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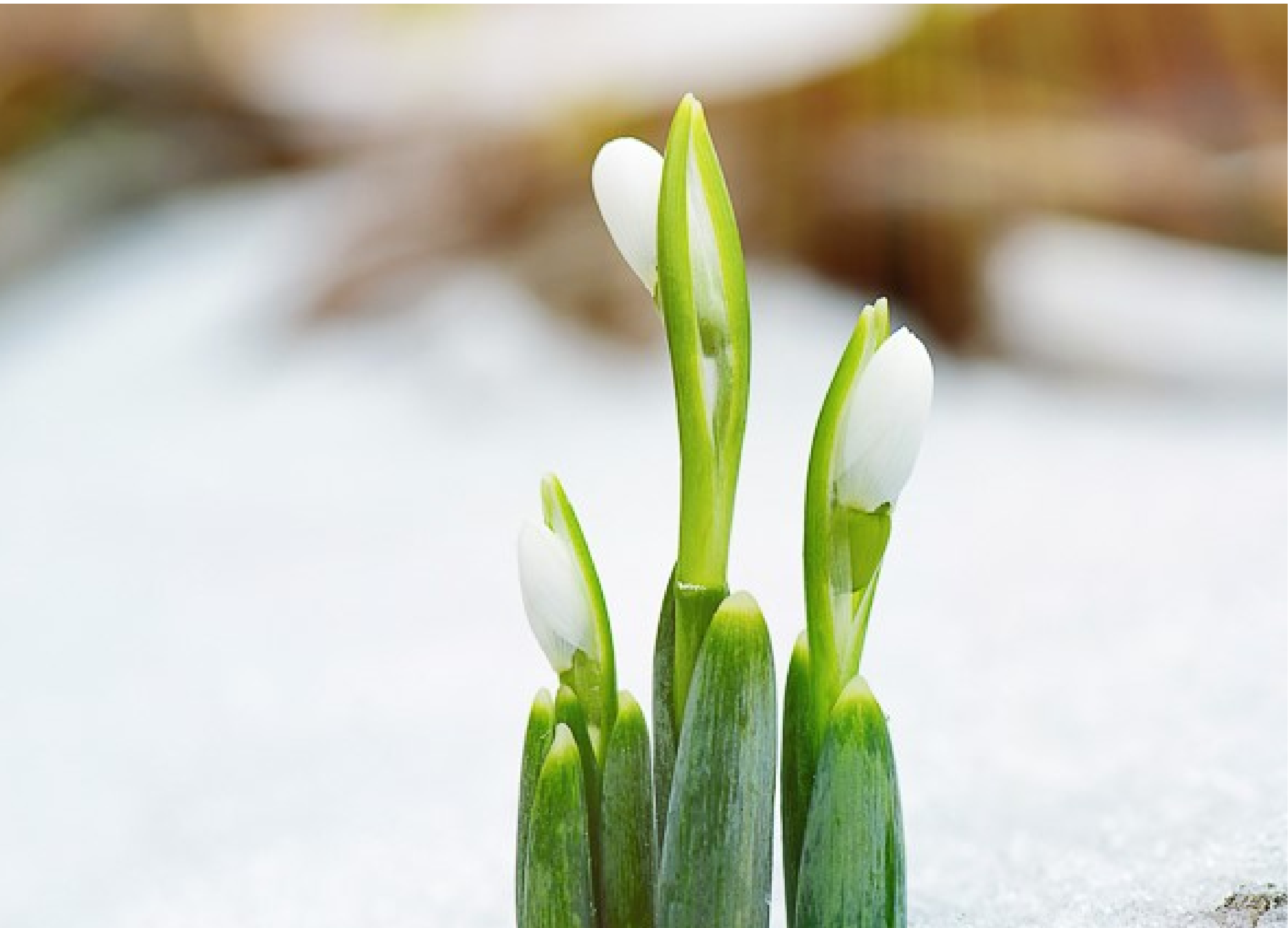

→ Rights of withdrawal – and what you can achieve with them

It is not only during difficult times, but in fact with every transaction, that the question arises under what circumstances the parties can withdraw from the contract. Frequently, such arrangements are not in the forefront of the parties' minds during negotiations, when seeking a conclusion under high pressure, but they are often discussed in highly emotional terms. What makes for a "good" right of withdrawal though?

