Rödl & Partner

M&A DIALOGUE

LEGAL, TAX, FINANCIAL NEWS

Issue: June 2020

Articles in this issue

→ Updates to merger regulation involving medium-sized privately owned businesses

The aim of the draft "Tenth Law amending the Law against restrictions in competition to achieve a focused, proactive and digital Competition Act 4.0 (GWB Digitalisation Act)", is to modernise competition regulation in order to keep up with the increasing digitalisation of the economy. At the same time, it also implements EU Directive (EU) 2019/1. The implementation of European competition law is intended to align standards in the member states and facilitate Europe-wide collaboration between authorities. The law was initially intended to take effect in 2020; however, the impact of the Covid-19 crisis could mean delays.

GOAL OF UPDATING THE LEGISLATION

The goal of updating the legislation is to "create an organisational framework that meets the requirements for digitalising and globalising business."

Substantial amendments include the modernisation of the control of abusive practices, acceleration of procedures, an increase in the second domestic turnover threshold, and the further development of the legal framework for compensation for cartel damages.

In addition, the draft law revised formal merger control regulations "in order to structure these more effectively and to enable the Federal Cartel Office to focus on the mergers most relevant to maintaining competition". The draft emphasises that the German merger regulatory system is generally a well-functioning instrument of preventive competition policy, but in practice, there is still a need to improve some individual aspects.

SIGNIFICANT CHANGES IN THE AREA OF MERGER REGULATION

One significant change in the area of merger control regulations is the increase in the second domestic turnover threshold from EUR 5 million to EUR 10 million. Mergers of minor economic significance will therefore no longer be subject to any vetting. This is intended to reduce the number of merger notifications by about 20 percent. The increase in the threshold should also help to reduce the burden on companies, in particular medium-sized private ones. The legal justification claims that the existing domestic turnover threshold, particularly in the case of medium-sized private companies, tends to impose notification for mergers of low economic value, leading to a delay in these transactions.

Logically, one consequence is the elimination of what is referred to as the connection clause in Section 35 (2) sentence 1 GWB, which previously exempted mergers with small companies from merger controls if, despite breaking the turnover threshold, the combined turnover of the target company and vendor jointly earned otherwise was below EUR 10 million globally in the last full financial year.

In addition, the so-called insignificant market clause in Section 36 (1) no. 2 GWB (Competition Law) is to be amended. Under the present legal situation, this ensures that mergers are not prohibited even if the conditions for a prohibition are indeed present but the total turnover in the relevant market was less than EUR 15 million in the previous calendar year. The threshold is likely to be increased to EUR 20 million. In addition, a group of related (insignificant) markets should be able to be considered. Medium-sized private companies are more likely to be active as dominant players in insignificant markets. The legislator would therefore like to prevent mergers being prohibited for competition considerations in an overall economically insignificant market.

In its stated objectives, the amendment to the law clearly emphasises that "special grounds for intervention with regard to the systematic purchase of fast-growing companies by "digital companies with a strong market position" are not considered necessary, but are providing a new tool for intervention. Among other things, under the new Section 39a (1) GWB, the Federal Cartel Office is expected to be allowed to intervene even when the intervention thresholds valid at the time have not been reached. A corresponding provision is expected to set a period of three years during which companies in a list of economic sectors yet to be named, can also be requested to report any mergers where the target companies have sales below the applicable domestic turnover threshold and where there are indications that domestic competition could be restricted by future mergers in the economic sectors specified.

The background is to avoid the risk of major companies and/or groups becoming dominant at the expense of medium-sized companies. Through acquisition strategies, competitively problematic concentrations can be created, particularly in regional markets if mergers are exempted from merger controls. The reason for this is that the turnover of the target company lies beneath the second domestic turnover threshold (in the future EUR 10 million). Companies that are already market leaders could buy up small competitors and also potentially dangerous newcomers without being subject to a merger control review by the Federal Cartel Office.

The Federal Cartel Office can only require companies that have achieved a global turnover of at least EUR 250 million in the last financial year to notify such mergers. This refers solely to the turnover of the purchaser.

