Private Equity

Contributing editor
Bill Curbow

2019

GETTING THE DEAL THROUGH

GETTING THE DEAL THROUGH

Private Equity 2019

Contributing editor

Bill Curbow

Simpson Thacher & Bartlett LLP

Publisher
Tom Barnes
tom.barnes@lbresearch.com

Subscriptions
Claire Bagnall
claire.bagnall@lbresearch.com

Senior business development managers
Adam Sargent
adam.sargent@gettingthedealthrough.com

Dan White
dan.white@gettingthedealthrough.com

Law Business Research

Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 3780 4147
Fax: +44 20 7229 6910

First published 2005
Fifteenth edition
ISBN 978-1-83862-084-4

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

Preface

Private Equity 2019

Fifteenth edition

Getting the Deal Through is delighted to publish the fifteenth edition of *Private Equity*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on the British Virgin Islands, Canada, Colombia, Egypt and Thailand. The report is divided into two sections: the first deals with fund formation in 22 jurisdictions and the second deals with transactions in 23 jurisdictions.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Bill Curbow of Simpson Thacher & Bartlett LLP, for his continued assistance with this volume

GETTING THE
DEAL THROUGH

London
February 2019

Germany

Tarek Mardini and Sebastian Käpplinger

P+P Pöllath + Partners

Formation

1 Forms of vehicle

What legal form of vehicle is typically used for private equity funds formed in your jurisdiction? Does such a vehicle have a separate legal personality or existence under the law of your jurisdiction? In either case, what are the legal consequences for investors and the manager?

The most common legal form is a closed-ended fund organised as a German limited partnership (KG) as it is tax-transparent, allows flexible structuring and provides limited liability to investors. KGs have separate legal personality. The general partner (GP) of the KG is personally liable for the debts of the KG. To reduce liability risks, typically a company with limited liability (GmbH) serves as GP (GmbH & Co KG). The investors join as limited partners. The fund manager is typically acting as managing limited partner of the KG. Besides the KG, several other legal forms are available for German private equity funds (eg, investment KG, investment AG, UBG). However, the KG is the market standard (in particular for registered, ie, 'sub-threshold', fund managers).

2 Forming a private equity fund vehicle

What is the process for forming a private equity fund vehicle in your jurisdiction?

The formation of a KG is simple. The KG comes into legal existence with the signing of the limited partnership agreement (LPA) by the GP and the limited partners. To ensure limited liability for investors, the KG and its partners will be registered in the German commercial register. Also, the beneficial owners must be reported to the transparency register. Notarisation of the LPA is not required, but the filing with the commercial register must be effected by a notary. Signatures of investors must be notarised by a notary public (if taking place outside Germany, generally an apostille in accordance with the Hague Convention has to be provided by the notary public). Limited partners in the form of an entity must provide proof of their valid existence and due representation by the signatories. The fees and expenses for the notarisation of filing with the commercial register and the registration fees are fairly small and generally do not exceed €2,000. Filings can usually be effected within two to four weeks. The KG itself has no minimum capital requirements. A minimum registered capital of €25,000 applies to a GmbH serving as GP.

3 Requirements

Is a private equity fund vehicle formed in your jurisdiction required to maintain locally a custodian or administrator, a registered office, books and records, or a corporate secretary, and how is that requirement typically satisfied?

A separate custodian is necessary if the fund is managed by a fully licensed manager under the KAGB (the German implementation of the Alternative Investment Fund Managers Directive (AIFMD)). A custodian is not necessary in the case of a registered (sub-threshold) manager. A fund in the form of a KG requires a domicile in Germany and must comply with the commercial law requirements regarding book-keeping. The fund manager typically serves as managing limited partner of the fund and also performs corporate secretarial and administrative tasks. A separate administrator is rather uncommon (as opposed to other jurisdictions).

4 Access to information

What access to information about a private equity fund formed in your jurisdiction is the public granted by law? How is it accessed? If applicable, what are the consequences of failing to make such information available?

The records maintained at the commercial registry are public via the internet. This includes the identity of the investors as limited partners and their liability amounts (typically expressed as a small percentage of the capital commitment). Such disclosure can be avoided by interposing a nominee as direct limited partner, to hold and manage its limited partner interest for and on behalf of the investors as beneficiaries. Filing of the partnership agreement is not required, thus the fund terms remain confidential. The partnership is required to file its annual financial statements with the commercial register and to publish them in the electronic Federal Gazette. The articles of association of the GP are filed with the commercial register and are available to the general public. Fines and other enforcement measures can be imposed for failure to make required filings. In 2018, Germany introduced the transparency register under the EU anti-money laundering (AML) law. The transparency register must include all beneficial owners unless the beneficial owners are already shown in public documents in the commercial register.

5 Limited liability for third-party investors

In what circumstances would the limited liability of third-party investors in a private equity fund formed in your jurisdiction not be respected as a matter of local law?

The investor's liability as limited partner in relation to the partnership is limited to such investor's capital commitment. Liability in relation to third-party creditors of the fund is limited to the liability amount registered with the commercial registry, typically a small percentage of the actual capital commitment. If this amount has been paid into the partnership, then there is no additional liability of such limited partner to third parties. Potentially, there is a risk that a limited partner is treated as GP (ie, fully liable to third parties) for the period of time between its admittance to the partnership and registration of such limited partner with the commercial register (whether when subscribing to a fund in the fundraising process or in the case of a transfer). However, technical solutions are available and common to avoid such risk (eg, making the registration with commercial register a condition precedent for the formal admission to the partnership). Otherwise, there are generally no circumstances in which the limited liability of limited partners would not be respected as a matter of German law.

6 Fund manager's fiduciary duties

What are the fiduciary duties owed to a private equity fund formed in your jurisdiction and its third-party investors by that fund's manager (or other similar control party or fiduciary) under the laws of your jurisdiction, and to what extent can those fiduciary duties be modified by agreement of the parties?

A fund manager's fiduciary duties are mainly based on the rules of conduct imposed by the AIFMD. This means a fund manager must act honestly, fairly and with due skill, act in the best interests of the fund and its investors and treat all investors fairly. Furthermore, the fund manager must take all reasonable steps to avoid conflicts of interest where possible. These fiduciary duties cannot be altered by agreement. However, the fund manager and the investor can agree on higher threshold for the fund manager's liability (see question 7).

7 Gross negligence

Does your jurisdiction recognise a 'gross negligence' (as opposed to 'ordinary negligence') standard of liability applicable to the management of a private equity fund?

The management of the fund (ie, the GP, the managing limited partner, or both) must by law apply the standard of care of a prudent business person. In particular, the management must follow the legal requirements for book-keeping, preparing of statutory accounts and filing of tax returns of the fund. In practice, however, partnership agreements typically restrict the liability of the GP and the managing limited partner to gross negligence and wilful misconduct. Some commentators in legal publications dispute, however, whether such a restricted standard of liability can be enforced in court as between the partners of a partnership.

8 Other special issues or requirements

Are there any other special issues or requirements particular to private equity fund vehicles formed in your jurisdiction? Is conversion or redomiciling to vehicles in your jurisdiction permitted? If so, in converting or redomiciling limited partnerships formed in other jurisdictions into limited partnerships in your jurisdiction, what are the most material terms that typically must be modified?

Fund sponsors need to be aware of the special rules on the taxation of a private equity fund – for more information see question 17 et seq. German regulated investors, such as insurance companies, require a free transferability of their interest in the fund. If the sponsor uses the limited partnership (GmbH & Co KG) as the most common private equity fund vehicle in Germany, investors need to be registered with the commercial register of the KG in order to be shielded from unlimited liability.

There are no specific rules for a conversion of a non-domestic vehicle into a domestic vehicle. Possible from a legal perspective is redomiciling of a non-domestic vehicle to Germany. This would result in the case of a limited partnership to a conversion of the vehicle into a German limited partnership (GmbH & Co KG). The most material change of such redomiciling will be the fact that the KG and its investors need to be registered with the local commercial register in order to benefit from limited liability. Potential negative tax effects of such conversion or redomiciling have to be analysed in advance on a case-by-case basis.