When looking at rights of withdrawal, we basically need to distinguish between two different forms:

1. Withdrawal before completion
2. Withdrawal after completion

WITHDRAWAL AFTER COMPLETION

Although it occurs later, the second case should be addressed first. Such withdrawal rights are generally excluded, and for good reason. In the case of complex transactions, it is only theoretically possible to reverse payments and performances already exchanged (years later). Even the most detailed provisions reach their limits. The questions addressed by the law covering the guaranteed return of payments and services exchanged, wear and tear, the compensation for possession expenses, reimbursement of expenses and profits withdrawn are in fact unable to adequately define this. In the case of company acquisitions or real estate transactions, unwinding a contract after closing is no longer that simple. For example, the buyer is to be reimbursed for actual use and the increase in value must be compensated – and what's more, with the burden of proof. As a result, a withdrawal after completion (even in the case of warranty claims) is usually ruled out.

The only case in which this can occur is fraudulent misrepresentation (the threshold for "fraud" in a civil law context is relatively low). In this case, all limitations of liability by mandatory operation of law become invalid and withdrawal remains possible. However, in times of economic growth, it is usually not advisable to give up a business. This is due to the growth in value, since the aim of withdrawal is to revert the parties to the status they were in prior to the contract. A lucrative deal would have to be reversed – whether this makes sense in a specific case needs very careful consideration. Even for the buyer who was defrauded, this is only be a good outcome in exceptional cases.

In this context, we cannot overemphasize the importance of drafting the contract in such a way to ensure that no "hidden" rights of withdrawal are agreed. Poorly drafted retentions can mean that the purchase price is regarded as not fully paid. A retention is a part of the purchase price and thus part of the primary payment obligation. In the event of disputes concerning the payment of retentions, poorly drafted rights of withdrawal can lead to one party being able to unwind the purchase due to non-fulfilment of a primary payment obligation. Withdrawal must be excluded in the event of disputes about the payment of retentions, otherwise you may experience some unpleasant surprises.

WITHDRAWAL BEFORE COMPLETION

Rights of withdrawal that may apply prior to completion, usually occur in the form of what are known as long-stop dates (non-completion until a specific point in time), or intervene if significant and disadvantageous changes have occurred since the conclusion of the contract. In this case, the law already provides the option in Sections 323 et seq. of the German Civil Code of withdrawing from a previously concluded purchase contract. This is incorporated into purchase contracts and converted into rights of withdrawal.

For the long-stop date, you need to ensure that it leaves sufficient time after the scheduled completion date. You must in particular take into account that, if relevant, antitrust proceedings or other restructuring measures will take time to complete. Six to twelve months after the planned date is definitely not excessive, since neither party has any interest in allowing a right of withdrawal to arise prior to this date or to have to postpone the date yet again due to unforeseeable delays (e.g. in the event of antitrust proceedings). Ultimately, this right of withdrawal is there to enshrine the case law on "definitive failure of the contract" in rules and to create legal certainty. An open-ended stalemate needs to be avoided. However, when both parties wish to adhere to the contract, they may be setting a trap for themselves with tightly defined long-stop dates.

In the context of withdrawal prior to closing, the task for the lawyers involved is a different one. These cases can occur. In particular, in the event of non-payment of the purchase price when due, the Seller would generally like to (be able to) withdraw from the contract. The arrangements regarding due dates must be defined with total clarity and avoid any unclear legal terms and/or influence from third parties. Otherwise, you are lulled into a false sense of security that is more likely to end in years of litigation than in the unwinding of the transaction.

CONCLUSION

Withdrawal is a powerful tool and a sharp sword – but only when properly managed and used with care. During its application, skilled legal advice can help to avoid undesirable consequences.

