Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

Issue: September 2020

→ Insuring transaction risks – a potential deal stabiliser

Although the coronavirus crisis has slowed down the deal flow, it has by no means come to a standstill. However, the market is adapting to the shift in challenges posed by the COVID-19 pandemic, meaning that, for example, *material adverse effect* clauses are being given a much higher priority.

Nevertheless, despite the billions that are to be made available to the economy by way of state and supranational support programmes, in such unprecedented times the following mantra applies perhaps more than ever: *Cash is a fact*! Company valuations are struggling to properly price in the risks added by the pandemic, and fears on the part of sellers that *warranty breaches* could be used to at least partially "refinance" a deal will certainly not diminish in the current situation.

In this respect, the notion takes hold that at least the latter doubts concerning the intentions of a party in the context of a transaction should be dispelled by taking out appropriate insurance, and that the economic consequences of a *breach of warranty* should be set out in a way that is comprehensible to the parties.

Now that warranty & indemnity (W&I) insurance has become standard in private equity, these products are also becoming increasingly popular in corporate M&A deals. This steadily increasing demand on the part of insurance buyers in recent years (the vast majority of W&I insurance is a buy-side policy) corresponds to a significant increase in the number of providers, a noticeable reduction in premiums or extension of coverage, as well as a steadily growing range of complementary services, which already include contingent legal risk insurance in addition to tax liability insurance. In addition to the classic unknown risks in those areas scrutinised as part of due diligence, even known risks with a low or moderate probability of occurrence can be the subject of insurance.
However, whether an insurance policy benefits a deal in times of COVID-19 is to be questioned in several respects.

W&I Insurance

As mentioned above, the question of the liquidity required for a transaction is of considerable importance for both parties: The decisive factor for the buyer is that, in the event of a *breach of warranty*, he can turn to a solvent claimant, i.e. the excess purchase price share paid with regard to the breach of warranty can also be recovered. For the seller, it is without doubt of considerable importance at present that the purchase price is also paid in full upon closing and does not remain in an escrow account as a security for potential claims and, therefore, would only become available to the seller after the expiry of the corresponding warranty period. These expectations held by the parties can essentially be met by taking out W&I insurance. However, expectations here should not be too high:

Firstly, it depends on which deductible has been agreed between the parties prior to performance by the insurance company. If this is high, the buyer can insist on the retention of purchase price to secure this deductible to be borne by the seller even if an insurance policy is taken out. At the same time, the coordinated structuring of the insurance cover and the warranty catalogue is of considerable importance. Should there be more extensive gaps between the risks covered by W&I insurance benefits and the catalogue of warranties provided by the seller, the purpose of "extensive" liquidity from a retention of purchase price pursued by taking out W&I insurance can quickly become limited.

As a result, the use of such an instrument in a transaction should be planned from the outset and taken into account throughout the entire process. As there is, of course, also a considerable interest on the part of the underwriters of W&I insurance solutions in avoiding reduced due diligence scopes for the consultants commissioned with the audits due to liquidity considerations on the part of the buyers and, thus, potentially overburdening them with increased risks, a number of underwriters expect an early involvement in the entire structuring and sequence of the due diligence process. Similarly, the required coordination of the sales and purchase agreement (SPA) – not only between the parties and their advisors, but also the corresponding coordination of the contents of the insurance policy with the insurance provider – may increase the transaction's complexity.

Title Insurance

The reasons for taking out a title insurance policy are, in part, different from those for W&I insurance. The following key rule applies: title insurance is recommended in the event of legal risks arising during the due diligence process in relation to the seller's title to the shares or the target's title to the property. Nevertheless, in similar fashion to W&I insurance, title insurance in the private equity sector is now taken for granted in certain regions.

As mentioned above, title insurance is primarily used to insure the title and its characteristics (such as, for example, possession, use) of the target's shares and/or property against the assertion of a challenge by a third party. The results of the due diligence process are regarded as so-called "known risks" by the insurer and can be insured on the basis of the insurance policy against a deductible of the insured. Otherwise, the results of due diligence and the risks mentioned therein will be excluded from the insurance cover.

Nowadays, however, we are noticing an increased risk tolerance on the part of insurers, so that title insurance policies are issued for shares and property, including in regions with less legal security (such as in South-Eastern Europe). In addition to broadening the geographical scope, the spectrum of risks covered has also been extended. In the case of the shares, for example, all corporate law risks are insured. With regard to property, in addition to the right of ownership, other additional issues are insured, such as construction rights (building permits, urbanism plans), rights of use, rights of way, and income from rents.

