. Such preparation is made easier by the fact that the relevant information which needs to be disclosed is to a large extent set out in regulations published by the Ministry and only the questions drafted specifically for the transaction will have to be answered in a separate work-stream. In addition, the FDI process should be implemented in a transparent and co-operative manner. In our experience nearly all foreign investments will ultimately be approved if the FDI process is structured correctly. However, we also expect that going forward the Ministry may expect certain commitments or covenants from the foreign investors in case the transaction is deemed to affect security interests which need to be protected. In this regard we have observed that the Ministry is recently increasingly looking to enter into public law contracts with the parties to the transaction in order to establish such commitments and covenants.

Approval and filing requirements of the Chinese government

If the Chinese buyer pays the purchase price through its outbound assets (e.g., funds located in Hong Kong S.A.R., the US or the British Virgin Islands), the transaction does usually not require the approval of the Chinese authority. In other cases, the Chinese investor will need to obtain approval from or file the transaction with the competent authority in China in order to pay the consideration. Depending on the size and form of the investment, the approval or filing authority is either the central or the local competent authority in China. Even if the transaction requires no approval but only filing, it may not proceed until all the required documents are submitted to the competent authority. The competent authority is thus given the opportunity to influence the transaction.

Investments of USD 300 million or more and overseas investments by central SOEs are subject to filling with the National Development and Reform Commission (NDRC). For projects of USD 300 million or more, investors need to obtain a pre-approval before submitting a binding offer or taking any key actions. Projects of over USD 1 billion or involving sensitive countries, regions or industries require the NDRC approval. Projects of less than USD 300 million invested by a Chinese party are generally filed with the competent provincial NDRC offices.

Overseas investments by Chinese enterprises are subject to approval if sensitive countries, regions or industries are involved. For overseas investments subject to approval, the central SOEs are required to apply to the Ministry of Commerce of China (MOFCOM) and the local enterprises to the MOFCOM through their local provincial MOFCOM offices. The non-sensitive outbound investments are subject to filing only. The central SOEs are required to file with the MOFCOM and the local enterprises with the competent provincial MOFCOM offices.

After approval by or filing with the competent authority as mentioned above, investors may pay the purchase price directly through the bank. The State Administration of Foreign Exchange (SAFE) exercises its supervisory powers through the supervision over the bank. Due to the significant decline in China's national foreign exchange reserves in the first half of 2016, SAFE and the People's Bank of China have both introduced a more stringent foreign exchange management regime since November 2016. In accordance with the new regulations, review by the "relevant department" will apply to projects exceeding USD 50 million. The "relevant department", in practice, refers only to SAFE or its relevant local branch. These measures resulted in a significant drop in outbound investment by Chinese companies in the first few months of 2017.

In August 2017, the State Council issued the *Guiding Opinions Concerning Further Guiding and Regulating the Direction of Overseas Investment* (the "Guiding Opinions"), which provides that overseas investment projects related to the Belt and Road Initiative in infrastructure, high technology, agricultural cooperation and service industries are encouraged by the State and those in real estate, hotel, cinema, sports club and entertainment industries are restricted by the State. Considering that the Chinese investors rarely invest in Germany in such restricted industries so far, the Guiding Opinions have only a very limited impact on investments in Germany.

Merger Control

Whether a transaction is subject to merger control depends on the group turnover of the parties to the transaction in the relevant regions. In accordance with Section 35 of the Act against Restraints of Competition (Gesetz gegen Wettbewerbsbeschränkungen, GWB), the merger control provisions shall apply if the combined aggregate worldwide turnover of the buyer and the target was more than EUR 500 million and the turnover of the buyer or the target in Germany was more than EUR 50 million and that of another party in Germany was more than EUR 17.5 million in the last business year preceding the transaction. To cover the acquisition of highly priced start-ups, the merger control provisions shall also apply if the EUR 17.5 million threshold is not met but the consideration for the transaction exceeds EUR 400 million, provided that the target has significant business activities in Germany.

Since group-wide turnover is relevant, the question of whether the turnover of all SOEs or at least of all SOEs controlled by the same State-owned Assets Supervision and Administration Commission (SASAC), should be added together, is discussed if the acquirer is an SOE. In a decision of the EU Commission in April 2016, the Commission based its decision regarding the China General Nuclear Power Corporation (CGN)[4] on the Community-wide total turnover of CGN and all other energy companies controlled by Central SASAC. In the CRRC/Vossloh decision, the Bundeskartellamt stated with regard to a company controlled by Central SASAC that the group of companies pursuant to Section 36 (2) ARC includes at least all majority state-owned companies in China, without going into the different levels here[5].

If the turnover thresholds are met, a mandatory filing to the German Federal Cartel Office is required. Once notified, the authority has one month to review and clear the transaction (Phase I). If the authority identifies competition issues, it will at the end of Phase I open in-depth proceedings which take up to 5 months from the notification date. The parties to the proceedings will have to wait for the clearance (standstill obligation), gun jumping can lead to significant fines and all implementing measures are void if taken prior to clearance.

Key points in practice

For German sellers, deal certainty is top priority.

If an M&A transaction becomes public but does not close, it will be difficult for the seller to find another suitable buyer. Moreover, the seller has to bear high cost in the transaction. This is especially true in a bidding process where the seller selects one buyer and rejects the other bids. In the case of Chinese buyers, German sellers are

[4] Fall M.7850 - EDF / CGN / NNB Group of companies Rn. 29 to 50 (http://ec.europa.eu/competition/mergers/cases/decisions/m7850_429_3.pdf).

[5] https://www.bundeskartellamt.de/SharedDocs/Entscheidung/DE/Fallberichte/Fusionskontrolle/2020/B4-115-19.pdf?__blob=publicationFile&v=2

often concerned about whether the transaction can be completed after the agreement has been executed – Chinese authorities may not issue required approvals, there may be payment issues due to foreign exchange control (there are actual cases), or (as in the Hahn Airport deal) the Chinese buyer decides not to perform the agreement. Recently, uncertainty whether and in what time frame a Chinese buyer will receive FDI clearance has become an additional concern.

In the bidding process, if a Chinese buyer wants to beat its European competitors, it needs to first address the seller's concerns and, if necessary, also accept a substantial down payment on conclusion of the SPA or provide a bank guarantee from an international bank recognised in Germany.

Transaction structure - European investment platform

Legally, Chinese companies may directly purchase shares in German companies. In most cases, however, a European company, such as a German or Luxembourg limited liability company, i.e., GmbH or SARL, will be established as an investment platform to simplify the execution of the transaction. Investors should seek expert advice on the structure of the transaction as early as possible, especially on issues such as tax, financing, warranty liabilities, control etc.

Further, the shareholder structure of the buying entity is decisive for merger control proceedings and FDI approvals. In addition, banks and notaries as well as certain sellers have to fulfill anti-money laundering proceedings requiring them to investigate the shareholder structure of the buying entity in detail. Chinese buyers often have complex shareholder structures because different investors are participating in the deal and the shareholder structure is changing during the process, which makes it challenging to comply with such requirements. From German perspective, the shareholder structure should ideally be fixed before signing.

Financing

The purchase price is required to be paid on the closing date without delay. Thus, the buyer needs to consider in time how to finance the transaction. In Germany, sellers often require equity or debt commitment letters or proof of funds and expect that financing is agreed as of signing. In China, a buyer usually negotiates with banks and equity investors at the same time and makes the final decision last minute before closing. If funds are to be provided by a European bank, sufficient time must be set aside for negotiation on financing. During the period between signing and closing of the transaction, the seller needs to be kept informed of the availability of funds at any time. Prior to closing, the buyer should coordinate with the bank to pay the purchase price into the seller's account on the closing date to ensure a successful closing. Timing of the payment is in particular a challenge, if funds need to be transferred from China. Ideally, funds should be transferred to the bank account of the European investment vehicle a few days prior to closing to make sure that purchase price can be paid exactly on closing date.

No direct instructions to the management of a stock corporation

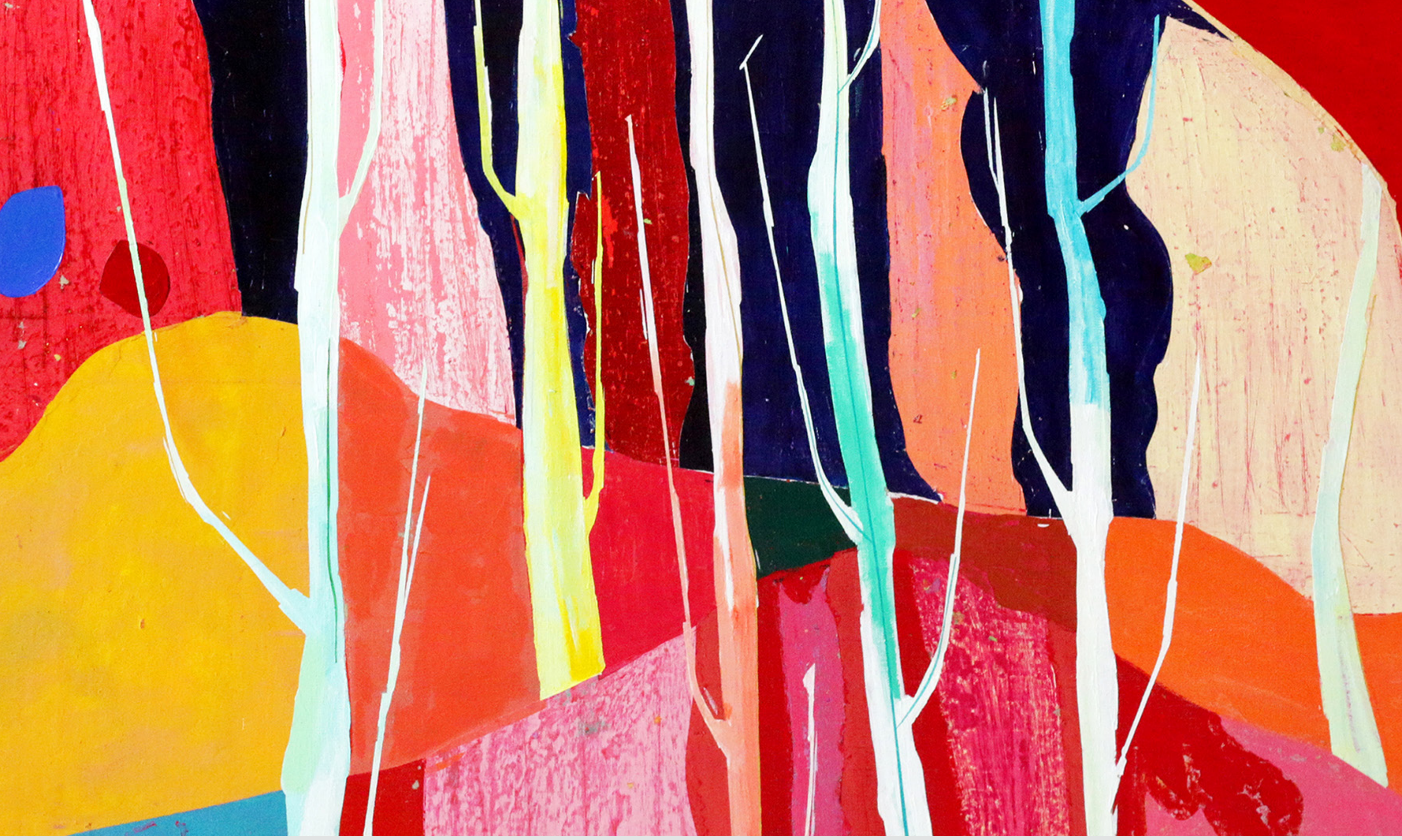
When acquiring a German AG, Chinese investors are often surprised that German law does not allow major shareholders to issue instructions to the company's management. The major shareholders have only very indirect influence on management when the supervisory board (appointed by the shareholders) decides on management candidates.

Requirements of notarisation

M&A transactions in Germany usually require notarisation, resulting in increased transaction costs. German law requires the agreement to be read out aloud in front of a notary, and the signatories, such as authorised lawyers or employees of the parties, have to be present throughout such procedure. In contrast, in China, it is customary that the buyer's senior representative shall solemnly sign the transaction. To resolve this conflict, the parties may arrange for an alternative short form document to be executed by their senior representatives at a celebration ceremony in addition to notarisation.

Conclusion

For Chinese investors and German sellers, cross-border M&A is about tackling not only language barriers but also cultural challenges. In particular, early planning, professional advice, and a basic understanding of the course of dealing and practice in each other's market are essential to avoiding various problems. In the early days, Chinese investors used to try their luck on cross-border M&A on their own. In recent years, however, they begin to engage professional advisors such as investment banks, lawyers, and tax advisors. Nevertheless, Chinese investors are still reluctant to involve professional advisors not only in the implementation, but also in the strategy and structuring of a transaction. The involvement of professional advisors enables Chinese investors to accomplish complex M&A transactions successfully in foreign countries.



Merger Control in Germany

Tilman Siebert

When does German merger control apply?

German merger control applies if the transaction qualifies as a reportable concentration and the parties meet the relevant turnover thresholds.

Reportable concentration

German merger control considers several transaction scenarios as relevant:

- **Acquisition of shares or voting rights**: Any acquisition which reaches or exceeds 25% or 50% of the shares or voting rights in another company is considered as a reportable transaction.

