Rödl & Partner

# M&A DIALOGUE

## LEGAL, TAX, FINANCIAL NEWS

Issue: February 2021

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# → Statutory cap on directors' pay

Directors of medium-sized companies whose hearts stopped for a moment as they read the headline should feel reassured – there is now indeed a statutory cap on directors' pay, but this only affects directors of listed stock corporations.

A little over a year ago, the Shareholder Rights Directive II was transposed into German law (ARUG II). The regulations on the remuneration of directors of listed companies, probably the most debated topic in this regard, are now to be applied from the beginning of 2021.

The following article addresses the remuneration system, being the core element of the regulations on directors' remuneration, with particular focus on the cap on directors' pay.

## Major principles of the remuneration system

Even before the amendment of the German Stock Corporation Act by ARUG II, the supervisory board of the stock corporation had the power to have the general meeting resolve on the directors' remuneration system. However, this was merely an option that the supervisory board could exercise; there was no obligation imposed by the Stock Corporation Act in this regard. At the same time, the Stock Corporation Act did not specify any requirements on how the remuneration system should be designed. The Stock Corporation Act now lists specific requirements for the remuneration system of listed stock corporations.

The legislator has pursued especially the following goals:

- increasing shareholders' participation in the decision-making process concerning the remuneration of directors of listed stock corporations ("Say on Pay")
- ensuring that directors' pay serves sustainable development of the company and is not linked to short-term objectives; and
- capping directors' pay to respond to the ongoing discussion about excessive remuneration of directors.

## Participation of the general meeting

In order to give shareholders more say on directors' pay, the supervisory board must now submit the directors' remuneration system to the general meeting for approval at least every four years. For the first time, this must take place as part of the annual general meeting for the 2021 financial year. If any changes are made to the remuneration system within four years of its approval by the general meeting, the remuneration system must be submitted to the general meeting for approval again.

The approved remuneration system does not affect any current agreement with director, but has only effect for future directors' contracts.

If the general meeting of the stock corporation y does not approve the submitted remuneration system, this will have no direct influence on the directors' pay. The supervisory board is rather required to examine the concerns of the general meeting about the submitted remuneration system and to submit a verified remuneration system to the general meeting in the following year for approval. However, it is not obliged to adjust the remuneration system after its re-examination.

Although the general meeting was given more say in the remuneration matter by ARUG II, it remains a rather blunt instrument, since the supervisory board continues to hold on to the remuneration system once it has been approved.

The only exception here is the maximum of directors' pay. In that regard, shareholders have the right to vote against the supervisory board's proposal at the general meeting and propose an exact amount of such cap themselves. If the general meeting supports the countermotion, the supervisory board must strictly comply with it.

## Content of the remuneration system

The Stock Corporation Act now also explicitly specifies the individual components of remunear-tion systems.

With regard to these components, a distinction should be made between the principles governing the remuneration system and the different types of remuneration. The principles governing the remuneration system (e.g. maximum of directors' pay) must always be submitted to the general meeting. In addition, the general meeting should be informed of the types of remuneration that are to be actually awarded to the directors. This includes, for example, fixed remuneration or the granting of stock options.

Mandatory basic principles to be presented include, e.g.:

- maximum of directors' pay;
- presenting how the remuneration contributes to the business strategy and the long-term development of the company; and
- considering the salaries of employees of the company when determining the remuneration of the directors.

When drafting the regulation on the maximum of directors' pay, the supervisory board has the option to cap the remuneration of individual directors or the overall remuneration of all directors. The supervisory board is also given some leeway as regards the amount of the cap – it can choose between an exact amount and a flexible variant in which the cap is set in proportion to the remuneration of the other employees.

### Conclusion

Through the implementation of ARUG II, shareholders in Germany are for the first time legally entitled to have a say on the remuneration of the directors, even if this right remains very limited.

