Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

Issue:
July
2021

In this issue, you can read about

→ M&A and Joint Venture

In times when full acquisition of a company through classic M&A may still hold significant economic uncertainties – either due to negative consequences of the COVID pandemic for the target company or, on the contrary, because it is too expensive due to existing market conditions and the related opportunities – partial acquisition in the form of a joint venture may be an alternative option worth considering. But also entering into such strategic partnership involves particular challenges. Some of these issues are discussed below.

Control of target company

As part of a transaction the buyer usually acquires full control over the target company. He is able to implement his concept of further business development without having to take into consideration any third-party opinions. A joint venture, on the other hand, is always a mutual undertaking of several parties involved in the target company who have to come to an agreement at least on key issues. Also in a situation where one of the partners acquires the majority of shares, the minority shareholder will not renounce all of his rights that enable him to exercise influence.

In this sense, in a transaction where the buyer acquires only part of the shares, the document on which negotiations will often focus is the articles of association (and a shareholder agreement, if additionally concluded) and not the SPA. This is because regulating the issue of corporate governance is of decisive significance in a joint venture. Although a "partnership-based" collaboration where shares are allocated evenly on a 50/50 basis is regarded as balanced and, thus, fair, it is exactly this parity of votes that carries significant risk of failure of the joint venture where partners have different visions as to the further course of the business. Therefore, clear stipulations on how to resolve such deadlock situations are a central element of every joint venture agreement. A solution can be the incorporation into a joint venture agreement of regulations on conducting a mediation process as soon as a conflict arises or on allocation of the final decision-making power to one of the partners (coupled with an exit right of the other partner, if necessary). It is essential to avoid a situation where the company is "paralyzed" over a longer period of time.

Similar rules also apply, however, if shares are allocated on non-equal terms because also a minority shareholder will want to reserve veto rights in order to prevent abuse of the majority rights by the partner.

Purchase price or capital contribution?

When forming a joint venture, the partners focus on appropriate valuation of the assets to be contributed to the new company by both of them. Here, in particular when valuing the assets and liabilities to be contributed – often in the form of a (line of) business – it is essential that the same valuation principles and assumptions are used so as to ensure comparability. This applies, on the one hand, to assumptions made in business planning, such as growth rates in sales revenues and/or cost items, and, on the other hand, to assumptions made when determining the discount factor.

Although in the case of establishing a joint venture in the due course of a M&A deal the transaction aspect is of significantly greater importance because part of the shares in the target company are acquired, the issues that arise are similar: This is because a buyer of course wants the target company (and thus his own shareholding) to benefit from his financial investment whereas the seller is also interested in being remunerated for his previous engagement in the target company in the form of a purchase price.

Only in exceptional cases will it be possible to avoid this conflict of objectives. Should the target company be in economic difficulties, a seller could agree that the buyer not only pays a small purchase price, but also significantly contributes to the restructuring of the target company because after such recovery the seller will be able to achieve a more attractive purchase price when finally exiting the target company.

Practical incorporation?

There are also merely practical issues that accompany such partial acquisition by forming a joint venture that should not be underestimated.

For example, work and corporate cultures of both business partners are fully compatible only in exceptional cases and yet each partner will expect that the one known to him will be applied in the target company.

If the target company was part of a larger group it can be expected that also the group-wide IT and accounting systems have been integrated into the seller's landscape. On this basis, when a joint venture is formed, the joining partner / majority shareholder may factually receive access to business areas that are actually not the subject of the joint venture.

Temporary partnership

If, in a M&A transaction, the buyer decides to initially acquire part of the target company, his intention is normally to minimise existing uncertainties regarding the acquisition of the entire enterprise and to fully eliminate them over a certain period of time. In this respect, joint venture solutions are not of permanent nature, as a rule. This means that already the purchase agreement or at least the shareholder agreement has to anticipate and regulate the termination of collaboration, or the "exit". In order to maintain – on the part of the buyer – a certain degree of flexibility necessary for verifying and eliminating uncertainties and risks, the buyer may request the seller as the fellow shareholder to transfer the remaining share portion to the buyer, thus rendering him the sole shareholder ("call option"). At the same time, exercising the call option is subject to the fulfilment of certain agreed-upon general conditions, including the core elements and calculation of the purchase price yet to be paid. Should the buyer not exercise the call option within a fixed period of time, the seller usually holds an equivalent put option that enables him to sell the minority share (possibly being unattractive to third parties). Apart from that, it is common to agree on sale prohibitions or rights of first refusal to secure the parties' positions.