9 Fund sponsor bankruptcy or change of control

With respect to institutional sponsors of private equity funds organised in your jurisdiction, what are some of the primary legal and regulatory consequences and other key issues for the private equity fund and its general partner and investment adviser arising out of a bankruptcy, insolvency, change of control, restructuring or similar transaction of the private equity fund's sponsor?

There are no legal or regulatory rules directly connecting an event at the fund sponsor level with the private equity fund and its GP and investment adviser. It is possible, though – depending on the group structure – that events such as bankruptcy, insolvency, change of control or restructuring at the sponsor level will lead to regulatory consequences at the manager level or at the level of the investment adviser. For instance, change of control events in the top holding company of a group will require a notification process to the regulator. Furthermore, a bankruptcy or insolvency of the GP leads to an automatic removal of the GP from the fund and the fund being switched into 'run-down mode'.

In practice, it is common that the fund LPA contains at least change of control provisions with regard to the GP and the fund manager. It is then left to the negotiations with the investors how extensive these provisions are with regard to other events and other entities of the manager group.

Regulation, licensing and registration

10 Principal regulatory bodies

What are the principal regulatory bodies that would have authority over a private equity fund and its manager in your jurisdiction, and what are the regulators' audit and inspection rights and managers' regulatory reporting requirements to investors or regulators?

The regulatory body in Germany is the Federal Financial Supervisory Authority (BaFin). The regulation of private equity funds in Germany is based on the AIFMD. The regulatory regime is therefore foremost a regulation of the manager and only indirectly a regulation of the fund itself. BaFin has inspection rights towards managers as well as the right to perform an audit. In addition, each fully licensed manager must itself have an auditor perform an audit on the manager's regulatory compliance.

The regulatory reporting requirements are as follows.

Registered managers (AIFMD sub-threshold managers)

- Reporting obligations to BaFin:
  - annual report of information pursuant Annex IV of delegated regulation (EU) 231/2013 (AIFMD Annex IV Reporting); and
- reporting obligations to the German federal bank (Bundesbank):
  - monthly report regarding the composition of the fund's assets and the adjustment of the fund's assets as a result of revaluation; and
  - quarterly reporting of granted loans of each amount over €1 million.

Fully licensed managers

- Reporting obligations to BaFin:
  - ad-hoc notifications in the case of material changes (eg, dismissal of a managing director or reduction of own funds);
  - annual financial statement of the manager; and
  - AIFMD Annex IV Reporting; and
- reporting to Bundesbank:
  - same as registered managers (see above).

As for the regulatory reporting to investors, half-yearly and yearly reports are mandatory for fully licensed managers. For registered managers, there is no regulatory investor reporting requirement; however, annual reports are required by German commercial law.

11 Governmental requirements

What are the governmental approval, licensing or registration requirements applicable to a private equity fund in your jurisdiction? Does it make a difference whether there are significant investment activities in your jurisdiction?

Regulation of private equity funds is primarily exercised through the regulation of the managers. It requires that the manager is either fully licensed or registered with BaFin under the KAGB.

Registered managers (AIFMD sub-threshold managers): registration process

Availability

The registration process is only available to certain small or medium-sized managers. The most important category of these small to medium-sized managers are known as sub-threshold managers under the AIFMD/KAGB. In practice, most German private equity fund managers fall within this category.

Sub-threshold managers under the KAGB are managers with assets under management of not more than €100 million (in the case of leverage) or not more than €500 million (no leverage) and who only manage special alternative investment funds (special AIFs). Special AIFs are AIFs whose interests or shares may only be acquired according to the fund documents by professional investors or semi-professional investors (ie, non-retail funds). Besides the requirements mentioned above, special private equity AIFs managed by sub-threshold managers are in principle not regulated.

In interesting option for a sub-threshold manager in the small to mid-cap market segment is to get additionally registered under the EU EuVECA regime to benefit from an EU marketing passport.

Registration procedure

The registration procedure for sub-threshold managers is comparatively simple. It requires the submission of an informal registration request together with certain 'corporate' documents on the manager and the managed funds (such as the fund's limited partnership agreement (LPA) and the manager's articles of association). In addition to being a special AIF, the fund may not require the investors to additionally pay in capital beyond the investor's original commitment.

The possible EuVECA registration is in line with the EuVECA requirements on the manager and the fund.

Ongoing issues

An advantage of the registration is that only few provisions of the KAGB apply to a registered-only manager, mainly the provisions on the registration requirements, ongoing reporting requirements and the general supervisory powers of BaFin. However, fund-specific requirements do not apply to registered-only managers and their funds. In particular, the depositary requirements and marketing requirements as well as the additional requirements of the KAGB for fully licensed managers do not apply.

On the downside, the registration restricts the manager to the type of funds and investors for which the registration was obtained (ie, only special AIFs and professional or semi-professional investors). Furthermore, a registered manager does not benefit from the EU marketing passport under the AIFMD. A registered manager can, however, opt in to become a fully licensed manager.

Fully licensed manager: licensing process

Availability

Fund managers who do not qualify for a registration or who opt out of a registration must apply for a full fund-management licence with BaFin under the KAGB. A full fund-management licence opens the door for a manager to market funds to retail investors as well as to the EU marketing passport under the AIFMD.

Licensing procedure

The licensing procedure is a fully fledged authorisation process with requirements equivalent to the requirements for granting permission under article 8 AIFMD. The licensing procedure checks requirements, such as sufficient initial capital or own funds, sufficiently good repute of the directors and shareholders, and organisational structure of the manager.

Ongoing issues

The licensing of the manager results in the manager being subject to the entirety of the KAGB. This means, in particular, the following:

- the required appointment of a depositary for the funds;
- access to setting up contractual funds;
- adherence to the corporate governance rules for funds set up as investment corporations or investment limited partnerships (investment KGs);
- adherence to the fund-related requirements of the KAGB;
- adherence to the marketing rules of the KAGB;
- access to the marketing passport under the AIFMD;
- access to the managing passport under the AIFMD; and
- adherence to the reporting requirements of the KAGB.

12 Registration of investment adviser

Is a private equity fund's manager, or any of its officers, directors or control persons, required to register as an investment adviser in your jurisdiction?

The German regime requires the entity that is conducting the portfolio and risk management of a fund to have a licence as a fund manager under the KAGB/AIFMD. There is no separate registration as an investment adviser. If a separate entity is advising the fund manager, such entity might need a MiFID licence for investment advice.

13 Fund manager requirements

Are there any specific qualifications or other requirements imposed on a private equity fund's manager, or any of its officers, directors or control persons, in your jurisdiction?

The regulatory requirements differ depending on whether the manager is fully licensed or a registered manager.

A registered manager does not have to meet any regulatory capital requirements or suitability requirements. It is sufficient for the manager to meet the capital requirements under company law (eg, €25,000 for a German GmbH). In practice, though, BaFin prefers to see that a registered manager has sufficient substance to be able to manage the fund.

The possible EuVECA registration requirements are in line with the EuVECA requirements on the manager and the fund.

A fully licensed manager must hold at least €125,000 initial capital. In addition, the manager must have additional own funds if the value of the assets under management exceeds €250 million. The additional own funds amount to 0.02 per cent of the value of the investment assets under management that exceeds €250 million. This corresponds to €20,000 per €100 million. Regardless of these calculations, the manager must have own funds amounting to at least 25 per cent of the fixed overhead costs.

A fully licensed manager needs at least two managing directors. The managing directors must be reliable and professionally suitable. The professional suitability is regularly given if the managing director has held a managerial position with a fund manager for at least three years. BaFin assesses the professional suitability individually, however, so the suitability can also be proven with less relevant professional experience.

14 Political contributions

Describe any rules – or policies of public pension plans or other governmental entities – in your jurisdiction that restrict, or require disclosure of, political contributions by a private equity fund's manager or investment adviser or their employees.

There are no such detailed rules or restrictions in Germany (other than the general criminal laws on bribery). This probably reflects the fact that investments of public pension plans and other governmental activities in private equity funds are still rather limited in Germany.

15 Use of intermediaries and lobbyist registration

Describe any rules – or policies of public pension plans or other governmental entities – in your jurisdiction that restrict, or require disclosure by a private equity fund's manager or investment adviser of, the engagement of placement agents, lobbyists or other intermediaries in the marketing of the fund to public pension plans and other governmental entities. Describe any rules that require a fund's investment adviser or its employees and agents to register as lobbyists in the marketing of the fund to public pension plans and governmental entities.

