Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

Issue: January 2021

In this issue, you can read about

→ Compliance in M&A transactions

Compliance is on the agenda of almost every company. Most companies of a certain size have even appointed their in-house compliance officer in charge for all compliance related issues.

Nevertheless, the significance of compliance in M&A transactions is often underestimated or not appreciated at all. Traditionally, the focus in this context is on issues such as merger control and, within the due diligence, on labour or environmental issues. The results are then incorporated into an acquisition agreement e.g. by means of conditions precedent (obtaining clearance from the competent anti-trust authority) or guarantees and/or indemnity clauses (as in the case of environmental risks). But compliance involves much more:

Data protection

The new data protection regulations make it necessary to reflect on how to conduct a due diligence in conformity with the law before starting the latter.

In the course of a due diligence a large number of documents are provided by the potential seller, which are often confidential and in some cases also contain personal data (like employees' names for example). It is thus common to sign non-disclosure agreements. But such an agreement is only binding on the signatories (the seller and the potential buyer) but does not mean that the possibly affected third party (e.g. employee, customer or supplier) also agrees to the disclosure of his data to the prospective buyer. . Normally, this is not the case even if such a third party has provided to the company for sale a statement of consent to the processing of its data because such statement of consent usually refers to the (contractual) relationship between the parties (employer/employee, customer/supplier) and the associated data processing but does not include the disclosure of the data to a potential buyer. There are two solutions to this problem:

- When making the data available or setting up the data room, care is taken to ensure that all personal data is made unrecognizable, although this is likely to be extremely difficult in practice.
- The target company and/or the seller and the potential buyer justify the lawfulness of the disclosure of data by a legitimate interest of the controller and the third party (Article 6 (1) f) GDPR), which is the sale being not viable without a prior analysis of the company by the potential buyer. The parties should sign an agreement regulating the purpose of data processing by the potential buyer as well as the security measures to be complied with and, possibly, the deletion of the data after completion of the due diligence.

Competition law

Another problem is that the disclosure of information may be contrary to the principle of competition law saying that no strategic information (e.g. relating to prices, conditions or other confidential information e.g. about new products) may be made available to competitors. Though the seller will not be inclined to reveal such information before the transaction is concluded, potential buyers often insist on obtaining at least some information they regard as essential for deciding whether or not to buy the company.

A possible solution in such a scenario is to make available certain sensitive information only to a very narrow group of people, often only the consultants of the potential buyer (the so-called *clean team*). In this case, data may be analysed but the result of the analysis is disclosed to the potential buyer only in filtered form, e.g. by stating that no special risks have been identified. This helps prevent the potential buyer – who is at the same time often the seller's competitor, at least until the acquisition is completed – from drawing any advantages from such information, or the parties from concluding collusive arrangements.

KYC / DAC6

Other aspects of compliance that might have to be taken into account in M&A transactions include:

- Sell-side background check (Know Your Customer - KYC) including shareholders and management because pending proceedings against them may affect permits or authorisations held by the target company.
- Structuring the transaction from the tax perspective in due consideration of the new so-called DAC 6 regulations because, depending on the given structure, it might be reportable to the competent tax authorities. Due to limited space, it is not possible to exhaustively explain the DAC 6 regulations in this article but a detailed

description can be found in our [Special theme issue].

Conclusion

Compliance is becoming more and more important also in M&A transactions and it touches on subject areas one would not necessarily think of immediately in this context. It is therefore all the more important to think about this in good time and to provide for appropriate measures and agreements.

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→ Application of the restructuring clause, Article 8c (1a) of the German Corporate Income Tax Act

When acquiring shares and replacing shareholders in this process, it is advisable for companies to keep an eye on losses that have not yet been utilised. The utilisation of losses made in the past primarily depends on the percentage of the shareholding acquired. If less than 50 percent of shares in a company is acquired by a shareholder directly or indirectly within five years, the existing losses can be further utilised in an unchanged way. However, if more than 50 percent of the shares is acquired directly or indirectly by the same acquirer within five years, this is referred to as a harmful acquisition of shares pursuant to Article 8c (1) sentence 1 of the German Corporate Income Tax Act. Under that provision, losses existing but not utilised up to that point can no longer be utilised. An exception to this principle is the so-called restructuring clause under Article 8c (1a) of the German Corporate Income Tax Act. According to that clause, such acquisition of shares is not deemed to be harmful if the shares were acquired for the purpose of restructuring the company. The option to utilise losses is not forfeited at the company level and the losses can continue to be utilised.