It is only through their mandatory vote on capping directors' pay that the shareholders have the opportunity to teach the company's management a lesson if they are dissatisfied with the directors' performance.

In order to avoid capping the remuneration by the general meeting, the company should have in place a balanced remuneration system that aligns the interests of the directors with those of the shareholders.

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# → StaRUG – Closing the gap

On 1 January, the "Act on the Stabilisation and Restructuring Framework for Enterprises" ("StaRUG") came into force. The Act was transposed into national law based on an EU directive serving also as a frame of reference for drafting the Act's over 100 very extensive and complex articles.

At the same time, it is remarkable how quickly the new law was implemented. In September 2020, the draft bill was presented, around four weeks later the government draft followed, on 17 December the Bundestag passed the law and on 29 December it was published in the Federal Law Gazette.

### Further development of the restructuring landscape

Opinions of experts about the Act are greatly divided. While insolvency practitioners have often pointed out that the Act should be significantly amended because it is too debtor-friendly for them, pre-insolvency restructuring experts seem to be amazed by the Act.

Nonetheless: especially in view of the consequences of the Covid-19 pandemic, the German government has shown that it does not want to lose any time and wants to strengthen Germany as a restructuring location by giving the country a new tool, especially after the regulations on the temporary suspension of the obligation to file for insolvency for over-indebted companies expired (in part) on 31 December 2020 or continue to apply only in the context of the so-called November and December rescue package.

Even though the timing of the legislative process was strongly influenced by the Covid-19 pandemic, the new Act affects all companies that are in (imminent) distress or in need of restructuring. As for companies that do not have to file for insolvency, the new framework gives them an opportunity for (financial) restructuring outside of insolvency proceedings. The procedure can only be initiated upon request and the debtor also retains control of the procedure.

### The gap is closed

StaRUG thus closes an often debated gap between court-supervised restructuring as part of insolvency proceedings and out-of-court restructuring. At the same time, it also puts an end to the consensual restructuring culture in Germany.

Outside of insolvency proceedings, restructuring usually required consent of all parties involved. For example, unwilling and uncooperative creditors ("hold out") can be outvoted only in insolvency proceedings. StaRUG provides a new solution approach here by providing a framework outside of insolvency in which creditors can decide on a restructuring plan with a qualified majority of 75 per cent of the voting rights in the groups of creditors to be formed. At the same time, individual groups of creditors can be outvoted. The non-consenting minority is bound to respect the results and effects of the plan confirmed by the court.

In addition, all parties involved in a restructuring under StaRUG can achieve legal certainty – irrespective of whether individual groups were outvoted – because a restructuring plan, if confirmed by the court, becomes non-contestable. However, the modular structure of the Act also makes it possible to carry out the restructuring without the involvement of the court.

Irrespective of the many possibilities offered by StaRUG, it should be borne in mind that it is essentially an instrument for financial restructuring. For example, restructuring under StaRUG cannot affect employee rights.

### Conclusion

For the first time, Germany as a restructuring location has now in place a "partly consensual" restructuring regime outside insolvency proceedings. This closes the gap between consensual out-of-court restructuring on the one hand and insolvency proceedings on the other. The new restructuring alternatives are complex and challenging. In order to make the best possible use of the framework and to avoid any surprises as creditors and business partners, it will be necessary to become acquainted with the new regulations early on with the help of expert advisers and to take appropriate preparatory measures.

Even though the possibilities for operational restructuring are extremely limited, StaRUG means considerable progress for financial restructuring. Especially the restructuring of complex financing structures – regardless of the size of the company – may be seen as the main area of application of the new law.

