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→ Transferring employment relationships as part of share & asset deals

Share Deal and Asset Deal – two popular terms whose meaning is generally clear. A share deal means the sale and transfer of shares in a company by the seller as its shareholder to a third party as purchaser, resulting in a transfer of the company as a whole, including all rights and obligations. By contrast, an asset deal is about selling only individual “assets”. In this case, the seller is usually the company itself that sells and transfers certain or all assets to the purchaser. So far so clear. But what are the particular differences between the two, especially with regard to employment relationships? There is this ominous *passing of a business* (*Betriebsübergang*) regulated in Article 613a of the German Civil Code (BGB); a topic that most transaction parties feel they do not like because it is problematic. But, it is not as bad as it seems, actually. Of course, as always, the devil is in the details but let's start from the beginning:

The easier one first: the share deal

The share deal is generally the easier type of a transaction. With the transfer of all rights and obligations, also all contractual relationships are normally passed to the new owner (the purchaser) of a company (there are always exceptions – keyword: change of control clauses). This also applies to employment relationships. For those involved, nothing changes. The employer (the company), employment contracts and terms and conditions of employment remain the same as before. Only the corporate structure changes, but on the outside, everything looks the same. Thus, in terms of transferring employment relationships, no special steps are necessary.

Despite this, or perhaps exactly because of this, it is advisable to have a closer look on the employment relationships as part of a due diligence review conducted before a share deal and prepare a risk analysis. After all, along with the obligations of the company arising from employment relationships, the purchaser also takes on liability connected with those matters. If the seller failed to meet its obligations arising from employment relationships – unpaid salaries being the simplest example – then employees may assert their claims against the purchaser. If the predecessor has violated labour law regulations, the consequences of any offences subject to fines may hit the purchaser; it is not always only about offences (very expensive at that), sometimes also crimes are committed. And the selection of regulations to violate is broad; the acts on working time and minimum wages are only a small chunk of it.

But no reason to panic, there are solutions. If such risks are detected during due diligence conducted ahead of the transaction, they can be appropriately addressed in the share purchase agreement (SPA). Popular methods here are for example the inclusion of an appropriate price adjustment clause or incorporation of indemnities into the SPA thanks to which the problem ultimately remains with the seller. In short, as always, the rule applies: better safe than sorry.

And now onto the asset deal: transfer of business

Things are a bit different with the asset deal and here the already mentioned transfer of business comes into play. In short, Article 613a BGB reads that if a business or part of a business passes to a new owner, then all employment relationships existing at that time are passed along and such employment relationships cannot be terminated because of such a transfer of business or, if terminated, such termination will be invalid.

And the question in what situation a business or part of a business is deemed to be transferred is to be answered on a case-by-case basis. Either individual (production) areas of a company can be transferred or sometimes alone the transfer of equipment used for operating the company may constitute such a transfer. The decisive keyword is the so-called organisational unit.

If such a transfer of business takes place, several aspects should be observed. For example, employees have the right to object. This means that the company must notify the employees of the transfer of business and that

they can object to it within one month of the date they receive such information. This is because forcing employees to work for a new employer is prohibited; and this rule applies here because unlike in a share deal, the employer changes as a result of the asset deal.

The crux of the notification required under article 613a(5) BGB

And the crux sometimes lies precisely in this notification requirement: the hurdles to ensuring the correctness of such a notification letter have now become so big that it sometimes seems almost impossible to formulate it correctly. Employees must be informed of all details of the transaction such as the timing, the reason, the legal, financial and social consequences of the transfer and measures planned to be taken in respect of the employees. Easier said than done. And it can get really complicated if both the seller and the purchaser are bound by collective agreements or have advisory councils and works agreements in place. In this case, employees must be precisely informed what rules will apply to them in the future. In such cases, Article 613a (1) BGB provides for a mechanism that is not crystal clear even after reading the provision several times.

But where is the problem? What damage does an incorrect notification do? Well, an incorrect notification may cause that the above-mentioned deadline for raising objections by employees will not begin to run. And now imagine the following scenario: You want to acquire a certain business unit that is useful to you only if acquired in its entirety with employees working there. Incorrect notification can lead to a situation that employees may still be able to leave long after the transfer by exercising their right to object.