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→ Real estate transactions – Perennial tax issues

Due to the ECB's low interest rate policy and high demand, investments in real estate are currently experiencing a real boom. According to the Handelsblatt newspaper, transaction volumes in German commercial real estate grew by around 19 percent to approx. EUR 73 billion in 2019. In addition to the business and legal aspects, tax considerations play a significant role in investment decisions. Tax risks can become deal breakers. The way in which real estate transactions are structured creates the basis that is decisive for the future tax burden (e.g. a non-commercial partnership, extended trade tax reduction). There are basically two types of real estate acquisition: On the one hand, the company owning the property can be acquired (known as "share deal"). On the other hand, it is also possible to acquire just the property from a company (known as "asset deal").

TAX LIABILITY OF THE PURCHASER

In a share deal, the buyer acquires the shares in a real estate company. He assumes all the past tax obligations of the real estate company for which the latter is still legally liable at the time of purchase.

In an asset deal, the purchaser acquires only the property. In this case, the purchaser's liability is governed by Section 75 AO (German Tax Code). This liability is limited both in scope (including trade tax, VAT) and in time. A prerequisite for the liability of a purchaser under Section 75 AO is the transfer of ownership of a company and/or a sub-unit managed separately within the company as a whole. According to established case law, this definition shall also include the acquisition of a property and the simultaneous takeover of existing rental or lease agreements.

Tax due diligence in the event of either an asset deal or a share deal reveals the potential tax risks. Comprehensive and individually tailored tax clauses in the purchase contract protect the buyer from an unexpected tax burden.

VAT ON ASSET DEALS

In the event of a real estate transaction in the form of an asset deal, the first step is to review whether it represents a non-taxable transfer of an entire business [Geschäftsveräußerung im Ganzen (GiG)], or a supply of immovable property being subject to VAT. The transfer of an entire business applies when a company, or a separately managed sub-unit within the company is transferred as a whole. For example, the transfer of an entire business occurs when a rented property is sold and the buyer takes over the rental contracts. Since the transfer of an entire business is not subject to VAT, no VAT is charged on the purchase price. However, the buyer inherits the VAT legal position of the vendor, i.e. he continues the relevant input VAT adjustment period under Section 15a UStG (VAT Act). For this reason, the submission of documentation under Section 15a UStG is indispensable preferably prior to the conclusion of the purchase agreement.

If no transfer of an entire business occurs, the real estate transaction is a supply of immovable property, which in principle is exempt from VAT. From a seller's perspective, the VAT option is often to be recommended in order to avoid input tax adjustments in case of a VAT exempt sale. In this case, in addition to the purchase price, VAT is payable by the purchaser to the tax office (known as "reverse charge procedure"). At the same time, the purchaser can deduct the input tax. The risk of output revenues which do not allow deduction of input tax, with the result that the input tax on the purchase price is not deductible, is therefore borne by the purchaser. In order to avoid this risk, the purchaser will generally not want to opt for VAT and will prefer to make the purchase of the property VAT exempt.

Since there is a whole bunch of different options transferring real estate, it is often not easy to decide whether the transfer of an entire business occurs in a given case or not. The large number of rulings from the European Court of Justice (ECJ) and the Federal Financial Court (BFH) and the financial courts (FG) additionally makes reviewing this difficult. In practice, the contracting parties in most cases agree on a treatment of the transaction being subject to VAT or not after a risk assessment (in particular of possible additional retrospective VAT payments, or interest on retrospective charges), and add compensation arrangements to the contract to cover the event of a different assessment by the tax authorities.

TRADE TAX

When structuring a real estate transaction, the trade tax is of significant importance. Real estate companies may either not be subject to trade tax as asset management companies (e.g. a non-commercial partnership) or take the option of the extended trade tax reduction, with the result that the generated rental income, among other things, is not subject to trade tax. Application of the extended trade tax reduction requires the exclusive leasing of property on land owned by the company throughout the entire tax period.

For both the application of the extended trade tax reduction, and in the case of asset management activities, operational facilities have a considerable impact on the future trade tax burden of real estate companies. If the leased property includes any operational facilities – even if only to a limited extent – the application of the extended trade tax reduction is totally precluded. In a non-commercial partnership, the pre-requisites for the co-leasing of operational facilities are less stringent. However, even non-commercial partnerships can also tip over into business activities.

