Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

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Articles in this issue

→ Jurisdiction or arbitration clause: last but not least

Contracts to purchase a company all too often end up in a dispute in court. The classic "bones of contention" are the guarantees, the scope of the obligations of the vendor to publish information, which are not discussed and are often unknown, as well as disputed interpretations of the often very complex contractual arrangements that are frequently amended repeatedly, in a hurry, just prior to signing. Reason enough, therefore, to consider the possibility of a future legal dispute and to make provisions for this during the negotiation of the contract. This is normally done in the so-called "final provisions", i.e. the last clause of the contract, but the potential impact of a well or poorly written final clause should never be underestimated.

THE STARTING POINT

If the parties do not set out arrangements in the purchase contract – or if they are unable to reach agreement on such arrangements – then the ordinary national (civil) courts are competent to settle any disputes. As a general rule in this case, a law suit has to be filed against the defending party before the district court that has jurisdiction over its place of business, unless a special place of jurisdiction intervenes. The ordinary legal recourse usually involves at least two instances. The regional court's judgements can generally be appealed against in the higher regional court. If there are grounds for a further appeal, this can then be submitted to a third court at Federal level.

THE INTERNATIONAL ASPECTS

If no choice of jurisdiction is made, or only inadequately defined, this will have a negative impact, at the latest, if it turns out that the opposing party does not have a registered company office in Germany, or has moved it abroad since the purchase contract was signed. Also under international procedural law, the first principle is that, unless the contract specifies otherwise, a case must be submitted to the national court having jurisdiction over the defendant's registered office. This has some very negative consequences for a (German) company filing a law suit: firstly, the writ of claim and all supporting documents need to be translated into the official language of the place of jurisdiction. Moreover, in some countries, when a claim is filed by an overseas party, collateral has to be deposited by the claimant to cover the potential costs for all stages of the proceedings. In addition, the duration of the procedure and the quality of the court decisions may vary enormously from one country to the next.

POSSIBLE APPROACHES

It is therefore advisable to take steps to ensure that initiating and going through a law suit does not become an insurmountably high barrier.

If you wish to keep disputes under the jurisdiction of the ordinary national courts, at least the place of jurisdiction, i.e. the locally competent court, should be defined in the purchase contract. In this case, the language of the procedure and the rules of procedure are prescribed by law, and cannot be changed by the parties. If one of the parties has their registered office abroad, the place of jurisdiction should also be chosen taking into account the enforceability of a ruling. It is relatively simple to file a suit in a German court against a party that has their registered office in China. However, it is then almost impossible to enforce this judgement in China. If the party involved does not have any assets in Germany, the initially preferable choice of Germany as the place of jurisdiction can quickly become a dead-end.

Especially when buying a company, an alternative to any ordinary national court's jurisdiction is the option to agree to assign jurisdiction to an arbitration organisation. This can have a series of benefits for the parties to arbitration. Arbitration proceedings may initially often be more expensive than a procedure in the public courts. However, the weight of the cost can shrink in relative terms, and even become favourable, if a case were to end up passing through several instances before the public courts. Arbitration generally only involves a single instance. Especially for complex disputes that cannot clearly be settled one way or the other, that is both a curse and a blessing.

In arbitration proceedings, the parties have much greater influence on how the procedure is structured: the number of arbitrators, the language used, the location of the proceedings, and the rules of procedure can generally be influenced by the selection of the arbitration institution. Arbitration has the additional benefit of not being public.

THE WORDING OF THE ARBITRATION CLAUSE

The arbitration clause needs to be worded with extreme care. As a starting point, you can adopt the recommended standard arbitration clause of the relevant institution, but this needs to be adapted to suit each individual case: in the case of disputes arising from circumstances covered by company law, this may involve applying supplementary arbitration arrangements (for example, at the German Institute for Arbitration or DIS) or restricting the obligation to reimburse legal costs for out-of-court proceedings.

When selecting the place of arbitration and the arbitration organisation, you should also be thinking about which legal provisions this choice implies: especially under Anglo-Saxon legal systems (e.g. ICC Arbitration Clause with London as the place of arbitration), a German party may find itself unexpectedly obliged to make legal disclosures, which simply do not exist under German procedural rules, and for which a German party would not normally be prepared.