- **Acquisition of control**: An acquisition of control over another company also qualifies as reportable. The acquisition of a majority shareholding will always constitute an acquisition of control, but control can also be acquired with a minority shareholding if additional factors (such as a de facto majority in the shareholders assembly or veto rights in relation to key strategic business decisions) give the purchaser the ability to determine the market behaviour of the target.

- **Acquisition of assets**: Asset deals can also qualify as reportable if the acquired assets constitute a revenue-generating business and the market position associated with the acquired assets is transferred to the purchaser. The concept of a reportable asset deal not only catches asset deals in which an entirety of a company's assets is acquired, but can also include the acquisition of trademarks or patents, provided that these IP rights already generate revenues and the market position attached to the IP rights transfers to the new owner together with the IP.

- **Acquisition of a competitively significant influence**: An acquisition of shares can qualify as reportable even below the 25% level of shareholding if the acquirer is given additional rights in relation to the target which make his position comparable to that of a shareholding of 25% or more, provided that the influence is competitively significant (i.e. where the parties are competitors or where there are relevant vertical relationships).

- **Establishment of a joint venture**: Where two parties each acquire 25% in another company, the transaction is considered as a merger between the parent companies on the market on which the JV is active. Similarly, where two or more companies acquire joint control over another company, each of the parents and the joint venture are parties to the transaction with the consequence that each parties' revenues will have to be taken into account for the application of the turnover thresholds.

The scope of German merger control regarding the types of transactions which constitute reportable concentrations is therefore wider than the merger control rules of other jurisdictions, including the concepts used in EU merger control (which is based solely on the concept of an acquisition of control).

Turnover thresholds

If the transaction qualifies as a reportable concentration, it will have to be notified if

- the parties generate combined worldwide turnover of EUR 500 million or more; <u>and</u>

- one of the parties generates domestic turnover in Germany of EUR 50 million or more; <u>and</u>

- another party generates domestic turnover in Germany of EUR 17.5 million or more.

If the transaction value (i.e. the value of the consideration) is EUR 400 million or more, only the first two thresholds (EUR 500 million worldwide and EUR 50 million in Germany) are relevant, provided that the target company is active on the German market to a significant extent (e.g. through R&D activities or other non-revenue generating commercial activity). The Federal Cartel Office has published a guidance document to provide more detail as to how it calculates the value of the consideration and which factors are relevant to determine whether the target has significant activities on the German market.

The latest revision to the German Competition Act has introduced the possibility for the German Federal Cartel Office to order companies to notify transactions below the above thresholds if there are indications that future transaction might impede effective competition. For such a notification order, the Federal Cartel Office first needs to have conducted a sector inquiry into the relevant markets. In addition, the purchaser must have global revenues of EUR 500 million and a market share in Germany of 15%

or more. Provided these conditions are met, companies can be ordered to notify all transactions involving a target with domestic revenues of EUR 2 million or more in Germany, provided that two thirds of the target's total revenues are generated in Germany.

Even if the above turnover thresholds are met, the German Federal Cartel Office will not have jurisdiction if the transaction falls into the jurisdiction of the European Commission.

Parties are typically the acquirer and the target – the seller and its revenues are not relevant unless the seller retains a shareholding in the target of 25% or more or will be in a position to exercise joint control over the target with the purchaser.

When calculating turnover, each parties' consolidated group net turnover (excluding taxes, discounts and rebates) in the last completed fiscal year needs to be taken into account. Since the group concept includes all entities which directly or indirectly exercise control over the parties, state-owned buyers will have to include the revenues of all other entities under common control, which in practice can be very challenging to obtain. Geographic turnover is allocated to the jurisdiction where the relevant goods or services are provided (i.e. usually the location of the customer). Special rules for geographic turnover allocation apply to companies in the financial services industry, where turnover is allocated to the location of the relevant branch.

Procedure

Standstill obligation

German merger control provides for mandatory notification and a standstill obligation, i.e. notifiable transactions cannot be implemented prior to having obtained clearance from the German Federal Cartel Office. Violations of the standstill obligation can be sanctioned with fines of up to 10% of the global worldwide revenues of the parties and fines of up to EUR 1 million for the responsible individuals. In addition, all implementation measures put in place prior to having received clearance are void and unenforceable. Care should therefore be taken to avoid gun-jumping, in particular through measures by which the acquirer gains an influence over the target's market conduct prior to clearance, even if these measures in themselves do not qualify as reportable concentrations. Transactions implemented in violation of the stand-still obligation can be dissolved by the Federal Cartel Office if the transaction is leading to a significant impediment to effective competition.

Notification

The notification is usually prepared and submitted by the purchaser and will include information on the parties and their corporate structure, the relevant revenues, a description of the transaction mechanics, information on the relevant markets and market data (including market shares). In straightforward cases there is usually no need to include transaction documents, register excerpts or internal corporate documents – however, in cases with potential competition issues, such documents can and will regularly be requested by the Federal Cartel Office. The notification and its contents will not be public although the competition authority will publish the fact that a notification has been received. Also, Federal Cartel Office can and regularly does seek input and views from third parties (customers, suppliers, competitors) on the transaction. Providing false, misleading or incomplete information in notifications can be fined by the Federal Cartel Office up to 1% of the global worldwide revenues of the parties.

Deadlines

Following receipt of a complete notification, the Federal Cartel Office has 1 month to review whether the transaction raises competition concerns (Phase I). If there are no concerns, the authority will issue an informal letter stating that the conditions for a prohibition of the transaction are not met. If the authority identifies competition concerns, it can open an in-depth review (Phase II) which ends 5 months after receipt of the complete notification. This deadline can be extended with consent of the merging parties, if the parties offer commitments to address competition concerns, or if the Federal Cartel Office has to issue formal requests for information to obtain data or documents from the parties (so-called "stop-the-clock").

At the end of Phase II, the competition authority will issue a formal decision which either clears or prohibits the transaction. The Federal Cartel Office does not necessarily have to make full use of the deadlines but can (and often does) grant clearance prior to expiry of the deadlines, provided that the transaction does not raise competition issues or if all concerns have been sufficiently addressed (e.g. by commitments).

Substantive Review

The transaction will be approved unless it impedes effective competition, in particular by creating or strengthening a market dominant position. The Federal Cartel Office will therefore analyze the parties' market position and the effects of the transaction on customers, suppliers and competitors.

The German Competition Act contains a presumption of individual market dominance for parties having a market share of 40% or more and a presumption of collective dominance where three or fewer companies active on the market have a combined market share of 50% or more or five or fewer companies have a combined market share of two thirds or more. These presumptions are rebuttable and the Federal Cartel Office will not only rely on these presumptions, but will always base its decision on a full analysis of the affected markets and the effects of the transaction on competition.

If the Federal Cartel Office identifies competition issues which would pose grounds for a prohibition order, the parties can offer commitments in Phase II to address these concerns. Typical remedies include for example divestitures to remove overlaps, and there is a strong preference by the Federal Cartel Office to have such divestitures completed prior to implementation of the underlying transaction (upfront-buyer principle). Behavioural remedies are in principle also possible (although not preferred by the authority), provided that these solutions also effectively address the competition concerns and do not require an ongoing monitoring by the Federal Cartel Office. A guidance document on remedies and their implementation is published by the competition authority on its website.

The review by the Federal Cartel Office is limited to the competitive effects of the transaction on the market. That being said, the authority has in its decisional practice analyzed and taken into account whether state-owned companies have a competitive advantage (e.g. through far-reaching vertical integration, access to significant financial resources or the ability to apply low price strategies). Other factors, such as national security or other public interest issues are not relevant (although these issues will be highly relevant in parallel foreign investment proceedings before the German Ministry of Economics and Energy).

Appeal

The informal clearance letters issued at the end of Phase I cannot be appealed. The formal decisions by the Federal Cartel Office after a Phase II review can be appealed by the parties (in the event of a prohibition order or a clearance which is only granted subject to commitments) and by third parties which have been formally admitted to the Federal Cartel Office's merger control proceedings as interested third parties.

Ministerial exemption

A prohibition order of the Federal Cartel Office can be overruled by the German Minister for Economy and Energy if the anticompetitive effects of the transaction are outweighed by benefits to the economy as a whole or if there is an overriding public interest in the completion of the transaction. This ministerial exemption is a largely political process and the Minister for Economy and Energy has a wide discretion as to the decision. To initiate ministerial exemption proceedings, the parties to the transaction have to submit a formal application to the Minister for Economy and Energy. However, ministerial exemption proceedings are rare and have been successful only in a very limited number of cases.

Regulation on outbound investment by Chinese enterprises

Hui Zhao

With the rapid development of China's economy, more and more Chinese enterprises choose to invest overseas as part of their "going global" endeavours. The outbound investment by Chinese enterprises is subject to the regulation by competent authorities, which mainly include the National Development and Reform Commission (NDRC), the Ministry of Commerce of the People's Republic of China (MOFCOM), the State Administration of Foreign Exchange (SAFE), and their respective branches. Under some circumstances, depending on the status of the investor, other authorities may be involved. For example, if the investor is a SOE, it will be regulated by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) and its branches. In this article, we will briefly introduce the regulation and approval on the outbound investment by Chinese Enterprises.

NDRC

In April 2014, the NDRC issued Order No.9[1], changing the method of outbound investment regulation from item-by-item approval to a filing-based regime which requires approval under certain circumstances. Based on the Order, and in combination with the actual development of outbound investment, the NDRC issued the *Measures for Administration of Outbound Investment by Enterprises* (the "Administrative Measures for Enterprises") on 26 December 2017, the *Notice of the National Development and Reform Commission on Circulating the Catalogue of Sensitive Industries for Outbound Investment (2018 Edition)* (the "Sensitive Industry Catalogue") on 31 January 2018, and the *Notice of the National Development and Reform Commission on Circulating the Accessory Format Text of the Measures for Administration of Outbound Investment by Enterprises (2018 Edition)* (the "Accessory Format Text") on 9 February 2018. The above notices and administrative measures all took effect on 1 March 2018.

Scope of application

Outbound investment

Outbound investment refers to the investment activities where an enterprise within the territory of the PRC, directly or via an overseas enterprise under its control, acquires overseas ownership, control, business management right, and other related rights or interests, by contributing assets or equities, or providing financing or guarantees. The investment activities referred to in the Administrative Measures for Enterprises mainly include but are not limited to the following circumstances:

a) Acquisition of the ownership, usufruct or other equities in overseas land;

b) Acquisition of franchise or other equities for overseas natural resources exploration and development;

c) Acquisition of the ownership, business management right or other equities in overseas infrastructure;

d) Acquisition of the ownership, business management right or other equities in overseas enterprises or assets;

e) Establishment, renovation, or expansion of overseas fixed assets;

f) Incorporation of an overseas enterprise or additional investment in an existing overseas enterprise;

g) Establishment of an overseas equity investment fund or equity investment in such fund; and

h) Control over an overseas enterprise or assets by means of agreements, trusts or otherwise.[2]

Investors

The investors to which it applies include various types of non-financial and financial enterprises. This is the first time that the financial enterprises are explicitly included therein.

[1] *Measures for the Administration of Approval and Filing of Outbound Investment Projects,* promulgated on 8 April 2014 and implemented as of 8 May 2014.

[2] Article 2 of the *Measures for Administration of Outbound Investment by Enterprises,* promulgated on 26 December 2017 and implemented as of 1 March 2018.

Administration of approval and filing

Approval

The sensitive projects conducted by a Chinese enterprise, either directly or via an overseas enterprise under its control, are subject to the approval of the NDRC.

Sensitive projects include projects involving sensitive countries and regions and those involving sensitive industries.

The NDRC is responsible for the approval of project application reports. To be specific, if the investor is a centrally administered enterprise, the application report shall be submitted by its group company or the head office to the NDRC; if the investor is a local enterprise, the application report shall be directly submitted by itself to the NDRC. The NDRC shall make a decision on whether to approve the project within twenty (20) business days of acceptance of the report. If special conditions of the Administrative Measures for Enterprises are met, another ten (10) business days at most may be granted for such decision-making.

Sensitive projects	
Projects involving sensitive countries and regions	Sensitive countries and regions include: • Countries and regions that have not yet established diplomatic relations with China; • Countries and regions where wars and civil strife occur; • Countries and regions where investment by enterprises shall be restricted pursuant to the international treaties and protocols concluded or acceded by China; and • Other sensitive countries and regions.
Projects involving sensitive industries	Pursuant to the Sensitive Industry Catalogue[3], sensitive industries include: • Research, production, maintenance and repair of weapons and equipment; • Development and utilisation of cross-border water resources; • News media; and • Industries for which outbound investments by enterprises shall be restricted pursuant to the *Notice (Forwarded by the General Office of the State Council) of the National Development and Reform Commission, the Ministry of Commerce, the People's Bank of China, and the Ministry of Foreign Affairs on Circulating the Instructions for Further Directing and Regulating the Orientation of Outbound Investment (Guo Ban Fa [2017] No.74)*, specifically: - Real estate; - Hotel; - Movie theatre; - Entertainment; - Sports club; - Establishment of equity investment fund or investment platform with no specific industrial projects.

