Rödl & Partner

M&A DIALOG

LEGAL, TAX, FINANCIAL NEWS

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In this issue, you can read about

→ New subject areas in Tax DD under ATAD: Foreign Tax Act

On 24 March 2020, the second draft of the Act on the Implementation of the EU Anti-Tax Avoidance Directive (ATAD-UmsG) was published. On 28 September 2020, the Finance Committee of the German Bundesrat surprisingly included its own ATAD implementation proposals in its recommendations for an opinion concerning the government draft of the Annual Tax Act 2020. It is therefore still quite possible that, in addition to the Controlled Foreign Company (CFC) rules, there will be central changes in intra-group financing under Article 1a of the Foreign Tax Act (AStG).

CONTROLLED FOREIGN COMPANY RULES

German CFC rules constitute a deviation from the so-called separation principle, so income arising in foreign subsidiaries and permanent establishments becomes taxable in Germany. Although the regime under the Act remains unchanged, changes are expected to be introduced to the so-called list of activities which exhaustively defines income exempt from the CFC rules. In future, for example, charging interest will be considered harmful without exception and dividends will have to be treated differently depending on the tax already paid and the size of the shareholding.

As a trend towards lower tax rates can be observed worldwide, CFC rules are increasingly focusing on foreign subsidiaries and permanent establishments. If it turns out that the foreign income is taxed at a rate of less than 25 percent (as determined according to German regulations), the rate is considered by the legislator as a low tax rate.

Interest and investment income of foreign holding companies in low-tax countries may then become subject to CFC rules in Germany. According to the recommendation of the Finance Committee of the German Bundesrat, the low tax rate threshold should be lowered to 15 percent. However, countries such as the Netherlands or the USA are currently considered low-tax countries under the Foreign Tax Act.

The same may apply to foreign subsidiaries and permanent establishments in whose local business German group companies are quite considerably involved. If, for example, a German head office posts employees abroad to help in sales activities or in the provision of services, this may constitute a harmful practice within the meaning of the Foreign Tax Act.

Failure to identify that CFC rules apply to a given matter can lead to high liquidity outflows on the part of the German parent as tax claims are subject to high interest rates, and these liquidity outflows should be identified during tax due diligence.

INTRA-GOUP FINANCING

The planned Article 1a (1) AStG-E (draft) would introduce a cap on the deduction of expenses for tax purposes arising from cross-border financing relationships within an international corporate group under certain conditions.

If the provision is implemented in the version of ATAD-UmsG as drafted, it will be necessary in future to examine whether a third party would have granted the loan to the corporate company under the same conditions. Such examination would focus on the solvency of the borrower and on determining whether taking out the loan was economically necessary judging by the object of the company. If yes, it should then be clarified whether the parties have agreed an interest rate at arm's length.

The determination whether the agreed interest rate is at arm's length is made based on the refinancing costs of the multinational group and thus, de facto, creditworthiness of the group is assessed based on a group rating. Interest payments of a German group company based on higher interest rates than the group financing would be adjusted to increase profits.

The fact that the proposed Act is a hot topic is becoming visible against the background of the most recent rulings on outbound cases, with which the BFH (Federal Tax Court) is challenging its previous case law. Accordingly, implicit support does not substitute intra-group collateral required in loans. If no sufficient and recoverable collateral is provided, this lack should be compensated for by charging higher interest rates. This might diametrically run counter to Article 1a AStG-E.
The draft of ATAD-UmsG is in conflict not only with earlier rulings of the BFH, but also with international standards concerning recognising

financial transactions. Double taxation in cross-border group structures would probably be inevitable. Therefore, it is a welcome development that the legal regulations and tightened provisions pursued by the BMF (Federal Ministry of Finance) have been excluded from the recommendations of the Finance Committee of the Bundesrat.

CONCLUSION

The changes to the Foreign Tax Act arising from the Act on the Implementation of the EU Anti-Tax Avoidance Directive (ATAD-UmsG) would lead to double taxation. These higher tax costs should be estimated as part of tax due diligence – irrespective of the unclear legal situation in the international context. Ideally, first tax optimisation areas could be identified already at that stage.

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→ Blockchain-based business models and M&A – an outlook

Innovative technologies usually quickly find their use in the transactional practice. Blockchain technology, or more generally speaking Distributed Ledger Technology (DLT), is no exception. Here, in particular two scenarios can be distinguished. On the one hand, there are cases where blockchain applications become the subject of a transaction process as they are used by the companies involved and so become part of the (due diligence) process. On the other hand, it is – theoretically at least – also possible – that, conversely, the transaction process itself is mapped in whole or in part through a blockchain application.

