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M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

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→ Purchase price determination in company acquisitions

When selling a company, the seller usually wants to achieve a fixed price. The buyer, on the other hand, aims for a variable purchase price in order to hedge against possible risks. This applies especially in today's times plagued by the corona virus pandemic. The following article explains the main features of the mechanisms commonly used to determine the purchase price and their respective advantages and disadvantages.

For the seller of a company, it is of central importance to be paid –after the end of the negotiations– the purchase price originally agreed with the buyer. To ensure this, it is in the seller's interest to agree on a fixed price that will not be adjusted later on. By contrast, the buy-side usually prefers a variable purchase price. In this scenario, a preliminary purchase price is normally paid first and is usually determined on the basis of valuation methods commonly used in practice. This is usually done on the basis of already existing annual financial statements. The seller's shares are typically transferred to the buyer upon payment of the preliminary purchase price. In order to determine the final purchase price, closing accounts (interim financial statements or annual financial statements) are then prepared as of the date of finalizing the acquisition agreement, i.e. the date on which the shares are transferred to the buyer. On this basis, the purchase price is then adjusted, if necessary. Factors that are taken into account for adjustment purposes include net cash (cash and debt free), often net current assets and sometimes also equity. A purchase price is adjusted if the values deviate from the items based on which the preliminary purchase price was determined. It is therefore of central importance to define cash items, liabilities and also the working capital. Whether the purchase price is later reduced or increased is a question of the negotiating position of the seller.

Purchase price adjustment mechanisms often come with disadvantages for the seller. In this scenario, the seller is still entitled to the net cash generated up until the closing date. Nonetheless, it is the buyer who controls the purchase price adjustment process because the closing accounts are prepared under his supervision after the closing date, he determines the purchase price adjustment amount and the seller is often on the defensive if he wishes to object to the proposed adjustment amount assuming the objection is substantiated.

Regarding the issue of possible disputes, the parties usually agree on a dispute resolution mechanism, but this can be time-consuming and cost-intensive. In addition, to secure the amount to be adjusted, if any, the buyer normally does not pay the full amount of the preliminary purchase price immediately, but retains part of it. Finally, the seller bears the risk of any negative developments occurring up until the closing date, as a result of which the preliminary purchase price agreed upon when signing the agreement and the final purchase price may differ considerably to the disadvantage of the seller.

To avoid these disadvantages, the so-called locked box mechanism has been developed. With this mechanism, the parties agree on a fixed purchase price based on the last annual financial statements, which is not subject to any adjustments (locked box). In this context, it is assumed that between the last balance sheet date, on which the fixed purchase price is based, and the closing date, no funds are transferred by the company to the seller and the related parties. In economic terms, the buyer thus takes over the company with its value as from the last balance sheet date. The buyer is entitled to the profits generated during this period, but he must also bear any losses. As compensation for this, the parties often agree that interest will be computed on the purchase price as from the last balance sheet date.

A central element of the locked box mechanism in this context is that the seller guarantees or undertakes to ensure that between the locked box balance sheet date and the closing date the company only operates in the ordinary course of business and that no unpermitted liquidity is transferred to the seller and related parties and no such obligations exist (*no leakage*). Unpermitted outflows of funds include, for example, profit distributions, capital repayments, payments of transaction bonuses and forgiveness of debts or liabilities of the seller. The only permitted liquidity outflows are those that occur in the ordinary course of business, such as the repayment of financial liabilities to the seller or contractually agreed payments arising from service contracts.

Furthermore, in addition to general balance sheet warranties, the buyer often insists on specific covenants regarding selected individual balance sheet items, as the buyer relies on the balance sheet prepared by the seller and has no possibility to adjust the purchase price based on accounts prepared as of the closing date. Under the locked box mechanism, the fixed purchase price is usually agreed based on the last annual financial statements of the company or financial statements prepared specifically as of a date prior to the signing of the agreement.

Conclusion

The locked box mechanism is recommendable mainly for the sell-side. The main advantage is that the purchase price is not adjusted after the closing date. This ensures "price certainty". Thus, post-completion payment obligations for the seller can still only arise from warranty or indemnity obligations or other breaches of contractual duties. Another advantage can be that no interim financial statements have to be prepared as of the closing date and this can help avoid any cost-intensive and time-consuming disputes about this issue and about the purchase price adjustment. For this, however, up-to-date and audited financial statements must be available as of the date of signing the agreement, on the basis of which the fixed purchase price can be determined.