None. Where applicable, the disclosure requirements under MiFID II apply if intermediaries are used in the marketing of the fund interests. German law treats potential investors as the regulatory client of the MiFID intermediary. This results in the application of the MiFID rules of good conduct and cost-disclosures rules to the relationship between the intermediary and the potential investor.

16 Bank participation

Describe any legal or regulatory developments emerging from the recent global financial crisis that specifically affect banks with respect to investing in or sponsoring private equity funds.

As a consequence of the global financial crisis, credit institutions in the meaning of the Capital Requirements Regulation are prohibited from conducting guarantee and credit business with private equity funds. However, this prohibition only applies if the balance sheet total of the credit institution exceeds a certain threshold. Under the same conditions, credit institutions are also prohibited from conducting proprietary business.

Taxation

17 Tax obligations

Would a private equity fund vehicle formed in your jurisdiction be subject to taxation there with respect to its income or gains? Would the fund be required to withhold taxes with respect to distributions to investors? Please describe what conditions, if any, apply to a private equity fund to qualify for applicable tax exemptions.

Partnerships

For funds in the form of a partnership (eg, KG), the general rules of taxation are applicable (ie, the special tax regime for corporate funds under the German Investment Tax Act, see below, is not applicable). Therefore, if the fund is structured as a partnership that is not engaged in trade or business, it is neither subject to German income tax nor German trade tax (ie, the partnership is treated as 'transparent' for tax purposes). Any income derived by the partnership is immediately allocated to its partners and taxed at the level of the partners in accordance with the rules of the tax regime applicable to the respective partner. On the other hand, if the fund vehicle qualifies as engaged in a trade or business, the fund itself is still not subject to German income tax, but it is subject to German trade tax.

There are no withholding tax implications at the level of the partnership itself. Withholding tax implications can arise from the underlying investments made by the fund.

Investment funds

Funds in the form of a corporation or of a contractual type are covered by the Investment Tax Act (investment funds). Under the opaque regime, the fund is subject to taxation in respect to certain domestic German income (in particular, dividends and real estate income, but not capital gains from the sale of securities unrelated to real estate and unrelated to a permanent establishment in Germany) at fund level (15 per cent tax rate (ie, German corporate tax)). The exemption for dividends (section 8b of the German Corporation Tax Act) is not applicable at fund level even if the relevant threshold (ie, 10 per cent) is exceeded. In addition, German trade tax may be triggered at fund level if it is engaged in trade or business in Germany (subject to a potential exemption if the fund does not engage in 'active entrepreneurial management' in relation to its assets).

Investment funds are required to withhold tax for the taxable income of their (domestic) investors, but not for the income from the sale of fund units.

In general, there are no tax exemptions at the level of the investment fund. In return, at the level of the investor investment fund proceeds are subject to partial exemptions depending on the respective fund type (equity fund, mixed fund or real estate fund).

At the investor level, there is a lump-sum taxation for investment fund proceeds (ie, distributions, predetermined tax bases and capital gains from dispositions or redemptions). For individual investors, the actual rate of investor level taxation depends on whether the investor holds the fund interests as part of their non-business or business assets. For individuals that hold their investment fund interests as part of their non-business assets, such items are subject to flat income tax. For individuals that hold their investment fund interests as part of their business assets, principally, the full amount of such items is subject to income tax at their personal rate. For corporate investors, the full amount of such items is subject to corporation tax. In addition, German trade tax may be triggered. The partial income taxation and the exemption pursuant to section 8b of the German Corporation Tax Act do not apply. In return, investment fund proceeds are subject to partial exemptions depending on the respective fund type. With respect to equity funds, the partial exemption is:

- 30 per cent of such proceeds for individuals that hold their investment fund interests as part of their non-business assets;
- 60 per cent for individuals that hold their investment fund interests as part of their business assets; and
- 80 per cent for corporate investors.

With respect to mixed funds, half of the applicable partial exemption rate applicable to equity funds is available. With respect to real estate funds, the partial exemption is 60 or 80 per cent of the proceeds, depending on whether the fund invests at least 51 per cent of its value in German or non-German real estate and real estate companies. In return, income-related expenses and operating expenses may not be deducted to the extent of the available partial exemption percentage. With regard to trade tax, half of the applicable partial exemption rate applies.

In addition, if the investment fund qualifies as a specialised investment fund, the fund may opt to be treated transparently for tax purposes. As a result, the fund itself would not be subject of taxation.

18 Local taxation of non-resident investors

Would non-resident investors in a private equity fund be subject to taxation or return-filing requirements in your jurisdiction?

In general, non-resident investors of a private equity fund structured as a partnership will be subject to taxes in Germany pursuant to the German general tax rules for non-residents. If the fund is structured as a partnership having asset management status (ie, is not deemed to be in business and not engaged in business activities for German tax purposes), non-resident investors are generally (if holding less than 1 per cent indirect share in such portfolio company) not taxed on capital gains realised by the fund from the sale of a portfolio company and they are not required to file tax returns in Germany. However, income of non-resident investors might be subject to the German withholding tax (eg, with regard to dividend distributions from a portfolio corporation held by the private equity fund). A refund, an exemption or a reduction of withholding tax may depend on certain filing procedures. This may also apply with regard to certain double taxation treaties.

The distributions to a non-resident investor of an investment fund will not be taxable in Germany and will not be subject to withholding tax. As a result, non-resident investors who make German investments via (domestic or foreign) investment funds only have to bear a German tax burden, as far as there is a taxation at fund level (fund input side). The German non-taxation of distributions to non-resident investors (fund output side) is completely independent of which assets the fund holds, in which country the investor is domiciled and whether there a double taxation agreement is applicable.

19 Local tax authority ruling

Is it necessary or desirable to obtain a ruling from local tax authorities with respect to the tax treatment of a private equity fund vehicle formed in your jurisdiction? Are there any special tax rules relating to investors that are residents of your jurisdiction?

It is desirable to obtain a binding ruling from the local tax authorities on the tax classification of the fund to increase the level of comfort of both investors (including foreign investors) and fund managers as the tax status may not be clear (also depending on the investment strategy). If the fund is structured as a partnership, an advanced tax ruling should ideally ensure that the asset management criteria are met from the point of view of the tax administration. For investment funds under the German Investment Tax Act that want to be taxed transparently, it may be desirable to obtain a binding ruling to ensure that the criteria for a specialised investment fund are fulfilled. In certain cases, rulings regarding VAT treatment can be obtained.

There is no special treatment of income from a fund in the form of a partnership. The income is taxed at the level of German-resident

Update and trends

In December 2017, BaFin published a new investment circular with regard to the German Insurance Ordinance. The Insurance Ordinance is relevant for investments by certain non-Solvency II investors, such as local pension funds and small insurance companies. A prior draft had included severe restrictions for investments in non-EU (managed) private equity and debt funds. However, the final version of the circular, while not perfect, contains some helpful clarifications. In particular, the circular explicitly allows the incurring of debt, at least for purposes of bridging of capital calls in the case of directly investing private equity funds. A time limit for such borrowing is also no longer included. Certain limitations apply, however, for private equity fund of funds. Also, the circular clarifies that direct investments in closed private equity funds by 'special funds', which are relevant for institutional investors, remain eligible. Thus such investors can continue to invest up to 20 per cent of the value of their special funds in private equity funds without hereby burdening the quota for alternative investments. Regarding investments in certain debt funds that invest in non-subordinated debt, certain restrictions, unfortunately, remain in place (geographic limitations, requirement of a fully licensed AIFM and a 7.5 per cent quota for alternative investments rather than participation quota). German lawmakers do not currently intend to extend the MiFID rules for high-frequency trading, commodity position limits or capital adequacy to fund managers. In 2016, Germany expressly regulated the activities of German debt funds and thereby addressed 'shadow banking' concerns.