BLOCKCHAIN APPLICATIONS AS THE SUBJECT OF A TRANSACTION PROCESS

As with any emerging technology, it is expected that blockchain applications will become more and more common in M&As. For example, pure blockchain start-ups can themselves become targets in M&A transactions. It can also happen that, as part of a transaction, significant parts of the value chain of the companies to be subject to due diligence will be strongly driven by this technology, as for example in FinTechs.

GROWING REGULATORY FRAMEWORK – EXAMPLE: ELECTRONIC SECURITIES

In this context, it should be positively assessed that the regulatory framework concerning the supervision of blockchain technology is growing. From the perspective of transaction law, this trend is welcome, as it makes both the development and the subsequent assessment of blockchain-based business models easier. This summer, for example, the German draft law on the introduction of electronic securities attracted considerable attention. Under current legislation, on principle it is mandatory that securities are represented by (physical) certificates. According to the new draft law, it should now be possible to replace the certificate with an electronic document. The new draft law assumes that instead of issuing a securities certificate, an entry will be made in an electronic securities register. It further explains that this electronic securities register may also be kept on a decentralised, forgery-proof recording system where data are recorded in chronological order and stored in a manner ensuring protection against their unauthorised deletion and subsequent modification, shortly speaking, also by using blockchain applications.

Another effect of the draft law that would have an impact on other areas significant for the transactional practice is the comprehensive protection of ownership as envisaged in the draft law, where electronic securities will be considered movables (German: *Sache*) within the meaning of Article 90 of the German Civil Code (BGB). In other words, this means that a digital asset will expressly be treated as a physical object.

SPECIAL ATTENTION TO THE HISTORY OF IMPLEMENTATION OF BLOCKCHAIN-BASED BUSINESS MODELS

When reviewing blockchain-based business models from the perspective of transaction law, special attention should also be paid to the history of the implementation of such models. What sounds like a banality may well be laden with pitfalls. Especially when blockchain projects, often using associated financing via ICOs (Initial Coin Offerings), were in their infancy, they were believed not to be subject to any regulation in many areas. Errors arising from such misconception can therefore be found in many constituent documents and design decisions. In the "Wild West" times, for example, published capital market information often contained errors that could give rise to liability. This applies in particular to the so-called white papers, which in some cases contained insufficient information about risks. But also other contractual stipulations, such as those governing the provision of capital market services, should be critically reviewed taking into account the timing of their drafting. In this context, the following rule of presumption may be used as a precaution: The longer ago a contract was drafted, the higher the risk that at the time of drafting the contract legally relevant information was not taken into account. This is the case, for example, with the obligation to prepare a prospectus which might have been overlooked.

THE TRANSACTION PROCESS ENTIRELY "ON BLOCKCHAIN"?

Furthermore, blockchain's special feature, at least in theory, is that Distributed Ledger Technology has the potential to be used in the transaction itself through the use of so-called smart contracts. Smart contracts can be used to map the business or contract logics in whole or in part by means of a program code using blockchain technology. In this process, transaction conditions agreed between the parties are logged as a protocol in the blockchain. If the conditions are met, the intended legal consequences (e.g. the transfer of the purchase price upon registration of the new owner in the electronic company register or the transfer of an earn-out amount deposited in an escrow account upon publication of the annual financial statements coupled with the fulfilment of specified ratios) are triggered through a technical process without the involvement of the parties or third parties – and thus without any possibility for any party to influence the transaction. Since relevant conditions and times under a contract can be automatically verified and reconciled, such applications enable highly autonomous interactions. Since the conditions of a transaction are logged in the code, intermediaries such as banks, which in a "classic" contract signing situation would otherwise have ensured the necessary level of trust among the parties to the transaction, basically become dispensable. Therefore, it would be quite conceivable to conduct company acquisition transactions via smart contracts. In reality, however, there are currently significant obstacles to this scenario. Above all, there is no appropriately differentiated ecosystem within which the desired transaction logic could be mapped from the beginning to the end of the process. An example: although smart contracts can currently be used to transfer digital assets, such as a token, it is currently impossible – at least in Germany – to use them for transferring company shares.

CONCLUSION

The number of transactions involving aspects of blockchain technology will probably increase in the future. Even if this innovative technology has potential for being used in implementing transactions, this will rather not be the case in the foreseeable future. This is contrasted by cases where it is necessary as part of due diligence for example to assess amongst other business transactions that are implemented using blockchain technology (e.g. ICO as alternative financing instrument). In all probability, there will be more such cases in the future. Especially in the area of FinTechs or tokenisation-based business models, it will become more important to be able to deal with the legal aspects of the technological part of the transaction. In due diligence audits of relevant targets and transactions, even tech transactions lawyers are no longer able to act as software experts. This is because in such cases it is particularly important to check the security of the program code of the smart contract logged in the

blockchain and run the necessary simulations on the basis of which a legal assessment of the transaction can be performed and its particular features reflected in its architecture and documentation.