[3] *Notice of the National Development and Reform Commission on Circulating the Catalogue of Sensitive Industries for Outbound Investment (2018 Edition),* promulgated on 31 January 2018 and implemented as of 1 March 2018.

Filing

The non-sensitive projects directly conducted by Chinese enterprises, i.e. the non-sensitive projects involving the direct contribution of assets or equities, or the provision of financing or guarantees by Chinese enterprises, are subject to filing with the NDRC.[4]

Investor	Additional requirements	Authority responsible for filing	Time limit for filing
Centrally administered enterprise	None	NDRC	Issue a filing notice within seven (7) business days of acceptance of the project filing form
Local enterprise	Chinese investment is USD 300 million or above	NDRC	
	Chinese investment[5] is less than USD 300 million	The provincial development and reform authority at the place where the investor is registered	

In addition, the Accessory Format Text[6] specifies the materials to be submitted and information to be disclosed by the investor when applying for outbound investment approval/filing. Higher requirements are set out in terms of the scope and the accuracy of the information to be disclosed, which not only includes the investment destination and the investor, but also the controlling shareholders, the de facto controller, and the entire investment path of the investor.

Notification

Where an investor launches a large-scale non-sensitive project[7] through an overseas enterprise under its control, it shall submit a report on such project prior to the implementation of the same.

Information reporting obligations

In order to enhance the supervision over outbound investment during and after the investment project, the Administrative Measures for Enterprises also introduce rules governing the reporting of project completion, major adverse situation, and inquiries and reports on material issues.

For a project subject to approval or filing, the investor shall submit a report on project completion through the network system within twenty (20) business days of completion of the project.[8]

During an ongoing outbound investment, where any seriously adverse circumstance occurs, such as heavy casualties of the dispatched personnel, a significant loss of overseas assets, or damage to China's diplomatic relations with the

[4] Article 14 of the *Measures for Administration of Outbound Investment by Enterprises.*

[5] "Chinese investment" refers to the sum of such assets and equities as currencies, securities, physical objects, technologies, intellectual properties, equities, creditors' rights, and the financing and guarantees invested or provided by the project investor, either directly or via an enterprise under its control. (Article 14 of the *Measures for Administration of Outbound Investment by Enterprises*).

[6] *Notice of the National Development and Reform Commission on Circulating the Accessory Format Text of the Measures for Administration of Outbound Investment by Enterprises (2018 Edition)*, promulgated on 9 February 2018 and implemented as of 1 March 2018.

[7] This refers to non-sensitive project where Chinese investment is USD 300 million or above. (Article 42 of the *Measures for Administration of Outbound Investment by Enterprises*.)

[8] Article 44 of the *Measures for Administration of Outbound Investment by Enterprises.*

countries concerned, the investor shall submit a report on the seriously adverse circumstance through the network system within five (5) business days of the occurrence of such circumstance.[9]

In addition, the NDRC and the provincial development and reform authority may issue a letter of enquiry on significant matters in process of outbound investments to the investor. The investor shall submit a written report explaining the matters specified in such letter of enquiry within the required time limit.[10]

MOFCOM

The *Administrative Measures for Outbound Investment* (the "Administrative Measures") issued by MOFCOM on 6 September 2014 applies to Chinese enterprises which, through incorporation, M&A, or any other methods, acquire ownership of an overseas non-financial enterprise or obtain ownership, control, business management right, and other equities in an existing non-financial enterprise.[11] It does not apply to outbound investment by financial enterprises.

Approval

Pursuant to the Administrative Measures, outbound investment involving sensitive countries and regions and sensitive industries is subject to the approval of MOFCOM and the provincial commerce authorities, while the rest is only required to file with the above agencies. To be specific, sensitive countries or regions refer to countries or regions that (i) have not yet established diplomatic relations with the PRC, (ii) are subject to UN sanctions, and (iii) are announced to be subject to approval by MOFCOM as it deems necessary. Sensitive industries refer to industries which export products and technologies restricted under China's export control that affect the interests of more than one country (region).

Investor	Authority responsible for approval	Time limit for approval
Centrally administered enterprise	MOFCOM	Within twenty (20) business days of acceptance of an application for approval by a centrally administered enterprise
Local enterprise	Apply to MOFCOM through the provincial commerce authority	• The provincial commerce authority conducts a preliminary review and reports to MOFCOM within fifteen (15) business days of acceptance of an application for approval by a local enterprise. • MOFCOM make decisions within fifteen (15) business days of receipt of the opinion of preliminary review of the provincial commerce authority.

Filing

For outbound investments subject to filing, the centrally administered enterprises shall file with MOFCOM while the local enterprises shall file with the provincial commerce authorities at their respective locality. MOFCOM or the provincial commerce authorities shall make decisions within three (3) business days of receipt of the filing form.

9 Article 43 of the *Measures for Administration of Outbound Investment by Enterprises.*

10 Article 45 of the *Measures for Administration of Outbound Investment by Enterprises.*

11 Article 2 of the *Administrative Measures for Outbound Investment*, promulgated on 6 September 2014 and implemented as of 6 October 2014.

Authenticity review

According to the notice issued by MOFCOM on its website on 2 December 2016, when going through procedures of outbound investment approval or filing, in addition to the materials submitted in accordance with the current provisions, Chinese investors are also required to submit other supplements that can prove the authenticity of the proposed outbound investment, such as the relevant articles of association (or contracts, agreements) of the overseas enterprise established either through incorporation or M&A, the relevant resolutions of board of directors or investment resolutions, the latest audited financial statements, and the description of the implementation of the preliminary work (including due diligence, feasibility study report, description of the sources of investment funds, and analysis and assessment of the investment environment). After reviewing and confirming the authenticity of outbound investment, the competent commerce authority will officially accept the application from the investors and then consent to their application for approval/filing.

Information reporting obligations

On 18 January 2018, MOFCOM, the People's Bank of China, SASAC, CBRC, CSRC, CIRC, and SAFE jointly issued the *Provisional Measures on the Reporting for Filing (Approval) of Outbound Investment* (the "Provisional Measures"), which specifies the information reporting obligations of Chinese investors. In accordance with this Provisional Measures, a Chinese investor shall, upon completion of relevant approval/filing, submit its information of outbound investments at key stages on a regular basis to the authorities with which it goes through the filing (approval) procedures.[12]

The information submitted by a Chinese investor includes but is not limited to:

- Monthly and yearly information required by the *Statistical Rules of Outbound Direct Investments*;
- Prophase matters of outbound investments and M&A;
- Progress of outbound investment projects under construction;
- Major problems in outbound investments; and
- Compliance with local laws and regulations, protection of resources and environment, protection of legitimate rights and interests of employees, performance of social responsibility, implementation of security protection system etc.[13]

In case of a major adverse event or an emergency security accident during an outbound investment, the Chinese investor shall, under the principle of "one case one report", report to the relevant authority, and the latter shall further inform MOFCOM thereof.[14]

SAFE

Chinese investors making outbound direct investment shall not go through foreign exchange registration until they obtain the approval of, or complete the filing with relevant competent authorities required by regulations of the State.[15]

Direct foreign exchange registration

In 2015, SAFE cancelled the foreign exchange registration approval for outbound direct investment. Instead, banks would directly review the foreign exchange registration for outbound direct investment, and SAFE would implement

[12] Article 12 of the *Provisional Measures on the Reporting for Filing (Approval) of Outbound Investment*, promulgated and implemented on 18 January 2018.

[13] Article 13 of the *Provisional Measures on the Reporting for Filing (Approval) of Outbound Investment.*

[14] Article 16 of the *Provisional Measures on the Reporting for Filing (Approval) of Outbound Investment*.

[15] Article 17 of the *Regulations of the People's Republic of China on Foreign Exchange Control*, promulgated on 29 January 1996 and amended on 1 August 2008.

indirect supervision via the banks.[16] In addition, the Notice also cancels the foreign exchange filing for outbound reinvestment, providing that where an overseas enterprise established or controlled by an investor establishes or controls another overseas enterprise through reinvestment, the foreign exchange filing will not be required.

Authenticity and compliance review

Since November 2016, SAFE has tightened its control over outbound investment and outward remittance of funds, conducting enquiries on outbound investment and outward remittance involving more than USD 5 million. In early 2017, SAFE issued the relevant notice to enhance the authenticity and compliance review of outbound direct investment. According to this notice, when going through the procedures of outbound direct investment registration and outward remittance of funds, a Chinese investor shall, in addition to submitting relevant documents for the review as required, explain the source and purpose (utilization plan) of its investment capital and provide the resolution of board of directors (or partners resolution), contract or other proofs on authenticity to the relevant bank.[17]

In addition, it should be noted that, in response to irrational tendencies in outbound investment, on 6 December 2016, the heads of the NDRC, MOFCOM, the People's Bank of China, and SAFE announced during press conference that they would pay close attention to some irrational tendencies in outbound investment in such industries as real estate, hotel, movie theatre, entertainment, and sports club, as well as the risks in large-scale non-core investment, outbound investment by limited partnerships, investment in offshore targets that have assets value larger than the Chinese acquirers, projects that have very short investment period and other types of outbound investment.

SASAC

The State-owned Assets authorities will also be in the picture if the investor is an SOE. SOEs are required to apply to SASAC for approval or filing for specific outbound investment according to different standards. The competent local authorities at all levels usually administer the approval or filing of outbound investment activities of enterprises within their jurisdictions according to specific situations.

In January 2017, SASAC issued the Measures for Supervision and Administration of Outbound Investment by Centrally Administered Enterprises that governs the outbound investment by centrally administered enterprises, which, for the first time, introduced a negative list for outbound investment projects by centrally administered enterprises. SASAC is responsible for preparing and publishing the negative list, which will adopt categorized supervision by specifying prohibited and specially supervised outbound investment projects.[18] By far, however, SASAC has not yet released any negative list mentioned thereunder.

Category	Requirements
Prohibited outbound investment projects included in the negative list.	No centrally administered enterprise is allowed to make investment.
Specially supervised outbound investment projects included in the negative list.	Upon completion of the internal decision-making procedures, centrally administered enterprises shall submit to SASAC for review and approval prior to its first submission to relevant authority of the State (the NDRC, MOFCOM, etc.).
Outbound investment projects not included in the negative list.	Centrally administered enterprises may make decisions at their sole discretion based on their development strategies and plans.

[16] Article 1 of the *Notice of the State Administration of Foreign Exchange on Further Simplifying and Improving the Foreign Exchange Administration Policies for Direct Investment*, promulgated on 13 February 2015.

[17] Article 8 of the *Notice of State Administration of Foreign Exchange on Further Promoting the Reform of Foreign Exchange Control and Improving the Authenticity and Compliance Review*, promulgated on 26 January 2017.

[18] Article 9 of the *Measures for Supervision and Administration of Outbound Investment by Centrally Administered Enterprises*, promulgated on 18 January 2017.

In addition, a centrally administered enterprise shall not make any non-core business investment outside the PRC in general. Where a non-core business investment is necessary for special reasons, the enterprise shall first report to SASAC for review and approval, and make such investment in cooperation with a centrally administered enterprise who has advantages in the relevant investment fields upon approval.[19]

To conclude, through rounds of amendments to relevant laws and regulations, a filing-based regulatory regime which requires approval under certain circumstances has been established for outbound investment by Chinese investors. In practice, the regulatory authorities review the authenticity and compliance of outbound investment and make it a guiding principle. With the promulgation of the NDRC's *Measures for Administration of Outbound Investment by Enterprises* and the progress of MOFCOM's *Regulations on Outbound Investment Law*, it is expected that this will further enhance the certainty of the government's regulatory process, improve the position of Chinese enterprises in competition with other overseas enterprises, effectively regulate and guide outbound investment activities, and promote the sound development of outbound investment.

[19] *Id.*

Stake-building in German public companies - PIPEs and more

Dr. Christian Cornett Dr. Tilmann Becker

What are PIPEs

The heading **PIPE** describes an investment of private or institutional investors in the equity of listed companies (**p**rivate investment in **p**ublic **e**quity). In contrast to the public placement of shares, where the shares are offered to the general public, the acquisition of shares in the framework of a PIPE-transaction is typically arranged privately. The most common forms of PIPE are (1) a subscription of new shares in a listed target by one or two subscribers (typically without the target' s other shareholders subscribing for shares at the same time) and/or (2) an agreement between the investor and other shareholders of the target to acquire existing shares. Often, but not always, the agreements are entered into between the investor(s) and the listed target and/or the investors(s) and seller(s) and an investment bank (and sometimes others, e.g. share lenders, arrangers etc.). A PIPE transaction is further often combined with other elements, such as block-trades or the use of financial instruments (often total return swaps and/or forward arrangements), the acquisition of convertibles, share lending arrangements etc. Due to these numerous elements available, it is possible to tailor the PIPE transaction to the specific investment situation and the interest of the parties involved, although it should be noted that over time certain standards have evolved in the markets.

While a simple PIPE will still often (merely) be a subscription of new shares directly from the issuer, many PIPE investments consist of several elements/stages and the final structure typically depends on the situation at hand, balancing the various interests.