In this context, a critical note is that such provisions to register future mergers, with the associated de facto lowering of intervention thresholds are not per se exactly helpful to the medium sized private companies concerned. Rather, in their practical application, it will be necessary to ensure that no additional burden is created on medium-sized private companies, e.g. if these provisions apply primarily in the markets of medium-sized private companies. Here, we must hope that the provisions are applied with a light touch and a scope that is appropriate for medium-sized private companies.

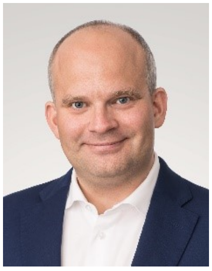
The requirement to notify the publication of completion is to be deleted in the new version of Section 39(6) GWB. Under the existing Section 39 (6) GWB, the completion of a registered merger has to be reported to the Federal Cartel Office. To reduce the burden on both the Federal Cartel Office and the company, there will be no duty to notify completion.

Finally, the existing set of deadlines for Section 40 (2) GWB for carrying out a full audit procedure is to be extended from four to five months. In return, in order to ensure a rapid merger control procedure, the option to extend the deadline with the agreement of the companies making the notification has been restricted.

CONCLUSION

The update to the legislation further strengthens the powers of the Federal Cartel Office. It is intended to enable rapid and effective intervention, especially in markets in the digital economy. By doubling the current second domestic turnover threshold, low by international standards, the Federal Cartel Office should be able to focus better on mergers that are relevant for competition. The number of transactions that medium-sized private companies have to notify should fall. Overall, we need to wait and see to what extent the reduction in the burden on medium-sized private companies intended by the changes in the law actually materialises. In particular, the new instrument of provisions for the notification of future mergers should be critically monitored.

FOR FURTHER INFORMATION, PLEASE CONTACT



Michael Beder
Rechtsanwalt (German Lawyer)
Associate Partner

T + 49 89 9287 803 13
michael.beder@roedl.com

Elisabeth Schmidt
Rechtsanwalt (German Lawyer)
Management Degree (BA)
Senior Associate

T + 49 89 9287 803 22
elisabeth.schmidt@roedl.com

→ Income tax and social security as a deal breaker

Income tax and social security do not generally form the focus of a tax due diligence. In most cases, all that is done is an analysis of the report from the most recent external income tax audit, and the audit reports from the pension insurance providers and/or health insurance companies. In individual cases, however, significant income tax and social security liability risks may exist within a target company. For this reason, this area should never be entirely dropped from a tax due diligence but, depending on the sector, it may even be its main focus.

EMPLOYER LIABILITY

An employer is liable for the income tax retained and paid for employees under the regulations. If a social security insurance obligation exists, the employer must also deduct social security contributions. Due to the lengthy time limits, which well exceed the limitations applicable for tax, retrospective social security contributions payments in particular constitute a significant potential risk.

An asset deal cannot provide a complete waiver for the extensive liability for income tax and social security contributions owed by the target company under a share deal. However, the liability of the entity taking over the company for corporate taxes in the case of an asset deal is limited to two years and to the purchase price amount of the full or partial business. Beyond that, only a guarantee or indemnity clause in the SPA (share purchase agreement) can protect against any liability for income tax and social security contributions.

BOGUS SELF-EMPLOYMENT

Independent freelancers or others operating in similar ways, e.g. sub-contractors, may turn out to be subject to income tax and social security insurance due to the statutory regulations on self-employment. If this is only recognized retroactively, the employer has to pay the total contributions (including the employee's share) for at least the last four years of the duration of the employment relationship. If intent to defraud is assumed, this period can be increased to 30 years.

Only in a case where the employment or contractual relationship still exists, can the employer assert claims against the bogus self-employed party. In practice, this is usually only possible to a very limited extent. There is no possibility of reimbursement of the contributions to be paid by the employer.

Cases of doubt can be clarified using a request procedure for status clarification with the German pension insurance federation. In a tax due diligence process, such procedures are frequently requested.

SHARE OPTIONS

(Senior) employees are often granted options that give them the right to acquire shares in their employer's company or partnership at a price that is defined in advance. With regard to the tax treatment of the non-cash benefit for the employee represented by a grant of share options, in particular the question of the income tax timing frequently gives rise to legal disputes. The question of the period of receipt arises for the employer, since they have to withhold and pay income tax at the time of receipt of the non-cash benefit. If the employer fails to comply correctly with this obligation, there is a risk of him being liable for the income tax.