Regarding the issue of VAT on management fees, there is an update on the legislative side. As of 1 January 2018, a new provision under the German VAT Act became effective with the purpose of implementing the European Court of Justice's (ECJ) jurisprudence (in particular, the *Fiscale Eenheid* case (No. C-595/13) of December 2015) by 'selectively extending' the scope of application of the relevant VAT exemption (see question 21). However, the rather narrow framework laid out by the German tax authorities with the requirement of a catalogue of cumulative criteria is unsatisfactory – and in our view not in line with the spirit of the ECJ jurisprudence. However, there is hope that this strict interpretation will not stand as the VAT exemption of special AIFs is on the agenda of the EU VAT Committee and courts may take a different view.

A new German federal government was formed based on a coalition agreement dated 7 February 2018. This agreement lays out the plan of the new government for the next four years. It stipulates that the existing flat income tax on interest income will be abolished (in connection with the establishment of an effective automated exchange of information). This relatively brief statement in the coalition agreement raises many questions that will have to be clarified by the legislature (eg, the term 'interest income' is not specified). It also remains unclear whether the currently applicable lump-sum savings allowance will apply to interest income in the future. If this is the case, it must be clarified whether the true income-related expenses can be deducted if the lump sum savings allowance is exceeded. In the case of an investment in an investment fund, it remains to be seen how the taxation of interest income with the personal rate will be ensured. This is unclear as an obligation of investment funds to publish their tax bases no longer exists. Currently, all fund income of a private investor is taxed on the basis of the flat income tax. If the flat income tax on interest income would indeed be abolished, a split between interest income and other income would have to be made. In general, it remains true that the tax landscape is complex and subject to constant change.

The German Federal Ministry for Economic Affairs and Energy published in November 2018 the long-awaited draft law revising the German Placement Agent Regulation (FinVermV). FinVermV is relevant for all brokers and advisers whose work is subject to §34f GewO (Placement Agents). The changes aim to conform FinVermV to the European regulation under Directive 2014/65/EU (MiFID II), such that the requirements of MiFID II now apply to Placement Agents. We expect that the revised FinVermV will enter into force in March 2019. Transitional provisions have not been included. If this is not changed, Placement Agents will need to implement and apply the new requirements, in particular regarding recording conversations, at very short notice.

investors in accordance with the general rules applicable to the respective investor and the respective type of income. Domestic and foreign investors of investment funds are formally treated equally. However, the partial exemption rates provided in the German Investment Tax Act only benefit German investors, because foreign investors are generally not subject to any tax obligation in Germany at the level of the investment fund investor.

20 Organisational taxes

Must any significant organisational taxes be paid with respect to private equity funds organised in your jurisdiction?

There are no significant organisational taxes (including no stamp duties) required to be paid with respect to private equity funds organised in Germany.

21 Special tax considerations

Please describe briefly what special tax considerations, if any, apply with respect to a private equity fund's sponsor.

The carried interest of a sponsor of an asset managing (ie, non-trading) private equity fund is not subject to German trade tax. In addition, there is a 40 per cent income tax exemption, resulting in an effective rate of income tax of around 28.5 per cent, if certain cumulative criteria are fulfilled (in particular, the fund must qualify for asset management status and the carried interest must be paid only after the investors have had all their invested capital paid back). Otherwise, such income is generally fully taxable at normal German income tax rates.

In general, the management fee payable to the managing partner of a fund was subject to the German VAT until end of 2017 (regardless of whether such management fee is structured as a priority profit share). According to the revised German VAT Act as of 2018, the management of UCITS and of certain AIFs that are comparable to UCITS, are exempt from VAT. The German VAT Act does not stipulate which types of AIF are comparable to UCITS. The German tax authorities have established criteria that must be fulfilled in order to benefit from the VAT exemption (eg, the AIF has to offer shares to the same group of investors and be subject to similar obligations and controls as UCITS). In addition, it was clarified that open-ended special AIF will be exempt from VAT without fulfilling the established criteria, whereas the administration of closed-ended AIF will only be exempt from VAT if certain previously established criteria were cumulatively met.

22 Tax treaties

Please list any relevant tax treaties to which your jurisdiction is a party and how such treaties apply to the fund vehicle.

Germany has signed tax treaties with most OECD states and with many other states. Because of tax transparency, such treaties generally do not apply to a fund structured as a partnership, but directly to its partners. For the specific taxation under a tax treaty, it may be relevant whether the fund qualifies as a commercial or asset-managing partnership and if there is any permanent establishment. If the fund vehicle is structured as a corporation, such tax treaties generally apply to the corporate fund itself. However, each case must be carefully assessed for tax consequences arising from the applicable treaty and the relevant rules in each jurisdiction (eg, whether there is an applicable treaty override).

23 Other significant tax issues

Are there any other significant tax issues relating to private equity funds organised in your jurisdiction?

Depending on the structure of the fund and its assets, different German tax regimes apply. The structure of the specific investment may have far-reaching tax consequences at the fund level, but also at the investor level (eg, the structure may be relevant for the question whether the income of a foreign investor in a German is taxable (and subject to German tax filings), subject to withholding tax or whether double taxation treaties apply). The German tax landscape is complex and subject to constant change. Thus consulting experienced tax counsel regarding the establishment and investment activities of the fund as well as fund investments by investors is highly recommended.

Selling restrictions and investors generally

24 Legal and regulatory restrictions

Describe the principal legal and regulatory restrictions on offers and sales of interests in private equity funds formed in your jurisdiction, including the type of investors to whom such funds (or private equity funds formed in other jurisdictions) may be offered without registration under applicable securities laws in your jurisdiction.

Only funds managed by German registered sub-threshold managers (see questions 11) can be marketed on a private placement basis to professional and semi-professional investors in Germany. Also, marketing under the EuVECA regime is still rather simple and the regime provides an EU marketing passport. In the case of a fully licensed manager, the marketing of the fund requires BaFin approval.

25 Types of investor

Describe any restrictions on the types of investors that may participate in private equity funds formed in your jurisdiction (other than those imposed by applicable securities laws described above).

It is possible to form a private equity fund for retail investors. However, market practice is that private equity funds are only formed for participations by semi-professional and professional investors.

26 Identity of investors

Does your jurisdiction require any ongoing filings with, or notifications to, regulators regarding the identity of investors in private equity funds (including by virtue of transfers of fund interests) or regarding the change in the composition of ownership, management or control of the fund or the manager?

There are no regulatory filing requirements towards BaFin with regard to the identity of the fund investor. A fully licensed manager must notify BaFin of every change of ownership and every change of management with regard to the fund manager. A registered manager does not have these obligations. In the case of funds in the form of a KG, investors and any transfer of interests must be registered in the commercial register.

27 Licences and registrations

Does your jurisdiction require that the person offering interests in a private equity fund have any licences or registrations?

In principle, a person who sells financial instruments (including fund interests) needs a MiFID licence under the German Banking Act. However, if the person sells only fund interests of a fund managed by fully licensed AIFM, a simpler licence under the German Trade Act suffices if the respective fund is approved for marketing in Germany. Unlike in the United Kingdom, German law considers the potential investor to be the regulatory client of the placement agent.

28 Money laundering

Describe any money laundering rules or other regulations applicable in your jurisdiction requiring due diligence, record keeping or disclosure of the identities of (or other related information about) the investors in a private equity fund or the individual members of the sponsor.

The German Anti-Money Laundering Act is based on the EU Anti-Money Laundering Directive. Every investor must be identified and the investor's beneficial owner must be disclosed (know-your-customer-process). The obtained documents and information must be stored. In addition, German has implemented a transparency register with regard to beneficial owners in a vehicle. In a typical private equity structure, the aforementioned AML requirements do not extend to the members of the sponsor (except for disclosures in the transparency register).

Exchange listing

29 Listing

Are private equity funds able to list on a securities exchange in your jurisdiction and, if so, is this customary? What are the principal initial and ongoing requirements for listing? What are the advantages and disadvantages of a listing?

Private equity funds in Germany are typically structured as limited partnerships (KG). Partnership interests in these funds are not tradable on the stock exchanges. However, there are very few private equity companies structured as a corporation that are listed on the stock exchange. Such listing provides investors with greater liquidity as the shares are publicly traded, thus retail investors may invest. Unlike a fund organised as a partnership, however, a fund organised as corporation is not transparent, but is subject to German corporate tax at the fund level.

