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M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

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→ Bond restructuring during the crisis

The effects of the COVID-19 pandemic are presenting challenges to issuers around the world. A difficult liquidity situation may raise question marks about planned interest and repayment deadlines. The occurrence of an event of default that triggers termination by the bondholder, such as the bond issuer struggling to make payments, can lead to premature repayment of the bonds at nominal value plus interest, which in turn increases the issuer's liquidity problems or may even lead to its insolvency. Placing new issues is difficult due to the volatile capital markets and reticence by investors.

If a bond issuer is in payment difficulties, and runs the risk of being unable to its debts under the bond, it can be restructured, subject to certain conditions, even outside of insolvency proceedings. This may particularly be the case, when the bondholders represent the largest, or one of the largest groups of creditors.

The options offered by the Debt Securities Act (SchVG [Schuldverschreibungsgesetz])

Outside of insolvency, restructuring in particular is an option by means of majority decisions by the bondholders' meeting. This is then binding on all bondholders. This option is available under the Debt Securities Act (SchVG).

The SchVG, dated 31 July 2009, provides the legal basis for all bonds issued under German law after 5 August 2009. For bonds issued previously, it can apply subject to an opt-in decision being taken in advance. Without recourse to the possibilities of the SchVG, adjustments are only possible by going down the rocky, and for publicly offered bonds, well-nigh impossible road of separate agreements with each individual bondholder. This would always require the bondholder to have full knowledge of the bondholders' identity, or being able to obtain this information. In the case of bearer bonds, this is a time-intensive and complex process in practice.

SchVG Section 5 (3) lists the individual restructuring measures that can be adopted at a bondholders' meeting. In particular, a reduction and a change in the maturity of the repayment of the principal amount and interest, or the swap of the bonds into/ company's equity are envisaged. However, no additional obligations may be imposed on the bondholders.

A resolution of the bondholders' meeting relating to individual restructuring measures generally requires a qualified majority of 75 percent of the voting rights present, unless a higher majority is required in the terms and conditions.

Holding the bondholders' meeting

Calling a bondholders' meeting requires publication of the invitation in the electronic German Federal Gazette at least 14 days before the date of the meeting. In practice, it is anything but certain especially in the case of bonds held by a large number of creditors, that any planned restructuring measures can be decided at the first bondholders' meeting. Resolutions that make changes to the essential content of the bond terms and conditions can only be passed by this meeting if those present represent at least half of the outstanding bonds by value. If it is determined that the quorum has not been reached, a second meeting can be convened. In this case, those present must represent at least 25 percent of the outstanding bonds. The route of holding two successive bondholders' meetings is more likely in practice.

The advantage of restructuring through a vote at the bondholders' meeting is that it is binding on all bondholders, i.e. it also applies to those who were outvoted or absent.

Like the resolutions at an annual general meeting of a stock corporation, the resolutions of the bondholders' meeting may be challenged by bondholders pursuant to Section 20 SchVG. However, the so-called approval process allows an accelerated execution of resolutions and valuable time to be gained.

Simplifications in the time of COVID-19

Implementation also appears difficult given the likelihood of continuing restrictions on contacts and meetings due to the COVID-19 pandemic. The law to mitigate the consequences of the COVID-19 pandemic in civil, insolvency and criminal law proceedings (COVID-19 Act) provides specifically for virtual meetings or resolutions in text form or by written submission of votes, inter alia only within the context of the Annual General Meeting of a stock corporation or for resolutions by the shareholders of a limited liability company.

However, the SchVG has from the start offered the possibility of the bondholders' meeting for voting without a meeting, which becomes even more important in the event of payment difficulties under unusual circumstances, such as the current COVID-19 pandemic. A vote without a meeting is understood as a vote without a physical meeting. In principle, the provisions concerning convening and holding the bondholders' meeting are to be applied mutatis mutandis to votes without meeting. During a voting period lasting at least 72 hours, the bondholders can submit their vote in text form to the vote coordinator, a notary appointed by the bond issuer. If no quorum is established for the vote without a meeting, the scrutineer can convene a bondholders' meeting; the meeting is then regarded as a second meeting.

Practice has shown that, due to the waiver of the physical presence of the bondholders at a meeting provided for by law, the first bondholders' meeting is usually held as a vote without a meeting, despite this leading to an extension of the time period due to the legally prescribed voting period.