Those regulations which address the transfer of shares between the parties of the original share purchase deal are supplemented with agreements regulating the transfer of the shares to third parties during the lifetime of the joint venture. In this context, the majority shareholder is usually granted the right to force the minority shareholder to sell the remaining shares still held by that shareholder if a third party is interested in buying the share for a certain minimum price so that the third party can acquire 100% of the shares in the target company ("drag-along right"). Also in this case, there is an equivalent regulation to protect the interests of the minority shareholder. If the third party would be satisfied also with purchasing the majority share, the minority shareholder may join in the purchase process between the majority shareholder and the third party in such a way that he may request the third party also to acquire a respective part of the shares held by the minority shareholder. As a result, there would be three shareholders remaining in the company, since the previous majority shareholder as well as the minority shareholder would each sell a proportionate portion of their shares to the third party ("tag-along right").

Exit price

Since the partnership is not of permanent nature, also the exit scenario should be clearly and unambiguously regulated right from the start. Basically, the exit price should reflect an appropriate purchase price that would be agreed between independent third parties, i.e. at arm's length. This means that the entire amount of the increase in hidden reserves achieved over the time of holding the shares together should be proportionately reflected in the increase in the price. The parties should therefore agree on the Discounted Cash Flow method (according to IDW S 1) to apply. This method is, however, also largely based on assumptions, both regarding the underlying planning for the next three to five years and regarding the determination of a risk-adequate interest rate. Here, in particular the determination of an appropriate peer group of comparable companies plays a key role. Therefore, clear stipulations should be incorporated into either the joint venture agreement or the shareholder agreement from the outset in order to avoid any disputes. It is also possible to determine at the beginning by whom and how this peer group should be determined. Moreover, certain surcharges and discounts on the market value of the shares determined in this way may be made, depending on the reasons for the exit of a given partner. If he acted to the detriment of the joint venture, the other party should have the possibility of purchasing his portion of the shares at an appropriate discount. If e.g. the parties agree that a certain period of time must lapse, the market value should be paid as compensation at the end of that period.

Conclusion

As far as the parties are aware of the challenges inherent in "collaboration" (even if entered into only for a limited time), forming such a joint venture may be an interesting alternative to the acquisition of all shares through classic M&A. In this context, attention should be paid just as much to actual issues relating to the formation of such a joint venture as to the manifold legal and economic issues of joint control, decision-making and termination of the joint venture.

For more information please contact

Hans-Ulrich Theobald
Attorney at Law (Germany)
Partner

Prague (Czech Republic)

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

Isabelle Pernegger
Certified Public Auditor (Germany),
Certified Tax Consultant (Germany)
Partner

Nuremberg (Germany)

Phone +49 911 9193 3381
isabelle.pernegger@roedl.com

→ The U.S. Fiscal Climate in Transition (Again)

On May 28, 2021, the new U.S. government announced the budget for 2022. At the same time, the U.S. Department of the Treasury published comments in the form of the so-called Green Book. The Green Book presents and explains in detail the tax reform proposals (called revenue proposals) of the Biden administration, some of which are already known.

Even though it is not yet clear to what extent the reform proposals can be implemented into the U.S. tax policy, they should nonetheless be examined now and taken into account in M&A transactions with a U.S. nexus.

Objective of the tax reform proposals

The Green Book includes two packages of measures: the American Jobs Plan and the American Families Plan. The American Jobs Plan is particularly relevant for M&A transactions. Its key objective is to reform corporate taxation so that companies, especially international corporations, pay their fair share of taxes. Other objectives of the American Jobs Plan are to create incentives for relocating jobs and business activities to the USA and to promote renewable energies. The tax reform proposals are generally intended to create additional tax revenue that will increasingly be used for education, infrastructure and clean energy.