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# → Share Deal: Tax structuring opportunities

The tax optimisation of the transaction is essential for a successful share deal. In this process, the seller strives to achieve the lowest possible tax burden on the capital gain. But also for the buyer, the structuring of the transaction is an often underestimated aspect of setting the course for future tax outcomes: In addition to the acquisition process itself (e.g. avoidance of real estate transfer tax), the transaction structure has an impact on the future regular taxation of the target company (e.g. deduction of financing costs, utilisation of losses), on the taxation of profit distributions, and on an tax optimized exit – especially for private equity companies. Below, the holding structure and the simple accrual model (a model of allocating the exiting shareholder's shares in the company's assets to the remaining shareholder) are presented as two buy-side structuring scenarios.

## Holding structures as corporate structuring model

In the case of a corporate structure organised purely as non-transparent corporations, the implementation of a holding structure can bring considerable advantages for the buyer with regard to the taxation of distributions, but also in the event of an exit: in the case of individuals, dividends are generally subject to the final withholding tax of approx. 25 per cent (plus solidarity surcharge and church tax, if applicable). In the case of a two-tier corporate structure, the effective corporate income and trade tax burden plus solidarity surcharge, if applicable, amounts to approx. 1.5 per cent. While 60 per cent of the profits from the sale of shares in corporations by individuals are generally subject to the personal income tax rate (resulting in a tax burden of approx. 28 per cent at the maximum tax rate plus solidarity surcharge and church tax, if applicable), only 5 per cent of these capital gains are subject to taxation in the case of corporations acting as shareholders (resulting in an effective corporate income and trade tax burden plus solidarity surcharge of approx. 1.5 per cent). As shown above, the implementation of a holding structure, leads to significant lower taxation rates for future profit distributions and exit scenarios for corporations acting as shareholders compared to the direct participation of individuals.

However, in the case of such holding structures, the tax treatment of any financing costs (e.g. interest) can be problematic. The financing costs associated with the share purchase are covered by the buyer and thus they are incurred at the level of the holding company. In contrast, the operating profits flow to the target company. Accordingly, the holding company´ s possibility to offset the financing costs is limited. This can lead to structural loss and interest carry-forwards. Scenarios like these can be prevented by the so-called debt push-down. The aim is to shift the financing costs from the acquiring shareholder to the target company. This enables offsetting the costs against the operating profits of the acquired company. One of the variants of the debt push-down structure is the merger of the holding company and the target company after the transaction. In general, such a merger can be conducted income tax neutral. It should be noted, however, that in the case of real estate holding companies, such post-acquisition measures can trigger real estate transfer tax again.

Another variant of a debt push-down is the establishment of a tax group between the holding and the target company. For this, however, the requirements for forming a tax group for income tax purposes (financial integration from the beginning of the financial year as well as the structuring and implementation of the profit and loss transfer agreement) must be fulfilled.

## Simple accrual model

If the target company has the legal form of a GmbH & Co. KG, this circumstance opens up further opportunities for structuring the acquisition transaction. The so-called simple accrual model enables continuing operations of the acquired partnership in the legal form of a limited liability company (e.g. GmbH) without great effort. First, the limited partner’s shares in the limited partnership are acquired by a newly founded *GmbH*. In the second step, the *GmbH* acting as the general partner exits the *GmbH & Co. KG*. As a result, all assets of the target company accrue to the newly founded *GmbH* as its only shareholder. The new *GmbH* becomes the universal successor to the assets and liabilities of the *GmbH & Co. KG*. From a tax point of view, the share deal means the transformation of the purchase price into depreciation potential (step-up) due to the transparent taxation of partnerships. At the same time, the buyer can easily integrate the target company into its existing non transparent corporate structure and, for example, benefit from the tax advantages of a holding structure.

## CONCLUSION

By considering the tax aspects with regard to the structuring of a transaction early on, the buyer can minimise its future tax burden. In addition to the above-mentioned structuring models, there is a vast array of pre- and post-deal options for tax structuring. In order to find an optimal transaction structure for all parties involved, the individual factors of the target company, the seller and the buyer should be taken into account. The conduction of a Tax Due Diligence can reveal further influencing factors (e.g. existing loss or interest carry-forwards) and structuring options. We therefore recommend to address structuring considerations at an early stage of the transaction process.