A second bondholders' meeting always has to be held as a physical meeting, in order to protect the bond creditors. This can present an obstacle, if restrictions deriving from the COVID-19 pandemic continue.

Keeping an eye on the options

Therefore, the SchVG offers issuers and bondholders the possibility of amending the bond's terms and conditions, especially under the effects of an ongoing crisis, to tackle the threat of financial difficulties or even insolvency for the bond issuer. Restructuring bond conditions can be implemented in approximately three months, taking advantage of all possibilities to manage the time-limits permitted. Careful planning is advised to avoid the risk of a legal challenge of such decisions.

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→ Violation of holding periods. Things to do when acquiring a company

Tax-neutral restructuring often triggers tax-related claw-back/holding periods (e.g. Section 15 (2), Section 18 (3), Sections 22 and 24 German Reorganisation Tax Act (UmwStG [Umwandlungssteuergesetz]), Section 6 (5) Income Tax Act (EStG [Einkommensteuergesetz]). In addition to holding periods for income tax purposes, holding periods for real estate transfer tax purposes in accordance with Sections 5 (3), 6 (5), 6a of the Land Transfer Tax Act (GrEStG [Grunderwerbsteuergesetz]) must be observed.

Subsequent transactions occurring within the claw-back period generally lead to retroactive taxation of the restructuring and thus to an additional tax burden. Due to this a review of past restructuring is usually carried out in the course of a company acquisition Depending on the view taken of the transaction, there are different areas to focus on.

Example of a restructuring triggering a claw-back period (Section 20 UmwStG)

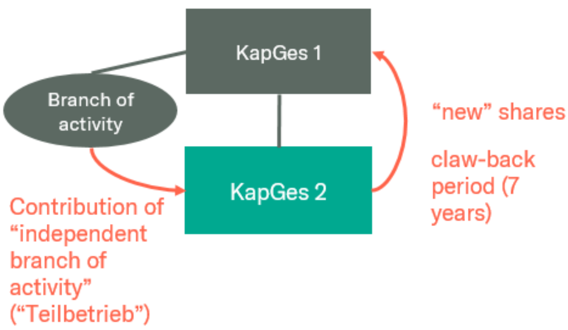
Subject to certain conditions, it is possible to transfer a business operation, parts of a business operation and interest in a partnership to a corporation at book value, and therefore tax-neutral. In return, the person or entity making the contribution (contributor) receives new shares in the corporation.

Contributions below the fair market value generally trigger a **7-year claw-back period.** The period starts on the date of the contribution.

In this case, **retroactive** taxation of the **contribution transaction may arise at the level of the contributor**, if the contributor sells the new shares (subject to tax restrictions) within a period of seven years (Section 22 (1) UmwStG, so-called “Einbringungsgewinn 1”).

The following practical example should illustrate this:

The contributor – Corporation 1 (KapGes 1) - receives, in return for the tax-neutral contribution of a part of its business operation (independent branch of activity; “Teilbetrieb”) at book value (here: a spin-off to create a new establishment) into KapGes 2, “new” shares in Corporation 2 (KapGes 2).



Contributing party (KapGes 1) is the seller:

If KapGes 1 is the seller, then the sale of the shares in KapGes 2 (the shares received in exchange) would lead to retroactive taxation of the contribution at the level of KapGes 1. The reason for this is that the sale of the shares in KapGes 2 is subject to a tax privilege (Section 8b (2) and (3) Corporation Tax Act (KStG [Körperschaftsteuergesetz])), whereas the sale of a part of the business operation would have been subject to regular taxation as current income . The received shares in KapGes 2 are therefore subject to **a 7-year claw-back period.**

The sale of the shares in KapGes 2 within this claw-back period leads to retroactive taxation of the gain from the contribution (“Einbringungsgewinn I”) at the level of KapGes 1, whereas a reduction of 1/7th for each full year since the date of the contribution is applied. At the same time, the acquisition costs of the received shares in KapGes 2 increases.

Contributor (KapGes 1) is the target company:

The sale of the shares in KapGes 1 has no direct effect on the claw-back period for tax purposes. However, the claw-back period is not irrelevant for the buyer of KapGes 1.