Perhaps, this is rather a theoretical problem and, furthermore, employees should think it through whether to exercise their right of objection because if they do, they go back to their previous employer. But if he has no vacancies to fill –in the end he sold the business– then he can terminate the employee’s employment on the grounds related to the company and such termination will not be held inadmissible due to the transfer of business. Nonetheless, such risk should be taken into account beforehand or, ideally, a correct notification letter should be prepared so that it is clear at least after the one-month deadline for raising objections which employees will work for the purchaser in future.

Nothing is impossible

The bottom line is: okay, it's not easy, but it's not impossible, either. Depending on the type of the transaction, the relevant risks and issues should be examined, discussed and resolved in good time beforehand so that there are no unpleasant surprises afterwards and so that, also in the case of a formal issue (as with a transaction), the words of the Hermann Hesse poem "Stages" saying "A magic dwells in each (new) beginning" can come true.

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→ Optimising equity rollovers in transactions from tax aspects

Especially in times of coronavirus and low interest rates, sellers and buyers have very different price expectations. In addition, private equity investors in particular often have a strong interest in retaining the seller within the company for a transitional period. Against this background, Owner Buyouts (OBOs), in which the previous shareholders roll a portion of their ownership stake over into the new equity capital structure put in place by the acquiring NewCo, are an interesting model for both seller and buyer. The seller has the option to gradually withdraw from the company. In addition, he participates proportionately in future opportunities and risks of the company and a successful resale (exit). The buyer builds confidence among employees and customers and facilitates the transfer to the new shareholders. In business practice, equity rollovers are mainly structured as minority shareholdings (usually less than 25 per cent), as the buyer wants to retain full control over structuring the business of the company and making final decisions.

This becomes particularly attractive to the seller when the model can also be optimised for tax purposes. The following base case will help illustrate the opportunities:

A medium-sized company in the legal form of a GmbH & Co. KG (limited partnership in which a limited liability company, GmbH, acts as the general partner) intends to bring an investor on board as part of an external company succession plan. The company founder wants to gradually transfer the business and therefore intends to remain at the company's disposal for a while.

Option 1: The seller sells 100 per cent of his equity interest to the external investor. This is followed by a rollover of equity so that the seller holds an equity interest in the acquiring company.

Option 2: Sale of the majority of his equity interest in *KG* (limited partnership); the seller himself retains 20 per cent of his equity interest.

Option 3: Sale of 80 per cent of equity interest to the external investor and contribution of the remaining 20 per cent of equity interest to the NewCo.

Modified example: Not the equity interest in the *KG* (limited partnership) but in the *GmbH* (limited liability company) is sold.

Solution for Option 1: The capital gain is taxed at 100 per cent. Assuming that the tax rate is 45 per cent, then with a sales price of 100, only 55 could be invested in the rollover of equity into the NewCo. If the reduced tax rate can be applied because the shareholder is older than 55 and has not yet claimed the tax relief, the tax burden can be reduced to approx. 22 per cent. Ultimately, however, only the net sales price can be invested in the rollover of equity, which is not an attractive option from a tax and thus financial point of view.

Solution for Option 2: In this case, the capital gain is also fully taxable; it is only a capital gain earned from 80 per cent of the equity interest in *KG* (limited partnership) but nevertheless tax must be paid. The reduced tax rate does not apply since not all of the equity interest is sold, but the reduced tax rate could be claimed for the later sale of the 20 per cent of the equity interest in *KG* (limited partnership) if the other requirements are met. All in all, however, this is not a tax-optimal outcome.

Solution for Option 3: Only in this case one could speak of a genuine equity rollover. First of all, the seller pays, again, tax on 80 per cent of the capital gain at the full tax rate. The 20 per cent, however, can be contributed to the NewCo at book value in a tax-neutral manner (Article 20 *UmwStG* (German Transformation Tax Act)). This first step offers a liquidity advantage, since the tax burden on the 20 per cent of the equity interest in *KG* (limited partnership) does not apply. Even if all requirements were met, the reduced tax rate would probably not apply either if the 20 per cent of the equity interest in *KG* (limited partnership) were first transferred at book value and then the remaining equity interest was sold.