P+P Pöllath + Partners
Attorneys-at-Law | Tax Advisors

Tarek Mardini tarek.mardini@pplaw.com
Sebastian Käpplinger sebastian.kaepplinger@pplaw.com

Potsdamer Platz 5
10785 Berlin
Germany
Tel: +49 30 25 353 0
Fax: +49 30 25 353 999

An der Welle 3
60322 Frankfurt/Main
Germany
Tel: +49 69 247 047 0
Fax: +49 69 247 047 30

www.pplaw.com

30 Restriction on transfers of interests

To what extent can a listed fund restrict transfers of its interests?

According to German listing rules, it is practically impossible to restrict transfers of listed securities.

Participation in private equity transactions

31 Legal and regulatory restrictions

Are funds formed in your jurisdiction subject to any legal or regulatory restrictions that affect their participation in private equity transactions or otherwise affect the structuring of private equity transactions completed inside or outside your jurisdiction?

There are no legal or regulatory restrictions for funds managed by German sub-threshold managers to participate in private equity transactions. Fully licensed AIFMs, however, must comply with the AIFMD anti-asset stripping rules as well as with the investment-related restrictions of the specific fund category. For instance, open-ended funds may invest only a limited percentage of their assets into unlisted companies.

32 Compensation and profit-sharing

Describe any legal or regulatory issues that would affect the structuring of the sponsor's compensation and profit-sharing arrangements with respect to the fund and, specifically, anything that could affect the sponsor's ability to take management fees, transaction fees and a carried interest (or other form of profit share) from the fund.

BaFin mentioned in an unofficial statement that carry beneficiaries may only be persons that promote the purpose of the fund. In addition, under the European Securities and Markets Authority's remuneration rules, carried interest is deemed to comply with the risk alignment and other requirements of the AIFMD if it is paid only after contributed capital and hurdle payments to the investors (and if there is a clawback). The taking of transactions fees should be disclosed in the fund documents. Typically, transaction fees are deducted from the management fee.

Germany

Tim Kaufhold and Tobias Jäger

P+P Pöllath+Partners

1 Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction? What structures are commonly used in private equity investments and acquisitions?

Private equity investors still aim to acquire majority stakes. Given the cash available in private equity funds and the lack of target companies, private equity investors are nevertheless more and more willing to acquire minority interests as well. Whether they do so depends either on if they can increase their interest in the target during the holding period or on specific strategic ideas.

Leveraged buyout transactions dominate the private equity market in Germany. However, we have seen an increasing number of transactions in which private equity acquirers fully fund their investments with equity.

In most transactions, a private equity acquirer is willing to grant the management an equity portion in order to align interests with the management team. This management equity portion is in general, again, leveraged in comparison with the interest of the private equity acquirer.

Beside the acquisition of equity portions, we have also seen investment in other instruments such as profit participation rights or silent partnership interests. The private equity acquirer's willingness to enter into such investments depends on the particular case and strategy.

2 Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or later become public companies?

Private equity investors in Germany typically acquire private companies in leveraged buyout transactions that are organised as either limited liability companies, stock corporations or limited partnerships. The law provides for a framework of governance rules for each form of organisation, including for instance inalienable shareholder rights, necessary bodies or organs of the company, capital maintenance rules and requirements for insolvency filing.

The corporate governance rules imposed by statute are stricter for stock corporations and much more flexible for limited liability companies and limited partnerships. The strictest and most limiting corporate governance rules apply to listed companies, which have to be organised as a stock corporation (AG), a Societas Europaea (SE) or a limited partnership of shares (KGaA): for example, listed companies are required to comply with the codified corporate governance rules set out in the German Corporate Governance Code, last amended in February 2017, and with reporting and disclosure requirements on sensitive information that private equity investors typically do not want to share publicly.

To preserve maximum flexibility, as a result, private equity sponsors typically aim for acquiring or transforming the target company into a limited liability company. In a limited liability company more specific corporate governance rules are usually set out and agreed in the corporate documents (ie, articles of association, partnership agreement, shareholder agreement, rules of procedure for management, etc) of the target company. These further rules aim to increase control over management and limit its power. The rules that are imposed on management in addition to statutory requirements are mostly driven by the responsibilities of the private equity sponsors to supervise and control the management of the target companies in accordance with their internal portfolio guidelines.

Typically, only for an exit through an IPO do private equity sponsors accept the stricter governance rules that apply to the target company after its transformation into a stock corporation.

3 Issues facing public company boards

What are some of the issues facing boards of directors of public companies considering entering into a going-private or other private equity transaction? What procedural safeguards, if any, may boards of directors of public companies use when considering such a transaction? What is the role of a special committee in such a transaction where senior management, members of the board or significant shareholders are participating or have an interest in the transaction?

The issues the board of directors of public companies face when considering entering into a transaction depend on the role of the public company within the transaction:

- If the listed company acts as a seller the board of directors represents the company in the negotiations and preparation of the transaction and also in the conclusion of the agreements to implement the transaction. If the transaction or the preparation of a transaction is to be considered as insider information for the (selling) listed company, the board of directors has to make an ad hoc announcement in order to inform the market on the intended sale of the target. Under certain prerequisites management may decide on a deferral of such ad hoc announcement to avoid disadvantages in the selling process. However, such a decision on the deferral needs to be documented in minutes and supported by the board. Decisions on allowing potential buyers to undertake due diligence on the target have to be carefully considered and the information presented in the due diligence has to be thoroughly selected. Management has to ensure that no insider information is being passed in the due diligence process to the potential buyers of the target. The board of directors must also consider if allowing a due diligence already requires approval by the supervisory board according to the corporate governance guidelines, which is typically the case. To avoid personal liability and to enable the supervisory board to perform proper control over management (but not for the legal effectiveness of the transaction) the board of directors typically requires an approving resolution of the supervisory board before signing the deal. In rare cases, however, where the listed company sells its major assets in the transaction, a shareholder resolution needs to be obtained in order for the transaction to become legally effective.
- If the listed company is the purchaser of the target the board of directors has to consider at what point in time the preparation or conclusion of the transaction becomes insider information that requires an ad hoc announcement to the market. The board of directors may also make a decision on a deferral. A resolution of the supervisory board is required before the actual signing of the

transaction, and not only for legal effectiveness but also to enable proper control of management by the supervisory board.
- If the listed company is the target of an attempted public takeover, the board of directors has to decide on allowing the potential bidder to undertake due diligence. It has to decide if and what information can be provided to a bidder without violating the company's interests and without passing on insider information. This decision can already require approval by the supervisory board, to avoid personal liability for the management. In any case, it is at least advisable that each decision of the board of directors is supported by a resolution of the supervisory board. The management board is allowed to take pre-bid defensive measures as well as certain post-bid defensive measures in accordance with the Takeover Act and the Stock Corporations Act, but the rules are strict and in general the board of directors is rather limited in taking any defensive measures against a hostile takeover. In any event, the board of directors and the supervisory board have to give a public statement and give comments on the evaluation of the public takeover offer from their perspective.
- Disregarding the role of the company in the transaction if any benefits are gained by or promised to the board of directors in connection with the transaction, such benefits need to be disclosed and a conflict of interest shall not affect the decision of the board, otherwise the board could face personal liability.

4 Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

If the target company is publicly listed, an investor must notify the target company and the Federal Financial Supervisory Authority (BaFin) once it obtains or surpasses 3, 5, 10, 15, 20, 25, 30, 50 and 75 per cent of the target's voting rights pursuant to the Securities Trading Act (WpHG). In turn the target company has to publish the voting rights of the investor. The obligation to notify also applies if the voting rights are held indirectly (eg, through financial instruments). Investors reaching 10 per cent of the voting rights in a listed company must inform the target company of their intended objectives and their source of funding within 20 trading days. The investor must further specify its intentions with respect to:
- its strategic goals or returns from investing;
- the acquisition of additional voting stock in the next 12 months;
- exerting influence on the company's management or supervisory board; and
- the substantial modification of the capital structure of the target.

In turn, the target company needs to disclose such information to the public.

If more than 25 per cent or the majority of shares in an unlisted German stock corporation are acquired, the acquired company must be notified. The same applies in case of a shortfall of these thresholds. In the case of a failure of such requirements, the shareholder may not exercise the voting rights from its shares.