From the buyer's point of view, it is advantageous to agree on a preliminary purchase price and adjust the purchase price in the course of the transaction. With such a flexible solution, any negative business developments taking place in the period between the locked box balance sheet date and the closing date can be taken into account. In the locked box system, it is the buyer who bears the risk of negative business developments – i.e. during a period in which he had no control over the company. However, if the seller is willing to guarantee that he has run the company in the ordinary course of business and that there have been no unpermitted outflows of funds, this risk for the buyer is relatively low and often bearable if appropriate contractual arrangements are made. In addition to the business risk, however, the buyer also bears the risk of negative market developments. Buyers sometimes try to counter this risk by agreeing the so-called "material adverse change" (MAC) clauses. Apart from the fact that many sellers do not agree to MAC clauses, such clauses offer only limited protection, as they are usually conceptualised to address only serious negative developments. However, it should be noted that in the uncertain times of the corona virus pandemic, buyers sometimes try to minimize the risk of negative developments or let it remain entirely with the seller not least by agreeing on closing accounts and MAC clauses. Locked box systems had caught up on popularity with purchase price adjustment systems before the outbreak of the corona virus pandemic and are also frequently agreed in bidding processes. It remains to be seen whether this will continue in times of the corona virus. In the end, however, it is a question of the seller's bargaining power whether he is able to enforce the locked box system.

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→ Stipulations of case law regarding the so-called "tax clauses"

Tax clauses are an integral part of company acquisition agreements. Tax clauses are often used to agree which of the parties to a legal transaction will bear the taxes arising from that transaction in economic terms or in the light of civil law (tax burden clause).

Somewhat different are clauses that make the effectiveness of a contract in terms of civil law conditional on a specific tax treatment procedure agreed by the parties or the occurrence of a specific tax consequence (tax effect clause). Finally, clauses that can be described as tax avoidance clauses are aimed at designing a transaction in such a way that tax is not incurred or a certain tax treatment procedure does not take place. Alongside these clauses, contracts often include arrangements concerning price adjustments, rights to obtain/duties to provide information, rights/duties to cooperate, maximum liability amounts, statute of limitations rules or payment dates.

Use of the clauses in the light of civil law

The question of how tax clauses are implemented in civil-law contracts largely depends on the purpose pursued. Arrangements regarding information rights or payment dates, for example, are simply made by incorporating a relevant contractual provision. If, on the other hand, the tax clause concerns the payment of taxes by one of the parties or their avoidance, independent guarantees are usually used in practice (especially in company acquisition agreements). In addition, simple indemnities or their mixed forms are common, and tax clauses can also take the form of legal covenants.

Tax effect clauses

There is virtually no case law on the effectiveness or consequences of tax clauses. Many occurring problems and cases of liability are solved in a strictly practical manner or in line with commercial principles. Nevertheless, the following should be noted:

The landmark ruling of the German Federal Fiscal Court (Bundesfinanzhof, BFH) of 24 November 1992 on this matter, which dealt with a tax clause in the narrow sense that turned out to be ineffective and, thus, fell short of its purpose, was astonishing in that it expressly left two obvious basic questions unanswered: The Court did not consider or find a solution to the conflicting approaches as regards the civil law nature of tax clauses that were discussed in the literature up to the time of the ruling, nor did it answer the question of whether a tax clause agreed in a legal transaction was also effective under tax law. Instead, the Court stated only that a tax clause agreed in a specific case had to be notified to the tax office "as soon as possible" if the parties wanted to "rely on it". However, this statement should be approached on a case-by-case basis as every case is different; furthermore, the Court was supposed to rule on a tax effect clause.

Only in the case of such clauses, but not, for example, in the case of tax burden clauses, can the tax authority therefore invoke the prohibition of inconsistent behavior because only in their case can the tax clause have a "third-party effect". In the case of a land purchase agreement, for example, it would make no sense to make the possibility of relying on the tax clause conditional on a notification to the tax authorities, because Article 13 no. 1 of the German Real Estate Transfer Tax Act (GrEStG) ensures that the tax may be claimed both from the seller and from the buyer. Thus, in my opinion, the Federal Fiscal Court addresses in its case law neither tax burden clauses, which only allocate the responsibility for undisputed tax claims that already exist, nor tax avoidance clauses.

Tax avoidance clauses

Tax avoidance clauses aim to prevent a certain tax consequence from occurring. Already in the 1980s, the Federal Fiscal Court considered such tax clauses as generally permissible, saying in my opinion correctly that they do not constitute tax abuse within the meaning of Article 42 of the German Fiscal Code (Abgabenordnung, AO). The justification was that the resulting legal clarity was also in the interest of the party entitled to levy the tax (federal, state or local government).

But courts make an exception from this principle in cases where tax avoidance is in conflict with the mandatory provisions relating to balance sheets for commercial purposes and the tax balance sheet regulations. The prime example are tax clauses according to which any payments received by a shareholder must be returned if during an external tax audit tax inspectors come to conclude that a hidden profit distribution was made. According to case law, such clauses are not permissible as they are used to annul the tax treatment of the hidden profit distribution. Only the civil-law aspects can be designed in the contract but not the taxable event itself as it is not subject to the principle of party disposition.

