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Foreign Investments in Germany

Legal and Tax Aspects of M&A and Real Estate Transactions

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Legal and Tax Aspects of M&A and Real Estate Transactions
3. Ed. – Munich; Berlin; Frankfurt/Main: P+P Pöllath + Partners, 2013

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ISBN 978-3-9815017-4-2

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2013

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Introduction

There are many reasons for an investment in Germany. *Made in Germany* is a globally recognized brand of quality. Germany is renowned as a leading export nation and home to Europe´s best-performing and largest economy.

A stable political environment, a dynamic economy and an open-minded and welcoming society have made Germany one of the world´s premier locations for business investments. During the last 20 years, the modernization and integration of the East German economy has been promoted successfully, domestic structural problems in the labor market have been addressed by gradual deregulation and bureaucratic regulations have been simplified. In recent years, Germany has managed to emerge from the economic crisis largely unscathed due to decisive political and economical action and remains to be the fourth largest economy in the world.

The German legal framework is based on the rule of law which warrants a sound and reliable legal system. The codification of legal principles and a highly developed judicial system create an environment that guarantees efficiency and predictability for foreign investors.

The following is a brief guide for those investors seeking information on the legal and tax framework for foreign investments in Germany.

Enjoy the guide, yours P+P

A. Investment Possibilities

I. Share Deal vs. Asset Deal

1. Basic Differences

Investments in German companies can be structured as share deal or as asset deal. Both types of transactions are significantly different in terms of their economic and legal effects.

In a share deal the purchaser acquires all (or a part of the) shares in the target company from one or more sellers. With the acquisition of such stake, the purchaser automatically becomes the owner of the legal entity as a whole including all of the target company's assets, rights, claims and liabilities. Also, all of the target company's contracts with third parties (e.g. banks, customers suppliers, trade agents etc.) with all related rights and obligations as well as all public approvals, permits and registrations (including registered IP rights) are automatically taken over. Thus the target company's business operations continue to be performed virtually irrespective of the change in ownership.

In an asset deal the purchaser acquires either all or individual assets as for example real estate, production facilities, machines, computers, licences, etc. directly from the target company. As a result, the business operations are henceforth continued under a new, different legal entity (the purchaser itself or one of its subsidiaries/special purpose vehicles). The purchaser can select the most attractive assets and avoid the take-over of assets which are inappropriate or even contain certain risks or liabilities (so-called *cherry-picking*). Such an approach is advisable if the target company has already filed for insolvency, for instance, or if the purchaser intends to acquire only one of several business units consolidated under one company.

2. Transfer of Liabilities

Since a share deal leads to the assumption of all the existing claims and liabilities of the target company whether known or unknown to the purchaser, a thorough review of the target company (legal due diligence) is recommendable. In an asset deal, by contrast, there is no such automatic transfer of rights, claims or liabilities. Nevertheless when continuing the existing business (or at least its substantial core) the purchaser of assets may be liable for debts or obligations initially incurred by the seller according to the following exceptional provisions:

- When using the existing business name the purchaser may be liable for debts incurred by the previous owner pursuant to section 25 para. 1 of the German Commercial Code (HGB), however this assumption can be excluded by agreement with the seller and entry in the commercial register.
- The purchaser may also – to a limited extent – be liable for previous taxes (in particular value added tax, trade tax, wage tax and withholding tax) pursuant to section 75 of the German Fiscal Code (AO), however this liability is excluded in case of an acquisition from the insolvency administrator in the course of insolvency proceedings.
- Existing employment agreements are transferred to the purchaser together with a business or a business unit pursuant to section 613a of the German Civil Code (BGB) unless the respective employee explicitly objects. Other contracts with third parties related to the acquired assets stay with the selling company; i.e. any transfer to the purchaser is

subject to the consent of the respective other contractual party (this may lead to renegotiations and loss of beneficial terms and conditions).

- The acquisition of real estate can render the purchaser responsible for existing contamination and clean-up costs pursuant to section 4 para. 3 of the German Federal Soil Protection Act (BBodSchG).
- Theoretically, under EU Law the purchaser can be made liable for the repayment of unlawful subsidies granted to the seller by the EU or for damages and fines resulting from a violation of EU competition rules committed by the seller.

3. Tax Issues

Against the background of the overall lower taxation of capital gains (especially if the seller is a corporation) sellers will tend to prefer to structure a transaction as a share deal. From a purchaser's point of view an asset deal is advantageous because the hidden reserves (the difference between book values and purchase price) for depreciable movable assets can be written off (so-called *step-up*). In addition most of the transaction expenses are deductible immediately or by way of depreciation. However, tax losses carried forward incurred by the selling company cannot be used by the purchaser in order to reduce tax base. The tax situation ist similar in a share deal, if the selling company has no substantial hidden reserves. In the event of a transfer of more than 50 % of the shares in a corporation the unused losses expire pursuant to section 8c para. 1 of the German Corporation Tax Act (KStG). Following an asset deal at least the seller can seize unused tax losses carried forward in order to reduce profits. The direct transfer of real estate in the course of an asset deal is subject to real estate transfer tax (in most federal states approx. 5 %). If instead the real estate is held by a corporation or a partnership and less than 95 % of the shares in the respective company are sold, no real estate transfer tax will be triggered. Therefore structuring a real estate transaction as a share deal (involving 94.9 % of the shares) can be a means to avoid real estate transfer tax.

4. Contract Design

In practice, share deals are more common than asset deals. A share purchase agreement regularly focuses on more extensive representations and warranties (in order to reduce risks resulting from the assumption of liabilities, inter alia) whereas the drafting of an asset purchase agreement requires detailed identification of every single asset to be transferred. Share purchase agreements concerning shares in German limited liability companies (GmbH) have to be notarized in front of a German notary public (subject to fees) whilst asset purchase agreements only require notarization if they involve the transfer of real estate. Ultimately appropriate and creative contract drafting can adapt the legal and economic effects and balance to a certain extent the respective disadvantages of both types of transactions.

II. Acquisition of Various Share Types

1. Limited Liability Company (GmbH)

a) General

The GmbH is by far the most frequently used corporation form in Germany. According to current statistics, around one million commercial entities are organized as GmbHs. One of the main advantages of a GmbH is that the shareholders are not personally liable for the company's

debts. However, foundations of a GmbH, as well as capital increases and share transfers, require notarization by a notary public.

b) Share Capital

The nominal share capital must be determined in the articles of association and amount to a minimum of EUR 25,000. Before the 2008 reform of the Limited Liability Companies Act (GmbHG), each shareholder was only permitted to subscribe to one share in the company and each share was required to have a minimum amount of EUR 100 and be divisible by 50. The 2008 reform of the GmbHG granted shareholders much greater flexibility regarding the amounts of their contributions. Shareholders may now subscribe to as many shares as they wish and such shares must be denominated in an amount of at least EUR 1.00. This new flexibility has particularly simplified the purchase of shares if a shareholder intends to sell only a part of his stake, as well as joint ventures and management participation programs.

c) Maintenance of Share Capital

The GmbHG provides for the maintenance of the nominal share capital insofar as it is not permitted to make distributions to shareholders if the remaining assets (at book value) would not cover the company's share capital and its liabilities. In other words, only free reserves and accumulated profits are allowed to be distributed to shareholders. The 2008 reform of the GmbHG reinstated the traditional *balance sheet-based* approach of determining whether a transaction between a shareholder and a GmbH affects its net assets and therefore constitutes a distribution. Such approach – and thereby the permissibility of balance sheet-neutral transactions such as cash pooling systems, as well as upstream securities in connection with leveraged buy-outs – had been questioned by a decision of the German Federal Supreme Court in 2003. The lawmaker of the 2008 GmbHG reform overruled such decision, in particular aiming to put cash pooling systems on a secure footing.

d) Authorized Capital

The 2008 reform of the GmbHG implemented the instrument of authorized capital as known in the German stock corporation. The primary purpose of authorized capital is to facilitate the financing of the limited liability company through the allocation of new equity capital. The GmbHG now enables the shareholders to authorize the managing directors of the company for a maximum term of five years to increase the registered capital of the company by issuing new shares against contributions in cash or kind. The nominal amount of the authorized capital may not exceed half of the existing registered capital at the time of authorization. Making use of the authorized capital does not require another shareholder resolution. In this light, the authorized capital may be a flexible and cost-saving instrument for German limited liability companies to increase their share capital. The possibility to create authorized capital gives the management of a GmbH an instrument with which to obtain further financial means or to set up management incentive programs without convening general meetings.

e) Commercial Register

It is important to know that only such shareholders who are registered in the shareholders' list are deemed to be shareholders of the respective GmbH. A copy of such shareholders' list must therefore be filed with the competent commercial register and is publicly available to anyone who is interested. The 2008 reform of the GmbHG introduced the possibility of acquiring shares in a GmbH in good faith whereby the shareholders' list serves as a point of reference. In

principle, a purchaser can trust that a person entered in the list actually is a shareholder in the company. However, this applies only if the respective entry has been incorrect for at least three years without objection, so the theoretical possibility of good faith acquisitions will not actually make due diligence procedures superfluous.

f) Management

A GmbH is led by one or more managing directors. Contrary to the legal concept in a German stock corporation, the applicable law allows shareholders of a GmbH to appoint and remove managing directors relatively easily at any time. Further, managing directors are bound by instructions provided by the shareholders' meeting. In general, the managing directors are responsible for business management and the representation of the GmbH. A legal entity is not allowed to serve as managing director. For some business transactions, the managing directors need to obtain the prior consent of the shareholders' meeting. Usually, such business transactions are described in detail in the articles of association or in the rules of procedure for the management.

g) Advisory Board/Supervisory Board

Moreover, the shareholders of a GmbH can opt to implement an advisory board or a supervisory board. Managing directors must not be members of a supervisory board. If a GmbH (together with its subsidiaries) has more than 500 employees, the foundation of a supervisory board is required by mandatory labor law, whereby the employees are entitled to appoint at least one third of its members. In the event that a GmbH has more than 2,000 employees, half of the members of the supervisory board are appointed by the employees. In cases of a tie vote, the chairman of the supervisory board appointed by the shareholders has a casting vote.

h) Administrative Seat Abroad

The 2008 reform of the GmbHG eliminated the requirement that the registered seat of the GmbH had to be identical with its principal place of business. Therefore, it is now possible for a GmbH to have its administrative seat abroad while its registered office remains in Germany. This allows for a more flexible handling of GmbHs, which may now move their principal place of business to any other country without any corporate restrictions. This is not restricted to the European Union as long as the third country recognizes the applicability of German law to the GmbH. The possibility to operate abroad in the familiar legal form of a GmbH might be a particularly attractive option for German groups and their foreign subsidiaries.

i) Entrepreneurial Company (UG)

The government's first draft of the 2008 reform of GmbHG intended to reduce the minimum share capital of a GmbH from EUR 25,000 to EUR 10,000. The legislator ultimately decided to maintain the previous minimum capital. For new businesses that only have a limited amount of nominal capital at the start of operations and only require a small amount of capital, the reform introduced an alternative to the established form of the GmbH called an entrepreneurial company (UG) which can be founded with an initial share capital of EUR 1.00. An UG is more or less a GmbH with the special characteristic that a quarter of the annual profits must be put into the capital reserves until the share capital amounts to EUR 25,000. Since the implementation of the UG, foreign corporate entities, which, after being acknowledged by German law, used to attract increasing attention due to their low share capital, have disappeared from the scene. The English limited liability company, which used to be the preferred choice in this regard, has been

almost completely replaced by the UG. The UG has found great reception, especially in the field of small enterprises or used solely as an investment or trust vehicle. The number of UGs has increased over the short period of its existence to around 75,000 registered entities.

2. Stock Corporation (AG)

a) General

Alongside the GmbH, the second major type of German corporate entity designed for mid-cap and larger corporations is the stock corporation (AG). The shares in an AG may be, but must not necessarily be, publicly listed. In fact, most of the German AGs are not listed, but are privately held.

The legal regime that applies to an AG is considerably stricter than the one that applies to a GmbH. As a rule of thumb, the articles of association of an AG may only contain provisions that deviate from those contained in the German Stock Corporation Act (AktG) when this is expressly permitted by the Act, whereas the articles of a GmbH may contain any provision unless such provision is prohibited under the German GmbHG. As a consequence, the flexibility in structuring an AG is quite limited, in particular with respect to its corporate governance.

b) Corporate Governance

The three mandatory corporate bodies of an AG are the management board, the supervisory board and the shareholders’ meeting.

aa) Management Board

The management board is responsible for the management of the company. The authority of the management board to represent the company may not be restricted vis-à-vis third parties. In addition, the management board is not subject to instructions from the shareholders’ meeting or the supervisory board. However, the articles of association may impose certain restrictions on their powers of representation (internally, i.e. vis-à-vis the company), by decision of the supervisory board or the shareholders’ meeting and by the rules of procedure of the management board, if any.

The members of the management board are appointed by the supervisory board for a term not to exceed five years, with dismissal only possible for cause.

bb) Supervisory Board

The members of the supervisory board are elected by the shareholders’ meeting, unless employee representatives are delegated to the board according to mandatory codetermination law. As a general rule, if an AG has more than 500 employees, one third of the board shall consist of employee representatives, and if it has more than 2,000 employees, half of the supervisory board members shall be elected by the employees (see 1.g) above). The supervisory board shall, in particular, supervise the management board and is competent for the (internal) consent to certain operative measures.

cc) Shareholders’ Meeting

The shareholders’ meeting shall resolve on all matters expressly attributed to it by law or the articles of association. The shareholders’ meeting is not allowed to instruct the management board with respect to the operative management of the AG unless the management board itself

has requested that a decision be made by the shareholders' meeting. However, according to a doctrine established by the German Federal Supreme Court in its so-called "*Holzmüller*" decision, the shareholders' meeting shall grant its consent to matters relating to the management of the company which materially affect the membership rights of the shareholders, in particular upon the intended sale and disposal of material assets.

c) The German Corporate Governance Code

The German Corporate Governance Code, adopted in 2002, does not constitute statutory law. It contains recommendations and suggestions for German listed stock corporations that aim to make the German corporate governance system transparent and understandable, and to promote the trust of international and national investors, customers, employees and the general public in the management and supervision of listed AGs. The management board and the supervisory board shall declare annually that the recommendations of the Code have been and are complied with, or which of the Code's recommendations have not been or are not applied and why they are not applied (*comply or explain*). Some important recommendations of the Code relate to, *inter alia*, the composition of the overall compensation of members of the management board, reports on the shareholdings in the company held by individual members of the management board and the supervisory board, and the information of shareholders and third parties during the fiscal year by means of interim reports.

Even if the Code does not constitute statutory law, according to a decision of the German Federal Supreme Court, approval given by the shareholders' meeting for the actions of the management board and the supervisory board may be set aside by the court if an incorrect declaration of compliance with the Code has been issued. The court has also noted that, in case certain recommendations of the Code are no longer complied with, the declaration has to be amended immediately.

d) Share Capital, Shares, Sale and Transfer of Shares

The minimum stated share capital of an AG amounts to EUR 50,000. The minimum nominal amount per share is EUR 1.00. The creation of preference shares is possible. The shareholders' meeting may resolve upon an authorized or contingent capital.

In contrast to the law governing the GmbH, the sale and transfer of shares in an AG does not require a specific form. According to the articles of association, however, the transfer of registered shares – as opposed to bearer shares – may be subject to the consent of the company. Consent is generally granted by the management board through consideration of the best interests of the company.

Any actions with respect to the shares in a listed AG must comply with insider trading law. The violation of insider trading directives routinely constitutes a criminal offence.

As set out in F.III.1., certain notification requirements must be complied with for shareholdings in both listed and non-listed companies. A violation of these rules results in a suspension of the respective shareholders' rights, in particular the voting right at the shareholders' meeting.

3. Limited Partnership (KG)

a) General

A German KG consists of at least one general partner and one limited partner. The general partner has personal and unlimited liability for the partnership's debts but generally no participation in the share capital of the KG. He is responsible for the management and representation of the KG. Limited partners are not liable for the partnership's debts once they have paid their subscribed capital contributions committed to be registered with the commercial register. Prior to payment, the liability is capped at the agreed and registered contribution amount. Unless otherwise agreed, limited partners are excluded from the management and representation of the KG. They are generally only entitled to receive certain relevant information relating to the annual financial statements and have the right to object to the general partner's decisions only to the extent that they go beyond the ordinary course of business.

b) GmbH & Co. KG

It is legally permissible and very common to implement a GmbH as general partner, offering the opportunity to investors to manage the KG via a GmbH, thereby avoiding the risk of personal liability as general partner. Thus, investors can benefit from the advantages offered both by a KG and a GmbH.

c) Partnership Limited by Shares (KGaA)

The legal form of a German KGaA is a combination of a KG and an AG (see 2. above). As with an AG, the limited partnership interests are shares that can be traded via stock exchanges. The minimum share capital of the KGaA amounts to (in total) EUR 50,000. Similarly to a KG, the shareholders of a KGaA are divided into limited and general partners. Thus, except for some special provisions in the Stock Corporation Act (AktG) for a KGaA, the general provisions of the AktG for an AG and the provisions of the German Commercial Code (HGB) for a KG apply.

4. Other Partnerships

a) Silent Partnership

Silent partnerships are advisable for investors intending to invest and participate in a company without disclosing their participation to third parties.

In the absence of detailed legal regulation, the internal relationship between the silent partner and the company is to be agreed upon by the partners of the silent partnership in the silent partnership agreement. The agreement typically provides for certain funding obligations of the silent partner in exchange for participation in the profits of the company. Statutorily, the silent partner does not have any managing rights (*typical* silent partnership). However, such (internal) managing rights may be stipulated in the silent partnership agreement (*atypical* silent partnership).

In relation to third parties, the company is managed by the non-silent partners only. The external legal structure of the silent partnership is therefore similar to a (subordinated) loan.

b) Public Private Partnership (PPP)

In PPPs, private investors and public bodies cooperate to develop, operate or maintain certain long-term projects. Infrastructure projects like the building of highways (e.g. the *Autobahn*), toll charge systems, waste management or waste water disposal are typical examples for *PPPs*.

PPPs in Germany are not governed by any specific statutory law. As a consequence, PPPs require detailed written joint venture contracts. Generally, but subject to the contractual agreement between the parties, the private investor is responsible for planning, establishing and financing the project. In exchange, the private investor gains access to new business areas generally engaged by the public sector.

5. European Companies

In addition to the aforementioned national legal entities for the incorporation or establishment of a business in Germany, one legal form based on European law has become available in the member states of the European Union (EU) and the European Economic Area (EEA), notably the SE. Another supranational form of entity, the SPE, has not yet been agreed upon at the European level.

a) European Stock Corporation (SE)

The European Company (denoted by its Latin name Societas Europaea, abbr. *SE*) is a European AG. The legal framework of the SE is based on Community law directly applicable in all EU and EEA member states as well as – on a larger practical degree – on the respective relevant national legislation enacted to implement the SE in the different jurisdictions. An SE can be incorporated in five ways:

- merger of two stock corporations;
- incorporation of joint holding SE;
- incorporation of joint subsidiary SE;
- conversion of German stock corporation; and
- incorporation of an subsidiary SE by another SE.

An SE can thus be used as a vehicle for cross-border mergers, since it may be established by way of merger of two or more companies in different EU/EEA member states. However, since the European Directive on Cross-Border Mergers was implemented in Germany in 2007, certain corporations existing under German law may also directly be merged with entities in other EU/EEA member states.

The SE provides two different corporate governance systems and allows for more flexibility with respect to employee participation (each see below). The SE has the following main features:

- Once registered, the SE has legal personality.
- An SE is required to have a minimum amount of subscribed share capital of at least EUR 120,000.
- The shares of an SE can be traded on a stock exchange.
- The registered office of the SE and its head office, meaning the place where effective control of the SE is exercised and the management of the SE is situated, must be in the same EU/EEA member state, but may be moved from one member state to another without the SE being dissolved or wound up. However, an SE must offer those shareholders objecting the move across the border to acquire their shares against equitable compensation in cash.

- The articles of association of an SE can either provide for a one-tier-corporate-governance-system with an administrative board which is responsible for both, the management, including the election of managing directors, and the supervision of the affairs of the company, or a two-tier structure consisting of a management board and a supervisory board like in a German AG (see 2.b) above).
- An SE is not subject to national employee participation or co-determination law. Instead, employee participation and co-determination is – subject to certain limitations – governed by an agreement between the management and the employees, represented by a so-called *Special Negotiating Body*. The negotiations are mandatory part of the process of establishing an SE and a prerequisite for its registration.
- An SE must be treated by the EU/EEA member states as if it were an AG, i.e. laws applicable to an AG in the member state where the SE is registered, in Germany in particular the Stock Corporation Act (AktG), are applicable to the SE, unless the EU regulation or the national implementation laws provide otherwise.

The administration and management, shareholder rights and corporate governance of a *German* SE are primarily governed by its articles of association and by national statutory laws. In essence, German laws have more of a practical influence on the governance of an SE than the European legal framework.

b) European Private Company (SPE)

As of June 2008, the European Commission intends to implement a European GmbH (denoted by its Latin name Societas Privata Europaea, abbr. *SPE*) for the medium-sized businesses. Contrary to the SE, with only few exceptions, the SPE shall be entirely governed by European Community law directly applicable in all EU/EEA member states. This is expected to significantly facilitate cross-border business and reduce costs and complexity normally associated with setting up and maintaining a business in another member state.

However, since June 2008, the legislative process on this matter has been stalled. Neither the draft legislation of the European Commission nor the compromise proposed by the Hungarian EU-Presidency in 2011 have been agreed upon. Some member states fear interventions in certain national interests governed by its statutory laws on a GmbH. It is therefore not clear if and when the SPE will, in fact, become available.

6. Joint-Ventures (JV)

Two or more enterprises can cooperate in the form of a JV. Reasons for the establishment of a JV can be that a participant of the JV is seeking access to a new market or has very special know-how which is of great interest to the other JV partner. Usually, both JV partners benefit from the cooperation.

JVs can appear in various forms. In the case of a contractual JV, the cooperation is only based on bilateral agreements without forming an independent organization. Such JV agreements can be entered into by any legal entity regardless of their legal form. The contractual JV is preferably used for specific projects or a time limited cooperation. The parties to the contractual JV agreement should be cautious not to form a partnership (GbR) to prevent its several and joint liability. In the case of an equity JV, the partners of the JV set up a single-purpose vehicle for their collaboration. Such entity often adopts the legal form of a German KG or a GmbH, rarely

an AG. An equity JV is usually accompanied by an agreement between the involved entities regulating their relationship regarding the new established legal entity, in particular with respect to the financing of the JV, share transfers and exit related rights. A JV may be subject to German or European antitrust laws and merger control.

III. Acquisition of Real Estate

1. Description of and Title to Real Estate

a) Cadastral Map

In Germany, land is registered both with the land survey office and the land register. Therefore, a title search is quick and reliable.