When shares in a limited liability company (GmbH) are acquired, a new list of shareholders has to be registered with the competent commercial register, which is publicly available. Any new partner to a partnership needs to be registered with the competent commercial register.

As of 1 October 2017, there have been new filing requirements for acquirers of shares pursuant to amendment of the Money Laundering Act. All legal entities governed by private law have to file certain data with the Transparency Register, inter alia regarding the beneficial owners in the company (ie, persons directly or indirectly holding more than 25 per cent of the shares or control more than 25 per cent of the voting rights or exercising control in a comparable way (eg, by voting trust or pooling agreements)). Exemptions apply for listed companies owing to the equivalent filing requirements pursuant to the WpHG and such entities for which the relevant data is available from other (electronic) registers. Violation of the filing obligation is punishable by a fine.

According to the Capital Investment Act (KAGB) disclosure requirements with respect to M&A transactions in which the management of alternative funds (AIFM) are involved must be considered. When such AIFM acquires, disposes or holds shares of a non-listed company on behalf of an of alternative investment fund (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 per cent. When an AIF, individually or jointly, acquires control over a non-listed company or an issuer the AIFM managing such AIF must notify the non-listed company concerned, the shareholders of the company and the competent authorities of the home member state of the AIFM, and must make available further information with respect to inter alia the situation with respect to the voting rights and when control was acquired, the policy for preventing and managing conflicts of interest and the policy for external and internal communication relating to the company in particular as regards employees, 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. The company needs to inform the employees' representatives or, where there are none, the employees themselves, without undue delay of the information.

According to the Foreign Trade Act and the relevant ordinance, the Federal Ministry of Economics and Energy (BMWi) needs to be informed if the investor originates from outside the EU or EFTA (see question 18).

According to the merger control provisions of the German Act against Restraints of Competition, transactions have to be disclosed to the Merger Control Authority if the parties to the transaction meet certain thresholds.

5 Timing considerations

What are the timing considerations for negotiating and completing a going-private or other private equity transaction?

Typically, private equity and going-private transactions are advised by investment banks or M&A advisers.

The acquisition of private companies is usually organised in auction processes coordinated by M&A advisers of the seller. The duration of such a transaction (including the planning phase and post-closing measures) varies from a few weeks up to several months, depending on the individual circumstances, such as the size of the transaction, transactional and financing structures, time pressure on the buyer's or seller's side and if public approval or clearances (eg, antitrust) are necessary. The timeline for the auction is set out by the M&A advisers organising the process. The auction process starts with sending out teasers to potential buyers and conclusion of a non-disclosure agreement. Interested bidders gain access to an information memorandum containing basic financial and legal information about the target company and are then asked to submit non-binding offers outlining their ideas regarding the purchase price and transaction structure. Certain bidders are then selected and are granted access to a data room to perform due diligence on the target, which, depending on the size of the transaction, takes one to three months. After the due diligence the bidders are requested to submit binding offers including a mark-up of the sale and purchase agreement provided by the seller. The seller then enters into negotiations with its preferred bidders. Besides the negotiation between the seller and the bidder, the bidder typically is negotiating financing and warranty and indemnity (W&I) insurance for the transaction. These side negotiations usually set the minimum time frame for the negotiation between the seller and the bidder as these elements are a prerequisite for signing the transaction. The conclusion of the sale and purchase agreement (the Signing) and the actual transfer of the shares (the Closing) are typically done in two separate steps, as the transfer in rem of the shares in most transactions is subject to the payment of the purchase price and other conditions precedent (eg, merger control clearances and other public approvals). If merger control clearance is required there is period of at least one month between the Signing and the Closing, as this is the time frame when the Federal Cartel Authority may review the transaction and declare clearance or denial.

To take a publicly listed company private the acquisition of shares by a private equity investor are typically initiated through a block trade by which – outside the stock exchange – the acquisition of a bigger share package is being negotiated with one or several major shareholders. This is then combined with a public tender or takeover offer to obtain control over the publicly listed company. In any event, if a party obtains control of a public company either through a block trade purchase on the stock exchange or a public tender (ie, acquires at least 30 per cent of its voting rights, as defined by the German Takeover Act), a public takeover offer becomes mandatory. This requirement needs to be considered if a private equity investor acquires or intends to acquire a substantial participation in a publicly listed target. Once the investor obtained control or the intention of the investor to make a public offer has been announced, the process for the takeover offer normally takes about 12 weeks (maximum up to 22 weeks). The duration of possible stakebuilding measures or a due diligence review before control has been obtained or an announcement of an offer has been made varies widely depending on the individual circumstances. To efficiently take a publicly listed company private (ie, not only cancel the listing with the stock exchange but also have no further minority shareholders in the company (for the consequences of having minority shareholders with respect to corporate governance requirements, see question 2)), private equity investors in Germany aim to acquire 100 per cent of the shares in the target. However, it is almost impossible to acquire 100 per cent of the shares in the target through a public takeover offer, as not all shareholders will accept the offer. In this case German law provides for procedures to squeeze out the minority shareholders. However, the prerequisites for a squeeze-out of minority shareholders are very strict and formal: the investor needs to hold at least 90 per cent or 95 per cent of the share capital in the target company and must pay or offer adequate cash compensation to the minority shareholders. Depending on the legal grounds for the chosen procedure to squeeze out the minority shareholders, the preparation (in particular the report on the adequacy of the offered cash compensation) and execution of the squeeze-out can take several months. If the minority shareholders dissent or object to the squeeze-out and exhaust their legal remedies to appeal, the timeline for the squeeze-out is significantly extended (see question 6).

6 Dissenting shareholders' rights

What rights do shareholders of a target have to dissent or object to a going-private transaction? How do acquirers address the risks associated with shareholder dissent?

Shareholders of a target are protected against going-private transactions in several ways. First of all, any bidder acquiring, directly or indirectly, 30 per cent or more of a listed (on an organised market) stock corporation's voting rights must make a mandatory offer to the remaining shareholders of the target to acquire their shares according to the Takeover Act. In this public takeover offer the bidder must offer adequate consideration to the remaining shareholders, which can be challenged and reviewed in court by the shareholders. However, this right for each individual shareholder does not prevent the completion of the transaction itself per se, as it causes only a review of the compensation. This may be different when a bidder makes an offer under condition of reaching a certain number of voting rights with the offer. Typically, bidders aim to acquire 75 per cent of the voting rights or a 90 or 95 per cent of the share capital, so following the public offer the bidder is able to actually take the company private and initiate substantial corporate measures such as a delisting, statutory mergers, domination and profit and loss transfer agreements or squeeze-out resolutions, etc. If the required quota in the public offer is not reached, the transaction fails. However, individual shareholder(s) who do not hold enough shares to jeopardise the threshold will not be able to dissent or object to the transaction. Minority shareholders can only decide to either sell their shares or remain shareholders in the company.

Following a public offer, if a corporate taking-private transaction of the bidder requires a shareholder resolution and registration with the commercial register for its effectiveness (as is the case with, for example, mergers, change of legal form and corporate squeeze-outs), minority shareholders may try to interfere by taking action against the validity of the resolution (for example, the squeeze-out resolution) by filing a suit to set aside the shareholders' resolution for violating the law or the articles of association. Such litigation is mostly manageable for the company and the bidder by taking advantage of a special release proceeding. The rights of minority shareholders to challenge the validity of a resolution may only hold up the transaction, but will not be able to finally prevent it. However, the possibility of a going-private transaction being held up can affect the decision of bidders to launch an offer in the first place, as time can be essential (eg, for financing). Claims of minority shareholders with the aim of receiving additional compensation usually do not impede the effect of the squeeze-out itself (except for the takeover-related squeeze-out).

7 Purchase agreements

What notable purchase agreement provisions are specific to private equity transactions?

In general, purchase agreement provisions in private equity transactions are similar to other common purchase agreement provisions for acquiring shares in companies. Nevertheless, there are certain aspects, which are regularly included in purchase agreements, if private equity acquirers are involved.

For example, private equity investors are as sellers reluctant to provide operational representations and warranties. Therefore, private equity sellers regularly demand the purchaser to take out W&I insurance to limit possible liability under the sale and purchase agreement. Private equity acquirers often ask for special warranties with regard to environment, social and governance standards, sometimes directly relating to the United Nations Standards of Responsible Investment.