Another example of an exception, according to case law, are cases in which tax law deviates from the principles of civil law, be it due to the beneficial ownership approach laid down in Article 39 of the German Fiscal Code (AO) or due to a different definition of terms in tax laws. In this case, it is not possible to use a contractual clause to give a tax term a different meaning under civil law.

Tax burden clauses

The permissibility or consequences of tax burden clauses, i.e. clauses which allocate the tax burden resulting from a legal transaction to one of the parties to that transaction, have, as far as can be seen, not been addressed in tax case law rulings. According to what has been said about tax avoidance clauses, such clauses are in my opinion subject to the general rules of civil law and can therefore be freely agreed within the framework of private autonomy. They do not affect, change or negate the taxable event, which is why there is no need for tax law to regulate them. However, tax burden clauses have occasionally been the subject of case law of the civil courts, albeit with a completely different focus. For example, in insurance law, the so-called value added tax clause, according to which value added tax is only reimbursed by the insurer if it has actually been paid, was declared invalid because the clause was considered surprising. Since company acquisition agreements are usually drafted and negotiated on an individual basis, this hurdle should be easy to overcome.

Conclusion

Tax clauses in company acquisition agreements are mostly clauses with which the tax burden arising from a transaction is allocated among the parties (the so-called tax burden clause). This usually does not pose any problems. On the other hand, increased attention should be paid in the case of clauses with third-party effect where the tax authorities are such a third party, and in the case of retroactive clauses as well as clauses whose stipulations deviate from mandatory tax law provisions.

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→ Transactions in difficult times of corona virus

The Covid-19 pandemic dominates our daily lives and thus also has a far-reaching impact on M&A transactions: While the healthcare sector or the IT industry see an increased number of deals, additionally fuelled by the Covid-19 outbreak, the economic situation in other industries has worsened. It's testing time for company financing solutions; approvals from authorities or boards are no longer granted. In addition, the range of temporary aid offered by the federal government to companies is currently very heterogeneous. Against this background, the earnings situation, in particular, and thus the valuation of companies in the context of transactions, is becoming more complex. Generally, the impacts of corona virus on the M&A business are very diverse and, above all, multi-layered.

This article gives a brief overview of the impacts of the corona virus pandemic on the earnings situation and the balance sheet, currently being a hot topic in the M&A business as a direct result of the pandemic. In addition, the article aims to provide an insight into risk-mitigating mechanisms for the buy-side in an M&A transaction, which are becoming increasingly important in the current market environment.

Impact on the earnings situation

In the wake of the corona virus pandemic, many companies struggle to keep their head above water with their sales revenues coming under pressure due to partial or total lockdowns and the related slump in demand. Companies that delay adjusting their cost structures to stabilise profitability are making it difficult to determine their level of sustainability in the course of financial due diligence conducted as part of an M&A transaction. This aspect is further aggravated by additional restrictions in freight transport, which means that many companies have to spend much more money at short notice to adjust their supply chains or face delivery bottlenecks.

As a means of reducing costs in the short term, many companies send their employees on short-time work and resort to rent holidays for their business premises. In addition, trade shows are being postponed and meetings are being held online, which rapidly reduces companies' advertising and travel costs in the era of the corona virus pandemic. Thus, estimating costs on a sustainable basis to have a reliable basis for an adequate company valuation is becoming a greater challenge.

It is currently relatively difficult to calculate the purchase price on the basis of common valuation methods, such as multiples-based valuations, given the reasons mentioned above (decline in sales revenues, supposed cost savings, etc.). Purchase prices should therefore increasingly be made dependent on the future development of the company, e.g. by applying earn-out regulations.

Impact on the balance sheet

The evaluation of the balance sheet also becomes more complex as a direct result of Covid-19. Companies temporarily receive subsidies, which in the course of an M&A transaction should be examined for any repayment obligations and possibly taken into account as a purchase price deduction (net debt) or otherwise considered in the purchase agreement. In addition, payment deadlines are changed, rental and lease payments suspended and liabilities postponed in order to secure short-term liquidity. This temporarily reduces the level of the working capital and would not be sufficient in the target company's normal course of business. To address this problem, we recommend that the buy-side incorporate a working capital mechanism into the purchase agreement.

In general, the current pandemic is spreading uncertainty on the part of the buy-side in M&A transactions. This aspect is further aggravated by increasing dynamics in many markets, which can cause the earnings situation of a target company to change rapidly at short notice or make planning assumptions no longer feasible. Therefore, we additionally recommend incorporating the so-called Material Adverse Change clauses (MAC clauses), which allow the sell-side to terminate or modify the agreement if additional negative events occur.