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→ Damages for breach of warranty in M&A transactions

M&A transactions are usually a special situation for sellers and/or buyers that do not occur on a daily basis. Given the reach of the decisions involved, the parties often agree on a list of warranties in the acquisition agreement in order to ultimately clarify particularly important aspects of a transaction and to define the position which the parties owe under the agreement. If a breach of a warranty becomes apparent after the transaction has been completed, the buyer is entitled to damages in the best case scenario.

The situation usually fundamentally changes after the transfer of the business, and if a warranty is breached, there always arises the question of the consequences of such breach for both parties to the agreement – in particular for the aggrieved buyer – and the problem of how to calculate damages.

This article deals with the treatment of damages after the completion of an M&A transaction. Our article of June 2020 already highlighted the issue of damages in case of a breach of obligations to provide relevant information before the agreement is signed.

WARRANTIES CREATE A "POSITIVE INTEREST" ON THE PART OF THE BUYER.

With warranties made in the acquisition agreement, the parties assure one another as part of the M&A transaction that a certain position will be achieved; the buyer therefore has a claim for the fulfilment of such warranties. If, however, the actual position of the party differs post M&A from the warrantied position, the party suffers damage as the warranty was not fulfilled. In the case of such a so-called "positive interest" the creditor is to be placed in the same position as if the debtor had properly fulfilled the warranty.

In the case of such claims resulting from warranties, priority is generally given to "in-kind" remedies that restore the position of the aggrieved party as if the damage had not occurred-i.e. the repair of a defective building or the supply of a machine that failed to be supplied contrary to what was warrantied in the agreement. In M&A transactions, however, the provision of an in-kind remedy is only possible in cases where the defect or failure had no further impact on the company's cash flows.

FINANCIAL COMPENSATION FOR THE LOSS OF VALUE IN CASES OF REDUCED CASH FLOWS LEADING TO A POSITION CONTRARY TO THE WARRANTY

If, on the other hand, a breach of a warranty also has an impact on the company's performance and reduces its cash flows, it is not possible to compensate for such breach on an in-kind basis. This can be the case, for example, if the target company lacks the warranted capabilities or customers, or does not hold the warranted patents. In such cases, in addition and subsidiarily to in-kind remedies, financial compensation for the loss of value is paid. This should place the aggrieved party in the same position as if the warranty included in the acquisition agreement had been fulfilled. Business valuation is the adequate instrument for determining compensation, especially if the consequences of damage cannot be clearly determined and additional claims for lost profits are sought.

BUSINESS VALUATION AS A TOOL FOR DETERMINING FINANCIAL COMPENSATION FOR THE LOSS OF VALUE

Appropriate financial compensation for the loss of value is intended to compensate the aggrieved party for the reduced value of the target company as a result of the breach of the warranty. The calculation of such compensation usually requires comparing two business valuations: one based on planning taking into account the breach of the warranty and the actual situation caused by this breach, and the other based on the hypothetical planning scenario assuming that the warranty is fulfilled. The difference in value should be calculated on the basis of detailed integrated business planning in accordance with the IDW S1 valuation standard promulgated by the Institute of Public Auditors in Germany [Institut der Wirtschaftsprüfer e.V.] and discounted as of the relevant valuation date using the net present value method. In doing so, attention should be paid to ensuring transparency of the planning and the valuation procedure.
Simplified valuation methods – for example using multiples – however, aim at a "perpetual annuity" assumed to be indefinite and often do not take into account complex legal problems relating to damages as the calculation process is unidimensional; they are therefore no suitable methods in legal disputes.

The damage to be compensated - the "positive interest" (German: *Positives Interesse*, which means the interest in being placed in the position as if the contract had been properly fulfilled) - is the difference between the values determined as a result of both fundamental valuations.

The purpose of the "positive interest" provides for two essential parameters for company valuation, namely the information date [date at which information for valuation purposes is available] and the valuation date [date to which future cash flows arising post transaction are discounted]:

- the purpose of the "positive interest" is to place the beneficiary in the position he would be in if the warranty was fulfilled. The period for which damages are determined in the event of a breach of a warranty is the time of the last verbal negotiations (information date). In this respect, damages are determined based both on actual data and on planning data valid as of the information date.
- The valuation date is to be distinguished from the information date. The valuation date is the date of the effective transfer of assets; future cash flows arising post transaction are technically discounted to that date. In a second step, the present value of the company's cash flow for the hypothetical and the real scenario should then be compounded as of the date of the last verbal negotiations using an appropriate rate of return on the investment. In this respect, the value is adjusted in respect of two time components: on the one hand, it is adjusted in respect of the period between the date of the transfer of assets and the date of the last verbal negotiations and, on the other hand, in respect of the finite or infinite period after the date of the last verbal negotiations, depending on the damage caused by the failure to fulfil a warranty.