Every piece of land is divided up into cadastral plots. Each piece of land consists of at least one cadastral plot but may consist of several. Each cadastral plot is given a corresponding plot number and is registered with the land survey office. The cadastral map contains valuable information on the exact boundaries, the cut and the location of the cadastral plots. It is also important to examine the cadastral map to ensure the property is accessible by public roads. In addition, the cadastral maps contain information on the existing development and superstructures, i.e. buildings crossing the boundaries.

b) Land Register

The cadastral plots are also registered in the land register. The land register is maintained at the local courts. It is divided up into an inventory and three sections. The inventory contains the plot number. Section 1 contains information on ownership of the plot of land, i.e. the owner or, in case of several co-owners, the shares of the co-owners, and sometimes notes of registrations of easements in favor of the plot of land. Section 2 contains encumbrances, including easements, limited personal easements, usufructs, priority notices (of conveyance) and restraints on disposal such as heritable building rights (see 2.d) below). Section 3 contains the liens such as mortgages, land charges and annuity land charges. The rights registered in the land register have different priorities/ranks. Generally, the priority of the rights depends on the time of their registration, i.e. the older right is ranked higher than the more recent right.

c) Good Faith

Anyone may rely on the content of the land register in good faith and is protected to the extent that the content of the land register is considered to be correct, regardless of its actual correctness. Therefore, it is possible to acquire land from the owner registered in the land register even if he is not the true legal owner. Further, encumbrances that are not registered in the land register are generally deemed as nonexistent vis-à-vis a purchaser. This leads to great transparency and makes real estate transactions reliable and safe.

Unlike the commercial register, the land register can only be inspected online by a notary public. Furthermore, in order to receive information from the land register a valid interest must be demonstrated. However, the purchaser of a real estate property generally has such valid interest. Cadastral maps are publicly available (and in some municipalities even online).

2. Types of Ownership in Real Estate

Every person and every public or private legal entity (e.g. German federal states, cities, municipalities, stock corporations or limited liability companies, as well as registered

partnerships or private partnerships) may be the owners of land. There are different types of real estate ownership.

a) Sole, Co- and Joint Ownership

The most common form of ownership is sole ownership, i.e. one person or company owns a piece of land. Where land is owned by several persons or companies, they are co-owners or joint owners. In the former, more common case, every co-owner has a share of the property to a certain fraction, e.g. one half. Each co-ownership share can be sold and encumbered separately and generally without the consent of the other(s). In case of joint ownership, each owner owns the whole land jointly with the other owner(s) and is therefore restricted by the rights of the other owner(s). The whole piece of property can only be sold and encumbered by all joint owners, but not separately.

b) Buildings and Other Components

Ownership of land includes all objects firmly attached to the land, e.g. buildings and garages (as to the exception of a heritable building right, see 2.d) below). The premises attached to the land consist of all components used for their construction. Under certain circumstances this can include the fixtures and fittings of a building, if they were customized to the building structure, if they form a unity with the building and they have considerable impact on the appearance of the building as a whole. The sale of real estate thus regularly includes the building located on it. By contrast, in the newly-formed German states (Brandenburg, Mecklenburg-Pomerania, Thuringia, Saxony, Saxony-Anhalt) and the eastern part of Berlin before 1990, usually ownership was only procured for buildings, whereas the land on which it was located was simply leased. This regulation was continued after reunification of the German states, so this concept of independent ownership of buildings still exists in Eastern Germany.

c) Condominiums

aa) General

German law also acknowledges the individual ownership of condominiums, which can also include the right to the exclusive use of parking spaces, cellars or balconies. The individual ownership of the condominium itself includes the co-ownership of all commonly used spaces in the condominium building. This co-owned common property embraces the land itself, as well as all those sections and facilities of the building that are not subject to individual ownership. A fund for maintenance work is created for the maintenance of the common property which is not refunded upon the sale of the condominium.

bb) Conversion into Condominium

To convert a property into condominiums and common property a notarized partition deed must be drawn up containing a description of each apartment and colored plans of the building illustrating the individually owned condominium spaces. Generally the ratio of co-ownership of the common property corresponds to the ratio of the individually owned condominium space in relation to the whole building, but may alter due to subsequent expansions within the building, e.g. in the attic. Such conversion requires a governmental certificate confirming separated units. Each condominium is individually recorded in a separate folio in the land register (condominium land register) and is henceforth, with respect to the applicable law, independent of other condominium property on the same site.

cc) Transfer

Like land, a condominium is independently transferrable and can be independently charged or otherwise encumbered. Likewise, a foreclosure sale does not affect other condominiums. The sale of the condominium can, however, under certain circumstances require the approval of other condominium owners on the same site or of the building administrator.

d) Heritable Building Right

Finally, heritable building rights can be created under German law. A heritable building right entitles one to build and own a building on a piece of land (or below ground, e.g. underground parking) for a certain period of time, e.g. 99 years. The building is considered an integral part of the heritable building right and not of the land. Heritable building rights are often used by municipalities or the Church in order to retain ownership of land while receiving an annual ground rent, usually 4 to 5 % of the value of the land per year. Like rent, ground rent can be subject to indexation, i.e. increase in accordance with a certain index such as the consumer price index. A heritable building right is created by way of a contract between the owner of land and the beneficiary and has to be registered in the land register (see 1.b) above). Moreover, a separate folio, the heritable building right register, is created in which the beneficiary of the heritable building right is registered as the owner of the heritable building right. Like land, the heritable building right can be sold and purchased and may be encumbered with easements and charged with land charges. However, the owner of the land will usually reserve the right to approve such transactions, i.e. prior consent is required for any transaction. Upon the expiration of the heritable building right, the owner of the land automatically becomes the owner of the building and therefore has to pay compensation to the beneficiary. Lease agreements concluded by the beneficiary automatically devolve to the owner of land. It is also possible to agree on a right to acquire the land in favor of the beneficiary.

3. Encumbrances and Charges

a) Priority Notice

A priority notice secures the enforcement of a claim relating to a property, e.g. the right of conveyance. It is recorded in the land register (see 1.b) above) and has, at that point in time, the immediate effect of invalidating any subsequent transaction concerning the same plot of land to the extent that the beneficiary's claim would be impaired. It thus preserves the priority of the beneficiary's position over any right with respect to the estate which was created subsequent to the beneficiary's own claim. Any dispositions by way of foreclosures, distress warrants or insolvency proceedings, as well as any contractual dispositions made by the seller, are invalid vis-à-vis the beneficiary to the priority notice. In case of insolvency of the seller, such priority notice will entitle the purchaser protected by such priority notice to claim performance despite the insolvency proceedings without being subject to an insolvency quota. Consequently, German purchase agreements regularly stipulate that the purchase price shall not be due before the priority notice of conveyance has been registered in the land register.

b) Easement

An easement obliges the owner of the encumbered plot of land to tolerate specific conduct by someone else (the beneficiary of the easement) on his or her plot of land or to refrain from specific conduct on the plot of land for the benefit of someone else. The easement may be

registered in favor of and restricted to a certain person/company, a limited personal easement, e.g. a tenant's right to run a retail store or a permanent right of residence. More often, easements are registered in favor of the respective owner of a plot of land, e.g. to secure a right of way or a pipe way leave. Since easements have a material impact on the value of a property because they restrict the right of use or secure an adequate use of the property, all existing or required easements should be reviewed in the course of due diligence.

c) Usufruct

A usufruct on a plot of land entitles the beneficiary to possess the land and to take the emoluments of the land and accessories, e.g. rent payments.

d) Charge on Land

A plot of land may be encumbered in such a way that recurring acts of performance are to be made from the plot of land to the person in whose favor the encumbrance is created (charge on land). It is possible to agree as to the content of the charge on land that the acts of performance to be made are adjusted to changed circumstances without notice if, based on the requirements stipulated in the agreement, the type and scope of the encumbrance of the land can be determined. The charge on land may be created in favor of a certain person/company or the respective owner of another plot of land. Often, a charge on land is created to ensure that credit facilities are repaid which were concurrently agreed upon between the parties.

e) Other Land Charges

German law provides for a number of security interests in real estate. The most important security interests are mortgages and land charges, the difference being that the mortgage secures a specific debt and the land charge does not, for which reason the land charge is the preferred security interest in most transactions. They both give the beneficiary (primarily banks) the right to collect a specific sum of money by way of a forced sale or forced management of the encumbered plot of land. The transferability of a mortgage/land charge can be increased by the creation of a certificate.

4. Transfer of Title and of Leases

A peculiarity of German law is that, in addition to the purchase agreement, a special agreement regarding the conveyance itself is required. Usually this agreement is included in the purchase agreement, i.e. seller and purchaser agree that the title of property shall pass from the seller to the purchaser (see B.IV.).

If the agreement regarding conveyance is concluded separately from the purchase agreement, it must be notarized like the purchase agreement itself. However, the agreement regarding conveyance must be concluded before a German notary in the physical presence of both parties, whereby either party may be represented by an agent. It can only be unconditional and must not contain any sort of time limit (however, this stipulation does not apply to the purchase agreement). The entire agreement, including the agreement regarding conveyance, is valid only if the seller is the owner with unrestricted authority to dispose or a third person with authority granted by the unrestricted owner. If the seller does not have the authority to dispose, the purchaser can only acquire the title if the seller is registered as owner in the land register and the purchaser acts in good faith (see 1.c) above).

The conveyance will only become effective upon its registration in the land register, which may take a long time. However, the parties may enable the purchaser to use the property as soon as possible. It is thus common practice in real estate transactions to agree that the economic ownership (*transfer of possession*) will be passed on earlier, irrespective of the registration of ownership in the land register, but generally not before the registration of a priority notice of conveyance (see 3.a) above) and the payment of the purchase price. This includes, inter alia, the right to collect rent.

The legal transfer of the lease agreements from the seller to the purchaser, however, will occur by operation of law upon the registration of the purchaser in the land register. However, this automatic transfer only applies in case the seller, owner of the real estate and landlord under the lease agreement are identical. If not, it is not sufficient to agree upon the transfer in the purchase agreement. Rather, an agreement between all three parties involved – purchaser, seller and tenant – is required. In case a lease agreement has been concluded but the premises have not yet been handed over to the tenant, the purchaser has to assume all obligations of the landlord in the purchase agreement in order to ensure a transfer of the lease. As the purchaser assumes all obligations of the landlord, including the liability for any deposit made by the tenant, it should be ensured that all deposits are in fact transferred to the purchaser.

IV. Acquisition of Leveraged Loans

1. Attractiveness

Despite the recent strong improvement in the German economy, some portfolio companies of private equity investors are still suffering from the credit crunch or over-leveraging in the pre-crisis years as the economy slows. Those are prepared to or have no alternative but to breach the financial covenants of the facility agreements, even if they struggle to find new lenders for necessary refinancing. As a consequence, the prices of leveraged loans of these companies fall well below par. This, on the other hand, attracts investors to acquire leveraged loans.

2. Necessity of Banking License

According to the German Banking Act (KWG), the acquisition of a leveraged loan does not necessarily require a banking license, so that even private equity funds may generally purchase the loans of their portfolio companies. A banking license is only needed if an entity carries out *credit business*, i.e. inter alia, professional loan granting. The acquisition of leveraged loans, the facility repayment and/or the enforcement of claims as such do not constitute a *credit business*. However, this might be different in the case of refinancing a loan, if the acquisition also comprises unused commitments or if a facility agreement gives the lenders certain ancillary rights, e.g. determination of new interest rates. Therefore, it is advisable to examine in each individual case whether a banking license is required in connection with the acquisition of a leveraged loan.

3. Transfer of Loans

Under German law the transfer of a loan does not have to meet any specific formal requirements, i.e. a loan transfer agreement can be signed on the parties' private capacity without notarization. The transfer of a loan, however, should always be indicated to the borrower in order to avoid his making payments to the transferor with debt discharging effect.

4. Assignment Clause

Another legal aspect concerning the acquisition of a leveraged loan is the assignment clause in the facility agreement. Does the assignment clause permit the assignment of the lender's rights arising from the facility agreement to the respective acquirer of the leveraged loan? In this respect, some facility agreements restrict the potential circle of acquirers to banks and financial institutions and expressly exclude any funds or other such entities. Further, many facility agreements require the consent of the company to the change of lender.

5. Specialties

If the acquirer of a leveraged loan is simultaneously a shareholder of the borrower and the lender, two main issues arise from a German legal perspective: first, the subordination of any repayment claims of the acquirer arising from the facility towards other creditors in case of borrower's insolvency and, second, the conflict of interest as the shareholder will be both owner of the borrower and its creditor.

a) Subordination

According to German insolvency law, any outstanding shareholder loan or similar contribution is always a subordinated insolvency claim and the repayment of any shareholder loan or similar contributions within the time period of one year before or after insolvency proceedings are filed can be reclaimed by the insolvency administrator. Since this rule also applies to a loan which a shareholder has acquired from a third party, an investor must always be aware of his subordinated position in case of the insolvency of the portfolio company. However, the aforementioned rules do not, inter alia, apply to shareholders holding less than 10 % of the registered capital of the borrower.

b) Conflict of Interest

If the leveraged loan was granted by a syndicate and the shareholder only acquires a part of the facilities granted to the portfolio company, the shareholder might encounter a significant conflict of interests to the possible disadvantage of other creditors: On the one hand, the shareholder represents the owner of the borrower and, on the other hand, it is part of the syndicate. Due to this conflict of interests, there is a material risk that the shareholder´s voting rights in the lenders' syndicate might be withdrawn under German law. Facility agreements sometimes even expressly provide for the disenfranchisement of the acquiring sponsor or sponsor affiliate for voting purposes.

B. Transaction Procedures

I. Acquisition Procedures

Sales processes in Germany are typically set up as a private sales process or an auction process. In both cases, the seller must be well-prepared prior to starting a transaction process with one or more potential purchasers. This includes the prior identification of risks and opportunities, as well as the feasible repair of identified deficits. In some cases, the seller decides to carry out its own vendor due diligence to obtain the aforementioned information about the target company in preparation for the upcoming transaction and to speed up the intended sales process.

1. Private Sales Process

a) Typical Procedures

A private sales process is characterized by a sales process with only one potential purchaser. In Germany, a private sales process typically begins with a letter of intent/memorandum of understanding between seller and purchaser with respect to the intended purchase of the company, which is essentially non-binding (see II.2.a) below). However, the potential purchaser is interested in negotiating a binding exclusivity period prior to starting its costly due diligence work. After signing a separate confidentiality agreement or, respectively, a confidentiality clause within the letter of intent or the memorandum of understanding, the potential purchaser obtains the possibility to execute due diligence, including an interview with the management of the target company. After scrutinizing the company, the parties negotiate a sale and purchase agreement on the basis of the terms agreed upon in the letter of intent/memorandum of understanding, appropriately modified by the findings from the due diligence process and the management presentation.

b) Disadvantages for Seller

The option for the seller to sell its company by means of a private sales process bears two major disadvantages for the seller:

- On the one hand, the seller is typically not in the position to facilitate the sale of its business at the highest price on the best possible terms due to the simple fact that there is no market and therefore no market price determined by supply and demand.
- On the other hand, the acquisition process is necessarily terminated if the only existing potential purchaser decides, for whatever reason, to terminate the negotiations with the seller. Furthermore, a broken deal leads to reduced market value of the target company (following a failed transaction the market assesses the target company as *shelf warmer*) at least for a short/medium-term.

c) Advantages for Seller

- Only one potential purchaser will receive confidential information on the target company.
- However a private sales process may be less expensive than and not as time-consuming as the execution of an auction process with respect to the generated transaction costs.

2. Auction Processes

a) Typical Procedures

An auction process is quite common in order to achieve a higher price by generating higher demand with multiple potential purchasers. Consultants (e.g. a M&A consultant or an investment bank) provide their business contacts to many potential financial and/or strategic bidders and prepare a company teaser describing the company to be sold in general without disclosing any individual information identifying the target company. In case potential bidders are interested in obtaining more information about the target company through receipt of an information-memorandum, they must first sign a separate confidentiality agreement/non-disclosure agreement. At the same time, the seller and its consultants have completely assembled the (in most cases virtual) data room with all available information on the target company (see III.5. below). All potential bidders who are interested in purchasing the company are invited to submit a non-binding offer letter containing a first proposal for the purchase price and answers to specific questions requested by the seller. The seller is particularly interested in how the respective bidders are financed and how they can secure the purchase price. The seller then decides to grant a limited group of potential purchasers access to the data room and to the management of the target company in this second phase of the process. After execution of the due diligence and interviews with the management have been conducted, all further interested potential bidders are invited to submit a final (but also typically non-binding) letter. After evaluation of all final offer letters and comments on the sale and purchase agreements, the seller decides which potential bidders will proceed to the third phase of the auction process. Those potential purchasers will have the opportunity to negotiate the respective sale and purchase agreements with the seller. Sometimes, bidders request an exclusivity period during this last phase to enhance their position.

b) Disadvantages for Seller and Purchaser

The auction process is a very time-consuming and costly process. The seller often has to negotiate two sale and purchase agreements simultaneously at the end of the last phase of the auction process. Due to the existing demand among the potential purchasers, each purchaser has to figure out which purchase price and which amendments to the sale and purchase agreement are essential to obtaining the target company.

II. Getting Started

1. Information-Memorandum

In an auction process potential bidders receive the first detailed information on the target company upon receipt of an information-memorandum (after signing a non-disclosure agreement and often after receipt of a first transaction teaser). The information-memorandum generally contains commercial, financial, legal and tax-related facts on the company. The business description and the organization of the target company are the most important pieces of information for the purchaser. Typically, the information-memorandum is prepared by the seller together with its consultants (e.g. M&A consultant or investment bank).

2. Preliminary Agreements

a) Letter of Intent/Memorandum of Understanding

The letter of intent and the memorandum of understanding are instruments used to bring together the seller and potential purchaser in a private sales process. Those (sometimes only one-sided) declarations are typically the first written documents in which the seller and potential purchaser announce their initial intention with regard to the execution of the transaction and their current negotiation results. Most statements made in a letter of intent or memorandum of understanding are non-binding, unless explicitly stated otherwise.

Such letter of intent or memorandum of understanding often contains a few explicitly binding clauses regarding the granting of a period of exclusivity, including legal consequences in case of a breach, a confidentiality clause, clauses dealing with the payment of costs in case of a broken deal (e.g. break up fees or reimbursement of expenses) and non-solicitation and non-competition clauses.

b) Confidentiality Agreement/Non-Disclosure Agreement

Irrespective of whether it is a private sales process or an auction process, the seller is interested in having an extensive confidentiality agreement with the potential purchaser or bidder. The confidentiality agreement protects the seller and the target company against any transfer of information resulting from the potential purchaser's access to all transaction documents (in particular to the documents in the data room). Within this context, it is important for the seller to define special terms for the confidential information, the purpose of the disclosure, as well as the disclosure and receipt of information. At the end, the seller is well advised to actually disclose information only on a need-to-know basis and only step by step depending on the importance of such information for the

- business to be sold; and
- potential purchaser, bearing in mind the position of this purchaser in the business market (e.g. in case the seller is a strategic investor acting on the same or similar markets as the target company). Critical information (e.g. agreements with customers showing the margins of the target company) are only disclosed shortly before or at the signing, or to a (neutral) third party bound by law to maintain confidentiality.

III. Due Diligence

1. Purpose of a Due Diligence

Due diligence is an investigative process designed to evaluate the commercial, financial and legal situation of the target company. The extent of the process varies from case to case depending on the type of company being acquired. By conducting a due diligence investigation, the potential purchaser of a business attempts to reveal all material facts and identify any material risks associated with target's business. On the basis of the findings of the investigation the potential purchaser will decide whether to complete the transaction and how to structure it. Moreover, the findings of the investigation have a bearing on the documentation to be negotiated, e.g. the purchase price and seller's representations and warranties. Finally, due diligence provides the purchaser with information of the target company significant for post-closing integration measures. Pursuant to German case law, the seller is obliged to fully disclose

all essential facts which may have an impact on the potential purchaser's decision on whether to complete the acquisition or refrain from it.

Most due diligence processes are initiated by the potential purchaser. However, the number of vendor due diligence processes, i.e. the seller and his advisors conducting due diligence on the target company, has increased in recent years. The advantages of conducting vendor due diligence for the seller can be considerable. Foremost, it gives the seller the chance to identify and react to any issues, which may have an impact on the value of the assets about to be sold before the sale process has started. In addition, the preparation of the vendor's own due diligence report may also save precious time, in particular in a tightly scheduled auction process.

2. Components of a Due Diligence

Usually, the due diligence investigation consists of financial, legal, tax and commercial elements. Depending on the business of the target company, the due diligence process may also cover environmental examinations, technical issues, human resources and/or insurance issues. In general, due diligence is carried out by the potential purchaser himself and his legal, tax, commercial and financial advisors and – if applicable – other consultants.

3. Focus of Legal Due Diligence

The topics of legal due diligence may vary from transaction to transaction. However, the scope of legal due diligence generally includes corporate and commercial legal documentation of the target company, financing of the target company, material contracts (in particular leases and agreements with suppliers and customers), human resources, real estate, intellectual property and information technology, litigation, public affairs, environmental issues and insurance policies.

4. Focus of Tax Due Diligence

Tax due diligence is conducted to obtain information on tax risks at target company level which might (e.g. in the course of a subsequent tax audit conducted by German authorities) result in a tax burden of the target company or the purchaser. Such tax issues are not only relevant in the course of a share deal, but also in an asset deal where the purchaser may – under certain circumstances – become liable for business taxes on the assets. Moreover, tax due diligence provides details on the target company in respect to a tax-efficient acquisition structure, as well as post-acquisition reorganization.

5. Due Diligence Process

As outlined above, the due diligence process is usually conducted in cooperation with several participants, such as the management of the target company, external financial advisors, lawyers, tax advisors and other consultants. The due diligence investigation inevitably exposes conflicts of interest between seller and potential purchaser. For obvious reasons the seller does not want to disclose detailed information about the target company before being certain that the potential purchaser will actually complete the acquisition, while the purchaser typically requests comprehensive disclosure of all relevant information and documentation about the target company at an early stage of the due diligence process. To satisfy both sides, in most auction processes only basic information is provided in the beginning, with more confidential information to be disclosed at a later stage to the shortlisted bidders. However, regardless of whether the transaction is executed as a private sales process or an auction process, a successful due

diligence process always requires the close cooperation of every party involved, including the management and the key personnel of the target company.

The information disclosed by the seller is usually presented in a virtual data room. Such a virtual data room easily enables international networking and collaboration among the potential purchaser and his advisors. Generally, the consultants (in particular tax advisors and lawyers) prepare request lists tailored to the specific transaction and due diligence questionnaires to be delivered to the management of the target company. The requested material is then presented for review in the data room.