To add to the complexity of the transaction, insurers usually have specialised teams for W&I and title insurance. The insurance premium – with or without deductible – is also determined differently for each insurance policy.

Conclusion

If well prepared, taking out insurance against transaction risks in times of the coronavirus crisis can have a positive effect on liquidity considerations, which are not insignificant.

For further information, please contact

Hans-Ulrich Theobald
Rechtsanwalt (German Lawyer)
Partner

Prague (Czech Republic)

T +420 2 2110 8311
hans-ulrich.theobald@roedl.com

Bogdan Frățilă
Avocat (Lawyer Romania)
Country Managing Partner

Bucharest (Romania)

T +40 21 3102 162
bogdan.fratila@roedl.com

→ Using jouissance rights for a tax-efficient financing structure

When financing the purchase price for the acquisition of a company, mezzanine capital, can be considered in addition to the "classic" financing instruments. Mezzanine capital is characterised by its subordination to senior loans and often serves to close funding gaps. The term "mezzanine capital" is not a strictly defined term. It is a hybrid form of equity and debt capital which can be structured in such a way as to lean either more towards equity or debt capital, depending on the circumstances of the individual case.

Jouissance rights are a special form of mezzanine capital. According to a judgement issued by the Federal Court of Justice (BGH), jouissance rights are claims under the law of obligations which can be structured in such a way that they grant the holder a legal status similar to that of a shareholder, however, without conveying voting and administrative rights under company law.

In a recent judgement, the Federal Court of Finance (BFH) specified the principles for the tax treatment of income resulting from jouissance rights and thus created legal certainty. The facts of the case as well as the legal arguments are discussed below.

Facts

A Canadian subsidiary (CanCo) had issued jouissance rights to its domestic parent company (GerCo). Payments resulting from the jouissance rights were fixed at an amount of at least 4% and at maximum 16% of CanCo´ s net profit. GerCo treated the payments received as tax-free dividend income, whereas CanCo treated the cash distribution as tax-deductible interest payments.

In the course of a tax audit, the German tax authorities classified the payment distributions received by GerCo as taxable interest income instead of equity-related dividends and subsequently amended GerCo's tax assessment notices. Subsequently, GerCo took legal action against this decision.

Judgement of the BFH

The Federal Court of Finance (BFH) confirmed the view of the tax authorities and came to the conclusion that the payments resulting from jouissance rights were to be treated as taxable interest income received by GerCo. In the judgement, the Federal Court of Finance (BFH) refered to the wording of Section 20 Para. 1 No. 1 Income Tax Act (EStG) – as well as Section 8 Para. 3 Sentence 2 Corporate Tax Act (KStG) – and considered jouissance rights as equity-related financing instruments in cases where the holder of the jouissance right participates in the profit and the liquidation proceeds of the issuing company. Only if both conditions are cumulatively met such payments resulting from jouissance rights will constitute tax-free dividend income. If one of those two conditions is not met, the Federal Court of Finance (BFH) takes the view that the jouissance rights will not be considered as equity-related jouissance rights ("beteiligungsähnliche Genussrechte"), but rather as debt-related jouissance rights ("obligationsähnliche Genussrechte") from which taxable interest income is generated.

In the case at hand, the participation of GerCo in the liquidation proceeds of CanCo was not (explicitly) stipulated in the jouissance rights agreements. In the view of the Federal Court of Finance (BFH), the final assets of a corporation to be wound up must be taken into account, i.e. the participation of the holder of jouissance rights in any (additional) liquidation proceeds and the associated participation in the hidden reserves of the issuing company. In the absence of any such participation in the liquidation proceeds, other circumstances cannot substitute this indispensable requirement for assuming equity-related jouissance rights:

- Both the profit-related nature of distributions resulting from jouissance rights and the subordinated repayment of jouissance capital at par value in the event of liquidation do not result in a participation in the liquidation proceeds.
- The position of the holder of jouissance rights as sole shareholder itself is also insufficient. Although sole shareholders would be entitled to participate in all hidden reserves of the issuing company, this fact does not result causally from the jouissance rights agreements, but rather from the position of the shareholder.