When it comes to deal certainty, sellers demand security of the financing from private equity acquirers. Therefore, private equity acquirers usually enter into an equity commitment letter in favour of the special purpose vehicle.

8 Participation of target company management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues? Are there timing considerations for when a private equity acquirer should discuss management participation following the completion of a going-private transaction?

In general, there are no differences between going-private transactions and other private equity transactions regarding future management participation. Nevertheless, there might be specific issues with regard to compensation or management participation arising from specific regulatory provisions arising from the listing of a target. These provisions no longer apply after the delisting of the target.

The existing service agreements of the management team members are usually renewed. A private equity acquirer normally offers to increase compensation, as well as to set a fixed time period for the service agreement of up to five years.

Beside the service agreements of the management team members, which usually include bonus provisions in connection with operational and financial targets, a private equity acquirer intends to incentivise the management team on a successful exit. This is usually done by offering either an equity participation or an exit bonus. A manager's equity stake is mostly legally held by a pooling vehicle or by a trust company via a trusteeship. In smaller deals the managers occasionally hold their shares directly. In any event, equity participations are structured in order to minimise the risk of the tax authorities arguing that profits from the equity participation are treated as employment income and, therefore, a higher tax rate applies. On the other hand, an exit bonus is treated as employment income.

Generally, a private equity acquirer should contact the management of the target company as soon as possible in order to be able to agree with the management on a term sheet or even a shareholders' agreement until the singing of the share purchase agreement has taken place. Early discussions also offer the possibility to convince the management team of the private equity fund. This can be a relevant advantage in an auction process.

9 Tax issues

What are some of the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

The basic tax issues that private equity acquirers face in their transactions are, on the one hand, the ability to use the expenses and losses of the target company such as interest costs and, on the other hand, the tax-efficient reorganisation to forward the profits of the target company to the acquisition vehicle. This can be achieved, subject to certain limitations, by the formation of a fiscal unity between the acquisition vehicle and the target company. Therefore, the taxable result of the target company is attributed to the holding company if certain requirements are met (eg, execution of a profit transfer agreement). With respect to interest costs, which are an issue in leveraged buyout transactions, German law limits the deductibility of such expenses up to the amount of interest earnings and above up to a maximum of 30 per cent of the tax EBITDA. The limitation does not apply if the tax costs are less than €3 million, the company is not part of a fully consolidated group or it has an equal or higher equity ratio as the group itself, whereby 2 per cent below is insignificant.

Additionally, under German law the losses of the target for direct or indirect acquisitions of 50 per cent of the shares within a period of five years, which applies typically to private equity participations, are in total not deductible.

Furthermore, if the target company owns real estate, the indirect or direct acquisition of at least 95 per cent of the shares of the company may cause real estate transfer tax between 3.5 and 6.5 per cent, whereby the tax calculation base is the partial value of the real estate.

10 Debt financing structures

What types of debt financing are typically used to fund going-private or other private equity transactions? What issues are raised by existing indebtedness of a potential target of a private equity transaction? Are there any financial assistance, margin loan or other restrictions in your jurisdiction on the use of debt financing or granting of security interests?

Senior loans provided by traditional banks are the most common way of financing private equity transactions. A growing amount of senior loan financing is provided by alternative financing providers such as debt funds, which have higher interest margins and usually request the opportunity to also invest through additional mezzanine financing instruments to achieve higher margins. In larger transactions high yield bonds can be seen, but this form of financing is commonly used by strategic investors.

Existing indebtedness of the target company is usually fully exchanged and refinanced in the acquisition, as lenders to the acquiring company aim to obtain full access to existing securities and the cash flow of the (operative) target company. However, upstream guarantees and securities by subsidiaries (target companies) issued to their parent company (acquiring company) interfere with German capital maintenance rules. Therefore, it takes some effort to structure a debt-push-down, which is typically achieved through a profit and loss agreement or a merger between the target and the acquiring company.

11 Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in going-private transaction purchase agreements for private equity transactions? What other documents typically set out the financing arrangements?

To take a publicly listed company private, a public takeover offer has to be initiated. The bidder is required to transmit an offer document to BaFin and to publish the offer. For the public offer an independent financial services institution (eg, an investment bank) needs to provide a letter confirming the availability of sufficient funds to pay for the offer (ie, the bidder needs to have sufficient financing to purchase all outstanding shares in the target company). As the financial services institution may be held liable if the bidder is unable to pay for the respective shares, the bidder needs to have and prove enough debt and equity financing for the financial services institution to submit such a confirmation letter.

12 Fraudulent conveyance and other bankruptcy issues

Do private equity transactions involving debt financing raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

There is no legal institution in the German legal system comparable to the fraudulent conveyance law known, for example, in the US. In Germany, the protection of creditors is ensured mainly by capital maintenance rules, the insolvency contesting rules and the obligation to file for insolvency if the company becomes overindebted or illiquid. In addition, there are also accompanying legal institutions developed in law, such as the prohibition for shareholders of existence-destroying interventions. The provisions of German corporate law, however, are not sufficient to protect the creditors properly against the risks resulting from excessive debt financing: the capital maintenance rules are, for example, only addressed to shareholders. The financing banks are not addressed by the relevant prohibitions. Moreover, the creditors of limited liability companies are, under the Limited Liability Companies Act, only protected against the occurrence of a loss in share capital, but not against other actions that may disadvantage creditors.

More comprehensive creditor protection is provided by the insolvency contesting rules intended to reverse transactions that harm all creditors, or that favour individual creditors to the detriment of the others. In contrast to fraudulent conveyance, a disadvantageous legal act prior to the opening of insolvency proceedings alone is not sufficient under the Insolvency Act (InsO) to substantiate a contest. The InsO contains various contestation reasons that have to be fulfilled additionally. Of particular importance is the possibility to contest a transaction owing to wilful disadvantage. On this basis, particularly high-risk transactions or transaction structures that are likely to cause insolvency of the company can be reversed by a liquidator.

13 Shareholders' agreements and shareholder rights

What are the key provisions in shareholders' agreements entered into in connection with minority investments or investments made by two or more private equity firms or other equity co-investors? Are there any statutory or other legal protections for minority shareholders?

With regard to protections of minority shareholders, German corporate law provides information, monitoring and examination rights as well as the right to request a shareholders' meeting, depending on the legal form of the company in each case, to a greater or lesser extent. In addition, under German law the amendment of the purpose of the company is subject to the mutual consent of all shareholders, if not otherwise explicitly provided for in the articles of association. Other substantial amendments to the articles of association require qualified majorities. For example, capital increases require the consent of a qualified majority of 75 per cent of the shareholders' votes in the shareholders' meeting of a GmbH and in the general meeting of an AG, whereby solely the articles of association of an AG may provide for a lower majority requirement (a simple majority).

Beside these statutory minority shareholders' protection rights, a private equity firm, as minority investor, will ensure further minority rights in a shareholders' agreement with private equity co-investors or other shareholders. These are rights such as veto rights, information rights and reporting obligations of the target's management, as well as non-compete and non-solicitation provisions. Regarding the target's shares, the private equity investor will ensure that transfer restrictions, rights of first refusal, drag-along rights, tag-along rights and, as the case may be, call and put options are in place. In any event, the private equity investor will ensure that it can exit its (minority) interest, usually by triggering an exit for all shareholders.

Update and trends

On 20 December 2018, the German federal government enacted a threshold decrease for the review of certain foreign investments from the previous 25 per cent of voting rights in a German company to a 10 per cent threshold. In the context of investment review, the German Federal Ministry of Economics and Technology can review foreign investments into German companies and prohibit them in the event that public security or order are endangered. Therefore, if a foreign private equity acquirer intends to purchase a participation of at least 10 per cent in critical business infrastructures, such as the arms industry, IT security industry or media companies, such acquisition may trigger investment monitoring. The amendments entered into force on 29 December 2018.