If KapGes 1 is the target company, it must be examined in the context of the acquisition of the company whether the conditions for the tax-neutral contribution were fulfilled; in the present example, especially whether an independent branch of activity (“Teilbetrieb”) was given.. Should it be determined during a later tax audit that those conditions were not met, retrospective taxation would take place at the level of KapGes 1.

This risk can be covered within the framework of the share purchase agreement by means of a corresponding tax indemnity or tax guarantee in favour of the buyer.

If the buyer plans a restructuring after acquisition of the target companies (KapGes 1 and KapGes 2) that affects KapGes 2, it must also be checked whether the planned restructuring would lead to a violation of the holding period and thus to retroactive taxation of the contribution at the level of KapGes 1. In practice, this risk is usually not covered by a tax indemnity/tax guarantee, since the retroactive taxation is only triggered by an action on the part of the buyer.

Conclusion

Company transactions occurring within claw-back periods can lead to not insignificant additional tax burden. For this reason, the tax risk due to existing claw-back periods should always be determined as part of a tax due diligence. If restructuring of the target company is necessary from the buyer’s perspective, possible claw-back periods that exist due to previous restructurings must be taken into account or the tax implication should be included in the negotiations.

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→ USA: Share deal vs. Asset deal. Transaction Structuring

We repeatedly discover that the transaction structure was not discussed within the terms of the Letter of Intent ("LOI") and subsequent negotiations can be costly for the buyer. This question does not only apply for the US, but also internationally, because the answer can potentially yield considerable benefits or disadvantages to both buyers and sellers. Below, we discuss the factors influencing the transaction structure from the perspective of the buyer, unless otherwise stated.

Share vs. Asset Deal – General Differences

In a share deal, the shares of a company are transferred to the buyer, while in the case of an asset deal only certain or possibly all assets and liabilities are identified and purchased from the target company by the buyer. In a share deal, the buyer acquires a separate legal entity, while under an asset deal the assets and liabilities acquired can be transferred directly into the purchasing legal entity. However, it is often useful to establish a separate legal entity that takes over the business that was acquired via the asset deal.

Benefits of an asset deal for the buyer

The most obvious advantage of an asset deal is what is popularly known as "cherry picking". This means that the buyer can usually select the individual assets and liabilities that are to be transferred upon purchase. This can be important in the case of liabilities, especially in case of unknown risks or with companies at risk of insolvency. Examples of these liabilities are pension obligations, warranty risks or to what extent employees are to be transferred. However, a buyer cannot fully protect himself by means of an asset deal (e.g. environmental risks with the acquisition of land).

Often, the most important factor in the decision whether to seek an asset deal as a buyer is the tax impact of the transaction.

In the share deal context, the investment is recorded without tax revaluation, and no deduction with respect to goodwill is recognized for U.S. income tax reporting. In case of an asset deal, all assets and liabilities including intangible assets are revalued in the GAAP and tax balance sheets as part of the Purchase Price Allocation ("PPA") and the excess of the purchase price consideration over tangible and intangible assets acquired is recorded as goodwill. Intangible assets including goodwill can be amortized over 15 years for tax purposes, an amount that is often significant in a transaction.

Disadvantages of an asset deal for the buyer

Existing contracts are not automatically transferred with an asset deal. Permits, certificates, and similar rights may be linked to the Target legal entity and are consequently not transferred as part of an asset deal. Therefore, long-term contracts which are critical to the success of the company may be a reason to choose a share deal over an asset deal. However, careful consideration should be given whether these contracts contain a change-of-control clause, which requires the consent of the contracting party for the successful transfer of the contract to the buyer in the event of the sale of the business.

In that case, the automatic transfer of such a contract is not possible under either a share deal or an asset deal.

Disadvantages of an asset deal for the seller

In the U.S., the question during the negotiations as to whether the seller will suffer a tax disadvantage in an asset deal compared to a share deal depends heavily on the tax identity of the company and the option exercised on how to be taxed.
In a share deal, profit is generally taxed at a lower tax rate compared to the regular tax rate. The tax rates can nominally vary by up to approx. 20%.

In the U.S., a distinction is made between transparent and non-transparent entities, similar to the taxation of a private limited company in Germany (GmbH) (non-transparent, i.e. at company level) and of a partnership (transparent, i.e. at the level of the partner).