The later enforceability of a decision also plays a role here that should not be underestimated: although most countries are members of the New York convention on the recognition and enforcement of foreign arbitral awards, also in this case the devil here is in the detail: depending on the arbitration institution selected, and the place of arbitration and enforcement, the chances of a successful enforcement vary enormously.

CONCLUSION

Agreements on the place of jurisdiction are typically covered in the so-called final provisions. This context is not appropriate for a matter of this importance. Even the most elegant liability and guarantee clauses are of no use if the claims cannot be implemented and enforced in practice. Therefore, the rule for the jurisdiction or arbitration clause is: last but not least.

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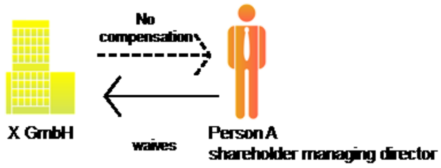
→ Tax traps relating to pension commitments of the shareholder managing director of a business

A pension commitment is a common part of the retirement package for a shareholder managing director, especially in medium-sized companies. When buying a business, a buyer will often insist that the pension entitlement is settled and cleared by the previous shareholders before the transaction is completed. When restructuring pension entitlements, you need to be aware of the tax consequences to avoid any unpleasant surprises.

WAIVING THE PENSION ENTITLEMENT

By waiving their pension entitlement, the shareholder managing director declares that they waive this without receiving any compensation.

Example:



At the start of retirement during the 2018 assessment period, person A waives the pension commitment made to him/her by way of a termination agreement with the GmbH (limited liability company) without any compensation and without any business reason. The pension provision at the last balance sheet date was:

- Tax balance sheet: EUR 250,000
- Market value: EUR 350,000

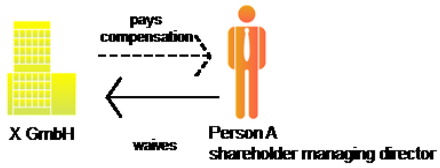
In the tax balance sheet, the waiver leads to a reversal of the pension provision liability, which increases earnings, in the amount of EUR 250,000. The waiver imposed by the business situation leads to a so-called hidden contribution to the company by the shareholder managing director amounting to EUR 350,000 that has to be settled off-balance sheet. The waiver thus leads to an expense for the company of: EUR 100,000.

For the shareholder managing director personally, the waiver leads to a fictitious, taxable salary receipt, equalling the total of the hidden investment, and also to subsequent acquisition costs for the company totalling EUR 350,000. The increased acquisition costs affect the capital gain in case of a sale of the shares. However, the partial income procedure, which applies in case of a sale of shares, only leads to a partial compensation of the tax burden from the inflow of the hidden contribution.

COMPENSATION IN LIEU OF A PENSION COMMITMENT

Compensation is provided in lieu of a pension commitment when the shareholder managing director waives their pension but receives compensation in lieu thereof.

Example (as with waiver), but A receives compensation in the amount of EUR 350,000:

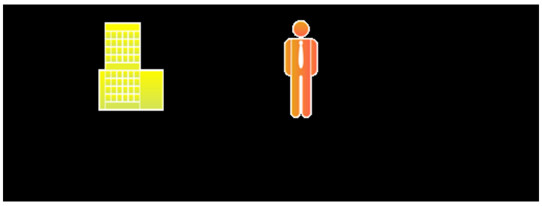


At the level of the GmbH, the same tax consequences apply as in the case of a waiver. In addition, there is an expense in the amount of the compensation, which qualifies as a hidden profit distribution and has to be corrected off-balance-sheet, so that the P&L effect of this is EUR 0. As a result, there is still a cost of EUR 100,000.

For the shareholder managing director personally, the same tax consequences apply as in the case of a waiver. In addition there is a hidden profit distribution equalling the compensation, which - for the shareholder managing director - is subject to capital gains withholding tax. Therefore the shareholder managing director suffers double taxation.

ASSUMPTION OF OBLIGATION

In the case of an assumption of obligation, an external company takes over the shareholder managing director's pension commitment, with discharging effect.



Example: Transfer of pension commitment incl. assets totalling EUR 350,000 to Company Y. Other values remain unchanged.