- Even a long term of jouissance rights (in the case at hand: 40 years) does not lead to an equity-related jouissance right.
- Ultimately, a conversion right of the holder of jouissance rights to acquire shares in the company is also of no significance for the estimation whether the hybrid financing instrument at hand qualifies as equity-related jouissance right or debt-related jouissance right.

Comments

The above explanations demonstrate that there is considerable tax structuring potential when using jouissance rights for financing the purchase price of company acquisitions:

- If the jouissance rights agreement provides for a participation in the profits and liquidation proceeds of the issuing company (= equity-related jouissance rights), the distributions resulting from such jouissance rights represent dividend income which is 75% tax-free for a recipient in the form of a corporation. However, the distributions do not reduce the tax base of the issuing company.
- If the jouissance rights agreement provides for a participation in profits but not an explicit participation in the liquidation proceeds of the issuing company (= debt-related jouissance rights), the distributions resulting from such jouissance rights qualify as interest income which is either fully taxable for the jouissance right holder (in case of a corporation) or subject to a 25% withholding tax (in case of an individual). In this case, the distributions constitute deductible interest expenses for the issuing company which reduce the tax base.

Therefore, it should be assessed in each individual case whether the tax implications of using jouissance rights as financing instrument are in line with the economic interests of the buyer.

For further information, please contact

Dr. Patrick Satish
Certified Tax Consultant (Germany)
Associate Partner

Nuremberg (Germany)

T + 49 911 9193 1056
patrick.satish@roedl.com

Manuel Tremmel
Associate

Nuremberg (Germany)

T +49 911 9193 1257
manuel.tremmel@roedl.com

→ Last but not least – accompanying post-closing

M&A processes are characterised by different phases. Ultimately, with the closing of the transaction, the owner of the shares or assets has legally changed. Experience shows that the subsequent "post-closing" phase is not always afforded sufficient attention. During this period, however, findings from the entire transaction process must be followed up and implemented. This contributes to the successful continuation of operative business.

The added-value of a post-closing agenda

Post-closing relevant content depends significantly on the individual structure of the M&A process. In addition to legal, tax & financial due diligence as a source of information, the purchase agreement itself serves as a fundamental point of reference. In addition, operational "To Dos" often emerge in negotiations. Ideally, post-closing tasks should be collected during the entire process and structured in a post-closing agenda.

If the agenda is well-maintained, it then offers real added-value, as post-closing obligations regularly stem from a wide variety of areas and remain present over a long period of time.

Post-closing implementation of due diligence results

Risky findings from due diligence can regularly be resolved not just by mapping them in the contractual documentation (e.g. by including guarantees and exemptions or purchase price adjustments). Rather, recommendations are regularly encountered that only need to be addressed in the post-closing phase and which should be given a place on the agenda:

A glance at the commercial register may render it necessary to adjust granted powers of procuration in internal and external relations. This is the case, for example, if employees have changed or their contracts or positions have been amended. What cannot be ascertained from the commercial register, but which remains elementary for daily operative business, are the powers of procuration actually granted, which – especially in the form of a general power of procuration – grant the authorised individual considerable room for manoeuvre, which in this form may no longer be desired by the buyer.

Regular post-closing action is required in contract management. In an asset deal, it is necessary to obtain the consent of the contractual partners, e.g. in order to be able to continue commercially significant customer contracts. It may also be appropriate to renegotiate existing framework agreements, in order to improve their conditions for the future or to extend their terms. Any incomplete contractual documentation that is uncovered should be completed – e.g. by way of supplements. It is not unusual for general terms and conditions to require revision if they contain clauses that have since become legally ineffective, or which have become unsuitable for the new business area. It is precisely in this field that case law is both very active and decisive for the drafting of contracts.

In terms of employment law, the contracts presented during due diligence – often expanded over years – reveal a mixed picture. An adjustment may be advisable in order to clear up erroneous business transfers from the past according to Section 613 a German Civil Code (BGB).

The insurance management of the target company is often neglected. There is often potential for (economic) optimisation by way of integration into a Group insurance policy.

Furthermore, tax or legal registrations and official procedures are regularly required. For example, business transfers after acquisition must be registered with the competent municipality and the pertinent commercial tax office. These contents should – as they are often linked to statutory deadlines – be scheduled and noted on the agenda.