If the target is taxed transparently, then there is normally no significant additional tax burden for an asset deal compared to a share deal. This means that, even with an asset deal, the seller will enjoy the lower tax rate (exception: “Recapture of Depreciation” in the case of revaluation of balance sheet assets).

As long as the revaluation of the assets recognized by the target company is not material (meaning that the fundamental driver of increased value lies in previously unrecognized intangible assets, including goodwill), there is usually no significant tax disadvantage for a transparently taxed seller.

If no lower tax rate is applicable in connection with an asset deal, e.g. if Target is a “C Corp” (taxed separately from its owners), then the tax disadvantage of the seller is generally roughly equivalent to the tax benefit of the buyer. However, since the additional tax liability of the seller will likely accrue in the year of sale (absent the application of the income tax instalment sales rules), but the tax benefit of the buyer is spread over up to 15 years, it is frequently not economically justifiable to increase the purchase price via purchase price gross-up so as to induce the seller to agree to an asset deal.

Hybrid transaction structure – special case 338(h)(10) election U.S. Tax

A special U.S. income tax option for structuring is the so-called “338(h)(10) election” in which, under certain conditions, a share deal can be treated as an asset deal for tax purposes. This requires a joint declaration by the buyer and seller to U.S. tax authorities. The buyer must be acquiring at least 80 percent of the shares in the target.

The consequence of this joint declaration is that the GAAP balance sheet follows the application of a share deal (i.e. a subsidiary is transferred, which is booked as an investment in the company balance sheet of the buyer, but eliminated within the final consolidated financial statements of the parent company). However, for income tax reporting, the election reflects an asset deal treatment (i.e. potentially goodwill and the revaluation of assets in the (consolidated) tax balance sheet of the buyer).

If there are non-tax reasons why both parties prefer a share deal and the target’s tax identity allows for the election, the choice of this hybrid transaction structure may be very attractive for both buyer and seller.

Conclusion

It is imperative to check the benefits and disadvantages of transaction structure alternatives prior to the LOI phase. Both legal and tax factors are important when deciding which transaction structure should be pursued by the parties. The rule of thumb is that the seller may prefer a share deal, while the buyer may often prefer an asset deal. In order to negotiate the transaction structure, it is advisable that the buyer understands the seller’s tax situation. In addition to the special case of the “338 election”, there may be other alternative structures available to achieve a tax-basis step-up. The buyer should explore the availability of such structuring options at an early stage.

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→ M&A Vocabulary – Explained by the experts

“Cash Conversion Cycle“

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.

Working Capital is one of the most undermanaged aspects of companies financials. Often it is simply not optimized due to a lack of awareness or attention. Many companies don’t systematically track or report granular data. They miss out on significant cash optimizing potential.

What exactly is a cash conversion cycle?

The cash conversion cycle (CCC) is a metric companies use to assess effective cash flow management and optimize their cash flow. The ratio provides an indication of how long it takes in days to convert a company’s investments in inventory into cash. The process covers the time it takes to sell off inventory (Days of Inventory Outstanding, DIO), collect payments from customers (Days sales outstanding, DSO) and pay suppliers (Days payables outstanding, DPO). Whereas DIO and DSO are correlated with the company’s cash inflow, DPO resembles cash outflows. This can be summarized in the following formula:

Cash Conversion Cycle = DIO + DSO – DPO

The first part, **DIO** simply measures how long it will take the company to sell its inventory. The formula for DIO is as follows:

DIO = Average Inventory/Cost of Goods Sold x 365

An increase in DIO means it is taking longer for the company to sell its inventory. The smaller the number, the quicker it is selling inventory. This can be positive as demand for the company’s products might be high. However, further analysis might be worthwhile if limited inventory levels hinder the company’s ability to satisfy customer demands.

The second part, **DSO** measures the amount of time that it takes customers to pay the company for the purchased goods and services. The formula for DSO is:

DSO = Average Accounts Receivable/Total Credit Sales x 365

Obviously, if “cash-only” sales are the dominant payment method in a business, this ratio is zero. However, common payment terms in B2B are approx. 30 days as people use credit to finance their purchases. In order to manage the company’s cash flow a quick payment by customer’s, hence low DSO is favored in order to pay off suppliers without using external financing sources. An increase in DSO represents that the cash collections are not properly carried out. Customers are not paying on due time or the company is extending the payment date in order to ensure a deal. If this is the case, a thorough analysis of the company’s debtors should be undertaken.