PIPEs have evolved significantly and become more sophisticated over the last generation and vary considerably between jurisdictions/markets. This is in part due to the markets themselves and investor preferences, e.g. traditionally in some markets, investors object to dilutive, non-pre-emptive offerings. The frequency and appetite for PIPEs, however, is also reflecting legal restraints. This article sets out the potential market for PIPE-transactions in Germany (see II below). It also aims to render an overview of some of the key items in the German legal framework for German PIPE transactions (see III below). On this backdrop, certain legal challenges are discussed (see IV below). Finally, some key benefits of a PIPE-transaction are discussed (see V below) and our outlook (see VI below) sets out certain trends observed.

Markets

PIPE transactions in the German market can basically take place with respect to shares (or other equity-linked products) listed in one of two market segments: the regulated market and the unregulated market.

PIPE transactions pertaining to targets listed on the regulated market must take into consideration the extended regulatory regimes which, due to the applicable EU-regulations, are basically similar in all member states of the EU, including high admission, transparency and other legal requirements. PIPE-transactions relating to listed companies in the unregulated market, which comprises those securities that are not admitted to trading in the regulated market, are less comprehensively regulated.

Regulated market

The regulated market constitutes an organised market within the meaning of the German Securities Trading Act (“Wertpapierhandelsgesetz”, WpHG) which is subject to public law. If a company wants to be listed on the regulated market, it is required to undergo an admission procedure under German public law. In addition, those companies are subject to far-reaching follow-up obligations.

Unregulated market

In contrast to the regulated market, shares listed on an unregulated market are listed in a stock exchange segment which is organized under private law. It is regulated by the respective stock exchange itself, e.g. through the structure of their general terms and conditions. Companies and their securities listed on the unregulated market are subject to lower admission requirements than those mentioned under II.a. This is intended to facilitate access to capital markets for small and medium sized companies. While e.g. the insider regime also applies PIPE-transactions on an unregulated market, other legal regimes of substantial relevance for PIPE-transactions on the regulated market (e.g. the German take-over regime) do not apply.

The consideration of the respective market in which a target company is listed may, due to the divergent legal framework and obligations, therefore have an impact on the conditions and challenges that have to be weighed and considered in the context of each PIPE transaction.

Brief overview of key items of relevance for PIPEs and stake-building in Germany

In principle, in a perfect market the price of a share results from supply and demand; the trading volume often being referred to as “liquidity” of the share. If both supply and demand are high (i.e. where a high volume is created by the many purchases and sales), liquidity is typically high and price adjustments take place in a speedy manner. The market naturally seeks and finds a fair price. On this backdrop, the share price is often also referred to as fair price or market price, as it is formed by supply and demand.

For historic reasons, German law assumes a perfect market and high liquidity. As this is typically not the case in real life, in particular where uncertainty manifests itself in the markets, in times of turmoil such as a global crisis etc., in line with market and legal practice in most jurisdictions, certain particular items of German law are to be dealt with to structure PIPEs effectively. An investor considering PIPE should in particular be aware and take into consideration the following items:

- **Pricing and discounts:** Pricing and value of the shares are key to any PIPE transaction. While the future value and thus the price for any company will, amongst other things, typically depend on the investors' assumptions with respect to future earnings, growth etc., the company's stock price is of key relevance for both the success and the way to execute any PIPE. As the price is key, the elasticity of demand for the stock of the company is consequently also crucial for the timing and structuring of any PIPE. The prevailing assumptions that demand should be perfectly elastic obviously meet its limits where in the course of any block-building etc. the number of freely available shares and thus the liquidity is reduced.

  While often small blocks can be acquired without significant impact on the market price and/or the liquidity, a significant stock-building typically takes place outside of the market (OTC). Where existing shares are acquired, e.g. in agreed block-trades, the price can be freely agreed by the parties (subject to insider or market manipulation rules etc., see IV. below) and as the pricing takes place off market, it has no direct effect on the share price.

  Where new shares are issued to the investor by the issuer, discounts, if any, are only possible to a limited extent: while the new shares can generally be offered above market price, as a general rule, the new shares must be issued at least at the market price (in a given reference period), provided that under the current German stock corporation regime a quite small discount can be agreed (it being somewhat disputed whether the maximum permitted discount is 3% or 5% of the prevailing stock price) other than in exceptional cases (e.g. in a restructuring situation) where exemptions can be feasible.

- **Thresholds, e.g. the "10%"**: Sometimes market participants "have heard" that in Germany PIPEs are only possible up to 10%. While this is not the case in all constellations, it is true, that for market, legal and also historic reasons, most PIPEs in Germany result in shareholdings below 10%. One reason for this is that where the investors wish that the listed company itself receives the liquidity from the PIPE transaction, due to restraints in the German Stock Corporation Act ("Aktiengesetz", AktG), the other shareholders' mandatory subscription rights for new shares can only be safely eliminated for good cause and only for new shares totalling up to 10% of the total voting rights prior to such issuance of shares. This 10 % threshold results in a situation where an investor can only subscribe for a maximum of 9.1% of new shares being issued, unless the involved parties have obtained sufficient security that the mandatory subscription right of the existing shareholders can be excluded even above the 10 % threshold. In our experience, however, the issuance of new shares is often merely one element in a stake-building process; next to the subscription of shares additional shares can either be acquired on the market, in block trades or be secured by use of financial instruments. The combination of these elements allow investors to build a stake significantly exceeding the 10% threshold (see below), always provided that the investor(s) comply with other legal challenges such as insider-issues, avoid any market manipulation etc. (for details see IV below).

  Thus, while the 10% threshold (de facto 9.1% post capital increase) is often referred to in the search for new cornerstone investors etc., the 10% threshold is legally just one element and in particular when investments are combined with other elements (such as block-trades, financial instruments etc.), the 10% threshold merely relates to the issuance of new shares. It should be noted, however, that the 10% threshold is also relevant in other contexts (e.g. under the German Securities Trading Act (Wertpapierhandelsgesetz, WpHG), any shareholder acquiring 10% of the shares in a company listed on the regulated market is obliged to issue a specific notification setting out the shareholders intentions; a shareholding in a financial institution or bank needs approval if it reaches 10% etc.).

The 10% threshold may also become of relevance in some other aspect (for example where stakes in financial institutions or insurances are acquired) and in certain situations under the German foreign investment regime. In practice, however, a stake of 25% is often a more relevant threshold, e.g. due to tax and or anti-trust considerations. Overall, thresholds under the German foreign investment regime (10% or 20%), EU or German anti-trust regimes (typically 25 or 50%), the 30% under the German Take-Over Act or other applicable regulatory thresholds are to be taken into consideration. In addition, certain specific thresholds such as voting restrictions in the target's articles of association or qualified provisions applicable to the target (e.g. poison pills, specific change of control clauses etc.) are to be taken into due consideration before deciding on the implementation of any PIPE.

- **Stake-building and publicity**: Basically, whenever a shareholder and/or any party acting in concert with such shareholder or to whom the shares are attributed as well as any persons or entities controlling the shareholder(s) must render a formal notice to the German Financial Supervisory authority and the issuer whenever certain thresholds are passed (3%, 5%, 10%, 15%, 20%, 25%, 30%, 50%, 75%). As these notifications become public and have effects on the market, the thresholds are to be taken into due consideration in the structuring and timing of any PIPE.

- **Stake-building via financial instruments:** As any significant stake-building on the market has an impact on the price, for the last 10-15 years the use of financial instruments has evolved as a prevailing option used in PIPE transactions where the investor acquires existing shares: the use of financial instruments allows for a smoother stake-building, for better financial planning and - last, not least – for a more efficient handling of legal items such as insider rules, dealing with notification duties etc.

  While obviously insider rules etc. and a number of market particularities should be taken into account when stakes are being built by or involving the use of swaps or other financial instruments, one key legal consideration to be remembered is that whenever the 5% threshold (or any higher of the other notification thresholds stated above, referred to the total of shares and financial instruments) is passed.

  While the notification regime was earlier perceived as a nuisance only, the notification regime has been tightened repeatedly over the last decade. By now, even a mere delay in the notification will typically trigger a fine, and while most fines are in the five- or six-digit range, in recent years we have witnessed fines exceeding a million Euros. Thus, by now all market participants pay significant attention to the notifications. Notifications are to be made in electronic forms asap and no later than four days after the passing of a threshold.

  At KWM, we are admitted to making the necessary filings and have often under proxies filed such notifications – and advised on the proper structuring of PIPEs, also with respect to notification duties.

- **Feasibility and timing**: Understanding the importance of timing is crucial to most PIPEs, not only in Germany. While the trading windows etc. are in our experience of less relevance in Germany than in some other jurisdictions, other items such as the timing of the annual accounts, the financial calendar or fiscal year of the target company are to be taken into consideration next to the investor's own timelines. This typically leaves only a few windows of opportunity for the optimised PIPE implementation. In our experience, the implementation of most PIPE transactions will take between four to six weeks once the transaction(s) commence, however, sometimes the stake-building may take much longer. Evidently, a simple block-trade is faster while a comprehensive, staggered program consisting of different types of financial instruments, whether held to maturity or not, may take longer.

- **Limited due diligence only**: In many scenarios, in particular where a PIPE relating to a German stock corporation is implemented by way of an acquisition of existing shares on the market, for various reasons, in the German market a due diligence will in most cases be limited to a review of publicly available facts. Where new shares are issued in the context of a PIPE transaction, investors will often be requested to enter into a non-disclosure agreement and/or other confidentiality undertaking. Under German law, typically the issuer can and will only disclose information to a limited extent and provided that such disclosure is in the best interest of the issuer. Sometimes, an investor in this context is requested to give additional undertakings (lock-up, stand-still etc.), e.g. in a so-called investor agreement, which also may contain provisions that limit the investor's flexibility going forward. Sometimes a letter of intent is entered into prior to such an investment (which may include a mutual understanding of pricing, the process and/or information rights etc.). Whether such – often mutual – understanding is reached and the content will often depend on the circumstances of each investment.

As a general rule, however, investors will typically, have an interest in avoiding obtaining insider information during the investment phase to avoid being limited under the market abuse regulations provisions (for details see IV below).

Legal challenges

PIPEs are feasible and permitted under German law. Obviously, in the implementation and structuring of PIPEs a number of legal provisions and regimes are to be taken into due consideration. These are mainly the German Stock Corporation Act, the German Securities Trading Act, the German Take-Over Act ("Wertpapiererwerbs—und übernahmegesetz", "WpÜG") together with regulations under these Acts as well as European legislation, namely the Market Abuse Regulation (*Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse, EU MAR*) and various regulations as well as guidelines, including ESMA guidelines, setting out various regimes. As these regimes do not fully correspond and interact with each other, the interaction is sometimes patchy and the lack of convergence requires knowledge of market standards as applied by the regulators, banks etc.

On this backdrop, we herein restrict our overview of the legal challenges to implement PIPEs to some core considerations:

- **Insider information may neither be disclosed or used:** The relevant insider regime for PIPEs in Germany is set out in the EU MAR, according to which insider dealing arises where a person possesses insider information and uses that information for the acquisition of financial instruments. To avoid insider dealings etc., typically a clear insider policy is to be implemented at the outset of any PIPE transaction, at the latest before the implementation of the PIPE and ideally before insider information is even received. One basic consideration is, whether in lieu of the existing rules, an investor wishes to obtain insider information in the first place prior to an investment. Also, it needs to be decided on whether it is appropriate or advantageous or even necessary to implement a clean team and how to deal with scenarios where insider information is established or arises in the course of the PIPE. Given the specifics of the insider regulations, these scenarios should be assessed in each specific PIPE situation. In our experience, the safe-havens of legitimate behaviour as permitted in the EU MAR should be explored, discussed with respect to the situation at hand and be understood in time. The restrictions can be dealt with in a sober way, however, they should neither be fully exploited, nor should they be circumvented.

- **Market manipulation**: The market abuse regulation prohibits actions that can be qualified as market manipulation. It is prohibited, amongst other things, to give false or misleading signals as to the supply of, demand for, or price of a financial instrument.

  Inter alia, it is prohibited to secure the price of a financial instrument at an abnormal or artificial level. Thus, it is prohibited to enter into a transaction, to place an order or generally any other behaviour which is likely to give a false or misleading signal to supply, demand or price of shares, derivatives etc. Such actions may qualify as market manipulation just like any action likely to secure the price of shares and/or financial instruments. Such (false) signalising also includes disseminating information through media, including the internet. The EU MAR on the one hand sets out in detail which behaviour shall be considered as market manipulation (such as the placing of certain orders, cancellation or modification hereof), on the other hand it also sets out certain legitimate forms of behaviour, namely accepted market practices which are not to be qualified as market manipulation. In particular where a stake-building is pursued by way of transactions on the market or in the context of other activities relating to the target, it is mandatory to pay attention to MAR's market manipulation regime (together with the insider regime).

- **Public communication:** The prohibition to use or share insider information, together with the market manipulation regime on the one hand and the issuers obligation to inform the market of insider information (the issuer is subject to so-called ad-hoc duties) on the other hand sometimes result in a tension that needs to be taken into due consideration and should be addressed in time.

- **Thresholds:**

  - As mentioned above, any shareholder has to notify the German supervisory authority and the issuer in case the shareholder (alone or together with others due to attribution of the shares held by others or under the deemed acting in concert regime) passes the 3%, 5%, 10%, 15%, 20%, 25%, 30%, 50%, 75% threshold. As stated above, these notifications have effects on the market as they cause a public awareness and are thus to be taken into due consideration in the structuring and timing of any PIPE.