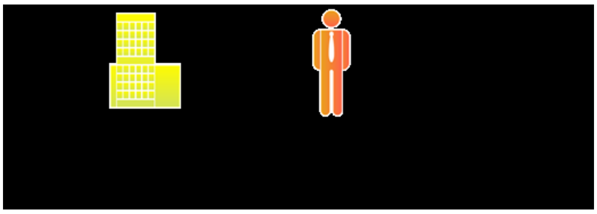
As a result of the transfer of the pension commitment including assets, the GmbH suffers a loss of EUR 100,000. This results from the release of the pension provision on the P&L which increases earnings, (EUR 250,000) and the derecognition of assets (EUR 350,000) which increases costs. The loss is spread over the year in which it occurred and the following 14 years, so that the retained earnings of the GmbH have to be increased by 14/15ths of EUR 100,000 and written down off-balance sheet over the following 14 years.

For the shareholder managing director, there are fictitious additional earnings of EUR 350,000 which are subject to tax.

TRANSFER TO EXTERNAL PROVIDER

If transferred to an external provider, the shareholder managing director's pension commitment is transferred, for example, to a pension fund.

Example: For the transfer of the fully acquired pension commitment, the pension fund demands a one-time contribution of EUR 350,000. The company makes an application under Section 4e of the Income Tax Act (EStG). Other values as above.



From the transfer of the pension obligation, the company achieves income totalling EUR 250,000. The company can deduct the excess portion of the reversed pension provision (EUR 100,000) as a business expense, spread equally over the next ten financial years

A transfer of the pension commitment to the pension fund in accordance with the above application remains tax-free for the shareholder managing director.

CONCLUSION

As the above examples make clear, resolving the pension commitment is unlikely to remain without tax consequences for either the company granting the pension or for the shareholder managing director. It is therefore advisable to address this topic early on in the transaction process in order to deal adequately with the tax consequences in the context of the overall transaction. In addition, there are further legal and economic aspects that also require attention.

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→ Acquiring an insolvent company

After several recent years of very positive economic development, the last few months have shown an increasingly sombre outlook for the German economy. Alongside the general worsening of the economic situation, there are also structural changes occurring in some important sectors of the domestic economy (e.g. automotive production, commerce) with corresponding negative effects on the financial situation of the companies concerned. Financial strain and the resulting distressed situation of companies, which will increasingly spread along the value creation chain to other indirectly concerned businesses, is also likely to have an impact on future market trends on mergers and acquisitions. This will increasingly put the option of acquiring insolvent companies on the table for both domestic and overseas investors. After a total of 19,552 insolvencies in 2018, which was the lowest level for many years, in the next few years we are expecting to see once again an increased number of companies filing for insolvency.

ACQUIRING AN INSOLVENT COMPANY

The acquisition of an insolvent company can be achieved either by acquiring the legal entity (the company) through a share deal, i.e. by acquiring the company's shares, or by acquiring its assets in an asset deal. This is also often referred to as restructuring by transfer. Thus, either the company, or only some assets, are transferred to a new legal entity.

Given the various benefits, including debt relief, less complexity and the release of increased potential from restructuring, an asset deal is the usual procedure in practice. In addition, the desired assets may be acquired selectively, also known as "cherry picking". If certain rights that are held by the legal entity are fundamentally necessary for the continuation of the business activity (patents, licences, brand names or other public permits issued to people or legal entities), and it is not possible to transfer these without the permission of third parties, it may prove more appropriate to structure the acquisition as a share deal in combination with an insolvency procedure. The reason for acquiring an insolvent company is, on the one hand, the opportunity to acquire assets at a considerable discount, and on the other hand, the ability to restructure the distressed company with the help of the administrator and the instruments available under insolvency legislation. This gives the potential buyer the opportunity to take over a company in a form that already meets his needs, i.e. with the necessary assets and (key) employees from his point of view, but without the burden of liabilities (such as pension obligations).

In addition, once an insolvency procedure has been initiated, the insolvency administrator is empowered to terminate long-term financial obligations (such as rental or lease contracts) that are disadvantageous or no longer needed. These attractive features of a purchase out of insolvency are also associated with some specific aspects that have an innately higher risk, and the potential buyer must be able to recognise and consider these in making any decision to purchase: For example, the guarantees and warranties that would otherwise form a normal part of other transactions will normally be very difficult to enforce here.