In the further course, the seller can participate in the so-called leverage effect. This is due to the fact that the NewCo will usually use debt financing. Assuming that 50 per cent of financing is obtained from debt financing, the

seller could acquire 40 per cent of the equity interest in the NewCo in exchange for the 20 per cent of his equity interest in *KG* (limited partnership), and thus have a 40 per cent share in the company's future profits. The contribution can also be further optimised as the contributing seller can receive certain consideration for his contributed equity interest. It may amount to a maximum of EUR 500,000 (absolute upper limit) or a maximum of 25 per cent of the book value, in our case of 20 per cent of the contributed equity interest. If the NewCo has the legal form of a *GmbH* (limited liability company), the seller could furthermore sell his shareholding after seven years in a tax-privileged manner under the partial income procedure [German: *Teileinkünfteverfahren*], in which only 60 per cent of the gain would be taxable. If the shares were sold before the expiry of the seven years' period, the gain taxable at the time of making the contribution would have to be subsequently taxed on a pro rata basis at the full tax rate (decrease of 1/7 for each year that has elapsed).

In the case of a *KG* (limited partnership), it is apparent that the partial equity sale is particularly advantageous for younger partners (<55 years of age) who are not yet able to take advantage of the reduced tax rate.

Modified example: If the medium-sized company was a *GmbH* (limited liability company), the above options would be similar, the difference being that the initial sale of the shareholding in *GmbH* would typically be subject to the partial income procedure, i.e. 60 per cent of the capital gain would be taxable (given that the highest tax rate is 45 per cent, this would result in a tax rate of 27 per cent).

In Option 3, it would also be possible to make a tax-neutral contribution at book value to the NewCo. However, the chronological order of the steps to be taken should be observed. In the first step, the NewCo must acquire 80 per cent of the equity interest, after which the remaining 20 per cent can be contributed to the NewCo (the so-called qualified 'share for share exchange' according to Article 21 *UmwStG*). In this case, the tax neutrality of the 'share for share exchange' is also connected with a seven-year freeze period, if the equity interest is contributed to a corporation. If the equity interest is contributed at book value, the hidden reserves will have to be retrospectively taxed when the equity interest in the NewCo is later sold (exit). Here, too, the retroactive taxation will decrease annually by 1/7 to zero.

In order to contribute the equity interest at book value, tax pitfalls must also be avoided. If an equity interest in *KG* is being contributed, the functionally essential business assets (including those owned by the partners, German: *Sonderbetriebsvermögen*) must be contributed along. If an equity interest in *GmbH* is being contributed, one should look out for corporate structures involving the economic and personal integration of legally independent entities (German: *Betriebsaufspaltung*) as the termination of such structures can lead to compulsory withdrawals. In both cases, this could be, for example, a land plot which the shareholder has left to the company for its use.

In the end, contribution transactions must be handled professionally also post-transaction. On the one hand, the 7-year period must be observed, and, on the other hand, the obligation to provide evidence of the ownership of shares each year pursuant to Article 22 *UmwStG* must be met.

Conclusion

The practical case presented above shows that equity rollover models offer attractive options for both parties involved in the transaction. The seller continues to be involved with the company, has a higher share in the company's result and can pass company succession to new owners in an organised manner. The buyer acquires continuity and confidence and enjoys a liquidity advantage, as the full purchase price does not have to be paid immediately. In addition, the fact that the motivated company seller remains involved with the company increases the company value, which pays off at exit as a higher purchase price can be achieved. This is a win-win for both parties.

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→ Technology assessment – essential for industry 4.0

While technology solutions have always played an important role in M&A activities, the challenges associated with the COVID-19 pandemic as well as the disruption of business models have made technology an absolute necessity.

The tech sector's strong position during the pandemic has led to a surge in M&A activities, higher valuations, historic highs in venture capital funding and numerous tech IPOs since the second half of 2020.

The following article presents the possibilities for assessing technologies and describes the essential drivers of technology assessment.

What Are The Options For The Assessment Of Emerging Technologies?

The value of technology is derived from the benefit it provides to the owner or a potential buyer. The assessment can be carried out using three different methods:

1. discounting the expected future cash flows of the technology ("discounted cash flow (DCF) approach");
2. market prices of comparable technologies ("market approach");
3. replacement costs of the technology ("cost approach").