6. Due Diligence Report

Depending on the potential purchaser's demand, legal due diligence may either result in a comprehensive due diligence report or a red flag report. A comprehensive due diligence report describes the documents reviewed by the advisors in detail. It also includes an executive summary that concentrates on the material risks and legal issues that may have an impact on the final bid, the preparation and negotiation of the sale and purchase agreement, as well as on the structure of the envisaged transaction. Contrastingly, a red flag report does not describe each disclosed document in detail, but rather summarizes the legal material risks and issues relevant for the terms, the structure and the completion of the acquisition, as well as for post-closing measures.

In principle, a due diligence report is primarily prepared for the client. The report may only be used for the envisaged transaction and may not be circulated to third parties without the prior approval of the respective advisor. In case of a leveraged transaction, the financing bank usually also requests a due diligence report before providing necessary funds to the purchaser. Commonly, the bank requests that a due diligence report prepared for the purchaser is forwarded for review rather than to entrust its internal and/or external advisors to conduct a due diligence on the target company. Permission to forward the due diligence report to the financing bank is typically provided in a reliance letter concluded between the advisor and the financing bank.

IV. Sale and Purchase Agreement (SPA)

1. *German* vs. *Anglo-Saxon* Contracts

Traditionally, commercial contracts under German law are substantially shorter than those Anglo-Saxon investors are used to in their own jurisdictions. To a certain degree, this also applies to SPAs in the mergers and acquisitions context, although the influence of Anglo-Saxon legal culture has been significant over the past two decades. *Anglo-Saxon style* SPAs are most frequent (and have become the market standard) in large and mid-cap private equity transactions, where the need for international syndication of debt or equity instruments has a strong impact on market practice. On the other hand, comparatively short "German style" documents continue to prevail in many all-equity-financed transactions (even very large ones) and in many transactions involving typical German medium-sized companies, as well as most transactions involving insolvency receivers. Or, as the CEO of a German corporation wishing to make a mid-cap acquisition stated when confronted with the seller's five-page *German style* SPA draft: "We only use this type of contract for the very small and for the very big acquisitions."

2. Relevance of Statutory Law

The brevity of German-style documentation should not be misread as sloppiness. Rather, it should be noted that most key areas of German corporate and contract law are dominated by extensive statutes such as the German Commercial Code (HGB), first enacted on May 10, 1879, and the 2,385 sections of the German Civil Code (BGB), most of which date back to January 1, 1900. Statutory law makes many of the definitions and much of the explanatory language of Anglo-Saxon style contracts redundant (or in many cases even misleading) under German law. On items like remedies for violation of warranties, calculation of damages, contributory negligence and the like, German contracts often rely on statutory law (including long-standing case law interpreting it). On the one hand, this makes German contracts shorter and easier to read than their Anglo-Saxon counterparts; on the other hand, the wording of the contract sometimes gives little guidance on practical handling issues as the wording is to be understood within the context of statutory law and general legal principles (which may or may not be known to the person actually dealing with the execution of the contract).

3. Interpretation of Contracts; Substance over Form

Principles of interpretation of contracts under German law differ substantially from common law principles. In particular, the purpose and intention of a clause is often predominant in interpretation (with results which may even be contrary to the wording, if taken literally). This explains why *boiler plate* language such as headings being for reference only, masculine terms including the feminine, plural including the singular, etc. are missing in typical German SPAs. In many cases, the parties choose German law but use English as the language of the contract. This requires great care by the lawyers involved because many standard terms in English-speaking M&A practice, such as "representations and warranties", "best knowledge" and the like, are by no means identical to the usual German counterparts or are ambiguous under German law. Such terms need to be clearly defined in the agreement in accordance with categories of German law.

4. Notarization Requirements and Fees

A peculiarity of German law is the importance of notaries public in transactional practice. Any German law agreement involving the transfer of GmbH shares or real property must be notarized. This means that the entire document, including any ancillary agreements related thereto and including any exhibits that, are substantially part of the agreement (other than lists and tables, to which an exception applies) must be read aloud by or in front of the notary. Therefore, allow a whole day for *signing* of a detailed German law SPA containing many exhibits! Foreign investors often avoid this by sending their German lawyers with a power of attorney. Note that for some purposes (such as capital increases in GmbHs and real estate purchases) the power of attorney itself needs to be notarized.

German notary fees are governed by a mandatory, non-negotiable fee schedule and are calculated on the basis of transaction value. Accordingly, they range from EUR 15 (e.g. for the notarization of a 200 page SPA involving the purchase of a heavily indebted GmbH for EUR 1.00) to a maximum amount of approximately EUR 55,000 (at a transaction value of EUR 60,000,000 or more, even if the SPA is only five pages long). Notary fees are customarily borne by the purchaser. In order to avoid the costly German notary fees, parties used to *flee* to Switzerland to have SPAs notarized by Swiss notaries (who are allowed to negotiate fees in

accordance with the actual work load and usually charge only a fraction of the German fees). Note that this practice is impossible for real estate transactions (for which notarization by a German notary is mandatory for the transfer of ownership) and has become less common with regard to GmbH shares following certain amendments of the GmbHG in November 2008.

5. Substantive Standards and Market Practice

In substance (although often not in style and wording), German law SPAs are similar to standards used elsewhere. When reading German SPAs, foreign investors may be confused by the distinction between the sale and the transfer which are described as two separate transactions. The *sale* constitutes the obligation to *transfer* the share while the transfer constitutes the actual passage of title. The same applies for the sale and the conveyance of property (see A.III.4.). The transfer (but not the sale) is usually subject to the condition precedent of payment of the purchase price. In cases in which antitrust filing requirements apply, the transfer (but not the sale) must be subject to antitrust clearance. A typical German SPA contains the sale as well as the transfer, but the transfer may be subject to certain closing conditions. A *German closing* therefore consists of mutual acknowledgements regarding satisfaction of such conditions, but no actual instrument on the transfer of title is executed upon closing.

Note that, under German law, only an AG may issue share certificates; titles to GmbH shares or KG interests pass by virtue of the agreement only, which is unusual for many foreign investors and makes them feel somewhat uncomfortable given that, as a matter of law, neither entries in the commercial registry nor a chain of previous transfers evidenced by notarial deeds inspected in legal due diligence constitutes conclusive evidence of share ownership in a GmbH. Amendments to the GmbHG enacted in November 2008 have improved the status of bona fide purchasers relying on the share register, which can be inspected online in the commercial register. A bona fide acquisition is now possible if the alleged owner has been registered as owner for at least three years, and no objections have been filed against such registration.

As in any jurisdiction, purchase price and adjustment clauses are core elements of the SPA. Since the beginning of the subprime crisis in 2007, net financial debt and working capital adjustments as of closing had become more frequent and *locked box* schemes (with fixed purchase prices determined on the basis of past figures and purchasers being protected only by restrictive covenants between signing and closing) had been on the retreat. In current (2013) transaction practice, both types of purchase price concepts are about equally frequent.

Representations and warranties are usually as detailed and comprehensive as in most other jurisdictions. During the financial crisis, market standards have changed and more comprehensive warranty catalogues have become standard practice (except in deals through insolvency for which the receiver will not usually give any business warranties at all). In recent years, the standards on warranty catalogues, caps, etc. have developed to a *middle ground* between the extremely purchaser-friendly standards of 2008/09 and the rather seller-friendly standards of the boom years 2005-2007.

V. Public Tender Offers

1. General

A particular way of acquiring control over a listed company is by way of a public tender offer. In cases in which a controlling position cannot be reached merely by the purchase of block holdings in off-market transactions, a public tender offer is often the only viable way of acquiring a majority stake in a listed company without purchases on the open market. In addition, if a private transaction or purchases on the open market cause the acquirer to reach or exceed the threshold of 30 % of the voting rights, an obligation to make a public tender offer will result from the transaction (so-called *mandatory offer*, see 2. below). As a consequence, the acquisition of a listed company is, in practice, often structured as a combination of purchases on the open market, the acquisition of one or more blocks of shares in private transactions, and the issue of a public tender offer.

2. Types of Public Tender Offers

Public tender offers can be made by way of two main types of offers, namely voluntary offers and mandatory offers. Voluntary offers aiming to acquire control over a listed company are so-called *takeover offers*. As opposed thereto, a *mandatory offer* must be made to the outside shareholders upon the acquisition of control in any way other than by a takeover bid, e.g. by an off-market purchase of shares, by way of purchase on the open market, by subscription in a capital increase or by merger.

"Control" is established by directly or indirectly holding 30 % or more of the voting rights. To determine whether the 30 %-threshold has been met, the voting rights directly held by a shareholder and certain voting rights imputed to him must be combined. For example, voting rights which are owned by a subsidiary of the respective shareholder, or voting rights which are owned by a third party for the account of the shareholder, are deemed to be voting rights of such shareholder. In particular, the voting rights of two shareholders who "coordinate" their conduct with respect to the company are added up and imputed mutually to both shareholders, with the exception of agreements in individual cases (*acting in concert*). "Coordination" between two shareholders is deemed to exist in cases in which they reach a consensus on the exercise of voting rights or otherwise collaborate with the aim of effecting a permanent and significant change to the company’s business strategy.

3. Issue of the Offer and Pricing

a) Offer Procedure

Once the bidder has decided to make a takeover offer, or once the 30 %-control threshold has been met, the bidder must immediately publish the decision or announce the fact that the control threshold has been met. Such publication must be made via the internet and via an electronic data dissemination system widely used by credit and financial institutions. Thereafter, as a rule, the bidder has a period of four weeks to prepare an offer document containing the full terms of the offer, and to submit the offer document to the German Federal Financial Supervisory Authority (BaFin) for verification. Upon approval of the offer document by the BaFin, the bidder must immediately publish the offer. The publication marks the beginning of the acceptance period. The acceptance period may generally not be less than four weeks and not more than ten weeks. At certain intervals during and after the expiry of the acceptance period, the bidder must

publish the respective acceptance level. In the event of a takeover offer, in order to protect those shareholders who have not accepted the offer within the regular acceptance period, there is generally a mandatory "extended acceptance period" of further two weeks during which the offer can still be accepted. Upon expiry of the acceptance period or, if applicable, the extended acceptance period, the transaction is settled by way of payment of the consideration for the shares in the target company.

b) Pricing

For both takeover and mandatory offers, the bidder generally has the choice between offering adequate consideration to the other shareholders either in cash or in liquid shares. The consideration must at least be equal to the higher of (i) the highest consideration which the bidder, persons acting in concert with the bidder, or their subsidiary undertakings have, during a period of six months preceding the publication of the offer document, granted or promised for the acquisition of shares of the target company, or (ii) the weighted average domestic stock market price of the shares during the three month period preceding the publication of the bidder's decision to make a takeover offer or of the bidder's attainment of the 30 %-control threshold. However, the consideration is adjusted to a higher price if the bidder, persons acting in concert with the bidder, or their subsidiary undertakings acquire further shares in the target company, either during the acceptance period or by way of an off-market transaction, within one year after the acceptance period, in case the consideration promised or granted for such shares exceeds the value of the consideration specified in the offer. An exemption thereto exists for the acquisition of shares in connection with a statutory obligation to grant compensation to shareholders of the target company, e.g. after the implementation of a domination and profit and loss transfer agreement, or in the case of a squeeze-out of the remaining shareholders.

4. Typical Takeover Strategies in Germany

Both takeover offers and mandatory offers basically follow the same legal regime. An important deviation, however, is that a mandatory offer may not be made subject to conditions, whereas for voluntary offers – and thus also for takeover offers – conditions are generally permissible. In particular, a takeover offer may be made subject to achieving a certain acceptance level. As a consequence, in order to ensure that a certain percentage of voting rights is obtained, bidders will usually make their offer conditional upon tendering the relevant number of shares into the offer. Most bidders try to reach a percentage of at least 75 % of the voting rights. Such majority is required for structural measures of the target company, such as changes to the articles of association, mergers, conversions, domination agreements and profit and loss transfer agreements.

Based on the fact that a mandatory offer cannot be made subject to conditions, bidders will typically try to avoid reaching the 30 %-threshold. The combination of a private transaction of 30 % or more with a takeover offer, subject to a certain acceptance level, is typically achieved by signing the private transaction prior to the announcement of the offer and closing the private transaction after the announcement. In so doing, the purchaser ensures that the offer is not a mandatory offer, but rather a takeover offer with conditions being permissible. In addition, the offer price can be based on the price agreed upon in the private transaction, whereby the risk that the offer may become more expensive due to rising stock prices is mitigated.

As an alternative to a private transaction, it is possible for the seller and the purchaser to enter into an agreement in the form of a so-called *irrevocable undertaking (to tender)*. The seller hereby undertakes vis-à-vis the purchaser – the future bidder – to tender its shares into an upcoming takeover offer. The main commercial difference from a private transaction is that, in so doing, the seller will be amongst the shareholders tendering their shares, and will thus be protected by all rules which are applicable to the offer, most importantly those with regard to any potential price adjustments after the completion of the takeover procedure, as set out above.

After a successful takeover with at least a 75 %-margin of the voting rights, the bidder will be able to take full control of the company, e.g. by way of implementation of a domination and profit and loss transfer agreement, by merger or – if the thresholds of 90 % or 95 % have been met – by way of a merger-related squeeze-out (at 90 %) or a regular squeeze-out (at 95 %) of the remaining shareholders.

C. Acquisition Financing from a German Perspective

I. Introduction

As in other jurisdictions, an acquisition by institutional investors or strategic buyers is also regularly made through an acquisition vehicle. German acquisition vehicles usually have the legal form of a limited liability company (GmbH). Since the acquisition vehicle, which does not have any purpose other than acquiring the target, does not own any assets, it has to be funded by the shareholders with (quasi-) equity (i.e. stated share capital, equity in the form of capital reserves, shareholder loans) and with debt made available by banks or institutional investors (e.g. senior debt, second lien loans, mezzanine debt, high yield bonds) in order for the acquisition vehicle to be able to pay the purchase price to the seller. The ratio of debt to equity depends on the market situation, the volume of the transaction, the strategy and expected rate of return of the investor, the expected capability of the target (group) to service debt and interest from free cash flow, the envisaged rating of the target (group) after the acquisition, and the syndication environment.

II. Financing Process

The financing process for an acquisition financed in addition to the required portion of (quasi-) equity by senior bank debt can generally be divided into three phases: the process usually starts with a term sheet summarizing at least the basic economic terms of the proposed financing. On the basis of the term sheet the facility agreement is prepared, negotiated and signed. On the closing date, after the conditions precedent of the facility agreement have been delivered or waived, the bank (or the bank syndicate) makes the funds available for the payment of the purchase price.

1. Term Sheet

Term sheets can range from short forms of just a few pages summarizing the basic economic terms such as, for example, the types and amounts of the facilities, the interest rates and the maturity profiles to long forms of over 50 pages anticipating almost every detail of the facility agreement such as mandatory prepayments, market disruption, tax gross up, increased costs, representations and warranties, information undertakings, financial covenants, general undertakings, events of default, transfer conditions, conditions precedent and conditions subsequent, transaction security and administration and enforcement of the transaction security. The term sheet often, but not necessarily, forms part of a commitment letter with the arrangers of the facilities setting out the terms and conditions on which the arrangers either agree to arrange the syndication of the facilities on a best efforts basis or commit to an underwriting.

2. Facility Agreements

Facility agreements throughout Europe are generally based on the standard documentation of the Loan Market Association (LMA) in London which is governed by English law. Since 2007, the LMA has also been publishing a German law version which is specifically adapted to the requirements of German law and banking practice whilst otherwise retaining the form and substance of the English law LMA documents. The choice of English or German law as the governing law of the facility agreement as well as the choice of the English or German language

depends on the background of the parties involved, the syndication requirements and the jurisdiction of incorporation of the target (group).

3. Closing

At closing, the bank (or the bank syndicate) makes the funds for which a utilization request has been delivered available for the payment of the purchase price, provided that all conditions precedent of the facility agreement have been delivered or waived. One of the most important conditions precedent is the granting of comprehensive transaction security, such transaction security usually including security over the shares in the acquisition vehicle, in the target company and in (at least the most important) subsidiaries of the target company as well as over the assets of the target company and of (at least the most important) subsidiaries of the target company such as bank accounts, receivables, fixed assets and current assets. If the transaction security documents cannot be signed prior to the closing of the acquisition, the transaction security must be taken as a condition subsequent. As yet only in the context of strategic investors, but, as a consequence of the financial crisis, also in the context of a financial investor, lenders also frequently expect security in the form of payment guarantees from the respective investor itself.

III. Specific Issues under German Law

In the case of an investment in a target (group) incorporated in Germany or finance documents governed by German law, acquisition financing faces – in addition to tax implications, which are discussed in Part D. – specific issues under German law.

1. Maintenance of Stated Share Capital

a) GmbH

According to the statutory capital maintenance rules of the Limited Liabilities Companies Act (GmbHG), a GmbH may not make payments to its shareholders if and to the extent such payments lead to the net assets of the GmbH falling short of its stated share capital or an existing shortfall being further increased. These rules also apply to up-stream guarantees and up-stream asset security given by a GmbH to secure financial indebtedness of its direct or indirect shareholders or the subsidiaries of such direct or indirect shareholders. A breach of the capital maintenance rules can result in personal civil and criminal liability of the management of the GmbH and of its shareholders to the extent the shareholders were involved in a shareholders resolution by which the GmbH was instructed to grant up-stream guarantees or up-stream asset security. Therefore, the managing directors of a GmbH which is asked to provide up-stream guarantees or up-stream asset security should request to add *limitation language* in order to limit the enforcement of up-stream guarantees and up-stream asset security or the amount of the enforcement proceeds which may be retained for distribution to the banks to that amount which is not required to cover its stated share capital, this amount, constituting the enforceable amount, being in principle equal to the distributable reserves of the GmbH.

b) Limitation Language

The typical limitation language which has evolved from the market does not just provide for the described limitation, but also for detailed rules that stipulate how the net assets and the

enforceable amount have to be calculated. For example, financial indebtedness incurred in breach of the finance documents and an increase in the stated share capital by conversion of funds of the GmbH are not usually taken into account for that purpose, even though such and other balance sheet adjustments which banks usually request lead to an artificial increase of the enforceable amount and might not be in compliance with the statutory rules for the calculation of the assets. Furthermore, limitation language also typically provides for rules for the formal process and the timeline for the calculation of the net assets and the enforceable amount after an enforcement notice has been served.

c) Other Legal Forms

The capital maintenance rules also apply in principle to a general partnership (OHG) and a limited partnership (KG) where the partners with unlimited liability are exclusively comprised of companies in the legal form of a GmbH. However, there are differences in the details. For example, if a GmbH & Co. KG, a limited partnership with the only general partner being a GmbH, gives an up-stream guarantee or up-stream asset security for the financial indebtedness of its general partner, limitation language should not be required. Even more far-reaching rules apply to the stock corporation (AG). An AG is prohibited from distributing any assets to its shareholders except for the distribution of its profits. This means that an AG, as a rule, cannot give up-stream guarantees and up-stream asset security at all.

d) Domination Agreements and Profit and Loss Transfer Agreements

The capital maintenance rules do not apply, and thus up-stream guarantees and up-stream asset security are in principle permitted if a domination agreement or a profit and loss transfer agreement is in place between the security grantor and the company for whose benefit the up-stream guarantee or up-stream asset security is given. The reason for this exception is that the security grantor as dominated company or profit transferring company receives by operation of statutory law a loss compensation claim against the other party of the domination agreement or the profit and loss transfer agreement. It is, however, unclear whether this exception also applies in a typical acquisition financing structure where the acquisition vehicle has no assets other than the shares in the target company and the loss compensation claim is not recoverable in the event that the transaction security is enforced.

e) Market Practice

Although third parties such as banks are not the addressees of the capital maintenance rules and the limitation language affects the value of up-stream guarantees and up-stream asset security considerably, most banks in Germany are familiar with the capital maintenance issue and are in principle prepared to accept limitation language. However, this is the market practice. No precedent is known where limitation language has already been tested in court. The area of up-stream guarantees and up-stream asset security is therefore still characterized by legal uncertainty, and the question to what extent up-stream guarantees and up-stream asset security may be given without incurring legal risks for the management must be carefully assessed on a case-by-case basis.

2. Maintenance of Liquidity

The managing director of a GmbH is personally liable for payments that the GmbH makes to its shareholders if and to the extent such payments resulted in the GmbH becoming illiquid, unless

the illiquidity was unforeseeable when using the diligence of a prudent business person. Generally, it is acknowledged that security given by a GmbH to secure financial indebtedness of its shareholders can qualify as a payment in that sense, but there are open questions as to the details. For example, there is no common view as to whether this rule applies to security over any asset or only to security over cash or assets which can be easily converted into cash. It is also unclear whether this rule only applies to the extent that the asset over which the security is given is no longer available for use to the business. To protect the managing directors of a GmbH from liability for causing the illiquidity of the GmbH when the creation of up-stream asset security is required, borrowers have started asking lenders to expand the scope of the limitation language, which was initially designed with a view to the capital maintenance rules, to the effect that the enforcement of up-stream asset security or the amount of the enforcement proceeds which may be retained for distribution to the banks is not only limited to the extent it is necessary to avoid a violation of the capital maintenance rules, but also to the extent it is necessary to avoid the illiquidity of the GmbH. Most banks in Germany are aware of this issue, but many of them are, at least at the moment, reluctant to accept this limitation as it further reduces the value of up-stream asset security.

3. Prohibition of Financial Assistance

An AG may not give any financial assistance to the buyer of its shares. This rule does not only apply to financial assistance with the acquisition itself, but also to any transaction following the acquisition that is closely connected with the acquisition such as the granting of up-stream asset security after the takeover of the AG has been completed and the buyer has taken control over the AG to secure the financing that was taken out for the acquisition. In principle, this does not apply if a domination agreement or a profit and loss transfer agreement is in place, but it is unclear whether this exception also applies in a typical acquisition financing structure (see 1.d) above). There are no financial assistance rules for the GmbH.

4. Prohibition of Compound Interest

Under German law, a lender and a borrower may not agree on compound interest in advance. Where delayed interest payments are concerned, instead of default interest on delayed interests, German law governed facility agreements therefore usually provide for lump sum damages to the amount of around 200 basis points above the then applicable interest rate to compensate for damages which the lender might incur due to the delayed interest payments, provided that the borrower still has the right to prove that no damages or lower damages have arisen. Although the prohibition of agreeing on compound interest in advance does not mean that the borrower could not be given the right to choose between payment of the interest in cash or accrual on the principal amount of the loan, after the claim for interest has fallen due, the prohibition of compound interest means that payments in kind (PIK) as they are typically used in English law mezzanine instruments are, under German law, not enforceable, and structures that aim to achieve the same result as a PIK structure have to be tested against the question of whether they constitute a circumvention of the prohibition of compound interest and are therefore not enforceable.