  - Whenever a shareholder (alone or together with others due to attribution of the shares held by others or under the deemed acting in concert regime) passes directly or indirectly the threshold of 30% of the voting rights in any company listed on the regulated market, a mandatory obligation to make a public take-over offer is triggered. Thus, de facto most PIPEs result in shareholdings below 30% in order to avoid the takeover obligation with respect to all outstanding shares, which is triggered whenever the shareholder (alone or together with others) reaches 30% of the listed company's outstanding voting rights.

  - Additional thresholds may become relevant in certain situations, e.g. an advance clearance from the German Financial Supervisory Authority is required whenever (de facto: before) a 10% threshold is (indirectly) reached in a financial institution or an insurance company. Similarly, an advance clearance is required under other public regimes, e.g. the German Foreign Investment or anti-trust regimes where respectively 10%, 20%, 25% (depending on the business operations of the target company) are acquired in a German issuer by an investor located or controlled from outside the EU.

- **Investor agreements and the principle of equal treatment of shareholders**: Under mandatory German law, any issuer is in principle obliged to treat shareholders equally. This principle has resulted in severe limitations in issuers ability to render a preferential treatment or special rights to investors in the context of PIPEs. Thus, during most PIPE investments (in particular where new shares are offered), where an investor wishes to ensure / negotiate special rights, this must be structured and balanced very carefully. It is, however, e.g. in investor agreements or other agreements, in practice sometimes possible to agree staggered preferential rights, typically limited to a period of 3 to 5 years, rarely longer. While soft commitments from the issuer are possible (and often complied with for relationship reasons, e.g. the use of best endeavours to promote (but not procure) that an investor representative shall join the supervisory board etc.), increasingly other strategic alignments are requested (and often achieved), e.g. by investors requesting for certain strategic expansions etc. or by activist shareholders requesting that the issuer should divest certain assets etc. Due to the equal treatment regime, whenever in the context of a PIPE specific operational or other strategic interests are to be pursued, the timing and way of dealing with such specific interests should be carefully planned.

Beyond these challenges, there are typically specific challenges (e.g. the specific shareholder structure, the specific German corporate provisions relating to the appointment of board members etc.) which should be analysed with respect to the situation at hand, however, in our experience in Germany, PIPEs are not just feasible, they are actually straight forward and legal challenges can be overcome if structured appropriately.

In the course of most PIPE transactions, at some point of time there will be moments to balance the secure path, allowing for flexibility on the one hand – and optimisation and dealing with different risk scenarios on the other hand. As in most capital transactions, as a general rule, the better the PIPE is structured and the simpler the PIPE is implemented, the more deal certainty and likely success of any PIPE increases.

Economic reasons and benefits

Especially in the current global economy, where liquidity has increased immensely, PIPEs have become increasingly relevant. Inter alia, while on the one hand the fund volumes of private equity investors are constantly increasing, on the other hand the number of potential target companies is decreasing. Yet, in many cases, the financial resources may not be sufficient for a complete takeover or such a takeover may not (yet) be intended. Therefore, private equity investors may be encouraged to consider alternative investment opportunities, e.g. a PIPE. PIPE transactions regularly provide several economic advantages. In general, PIPE transactions allow for a fast and cost effective raising and/or investment of capital. Beyond this, on liquid markets PIPEs facilitate investments from various investors – de facto expanding the base of the typical institutional investors considerably.

Furthermore, PIPE investments can be economically very attractive, since it is possible to acquire significant blocks of shares in listed companies at favourable conditions and in addition, due to the favourable entry and the often existing discrepancy between market value and potential company value, the investment has a considerable growth potential. Moreover, as a result of the coordinated and consensual investment process, there is no price-driving bidding process or similar limitation. Increasingly, more or less streamlined pre-transactions disclosure materials facilitate speedy processes (and, at the same time, reduce insider and market-manipulation risks). Last, not least, failed PIPE-transactions typically are not made public and thus do not impact the markets, as nearly all PIPE-transactions are only disclosed after the PIPE has been completed (or after a definite investment has been agreed/ committed etc.).

Another mentionable aspect is, that, by means of the investment agreement, an investor can be granted a specific (limited) influence over the company that exceeds the influence of a simple shareholder, e.g. by appointing members of the supervisory board and/or by agreeing certain strategic or other joint goals.

Last, not least: all other things equal, due to the listing of the investment, most PIPE investment allows for a high flexibility during the term of the investment, e.g. for a flexible refinancing (rendering the listed shares at a collateral at market price(s)) and/or flexible (partial) exit(s), e.g. by way of sale(s) shares on the stock exchange and/or blocks of shares. Moreover, equity-linked derivatives often allow investors to actively manage their PIPE-investments.

Outlook, trends and our service

In line with global trends, PIPE transactions have evolved into a customary form of investment in the German market. Certain market standards have been developed, inter alia due to the legal items outlined herein. Overall, PIPE-transactions in Germany are easier to implement than in many other jurisdictions, in particular where the target stake in a first stage is below 10% of the issuers voting rights. As a general guideline, where stakes are accumulated, the 3% (or, where financial instruments are employed; the 5%) and the 10% threshold are of high initial relevance.

Other restrictions, limiting PIPEs in many jurisdictions such as free float requirements, prospectus and or registration requirements are only relevant in the German market in very few, exceptional cases. Similarly, approvals, e.g. by the board of the target company, the exchange or independent market supervisors etc. which investors face in certain other jurisdictions, are typically not required in German PIPEs.

Although on average the prices on the German stock markets may be at a historic high level, in Germany the number of PIPEs is in some areas increasing these days. This is partly due to the significant liquidity that is flowing into the market. A more differentiated view, however, shows that PIPEs are taking place in selected industries: not just where corona has caused cash-flow drains, but also in numerous cases where either listed companies may wish to raise money quietly/in direct share issues or in situations where shareholders wish to establish or realise positions without influencing the market.

The KWM team has significant experience in all kinds of PIPE-transactions, acting for listed entities, institutional investors, opportunistic investors and/or strategic investors, including Chinese and other foreign investors. Our services include all relevant legal aspects, including (where requested) project co-ordination and comprehensive services and advice beyond legal items. In order to optimise our clients' position on the backdrop of our clients' specific interests, we often co-operate closely with our clients and their chosen investment banks, financial advisors and/or our clients' other advisors (auditors, tax advisors etc.).

We focus on the solution and define our role accordingly. We identify the client-specific problem, analyse the law, the economic and commercial issues and, based on our experience and the situation at hand, we develop one or more suitable structures reflecting our clients' needs and the issuer's and market's situation with respect to each transaction at hand.

Acquisition of German insolvent companies

Hui Zhao

The journey for Chinese companies to do M&As in Germany started with an insolvent company. Back in the 1990s, a pencil company from Shanghai acquired a pencil factory in East Germany. In the following period, China's acquisitions of German insolvent companies continued to increase. As more German companies went insolvent due to the financial crisis in 2008, many Chinese enterprises seized the opportunity to acquire German insolvent companies who possessed advanced technology. Although with good value and low price, an insolvent company is like a seriously ill person, and it is very difficult for such a person to recover or even become fit and healthy. Therefore, it is necessary to have sufficient knowledge about acquiring insolvent companies. Although the name of a company remains the same after insolvency as it was before, the nature of the company may be very different.

In view of the peculiarities of German insolvency procedure, we will discuss the relevant situations under the German insolvency laws, so that Chinese enterprises interested in M&A in German recognise the peculiarities of such companies and thus make the right decision:

Cause of insolvency and scope of insolvency estate

The current German Insolvency Statute (Insolvenzordnung, InsO) encourage early filing for insolvency and simplify the requirements for commencement of the proceedings. Generally, a company is obligated to file an insolvency request within a certain period of time in two specific cases: Illiquidity is the general reason for a corporation to open insolvency proceedings. The debtor shall be deemed illiquid if he is unable to meet his mature obligations to pay. Illiquidity shall be presumed as a rule if the debtor has stopped payments (Section 17 of the Insolvency Statute). Overindebtedness (the so-called "insolvency") is another reason for a corporation to file for insolvency proceedings. Overindebtedness shall exist if the assets owned by the debtor no longer cover his existing obligations to pay unless in the assessment of the debtor's assets, there is a high likeliness for the company to continue with the operation, such as with the shareholders'commitment to provide sustained financial support to the company (19 of the Insolvency Statute). Accordingly, the debtor may apply for insolvency as long as he is imminently or but not actually illiquid (Section 18 of the Insolvency Statute). Insolvency proceedings may commence as long as the expenses of such proceedings can be paid. It is also important to note that illiquidity or imminent illiquidity is based on the cash flow, while overindebtedness is based on the balance sheet. In other words, for a corporation, only when the debtor is insolvent and obviously lacks the ability to pay off the debts will it constitute the cause of insolvency.

The German insolvency legislation has been affected by the outbreak of COVID-19 in 2020. In response to the drastic economic effects of the pandemic, the German federal parliament (Bundestag) amended the German insolvency laws in March 2020, providing that a company does not have to file for insolvency if it operated normally before the outbreak and becomes insolvent as a result of the pandemic. This regulation first applied until the summer of 2020, and was then extended until the end of the year, and again until the end of April 2021. At this moment the expiration of the protection of this regulation does not yet have resulted in a large number of companies filing for bankruptcy in Germany. However, it cannot be excluded that in future there will be a huge number of companies entering into insolvency procedure, especially in the catering, hospitality, travel and transportation related industries.

Before the commencement of the insolvency proceedings, the value of the insolvency estate must be sufficient to cover the court and administrative expenses of the first-stage proceedings. Existence of long-term debts is not a reason to prevent commencement of insolvency proceedings. The Insolvency Statute provides that secured creditors should also claim their debts. In the first stage of the proceedings (within three months after the commencement of the insolvency proceedings), it is not allowed to separate the movables subject to retention of ownership from the insolvency estate, and the insolvency administrator has the right to choose to sell or not to sell such movables. Movables used as security will be sold by the insolvency administrator, and the proceeds from the sale shall be firstly used to pay the security related confirmation expenses and sale expenses and value-added tax. The rights of secured creditors may be restricted through insolvency plans.

Insolvency administrator

Section 27 of the Insolvency Statute provides that "[i] f insolvency proceedings are opened the insolvency court shall designate an insolvency administrator." The insolvency administrator must be a natural person with professional knowledge. After accepting a request to open insolvency proceedings and before making a decision on the request, the insolvency court may appoint a temporary insolvency administrator to grant general injunctions against the debtor in order to prevent any change in the debtor's property status that is unfavourable to creditors at that time. The court must make an announcement when adopting preservation measures or appointing a temporary insolvency administrator. Section 57 of the Insolvency Statute provides that "[d]uring the first meeting of creditors subsequent to the designation of the insolvency administrator the creditors may elect a different person to replace him. The court may refuse designation only of a person unqualified to assume such an office. Any creditor of the insolvency proceedings may bring an immediate appeal against a refusal of designation." Behaviours of the insolvency administrator shall be supervised by the court. In addition, the creditors' committee appointed by the court may also be elected by creditors, which embodies and reinforces the principle of creditor autonomy.

Personal management of debtors

Compared with the previous Insolvency Statute, the currently applicable Insolvency Statute has added Part Seven, which provides that a company may apply with the court for the right of personal management while filing for insolvency. In the personal management stage, although the company is in insolvency proceedings and an insolvency administrator is designated for it, the company may still enjoy the relative freedom of personal management. The purpose of personal management is to give the company an opportunity to carry out reorganisation at the last moment of insolvency.

Personal management by the debtor means that in the insolvency proceedings, the debtor may manage and dispose of the assets involved in insolvency proceedings under surveillance by a custodian if the insolvency court orders such personal management by a decision (Paragraph 1, Section 270 of the Insolvency Statute). Personal management procedure, although approved by the court, does not annul the insolvency proceedings. The procedure differs from the general insolvency proceedings in that the right of management and disposition of the debtor is still exercised by the debtor other than the insolvency administrator. Personal management does not apply to the insolvency proceedings of individuals under Section 304 of the Insolvency Statute. Generally, the debtor may be granted the right of personal management in a decision commencing insolvency proceedings only if the debtor files a request for or the creditors has been consented to personal management (if the request for opening the insolvency proceedings is filed by the creditor) and the insolvency court finds that personal management will not lead to a delay in the proceedings or other disadvantages to the creditors (Paragraph 2, Section 270 of the Insolvency Statute). In accordance with Section 271 of the Insolvency Statute, if the debtor's request for personal management has been refused by the insolvency court, but the debtor's personal management is requested by the first creditors' assembly, the court shall order such personal management and make an announcement on such order. In the event that the basis for personal management no longer exists, the decision of personal management may be repealed. If the debtor requests for repeal of the personal management order already issued, the court shall grant the request. If the creditors' assembly or a creditor with a right to separate satisfaction or a creditor of the insolvency proceedings requests for repeal of the decision, the requesting party must submit the proof of removal of the prerequisite for personal management. Before deciding on the request, the insolvency court shall hear the debtor (Section 272 of the Insolvency Statute).