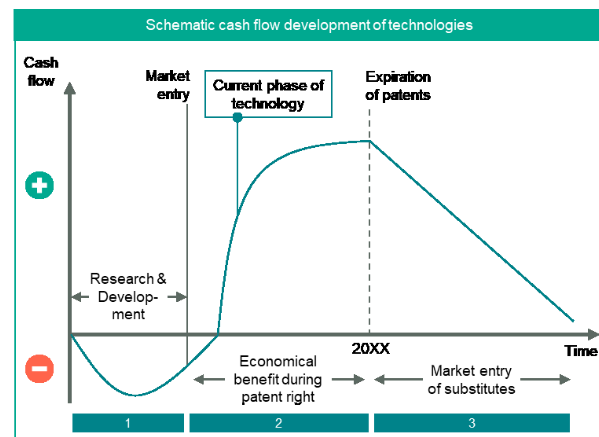
Especially for emerging and innovative technologies (e.g. development of COVID-19 vaccines), comparable market prices cannot be usually derived. Because there is a very fine line between non-targeted research and technology-specific development, replacement costs are typically difficult to quantify. Thus, when acquiring emerging and innovative technologies, the focus is always on uniqueness and the related future financial benefits.

How Does The Assessment Of Technologies Work?

The starting point for the assessment is the owner's or seller's business plan. This includes the technology's expected future cash flows and should therefore be analysed in the first place. In addition to conducting market and competitive analyses, technical experts who are able to assess especially the areas of application as well as the existing protection through e.g. patents should also be consulted.

An important criterion of the business plan is also the expected useful life of the technology and thus the time horizon over which cash flows can be expected.

Considerations about the following cash flow development of technologies are always helpful in this respect:



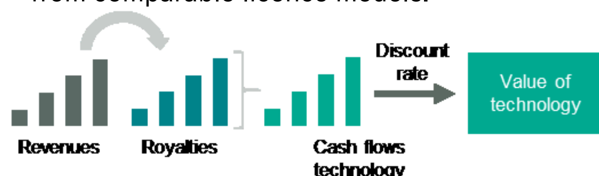
In particular, the extent to which possible patent protection can positively or negatively influence the value of the technology should be assessed.

Thus, it must be weighed up to what extent public disclosure of the patent enables "copying" after the patent protection expires and whether, if applicable, a "trade secret" that is only documented internally offers a longer-term protection against competitors.

After these preliminary considerations are made, the next step is to select an assessment approach. In practice, one of the two following methods is used in most cases:

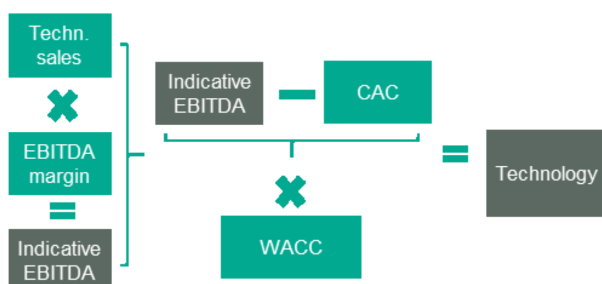
1. Licence price analogy method:

Here, an indicative royalty for the use of the technology is assumed. The royalty is derived from comparable licence models.



2. Residual value method:

It is assumed that although the technology is owned by the company, its "true benefit" only unfolds in combination with other assets of a company (e.g. production facilities, working capital, customer base, etc.). This is taken into account by deducting indicative lease/licence fees for other assets.



In both valuation methods, the discounting of future cash flows is carried out in a manner analogous to a company valuation based on the weighted average cost of capital ("WACC"). The starting point for this consideration is that the risk of the technology's financial surpluses is oriented towards the operational and financial risk of the company that typically uses the technology and pursues a comparable business model in comparable markets.

How Is The Assessment Carried Out In Practice?

In practice, it can be observed that the licence price analogy method is the one most frequently used.

However, determining the royalties often resembles the famous "search for a needle in a haystack". The amount of the licence fee to be paid by the licensee for a technology is often a matter of individual negotiations carried out between licensor and licensee, and their result. Therefore, applying this method may be limited in practice by the availability and resilience of comparable licences granted on arm's length terms.

In particular, the comparability between the reference technology and the technology to be assessed requires a precise analysis in practice with regard to the following criteria:

4. subject matter of the licence agreement,
5. rights of the contracting parties,
6. amount of the royalty,
7. reference basis of the royalty,
8. payment modalities and
9. territory and exclusivity.