What significant changes are planned

The planned tax changes highlighted in the American Jobs Plan essentially include:

- Increase in the corporate income tax rate from 21 to 28 percent at federal level
- Tightening of the Global Intangible Low-Taxed Income (GILTI) rules, such as the elimination of Qualified Business Assets Investments (QBAI), a type of tax allowance when determining GILTI
- Repeal of the Base-Erosion and Anti-Abuse Tax (BEAT) rules and introduction of the Stopping Harmful Inversions and Ending Low-Tax Developments (SHIELD) rules disallowing the deduction of certain payments to corporations in low-tax countries
- Repeal of the deduction for Foreign-Derived Intangible Income (FDII) and introduction of incentives for research and development
- Imposition of a 15 percent minimum tax on book profits of large corporations
- Introduction of an additional interest limitation in cases of excessive debt financing of U.S. companies.

Furthermore, the American Jobs Plan includes other proposals that primarily deal with the reduction of certain tax loopholes and benefits, such as the limitation of foreign tax credits from sales for hybrid entities.

In addition, there are far-reaching reform proposals related to the taxation of individuals, which are primarily addressed in the American Families Plan. The proposals include:

- Increasing the top income tax rate at federal level from 37 to 39.6 percent
- Reforming the taxation of capital income, such as taxing long-term capital gains and qualified dividends on income in excess of USD 1 million at ordinary income tax rates (thus including, for example, raising the top tax rate on such income from the current 20 percent to 37 or 39.6 percent).

According to the Green Book, most of the above-mentioned changes would be effective for tax years beginning after December 31, 2021. However, the proposals also provide for exceptions that would become effective upon implementation of the proposals into law, such as the aforementioned change in the taxation of capital income.

Impact on M&A transactions

At first glance, the planned changes appear to have primarily negative effects on M&A transact-tions with U.S. nexus. The main reason for this is the increase in the corporate income tax rate, resulting in a combined tax rate of 32.4 percent on average, which would lead to the United States having the highest tax rate among all OECD countries, thus making M&A deals expensive. The tightening of the GILTI rules, the introduction of the SHIELD rules and the higher taxation of the so-called high-income earners are also likely to make M&A deals in the United States less attractive if the prerequisites are met.
However, the reform proposals that incentivize M&A deals in the United States should not be ignored. In particular, the planned incentives for locating jobs in the United States, for research and development or for investing in low-carbon technologies offer many new opportunities and thus increase the attractiveness of M&A activities in the United States.

Since U.S. President Biden's general goal is to make the United States even stronger, more competitive and more resilient and, above all, to invest more in infrastructure, the M&A market in the United States is not expected to decline in importance as a result of the planned tax reform. However, it might be advisable to carry out M&A transactions soon in order to take advantage of certain regulations that are still in force. In addition to the low tax rates, such advantages include the possibility of immediate depreciation of capital goods, which is soon to expire.

Conclusion

The Green Book, published on May 28, 2021, was the official go-ahead for the U.S. tax reform envisaged by U.S. President Biden. Unlike the U.S. tax reform of 2017 under U.S. President Trump, which strongly favored M&A transactions in the United States, the current reform proposals in the Green Book move in two different directions. On the one hand, they herald additional burdens and disadvantages for M&A deals – not least due to the planned increase in the tax rate from 21 percent to 28 percent. On the other hand, however, they provide for certain reduced burdens and offer advantages for M&A deals, for example for manufacturing or technology companies. Therefore, M&A deals should be evaluated early on with respect to the potential effects.

For more information please contact

Dr. Dagmar Möller-Gosoge
Certified Tax Consultant (Germany)
Partner

Munich (Germany)

Phone +49 89 9287 805 51
dagmar.moeller-gosoge@roedl.com

Janine Kickler-Kreuz
Senior Associate, US Desk in Germany

Cologne (Germany)

Phone +49 221 94 99 09 498
janine.kickler-kreuz@roedl.com

→ M&A Vocabulary – Understanding Experts

"Audit vs. review vs. agreed-upon procedure vs. compilation"

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.

Classic financial due diligence (FDD) attempts to explain reliable results in a way that satisfactorily resolves existing information asymmetries. However, the degree of reliability of financial figures depends on whether an audit or less complex tests have been performed. We will discuss here the differences between audit, review, agreed-upon procedures (AUP) and compilation.