Restructurings in the follow-up of a transaction (e.g. subsequent involvement of a holding company) are time-consuming and often costly.

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# → M&A Vocabulary – Understanding Experts

## "Purchase Price Allocation"

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 or refresh a basic understanding of a term and provide some useful tips from our consultancy practice.

The accounting treatment of business acquisitions, i.e. the topic of Purchase Price Allocation ("PPA"), sooner or later becomes relevant in the transaction process. The provisions of IFRS 3 Business Combinations can be applied at the latest at the time of the initial consolidation of the acquisition target in the consolidated financial statements (share deal); however, they can also be applied in asset deals or mergers (in which case the effects are captured in the separate and consolidated financial statements).

Since key performance indicators (KPIs) such as EBIT, consolidated profit or loss or the amount of goodwill are influenced by a PPA, it is advisable to deal with this issue early on in the transaction phase as part of the so-called pre-deal PPA.

### PPA for the derivation of goodwill

In the context of a PPA, the total consideration transferred on account of the business combination (purchase price) is to be allocated to the identifiable assets, liabilities and contingent liabilities of the acquiree revalued to their fair values at the acquisition date. The positive amount remaining as a result of a PPA, being a difference between the total consideration transferred and the proportionate fair value of the net assets (revalued equity) determined taking into account deferred taxes, results in the goodwill to be recognised under intangible assets. The example below illustrates the derivation of goodwill under a PPA.

| Purchase Price Allocation | |
|---|---|
| Total consideration transferred | 10.000 |
| Net assets acquired (carrying amount) | 4.000 |
| Difference to be allocated | 6.000 |
| Trademark | 1.000 |
| Customer relationships | 2.000 |
| Patents | 200 |
| Advantageous contracts | 100 |
| Technologies | 500 |
| Allocation before deferred taxes | 3.800 |
| Deferred taxes | -1.160 |
| Allocation after deferred taxes | 2.640 |
| Goodwill | 3.360 |

## Practical challenges of the PPA

The practical challenges of a PPA usually concern the identification and initial measurement of internally generated intangible assets such as trademarks and customer relationships, for which there is an explicit prohibition on recognition in the IFRS consolidated financial statements and which have therefore often not been recognised in any form to date.

A fundamental understanding of the business model, corporate planning, existing value drivers and the legal environment of the acquiree is necessary for the identification of previously unrecognised intangible assets.

When determining fair values, it should be noted that only those cash flows should be taken into account that are solely attributable to intangible assets (stand-alone). Accordingly, the cash flows arising from the budgetary accounting should be adjusted for genuine synergy effects. The economic life should be determined according to objective criteria and thus from the perspective of hypothetical market participants.
The following valuation methods are used in practice:

- **Relief from Royalty method:** Valuation of trademarks, patents or technologies by using the analogy of royalty rates.
- **Multi Period Excess Earnings method:** Valuation of customer relationships using the residual value method.

Intangible assets usually involve a higher degree of risk than average business risk. Therefore, the WACC to be determined on the basis of a hypothetical market participant should be adjusted to the respective risk profile of the intangible asset using appropriate premiums for the discount rate.

The WACC-to-WARA method, which compares the weighted interest rate of all assets to the WACC and should correspond to it, can be used to check plausibility.

## Conclusion

In view of progressive digitisation, intangible assets are becoming increasingly important and are often the main value-drivers in companies. A transaction often has a significant impact on the balance sheet and key KPIs, as the so-called step-up of valuable intangibles can lead to substantial additional amortisation in the future. It is therefore advisable to take these effects into account early on in the transaction process.

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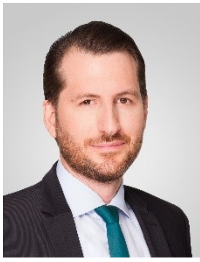

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