Conclusion

While technology solutions have always played an important role in M&A activities, the challenges associated with the COVID-19 pandemic as well as the disruption of business models have made technology an absolute necessity. Technology assessment always requires a detailed analysis of the expected future financial benefits of the application. A well-founded assessment of future application possibilities of the technology is therefore indispensable.

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→ M&A Vocabulary – Understanding Experts

„Retention Amount“

In this ongoing series, a number of different M&A experts from the global offices of Rödl & Partner present an important term from the specialist language of the mergers and acquisitions world, combined with some comments on how it is used. We are not attempting to provide expert legal precision, review linguistic nuances or present an exhaustive definition, but rather to give or refresh a basic understanding of a term and provide some useful tips from our consultancy practice.

A claim for damages is in the end only worth something, if you can enforce it. Based on this insight, the concept of agreeing on a retention amount (or a holdback) is used in business acquisitions – that is, part of the purchase price is withheld for a certain period of time as collateral for the buyer's possible warranty and indemnification claims against the seller. Various structuring instruments can be used for securing such claims. Apart from purchase price retention this may include various forms of third-party guarantees (e.g. suretyships or bank guarantees). W&I insurances are becoming more and more popular, in particular in large-volume transactions; they insure claims for liability arising from breach of warranty and indemnification obligations.

As opposed to earn-out structures, the claim for payment of the relevant part of the purchase price basically is not tied to the condition of fulfilling future covenants (e.g. achieving certain KPIs). Generally, the claim already arises when the contract is signed but the actual payment does not become due until a specific calendar date or a point in time that depends on an event occurring in the future. This enables the buyer to offset his claims against the seller arisen to that date, e.g. from breach of warranty and indemnification obligations. Formulating the exact conditions subject to which a retained amount may not (yet) be paid out (e.g. in the case of pending court proceedings) and the requirements the meeting of which will allow such a set-off and also the consequence of a subsequent purchase price adjustment (often in consultation with tax experts) are the most challenging tasks for a transaction lawyer when drafting a retention agreement.

Sometimes, the parties agree on several retention amounts and define different conditions for different risks and/or liability claims.

Retaining part of the purchase price as security is a very important element of the purchase price structure. At the same time, it is generally the easiest instrument to be used as collateral by all parties involved, since no third parties need to be involved. It is the most favourable form of collateral to the buyer – and thus the most burdensome to the seller. Therefore, as a rule, the buyer will only be able to successfully enforce a lump-sum amount retained as collateral for abstract, potential liability claims if he has a very strong negotiating position.

Invoking the information asymmetry in the purchase transaction alone, a fact that is true anyway in most cases, will not be sufficient to this end. The buyer can only expect to be heard by the seller if he substantiates his claim as such and the fact that its enforcement is jeopardised and, on top of this, if he is able to put a figure on such a claim. Therefore, when negotiating whether the retention of part of the purchase price will be agreed on and in what amount, two aspects are important, on principle, and the buy-side should refer to them in most cases cumulatively as arguments towards appropriate structuring:

1) specific findings on principles used for business valuation and purchase price determination and the related risks, obtained in particular from a due diligence review;

2) indications suggesting that the seller's assets for satisfying any claims of the buyer ("liable assets") will not be sufficient in the future or any other foreseeable obstacles hindering successful enforcement of a substantiated claim.

Potential Claims For Liability

Examples of identified liability risks are claims of authorities for the repayment of state subsidies , looming product liability claims from customers, possible fines to be imposed on the basis of anti-trust law, tax issues yet to be clarified that could result in additional tax claims.

In a situation where such risks are known to the buyer, the involved amounts are significant and risk materialization is probable, the buyer will have to consider a purchase price adjustment or even refraining from the acquisition at all. Instead, where risk is assessed to be moderate or in order to avoid the risk that negotiations will be cancelled at an advanced stage of negotiations, the buyer could demand that an indemnification obligation be included in the contract and that an appropriate amount of the purchase price be retained as collateral. The retention would then be valid e.g. until tax claims become time-barred or a final decision is passed in relevant proceedings.