BUY-SIDE PERSPECTIVE DECISIVE FOR FINANCIAL COMPENSATION FOR THE LOSS OF VALUE

The "positive interest" is based on the buy-side point of view; consequently, damages depend on the impact of the breach of a warranty on the company's cash flows from the buy-side point of view. In this respect, decisive is the subjective valuation of the company value from the buy-side point of view.

Following the principle of "pacta sunt servanda", this means that the buyer can rely in his planning scenario on the truthfulness of the warranties given by the seller and can continue to

pursue the business planning on which his acquisition decision is based from his perspective. The buyer may have entered into the transaction expecting to implement his own concept for continuing operations and to use viable synergies as well as intending to continue operations of the company in fundamentally changed circumstances after the transfer of the assets. In addition, capitalised interest should always be calculated subjectively. Given this perspective, the subjective enterprise value from the buy-side perspective may substantially differ from the sell-side perspective before the conclusion of the transaction and may be higher than the latter.

CONCLUSION

Warranties in company acquisition agreements are intended to ultimately clarify important aspects of the transaction and to define the position of the parties to be achieved under the agreement. In the event of a breach of a warranty, the aggrieved party is entitled to damages, alternatively financial compensation for the loss of value. Their amount is often determined based on business valuation from the buy-side perspective. Because warranties given have their consequences, sellers should try to limit the impact of the warranties in terms of time, content and legal consequences.

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→ M&A Vocabulary – Understanding Experts

„Third Party Claims“

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.

In negotiations of company acquisition agreements, the scope of the seller's liability is usually one of the most important points of negotiation. While existing and future risks are identified by means of due diligence, the distribution of risks is primarily determined by the design of the liability clauses in the company acquisition agreement.
Indemnities usually relate to risks that are known to the parties, whereas it is usually impossible yet to estimate the risk amount and the timing when the risk would materialise. The seller indemnifies the buyer from future liabilities that might arise from circumstances prior to the transaction. For example, these may be costs of cleaning up contaminated sites or tax liabilities for assessment periods when the seller was running the business of the company being sold.

In addition, the seller usually provides representations and warranties (so-called Reps & Warranties). Their subject matter and scope depend on the particular characteristics of the

target company. Frequently granted warranties concern the existence and unencumbered nature of the company shares being sold, the accuracy of financial statements, ownership of industrial property rights, the validity of essential contracts, sufficient insurance cover of the target company, non-existence of legal disputes and the holding of public law permits.

In the case of liabilities which may arise from third-party claims (e.g. from product liability) and fall within the scope of an indemnity or a warranty obligation of the seller, it should be ensured that provisions for the specific handling of such claims are included in the agreement. In particular, it should be regulated who has the control over or takes over the handling of defence against third-party claims and how and in what form the other party can or may support the latter or intervene in such defence. Furthermore, the parties should regulate how to deal with claims that are obviously unfounded.

If, for example, the seller has indemnified the buyer from product liability claims and if, after the transaction has been completed, third parties bring legal action against the target company, the seller is required to bear all costs incurred due to the assertion of these claims.

It is generally in the buyer's interest to organise and conduct the defence against third-party claims by himself, because the implications of such claims for the target company's business primarily affect him. Thus, from the buyer's point of view, it might be reasonable to agree to a quick settlement, e.g. in order to avoid damage to the company's reputation. Cost aspects can, by contrast, be of secondary importance, as these costs are borne by the seller as part of the indemnity or warranty obligation.

From the seller's point of view, on the other hand, it is often reasonable to be granted certain rights to influence the dispute between the buyer, or the target company, and third parties, e.g. to prevent unreasonably high settlement amounts or to influence the costs of legal defence.

Regulations that could be included in the agreement in this regard are manifold. In any case, the agreement should regulate at least cooperation obligations of the parties. Furthermore, it is possible to grant the seller the right to access only certain documents and information or the right of consent for certain issues such as the selection of legal advisers or regarding the conclusion of a settlement; the seller might also be granted the right in some cases to take control of the defence against third-party claims. From the buyer's perspective, it is always desirable to have control over handling third-party claims and to reasonably grant the seller the right to receive certain information in order to involve the seller in the claims handling process at an early stage and thus to reduce the risk of later objections and discussions with the seller on the extent of costs to be reimbursed.

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In psychology, 'resilience' refers to the ability of people to cope in the face of adversities of life, stress, and change – it thus describes the ability to handle stressful situations without suffering significant negative consequences. This also applies to economic systems or companies. They must show resilience on several levels and embrace possible crises turning them into opportunities. Ultimately, companies should learn lessons from stormy times or draw conclusions from them – making this knowledge an asset for a prosperous future.

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