As part of the Tax Due Diligence, it is normal to ask whether a request for a ruling from the Tax Office was submitted in such cases.

PERMANENT ESTABLISHMENTS

Even without a fixed business facility, companies can create a permanent establishment for tax purposes just because of their activities abroad. This can be the case for construction and assembly projects that exceed a certain duration. On the other hand, so-called representatives dependent on the company who are abroad can constitute a permanent establishment for tax purposes of the German company.

Internationally, there is a general consensus that the permanent establishment concept does not always correctly reflect current business models. In many cases, taxation can be avoided through lack of a physical presence in the source state, even though a significant part of the value creation takes place there. Given this, the OECD proposed an expansion of the permanent establishment concept in 2015, among other things. In future, for the establishment of a permanent establishment for tax purposes, it should be sufficient if representatives can act with de facto power of negotiation, or that these persons play a significant role in the conclusion of contracts.

Germany is still cautious with regard to the implementation of this new definition of the concept both in German law and in German double taxation agreements. Internationally, however, there is a clear and growing tendency to assign a tax liability to local representation, which may consist simply of individual employees, based on their local business activities, for example in the context of service facilities.

This means for employees employed in cross-border situations that their activities may in some circumstances constitute a permanent establishment for tax purposes for the employer. This will then automatically lead to local taxes and, where applicable, social security contributions for the employee.

The social security obligation abroad needs to be checked for each individual case and can only be avoided by submitting the necessary applications in advance for starting up the cross-border activity. A retrospective certificate can only be obtained in rare cases.

As part of the Tax Due Diligence, we therefore analyse whether cross-border employee deployment could potentially lead to foreign permanent establishments for tax purposes, which in turn would mean not only foreign corporate taxes, but also taxes and charges for employees.

If the obligation for tax and other deductions is identified for the overseas employees as part of the tax due diligence or foreign business audit, then there will normally be a risk of double taxation if the salary also continues to be subject to income tax and social security withholding in Germany.

CROSS-BORDER EMPLOYEE DEPLOYMENT

The “183-day rule” is now often no longer applied when looking at cross-border employee deployment within a company structure with permanent establishments. Usually, employees are only subject to taxation in the country in which their work is performed if

- they have spent a total of over 183 days within any calendar or fiscal year in the country where this work is performed, or
- the employer who is paying the salary, or for whom the salary is being paid, is resident in the country where the work is performed, or
- the wages are not being borne by a permanent establishment owned by the employer in the country where the work is being performed.

As, under international principles, a permanent tax establishment can generally not be an employer, “Employees of the permanent establishment” will be subject to tax and, if relevant, to social security charges from their first day of work in the country of the head office. In this case too, a review is needed, and the relevant applications should be submitted. The same applies to the reverse case when “Employees of the parent company” are working in the country of a permanent establishment; they are also subject to tax in the country of the company’s permanent tax establishment from the first day of working there, regardless of the “183-day rule”. As the employer is liable for the correct deduction of income tax, in these cases there are significant risks relating to tax and other charges for both employees and companies.

CONCLUSION

The employer is liable for making income tax and social security payments on behalf of their employees. In practice, it may often not be possible to reclaim any additional charges from bogus self-employed people or subcontractors.

Additional charges for employees are usually borne by the employer through loss compensation by the employer.

Retrospectively identified income tax and social security obligations therefore always lead to increased wage costs and compliance expenses. Ideally some initial starting points for tax improvements can be identified as part of the Tax Due Diligence.

FOR FURTHER INFORMATION, PLEASE CONTACT

Dr Dagmar Möller-Gosoge
Tax advisor
Partner

T +49 89 9287 805 51
dagmar.moeller-gosoge@roedl.com

Susanne Hierl
Rechtsanwalt (German Lawyer)
Specialist in tax law
Partner

T +49 911 9193 1081
susanne.hierl@roedl.com

→ Compensation for breach of disclosure obligations

The coronavirus crisis presents companies who are currently in an M&A process with numerous challenges. It is particularly critical if, shortly before notarisation of the SPA (share purchase agreement), potential business markets collapse, the order book situation significantly worsens, delivery chains are restricted and/or the prepared forecast for the current financial year is demonstrably no longer achievable. Against the backdrop of potential liability risks, the vendor always has to deal with the question of to what extent they must disclose circumstances that potentially reduce value, and what are the consequences of a breach of such a disclosure obligation.