It is foreseeable that the seller's risk assessment will be different, so it is not uncommon that at this stage of negotiations the parties exchange respective legal and tax opinions. The relevant issues should therefore be identified as part of a due diligence review as early as possible and an appropriate line of argumentation should be anticipated.

Critical Sell-Side Hallmarks

Indications suggesting that the seller does not have sufficient liable assets or access to them is hindered are e.g. a holding structure where the seller's vehicle bears little liability, offshore residency, a non-transparent ownership structure or weak financial position and net assets.

Negotiation Options

In deadlock situations, proposing a compromise or structures that mitigate the effect of a retention agreement on the part of the seller may have the effect that the seller will finally agree to the buyer retaining part of the purchase price. Such structures might include e.g. an attractive interest rate arrangement and/or depositing the retained purchase price into an escrow account, which means that the buyer would no longer be able to directly access the retention amount.

At this stage at the latest, the option of W & I insurance can also be introduced into negotiations. In this case, it is recommended to at least initially clarify in advance if the risk is insurable.

Watch Out For Sellers On The Brink Of Bankruptcy

In the case of sellers who are in financial difficulties, retaining part of the purchase price as collateral may create a risk that is often overseen.

If insolvency proceedings are initiated against the assets of the seller, the insolvency administrator has the discretion to decide whether the company acquisition agreement is continued – unless at least one party has completely fulfilled the contract at the time when insolvency proceedings are instituted. In this context, not only the main contractual obligations but also supplementary duties are of relevance. Here, agreements on the retention of part of the purchase price – just like purchase price adjustment or earn-out clauses – may open the door to such decision.

Conclusion

Especially for buyers that have a "strong" position and where small and medium transaction volumes are involved and the sell-side seems "risky", the retention of part of the purchase price is often a simple and affordable but also efficient means to secure liability claims.

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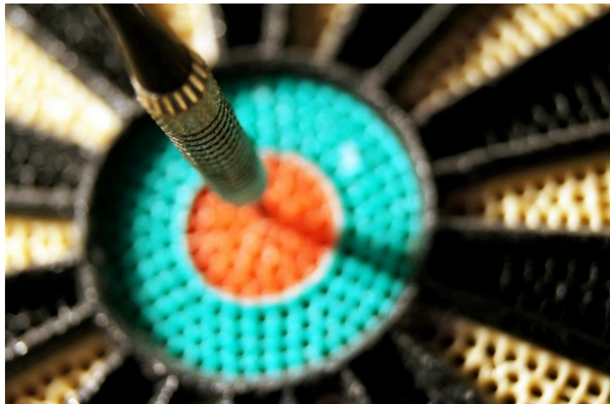
→ INVESTING IN ITALY
A Guide to Distressed M&A



The covid-19 pandemic and the emergency measures to reduce its adverse effects on public health have inevitably impacted the global economic framework.

Lockdowns, restrictions on the circulation of people and goods, the drop in the demand and supply of products and services have caused an economic and financial crisis for many companies.

The EU and its member states, including Italy, have intervened with several aid programmes to try to mitigate the negative impacts on the economy: however, the adopted and planned measures will not be sufficient to safeguard all entrepreneurial activities and, once the emergency measures expire, many of them will have to face the crisis.

In this context, such companies will be driven to seek fresh capital and potential new industrial partnerships, thus launching a new season of opportunities in distressed M&A.

To offer all our clients a first tool to approach this topic, we are pleased to share a brief GUIDE on an overview of the options available to players interested in investing in **Italian distressed or insolvent companies.**

The guide will focus on the acquisition of companies or business units, highlighting the main peculiarities of restructuring and insolvency procedures existing in Italy and the main effects of such procedures on the liabilities and claims of the company in crisis or insolvent.

The aim is to provide potential buyers or investors with an initial overview of the advantages and disadvantages of approaching an entity facing restructuring or insolvency proceedings.

The work is divided into two parts. The first part lists the primary restructuring and insolvency procedures under Italian law, briefly highlighting their features. The second part highlights the main consequences of the acquisition involving a distressed company, based on the restructuring or insolvency procedure to which it is subject. In particular, we will analyse the impacts on: the sale perimeter, liabilities passing to the buyer, workforce, pending contracts, the sale process and risks and guarantees. The firm remains available with its experts in this field for all interested parties who wish to deepen the topics.

We hope you will enjoy the reading (click here to download).

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