There are also additional topics such as the provision of special services outside of the simple property rental, commercial property trading, as well as the termination of real estate management during a tax period due to the sale of the last premises, which are particularly important for the applicability of the extended trade tax reduction.

REAL ESTATE TRANSFER TAX

Real estate transactions, whether in the form of an asset deal or a share deal, generally trigger real estate transfer tax. The level of the real estate transfer tax rate depends on the federal state in which the property is located. The real estate transfer tax rate varies between 3.5 percent (e.g. Bavaria) and 6.5 percent (e.g. North Rhine Westphalia).

In the case of share deals, the fact of so called consolidation of shares generally leads to the triggering of the real estate transfer tax. A popular structural instrument until now known as RETT blocker structures were designed to avoid real estate transfer tax. However, legislation is planned to tighten up the regulations on consolidations of share. There is currently discussion that an consolidation of holding over 90 percent, instead of the current 95 percent of the shares, will trigger real estate transfer tax after being held by the purchaser for ten years instead of the current five years. The legislative procedure for this change is planned to be completed in 2020.

CONCLUSION AND OUTLOOK

The devil is in the detail. Particularly in real estate transactions, tax aspects often play only a minor role in practice. However, transactions can conceal considerable risks for buyers and sellers, often in the millions due to the high value of the investment. Therefore, it is advisable to seek a tax adviser early in the process of real estate transactions.

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→ Purchase price adjustments via the working capital

A company transaction will often take longer than expected. Often, several months will elapse between the initial contact and the final integration of the target into the buyer's group of companies. In order to agree a fair purchase price even over a longer period of time, contractual clauses are often used to provide adjustment mechanisms for this. These mechanisms specify what the "ordinary course of business" involves and regulate to what extent the Managing Director may make changes within the company. These arrangements apply from the time of signing the purchase contract ("signing") to the transfer to the new owner ("closing").

In order to understand the changes made by the Managing Director, it is necessary to either create mid-term financial statements to enable the transfer of assets, or to set the transfer date at the end of the financial year.

On the one hand, the operational assets or working capital, and on the other the net debt, both play a fundamental role in the contract negotiations and the application of the adjustment mechanisms.

We examine these two items more closely below in relation to a proper continuation of the company and their inclusion in defining the purchase price mechanisms.

DEFINITIONS OF WORKING CAPITAL AND NET DEBT

Working capital is divided into trade working capital and other working capital. The calculation is made up as follows:

+	Accounts receivable
+	Inventory (incl. value allowance)
-	Accounts payable
-	Prepayments received on orders
-	Provisions for accounts payable
-	Provisions for outstanding invoices
=	**Trade Working Capital**

+	Other assets
+	Deferred charges
-	Other liabilities
-	Deferred income
=	**Other Working Capital**

The trade working capital plus other working capital constitute the total working capital. The determination of net debt is as follows:

+ Cash and cash equivalents
+ Securities
+ Receivables from shareholders/related parties
- Liabilities to banks
- Liabilities to shareholders/related parties
- Pension provisions
= **Net Debt / Net Cash**

ORDINARY COURSE OF BUSINESS

The term "ordinary course of business" defines to what extent seller may vary the working capital between signing and closing.

When drafting a working capital clause, you need to consider that this mechanism is required in order to maintain the value of the company, whether the same objectives cannot be achieved by means of a simpler and less restrictive mechanism, and that the managing director should not be hampered in continuing with regular business operations (e.g. in designing price strategies).

An effective clause for the "ordinary course of business" will therefore prevent the Managing Director from implementing measures that increase liquidity but run counter to the way the company was previously managed. This might mean, for example, delaying payment of supplier invoices in order to artificially inflate the bank balances.

INFLUENCING FACTORS

The challenge when agreeing on a working capital clause lies in defining a suitable reference value.

To achieve a realistic view of working capital, the accounting records must reflect changes accurately and the business model must be stable and cyclical.

In addition, historical values can be distorted by special effects, such as by high write-downs following an inventory count, or a high level of receivables due to a sharp increase in sales. However, future external developments must also be taken into consideration, such as an economic downturn or price increases by suppliers. If the previous year values can be adjusted suitably, a proper reference value must be specified which corresponds to the level in the previous year or the median value of the three previous financial years.