5. Voluntary Cancellations and Prepayments

Pursuant to mandatory rules of the German Civil Code (BGB), a borrower may voluntarily cancel a facility and make a prepayment with effect to the end of the applicable interest period without

the obligation to pay damages to the lender if the interest rate has not been fixed until the final maturity date. Any agreement that aims to exclude or impede this right is not enforceable. As acquisition finance facilities usually provide for roll over loans, this means that, for example, an obligation to pay a prepayment fee or a restriction of cancellations and prepayments to certain minimum amounts or multiples is not enforceable to the extent it shall apply to cancellations and prepayments which are made with effect to the end of an interest period.

6. Guarantee on First Demand

Facility agreements usually provide for payment guarantees “on first demand” under which the guarantor has to make payment merely upon a demand which meets the pre-agreed formalities, but under which the guarantor does in principle not have the right to prove that the guaranteed event has not occurred. According to German case law, which is still developing, only banks, credit institutions and international operating businesses may give a guarantee on first demand. A guarantee on first demand given by an entity that is not eligible to give a guarantee on first demand according to these rules may thus only constitute a simple payment guarantee.

7. Subordination

In a judgment dating from 1992, the German Federal Supreme Court (BGH) treated a lender as a shareholder in a case where (i) the shares in the borrower were pledged in favor of the lender and the claims for dividends, for the compensation in case of an exit of a shareholder, for the liquidation proceeds in case of a liquidation and for the sale proceeds in case of a sale of shares were assigned or pledged to the lender, (ii) the shareholders of the borrower undertook to obtain the prior consent of the lender before exercising certain membership rights and (iii) the borrower agreed to the request of the lender that a consulting firm elected by the lender takes over the de facto management of the borrower. This decision has led to some uncertainty in the legal community whether, in the insolvency of the borrower, customary covenants in facility agreements in combination with share pledges can lead to the result that the lender is treated as a shareholder with the consequence that the loans of that lender are subordinated. This view, however, has become more and more unlikely as the BGH indicated in another judgment of 1998 that the power of a person to have influence on a company does not lead to being treated as a shareholder if that power is based merely on economic strength or contractual covenants.

D. Taxation

I. Introduction to the German Tax System

The German tax system often has a reputation for being complex as it consists of more than 40 different types of taxes; however, it follows very strict and systematic rules. Also, the effective tax burden in Germany is lower in various cases than expected at first sight. Individuals and entities can often benefit from numerous exemptions, deductions and depreciation provisions.

The German tax system usually ties in with the residence of the taxpayer. If the latter has his domicile or residence in Germany, residence tax liability concerning his worldwide income is the consequence. For non-resident investors, non-resident tax liability concerning income from German sources results. The same rules apply for corporate entities; concerning corporate tax and municipal trade tax, the registered office and place of management in combination with a permanent establishment are decisive for resident or non-resident taxation in Germany.

Resident taxpayers are generally divided into two groups; the income is either business profit or non-business profit. However, it must be emphasized that non-business profits have to be re-qualified as business profits if certain criteria are met.

II. Business Taxation

1. Corporate Entities

a) Taxation of Corporate Income

German corporations such as the GmbH, AG and SE are subject to corporate income tax with respect to their entire income, whereas all income always qualifies as business income. Foreign corporations are subject to corporate income tax only with income generated in Germany (unless their registered office or place of management is in Germany; then the foreign corporation is subject to resident taxation). The corporate income tax rate is 15.8 % (including solidarity surcharge).

A distribution of dividends by a German corporation generally triggers withholding tax of 26.4 % which is creditable at shareholder level or equals the flat tax that is due at shareholder level. For dividend income and capital gains from the disposal of shares held by another corporation, Germany offers 95 % tax-exemption at the level of the shareholding corporation for corporate income tax.

The 95 % participation exemption is to be abolished for dividends received by portfolio investments after February 28, 2013, i.e., such dividends are subject to tax at regular rates. A portfolio investment means an investment where the shareholder holds directly less than 10 % of the share capital of the distributing corporation at the beginning of the calendar year in which the dividend is distributed. The 95 % exemption with respect to capital gains on such shareholdings remains unchanged.

In case a foreign corporation is subject to non-resident taxation in Germany, the withholding tax can be reduced to 15.8 % if certain substance criteria are met. Exemption from withholding tax applies to distributions to foreign EU corporations (minimum shareholding of 10 % required). Moreover, withholding tax can be reduced to a lower percentage or be eliminated/refunded according to a respective double tax treaty or an EU Directive. However, in these cases, the

foreign shareholding corporation must fulfill certain conditions in order to benefit from such favorable rules (see V. 2. below).

b) Trade Tax

A corporate entity is also subject to German municipal trade tax, as it is deemed to generate business income. Businesses which do not have their registered office or place of management in Germany but earn income which is allocated to a German permanent establishment are also subject to a municipal trade tax at a rate of 7 % to 17.2 % (average rate approx. 14 %), depending on the location of the permanent establishment.

For dividend income and capital gains from the disposal of shares held in another corporation, Germany offers tax-exemption for trade tax purposes by excluding this income from the trade income, resulting in an effective tax burden of only approx. 1.5 % for this income (so-called *Schachtelprivileg*). However, the exemption of dividends for trade tax purposes requires a minimum shareholding of 15 % at the beginning of the fiscal year.

The overall combined tax rate for corporations is approx. 29.8 % for corporate income tax and trade tax.

2. Taxation of Partnerships

a) Taxation of Income

German partnerships are the civil law association (GbR), the general partnership (OHG) and the limited partnership (KG). All assets, liabilities and income of a partnership with regard to taxes are allocated to the partners in proportion to their partnership interest (transparency of the partnership). However, the possibility of offsetting losses generated by a KG at the level of a limited partner is generally restricted to the amount of the respective committed equity.

Partnerships can either obtain business income or conduct private asset management. For business income, the general rules apply; all income related to the business is qualified as business income. Partnerships that solely conduct private asset management (generating interest, dividend income, lease income and capital gains) do not earn business income, except for partnerships that generate deemed business income due to their structure (general partner is a corporation and no managing limited partner).

Exemptions are made for the taxation of dividend income and capital gains. Dividend income and capital gains resulting from a disposal of shares in a corporation are 40 % tax-exempt and 40 % of related costs are non-deductible (so-called *Teileinkünfteverfahren*). Interest income is not tax-exempt and related costs are fully deductible.

The tax rate for partners is equivalent to the tax rates for individuals (see III.1. below).

b) Trade Tax

If a partnership conducts business activities, the entire income of the partnership is qualified as business income (i.e. also the income from non-commercial activities) and is thus subject to trade tax. To a large extent, the trade tax burden can basically be offset with the personal income tax liability of an individual partner in proportion to its equity interest in the partnership.

3. Anti-Avoidance Rules/CFCs Legislation

In order to prevent the misuse of legal forms, the use of proxies, tax havens and treaty/directive shopping, Germany has passed the Foreign Transaction Tax Act (AStG). Basically, the act gives tax authorities the right to ignore abusive and artificial circumstances which would lead to an untaxed constellation.

III. Taxation of Individuals

1. Resident Taxation

An individual with residence or domicile in Germany is subject to resident taxation, meaning the worldwide income is taxed in Germany, supplemented by a *solidarity surcharge*. Taxable events are exclusively enumerated in the German Income Tax Act (EStG), e.g., income of business, rental income, income from personal services (self-employed or employed), certain other taxable events listed in the act and capital income.

Income of individuals generated personally is currently (2013) taxed at a rate starting at 14.0 % (taxable income from EUR 8,131 to EUR 13,469), increasing proportionally up to 23.97 % (taxable income from EUR 13,470 to EUR 52,881). The marginal rate for taxable income from EUR 52,882 to EUR 250,730 is 42.0 %; for taxable income of EUR 250,731 and more it is 45.0 %. A solidarity surcharge of 5.5 % is added on to the respective tax rate.

For certain categories of interest income, dividend income and capital gains, a flat tax rate of 26.4 % (including solidarity surcharge) applies (so-called *Abgeltungsteuer*). Expenses and costs effectively connected with such capital gain are not deductible from the flat rate tax base. Flat rate taxation is not applicable but regular taxation applies in the following circumstances:

- The financial assets generate business income and are thus qualified as business assets.
- With respect to interest income: the borrower is a corporation and the lender holds at least a 10 % shareholding or is a related party of the borrowing corporation.
- With respect to capital gains: the shareholder has a shareholding in a corporation of at least 1 % at one point in time within the last five years.

The taxpayer can opt for standard taxation instead of flat rate taxation concerning dividend income in cases of:

- shareholding of at least 25 %; or
- shareholding of at least 1 % and employment by the corporation (typical MBO structure).

2. Trade Tax

Business income of an individual (sole proprietorship) is subject to trade tax; however, the trade tax burden can largely be offset with the personal income tax liability.

3. Non-Resident Taxation

If an individual is not subject to resident taxation, i.e. has no residence or domicile in Germany, but has income from a German source, he is usually taxed in Germany. The following list specifies the types of taxable events regarding non-resident taxation:

- business income to the extent of the business activities that can be allocated to a domestic permanent establishment or a permanent agent;
- rental income from domestic real estate;
- (if not already included in business income) capital gains resulting from the disposal of domestic real estate, except if the real estate does not qualify as a business asset and was held by an individual or non-business partnership for more than ten years;
- income from personal services which are utilized in Germany and provided by individuals (self-employed or employed) or entities;
- capital gains resulting from the disposal of shares in a German corporation (minimum shareholding of 1 % at one point in time within the last five years required);
- dividends and liquidation proceeds received from German corporations;
- performance-related interest income paid by German debtors and capital gains derived from the disposal of such instruments;
- certain other (non-performance-related) interest income (including capital gains) if the debt instrument is registered in Germany or secured by domestic real estate.

Sometimes double taxation results from such cases. The solution for this issue will be described in the section dealing with double taxation (see V.2. below).

IV. Indirect Taxes

1. German Real Estate Transfer Tax

a) Direct Acquisition of Real Estate

The direct acquisition of real estate (and certain rights in real estate, e.g. heritable building rights) located in Germany is subject to real estate transfer tax. Real estate transfer tax is already triggered by the legally binding agreement between the seller and the acquirer to transfer title of the real estate (i.e. the sale and purchase agreement (see B.IV.).

In case of an asset deal, the seller as well as the acquirer owes the real estate transfer tax; in practice, the parties usually contractually agree with each other that only the acquirer shall bear the real estate transfer tax.

b) Acquisition of Shares in a Real Estate Holding Company

Real estate transfer tax also becomes due if 95 % or more of the shares in a real estate holding entity (corporation or partnership) are held in *one hand*, e.g. obtained directly and/or indirectly by one acquirer or by controlling and dependent entities or by dependent entities only (tax group for real estate transfer tax purposes). However, partnership interests are counted by the number of partners and not by the percentage of equity interests held by the partners (so-called *per capita rule*).

Shares in a real estate holding entity that are indirectly owned via an interposed corporation can only be allocated to an acquirer if the latter holds 95 % or more of the shares in the interposed corporation (*indirect investment*).

If more than 95 % of the shares in a real estate holding entity are acquired by one acquirer, such acquirer is liable for real estate transfer tax.

Depending on the circumstances, a share deal of a real estate holding corporation may be structured specifically to avoid triggering real estate transfer tax. For example, this could be achieved through an interposed partnership and a third party minority investor in the partnership (so-called *real estate transfer tax blocker*).

c) Acquisition of Interests in a Real Estate Holding Partnership

Furthermore, real estate transfer tax becomes due if 95 % or more of the equity interests in a real estate holding partnership are transferred directly and/or indirectly to new partners within a five year period. For purposes of this rule, partnership interests are counted by the percentage of equity interests held by the transferring partner. In the case of an entity holding an equity interest in a partnership, this equity interest is deemed to be transferred to a new partner if 95 % or more of the shares in the entity are acquired by a new investor (*indirect investment*).

The real estate holding partnership is liable for real estate transfer tax.

A transfer of a real estate holding partnership may be structured without triggering real estate transfer tax by a deferred transfer of a minimum partnership interest of at least 5 %.

d) Draft Bill to Inhibit Real Estate Transfer Tax Blocker

According to a 2013 draft bill, the rules determining the participation of at least 95 % in a real estate holding entity (corporation or partnership) in *one hand* shall be amended, effective for transactions implemented after December 31, 2012. The new rules intend to inhibit a real estate transfer tax blocker.

Any transaction where a taxpayer has – directly and/or indirectly – an economic participation of at least 95 % in a real estate holding entity will trigger real estate transfer tax. The economic participation equals the sum of direct and indirect participation in the capital or assets of the entity. The indirect participation is computed by multiplying the percentages in the capital or assets of the entity. As a consequence, the *per capita rule* for partnership interests would no longer apply.

e) Tax Rates and Tax Bases

Generally, real estate transfer tax is levied at a rate of 3.5 % - 5.5 % on the tax base, depending on the location of the real estate. In case of a sale and purchase agreement, the tax base is the agreed consideration, i.e. the purchase price. Any part of the purchase price paid for buildings is included in the tax base.

The base for real estate transfer tax levied on taxable transfers relating to real estate holding companies is a certain tax value of the real estate as determined according to the Tax Valuation Act. The tax value is usually lower than the fair market value of the real estate (as a rule of thumb: some 75 % - 85 %).

f) Deductibility of Acquisition Costs

Real estate transfer tax should be deductible for income tax purposes in case of acquisition or unification of shares/interests of 95 % or more. Where 95 % of partnership interests are transferred to new owners within five years, it is under discussion whether the real estate transfer tax is deductible or treated as part of the acquisition costs of the acquired assets and must be capitalized. Like other capitalized acquisition costs, real estate transfer tax is amortized

over the standardized life of the buildings to the extent that the tax is allocable to buildings that qualify for depreciation and not to land.

2. German Value Added Tax

The German value added tax is a transaction tax. The delivery and supply of goods and services are subject to such tax. Value added tax conforms to the Council Directive 2006/112/EC on the common system on value added tax; therefore, there are no German specifics concerning the system itself.

The applicable rate in Germany for value added tax is 19 %, although a reduced rate of 7 % applies to certain privileged basic products (such as food and books), while other transactions are value added tax-exempt (such as transfer of shares or transfer of real estate) or non-taxable (such as the transfer of an entire business unit via an asset deal). Input value added tax on purchases is generally refundable if and to the extent that it is not related to non-taxable or certain tax-exempt turnover. Exports are tax-exempt, whereas input value added tax related to such transactions can still be claimed by the entrepreneur.

V. Discussion of Exclusive Tax Challenges

1. Acquisition of a Business

a) Basic Considerations

There are generally two ways to acquire a business:

- the purchase of (all) targets' assets (asset deal); or
- the purchase of the shares in the target (share deal).

The question of share deal versus asset deal has to be determined by taking all interests of both sellers and purchasers into consideration. Therefore the identification of an appropriate transaction structure is certainly a challenge. However, it is often even more challenging to design and implement an optimized acquisition structure that takes into account the annual tax burden for the purchaser, as well as appropriate taxation of a subsequent exit.

From the purchaser's point of view, the following aspects regarding taxation are crucial:

- tax-effective depreciation of the purchase price (*step-up*);
- efficient exit taxation;
- utilization of loss carry forwards of the target;
- deductibility of interest expense for acquisition debt from the tax base of the target;
- minimization of transaction costs (such as real estate transfer tax).

b) Asset Deal/Share Deal of Partnership Interests

aa) Asset Deal

With respect to current taxation, the acquisition of a business by a German acquisition vehicle via an asset deal is mostly more advantageous than a share deal for the purchaser. The purchaser can directly convert the purchase price into a tax-efficient depreciation (so-called *step-up*) to the extent that the assets are depreciable. The purchase price is allocated to the acquired assets which are entered in the balance sheet as of the acquisition date at their fair

market value, including goodwill – if any – and is amortized over the useful lifetime (goodwill: 15 years) of the assets. However, land can be written off only to the extent that the fair market value is permanently lower than the purchase price.

bb) Acquisition of Partnership Interests

With regard to taxes, the acquisition of partnership interests (see A.II.3) is basically equal to the acquisition of the assets from a seller. The same tax principles apply to the acquisition of partnership interests as the entity is transparent for tax purposes.

The acquisition of partnership interests permits the inclusion of certain investors' expenses in the tax calculation of the partnership income, e.g. interest expenses that arise from the acquisition financing on the partner level. From a German tax point of view, such interest expenses are allocable to the partnership. In the foreign partner's jurisdiction, however, such interest expenses might be allocated to the business on the partner level and thus provide for a *double dip* of the interest expenses in Germany, as well as in the foreign investors' jurisdiction. Case law and tax authorities challenge such structures under certain circumstances.

cc) Exit Scenarios

An exit from a German business investment is subject to income tax/corporate income tax at seller level and, in most cases, is also subject to trade tax. For individuals selling an entire business or partnership interest, tax relief (lower income tax rate) may apply if certain requirements are met. Trade tax is not triggered if:

- an individual or a partnership disposes of its entire assets or a separate business unit (the sale of the business by a corporation is subject to trade tax);
- an individual disposes of its entire partnership interest.

Due to the tax impact for the seller upon exit (taxation at full tax rate), an asset deal is often disadvantageous when compared to a share deal, and investments are thus more likely to be transferred by way of a share deal than by an asset deal.

With respect to a tax-efficient exit from an investment in a partnership, a tax-neutral conversion of the partnership into a corporation might be favorable; however, to take full advantage of a subsequent transfer of shares in a corporation, a holding period of seven years must be taken into account.

c) Share Deal of a Corporation

The capital gain resulting from a transfer of shares in a German corporation is 95 % tax-exempt if the seller is a corporation and 40 % tax-exempt if the seller is an individual that holds or has held at least 1 % of the shares at one point in time within the last five years or holds the shares as business assets. If the seller is a partnership, the taxation for income tax/corporate income tax purposes takes place on the partner level and tax exemptions depend on the status of the partner (individual or corporation); trade tax becomes due on the partnership level (if the shares are attributable to a domestic permanent establishment). With respect to foreign investors, a capital gain might be fully tax-exempt in Germany according to the respective double tax treaty (if the shares are not to be allocated to a domestic permanent establishment). Thus, a transfer of shares in a corporation is preferable for both the seller and the investor with respect to a subsequent exit from the investment.

By acquiring shares in a corporation, a step-up of the assets of the corporation does not take place, but the shares have to be capitalized at the acquisition costs (*no step-up*). Shares in a corporation are not depreciable; an extraordinary write down is only possible if the fair market value of the shares is continuously below the acquisition costs. Such write down is 60 % tax-effective only if the shares are held as business asset by an individual (or to the extent that an individual is partner in a business partnership holding the shares) and the shares belong to German business assets. Otherwise, write down is not tax-deductible. Therefore, as a result of the share deal, the purchaser cannot use built-in gains in the acquired business assets through depreciation.

As the acquired corporation qualifies as a separate taxpayer, additional considerations are required to match operating profits of the target corporation with acquisition debt financing costs at the purchaser level.

d) Loss Utilization

According to German rules, tax losses in a financial year can be carried back to the previous year up to an amount of EUR 1,000,000 (as of financial year 2013) for income tax/corporate income tax purposes (not for trade tax purposes) and can be carried forward further (loss carry forwards) without time restrictions (income tax/corporate income tax/trade tax). However, the utilization of loss carry forwards is limited to the *minimum taxation rule*. According to this rule, a base amount of EUR 1,000,000 loss carry forward can be utilized annually without restrictions and in excess thereof only to the proportion of 40 % of the remaining positive tax base of the respective financial year.

Such loss carry forwards are of value to a legal entity if it generates taxable profits in subsequent financial years (*deferred tax asset*). However, in the course of a sale transaction, loss carry forwards could cease to exist or be reduced. The most important rules for a forfeiture of loss carry forwards through a change of ownership are as follows:

- Asset deal: loss carry forwards cannot be transferred.
- Direct transfer of a partnership interest: trade tax loss carry forwards at the partnership level will be forfeited in proportion to the transferred percentage of the partnership equity interests. If partnership interests are not all transferred, the remaining loss carry forwards can be utilized only to the extent that a partner remains in the partnership (loss carry forwards for trade tax purpose are personalized). The tax losses for income tax purposes at partner's level shall be subject to the change of control rule (see next bullet).
- Transfer of shares in a corporation: If within a period of five years more than 25 % and up to 50 % of the corporation's shares are transferred to one purchaser, related parties of such purchaser or a group of purchasers acting in concert, then the corporation's loss carry forwards and current losses (corporate income tax/trade tax) will be forfeited pro rata. In case such transfer exceeds the 50 % threshold within five years, the entire loss carry forwards will be forfeited. Both rules shall apply, irrespective of a direct or indirect transfer of the shares in the corporation. An exemption from the loss forfeiture rules applies to the extent that the losses do not exceed the taxable built-in gains of the domestic business assets of the corporation at the time of the harmful transfer. In this case unutilized losses are preserved. In general, built-in gains are determined as the

(proportional) difference between the shareholders' equity of the corporation as computed for taxation and the market value of its shares to the extent that they are subject to domestic taxation.

- The same rules apply to trade tax loss carry forwards of a partnership held by a corporation in case the shares in the corporation are (directly or indirectly) transferred.
- Reorganization: For most reorganization procedures, such as a merger of entities, a spin-off, a contribution of a business unit in kind, a change of legal form from a corporation to a partnership and vice versa, the loss carry forwards of the transferred business unit, respectively legal entity, will be forfeited.

The German change of control rules provide for an intra-group reorganization exception: An exemption from the loss forfeiture rules applies if the same person is – directly or indirectly – the sole shareholder in both the transferring and acquiring entities. Nevertheless, restructuring and reorganization measures within a group might negatively affect the utilization of loss carry forwards.

To avoid this consequence, the seller may realize built-in gains before carrying out the transaction by utilizing loss carry forwards and then selling a business via a share deal with increased tax book values of the assets. Minimum taxation rules need to be considered.

A tax-efficient utilization of losses is also possible by establishing a tax group (see e) below). Within a tax group, profits and losses are taxed at top entity level and can thus be offset. However, it must be taken into consideration that losses of a tax group entity (*subsidiary*) incurred before the time of the group taxation (loss carry forwards from former financial years) cannot be utilized with profits within the tax group. Such loss carry forwards are *frozen* at subsidiary level as long as the tax group exists; however, they are subject to the German change of control rules.

e) Acquisition Structures

The deductibility of interest expenses for acquisition debt financing is a crucial issue in the tax structuring of acquisitions by means of a share deal. If the acquisition vehicle is financed with respect to the purchase price for the acquisition of the shares of the target entity, bank loans and/or shareholder loans will be provided in addition to equity of the investor to achieve a leverage effect. Interest expenses on the acquisition loan shall be deducted from profits of the operating target in order to reach a tax base that is as low as possible in net terms. Generally, a German acquisition vehicle is implemented to ensure that both the target entity and the acquisition vehicle are subject to German taxation. In particular, the following tax structures are usually recommended:

- Merger: The acquisition vehicle and the target entity are tax-neutrally merged. As a result, the interest expenses occur directly at target level.
- Tax group: Between the acquisition vehicle and the target, a tax group (*Organschaft*) is established. This requires that – inter alia – (i) the target entity is a corporation, (ii) the majority shareholder (controlling entity) is an individual or partnership conducting business activities or a corporation and (iii) a profit and loss transfer agreement is concluded for a period of at least five years. In a tax group, the taxable profit of the subsidiary (controlled corporation) is transferred and taxed at shareholder level (tax group parent).