With regard to the ninth amendment to the Act against Restraints of Competition (that became effective on 9 June 2017) the Court of the European Union confirmed in a judgment of 12 July 2018 (file number T-419/14), that private equity investors are liable for cartel infringements committed by their portfolio companies. With the verdict, the court confirmed a fine imposed by the European Commission on Goldman Sachs and Prysmian in 2014. A fund from Goldman Sachs Capital Partners had acquired Prysmian while it was already involved in a market-sharing cartel. In particular, the court confirmed co-liability of Goldman Sachs for the full period of its investment in Prysmian, although the participation was well below 50 per cent in the second half of the investment period. The ruling highlighted two issues: first, that private equity investors are in principle subject to the same liability principles as industrial groups; and second, the decision shows that the concept of 'control' is interpreted broadly and which criteria are relevant (eg, rights regarding the appointment of management). Against this background, strict governance rules imposed on the target and an antitrust due diligence prior to a company acquisition and a compliance organisation at portfolio company level after the acquisition may be advisable in order to reduce antitrust risks.

14 Acquisitions of controlling stakes

Are there any legal requirements that may impact the ability of a private equity firm to acquire control of a public or private company?

Besides antitrust regulations and the reporting obligations and review procedures contained in the Foreign Trade Act (see questions 4 and 18), there are certain limitations and obligations for private equity firms in larger transactions that fall under AIF regulations (see question 4) after acquiring control of a non-listed company. For a period of 24 months following the acquisition the private equity purchaser is prevented from stripping any assets from the target company that may have an impact on the ability to finance the transaction.

In the case of publicly listed companies, the Takeover Act has an effect: if a private equity firm gains control of a public company (ie, acquires at least 30 per cent of its voting rights), it is, pursuant to the Takeover Act, obliged to submit a mandatory public offer to the remaining shareholders of the target to acquire their shares. In certain cases, the voting rights from shares held by third parties have to be attributed in the calculation of the 30 per cent threshold (eg, voting rights of a subsidiary, bidder and third party are 'acting in concert'). In the event that two or more parties acquire control on the basis of the aforementioned attribution, the obligation to submit a mandatory offer generally applies to all acquirers.

15 Exit strategies

What are the key limitations on the ability of a private equity firm to sell its stake in a portfolio company or conduct an IPO of a portfolio company? In connection with a sale of a portfolio company, how do private equity firms typically address any post-closing recourse for the benefit of a strategic or private equity acquirer?

There are three key limitations on the ability of a private equity firm to sell its stake in a portfolio company in an IPO:

- institutional investors must by convinced of the business case of the portfolio company;
- the portfolio company must be 'IPO-ready', which means that the governance of the portfolio company must comply with the provisions for listed companies. In this context, portfolio companies that are organised as GmbHs need to be converted either to an SE, an AG or to a KGaA prior to the IPO; and
- market environment.

Key limitations for a trade sale are mostly price expectations of the seller and the lack of willingness of the seller to give warranties and indemnities to the buyer. Owing to the limited number of targets in the German market and the high price levels during 2018, the price expectations of the seller have not mostly been a deal-breaker. Potential liabilities for representations and for tax indemnities are regularly transferred to a W&I insurance. Private equity sellers very often expect that an acquirer enter into W&I-insurance. In 2018, escrows were very rare.

In the fourth quarter of 2018 we saw a slacking-off of the seller-friendly market environment, with a still constant deal flow at a very high level.

16 Portfolio company IPOs

What governance rights and other shareholders' rights and restrictions typically survive an IPO? What types of lock-up restrictions typically apply in connection with an IPO? What are common methods for private equity sponsors to dispose of their stock in a portfolio company following its IPO?

After an IPO only the statutory governance rights survive. A shareholders' agreement is usually terminated upon the IPO, which constitutes an exit of the private equity investor, although it could remain as a shareholder of the listed company. Under German statutory law it is to some extent possible, but rather unusual, to agree on rights to appoint board members for single shareholders in the articles of association of the listed company.

Lock-up periods usually have a duration of up to 12 months for private equity investors, but are sometimes longer when it comes to management. Management advisers regularly try to agree on a provision in the shareholders' agreement that in the case of an IPO, the lock-up for the management team will be not be longer than the lock-up period of the private equity investor. However, the proposal for the duration of the lock-up period is finally at the discretion of the underwriting banks.

Usually, in an IPO, only a small portion of the shares of the existing shareholders are sold. Private equity investors sell packages of shares after the termination of the lock-up period and in predefined time periods.

17 Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in industry focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

Private equity transactions occur across almost all industries. The yearly number of delistings owing to going-private transactions of private equity funds increased during the past year, but is still too low to identify sector-specific trends. Generally speaking, companies with stable cash flow and growth potential are suitable for going private. In addition, there should not be a high level of indebtedness to allow further leverage. It is also helpful if no significant free float makes it difficult to build a strong equity position. Ideally, there are entrepreneurs or founders holding a large stake in a company who want to strengthen it with the help of a stock market withdrawal. With respect to specific regulatory schemes limiting the potential targets of private equity firms, investments in critical infrastructure, such as the arms industry, may be monitored by the Federal Ministry of Economics and Technology.

18 Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or other private equity transaction?

With respect to financing a cross border transaction, when a cash offer is made in the context of a cross-border going-private transaction, an independent financial services institution (eg, an investment bank) needs to confirm the availability of sufficient funds of the bidder. The financial services institution may be held liable if the bidder is then unable to pay for the respective shares. However, this does not constitute a difference from mandatory public takeovers.

Germany is an open economy; foreign investments are, in general, permissible and welcome. However, foreign investments in target companies active in certain sectors may be reviewed on a case-by-case basis by the Federal Ministry of Economics and Energy (BMWi). The Foreign Trade Act and the relevant ordinance provide for a sector-specific review mechanism, mainly concerning the military and defence sector, and for a cross-sectoral review concerning acquisitions of companies in other sectors, but only by investors from outside the EU or EFTA, under which the BMWi may prohibit direct or indirect acquisitions of at least 25 per cent of the voting rights in a German target or impose obligations if it finds that the acquisition endangers public order or security in Germany.

Since July 2017, acquisitions of German targets active in specific areas such as critical infrastructure and development of industry-specific software for the operation of critical infrastructure must be notified to the BMWi. Apart from that, the BMWi acts on application for the issuance of a certificate of non-objection or on its own initiative in the cross-sectoral review. In the sector-specific review there is a general reporting obligation regarding relevant transactions.

In December 2018, the Federal Cabinet decided to lower the threshold for the review of the acquisition of defence and security-related infrastructure and companies to 10 per cent of the voting rights. In all other matters, the threshold of 25 per cent remains unchanged.

19 Club and group deals

What are some of the key considerations when more than one private equity firm, or one or more private equity firms and a strategic partner or other equity co-investor is participating in a deal?

In club or group deals the mutual rights and obligations should be determined as early as possible. Typically, the sale of a target company is subject to a formal structured auction process. In order to align the interests of the acquirers during the auction process, the acquirers should enter into a bidding consortium agreement to govern the obligations and the behaviour of the parties during the process. This agreement typically contains provisions with regard to the later acquisition and the operation of the target company and is substituted by the shareholders agreement, which follows after the closing of the transaction. Provisions with regard to deadlock situations should especially be provided for. With respect to the joint acquisition of at least 30 per cent of the voting rights in public listed companies ('acting in concert'), the Securities Acquisition and Takeover Act may lead to the obligation to submit a mandatory takeover offer towards the other shareholders. Bidding consortium agreements have to consider the 'acting in concert' rule and ensure that only one takeover offer by the consortium becomes mandatory.

20 Issues related to certainty of closing

What are the key issues that arise between a seller and a private equity acquirer related to certainty of closing? How are these issues typically resolved?

In 2018 the market was extremely seller-friendly. Therefore private equity acquirers, like all other acquirers, had to accept that closing usually only depended on antitrust clearance as the sole closing condition. It was only possible to obtain other closing conditions in the case of deal-specific issues.

Private equity acquirers were therefore generally not able to successfully negotiate material adverse change clauses or other termination rights, but rather had to accept break fees and 'hell-or-high-water' obligations.

P+P Pöllath + Partners
Attorneys-at-Law | Tax Advisors

Tim Kaufhold tim.kaufhold@pplaw.com
Tobias Jäger tobias.jaeger@pplaw.com

Hofstatt 1
80331 Munich
Germany

Tel: +49 89 24 240 372
Fax: +49 89 24 240 999
www.pplaw.com