If the parties were able agree on a common reference value, then the next step is to agree how large any deviation can be and still be judged to lie within the "ordinary course of business". This bandwidth of flexibility could vary within an absolute or a percentage range.

Where possible, special cases and/or events should also be taken into account when these are already foreseeable and when they may affect the level of working capital. One example of this is the number of public holidays at the end of the year that fall on a weekend, which will vary annually. If there are more business days at the end of the current year, then the accounting department has less time available to settle outstanding supplier invoices, so that *ceteris paribus* the level of cash funds and the accounts payable will be higher than in the previous year. This then impacts the working capital and the purchase price adjustment mechanism, even if the managing director had no intention of doing so.

CONCLUSION

Purchase price adjustment clauses are an important element when dealing with business takeover transactions and, when correctly applied, justify their existence by delivering a purchase price that is fair for both parties.

However, the risk of conflict is high, since both parties often interpret the "ordinary course of business" differently. It is therefore essential to start analysing working capital as part of a due diligence and to incorporate the insights gained in the purchase price negotiations. It is thus advisable to seek a solution that is acceptable to both parties, and to draft clauses as precisely as possible in order to avoid additional negotiations and potential disputes at a later date.

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→ M&A Vocabulary – Explained by the experts

“Signing and Closing”

In this ongoing series, a number of different M&A experts from the global offices of Rödl & Partner each present an important term from the English 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.

The transaction phase of the acquisition of a company ends after the drafting and negotiation of the purchase agreement, with its signing and the transfer of the company. In accordance with Anglo-Saxon legal practice, the date of undersigning of the agreement is referred to as the *signing*. By signing a purchase agreement, the parties undertake to transfer the ownership of the object of purchase. The date of execution and thus the actual transfer of ownership of shares in the case of a *share deal* or of assets in the case of an *asset deal* is referred to as *closing*. Several weeks, or even months, may pass between *signing* and *closing*. Practical reasons and/or the complexity of the transaction (e.g. the transaction is not yet wanted, possible or legally permitted) are the reasons for this common divergence in timing.

The interim phase between signing and closing allows the fulfilment of contractually agreed and/or legally required terms of execution (*conditions precedent* or *closing conditions*) e.g.:

- providing documents;
- waiver of pre-emptive rights;
- obtaining required approvals;
- lifting reservations by control bodies;
- obtaining permits or licenses
- clarifying *change-of-control* circumstances which may give important contractual partners a right of contract termination in the event of a change in ownership;
- replacing management;
- antitrust approvals;
- *carve-out* measures.

Other practical reasons for the transitional period include obtaining financing for the purchase price by the purchaser or the implementation of an orderly transfer. In practice, this means establishing suitable structures (administration, IT infrastructure, bookkeeping). As a rule, the transition is significantly easier if it takes place at the end of a financial year, or at a month end.

For minor transactions, *signing* and *closing* often occur together, since neither the fulfilment of closing conditions nor simplification of the transition are necessary.

The interests of sellers and buyers are typically opposed when it comes to the closing conditions. The seller’s interest is to keep the closing prerequisites minor and brief. On the other hand, the buyer is interested in increasing the security of the transaction from his perspective by increasing the closing preconditions; allowing the buyer the right to waive the closing conditions is advisable.

For the phase between *signing* and *closing* it continues to be common practice to reach additional agreements (*covenants* that prohibit the seller from carrying out certain actions), rights of withdrawal, compensation and *material adverse change* clauses. The latter refer to the case that the company’s economic situation, or in some cases, the overall economic situation changes significantly to its detriment.

On the date of *closing* the agreed *closing actions* and *closing deliveries* are performed. These include, among other things, the payment of the purchase price and/or provision of proof of payment, appointing new members of boards and other such bodies, resignation of officers and the transfer of further central documents. With the fulfilment of all *closing conditions* and taking all *closing actions*, the company's legal and economic transfer to the new owner is effectively complete. This concludes the acquisition from a legal perspective. The closing of the transaction is usually documented by a closing memorandum.

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