Audit

An audit provides reasonable assurance about whether the financial statements are free from material misstatement. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit will always detect a material misstatement when it exists.

The procedures selected depend on the auditor's professional judgment, including the auditor's assessment of the risks of material misstatement. In making those risk assessments, the auditor obtains an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. However, the auditor does not issue an audit opinion on the effectiveness of the entity's internal control. This would require a separate, different type of audit.

Furthermore, the audit of financial statements includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the legal representatives, as well as evaluating the overall presentation of the financial statements. Explicit conclusions are also drawn about the appropriateness of management's use of the going concern basis of accounting. If there is significant doubt on the entity's ability to continue as a going concern, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion.

The audit is conducted either in accordance with the International Standards on Auditing (ISA) or relevant local auditing standards. The report, including the opinion, is issued in the form of an "Independent Auditors' Report".

Review

A review provides a certain level of assurance that the financial statements do not require any major adjustments (conclusion on the financial statements). A review includes primarily making inquiries among personnel and performing plausibility checks of financial data. Typical audit procedures, such as observation or obtaining confirmations, are not performed here.

The procedures are carried out in line with the International Standard on Review Engagements (ISRE) 2400 or a corresponding local standard. The report is issued in the form of an "Independent Practitioners' Review Report".

Agreed-upon procedures

Agreed-upon Procedures (AUP) are tests of certain selected areas of the balance sheet and/or income statement. Here, individually agreed-upon procedures, such as target/actual comparisons, reconciliations and confirmations are carried out and any deviations identified are presented. No assurance is expressed here. Instead, users of the report draw their own conclusions from any inconsistencies.

Professional AUPs are carried out in line with International Standard on Related Services (ISRS) 4400 or a corresponding local standard. The report is issued in the form of a so-called "Independent Practitioners' Report" (on Applying Agreed-upon Procedures) or "Report on Factual Findings".

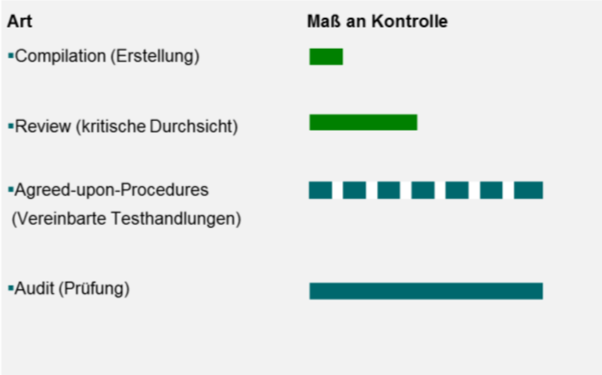
Compilation

A so-called compilation is a presentation of information and data by the management in the form of the preparation of financial statements. It essentially includes summarising financial information after any accrual/deferral postings. No tests are carried out in this case. Thus, there are no inconsistencies and no opinion or conclusion is expressed. In contrast to the options presented above, independence of the accountant is not a requirement for a compilation engagement.

Financial statements are prepared in line with International Standard on Related Services (ISRS) 4410 or a corresponding local standard. The report is issued in the form of a so-called "Practitioners' Compilation Report".

Conclusion

In summary, there are various types of how financial statements can be dealt with, depending on the level of control:



In the case of unaudited financial statements or financial statements that have been audited by a local auditor but where the level of examination cannot be assessed, it is recommended to modify an FDD so that it primarily focuses on the reliability of the figures.

For more information please contact:

Roger Haynaly
CPA (Germany)
Certified Tax Consultant (Germany), CPA (USA)
Partner
Shanghai (China)

Phone +86 21 6163 5305
roger.haynaly@roedl.com

Publisher's details

M&A Dialogue |
July 2021 Issue

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

Responsible for the content
Hans-Ulrich Theobald, Dr. Dagmar Möller-Gosoge, Roger Haynaly

hans-ulrich.theobald@roedl.com
dagmar.moeller-gosoge@roedl.com
roger.haynaly@roedl.com

Layout/Presentation
Claudia Schmitt
claudia.schmitt@roedl.com