To be able to apply the restructuring clause, however, it is mandatory that all of the conditions described below are met.

Restructuring

The shares must be acquired for the purpose of restructuring and the acquirer must have the intention to restructure the company. Thus, there must exist an ultimate nexus between the acquisition of the shares and the restructuring of the company. It is assumed that the acquirer has the intention to restructure the company if the acquirer had knowledge of the need to restructure the company already before acquiring it. Such intention is also assumed to exist if there is a temporal relationship between acquiring the company and developing a restructuring plan or if one of the measures listed in Article 8c (1a) sentence 3 of the German Corporate Income Tax Act is implemented. In addition to the intention to restructure the company, the restructuring process must actually take place. Specifically, this means that measures aimed at avoiding insolvency or indebtedness and at the same time maintaining essential company structures of the company should be taken.

Maintenance of essential company structures

To maintain essential company structures, the company must take one of the three measures alternatively:

- Adhering to a works agreement containing employment arrangements;
- Safeguarding of employment by complying with the 'sum of wages' regulation (*Lohnsummenregelung*); or
- Contribution of substantial business assets.

The first alternative (works agreement) is based on a measure arising from works constitution law. However, it is not a prerequisite that the company must have a works council. If it doesn't, the company may conclude individual agreements with its employees that contain employment arrangements. At least half of the employees subject to social security contributions must agree to this individual agreement.

Alternatively, the maintenance of the essential company structures is also possible via the 'sum of wages' regulation. The sum of relevant annual total wages within the company to be restructured may not fall below 400 percent of the so-called *Ausgangslohnsumme* (5 years' average wage total) within five years following the acquisition of the shareholding.

The third alternative is the contribution of substantial business assets by the acquirer. A substantial business asset is deemed to be contributed if new business assets equal to at least 25 percent of the assets included in the last tax balance sheet are contributed to the company within twelve months following the acquisition of the shareholding. The percentage of the minimum contribution decreases accordingly if less than 100 percent of shares is acquired. Due to the restructuring effect, the acquirer can also make a contribution in form of waiving valuable claims against the company.

Conclusion

If the conditions described above are met for an acquisition of shares, the restructuring clause can be applied. This prevents the forfeiture of existing losses, as the acquisition of a shareholding for the purpose of restructuring is not considered a harmful acquisition. The application of the clause rewards the voluntary commitment of the new shareholder who joins a company in times of crisis. In view of the economic consequences of the ongoing coronavirus pandemic, the importance of this restructuring clause could increase significantly in the near future.

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→ Sustainability criteria in M&A transactions

Sustainability criteria are becoming an increasingly important factor for institutional and private investors in choosing companies to invest in. Especially the so-called ESG criteria play a significant role in this context. The acronym "ESG" stands for "Environmental", "Social" and "Governance". These ESG criteria should indicate on an aggregate basis how sustainable a company's strategies are in environmental and social terms and in terms of (good) corporate governance. Recently, they have also had growing influence in M&A transactions and are more than just a short-term trend because they sustainably affect company value. It is therefore advantageous to have a look at how they can affect the transaction process.

Function and objectives of the ESG criteria

The development of the criteria over time can be analysed in quantitative terms using various ratios. In addition, qualitative factors can be considered using a scoring system. This includes the ability of a company to anticipate future strategic adjustments, e.g. making the production process more environmentally sustainable. With various weighting of the three main categories and after aggregating the partial results, the use of such a scoring system enables allocating the company an ESG score which can be later compared with that of its competitors.

ESG factors can influence the value of a company directly and indirectly. Directly in that a company can save costs if its employees receive competitive and fair pay and thus employee turnover is low, or in that the company has a low level of emissions and energy costs due to high energy efficiency. ESG aspects can influence company value indirectly in that they have an impact on the company's reputation and thus e.g. its ability to win new customers. The fact that the better the ESG score, the higher the company's value is confirmed by numerous studies. It is therefore logical that this point of view is also taken into consideration in due diligence.