- Target entity is a partnership: The target is a business partnership or will be tax neutrally converted into a partnership (change of legal form). Interest expenses for debt financing to acquire the shares of the target partnership are then allocated to the taxable income of the partnership (see b) above). Accordingly, the interest expenses are part of the tax base of the target partnership.

f) Interest Deduction

Interest deduction for business income in Germany is limited by thin capitalization rules, in particular from 2008 onwards, by the so-called *interest barrier* (*Zinsschranke*).

As a general rule, the net interest expenses (after balancing of interest income) are deductible in the financial year of expenditure only up to 30 % of the businesses' tax accounting-based EBITDA (earnings before interest, tax, depreciation and amortization).

Non-deductible interest expenses are carried forward to subsequent financial years and can only be deducted within the limits of the interest barrier rule. The interest carry forwards are forfeited according to the rules for a forfeiture of tax loss carry forwards (see d) above).

The interest barrier is not applicable if:

- the net interest expenses (excess of interest expenses over interest income of a financial year) of a business unit are less than EUR 3,000,000 (threshold); or
- the business (whereby a tax group qualifies as one single business despite the fact that separate legal entities are included) is not (or only partially) consolidated in the consolidated financial statements of a group (IFRS, German GAAP, other EU-GAAP or even US-GAAP can be applied); or
- the business is fully consolidated in the consolidated financial statements of a group, but the equity ratio of the business unit on a stand-alone basis is not lower than two percentage points of the equity ratio of the group in the consolidated financial statements (certain tax-related adjustments of GAAP to tax equity must be considered).

With respect to a corporation or a partnership held by a corporation, the last two exemptions above only apply if no harmful shareholder financing is in place. The financing of a stand-alone business entity is harmful if a shareholder with more than 25 % shareholding, a related party of such shareholder or a third party (e.g. bank) with recourse (back-to-back financing) to such shareholder or related party grants loans to the entity and the interest for these loans exceeds 10 % of the net interest expenses of the entity. Concerning a group entity, financing is harmful if a non-consolidated but more than 25 % shareholder of any group entity, or a related party or a bank with recourse to such shareholder or related party grants loans to any (domestic or foreign) entity belonging to the group and the interest for these loans exceeds 10 % of the net interest expenses of this specific entity.

The requirements for an escape are challenging to meet and careful tax planning is recommended.

To the extent that interest expenses are deductible for income tax/corporate income tax purposes, a 25 % add-back to the trade tax base is generally applicable.

g) Debt Push-Down to Foreign Subsidiaries

In some cases, the interest barrier rule might limit the interest deduction in Germany. In this situation, one should consider whether a debt push-down of financing costs to foreign group entities could be beneficial. This can be achieved by cross-border intercompany loans, as well as via distributions and third party debt recapitalization of the foreign group entities.

2. German Prevention of Double Taxation

Double taxation in Germany, as well as in a foreign jurisdiction, is mitigated by double tax treaties which are in place with more than 90 countries (*bilateral agreement*). If a double taxation treaty does not apply, Germany allows crediting of foreign taxes paid abroad in its income tax return (*unilateral measure*). If a double taxation treaty exists, business income and rental income is usually taxed in the jurisdiction in which the permanent establishment or real estate is located; capital income (interest, dividends and capital gains from the disposal of financial assets) is generally taxed in the jurisdiction of the foreign investor's residence. In some cases of capital income, Germany has the right to levy withholding tax.

Since income from dividends is of great importance to investors, emphasis will be placed on the following rules applying to them.

a) Dividends

aa) General Rule: Withholding Tax

Dividends distributed by a German corporation are generally subject to 26.4 % withholding tax, which is creditable to the German income tax/corporate income tax liability of the domestic shareholder. The withholding tax rate is reduced to 15.8 % for foreign corporations receiving dividends if the provisions under bb) are fulfilled. Furthermore, most double tax treaties provide that (i) such dividend income is subject to taxation in the jurisdiction of the shareholder's residence only and (ii) the withholding tax is limited to a lower rate of typically 15 % or (iii) the withholding tax is even reduced to 0 % if certain conditions are met (basically, the shareholder must be a foreign corporation holding a certain minimum shareholding in the German corporation). Moreover, withholding tax does not occur if the shareholder is a non-domestic EU-based corporation with a minimum direct shareholding of 10 % for at least 12 months uninterrupted.

bb) Treaty Shopping

According to German anti-treaty-/anti-directive-shopping rules, a foreign company is only entitled to (full or partial) relief from withholding tax under a EU Directive/Double Tax Treaty to the extent that:

- the company is owned by shareholders that would be entitled to a corresponding benefit if they earned the income directly (individual relief entitlement); or
- certain substance requirements (factual relief entitlement) are met (non-harmful income).

Income is *not harmful,* if:

- it consists of gross receipts generated by its own business activities; or

- with respect to income generated by non-business activities, there are non-tax related reasons for interposing the foreign company and the company has adequately equipped business substance.

The lack of an individual relief entitlement excludes indirect relief of higher-tier shareholders. Moreover, indirect domestic shareholders are not entitled to relief.

If a foreign company earns income on which withholding tax is imposed, this withholding will be reduced – unless there is an individual relief entitlement applicable – only to the extent that there are non-harmful gross receipts compared to the overall gross receipts earned (*Pro Rata Test*). Contrary to the previous rules, an *all-or-nothing* principle does not exist and only pro rata relief will be granted insofar as there is harmful income.

Earnings that are economically functionally linked to the own business activities (e.g. interest income generated by income which was subject to relief) qualify as gross receipts generated by own business activities.

For purposes of the Pro Rata Test, the gross receipts of the year in which the income is earned is generally decisive (withholding tax refund) or the gross receipts of the application year (withholding tax exemption). The tax administration must be notified about a (partial) loss of the requirements for withholding tax relief, whereby a de-minimis rule is provided.

When testing, the German authorities pursue a bottom-up approach and will stop the analysis if a (higher-tier) shareholder meets all of the conditions or is resident in a non-treaty country. In the latter case, no partial or full relief from German withholding tax is granted.

According to these rules, foreign direct shareholders who solely perform "pure" asset management or whose business activities are conducted by related or third parties can generally not take advantage of withholding tax relief in Germany.

The restrictions do not apply to a direct foreign shareholding corporation whose shares are publicly traded or that qualifies as an investment fund.

In order to take advantage of the withholding tax relief, the substance and activities of the foreign shareholder require careful consideration.

b) Transfer Pricing

aa) General Aspects

Transfer pricing in the following refers to the pricing of transactions (tangible and intangible assets, services, funds, etc.) between affiliated companies or related parties across national boundaries. The valuation of such a transfer is of special interest for tax purposes, since the affiliated companies or related parties are separately subject to taxation in different jurisdictions. In cases of such transactions, the typical market mechanisms that establish prices at arm's length between third parties may not apply.

bb) Arm's Length Principle

According to the arm's length principle, transfer pricing methods have become the accepted approach in dealing with cross-border intercompany transactions. The arm's length principle requires that consideration of any intercompany transaction must conform to the level that would have applied had the transaction taken place between unrelated (third) parties under similar

conditions. However, different countries may accept different methods (e.g. *comparable uncontrolled price method*, *resale price method*, *cost plus method* or *profit split method*) of calculating appropriate transfer prices.

If and to the extent that the arm's length principle is not met with respect to (national as well as international) transactions, the tax base of the respective German entity might be adjusted (at the latest in the course of a tax audit), resulting in an additional income tax/corporate income tax/trade tax burden (adjusted tax base) and additional withholding taxes (hidden profit distributions), as the case may be. Moreover, penalty charges may result.

German tax authorities basically accept the most common intercompany transfer pricing standards, in particular the comparable uncontrolled price method, resale price method and cost plus method.

cc) Exit Charge

In 2008, significant changes to Germany's transfer pricing legislation were introduced: A *transfer of functions* will be deemed to have taken place when a function performed by one entity is transferred cross-border to another group entity, even if the transfer is partial or temporary. In this context, "functions" are defined as the aggregation of similar operational tasks, including corresponding opportunities and risks, executed by certain departments of the enterprise. Under certain conditions, an appropriate transfer price is determined based on the discounted cash flow value of the functions transferred. The transfer price for the functions is deemed to be the average of the supplier's minimum price and the recipient's maximum price. Such transfer price will be subject to regular tax rates (so-called *exit charge*).

dd) Transfer Pricing Documentation

German tax law requires that the taxpayer maintains proper transfer pricing documentation in cases of intercompany cross-border transactions with regard to the type and content of his business relationships with related parties, including details on the calculation of transfer prices. For material business transactions, the entity must fulfill the documentation requirements in a timely manner (6 months after the end of the financial year) or in other cases, upon request by the tax authorities only. If no or insufficient documentation is available, the tax authorities are authorized to assume (estimate) a higher tax base at the German entity's level and in addition, assess penalty payments.

3. Taxation of German Real Estate Investment Trusts (REIT)

As in many other countries, the establishment of real estate investment trusts is now also available in Germany. The German Real Estate Investment Trusts Act of 2007 created significant opportunities for real estate holding entities and investors in German real estate. Real estate investment trusts are real estate holding companies in the legal form of an AG listed on a stock exchange. The business purpose of a real estate investment trust is limited to acquiring, holding, managing by renting out and leasing, and selling real estate (or rights of use of real estate), and acquiring, holding, managing, and selling shares in real estate business partnerships. Sale-and-lease-back structures are also permitted.

Income of real estate investment trusts is exempt from income tax/corporate income tax at the entity level if certain requirements are met (such as a minimum free float rate of 15 % (25 % at the time of listing), maximum individual shareholder participation of 10 %, minimum profit

distribution of 90 %). However, distributions of a real estate investment trust are fully subject to taxation on the investor level (without tax exemptions) and trigger withholding tax of 26.4 %.

E. Management

I. Conflicts of Interest within M&A Transactions

Whatever a manager does, whether he abstains from an action, or tolerates certain measures, he must exercise due care. Managers must identify and weigh pros and cons and balance conflicting interests. In this area, German law differs from general Anglo-American legal principles and practice in a distinct way. Shareholder primacy does not exist as a rule-of-law the manager of a company may not take only the interests of the company's shareholders into account. Rather, as the target's manager is responsible to the target itself, he must consider the legitimate interests of the target and of all its shareholders (i.e. not only the interests of the shareholders) – that is employees, creditors and the general public. Even in public tender offer situations (see B.V.), the managers of the target company are arguably not strictly obliged to act like auctioneers to achieve the highest price possible for the shareholders. Managers have broad discretion and this discretion is protected by the business judgment rule. As long as the managers decide on an entrepreneurial issue and can reasonably assume that, based on an appropriate basis of information, they are acting in the best interests of the company, the judge will not second-guess the managerial conclusion. However, a judge would consider whether a manager has lawfully determined the best interests of the company, i.e. whether the interests of all corporate constituencies were taken into account and that the manager was not erroneously driven only by shareholder interests (or worse, by his or her own interests as a present or future participation holder).

From the perspective of the managers, M&A transactions often entail the loss of a lucrative position, either by being laid off or by being forced to work under worse conditions. This *end game* situation induces managers to evaluate alternative employment scenarios and give up some of their loyalty to the target company. Eventually, this shift of loyalty may even result in an obstruction of the entire transaction. For this reason, members of management can often be regarded as the *third party* of the transaction. From the perspective of the remaining parties, it seems reasonable to contract for the management's loyalty.

II. Management Incentives

1. Transaction Bonuses by Target Company

In an M&A transaction, the management of the target company is typically granted a bonus upon exit. The amount of the bonus is between one and two annual gross salaries; on occasion it might increase depending on the achieved purchase price. The bonus is generally paid upon closing. The bonus payment might be granted on a fully discretionary basis or may be dependent on the achievement of certain steps in an M&A transaction, e.g. establishment of an info memorandum and data room, preparation of due diligence or management presentations. In return, the management is often asked to deliver a *directors certificate* or *warranty deed*. In such declaration, management has to guarantee to the seller that the management is not aware of any facts which are incorrectly stated in the vendor due diligence reports or which would lead to a breach of representation in the share purchase agreement with the potential purchaser. The liability under such certificate might be limited to the anticipated bonus payment.

In general, transaction bonuses paid by the employing company must be in appropriate proportion to the duties of such manager and the target company's condition. Moreover, these bonuses only have a sound legal basis if they are stipulated in the employment agreement in advance. Without such contractual basis, the bonus payments are only justified if they are paid in the interest of the company. This is deemed to be the case if, by receiving the bonus, the manager is bound to the company or if the recipient or other employees are incentivized to work for the company to achieve similar bonus payments.

2. Transaction Bonuses by Seller

Under German law, the supervisory board of a company is responsible for the appointment, revocation and compensation of members of the management board. Nevertheless, there are situations in which a shareholder intends to grant financial benefits to members of the management board in accordance with milestones to be achieved by the managers with respect to the company's conduct of business. Due to the fact that such benefits are not directly granted by the employing company, they are generally called *third party bonuses*. The performance-related milestones of these bonuses enable the alignment of the manager's conduct of business with the objectives of the third party providing the benefits. Therefore, from an economic point of view, bonuses granted by a shareholder within an M&A transaction coincide with the manager's interest, as well as the interest of the relevant shareholder, to achieve a high enterprise value for the company. However, it is disputed whether it is permissible under German law for a third party to grant transaction bonuses to the management instead of the company. It seems reasonable to demand approval by the supervisory board or at least require that it be informed.

3. Incentives within Public Tender Offers

In public tender offer situations (see B.V.) a manager's remuneration shall also be in an appropriate relationship to the duties of such manager and the target company's condition. Transaction bonuses by the seller to the management arguably require approval by the AGs supervisory board or that the board must be informed of such measures. A bidder might be inclined to offer or grant benefits to managers, only for the purpose of winning the management's favor in order to gain ground in competitions among several bidders. Without good reason, the acceptance of these benefits is a violation of the manager's fiduciary duty owed to the target company and is therefore invalid pursuant to the German Takeover Act. Certain benefits, however, are allowed, provided they are "justified". While the exact meaning of "justification" in this context remains rather vague, it is acknowledged that benefits allowing for the continuation of the management's services can be permissible.

In public tender offer situations, the management is obliged to make a statement on the offer to the target company's shareholders. If an incentive causes a conflict of interest for the management, it seems reasonable to ask this manager either not to join the management's statement or to explain the nature of the conflict and to hire an expert witness. Moreover, the bidder has to state in his bidding documents details of any monetary or cash equivalent benefits for the management or the supervisory board, even if the benefits might be justified under the aforementioned terms.

4. Taxation and Social Security Contribution of Transaction Bonuses

Bonus payments are fully taxable as ordinary income at the manager's individual tax rate (the maximum tax rate amounts to 45 % plus church taxes and solidarity surcharge). Provided that managers are above the maximum limits by virtue of their ordinary income, no social security contributions should arise with respect to these arrangements (maximum limits are currently EUR 69,600 (West Germany) and EUR 58,800 (East Germany)).

III. Management Participation

A private equity investor aims at aligning its own and concurrent interests of the management with the interests of the target company. For this reason, the implementation of an up-to-date Management Equity Program (*MEP*) is of utmost importance in management buyouts and became a conditio sine qua non. For this reason, the following principles address investments of private equity investors in particular. Nevertheless, if strategic investors implement management participation programs, these participations follow similar rules in general and, to a certain extent, the following policies can be applied accordingly.

1. Structuring

a) Participation Ratios and Amounts

Management will typically invest alongside the investor by way of an interposed trust vehicle or partnership in the acquisition vehicle. The quote depends upon the type and size of the deal and might vary from 3 % to 25 %. 1st line managers are requested to invest one to two gross annual salaries in addition to any potential transaction bonuses. 2nd line managers are allowed but not requested to invest between EUR 10,000 and EUR 100,000, also depending on the size of the deal and on the investment amount available to the management. In a secondary transaction, management is asked to reinvest at least 50 % net of taxes of their sales proceeds.

In a typical investment scenario, management could expect a money multiple of 10 and an envy ratio of 3. Money multiple means that management is able to receive 10 times their invested money if the business plan for the next 5 years is met and the company is sold on the same multiple as the entry multiple. Envy ratio is the ratio between the money multiple anticipated for the management and the one for the investor.

The envy ratio is accomplished by leveraging the acquisition of those shares that are acquired by the management. This leverage effect can either be achieved by a disproportionate subscription of shareholder loans or preference shares or a non-recourse loan for the managers.

b) Shareholder Agreement

The rights and obligations of the managers and the investor are stipulated in a shareholders or co-investment agreement. Such agreement includes – inter alia – provisions on the exit and the so-called leaver scheme. In case of an exit, management is obliged to co-sell its shares with the investor (*drag-along right*) and vice versa: Management is entitled to request to co-sell its shares if the financial sponsor partially or in total sells its shares (*tag-along right*). In case of corporate actions, the rights of the management (subscription rights, retention of the capital structure, etc.) can be protected by anti-dilution clauses. The allocation of any exit proceeds follows the allocation of the shareholding in the acquisition vehicle. However, the parties can agree upon alternative liquidation preferences.

c) Leaver Scenarios

Upon termination of the manager's employment contract or upon the manager's cessation as managing director with the target company, as well as under other specifically stipulated circumstances, the private equity investor can request the respective manager to sell and transfer his shares (*call option*). The manager, respectively his heirs, might request the acquisition of his shares upon the occurrence of certain events (e.g. death, disability, retirement) (*put option*). In both cases, the repurchase price depends on the specific termination event. Parties distinguish between good leaver cases (e.g. death, invalidity, occupational disability, manager's termination for good cause) and bad leaver cases (e.g. manager's breach of duty, termination of manager's contract by the employing company for good cause). In good leaver cases, the repurchase price is equal to current fair market value of his shares, subject to vesting schedules. In bad leaver cases the manager is only entitled to the lower of the fair market value and his acquisition costs for his shares. Vesting of the shares might be subject to time (e.g. 25 % p.a.) or performance of the target company (e.g. achievement of certain EBITDA/free cash flow targets). Payment of the repurchase price might be made upon exercise of the respective option or deferred until the occurrence of an exit.

In addition, the management's participation might be subject to money-multiple hurdles (e.g. 2.5 times the invested money) or internal rate-of-return hurdles (e.g. 25 % p.a.) set by the financial sponsors (*ratchet*).

2. Tax Aspects

Structuring of management incentives in Germany is, to a considerable extent, tax-driven: stock option schemes are taxed like bonus schemes, i.e. the gain recognized by management upon exit is fully taxable as ordinary income. In contrast, MEPs can be structured in order to generate favorable capital gains for managers.

For shares acquired prior to January 1, 2009, the former tax regime applies. If a manager holds less than 1 % of the stated share capital of the company, the shares can be sold free of taxes after a holding period of at least 12 months. For shares acquired after January 1, 2009, the new capital gains flat tax of 25 % (plus church taxes and solidarity surcharge) applies if the shareholding is less than 1 %. If the shareholding is above 1 %, the capital gain is subject to the partial income procedure (*Teileinkünfteverfahren*), i.e. only 60 % of the gain is subject to the personal tax rate (plus church taxes and solidarity surcharge).

The acquisition of shares below fair market value will trigger fully taxable ordinary income. The same applies to the whole MEP gain, if the beneficial ownership in the acquired shares is denied by the tax authorities due to intensive restrictions of shareholder rights of managers, e.g. vesting, claw backs, transfer restrictions.

IV. Personal Obligations and Liability Risks of Managers in M&A-Scenarios

Managers in M&A transactions have personal obligations, the breach of which creates personal liability. This is relevant not only in private equity situations (with management participations on either one or both sides), but also between the target and its managers. Seller's or purchaser's managers and their advisors might have their own obligations and liabilities if they, for example, cause or induce a breach by the target company's managers, or if they otherwise participate in

that violation (which might constitute fraud or another tort or criminal offence) or because they fail to detect or disclose the breach.

A manager may breach his obligations by making disclosures. Any disclosure of a company's data or secrets to another person might constitute a breach of confidentiality. Disclosure to a competitor is certainly a breach and even a financial sponsor might be, or become, a competitor through another investee company. Releasing information may be a breach of third party rights, such as express or implied confidentiality obligations to customers, suppliers or employees. Disclosure can also constitute a breach of data protection laws – either industry-specific ones such as those in the financial and telecommunication industries, or general ones such as the Federal Data Protection Act.

Non-disclosure can also constitute a breach of a manager's obligations and expose the manager to liability. Generally speaking, conflicts of interest must be disclosed. For instance, direct contact between management and bidders (or contact in the absence of the seller's representatives) is forbidden, even without a special agreement to this effect, unless it is disclosed to the target and the seller.

F. Third Party Involvement

I. Antitrust Issues

The European and German antitrust laws cover the following three fields of regulation, also known as *the three pillars of antitrust law*:

- Prohibition of agreements restricting competition;
- Prohibition of abuse of a dominant position;
- Merger control.

The German and European antitrust laws coexist in such a way that both the German Act Against Restraints of Competition (GWB) and the European Treaty on the Functioning of the European Union are applicable as the case may be.

As the prohibition of abuse of a dominant position is only of secondary importance in case of foreign investments in Germany, the other two pillars are described below.

1. Restraints of Competition

All agreements between undertakings, decisions by associations of undertakings and concerted practices which have more than minor restrictions of competition as their object or effect are prohibited by the GWB. A prohibition under European antitrust law also requires that the agreement may affect trade between EU member states. The term *agreement* not only covers such between competing companies (*horizontal agreements*), but also agreements between companies which operate at different levels of the economy, e.g. in a supplier-customer relationship (*vertical agreements*).

Anti-competitive agreements between companies are exempt from the general prohibition if certain conditions are fulfilled, e.g. according to the GWB, specific cooperation facilities of small or medium-sized enterprises may be permitted in order to equalize disadvantages in competition with powerful large-scale enterprises.

Agreements that do not comply with the applicable anti-trust law may be void altogether or with regard to specific clauses, and are not enforceable. Moreover, third parties may be entitled to claim for removal, injunctive relief and/or damages. Finally, the authority can order an end to the conduct objected to in administrative proceedings and impose a fine of up to millions of Euros. Depending on its contribution to uncovering the cartel, a cooperative cartel member can be granted a reduction of up to 100 % of the fine imposed.

2. Merger Control

Merger control interdicts the construction of oligopolies or monopolies in the market by means of acquisition. When a company or a person intends to buy a company in the market in which they are already involved, they might have to apply for a merger control procedure if the turnover of the involved companies exceeds certain thresholds. According to the principal of a *one-stop-shop* on EU-level, German merger control is not applicable if the thresholds of the European Community Merger Regulation (ECMR) are met. In this case a notification must only be filed with the European Commission. Recently, the 8th amendment of the German GWB has introduced broad alignment with EU law.