When acquiring an insolvent company, it is also extremely important for the buyer to gain an understanding of the underlying causes of the crisis, identify the restructuring potential, and develop necessary measures for its realisation.

SPECIAL FEATURES OF THE ACQUISITION OF AN INSOLVENT COMPANY

Some special features must be taken into account when acquiring out of insolvency, which include the following:

- **Time factor**: On the one hand, liquidity must be ensured to enable the company to continue operations temporarily; on the other hand, care needs to be taken not to lose the confidence of stakeholders such as suppliers and customers, as well as banks. Therefore, any purchase out of insolvency will normally involve considerable time pressure.
- **Partners for negotiations**: When acquiring an insolvent company, management bodies that would normally be involved in negotiating the terms for the sale of the company may no longer be available. In addition, their freedom of action will be severely restricted by the insolvency administrator. Therefore it is important to involve the insolvency administrator at an early stage of any potential purchase.

- **Tactical Risks**: For the buyer, it may make sense to speculate on a target company filing an insolvency application, or to initiate it themselves, in order to negotiate the purchase contract during the initial bankruptcy proceedings. However, there is the potential risk in this context that it may end up benefiting a competing bidder.
- **Due Diligence**: The objective of a due diligence investigation is, above all, to identify the risks under insolvency law that might arise from the vendor's ensuing insolvency, and the ability to exploit any existing restructuring opportunities. This should include an evaluation of the operational, tax and financial risks. This all helps to achieve the best possible outcome of the negotiations with the vendor, and gain solidly-based, informed support from stakeholders, in order to be able to construct acquisition strategies and a restructuring plan on this basis.

CONCLUSION

The rules for acquiring a company out of insolvency are substantially different from those which apply to other transactions. Potentially interested buyers need, therefore, to carefully evaluate the challenges and opportunities involved in an acquisition out of insolvency. The issues presented here represent only a subset of what needs to be checked in any individual case, and further aspects may also apply.

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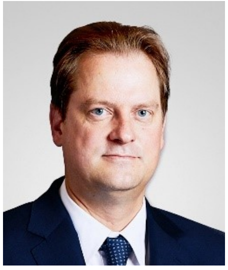

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→ M&A Vocabulary – Explained by the experts

MAC Clause

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 complex transactions, the parties to the contract may agree on so-called Material Adverse Change (MAC) clauses, in order to cover significant changes to the subject matter of the contract. Especially in the period between the signing and actual closing of a merger or acquisition, the contractual terms and conditions agreed by the parties may be affected by unforeseen circumstances that have a negative impact on the target company. The question then arises as to whether the buyer is still obliged to fulfil their agreed obligation, or is entitled to either withdraw from the contract, or alternatively to renegotiate its terms without being accused of breaking them.

Allocation of this "pre-closing" risk in a MAC clause can, therefore, be very useful in some individual cases, and in practice is frequently done during intensive negotiations. MAC clauses are often complex and need to be worded very precisely. The fundamental question to be answered is which circumstances are to be regarded as "significant" within the meaning of the clause. This can be achieved by explicitly listing individual features which would have a significant negative impact (for example considerable decline in turnover, the loss of important customers or major compliance infringements), or by defining a general provision. In the latter case, certain specific features that favour the vendor might be listed that should not be included (so-called carve-out clauses). In addition, MAC clauses should be used to manage those events which are excluded from the definition. Some examples of events that are not generally regarded as MAC events are terrorist attacks, natural disasters and changes in the political or economic situation of a country or its relevant legislation. Basically, a MAC clause can only relate to circumstances outside the buyer's control, as there would otherwise be no need to provide them with protection.

The clauses should also define the exact legal consequences, such as a right to adjust the purchase price or to withdraw from the transaction. The MAC provisions can also be included in the representations and warranties provided by the vendor, e.g. in the form of an assurance to the buyer that a significant adverse change shall not occur from a specific date, or within the period between signing and closing. In this case, the buyer would usually not be entitled to refuse to complete the transaction, but instead could seek compensation. MAC provisions are often also presented as terms of closing. In this case, the buyer would be entitled, should a major adverse change occur, to withdraw from the deal without becoming liable for a breach of contract. When a MAC clause is invoked, in practice, this rarely leads to a failure of the transaction, but instead generally triggers further negotiations on the purchase price.

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