ESG criteria in the transaction process – "Due Diligence is the key"

In addition to classic financial, legal, tax, commercial and IT due diligence, sustainability aspects are increasingly being analysed before a transaction is concluded. In particular, they are analysed as part of ESG due diligence which brings together experts (and their knowledge) from areas such as transaction, IT, legal and energy consulting as well as audit and compliance. Depending on the branch of industry and the specialty of the company to be analysed, this requires specifying various areas to focus on during such due diligence and involving various experts.

For example, a company from the automotive sector might want to switch to innovative, more sustainable drive technologies, which is an existential business transformation and therefore requires a fundamental strategic and financial analysis of economic and ecological sustainability of this project. By contrast, for a textile manufacturing company, aspects of employment and environmental law will be of crucial importance. Legal advisors and experts in energy and compliance analyse such a company, for example, in terms of energy efficiency and costs, the level of carbon neutrality achieved, and a possible loss of reputation or market share due to ethically and legally questionable (labour) conditions within the supply chain. In addition to an intensive exchange of information with the company being analysed, ESG due diligence relies on internal and external data such as the company's sustainability reports, expert assessments and an ESG rating from a rating agency, if available. Additionally, in an effort to compile the most comprehensive review of the company, an initial screening for controversies investigates publicly available specialists' analysis and news reports.

The findings obtained from these analyses should therefore also have an impact on financial due diligence and company valuation as regards the future development of the net assets, financial position and results of operations of the company. Explicitly, this would include, for example, increases or decreases in forecast cash inflows/outflows or the growth rate, which can be determined based on the target's current sustainability level and the associated future integration or transformation costs. This new multidimensional transparency also makes it possible to address sustainability aspects at an early stage during acquisition agreement negotiations and post-merger integration.

Conclusion

The analysis of sustainability or ESG criteria as part of the transaction process, ideally in the course of ESG due diligence, should always be case-by-case, as the same criteria will have a different impact across different branches of industry. For example, the "environmental" component will play a greater role in the manufacturing industry than in the case of an investment company. Furthermore, it is essential that the complex interrelationships and impacts of sustainability aspects on the future development of the company are adequately taken into account by developing a systematic and interdisciplinary approach.

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→ Spain: Acquiring "production units" in times of crisis

The restrictions on the Spanish economy caused by the Covid 19 crisis have led to an increase in bankruptcy petitions there, although the requirements for filing a bankruptcy petition have been relaxed also in Spain.

Building on the financial crises in Spain in 2007 and 2013, Spanish insolvency law is now considered technically advanced as well as practice- and needs-oriented.

One of the legal novelties introduced in Spain at the end of the last crisis (specifically in September 2015) is the regulation of the sale of the so-called "production units" by insolvent companies. In this context, "production unit" means the entirety of assets and third-party contractual relationships and, if applicable, administrative permits, organised for the exercise of the core or a subordinate economic activity.

The aim of this regulation is to make the acquisition of production units of insolvent companies attractive and feasible to solvent investors, in order to maintain the business operations of the "healthy" part of the insolvent company, while preserving the right of the creditors of the insolvent company to enforce the largest possible portion of their claims. The purpose was to avoid liquidation of the individual assets forming part of the insolvency estate, as this usually leads to job losses and the generation of very little or no income.

To win potential investors for this type of business acquisitions, it is important that they have exact knowledge of the type and amount of liabilities they will have to take on when buying the production unit before the actual transaction takes place. There has been no such certainty so far as there was no regulatory framework in place.

Contradictory case law caused great legal uncertainty, which has led to dramatic situations, e.g. the buyer of the production unit was ordered by a court to assume further liabilities – especially those arising from employment and social security obligations – even several years after the acquisition of a production unit, part of which were two or three times higher than the obligations to be assumed as part of the acquisition planned in the initial budget.