Insolvency proceedings

If a company wants to avoid the final insolvency liquidation, it may persuade its creditors to restructure its debts by developing a reorganisation plan, the so-called "insolvency plan". Section 217 of the Insolvency Statute provides for that "[c]ounter to the provisions of this Statute, the satisfaction of creditors entitled to separate satisfaction and of the creditors of the insolvency proceedings, the disposition of the assets involved in insolvency proceedings and their distribution to the parties concerned, as well as the debtor's liability subsequent to termination of the insolvency proceedings, may be settled in an insolvency plan." Accordingly, the insolvency plan of a company is of duality: it may contemplate either insolvency liquidation or reorganisation. Within a maximum of three months after the commencement of insolvency proceedings, the creditors' assembly must decide, based on the report of the insolvency administrator, whether the company should enter into insolvency liquidation or operate on the going concern basis with the objective of reorganisation. For the reorganisation, the Insolvency Statute, with reference to Chapter 11 of the U.S. Bankruptcy Code, adopts a more flexible approach, i.e., the reorganization can be achieved either through a total or partial transfer of the company or by subsistence of the company to pay off its debts with future profits.

Before the insolvency court decides to accept a request, it may appoint ex officio an interim administrator who will examine the operations of the insolvent company and the possibility of reorganization and prepare and submit a relevant report to the court. The report should be proposed at the first creditors' assembly. If the creditors' assembly chooses the insolvent plan, it may instruct an insolvency administrator to submit the insolvent plan, and the debtor also has the right to submit the corresponding plan. The insolvency plan shall consist of a declaratory and a constructive part: The declaratory part shall describe the measures taken or still to be taken after opening the insolvency proceedings and other relevant matters; the constructive part shall determine the transformation of the legal position of the parties involved, by the insolvency plan (Sections 219 to 221 of the Insolvency Statute). The creditors affected by the insolvency plan have the voting right, and each group of creditors with voting rights shall vote on the insolvency plan separately. The principles of necessary majorities and prohibition to obstruct shall be adopted in voting. "Necessary majorities" means that the sum of claims held by creditors backing the plan exceeds half of the sum of claims held by the creditors with voting rights. "Prohibition to obstruct" means that even if the necessary majorities have not been achieved, a voting group shall be deemed to have consented if the creditors forming such group participate to a reasonable extent in the economic value devolving on the parties under the plan (Sections 243 to 245 of the Insolvency Statute).

If a Chinese enterprise is interested in acquiring an insolvent company, it should negotiate with the insolvency administrator. The negotiation mainly deals with which assets to be acquired and their quality and price.

An insolvency plan agreed by both the creditors and the debtor is subject to court approval, and the court will not approve those plans violating the insolvency proceedings. After the approved insolvency plan comes into effect, the rights and obligations defined in the constructive part will have a binding effect for or against all the parties involved. At the same time, the insolvency court will decide to repeal the insolvency proceedings as well as the functions and powers of the insolvency administrator and the persons concerned. The implementation of the insolvency plan shall be monitored by the creditors' committee, the insolvency administrator and the insolvency court.

In insolvency liquidation, the assets will be distributed in equal proportions to all unsecured creditors. In addition, the insolvency priority system under the old law has been abolished, including the insolvency priority of employees and the privilege of salary claims in the insolvency estate, but the social security (social programme) in insolvency proceedings is guaranteed to the maximum extent of the protection of the original law. The protection for employees, their compensation entitlement and the compulsory transfer of employment relationship in the event of a transfer of the company under the Protection of Employees against Unfair Dismissal (Kündigungsschutz für Arbeitnehmer) shall remain unaffected.

Considerations for Chinese investors

When acquiring the assets from an insolvent company, the insolvency administrator is the negotiating counterpart of the investor. Appointed by the court or the creditors' assembly, however, the administrator acts only to the extent permitted by law and not in self-interest. In order mainly to help the creditors obtain the best conditions and maximize the realization of the insolvency estate, the insolvency administrator will not give any promises or guarantees (other than a promise of ownership) to the buyer with respect to the assets being sold.

The insolvency administrator has an obligation to protect the assets of the insolvent company. In the event that the company has ceased operations or has no income, the insolvency administrator is obligated to realize the assets of the company as soon as possible to avoid significant damages to the value of such assets. Therefore, Chinese investors should be well prepared to meet the tight schedule that the insolvency proceedings may require.

Insolvent companies are generally less expensive but may face a severer brain drain than normally operating companies. Generally, a company's excellent technology and sales talents will be poached by its competitors just as the company is showing signs of insolvency, which is unfavourable for the new investor to reorganise the company.

The employees of a company shall be transferred with its assets in accordance with the German Civil Code. In view of such principle, when a Chinese investor acquires all or substantially all of a company's assets or its stand-alone assets, the original employees of the company will be transferred to the investor's company along with the assets. New employment contracts will of course have to be signed. For employees that the Chinese investor does not want to take in, a solution should be discussed with the insolvency administrator prior to the acquisition of the assets. The legally permissible solution is to set up a so-called "transition company" to separate the assets and the employees. Since the separation requires a lot of persuasion efforts and also costs to set up a new company, the insolvency administrator may negotiate with the investor on the payment of such costs.

In addition, insolvent companies often have different reasons for their insolvency. It will very difficult for a Chinese enterprise to change the original situation of an insolvent company if it cannot bring substantial benefits to the company (such as low-cost components from China and sales to the Chinese market). Therefore, it is important for the Chinese investor to be well prepared before acquiring an insolvent company, including appointing experienced officers to lead the new company after the acquisition.

In short, the financial crisis has disrupted the original market landscape and the pandemic has also posed new issues. New opportunities, however, are emerging in various industries. New winners will undoubtedly be those companies that have survived the crisis and prepared themselves in advance for the post-crisis development and upgrading of their industries. Many German companies that would have been out of reach for Chinese enterprises in normal times are now likely looking for new buyers, especially buyers from China. Mature and capable Chinese enterprises should seize this rare opportunity.

How to control the management of a German company

Markus Herz

Executive summary

The control over and the influence on the management of a German company depends in particular on the legal form of the company.

For an investor, the GmbH is the ideal legal form since it offers flexibility with respect to the corporate governance and a direct control of the management by the shareholders. In contrast, the control of the management board of a German Stock Corporation is much more complicated and restricted by applicable laws.

In any case, an investor should seek to issue rules of procedures for the management, containing a catalogue of actions which require the prior approval of the shareholders' meeting or the supervisory board (in case of a Stock Corporation).

General

Already in the forefront of an acquisition of a company, the investor should consider the future management of the company and its control. Since the investor, in most cases, cannot or does not want to take over the management of a German company himself, the previous management is often retained. In this case, however, it is particularly important for the investor to be able to adequately control the management effectively and in a legally secure manner.

The possibilities for controlling and influencing the management of a German company depend in general on two factors:

1. the majority shareholdings in the company, and

2. the legal form of the company.

For the following we have assumed that the investor holds at least a simple majority of all votes in the respective company (i. e. at least 50% + 1 vote) and that no deviating majority requirements due to individual contractual agreements apply.

If the investor does not have at least a simple majority of voting rights, he can only exercise influence over the management by means of special rights which needs to be agreed upon individually with the other shareholders, e.g. by means of a shareholders' agreement.

The following differences arise with regard to the legal form of the company:

Limited Liability Company (GmbH)

The GmbH (i.e. a limited liability company) is probably the most popular German company form and represents the predominant form of companies by which investors invest in Germany.

The shareholders of a limited liability company are entitled to fully control the management and to receive all information about the company from the management at any time. This includes, inter alia, the dismissal or appointment of managing directors by the shareholders' meeting at any time.

Note: The appointment or dismissal of a managing director is not identical to the conclusion or termination of a managing director's service contract! The dismissal as managing director is possible at any time, the termination of the service contract only according to its provisions which normally contains regulations on notice periods!

The **shareholders' meeting** of a limited liability company may also issue instructions to the management at any time, which must be basically observed and implemented by the management.

Thus, an investor has ideal influence and control over the management of a GmbH which, conclusively, makes the GmbH to be the ideal legal form for an investor from a management-control-perspective.

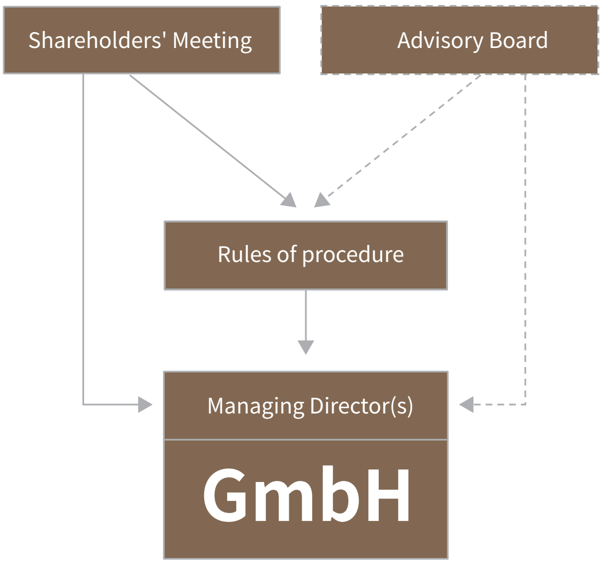
Insofar as there are other shareholders in the GmbH in addition to the investor, it may, for reasons of simplification, be an option to delegate at least some of the responsibilities of the shareholders' meeting to another corporate body: the advisory board. The (voluntary) advisory board of a limited liability company is comparable to the supervisory board of a stock corporation, but is not subject to such rigid restrictions and can be given significantly more authority:

E.g. it is possible for the advisory board to dismiss, appoint, monitor and instruct managing directors of a GmbH. The advisory board can thus exercise the same powers as the shareholders' meeting with respect to the management.

The Advisory Board should consist of at least three persons. The members of the advisory board are usually elected by the shareholders of the company. In general, the majority shareholders are entitled to elect the members of the advisory board. Ideally, the investor may not only elect the majority of the advisory board members, but there are also other advisory board members who can contribute additional know-how (such as industry or marketing experts). It is in the absolute discretion of the Investor which person to elect as member of the advisory board. Hence, the Investor should elect a trusted person for this position (which can also be an attorney or an accountant).

The establishment of an advisory board only makes sense, however, if the adoption of resolutions of the shareholders' meeting is otherwise only possible with disproportionately great effort or with time difficulties due to the absence of shareholders.

In any case, i. e. irrespective of whether an advisory board has been set up or not, **rules of procedure** for the management board are required. Such rules of procedure for the management usually include a catalogue of measures requiring prior approval. The management of the company may only carry out the measures mentioned therein with the prior consent of the shareholders' meeting or the advisory board. This enables the investor to control the degree of control very precisely.



A GmbH can have one or more managing directors. Managing directors can also be foreigners, i.e. not residing in Germany. Accordingly, investors have of course the possibility of appointing further managing directors from their own country or even from their own management company. This enables investors to appoint local and intimate representatives who are also able to communicate with the investor without language or cultural barriers. The investor is free to decide whether each managing director should be able to represent the company individually or whether only two managing directors should be able to represent the company jointly. The latter, however, only makes sense if all managing directors are on site and capable of acting. Otherwise, the company's management would be blocked and incapable of acting.

It should also be noted that managing directors of a German limited liability company are subject to certain obligations and liability regulations. We would be happy to provide you with detailed information in this respect separately.

Stock Corporation (AG)

In contrast to the GmbH, a stock corporation is much more difficult to control by the investor: The management board of a stock corporation manages the company on its own responsibility. This is provided for by law and means that the management board can in general make decisions on its own discretion. In particular, the role of shareholders is negligible in terms of influencing management. In detail:

The German stock corporation has only one **two-tier board**, consisting of the **management board** and the **supervisory board**. Other set-ups are not permitted under German law.

The shareholders elect the members of the supervisory board. The supervisory board then elects the members of the management board.

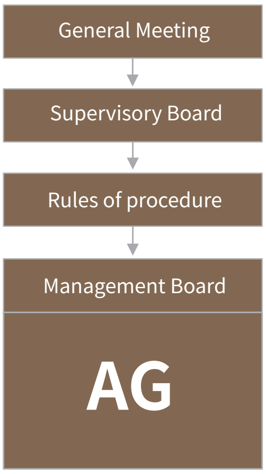
Thus, for the investor, the supervisory board is decisive: it has the statutory task of controlling, appointing and supervising the management board. However, its rights are much more limited in comparison to the GmbH: for example, the supervisory board cannot issue instructions to the management board (even the general meeting cannot issue instructions) and the management board cannot be dismissed at any time during its term of office. Rather, there must be serious reasons for a dismissal, which are listed in detail in the German Stock Corporation Act.

However, the management board is of course not completely out of control: the German Stock Corporation Act provides for a legal obligation to issue **rules of procedure** for the management board, which must also contain a catalogue of transactions requiring prior approval. The supervisory board can exercise partial and preventive control over the management board in this respect. Other ways of influencing management are difficult and only possible to a limited extent and as provided for in the German Stock Corporation Act. The rules of procedure therefore play a decisive role in a German Stock Corporation for an investor.

Since, contrary to the provisions of the GmbH, the general meeting of a stock corporation has virtually no influence on the management board, it is essential that the investor is sufficiently represented in the supervisory board. Here, too, the supervisory board must consist of at least three persons.