The last part, **DPO** is the ratio related to the average number of days it takes a company to pay its suppliers. The formula is as follows:

DPO = Average Accounts Payable/Cost of Goods Sold x 365

An increase in DPO is actually better, as it means the company has more time to collect payments from its customers to pay off its suppliers.

Overall, the shorter the cash conversion cycle is, the better the company is performing at processing intermediate products, selling inventories and recovering cash from these sales while paying its suppliers. Contrary, a rising CCC can indicate several operating challenges that need to be monitored (e.g. slow moving stock, key customers in financial distress or payment conditions by suppliers that are unfavorable).

Effective working capital management favored by stakeholders

Besides management, the ratio is also critical for other stakeholders (e.g. investors, credit analysts, banks, etc.) Tracking the CCC over multiple quarters can provide a view into the management attention working capital management receives, the optimization potential in this area or potential cash levels that need to be sustained.

How well working capital is managed can be monitored through various ways. Starting with a multiple period analysis of the CCC, the ratio can be benchmarked with industry best practices or its competitors.

How to optimize your working capital

Optimization potential can be realized in different ways affecting e.g. DSO and DPO.

Possible **opportunities to shorten DSO** include, but are not limited to:

- Automated invoicing;
- Short standard payment terms;
- Down-payment requests for contract work;
- Rebates / discounts not linked to product sales;

Besides these examples, one commonly used tool to reduce DSO is factoring. Factoring means that a business sells its accounts receivables at a discount to a third party which then collects the payments from a business customers. Depending on the discount this might be a possibility to optimize working capital.

Possible **opportunities to increase DPO** include, but are not limited to:

- Automated scanning of invoices;
- Standard payment terms;
- Fixed payment cycles (e.g. 2x a month);
- Optimize relationship with suppliers.

Based on these suggestions, the question comes to mind, whether it is possible to generate a negative CCC. The answer is yes. It means that that specific business model receives money up front or much quicker compared to the time it takes to make payments to its suppliers.

Cash is King, especially in times of crisis

So what role does the CCC play in a post-COVID-19 economic framework?

Many companies will see the CCC increase, as the DIO will increase due to the downward trend of the operations and hence higher stock levels (e.g. clothing that cannot be sold due to store closures). Customers might not be able to pay on time, which will have an impact on the DSO. Suppliers might want to receive payments up-front due to high economic uncertainty. Overall, the CCC will increase, making it even more important for companies to optimize its working capital management in times of crisis.

A crisis is a terrible thing to waste

A diligent use of the CCC might shift the loyalty with customers while also increasing the market share in a volatile economic landscape. Increasing the level of inventory in times of low demand might equip a business to gain market shares during the recovery period as it might be one of the few business able to satisfy suddenly increasing demand. Analyze your debtors / customers thoroughly. Some might be in economic distress and hence thankful for loyalty and support during a crisis. Increasing payment terms with these customers might initially increase DSO and hence the CCC, but in the long term this approach might secure a long-standing customer relationship. Developing trust with suppliers during a crisis is also important. Being transparent with the current business information and communicating financial figures despite uncertainties are key to establishing trust.

Summary

To sum it up, an active approach to manage the CCC – analyzing inventory levels, developing and nurturing long-standing customer relationships and further establishing trust with business partners – can **prepare companies to quickly bounce back once a recovery sets in.**

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Forum Global 2020

Due to the current developments around the coronavirus, the 21st Forum Global will take place in a purely virtual form this year.

From Monday, September 21 to Thursday, September 24, 2020, you can choose from six lectures in three parallel time windows every day.

You can look forward to informative webinars, which will inform you about current topics in the areas of law, tax, BPO, auditing as well as management and IT consulting. In addition, the theme and regional fairs offer exciting and detailed insights. At the virtual exhibition stands, our experts look forward to an interdisciplinary and international exchange with you.

You can find all the latest information about the event and the schedule on our Forum Global event website www.roedl.de/forumglobal (German). There you will soon be able to take a look at the extensive lecture program and register for the virtual Forum Global from the beginning of August.

We look forward to your virtual visit!

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