In principle, the impacts of the corona virus pandemic on target companies in potential M&A transactions are very heterogeneous. While especially customer-based industries (e.g. retail and gastronomy) are under pressure due to the current restrictions, the Covid-19 pandemic has been a catalyst for already existing trends, especially in the healthcare and IT industries. Remote work as well as digital processes and administration have suddenly become indispensable for the survival of institutions and companies, which means that, for example, the topic of IT security has come into even sharper focus. Business models that have been positively influenced by the corona virus should undergo careful scrutiny. In particular, the focus should be on the question of which developments really are long-term in nature so that too high a purchase price level can be avoided.

Conclusion

The impacts that the Covid-19 pandemic has on companies are very diverse, in terms of both earnings and the balance sheet. At the same time, market uncertainty in the area of M&A is increasing, making financial due diligence of a target company more complex and increasing its relevance. Common analyses of normalisation issues (quality of earnings) and purchase price adjustments (net debt) must be increasingly examined for impacts caused by the corona virus. In this context, risk-mitigating regulations such as earn-out clauses should also be given greater consideration.

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→ M&A Vocabulary – Understanding Experts

"Thin Capitalization" in Germany and Russia

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.

A company's need for capital can be generally covered by either equity or debt capital. The latter can be provided by a third party or a shareholder (the so-called shareholder debt financing).

A high level of shareholder debt financing often has tax implications: as a rule, the paid interest represents tax-deductible expenses on the part of the borrower, but on the lender's part it constitutes interest income subject to tax. Double taxation treaties generally provide that no tax is charged on interest in the source state, whereas the state of the lender has the right to tax the interest. If, on the other hand, the required capital is supplied as equity, the company can distribute profits only in the form of dividends. However, dividends are often a less advantageous option than the taxable interest because they are disbursed "after tax", i.e. they do not reduce the income tax base. Additionally, dividend distributions are often subject to withholding tax. If the lender and the borrower are resident in different countries, they can also use a high level of shareholder debt financing to profit from tax treatment differences between those countries.

To prevent such tax arrangements, international tax law includes a set of "thin capitalization" rules. Depending on how the transaction is structured, those rules prohibit or restrict the tax-deductibility of interest expenses under certain circumstances or allow interest to be reclassified into dividends and treated as such for tax purposes.

The thin capitalization rules under tax law are meant to, among other things, prevent undercapitalization resulting from excessive capital gearing, but they must be clearly distinguished from the company laws governing undercapitalization understood as an insufficient level of capital. The latter case occurs, for example, if equity is consumed by losses and falls below the amount of the registered capital. In Russia, corporate actions are required in such cases. Otherwise the company may be even liquidated under certain circumstances.

In terms of structure, the Russian thin capitalization rules are comparable to the shareholder debt financing rules which applied in Germany before the introduction of the interest capping rule [*Zinsschrankenregelung*]. While the debt-to-equity ratio allowed in Germany until 2017 was 1.5:1, the ratio permitted under Russian tax law is basically 3:1. In certain cases, e.g. in the case of leasing companies, the law permits even a ratio of 12.5:1. But as soon as this ratio is exceeded, the loan interest is reclassified into dividends. The debt-to-equity ratio must be checked based on accounting figures as of the last day of each calendar quarter. If the loan interest is reclassified, its excess portion is excluded from tax-deductible expenses and its payment triggers the obligation to pay a withholding tax on dividends of generally 15 per cent. However, if certain conditions stipulated in a relevant double taxation treaty (DTT) are met, the taxpayer may also apply the parent-subsidiary affiliation exemption available under the DTT on such reclassified interest and pay only e.g. a 5 per cent WHT (depending on the applicable DTT). While the tax consequences in terms of the amount of the tax payable on the interest reclassified into dividends are rather insignificant in the case of smaller operating loans to the tune of only a few hundred thousand euros, the Russian thin capitalization rules should be borne in mind when taking out larger loans as their tax effects may be very serious.

A practice frequently applied until several years ago to avoid the Russian thin capitalization rules was to provide finance through a sister company. This "gap" has been filled in the meantime, though. The Russian thin capitalization rules might also cover debt financing from banks if the borrower's associated company stands surety for the bank loan.

Besides the thin capitalization rules there are also other aspects of debt financing that should be taken into account. This includes the requirement according to which the agreed interest rate must be at arm's length. At the same time, Russian tax laws include a relatively generous safe harbour regulation in this respect (EURIBOR + 7 per cent).

Further, it should be noted that Russian tax authorities have recently also practiced reclassifying loans into investments (equity) in some cases, as a result of which interest is no longer tax-deductible. Such risk exists in particular when for certain reasons it is not possible to predict whether the Russian company will be able to repay the received loan.

CONCLUSION

While the thin capitalization rules have often rather minor tax consequences in the case of small loans, they should be borne in mind when taking out larger loans. It is also important to take into account other tax aspects of financing of subsidiaries. These include e.g. the interest rate requirements and the risk of a loan being reclassified into equity.

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