In addition, the supervisory board is entitled to obtain information from the management board at any time on the Company's affairs and to inspect its books and records. Shareholders are only entitled to some of these rights in the course of a general meeting. But even here, the right to information can be refused in certain cases.

In aggregate, it should therefore be noted that an investor in a stock corporation only has effective control and influence over the management board if he has the necessary majority in the supervisory board.



If possible, the structuring of an acquisition of a German stock corporation should consider the conversion into a GmbH.

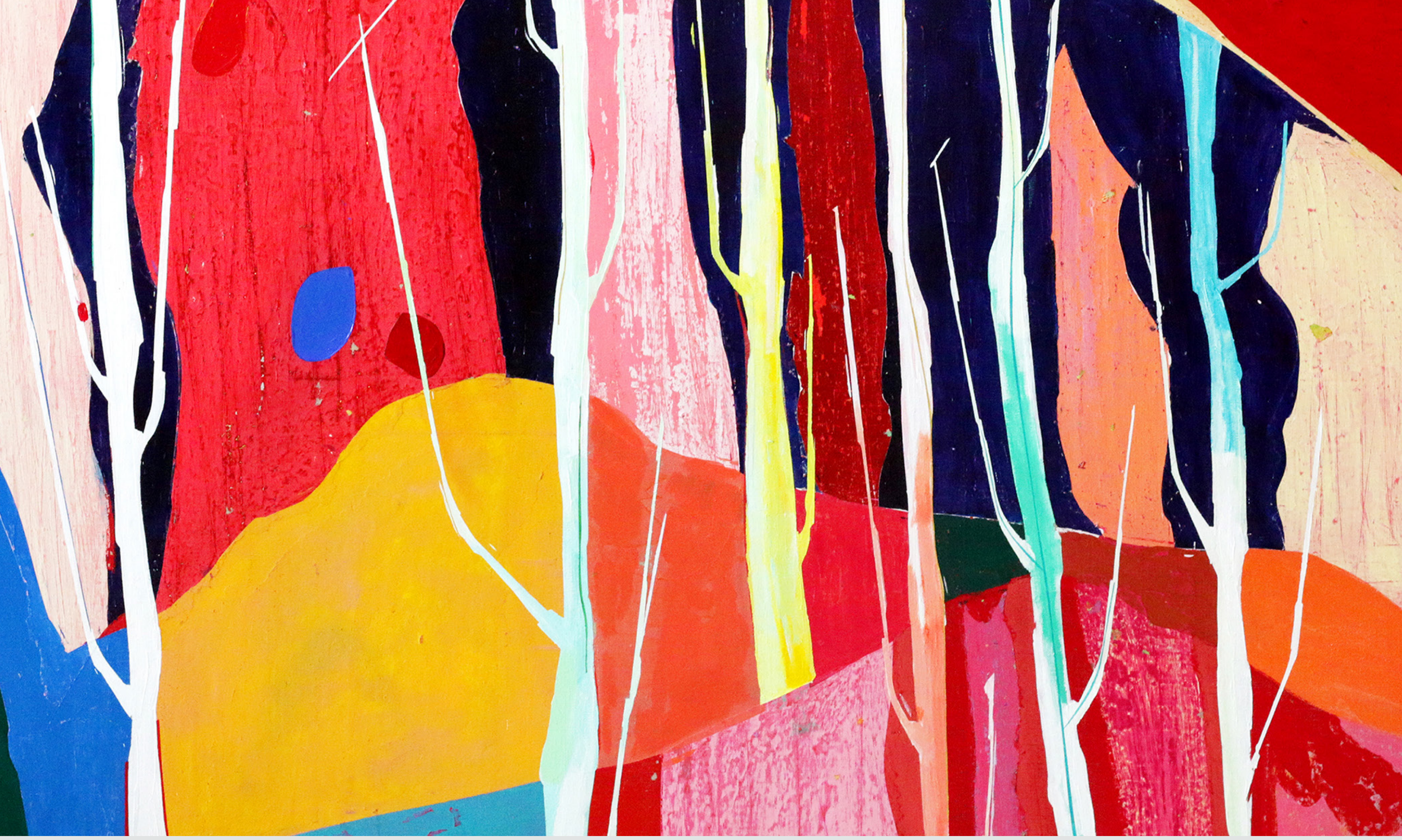
Other companies

In the case of other legal forms of companies (e. g. GmbH & Co. KG or KG), the investor has significantly more freedom to exercise control and influence over the management of the company. It is incumbent upon each individual case to provide for corresponding control and influence rights in the respective articles of association. Contrary to the detailed legal regulations on GmbH and AG, there are only very few statutory regulations for the other legal forms. Therefore, the correspondingly detailed set-up of the company documents is of crucial importance.

Miscellaneous

In addition to the aforementioned possibilities of direct control of the management, an investor has, depending on the legal form of the company, also further indirect control options. For example, the investor can have the company audited by a certified public accountant selected by him and thus have the accuracy of the figures provided by the management checked.

We will be happy to provide you with further detailed information on the control tools available to you for your planned investment or to explain them to you in a personal discussion.



Acquisition finance in Germany

Daniel Ehret

Structuring the financing of your acquisition

From an investor's perspective, it is key to find a financing solution that is suitable for the financing needs of the target entity. Investors should consider not only the funding of the purchase price, but also the financing of the target's working capital needs, potential capital expenditure and add-on acquisitions.

In funding an acquisition in Germany, investors regularly use both equity and debt instruments. With respect to the debt capacity of the target, investors need to be aware that lenders will base their credit decision – along with other criteria, such as the security position of the lenders – on the cash flows projected for the coming years. In addition, investors need to take into account the ratio between debt and EBITDA (leverage) when structuring the financing.

There is no general rule as to potential leverage levels in an acquisition scenario, since they mainly depend on the overall market situation, the industry section of the target group and its projected cash flows. However, many German banks are, due to restrictions imposed by the European Central Bank, not able to provide loans with senior leverage levels above 4.00x. Therefore, in highly leveraged transactions, sponsors frequently borrow from alternative debt providers, such as special debt funds (also known as "unitranche"-financings).

In an acquisition scenario, various types of potential debt instruments are available to finance the purchase price. In the German market, the debt structure regularly consists of senior bank term loans, which (in the current environment) are rarely complemented by mezzanine or second lien instruments. The question as to whether mezzanine or second lien debt is required for a financing also depends on the leverage level. In many highly leveraged acquisitions unitranche-financings – either coupled with a senior financing or a super senior revolving credit facility, or separately – are common. Typically, unitranche facilities have a longer average lifetime and therefore often combine senior and mezzanine elements.

Documentation and process

Documentation based on LMA forms is the standard for acquisition finance transactions in Germany. It typically comprises a term sheet, facility agreement, intercreditor agreement and security documents.

At the beginning of the financing process, the parties usually agree a **term sheet** setting out, at a minimum, the basic terms for the financing.

In Germany and other European markets, **facility agreements** are commonly based on the standard documentation prepared by the Loan Market Association (LMA) in London. The LMA-based facility agreement for leveraged transactions is a sophisticated document serving as a starting point in negotiations with lenders, which will – in German leveraged transactions – be amended to comply with German law. The LMA also provides a form for multicurrency term and revolving facility agreements governed by German law for investment grade borrowers. For financings where the borrower is non-investment grade, this form needs to be adapted.

The language of the facility agreement largely depends on the composition of the lender group and the syndication strategy. In large transactions where lenders from different jurisdictions participate in the acquisition financing, the facility agreement will typically be in English to facilitate the syndication process. However, in particular in mid-market transactions where the lenders are typically German domestic banks, the facility agreement is often prepared in German and, although its principles and structure follow those from the LMA form, a German language and German law governed facility agreement is typically shorter than the usual LMA-style agreements.

Where the financing structure consists of different layers of debt (*e.g.*, super senior revolving credits, senior debt, bonds, and shareholder loans), it is common practice to set out the relationship between the creditors in an **intercreditor agreement**. The intercreditor agreement is regularly based on the standard LMA documentation. It typically provides for the ranking between the different layers of debt (including a comprehensive subordination of shareholder financings to senior ranking bank debt) and, in the case of shared security, for the application of potential enforcement proceeds ("waterfall") among the creditors.

The provisions of an intercreditor agreement gain increasing significance in a distressed scenario. In order to find a suitable solution for the acquisition, it is essential to pay close attention to and conduct a thorough analysis of the impact of the provisions of the intercreditor agreement.

Guarantees and types of security

A typical German security package comprises guarantees, share and account pledges, assignments of receivables and – depending on the assets and business of the target group – other specific security such as, e.g., IP pledges, land charges or security over movable assets.

German law does not offer the option to provide security via floating charge. When agreeing the security package, investors should consider which types of security are appropriate for the individual financing, with particular focus on cost-benefit aspects and, where applicable, existing security previously granted to third parties. The security interests most commonly provided to secure the lenders claims are guarantees by the target group entities, pledges over the shares of the acquisition vehicle and the target group entities, account pledges and assignments of receivables. Where group entities own real property, mortgages and land charges are possible, but granting these types of security entails significant costs and fees. Security over movable assets may be granted. If the group owns substantial IP rights, such rights may be pledged or transferred as security.

Specific German considerations

Prohibition of financial assistance

A German stock corporation (AG) is prohibited from granting financial assistance (including the granting of security) for the acquisition of its own shares. Such a transaction may be rendered void, but may be exempt from the prohibition in constellations where a control and profit and loss transfer agreement between the AG and its shareholder is in place. The rules on prohibition of financial assistance do not apply to limited liability companies (GmbH).

Prohibition of compound interest

Under German law, a debtor may not agree in advance to any compound interest or to pay interest on due interest. Therefore, if a facility agreement is governed by German law, it regularly provides for lump sum damages (*pauschalierter Schadensersatz*) accruing on the overdue interest amount from the due date.

Upstream and cross-stream guarantees / security interests

The granting of guarantees or other security interests by a German limited liability company (GmbH), a German stock corporation (AG) or a limited partnership with a general partner that is a GmbH or another company with limited liability is permitted in general. However, German capital maintenance rules provide that the share capital of the company may not be repaid to the shareholders. The granting of a guarantee or other security for the borrowings of the parent or sister companies (*i.e.*, upstream security or cross-stream security) qualifies, under certain circumstances, as a prohibited repayment of share capital. Since a breach of these rules may result in criminal and/or personal liability of the managing directors, it is common practice to limit and restrict the enforcement of the guarantee or security contractually by inserting so-called "limitation language". In accordance with German law applicable to GmbHs and AGs, such "limitation language" often provides that, apart from additional exceptions, enforcement of the guarantee or security is not restricted if there is either a domination or profit and loss transfer agreement in place between the guarantor / grantor of security and the borrower (as dominating entity) or if distribution of the enforcement proceeds is covered by a fully recoverable claim of the guarantor / grantor of security against its shareholder for recovery of any losses incurred as a result of the enforcement.

Guarantees on first demand

Facility agreements in an acquisition context often provide for guarantees "upon first demand". Pursuant to German case law, such a guarantee on first demand may only be provided by companies experienced in international trade. Where this condition is not met, the guarantee may not be payable "upon first written demand", but should remain enforceable as a guarantee.

Parallel debt structure

In an acquisition financing, especially in a syndicated financing, it is typical for the transaction security to be administered by a security agent. Certain standard security instruments (in particular pledges) are accessory under German law, *i.e.* can only be granted to the holder of the secured claim. To enable the security agent to enforce such security in its own name, but for the account of the lenders, it is standard in a German law governed financing for the security agent to become a creditor in its own right according to an abstract acknowledgement of debt (parallel debt).

Post-acquisition restructuring

Investors should consider potential post-acquisition restructuring issues, when arranging the financing of the acquisition.

Depending on the legal form of the target entity and the acquisition structure, investors may want to transform the target after completion of the acquisition, plan for a down-stream merger of the acquisition vehicle into the target, or for a domination and profit and loss transfer agreement between the two entities. Where possible, such considerations should be factored into the financing structure at an early stage.

Exit considerations

An exit requires thorough preparation both on the M&A side and with respect to the existing financing. Investors should discuss and consider refinancing options when structuring the acquisition financing.

Given that facility agreements generally contain a change of control clause, the investor needs – in an exit scenario – to factor in the repayment of existing financial indebtedness under the financial documentation.

Under mandatory German law, a borrower may repay a loan with a variable interest rate at the end of each interest period, without having to pay prepayment or breakage costs (which might be substantial in case of long-term financings). Investors, therefore, generally seek to repay existing loans at the end of an interest period to avoid breakage costs.

Where letters of credit have been issued under an existing facility agreement and are still outstanding upon repayment of the facilities, these letters of credit typically have to be returned to the issuing bank or cash collateralised. Alternatively, the purchaser's lenders could either replace outstanding letters of credit (which is, however, often highly complex and time-consuming), or guarantee the outstanding letters of credit in favour of the existing lenders by assuming a back-to-back guarantee (*Rückavalierung*).

Key issues of setting up the right deal structure for Chinese investors

Markus Hill

Introduction

When acquiring a German business, investors have to look at a lot of different issues to determine the best deal structure. Besides business and legal criteria, taxation is probably the most important one and might sometimes even be a showstopper. As most Western countries, Germany has a rather complex and detailed tax system, with a wide range of legislation as well as decrees from fiscal authorities and jurisdictions of the fiscal courts which will make things even more complicated.