On 1 September 2020, a "systematised" version of the Insolvency Act came into force in Spain, which now precisely regulates the rights and obligations of the buyer of the production unit of a Spanish company in insolvency proceedings. The main features and advantages of the legal framework for this particular type of "asset deal" can be summarised as follows:

- It is a process **supervised by an insolvency court judge** and controlled by an insolvency administrator.
- The investor can limit **the scope of the production unit** he intends to buy.
- The acquisition has a "**universal succession**" effect, so consent of the respective other contracting party to the transfer is actually not required. This can be particularly useful for production units that hold licences or require official approvals for their business operations.
- The buyer does not take on **any tax liabilities.**
- The buyer does not take on **any liabilities arising from financing arrangements or commercial relationships.**
- Outstanding **social security obligations** are assumed by the buyer only to the extent that they are connected with the employment contracts of the employees who are part of the production unit to be taken over.
- This also applies to "**liabilities arising from employment relationships**" (salaries and severance payments): the buyer takes over only those liabilities that are attributable to the employees assigned to the production unit. In addition, the insolvency court may decide to grant an exemption for liabilities assumed by the the so-called salary guarantee fund.
- When evaluating production unit takeover bids, the court should give preference to those bids which, **from a qualitative point of view, offer a greater guarantee for the continuation of operations of the company and the maintenance of jobs.**

Overall, it can be said that from the perspective of investors interested in this type of transactions, the recent amendment to Spanish insolvency law has removed many uncertainties. As the number of insolvency proceedings is, unfortunately, expected to grow in Spain, this alternative way of acquiring companies will probably become more attractive, especially to investors in the automotive supply or the hospitality industry.

Conclusion

With the amendment to the Insolvency Act coming into force on 1 September 2020, the acquisition of production units of Spanish companies in insolvency proceedings has become an interesting alternative for solvent investors who can successfully integrate these units into their own companies.

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→ M&A Vocabulary – Understanding Experts

"Choice of law clauses"

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.

What are choice of law clauses and why are they important?

In the context of M&A transactions, it often happens that they reflect, in whole or in part, matters that extend to several countries (i.e. also jurisdictions). For example, the buyer and the seller may be based in different countries, or parts of companies or subsidiaries of a corporate group to be acquired, may be scattered over several countries. These circumstances give rise to the so-called legal "ties", which then, based on the complex Conflict of Laws rules in the individual jurisdictions, answer the question as to which law should be applied to interpret a contract. The answer to this question may be critical in respect of the enforceability of contractual claims, as each jurisdiction interprets contractual provisions differently and may set different limits to the contractual arrangements made between the parties.

In this respect, it is common and advisable to agree on a choice of law clause in contracts that have a foreign nexus. In doing so, the parties deliberately and expressly agree on the national law governing the contract in order not to be subject to the complex Conflict of Laws rules of private international law (and the time-consuming and costly enforcement of claims and rights under such rules) and thus avoid any uncertainties with regard to the interpretation of the contract.

Are the parties free to choose any law they want?

In most jurisdictions, the parties are free to choose the law they want to govern their contractual relationship. Nonetheless, it is advisable to check this on a case-by-case basis because especially in some non-European countries this freedom of choice is limited also in M&A transactions. Such limitation can lead to situations where, based on the law of a given country, local courts unexpectedly turn out to have jurisdiction over the contract and local law applies, which, in turn, can lead to unexpected implications for the interpretation of the contractual provisions. Also in European jurisdictions there are certain matters that are not subject to the parties' freedom of choice of law, e.g. certain claims arising from competition law or industrial property rights.

Is there a "right" and "wrong" choice of law?

In many cases, the choice of applicable law will be obvious because both parties are familiar with the legal system of a respective country or also because the market or the industry uses certain specific and customary agreements. It is advisable for the parties to align the choice of law and the jurisdiction clauses in order to avoid a situation where a court in country A has to apply the laws of country B that are unknown to it, which often leads to complications and the need for obtaining expensive legal opinions. Finally, there may also be technical reasons for incorporating a choice of law clause, e.g. if a complex transaction requires using the instruments of "trust" or "escrow" in a particular way that is known only under one particular jurisdiction. Beyond these practical aspects, only a close examination of the individual case will answer the question of which law is most favourable for a particular party in a particular scenario.

What aspects of the choice of law clauses should be considered?

As in all contractual clauses, care should be taken to ensure that the wording is as precise as possible. Thus, the parties should choose a law that actually can be applied, e.g. not the law of the United States, but the law of the State of New York.

In addition, the choice of law clause should address the question of whether the choice of law is limited exclusively to the enforcement of contractual claims or whether it includes, for example, tort claims that are connected to the contractual relationship (e.g. any duties of care during contractual negotiations).

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Publisher's details

M&A Dialogue |
January 2021 Issue

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