In general, transactions that are subject to merger control must not be closed before clearance or before the statutory waiting periods have expired.

a) European Merger Control

A merger is governed by the ECMR if the combined aggregate worldwide turnover of the companies is greater than EUR 5 billion and the aggregate EU-wide turnover of each of at least two companies involved in the merger is greater than EUR 250 million.

Furthermore, the ECMR is applicable if the combined aggregate worldwide turnover of all companies involved is higher than EUR 2.5 billion and the following terms are complied with simultaneously:

- The aggregate EU-wide turnover of each of at least two of the companies involved in the merger is higher than EUR 100 million;
- The aggregate turnover of each of at least two companies involved in a merger in each of at least three of these member states is higher than EUR 25 million;
- The combined aggregate turnover of any company involved in the merger in each of at least three member states is higher than EUR 100 million.

A merger is not subject to European merger control if two third of the EU-wide turnover of all involved companies is made in only one member state.

The substantive test to assess a merger is the SIEC-test, which examines whether a merger will have a significant impediment on effective competition. Market dominance is an example of such an impediment. As a rule of thumb, the Commission will assume market dominance if the undertakings have a market share of 50 % or more after the merger. Clearance of the notified merger may be made subject to structural or behavioral conditions and obligations.

The merger control procedure is divided into two phases. Phase I lasts for 25 days from the filing; 90 % of the notified mergers are cleared within this phase. Phase II is opened only if an in-depth investigation procedure is necessary. It lasts up to 90 days, but may be extended.

b) German Merger Control

The German merger control regime is contained in sections 35 to 47 of the GWB. German merger control will only apply if the combined aggregate worldwide turnover in the preceding financial year is higher than EUR 500 million and at least one company must have a turnover within Germany of more than EUR 25 million and a further company must have a turnover within Germany of EUR 5 million.

For the calculation of turnover on the acquirer’s side, the turnover of all companies controlled or controlling the acquirer have to be taken into account. On the target side, turnovers only attributable to companies controlled by the target company (i.e. not the group) are taken into account. In this respect, turnover thresholds are based on net turnover, derived from sales of products and provision of services. Excluded is all income generated from business activities in the normal course excluding taxes, intra-group sales and transitory items. If the operations of a company consist of trade in goods, only three fourth of the turnover is taken into account. It should be noted that the Federal Cartel Office (FCO) treats several timely successive transactions within two years between the same parties as one merger. For media companies

the respective turnover has to be multiplied by the factor of 8. For financial institutions and insurance companies, different thresholds are applied according to their business.

There are exemptions: A merger will not be subject to control, if a non-controlled company is involved which has a worldwide turnover of less than EUR 10 million. However, in contrast to before the 8th amendment, a notification obligation now exists irrespective of whether or not a market is a *de minimis*-market, i.e. a market in which goods or commercial services have been offered for at least five years and each of the product markets had a sales volume of less than EUR 15 million in the last calendar year. However, the FCO must clear a merger in such a market.

Even the acquisition of a single built-up or undeveloped property by way of an asset deal may principally meet the merger requirements of a so-called acquisition of assets, if the respective thresholds are exceeded.

The most significant change implied by the 8th amendment concerns the substantive test in German merger control. Whereas until now the dominance test was applied, German merger control is now in line with the ECMR and applies the SIEC-test. The creation or strengthening of a dominant position will only be an example of a substantial impediment. Note that the FCO will presume an individual market dominance if the company has a market share of 40 % or more.

In case the respective legal requirements are fulfilled, the parties must file a pre-merger notification. Hereafter, the FCO with seat in Bonn shall decide within one month (phase I) if the main merger control procedure has to be conducted. Without such a demand by the FCO, the approval is deemed granted. 95 % of the notified mergers are cleared in phase I. In the event of a main merger control procedure (phase II), the FCO assesses the merger depending on the market and company structure and conduct. Clearance may be subject to structural or behavioral obligations. After a deadline of four months (resp. five if obligations are assessed), the approval is deemed granted.

II. Foreign Investment Approvals

In principle, investments in German businesses are free and – except for only a few specific public related industries – not restricted (freedom of investment principles). The acquisition of companies with offices or places of business in Germany is only restricted with respect to investors with their seats or management outside the European Union (EU)/European Free-Trade Area (EFTA) on the one hand and the acquisition of German war-related industries on the other hand; that way the authorities have the exceptional right to restrain any acquisitions which endanger the public order or security of the Federal Republic of Germany.

1. General Investment Approvals

Since 2009, each direct or indirect acquisition of at least 25 % of the voting rights of a German company by an acquirer with its seat or management outside the EU/EFTA may be reviewed by the Federal Ministry of Economics and Technology (FMoET) within three months, beginning upon conclusion of the obligation to acquire a company (see B.IV.5.), respectively upon publication of the decision to make a takeover bid or publication of obtainment of control. Only if and to the extent the FMoET requests the delivery of documents relating to the acquisition, it has an additional two months to issue orders or prohibit the acquisition in case it endangers the public order or security of the Federal Republic of Germany.

If no concerns exist, each acquirer has a right to issuance of a clearance certificate vis-à-vis the FMoET. The application for a clearance certificate requires a description of the scheduled acquisition and information about the acquirer and its business. The clearance certificate is considered to be granted if the FMoET has not instituted review procedures within a period of one month beginning upon receipt of the application.

2. Approvals for Acquisitions of Defense-Related Industries

Only in case of the acquisition of a German company that manufactures or develops military weapons, cryptographic systems or other defense-related goods, the transaction must be announced to the FMoET. The notification requirement also applies in case of an indirect acquisition if a foreigner holds 25 % or more of the voting rights of the German parent acquirer.

The FMoET can only prohibit such acquisition within one month after receipt of the announcement, if and to the extent the prohibition is essential in order to protect the security interests of the Federal Republic of Germany.

III. Public Financial Control

When investing in German companies, investors are subject to various regulatory requirements, depending in particular on the kind and amount of their investment and the type of company in which they invest. As a general rule, these requirements are applicable in cases of companies incorporated in Germany; however, in some cases they may also apply to companies whose shares are admitted for trading on a regulated market in Germany. Due to the upcoming implementation of the of the Directive on Alternative Investment Fund Managers (Directive 2011/61/EU) into German law, additional notification requirements will also be triggered if investments are made in non-listed German companies by the managers of such funds (see 5. below).

1. Acquisition of Shares: Notification Requirements

When acquiring or selling shares in companies admitted for trading on a regulated market, as well as warrants, financial instruments or other instruments which give an unconditional right to acquire shares with voting power in such companies and, in so doing, exceeding or falling below certain thresholds in voting rights (3 %, 5 %, 10 %, 15 %, 20 %, 25 %, 30 %, 50 %, 75 %), any investor has to notify the company and the BaFin without undue delay, at the latest within four trading days. The notification period begins at the point at which the notifying party knows or in consideration of the circumstances must have known that his percentage of voting rights has reached, exceeded or fallen below the above-mentioned thresholds. It is assumed that the notifying party gets to know of this two trading days after reaching, exceeding or falling below the respective threshold. Voting rights may generally not be exercised if the notification requirement is not complied with.

Any purchaser of listed shares reaching or exceeding the threshold of 10 % or any higher threshold must disclose to the issuer within 20 trading days whether

- the investment is aimed at implementing strategic objectives or generating a trading profit;
- it plans to acquire further voting rights within the next twelve months by means of a purchase or by other means;

- it intends to exert an influence on the appointment or removal of members of the issuer's administrative, managing and supervisory bodies; and
- it intends to achieve a material change in the company's capital structure, in particular as regards the ratio between own funds and external funds and the dividend policy.

With regard to the objects of the purchase and the source of financing, the notifying party must state e.g. whether and to what extent means are debt or equity. Public tender offers are exempt from such disclosure, as well as purchases by investment companies regulated under the Undertaking for Investments in Transferrable Securities (UCITS) directive. The issuer is required to publish any information thus disclosed and information on all cases in which the disclosure requirement has been violated. Issuers may exclude application of the disclosure requirement in their by-laws.

When acquiring shares in AGs that are not listed on a regulated market and exceed the threshold of 25 % of the shares, the purchaser has to notify the company and the company has to publish such notification. No similar notification requirements apply to purchases of shares or interests in companies of other legal types, such as GmbHs.

2. Public Tender Offers

Any bidder making a public tender offer (see B.V.) to purchase shares as a whole or in part in a company admitted to trading on a regulated market is subject to certain notification and publication requirements. An offer document in the German language must be submitted to and approved by the German Financial Supervisory Authority (BaFin). Additional requirements apply to takeover bids and mandatory offers in case voting rights reach or are intended to reach at least 30 %. Upon written application by the bidder, BaFin may grant an exemption from the mandatory offer requirements in certain circumstances. In case of conflicting foreign rules, reliefs may be obtained with regard to cross-border purchases.

3. Control of Banks and Financial Institutions

When intending to acquire shares in a bank or other regulated financial services provider subject to the supervision of BaFin and, in so doing, exceeding certain thresholds in capital or voting rights (the minimum is 10 %), the purchaser must notify BaFin and the German Federal Bank of his intention to buy such qualified holding and must also provide evidence of his tustworthiness. An "intent of acquire" should be assumed as soon as the executive board of the interested acquirer (finally) has decided if applicable with the consent of the supervisory board in favor of the acquisition. BaFin will evaluate the notification within 60 working days as of the date of the letter by which it confirmed in writing the receipt of the full notification. Such assessment period might be prolonged up to 90 working days. BaFin may prohibit the intended acquisition, inter alia, if facts justify the assumption that the notifying party is not trustworthy or for other reason does not meet the requirements to be complied with in the interest of a sound and prudent management of the regulated entity.

4. Miscellaneous

With regard to listed shares, the prohibitions of insider trading and market manipulation should be observed as general rules of conduct.

The granting of loans to portfolio companies based in Germany may be subject to license requirements depending on the amount and quantity of the loan(s) granted.

Depending on the type of transaction and portfolio company, there may be further regulatory requirements, such as anti-money laundering checks on investors.

5. Additional Disclosure Requirements arising from AIFMD

Due to the implementation of the Directive on Alternative Investment Fund Managers (AIFMD) in German law on July 21, 2013 by means of the introduction of the Capital Investment Act (KAGB), the regulatory framework regarding the management of alternative funds will significantly change. With respect to M&A-transactions, disclosure requirements and rules on asset stripping in particular must be considered when control over non-listed companies is acquired.

a) General Disclosure Requirements

The AIFMD provides for a set of rules establishing several disclosure obligations for managers of alternative investment funds (AIFM) managing alternative investment funds (AIF) that acquire major holdings or control of non-listed companies and issuers. Hence, when such AIFM acquires, disposes or holds shares of a non-listed company on behalf of the AIF, the AIFM must notify BaFin of the proportion of voting rights of the non-listed company held by the AIF any time that portion reaches, exceeds or falls below the thresholds of 10 %, 20 %, 30 %, 50 % and 75 %.

b) Disclosure Requirements in case of Acquisition of Control

When an AIF, individually or jointly, acquires control over a non-listed company or an issuer the AIFM managing such AIF shall notify

- the non-listed company concerned;
- the shareholders of the company; and
- the competent authorities of the home member state of the AIFM.

Additionally, the AIFM must make available the following information:

- the identity of the AIFMs which either individually or in agreement with other AIFMs manage the AIFs that have acquired control;
- the resulting situation in terms of voting rights;
- the conditions subject to which control was acquired;
- the policy for preventing and managing conflicts of interest;
- the policy for external and internal communication relating to the company in particular as regards employees; and
- the date on which control was acquired.

In its notification to the company, the AIFM shall request that the board of directors of the company inform the employees' representatives or, where there are none, the employees themselves, without undue delay of the information. The AIFM shall use its best efforts to ensure that the employees' representatives or, where there are none, the employees themselves, are duly informed by the board of directors. Additionally, the AIFM acting on behalf of the AIF, must

disclose its intentions with regard to the future business of the non-listed company and the likely repercussions on employment, including any material change in the conditions of employment.

Any notification must be made as soon as possible, but no later than 10 working days on which the AIF has reached, exceeded or fallen below the relevant threshold or has acquired control over the non-listed company.

c) Specific Requirements regarding the Annual Report of AIFs exercising Control of Non-Listed Companies

When an AIF, individually or jointly, acquires control over a non-listed company or an issuer the AIFM managing such AIF is further required to request and use its best effort to ensure that the annual report of the non-listed company includes additional information and is made available by the board of directors of the company to the employees' representatives or, where there are none, to the employees themselves. Such additional information to be included in the annual report must contain at least a fair review of the development of the company's business representing the situation at the end of the period covered by the annual report. The report must also include, inter alia, any important events that have occurred since the end of the financial year and the company's likely future development.

d) Rules on Asset Stripping

When an AIF, individually or jointly, acquires control of a non-listed company or an issuer, the AIFM managing such an AIF shall for a period of 24 months following the acquisition of control of the company by the AIF:

- not be allowed to facilitate, support or instruct any distribution, capital reduction, share redemption and/or acquisition of own shares by the company;
- in so far as the AIFM is authorized to vote on behalf of the AIF at the meetings of the governing bodies of the company, not vote in favor of a distribution, capital reduction, share redemption and/or acquisition of own shares by the company; and
- in any event use its best efforts to prevent distributions, capital reductions, share redemptions and/or the acquisition of own shares by the company.

IV. Pre-Emption Rights

1. Pre-Emption Rights concerning Shares

The main purpose of any kind of pre-emption right is to prevent unmeant changes in regard to the proportions of shareholdings and the accession of new shareholders in the company. Hence, in many cases, the articles of association or existing shareholders' agreements of certain companies contain pre-emption rights in favor of the existing shareholders. Usually, the articles of association provide for detailed terms and provisions on the execution of pre-emption rights, in particular the beneficiaries shall be informed prior to an envisaged transaction or immediately after or within a specific time frame after the share purchase agreement has been concluded. Therefore, provisions relating to pre-emption rights must be reviewed carefully in a due diligence process. Furthermore, it is advisable to address this issue with the respective pre-emptor in a timely manner. In many cases, it should be easy to negotiate a waiver of the respective pre-emption rights.

2. Pre-Emption Rights concerning Real Estate

The land register is only allowed to register the purchaser of a property as new owner if confirmation is provided that the municipality does not execute its pre-emption right. A municipality may have a statutory pre-emption right, e.g. in case the real estate property is located in a redevelopment area or if the property is required for other public purposes. Therefore, usually all purchase agreements regarding German real estate (*asset deal*) stipulate that the purchase price shall not fall due before the respective waiver has been issued by the municipality.

Further, statutory and contractual pre-emption rights may exist, e.g. the statutory pre-emption right of a tenant to purchase his apartment in case it was converted into a separately owned condominium (see A.III.2.c)) during the term of his lease and is now being sold for the first time. Furthermore, preemption rights can be freely created by contract with any third party, including municipalities. Please note, however, that the pre-emption right must be registered in the land register in order to affect a transaction. Pre-emption rights that are not registered in the land register and are therefore not obvious to a potential purchaser will only allow entitlement to damages vis-à-vis the other party. If registered, the pre-emption right is enforceable not only against the owner of the estate, but also any of his successors.

G. General Legal Framework for Investments

I. Labor Law

1. General Employment Conditions

A uniform labor law codex does not exist in Germany. The provisions of German labor law derive from different laws and are supplemented and overlaid by provisions of the employment contract, European legislation, collective labor agreements and bargaining agreements. Protection of the employees is of great importance and a multitude of acts exists concerning, inter alia, working hours, maternity protection and protection against chemicals in the workplace. In a nutshell, one can say German labor law is highly regulated and predominantly employee-friendly.

2. The Employment

a) Employment Contracts

The majority of employment contracts are concluded for an indefinite period of time. However, employers are free to offer fixed-term contracts. German labor law stipulates several restrictions on this right. In general, a fixed-term employment contract can be entered into for a duration of up to two years. If the duration exceeds two years, the employer needs a special reason to justify the time limitation. Without such reason, the employment contract is valid for an indefinite term.

b) Temporary Work

Temporary work is allowed in Germany and available in nearly all industrial sectors and all kinds of jobs. A significant advantage of temporary work for the hirer is the greater flexibility compared to regular employment. The termination of temporary work contracts is independent from labor law restrictions and only subject to the contract between the hirer and the temporary work agency.

c) Social Protection

German employees are insured against illness, invalidity, age, unemployment and geriatric care by statutory social insurance. In general, employer and employees bear the costs in equal parts. Apart from such mandatory law, the employer is free to grant additional benefits, mainly occupational pension schemes, funded only by the employer or funded by employer and employees.

d) Termination of Employment

aa) Dismissal Protection and Reasons for Termination

Employees working for an employer with more than ten regular employees enjoy dismissal protection; the employment contract can only be terminated for specific reasons. Therefore, termination is only admissible for personal, conduct-related or operational reasons. Dismissal for personal or conduct-related reasons requires a previous warning and is supposed to be a last resort option. Dismissal for operational reasons is based on an organizational business decision. Labor law courts are not entitled to examine this entrepreneurial decision. However, an extraordinary dismissal is possible without a previous warning, if the default of the employee is

of such great extent that the continuation of employment is not reasonable for the employer. Examples of reasons are mentioned in the specific labor acts.

bb) Social Selection

Dismissal for operational reasons is only admissible if there are no other vacant jobs within the company that the employee is capable of doing. Finally, a social selection has to be executed which means that the personal needs and social situation of potentially affected employees must be taken into consideration. Social selection is under the control of the labor law courts.

cc) Notice Period and Required Form

Notice periods for termination can be found in the employment contract, in collective labor agreements or in statutory law and normally depend on the length of employment of the employee with the employer. The termination notice must be in written form.

e) Employee Transfer in Case of an Asset Deal

In case of an asset deal, the employees who belong to the unit sold are automatically transferred to the purchaser if they do not object the transfer of their employment. The question of under what circumstances an employee belongs to the unit sold is not answered by law and is subject to extensive case law of the German Federal Labor Court and the European Court of Justice. A careful assessment on an individual basis is necessary to identify those employment relationships that will be transferred to the new owner.

3. Collective Labor Law

a) Collective Labor Law Agreements (*Tarifverträge)*

Unions are of great importance in the German working world, especially for the determination of remuneration and other working conditions. During the last several years, German unions have become more and more willing to conclude flexible collective labor agreements to consider specific economic conditions. As a general rule, there is one union for each major sector of the economy, usually mirrored by a corresponding employers' association. The two sides represent the employers and employees in the periodic negotiations on collective labor agreements. Employment conditions set out in the collective labor agreement are binding for the employer, if the employer and employees are members of an employers' federation or union. Some collective labor agreements allow deviations from provisions set forth therein, if the employer faces economic difficulties or other circumstances that jeopardize jobs. Employers who are not members of an employers' federation are free to agree with the employees on deviating working conditions.

b) Workers' Council (*Betriebsrat)*

Employees of an undertaking's business unit with more than five regular employees are entitled to set up a workers' council. In case an undertaking operates more than one business unit, more than one workers' council may be established. The size of the workers' council depends on the number of employees. Workers' councils have considerable consultation and information rights, e.g. relating to such issues as dismissals, organizational changes, conditions of employment, vacation schedules, etc. Further, the employer shall inform the workers' council in full and in good time about an acquisition of the company, if a change of control occurs thereby. As a general rule, the briefing must occur before any decision on the deal is made. The relevant

documentation shall include information regarding the potential acquirer and his intentions with respect to the company's future business activity and the resulting consequences for employees. The obligation to inform does not exist if the operation and business secrets of the target company are thereby endangered.

4. Co-Determination

Co-determination in bigger corporations is also realized by the election of supervisory boards. The proportion of shareholder and employee representatives depends on the branch and the number of persons employed by the company. The proportion of employee representatives ranges between one third and one half (see A.II.1.g) and A.II.2.b)bb)). The chairman of the supervisory board provided with a casting vote is always a shareholder representative.

II. Public Law Issues

1. Building and Planning Law

The general compliance of a real estate property with building and planning law has to be reviewed in the course of due diligence of a property. Of course, any investor has to ensure that no risks with regard to building and planning law exist. In particular, there may be restrictions on the use of a property which have an impact on the investment decision, e.g. restrictions on the conversion into *luxury* real estate or on the permitted amount of rent charged in certain *underprivileged* areas. However, some aspects of planning law may not constitute a risk but may nevertheless have a material impact on the process of the transaction itself (such as the pre-emption right of a municipality, see F.IV.2.) or even on the pricing.

a) (Re)Development Areas

Municipalities may decide that a certain area needs to be developed for the first time or that an older area needs to be redeveloped. The aims of such (re)development will be set out in a (re)development plan that is binding in nature. In the land register of the affected real estate properties, a respective notice of (re)development will be registered (and may therefore be identified in course of the due diligence). The effect of such a (re)development area is that certain transactions require the prior consent of the municipality, inter alia:

- erection, demolition or change of use of a building, as well as material investments in a building;
- sale of a real estate property or the creation or sale of a heritable building right (see A.III.2.d));
- creation of encumbrances, e.g. a land charge for a financing bank or easements;
- conclusion of lease agreements or other usages for a fixed period of more than one year.

Therefore, basically all transactions of interest for an investor require the prior consent of the municipality.

As all urban (re)development measures aim to improve a certain area, such measures will most likely result in an increase of the value of the affected real estate properties. This increase in value, however, is collected from the owners of the real estate properties by way of a so-called compensation payment. The amount of such payment equals the amount of the increase of the

value of the real estate property. An investor should therefore consider these costs in his investment decision.

b) Energy Performance of Buildings Directive and Green Building

The energy efficiency of buildings and the integration of renewable energies in modern architecture are becoming increasingly important. There are both compulsory rules and voluntary standards.

Upon the erection or significant alteration of a building, an energy pass is to be issued according to the Energy Performance of Buildings Directive (EnEV 2009). EnEV 2009 is part of German building law and stipulates technical requirements for the efficient use of energy in residential and office buildings, as well as in some industrial buildings.

Since January 1, 2009 owners of a building generally have to provide an energy pass for their building to potential purchasers. Content and format are specified by the EnEV. There are two different qualities (based on the building or based on the actual usage in case of existing buildings). Certificates may only be issued by qualified individuals (e.g. architects, construction engineers). In case a sale or lease agreement is concluded without respective documentation, the owner may be fined up to EUR 15,000. However, in case the owner of an existing building does not intend to sell or lease the property, an energy pass is not required. The goal of EnEV 2009 is to diminish the energy demand of buildings by 30 % in comparison to the former EnEV 2007. In 2014 the provisions of EnEV 2009 will be further tightened.