Analysis of the Target

The first step in any transaction will be to analyse the target structure. This sounds like simple advice, but experience shows that investors, especially foreign ones not familiar with German entities, often do not distinguish properly from a tax perspective what they are acquiring.

From a German tax perspective three different scenarios might be relevant regarding the subject matter of an acquisition.

- **Acquisition of a corporation via share deal**

  Corporations like a GmbH or an AG are liable for corporate income tax at a flat rate of 15% for their worldwide income if they are resident in Germany. However, dividends from a corporate subsidiary and capital gains from the sales of shares in a corporate subsidiary are usually 95% tax exempt. In addition, foreign derived income might be tax exempt under a double tax treaty. A solidarity surcharge of 5.5% on the corporate income tax is also applicable. In addition, trade tax will be levied, which depends on the communities the business is located in as every community has a right to determine a municipal factor for the trade tax. Currently, the effective trade tax rates range from 7% up to approximately 19%. Given this, the overall effective tax rate for a corporation usually lies somewhere around 30% as a rule of thumb but might deviate significantly from this.

  Additionally, withholding taxes of 25% plus a solidarity surcharge of 5.5%, leading to an effective tax rate of 26.375% will be assessed on paid out dividends. However, Germany has concluded double tax treaties with almost 100 countries which usually reduce such withholding taxes significantly. For instance, the Sino-German double tax treaty only allows for a withholding tax for dividends of 5% for a qualified shareholder or 10% for almost any other shareholder. Please note, that companies in Hong Kong or Macau are not within the scope of and as such are not protected by the double tax treaty. Moreover, EU directives might lead to any withholding taxes being reduced to zero.

  The acquisition of a corporation does not allow for an automatic deduction and set-off of any expenses incurred by the shareholder, including any interest on the acquisition financing, against the income at the level of the acquired corporation. Such an offset of cost will require post-closing structures which are available in Germany (see below). Also, there will be no tax effective depreciation on the purchase price.

  Germany levies real estate transfer tax ("RETT") on the acquisition of at least 90% of the shares in a corporation owning German real estate. The tax rate depends on the federal state the property is located in, as any given state has a right to assess its own tax rate. Currently, the rates range from 3.5% up to 6.5% whereas the assessment base is the lower of either a specific complex valuation as defined by law or the fair market value of the property.

  No other transfer taxes will occur, and no VAT should be payable if the SPA is drafted properly.

- **Asset deal**

  An asset deal allows for an automatic deduction of any expenses incurred by the buyer, including any interest on the acquisition financing. There will be a tax effective depreciation on the purchase price, i.e. the acquired assets will be recognised at their acquisition cost within the financial statements and will then be depreciated in accordance with German tax law. This will require an allocation of the overall purchase price to the acquired assets. Please note that there will be assets which cannot be depreciated annually, like for instance shares in a corporation or land but an acquired goodwill will be depreciated straight-line over a period of fifteen years for tax purposes.

  The buyer – usually a German or foreign corporation – will then be taxed in accordance with its own tax regime. A foreign corporation would be subject to the same taxation as a domestic one (see above) on its German permanent establishment but no German withholding tax would be triggered upon a distribution. Also, Germany does not levy any branch profits tax.

RETT will be due if property is acquired. The tax assessment base will be equal to the part of the purchase price to be allocated to the real estate whereas the tax rate would again depend on where the property is located in (see above)

No other transfer taxes will occur, and no VAT will be payable if the transaction will be qualified as a transfer of a going concern. Otherwise, VAT will be due (depending on the assets acquired) which however will usually be credited or refunded to the acquiring entity.

- **Acquisition of a partnership via share deal**

  Foreign investors are often surprised how common partnerships are in Germany, especially within the "Mittelstand". Partnerships are taxed transparent except for trade tax purposes, i.e. any partner will tax its profit share individually in accordance with its own tax regime but the partnership itself will pay trade tax if applicable.

  No withholding taxes will be assessed on drawings from the partnership.

  Different to a corporation, the acquisition of a partnership does allow for an automatic deduction of any expenses incurred by the shareholder, including any interest on the acquisition financing and a tax effective depreciation on the purchase price. Even though legally the transaction will be a share deal, it will in fact be treated as an asset deal for tax purposes.

  Germany also levies RETT on the acquisition of at least 90% of the shares in a partnership owning German real estate. The taxation would be similar to those when acquiring a corporation. The same will be true for any VAT on the purchase price (see above).

Analysis of the Buyer

In a second step the proper deal structure requires an analysis of the buyer and what it wants to achieve.

The analysis starts with the legal form and the place of incorporation and tax residency if no acquisition company or any other blocker entity will be used. Things will be different if there is already a structure in place in Germany which can and should be used. Sometimes the interposition of a holding company, especially within the EU might become relevant.

It will then be of importance to determine whether the buyer wants to deduct any expenses incurred, including any interest on the acquisition financing in Germany. This will of course also include the question how the acquisition should be financed. Will this be done with equity only or will there be bank debt or other third-party loans as well? Will the funds of the shareholder be provided as pure equity or might a portion of this be provided as shareholder loans? All of these questions, especially the determination of the mix of the shareholder funds must consider the legal restrictions of each alternative and of course the possibility and limitations of tax deductions but also balance sheet effects as well. The repayment of shareholder loans is under normal circumstances legally easier as the repatriation of equity requires a profit distribution which will only be possible if sufficient equity is available. Interest on the shareholder loans is generally tax deductible to the extent the interest is at arms´ length. However, certain restrictions apply in the form of the "interest barrier" which will reduce the allowed annual deduction to 30% of the (tax) EBITDA unless the overall net interest of the company (including those for third-party loans) is below EUR 3m. Also, not all of the interest will be deductible for trade tax purposes due to an add-back to the taxable income of 25% of the interest. It should also not be forgotten that the interest will in most cases be fully taxable for the lender which will be detrimental if its tax rate is actually higher than those of the borrower or taxation will occur even without payment of the interest ("dry income"), e.g. if the loan is structured as a zero bonds or PIK note. However, no German withholding tax will be applicable for the interest if it is not profit-related.

Finally, exit considerations are of relevance. The sale of shares in a German corporation is tax exempt in Germany for a foreign corporate investor. If a German corporation will be the seller, only 5% of the capital gain will be taxable which will as a rule of thumb lead to an effective taxation of 1.5%. In contrast, the sale of a partnership or an asset deal is fully taxable in Germany; additionally, German withholding tax might be applicable if such profits would subsequently have to be distributed to the ultimate shareholder.

Deal structure

Considering the analysis of the Target and the Buyer, it will be possible to determine the best deal structure in any given case by observing mainly the following goals:

- **Legal and business requirements**

  If, for instance, the target company is a partnership and a corporation is preferred due to legal risks, there are tax efficient ways for a respective tax neutral reorganisation. Restructuring measures like mergers, contributions, spin-offs etc. are usually available to form or integrate an acquired group as intended without triggering capital gains taxation.

- **Effective deduction of expenses**

  After the acquisition of a corporation via a German corporation, the target entity could either be merged into the acquirer tax-neutrally or both companies could establish a fiscal unity by executing a profit-and-loss-transfer-agreement thereby allowing for a pooling of the results.

- **Minimisation of transfer taxes, e.g. real estate transfer tax**

  The acquisition of a partnership could be done by acquiring only 89.9% of the share at first and by acquiring the remaining 10.1% after a ten-year period. This will allow for a reduction of the RETT to only the remaining 10.1% whereas the acquisition of the first tranche will be exempt from RETT.

- **Optimised repatriation of payments (dividends, licence fees, interest)**

  The interposition of a holding company located in an EU member state might allow for a further reduction of withholding tax. However, in this context it should be noted that Germany has very detailed anti-abuse legislation, which can limit the application of such benefits.

- **Effects on financial statements**

  As an example, it will be possible to increase the equity within the financial accounts by using certain tax neutral reorganisations.

Final word

Even though the German tax system is rather complex the acquisition of a German business can usually be done in a tax efficient way satisfying the needs of the buyer and at best also of the seller. However, there is no way back from any tax leakage, once the documentation has been signed or a transaction has been implemented, and the facts have thus been established. Therefore, it is of utmost importance to check the tax consequences of any transaction and determine the deal structure in advance which requires an early involvement of the respective German tax advisers. Later intended changes to the deal structure and/or the target structure should be dealt with at the time of the transaction and not be treated separately and as such should already be incorporated in the actual deal structure. For instance, too many times we have seen an acquiring group pay additional RETT due to a later direct or even indirect transfer of shares in a company or a group not be able to get into its intended legal structure without triggering capital gains taxation.

Labour and Employment law in Germany

Martin Gliewe

Employment law advice on M&A transactions

Employment issues, such as the legal status of employment relationships, employees' representational and co-determining bodies or the involvement of labour unions are not only to be considered within every due diligence process. Employment issues may also have influence on tactical considerations regarding the structuring of a transaction. Thus, the question of whether the acquisition of the company should lead to a transfer of business (similar to the "TUPE"-regulations in the UK) in accordance with sect. 613a German Civil Code ("BGB") or not, as well as measures under works constitution law in advance of the transaction (e.g., planning and implementation of operational changes, the preparation and support of reconciliation of interests and social plan negotiations) influence the decision whether at all, when and how (asset deal or share deal) the company should be purchased.

Review of status quo

As a very basic task the status quo at the target needs to be examined and evaluated:

- **Do the existing employment contracts contain valid clauses or does the acquirer have to face the risk of payment that has not been taken into account (e.g., compensation for overtime or vacation or for reinstated employees due to invalid fixed-term clauses)? Are there long-term benefit plans to be considered?**

  The main aim is to find out which benefits the target company grants to the employees and whether particularly cost-intensive clauses are included in the contracts.

- **Does the target have an elected works council?**

  The existence of a works council can not only delay the M&A process significantly but should also be considered for the time after the transaction, especially for potential post-merger integration plans.

  A works council has several co-determination rights, for example with regard to holiday roster, working time regulation and remuneration structure. It has to be consulted when hiring or dismissing employees. The works council also needs to be involved when a company is restructuring its business. In many cases the employer must negotiate with the works council before executing the planned restructuring measure on how such restructuring will be carried out ("Reconciliation of Interest") and has to agree on a social plan providing for compensation for employees affected by the restructuring ("Social Plan"). A works council cannot prevent a restructuring process but can delay it considerably.

- **Is the target bound by collective bargaining agreements?**

  The involvement of a union has significant impact on the current and future remuneration structure and potential restructuring measures.

- **Does the target resort to the work of external personnel?**

  A further focus should be the review of relationships with external personnel, such as freelancers or interim managers. In some cases, freelancers are, by law, to be considered employees of the target even though treated as externals. This is known as "false self-employment", which leads to significant fines and is a very serious compliance issue.

Other key aspects include the handling of change-of-control clauses for key personnel, the handling of stock option plans and the correct treatment and consideration of company pension schemes.

Finally, it must be clarified whether potential restructuring or post-merger integration measures can be conducted after the acquisition or whether there are existing hurdles, such as long-term location guarantees or a ban on redundancies for operational reasons. In this context it makes sense to get an overview of the possibility of a separation of leading personnel and the associated costs.

For further details on potential employment law issues that might arise please refer to our brochure "Doing Business in Germany".

Structuring of the acquisition: Share Deal or Asset Deal?

For the further procedure, it is important whether the transaction shall be planned as an asset or a share deal.

In a share deal the buyer acquires the company by purchasing all or a certain percentage of the shares of the company.

In an asset deal the buyer acquires assets of the company, i.e., the target's assets individually. In this case, the regulations regarding a transfer of business can be applicable, which result in a transfer of all employment relationships to the purchaser in accordance with sect. 613a German Civil Code.

If only part of a business shall be transferred a practical difficulty of assigning employees to the correct part of the business arises. In principle only the employment relationships that are to be assigned to the transferring part of the business are then transferred. Affected employees may object to the transfer of their employment relationship to the acquirer within one month after proper information on the transfer.

According to § 613a Abs. 5 German Civil Code the employees affected by the transfer of business must be properly informed in text form about the time, reason, consequences of the transfer and the upcoming measures. The information may be provided by both the previous and the new employer. An improper information does not trigger the one-month period and, therefore, can lead to the consequences that employees may object to the transfer of their employment relationship even years after the transfer.

The employment relationships of transferred employees are to be continued unaltered with the acquirer and may not be terminated due to the transfer. Terminations for other reasons, however, remain possible.

Sect. 613a Civil Code also contains a "transformation regulation": as a general rule the provisions between the former employer and the employee based on applicable collective bargaining agreements or works agreements are transformed into the existing employment agreement and may not be changed to the detriment of the employee for one year.

In case of a share deal, however, Sect. 613a BGB does not apply. This can possibly facilitate restructuring measures after the acquisition, so that this must always be considered as an alternative option.

Drafting of company purchase agreements

The employment law structure of the company purchase agreement is of particular importance, as it can be the essential basis for decision-making for the subsequent implementation of further labour law measures. Thus, when drafting company purchase agreements from an employment law point of view, special attention must always be paid to the regulations for the transfer of employment relationships, for corresponding liability and guarantee provisions and an appropriate allocation of remaining risks.

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German Deals Hub

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Artwork: Happy Home - Unknown Landscape by Du Feichen