Post-closing source: Purchase contract

Typically, the buyer's payment obligations are not "settled" with the transfer of a fixed purchase price. The buyer party regularly withholds retentions ("escrow") or divides the purchase price into several tranches ("earn out"). This is usually advantageous for the buyer, but also forms part of the negotiation outcome to fix downstream purchase price components and payment dates in the future. The buyer should not miss these deadlines, as otherwise "penalty payments" (e.g. in the form of interest on arrears) will be due to his or her disadvantage.

A typical post-closing agenda should also note limitation periods, e.g. from warranty claims, especially as these dates are usually in the distant future and can, therefore, quickly be lost from view. It is precisely here that individual agreements – often graduated in small steps – regularly overlap statutory deadlines. If such deadlines are missed, there is a risk that the buyer's claims arising from the seller's assurances or warranties become time-barred.

In order to be able to maintain an overview of due dates, the post-closing agenda should include all amounts to be paid, as well as the payees and deadlines.

Conclusion

Post-closing-relevant topics often stem from the operational business, but ultimately harbour a bright array of numerous issues. If due attention is paid to this, the continuation or integration can succeed smoothly. If a post integration manager is deployed, it is advisable to seek close coordination and cooperation (we reported on this in the May 2020 issue of M&A Dialogue).

For further information, please contact

Regina Henfling
Rechtsanwalt (German Lawyer)
Commercial Lawyer (University of Bayreuth)
Associate Partner
Munich (Germany)
T + 49 89 92 87 80 313
regina.henfling@roedl.com

→ M&A Vocabulary – Experts understand

“Covenants”

In this ongoing series, a number of different M&A experts from the global offices of Rödl & Partner present an important term from the specialist language of the mergers and acquisitions world, combined with some comments on how it is used. We are not attempting to provide expert legal precision, review linguistic nuances or present an exhaustive definition, but rather to give a basic understanding or refresher of a term and some useful tips from our consultancy practice.

Covenants are collateral agreements in a contract. They become relevant in contracts for the purchase and sale of a business or shares if the relevant contract is executed in two steps: Signing and closing. In the phase between the obligation to purchase (signing) and the actual transfer (closing), the ownership and management regarding the business/company remains with the seller. The buyer therefore has a legitimate interest in a correct management of the business/company.

Covenants can be both positive and negative in nature, depending on whether they consist of obligations to act or to refrain from acting. Covenants that are common in practice include:

- Ordinary-Course-of-Business-Clause;
- Rights of access and information;
- Cooperation in connection with financing;
- Participation rights for obtaining approvals and consents;
- Confidentiality provisions;
- Provisions on communications and public announcements (press releases).

Covenants may be relevant also after closing. Typical examples are non-compete and non-solicitation clauses to prevent the seller from establishing or financing a competing business.

If agreed, covenants can be converted into post-closing covenants if they could not be fulfilled by closing date.

Overall, covenants enable the parties to execute the contract properly and make it easier to plan the transition period after the transfer of business/shares.

For further information, please contact

Dr. Vanessa Sofia Wagner
Rechtsanwalt (German Lawyer)
Avvocato (Lawyer Italy)
Associate Partner

Milan (Italy)
T +39 02 6328 841
vanessa.wagner@roedl.it

Invitation to the M&A Breakfast digital

Be part of the first virtual issue of the M&A Breakfast on the latest topic

“Company Purchase Prices in Times of Crisis”

Discover new insights and a distant look ahead with the renowned practitioners Daniel Ritter (Head of M&A - ZEISS Group) and Joachim von Lohr (Partner - HANNOVER Finanz GmbH). Our experts will complement the discussion with specialist presentations on current trends and the challenges associated with company purchase prices from a legal, tax and valuation perspective. Would you also like to know more about the current situation and its anticipated development? Then register now via the following link and secure your place in the webinar. Your participation is free of charge. We look forward to interesting presentations and an exciting exchange of experiences.

Publisher’s details

M&A Dialogue |
September 2020 Issue

Publisher
Rödl GmbH Rechtsanwaltsgesellschaft
Steuerberatungsgesellschaft
Wirtschaftsprüfungsgesellschaft
Denninger Straße 84
81925 Munich
Germany
T +49 89 9287 800
www.roedl.de

Responsible for the content
Hans-Ulrich Theobald, Dr. Patrick Satish,
Regina Henfling, Dr. Vanessa Wagner

hans-ulrich.theobald@roedl.com
patrick.satish@roedl.com
regina.henfling@roedl.com
vanessa.wagner@roedl.it

Layout/Presentation
Franziska Stahl
franziska.stahl@roedl.com