The Renewable Energies Heating Act (EEWärmeG) came into force on January 1, 2009. It stipulates that the owners of new buildings are obligated to generate a percentage of their heat (and cooling) requirements from renewable energies. This applies to both residential and non-residential buildings whose building application or building notification, respectively, was filed after January 1, 2009. The owner may decide at his own discretion which type of renewable energy is to be used. It is merely important that a certain percentage of the required heating and/or cooling is generated by the use of renewable energies. The percentage is dependent on the type of renewable energy chosen. Building owners who do not wish to use renewable energies may chose from a variety of so-called *compensation measures*. The EEWärmeG was amended with effect as of May 1, 2011. Since this date, the obligation to use renewable energies not only applies to new buildings but also to existing public buildings. This exemplary function must be complied with in respect to any buildings owned by public authorities. In addition, this obligation applies to any buildings leased to public authorities.

Besides these statutory requirements, so-called *green buildings* are en vogue. Green buildings are generally recognized as having lower energy consumption and a lower environmental impact than standard buildings and combine particular design features with special materials und utility systems (ventilation, heating, water etc.) to obtain a structure with very low to no impact on the environment. The exact definitions may vary, but the growing number of possible green solutions and approaches that emerged led to the development of national standards for green buildings such as the Leadership in Energy and Environmental Design, Green Building Rating System developed in 2000 by the U.S. Green Building Council, the Green Star Rating System developed by the Green Building Council Australia launched in 2002 and the BREEAM in the UK provided by the United Kingdom Green Building Council launched in February 2007.

Similarly, the German Sustainable Building Council was founded in 2007 and started to certify buildings in 2009. The German Sustainable Building Council has developed a German standard, also under consideration of EU requirements. It provides three certificates: "bronze", "silver" and "gold".

2. Environmental Law

a) Environmental Permits

In the course of a due diligence it is important to clarify whether the target company has obtained all required environmental permits and whether these permits have been complied with in all respects. Permits pertaining to immission control, water rights and waste legislation, as well as such permits for storing and discharging hazardous substances are the most common environmental permits.

Where an environmental permit is required for a certain business, a distinction is to be made between those types of permits granted to a particular natural or legal person and those granted in respect of a particular installation. Where a permit is granted to a particular person (e.g. the target company), it is personal and *attached* to the person and cannot be sold and transferred to a third party. Therefore, if the transaction shall be made by way of an asset deal (see A.I.) and the permit is required to carry on the business, the purchaser will have to apply for a new permit after the transaction. If the transaction shall be made by way of a share deal (see A.I.), the permit granted to the target company will generally remain unaffected by the sale and transfer. Where a permit is granted in respect of a particular installation, the permit is *attached* to that installation and will remain unaffected as well, irrespective whether the transaction is an asset deal or a share deal.

The permits issued by the authorities mainly include supplementary provisions such as, for instance, limit values or deadlines, with which the holder of the permit must comply. The business management should take particular care to comply with such supplementary requi-rements. Otherwise, the authorities may be entitled to withdraw the permit and stop operations.

b) Environmental Liability

With respect to damages inflicted on the environment, a number of laws regulating liability exist. The type of liability that occurs most frequently in practice is liability for contaminated sites. The party that caused the contamination and his universal successor, the current and the former owner of the property, as well as the occupant of the relevant property (e.g. the tenant) and – by way of exception and under certain conditions – the shareholder of a company may be obliged to remediate the contamination at their own expenses.

In connection with transactions, it is advisable to obtain special administrative information, e.g. from the register for contaminated sites, and to involve specialized companies which follow standardized procedures to examine environmental issues. In an initial phase, required documentation will be reviewed, the site will be inspected and the persons in charge will be interviewed. In the event that these activities result in indications of environmental risks, technical and environmental examinations will be made in a second phase.

Due to the liability risks described above, it is advisable for the purchaser to include a guarantee in the sale and purchase agreement concerning the absence of contaminated sites or detrimental changes to the soil. Both in the event that contaminations have already been

disclosed and in the event that the presence of such contaminations cannot be excluded, the purchaser should require the coverage of that risk by way of an indemnity.

3. Public Procurement Law

Due to German history, the state is the owner of a great deal of land, in particular in East Germany. Therefore, the state often appears as the seller of real estate properties. In case the state is involved, certain contracts have to be put out to tender. A violation of the public procurement law would render any respective contract void. Generally, this obligation exists only for contracts regarding the procurement of goods, building work and services. Therefore, the sole sale of land generally was and continues to be not subject to tender. However, the conclusion may change in cases in which the purchaser assumes further obligations, e.g. an obligation to build. In this case, the entire transaction may be legally regarded as constituting a building order or a building concession – and thereby be subject to the obligation to put out to public tender. Before 2009, there was still some uncertainty due to the so-called *"Ahlhorn jurisdiction"* as to which transactions have to be, in fact, put out to tender. This uncertainty has, in the meantime, been remedied to a large extent by the amendment of section 99 of the Act against Restraints of Competition (GWB) which came into force on April 24, 2009, as well as the judgment of the European Court of Justice dated March 25, 2010 in the matter *"Helmut Müller"*, which confirms the new version of section 99 as being consistent with European law. However, side agreements in purchase contracts which – even if merely partially – relate to services in which a public authority as the seller of a property takes a direct economic interest still remain subject to the regulations under public procurement law.

III. Investment Grants and Subsidies

Investors in Germany can benefit from numerous publicly offered incentives to all investors – regardless of whether they are from Germany or not. The German government, the individual federal states and the European Union provide funds. The support ranges from cash incentives to labor-related incentives, as well as incentives for research and development. Cash incentives provided in the form of non-repayable subsidies make up the main components of this package. Various forms of funds may be combined.

The level of grants available principally depends on the size of the enterprise and the number of new employees. Schemes are subject to alteration, a fact that must be taken into consideration. Grants and subsidies in Germany are generally approved or allowed under certain conditions, e.g. retaining in supported industry sector, minimum number of employees for a definite period, all associated assets must remain in the manufacturing facility. The intention of these conditions is to preserve the purpose of the subsidy.

1. Subsidies in the EU

The legal and financial framework of public funding throughout Europe is provided by the European Union, meaning that public funding must meet certain criteria applicable to all EU member states. The East German states (Brandenburg, Mecklenburg-Western Pomerania, Saxony, Saxony-Anhalt and Thuringia as well as special areas of Berlin) are supported as a *convergence region* on a high level of public funding. The EU institutions review this Cohesion Policy once every seven years. The next round of programs is to be launched in 2014.

2. Subsidies in Germany

Grants and subsidies from the German federal and regional governments are generally provided in the following ways:

- subsidies (some of which are repayable under certain conditions);
- loans at low interest rates (granted by various public credit institutions; maturities between ten and twenty years; maximum amount between EUR 500 and EUR 25 million, depending on the subsidy scheme);
- capital resources aid (also available from various public institutions); and
- guarantees (provided for investments in projects and equity holdings).

If the target of an investment is subsidized by any public grant or subsidy, the aid will not be granted automatically after the sale of the company. Furthermore, the repayment of grants or subsidies under certain conditions must be taken into consideration. In case of subsidies which breach the EU framework of public funding, certain subsidies can be reclaimed for an unlimited period. It is possible that the investor may be obliged to reimburse grants or subsidies. Hence, grants and subsidies are a considerable subject of due diligence, because reclaimable payments could be a crucial risk for an investor in various scenarios. A preventive subsidies-compliance may be installed.

If the development or restructuring of real estate is subsidized by any public grant or subsidy, the aid is commonly dependent on the fulfillment of specified conditions. The nature of these conditions is determined by the nature of the investment. The conditions can lead to restrictions on the permitted amount of the rental fees. They have to be met for a fixed period of time (between 5 and 30 years). Any violation of the conditions may lead to an obligation by the investor to reimburse grants or subsidies. In case of the purchase of subsidized real estate during the fixed period of time, the existing conditions commonly also apply to the purchaser. Failure to meet these conditions may lead to an obligation by the purchaser to reimburse grants or subsidies or may cause penalties to be imposed. Therefore, careful review in the due diligence process is absolutely necessary.

IV. Intellectual Property (IP)

1. Situation of Intellectual Property Rights

Germany is a member of all important international intellectual property treaties and its IP system complies with international standards concerning the types of protectable IP and the enforcement of IP rights. The German legal framework is said to be highly efficient, predictable and reliable. The protection of intangible assets has always enjoyed great importance in Germany, which is for instance reflected by Germany's ranking as no. 10 (of 144 nations) in innovation, including protection of intellectual property in the Global Competitiveness Report 2012/2013, as well as by the fact that the European Patent Office is based in Munich, Germany.

Most intangible assets enjoy protection as exclusive rights only after registration. Technical inventions are protectable (if they meet the requirements of the German Patent Act) as patents (max. 20 years), utility models (max. 10 years) or as topographies (max. 10 years); only in certain cases may duration of protection be extended (for pharmaceuticals and petrochemicals for 5 years). Non-technical intangible assets that enjoy protection after registration are

trademarks (renewable for 10 year terms, indefinite protection possible), design patents (max. 10 years) or domain names (indefinite term).

However, further protection exists for intangible assets without any registration, like copyright protection for works, which also includes software programs. Copyright protection is granted for a period of 70 years after the death of the author for works. Protection without registration is also granted for secret know-how, mainly by the Unfair Trade Practices Act (for the period of secrecy) and trademarks/trade names may also enjoy protection through use (i.e. well-known trademarks). As Germany is an EU member, *European* IP rights are in place (*community trademarks and community designs*) which automatically provide protection in Germany without a requirement for further national registration. Unitary European patent protection is on its way but not yet enacted.

2. Specific IP Issues in Transactions

After having identified all intellectual assets of the target (including the non-registered rights) specific issues should be observed in its acquisition.

a) Inventions/Patents

Under German law, an invention principally belongs to the inventor (mostly an employee) and in the past, the invention had to be claimed by the employer in writing vis-à-vis the employee within a period of 4 months after notification to be transferred to the employer. The respective statutory provision was changed as of October 1, 2009 – for employee inventions notified thereafter, the employer is now deemed to have acquired the invention by law if he does not release it to the inventor within 4 months. Payment of certain compensation to the employee/inventor by the employer (usually small standardized amounts if agreed in advance) is mandatory. If patents registered in the name of the target company are based on third parties' inventions acquisition from the inventor has to be proven.

b) Copyrights

Under German law, the copyright as such cannot be transferred but the author may only grant exclusive rights of use and exploitation to the purchaser/transferee. The author always retains his personality rights (*moral rights*) to the work. There is no work-for-hire principle in Germany, except in cases of software programs. Concerning other works created by employees, the economic rights to such works have to be transferred to the employer which can be provided in the employment agreement (also implicitly if the circumstances permit such interpretation).

c) Transfer of Rights and Availability

For registered IP rights, the transfer of rights should be filed with the relevant registers, even if it is not mandatory for validity of transfer, but necessary for later enforcement of rights against third party infringers. Another issue particularly in many share deals is to make sure that the relevant technology/know-how is accessible after acquisition. This may be effected by documentation and post-contractual non-compete obligations of the relevant people in the target which must be limited in time and scope and subject to certain compensation to be enforceable. With regard to software, respectively IT, the crucial points are to safeguard access to and availability of customized software (source codes, documentation), as well as to assure continuing disposability of the IT infrastructure and access to the data (data transfer is subject to

rather strict data protection laws) after closing an asset deal or acquiring a separate business division.

d) Licenses

With respect to (*exclusive*) license, technology transfer and R&D agreements, no permit or registration is required but there are certain anti-trust issues that merit attention as they could affect validity of the agreement. Transfer of any such agreement to the purchaser (in case of asset deals) requires the approval of the other contractual partner.

V. Information Technology (IT)

1. General Situation in Germany

Germany offers attractive conditions for either forming or acquiring IT- or IT-related companies. Four of the top 10 European software developers and vendors by revenue are German, including SAP, by far the largest one. The reasons for Germany's leading position are a stable and predictable legal framework, a sound economic environment, the availability of highly skilled personnel and a tradition of innovation (note that of all European countries German companies have the most patents and Germany is ranked fifth among the patent holding countries worldwide).

2. Specific IT Issues in Transactions

In Germany IT-related software and technology is protected by special provisions in the Copyright Act (UrhG) and, in some cases, by the Patent Act (PatG). The former type of protection comes into force *ex lege*, i.e. there is no formal registration necessary or even possible. The software's author – or the company employing the author – becomes owner of the copyright the moment he finishes his work. In contrast, protection by a patent is granted by the German Patent Office (*Bundespatentamt*) after a formal application has been submitted and the claim has been thoroughly examined and the validity recognized by the Office. Since the prerequisites for obtaining a patent for software are very strict, most developers do not attempt to file an application.

When acquiring a company in Germany due diligence (see B.III.) usually covers the following IT aspects: examination of the company's contracts in order to make sure that it has the necessary licenses and other intellectual property rights to operate the software in use. This becomes particularly important if the company uses individually developed or customized software. In this case it is important to make sure that the company has access to the source code in case the developer becomes insolvent. If the company itself develops software (or other products protected by the Copyright Act), it must be ensured that the license agreements it has entered into are sufficiently safe. If the outcome of such due diligence is not satisfactory, the purchaser has to either ensure that there will be no negative effects (e.g. by renegotiating the relevant contracts) or take such possible effects into account when calculating the price he is prepared to offer for the company.

3. Specific Issues regarding E-Commerce and other Internet-Based Activities

For companies which are active in E-Commerce (i.e. sell their products or services via the internet), there are specific laws which need to be taken into account, most of them dealing with

consumer protection. Those laws, however, are based on European Union standards and are therefore virtually identical throughout the EU member states.

VI. Product Liability

In Germany, the manufacturer, respectively the first importer to the EU, can be held liable for defects of its products that cause death or physical harm or damage other products. The German Product Liability Act is based on EU law and provides for a strict liability independent of default or a contractual relationship. Three types of product defects cause liability: design defects, manufacturing defects, and defects in marketing (improper instructions, failure to warn of latent dangers). Liability for personal harm is limited by law to EUR 85,000,000; any further limitations of liability (e.g. in general terms and conditions) are invalid. Thus, due diligence mainly serves to identify potential liability risks that require building up a reserve and/or proof of insurance coverage and can be reflected in the purchase price or in the SPA through indemnifications.

H. Specific Investment Scenarios

I. Venture Capital

1. General

The term *venture capital* refers to capital provided to companies as seed, start-up or growth money for the financing of early stages of the company's development. Companies seeking venture capital are often young and innovative businesses considered to have a high growth potential (e.g. companies from the IT or technology sector). However, those companies initially cannot cover the financial requirements for the implementation of their business models or their growth strategies with internal financing and have no access to affordable credit because of a lack of collateral. In contrast to typical bank financing, a venture capital investor offers unsecured long-term financing provided to the company as liable equity capital. Another main difference between typical debt financing and venture capital financing is the provision of support and managerial know-how to the management of the target company by the investor.

As consideration for the provision of venture capital, the investor is usually granted a minority equity stake in the target company's share capital, which is, in most cases, organized in the legal form of a German limited liability company (GmbH) or, less commonly, a German stock corporation (AG). The investment strategy of acquiring such minority shareholding is not to receive regular dividend or interest payments. Instead, a venture capital investor intends to hold its minority shareholding for a certain investment period only and to benefit from the increase of the company's inner value within an exit transaction to be consummated within or after the expiry of such investment period (see Part I. below for possible exit scenarios).

2. Transaction Procedures

a) Acquisition of Shares

In order to fund the target company directly and to avoid share transfers that are taxable on the level of the existing shareholders, the acquisition of the (minority) participation in the target company is not effected by way of an acquisition of existing shares from the founders, but by way of a capital increase in cash in the target company and the subscription of newly issued shares by the venture capital investor. According to section 55 et seq. German Limited Liability Companies Act (GmbHG) and section 182 et seq. German Stock Corporation Act (AktG), the consummation of a capital increase in both a GmbH and an AG requires a notarized resolution of the shareholders' meeting and registration in the commercial register.

b) Contractual Basis

In practice, the investment and the acquisition of the participation in the target company is based on an investment and shareholders' agreement governing the terms of the investment, the rights and obligations of the parties, as well as other aspects regarding the legal relationship of the parties *inter se*. In addition, most venture capital investments require an amendment of the target company's articles of association, e.g. in order to implement transfer restrictions on shares, different classes of shares or special investor rights and to comply with the corporate governance provisions agreed upon in the investment and shareholders' agreement. The amendment of the articles of association is effected by a shareholders' resolution, which

requires notarization and registration in the commercial register and which is usually resolved upon and filed for registration together with the capital increase resolution.

c) Investment and Shareholders' Agreement

aa) Investment Provisions

The investment and shareholders' agreement entered into between the existing shareholders, the investor and the target company initially regulates the terms and conditions of the investment and therefore contains provisions with respect to the size of the participation offered, the pre-money valuation of the target company and the amount and due date of the contributions to be made by the investor (e.g. based on the achievement of certain business milestones). In order to implement the investor's participation, the existing shareholders undertake to resolve upon the necessary capital increase, to issue the relevant amount of shares and to admit the investor to subscribe to such shares. Further, the existing shareholders are usually asked to waive any rights to subscribe to the newly issued shares, as well as any applicable anti-dilution protection. In return, the investor undertakes to subscribe the newly issued shares (which are usually issued at nominal value) and to make a further contribution (usually in cash) into the target company's capital reserves (section 272 para. 2 no. 4 German Commercial Code (HGB)) in accordance with the terms agreed upon (e.g. conditional upon the fulfillment of milestones).

bb) Investor Rights, Corporate Governance

A venture capital investor that provides fully liable equity capital to the company participates in the successful development of the company, but bears an entrepreneurial loss risk equal to that of the founders of the company at the same time. The investor will therefore insist that the investment and shareholders' agreement contains provisions on reporting obligations for the management and information rights by the investor, as well as corporate governance provisions that provide the investor with a sufficient level of passive control over the management and thereby over the development of the company. Typical corporate governance provisions within an investment and shareholders' agreement are the establishment of a supervisory board (including delegation rights of the investor) and approval requirements for fundamental shareholders' decisions and business transactions. Furthermore, it is common for the investor to ask the existing shareholders, the management and/or the company to represent and warrant the company's status at the time of the investment (e.g. with respect to certain business matters as well as title guarantees regarding the ownership in the existing shares in the company).

cc) Incentive of Management

The commitment and the incentive of the management are particularly important factors for the successful development of the target company. In order to commit the management to the company, investment and shareholders' agreements frequently contain so-called *vesting clauses*, according to which a founder who resigns as managing director of the company shall be obliged to fully or partially resign as a shareholder of the company and shall therefore transfer his shares in the company to the company and/or the remaining shareholders of the company. The amount of consideration to be paid commonly depends on the reasons for resignation (e.g. a g*ood leaver* shall typically receive the fair market value for the transferred shares, whereas a *bad leaver* might only demand the nominal value of the transferred shares).

d) Anti-Dilution

Early stage investments imply enormous difficulties in properly assessing the valuation of the target company. Such difficulties can be countered by so-called anti-dilution or valuation adjustment clauses, through which the investor is entitled to subscribe for further shares in the company at nominal value (without any premiums) in case a further financing round with third party investors is consummated based on a lower valuation than that upon which the investor's investment was based.

e) Exit-Related Provisions

Even more important for the safeguarding of the investment are so-called *liquidation preferences*, according to which the investor shall be, in case of an exit event, accorded a preference over remaining shareholders to receive certain amounts out of the exit proceeds. The amount of such preference payment depends on the bargaining powers in each individual case. Typically, the investor is entitled to the sum of his total investment, but the liquidation preference clause might also provide for a minimum interest or even entitlement to a multiple of the investment amount. The return of the investor can be further leveraged by allocating the remaining proceeds after the preference payment not only to the remaining shareholders (so-called non-participating preference), but to all shareholders, including the investor, pro rata according to their shareholdings in the company (so-called *participating preference*).

The power to enforce an exit transaction, notwithstanding the opposition of the other (majority) shareholders, is an equally important aspect for a venture capital investor, that intends to hold its (minority) participation for a limited investment period only. The investor may achieve this by so-called *drag-along clauses*, under which the remaining shareholders are obliged to sell their shares in the company along with the investor's shares in case a third party intends to acquire the company and the investor supports such exit transaction. In return, the remaining shareholders are often granted so-called *tag-along rights* (*co-sale rights*) that protect them against a unilateral withdrawal by the investor. Since the transfer of shares in a German limited liability company (GmbH) requires notarization, the whole investment and shareholders' agreement needs to be notarized if drag-along and tag-along rights are implemented.

II. Bank M&A

Bank M&A in a narrow sense is the investment of a third party (including foreign investors) in German credit and leasing portfolios or special German purpose vehicles pooling such credit and leasing portfolios (irrespective of whether the portfolio to be sold and transferred contains performing and/or non-performing credit agreements).

1. Common Deal Structure

Normally, this special kind of a portfolio transaction is structured as a

- customary asset deal by which either the credit/leasing agreement itself and all agreements in connection therewith (transfer of contracts) or as a *minus* all rights resulting from those agreements are transferred; or
- sometimes as a spin-off of the total portfolio to a new special purpose vehicle combined with a transfer of all shares of those company

to the (foreign) investor or any of its affiliated companies.

2. True Sales

Since the financial crisis 2008/2009 the securitization of portfolios by transferring the credit- and leasing portfolios to a new special purpose vehicle and issuing bonds or promissory notes which can be sold to (foreign) investors (so-called *true sale*) has declined strongly.

3. Banking Supervision Law

In addition to normally applicable fields of M&A law, e.g. corporate (see A.II.), finance (see C.), antitrust and competition (see F.1.), labor (see G.1.) and general tax law (see D.), banking supervision law is to be considered. If the acquisition of a credit portfolio acquired by a special purpose vehicle or directly by a (foreign) investor specific German or other foreign banking supervision law may be applied, i.e. in special constellations the acquirer has to have a banking license to continue the acquired business unless the acquirer has such license already.

Furthermore, the intention of an investor to acquire a significant amount of shares in a financial institution may be notifiable in advance under banking supervision law.

4. Value Added Tax Law

In case the seller does not transfer its entire (*portfolio*) business the deal has to be structured in accordance with the European Court of Justice jurisprudence to ensure that the tax authorities do not see the transfer of parts of its (*portfolio*) business to a third party as a factoring subject to the German VAT.

III. Acquisition of Distressed Companies

1. General

An investor seeking to acquire a distressed target in Germany should place careful time and consideration in deciding on the timing of the acquisition. There are four stages at which the target may be acquired: (i) prior to filing for insolvency proceedings, (ii) during preliminary insolvency proceedings, (iii) after the commencement of insolvency proceedings and (iv) as part of an insolvency plan after in-court insolvency proceedings have been terminated. Significant legal and factual considerations to be aware of in respect of the different scenarios will be outlined in this chapter.

2. Acquisition outside Insolvency Proceedings

Usually, the transaction is structured as an asset deal and in principal the same rules apply as when acquiring a non-distressed target. However, if the seller of the target company/assets is distressed then insolvency proceedings may eventually be started, in which case the investor runs the risk of an insolvency administrator either exercising its right to refuse performance of the purchase agreement or to contest the transaction. These special rights of an insolvency administrator are designed to serve the purpose of enabling the administrator to increase the value of the insolvency estate in order to generate the highest quota possible for distribution to the creditors.

a) Refusal of Performance

If the transaction contemplated under the purchase agreement is not fully consummated by either party, the insolvency administrator may review the transaction and, if he comes to the conclusion that the transaction is not favorable for the insolvency estate, choose not to fulfill the

purchase agreement. If the investor has made advance payments to the seller and the insolvency administrator refuses to fulfill the agreement, the insolvency administrator is not obligated to refund the investor's advance payments, but instead the investor's repayment claim is treated as an ordinary insolvency claim and will be settled at the end of the insolvency proceedings with a quota.

b) Contestation

Alternatively, the insolvency administrator may contest the transaction. The transaction is most vulnerable if it took place during the last three months prior to the request to open insolvency proceedings. The insolvency administrator can contest the transaction if the seller was insolvent at the time of the agreement, or when the seller disposed of the target business and the investor knew about this fact and the acquisition directly, respectively, or indirectly discriminates against the other creditors. A direct discrimination can be assumed if the purchase price is considered inadequate. For instance, price reductions because of the liquidity crisis are not accepted and may lead to a direct discrimination. In addition, it can be considered an indirect discrimination against the other creditors if the purchase price is no longer available in the insolvency estate of the seller and the insolvency estate is no longer enriched.

Nevertheless, if the investor wants to acquire the target during this time because, for instance, reputational damage of insolvency is reduced, there are ways to mitigate the risks connected with the insolvency administrator's right to refuse performance or contest the contract, *inter alia*, by structuring the acquisition as a cash transaction or by making the purchase agreement subject to the condition precedent of full payment of the purchase price.

3. Acquisition after Commencement of Insolvency Proceedings

Once the application for insolvency has been filed the insolvency court will appoint a preliminary insolvency administrator and assign them certain rights. Insolvency applications can be made on the basis of threatened illiquidity, illiquidity and over indebtedness of a company.

Normally, the debtor retains the authority to dispose of its assets during the preliminary insolvency proceedings. In this case the preliminary insolvency administrator's position is considered a *weak* one.

However, the court can also choose to appoint a *strong* preliminary insolvency administrator with the authority to dispose of the debtor's assets, although this is not very common.

In addition, the law to further facilitate corporate restructurings (ESUG), which came into force on March 1, 2012, introduced an alternative proceeding. Upon a respective application by the debtor, the insolvency court may leave the debtor's management itself in charge during the preliminary insolvency proceedings, who will be supervised by an insolvency monitor, and for restructuring purposes grant the debtor a *protective shield.* The protective shield acts to protect the debtor's assets against compulsory enforcement measures by its creditors for a fixed period of time (maximum of three months), which is determined by the insolvency court. In this time the debtor has to prepare and subsequently present an insolvency plan to the insolvency court.

a) Acquisition from the Debtor

Acquiring a distressed company during preliminary insolvency proceedings from the debtor, even with the consent of the *weak* preliminary insolvency administrator or the insolvency monitor, is not advisable. The risks connected to an acquisition of a company out of a liquidity

crisis also apply in this situation. In addition to this, the insolvency administrator has greater ability to contest the transaction as knowledge of the insolvency application is deemed sufficient to satisfy the knowledge element required to contest, and furthermore, information on insolvency applications is publicly available on the internet at www.insolvenzbekanntmachungen.de.

However, the rights of the insolvency administrator to refuse the performance of the purchase agreement or to contest the purchase agreement are excluded in circumstances where to exercise this right would constitute a breach of trust.

b) Acquisition from a *strong* Preliminary Insolvency Administrator

In instances where a *strong* preliminary insolvency administrator has been appointed, they would assume the role of seller. The rights of the insolvency administrator to refuse performance or contest the contract are excluded in this instance.

4. Acquisition during Insolvency Proceedings

a) Regular Insolvency Proceedings

In general, no insolvency-specific risks have to be considered when acquiring a company out of opened insolvency proceedings. The insolvency administrator acts as the seller under the purchase agreement and subsequently cannot contest the purchase agreement.

The acquisition from an insolvency administrator is usually structured as an asset deal and has the advantage for an investor that at this stage the transfer of certain liabilities by operation of law (for further details please see Chapter A.I.2.) is excluded. This applies to business and withholding taxes accrued from the beginning of the last calendar year prior to the acquisition and to liabilities that have been created in the conduct of business prior to the acquisition if the investor continues the business under its previous name. Furthermore, the assumption of obligations under existing employment agreements is limited. The investor cannot be held liable for any employment claims (including pension claims) that arose prior to the opening of the insolvency proceedings.

In respect of the negotiations, the insolvency administrator will not be willing to give any guarantees about the target. This is because the insolvency administrator has limited knowledge about the target and might be personally liable in the event of a breach of any guarantee. In addition, the insolvency administrator will often seek a quick sale with limited risk. Accordingly, locked box clauses and exclusion of liability clauses are rather common in purchase agreements with insolvency administrators. The insolvency administrator will be required to obtain the creditors' committee's, respectively, the creditors' assembly's consent to the conclusion of the sale agreement and will usually make this consent a condition precedent.

b) Self-Administration

In addition to debtors seeking to apply for self-administration during the preliminary stages of insolvency proceedings, debtors can also seek to apply for self-administration after insolvency proceedings have commenced. This option has been strengthened by the ESUG. If the creditors' committee unanimously supports any such application, the court is unable to reject the application on the grounds that self-administration is likely to be disadvantageous for the creditors. In such instances of self-administration, the target is sold by the debtor subject to the consent of the insolvency monitor. The prerequisites for the acquisition are the same as those described in respect of the open insolvency proceeding.

5. Acquisition by way of an Insolvency Plan

The insolvency plan shall provide for a comprehensive restructuring plan which is designed to take the target back to solvency and may, in general, contain any action that could also be legally undertaken outside of insolvency proceedings, including the sale of the target.

The terms of an insolvency plan have to be agreed between the creditors of the debtor insofar as their rights are modified therein (e.g. by a *haircut*) and confirmed by the insolvency court. Once the insolvency plan has become binding, the insolvency court will then release the debtor from the in-court insolvency proceedings.

As with the case of open insolvency proceedings, under an insolvency plan the transfer of certain liabilities which generally occurs by operation of law is excluded and there is no risk of refusal of performance or contestation by the insolvency administrator.

The law ESUG has improved the instrument of the insolvency plan by providing more freedom of action to the debtor and allowing for a more efficient adaption process. Furthermore, the ESUG introduced the option to include the target's shareholder rights in the insolvency plan and to do a debt-to-equity swap without their consent. Under the ESUG any corporate measures included in the insolvency plan are considered to be made in statutory form once the insolvency plan becomes legally binding.

I. Exit Scenarios for Investors

I. Scenarios

The scenarios of an exit can be manifold. Shares in a publicly traded company may be sold on the stock exchange or by way of a bulk sale. Shares in a privately held company can typically be sold by way of a private agreement subject to certain limitations of the articles of association and/or a shareholders' agreement of the company.

Potential alternatives to a sale may be a true merger of a company by way of general legal succession, typically in exchange for the issuance of new shares.

An exit from an investment basically triggers capital gains tax at seller level. The tax consequences are described in D. above.

The following outlines certain provisions of typically privately held companies dealing with exit scenarios in the articles of association and/or a shareholders' agreement.

II. Management of the Exit Process

A lead investor usually wishes to agree with minority shareholders in an investment or shareholders' agreement that the majority shareholder is in control of the exit process. An important feature is, *inter alia*, the decision on which advisors of the shareholders shall be retained in the exit process, in particular investment banks, corporate finance advisors, lawyers, accountants, etc. The majority shareholder typically desires that *his* advisors take the lead in the process.

III. Initial Public Offering (IPO)

In times of efficient capital markets, the IPO may be a preferred exit device and the parties may contractually agree on this preference. The IPO allows the investors to behave differently with regard to their respective shareholding. Whereas certain investors seek to dispose of their investment within a certain time frame (e.g. private equity investors), their strategic partners may be interested in a long-term ongoing shareholder relationship with the joint target company.

It is common that the parties agree on a time horizon with regard to an intended IPO. The parties may also pursue the exit by way of a trade sale (*dual track*; see IV. below) simultaneously with the preparation of the IPO.

If the IPO takes place, the shareholders are commonly subject to certain lock-up obligations, e.g. for a period of 6 to 12 months, vis-à-vis the issuing banks and/or the stock exchange. The shareholders may internally also agree on certain rules on how they may limit and prioritize any sales, if any, if they are not being made by way of a bulk sale, but rather through the stock exchange. Obviously, the main concern of all parties is to protect the stock purchase price in case of substantial disposal pressure.

IV. Trade Sale

The standard alternative to the IPO is the so-called trade sale, i.e. a sale of all or almost all outstanding shares in the target company, typically by way of an organized sales/auction process. Alternatively, the assets of such company and/or its subsidiaries may be sold in a third party transaction. A further exit alternative may be a recapitalization, by which shareholders

seek a return on their investment through one or more jumbo dividends that may be financed by the assumption of further debt by the target company. (For tax consequences, see D.)

In a privately held company, it is common that the shares are not freely transferable but rather that share transfers are subject to consent requirements of the management, the board or the shareholder assembly, respectively, and to preemptive rights or rights of first refusal of the other shareholders.

In case of a trade sale, the minority shareholder will typically request a tag-along right vis-à-vis the majority shareholder, which allows the minority shareholder to co-sell its shareholding together with the majority shareholder.

The other side of the tag-along right is the drag-along right. The drag-along right secures the majority shareholders' position to sell 100 % of the target company shares, thereby generally achieving a higher purchase price. The drag-along right is typically an undertaking of the minority shareholder vis-à-vis the majority shareholder. The majority shareholder may possibly seek to protect his drag-along right by obtaining a proxy from the minority shareholder in order to smoothly effectuate the trade sales process.

The minority shareholder may seek to obtain protection regarding the drag-along rights by the majority shareholder by agreeing that the disposal

- is being made according to the same conditions for the minority shareholder as the conditions agreed upon by the majority shareholder;
- (in certain scenarios) contains a minimum price (e.g. EBIT or EBITDA-related); and
- may not be an intra-group transaction of the majority shareholder.

V. VC Transactions

In VC transactions, it is common that investors obtain a liquidation preference upon exit that secures a prioritized return allocation to financial sponsors (waterfall). Typically, the most recent financing has priority over prior financing by other financial sponsors or the original investment of the founders of the company. In detail, these provisions may be rather complex (see H.I.2.e)).

J. Litigation and Arbitration

I. Litigation

1. General Remarks

When investing in Germany, foreign investors sometimes get involved in legal disputes with third parties or public authorities. In this respect, it is reassuring to know that Germany has a reliable, truly independent and cost-efficient court system in place, which is capable of helping the parties resolve their disputes in a reasonable and timely manner. Hence, Germany is ranked in the Economic Forum's Global Competitiveness Report 2012-2013 among the top 10 nations in the category of Judicial Independence.

2. Structure of the German Court System

The Courts in Germany are structured in a three-tier system. Decisions made by a court of first instance may be appealed in appellate court. If, after this second instance, the outcome of the case is still disputed, the aggrieved party can petition the highest German civil court, the German Federal Court of Justice (BGH), provided that the appellate court or the Federal Court of Justice admits the petition. While appellate courts are concerned with the facts of the case and the hearing of evidence, the court of highest instance is mainly concerned with issues of law. Hence, the BGH fosters the continuous development of the law, while appellate courts assert individual interests.

Although the courts of first and second instance are, strictly speaking, not bound by the decisions of the Federal Court of Justice, it is common practice in Germany that they follow these decisions. This leads to a high degree of legal certainty, since the decisions of the first instance courts are foreseeable and not surprising or made arbitrarily. This degree of legal certainty is based on Germany's many decades of democratic legal tradition and also on the fact that all laws in Germany are codified and available to everyone. This legal reliability and the resulting planning dependability make Germany attractive to both domestic and foreign investors.

3. Court Conduct

Legal proceedings before courts usually begin with a claim filed by a plaintiff. In his statement of claim, the plaintiff must explicitly define what he is seeking. This motion needs to be substantiated by a presentation of the facts and by the legal norms deemed relevant. After the plaintiff files his claim, the court then grants the defendant the possibility to reply to the statement of claim. If the defendant decides not to defend himself legally or not to respond to the claim, the court may decide in favor of the plaintiff simply on the grounds of default (so-called *judgment by default*). After both parties have presented their cases through written submissions, the court usually appoints a date for an oral hearing. The court prepares for this hearing by separating the disputed from the undisputed facts and by verifying whether the disputed facts are relevant to the case. Evidence is only gathered if the parties present the facts differently and the court considers such differences to be relevant to the outcome of the case. If so, both parties are granted the possibility to convince the court of their version of the facts through witnesses, documents, expert opinions, etc. Contrary to practice in common law countries, it is not possible to cross-examine witnesses and to question them about every aspect of the case. Questions

directed at witnesses must be directly related to the facts the court is seeking to prove or disprove. In practice, this accelerates the gathering of evidence since questions concerning irrelevant facts are not permissible. By conducting legal proceedings in such a manner, both parties save a considerable amount of time and money. After evidence has been gathered and the parties heard, the court announces its verdict and provides extensive written justification for its decision. Many court decisions are collected in comprehensive court casebooks that are available to judges and lawyers, as well as to laymen. In short, Germany enjoys a very transparent legal system.

II. Arbitration

1. Advantages of Arbitration

As compared to court litigation, arbitration is advantageous – especially concerning complex M&A disputes – as the parties can influence the nomination of the arbitrators, thereby ensuring that the arbitrators have the particular expertise necessary for the dispute. Furthermore, arbitration proceedings are confidential. They are also more flexible, as the parties can determine the procedure themselves. The arbitral award can be enforced more easily than ordinary court rulings, especially abroad, since there is an effective international network of treaties and conventions in place which governs the recognition and enforcement of foreign arbitral awards.

Arbitration is generally faster than litigation because there are no stages of appeal. Standard arbitration proceedings take between one and two years in total; even complex M&A arbitration proceedings can be completed in about two years.

2. Legal Framework

Arbitration comes into play if the parties agree on ad hoc arbitral proceedings according to the German arbitration law or on institutional proceedings according to the arbitration rules (DIS Rules) of the German Institution of Arbitration (DIS).

a) The German Arbitration Law

The German arbitration law in the 10th book of the German Code of Civil Procedure (ZPO) came into force on January 1, 1998 and comprises 42 provisions. It is based on the modern and internationally recognized UNCITRAL Model Law, is independent of all other provisions of Germany’s national civil procedure law and applies to all arbitrations taking place in Germany.

Parties can easily obtain the jurisdiction of an arbitral tribunal outside the ordinary court system by concluding an arbitration agreement by which all or certain disputes that have arisen or that may arise between them with respect to a defined legal relationship, are submitted to arbitration. Such arbitration agreements must be made in writing. In the event that consumers are involved, it is also required that the arbitration agreement be concluded as an independent contract separate from the main contract. For multi-party arbitrations with several claimants and/or respondents, it is advisable to include a provision for the selection of arbitrators in the arbitration agreement, as German arbitration law does not provide a statutory mechanism for the selection of arbitrators in multi-party situations.

In German arbitration law, it is mandatory that all parties be treated equally and given equal opportunity to present their case. It is possible for both, German and foreign attorneys-at-law to

appear as counsel before arbitral tribunals. In total, the provisions of the German arbitration law bestow a maximum degree of autonomy on the parties with regard to the organization of the proceedings. Although the law stipulates three arbitrators, if the parties do not determine otherwise, they may agree upon a single arbitrator, e.g. to save costs. As there are no fixed statutory provisions regarding the arbitrators' fees, the parties and the arbitrators have to agree upon the fees (e.g. on the basis of the costs for court proceedings or on the basis of the DIS rules).

In Germany, the Higher Regional Courts determine whether an arbitral award may be reversed or not. However, the grounds for reversal must comply with comparable international standards.

b) The Arbitration Rules of the German Institution of Arbitration

The DIS, Germany's leading institution for arbitration, and its arbitration rules, which were amended on July 1, 1998, represent an efficient and proven system of regulations which may be simply applied by using the standard arbitration clause recommended by the Institution. The DIS rules are currently available in seven languages.

The DIS rules are also based on UNCITRAL Model Law. The DIS provides administrative support during arbitration proceedings, for example during the formation of the arbitral tribunal, during the transmission of party pleadings or in case substitute arbitrators have to be appointed. According to the DIS Rules, the place of arbitration may be chosen at will, such that foreign parties can transport the rules of procedure to their chosen place of arbitration.

Unless the parties have chosen otherwise, three arbitrators determine the outcome of the case. In comparison to statutory German arbitration regulations, the DIS rules offer the advantage that they include a regulation for cases in which more than two parties are involved in a particular dispute. Problems that often arise through such a constellation, for example when appointing the arbitral tribunal, are easily solved through the DIS rules.

It is worth mentioning that, according to the DIS rules, the arbitral tribunal has the discretion to order the production of documents. In practice, most arbitral tribunals will investigate the facts only upon request of at least one party.

In international comparison, the DIS rules are a cost-efficient alternative to the regulations of other international arbitration organizations, such as the popular regulations of the Swiss Chambers' Court of Arbitration and Mediation or the ICC. The costs of DIS proceedings depend on the amount in dispute. An administrative fee for the DIS is added to the fees of the arbitrators (e.g. for a tribunal of three arbitrators with two parties involved, the fees for the arbitrators and the DIS (exclusive value added tax) for an amount in dispute of EUR 1,000,000 amount to approx. EUR 76,700, for an amount in dispute of EUR 10,000,000 to approx. EUR 225,900 and for an amount in dispute of EUR 100,000,000 to approx. EUR 456,900).

The DIS also succeeded in facilitating fast-track arbitration agreements by recently issuing the *Supplementary Rules for Expedited Proceedings*. By shortening the time period for the nomination of arbitrators and by limiting the number of written submissions, it is possible to bring arbitration proceedings to a close very quickly.

Depending on whether a single arbitrator or a tribunal of three arbitrators is nominated, proceedings based on these rules can be terminated within six or nine months, respectively, after the submission of the statement of claim. Such fast-track proceedings may be suitable if

the parties only want to obtain a decision on a specific legal question (e.g. if a material adverse change (*MAC*) has occurred).

3. Corporate Law Disputes

Germany also offers a reliable framework for arbitration proceedings involving shareholder disputes within a limited liability company (GmbH). When compared to the ordinary court system, this arbitration framework can be especially attractive to foreign companies with German subsidiaries who are involved in a dispute.

Although the ability to arbitrate such disputes had long been controversial, the BGH has approved it in a recent and well-noticed decision. The court, however, has also decided that arbitration clauses can only be deemed legally effective if strict conditions are fulfilled.

In particular, the arbitration agreement needs either to be embedded in the company's articles upon approval of all shareholders or to be concluded in an independent contract between all shareholders and the company. Furthermore, it is not only required that the company's executive bodies but also each shareholder be informed about the commencement and the course of the arbitration proceedings, thus enabling them to participate in the proceedings. Last but not least, each shareholder must be given the possibility to participate in the process of electing and nominating arbitrators and all shareholder resolution disputes concerning the same subject matter must be settled jointly before the same arbitral tribunal.

Although the decision of the BGH entails a complex regulating mechanism, this does not have to be an obstacle for arbitration agreements. In order to better meet the needs of its users, the DIS issued the *Supplementary Rules for Corporate Law Disputes*, which fulfill all the conditions set forth by the BGH. The supplementary rules are available in both German and English.

III. Mediation

1. About Mediation

Mediation is an alternative method of dispute resolution which parties in M&A or corporate law disputes should take into consideration. Contrary to litigation and arbitration proceedings, the results reached in mediation proceedings are not decisions imposed upon the parties by a court or arbitral tribunal. In the course of mediation proceedings, the parties directly negotiate with each other and settle their dispute on their own under the guidance of an impartial instance, the mediator. Judge-based dispute resolution systems focus on *hard* facts and come to a decision by strictly and solely following the settings of legal provisions. The core objective of mediation is not to find a decision merely regarding the applicable law, but to explore and consider the interests and needs of the disputing parties in the first place. The aspired result is a win-win-situation based on an agreement that is satisfactory for both/all parties.

2. Advantages of Mediation

Mediation is the method of dispute resolution which gives the parties the greatest freedom of scope with regard to the result and course of the proceedings. As there are no binding rules, every problem can be discussed and every compromise can be made – everything is possible within the legal framework. Contrary to litigation and arbitration, the parties are even free to terminate the mediation at every stage of the proceedings without further consequences. Particularly, if the parties are interested in keeping up a good relationship and continuing

business with each other after settling their dispute, mediation is an advantageous and recommendable procedure. On the contrary, contentious proceedings often leave one or even both parties dissatisfied and usually lead to the termination of personal and business relations.

Since mediation proceedings are confidential and nobody apart from the mediator and the parties needs to be involved, the parties can discuss and find a decision in a private setting. Ordinary court proceedings are time and cost intensive as disputes usually continue for years and several writs are exchanged. Mediation proceedings are based on the conversation of the parties and the parties often achieve an agreement in one closed session. As a result, the costs for mediation proceedings are regularly far lower than those for litigation or arbitration proceedings, especially with regard to disputes with a high amount at stake.

3. Legal Framework and Course of Proceedings

Mediation has successively gained more importance in contentious procedures in Germany over the last years. In summer 2012, the German Parliament adopted the *Mediation Act*. This Act sets basic provisions for mediation proceedings, such as sovereignty of the parties and confidentiality, and ensures that the mediation proceedings are governed by a qualified mediator. However, it does not contain any regulations concerning the signing of mediation contracts or the enforcement of decisions found in mediation proceedings. Thus these aspects are governed by the general provisions of Civil Law. A new provision in the German Code of Civil Procedure rules that the claimant should declare in the claim whether mediation proceedings have been initiated before the submission of the claim.

Mediation proceedings include five procedural steps. In the first step, the mediator explains the principles of mediation and the parties agree on rules for the proceedings. In the second step each party has the opportunity to depict the dispute from their point of view. In the third phase, the mediator discusses with the parties the interests of each party and their ideas for the settlement of the dispute. These interests and ideas are the basis for the discussion between the parties in the fourth phase. The final step includes the settlement and record of the achieved agreement.

Parties interested in settling their disputes in mediation proceedings should include a mediation clause as well as applicable rules of procedure into the agreements they enter into with each other. Several institutions, for example the DIS, have developed rules for mediation proceedings.

In order to ensure effective enforcement, mediated decisions should be stipulated in a notarial deed or an attorney’s settlement declared enforceable.

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