GENERAL DUTY OF DISCLOSURE BY THE VENDOR

There is no duty in principle on the contracting parties to disclose all the facts without being asked. However, the Federal Court of Justice (BGH) has consistently ruled that the contracting parties must voluntarily disclose circumstances which could frustrate the purpose of the contract, and that are therefore of fundamental importance for the decision by the other contracting party. In the case of acquisitions, the vendor bears an enhanced duty of disclosure and care, due to the economic value of the sale of a company.

If there is any intentional or fraudulent breach of the duty of disclosure, the vendor is liable; this liability cannot be waived. The BGH will assume fraud if the vendor responds incorrectly by plucking answers "out of thin air" to questions that are obviously significant for the purchaser. "Out of thin air" means that the vendor provides unsub-stantiated statements.

SPECIAL DUTY OF DISCLOSURE OWING TO THE CORONAVIRUS CRISIS

The obligation on the vendor to disclose information increases in scope due to the current coronavirus crisis. Special circumstances that arise due to the coronavirus crisis can have an immense economic impact and thus affect the purchase price.

Some examples could be the following:

- (potential) customer losses due to the economic situation or due to cost-cutting measures by customers;
- there are significant bottlenecks in supplies to the company, because the supply chains or suppliers can no longer meet demand;
- the company to be sold is threatened with insolvency, or it has not yet filed an application due to the suspension of legal obligations.

Although the purchaser will most likely perform his own due diligence to check for potential or existing risks/loss of income due to the coronavirus crisis, the due diligence process will probably not be able to discover all risks. For example, it is not always immediately discernible to the purchaser whether significant customers of the company have filed for insolvency. However, the risks and failures must be correctly priced in by the purchaser, making them extremely relevant to the level of the purchase price.

If the vendor decides to whitewash the impact or fails to disclose information, this may result in liability. In addition to a reversal of the contract, it is also conceivable that the purchaser may demand compensation equal to the difference in value had the vendor made sensible disclosures (residual trust damages).

CALCULATION OF RESIDUAL TRUST DAMAGES

The calculation of the residual trust damages is made on the basis of the difference in the value as enhanced by the deception and the value without the deception. The enhanced value is the hypothetical value that is derived from the vendor's deception. The value net of deception, on the other hand, is the value excluding the deception. As part of the claim for compensation, the purchaser must prove in two steps how high the difference, which means the added value due to the deception, actually was.

In step 1 questions of valuation procedure are clarified to allow calculation of the residual trust damage. Here, the discounted cash flow approach is used to determine the distorted value and the value net of deception. The state of knowledge at the time of signing is decisive.

What is important is that this is viewed from the purchaser's perspective. However, synergy effects or planned corporate concept changes can be considered, but only to a certain level. The lower limit of the value of the purchaser company is the amount for which the purchaser could have resold the target of the transaction to a third party (market value). This is particularly relevant if, for example, a deception relating to planned corporate concept changes would greatly increase the company's value, and if they prove impossible to implement would significantly reduce the value of the company well below the market value.

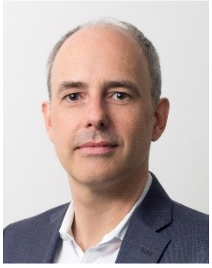
In step 2, the residual trust damage is calculated from the market value or, if higher, the deception-free company value. Arbitration courts or normal courts have to make assumptions in these cases, as to how the parties would have behaved in a hypothetical alternative scenario where there was no deception. To do this, the negotiation procedure is simulated working under the assumption that good faith and fairness are maintained in dealing with each other, and the purchaser applies rational behaviour in making decisions. Due to the necessity to reconstruct a situation in which there was no deception from the start, no effect for loss of trust may be included in the price determination.

At the end of the day, the court has to decide whether when reducing the agreed purchase price, the purchase price paid is reduced by applying the ratio of the reduction in the value of the company (new purchase price = old purchase price x (company value with no deception / company value including deception) or whether the company value reduction is simply deducted in full from the purchase price. Proportional reduction is suitable in those cases where the deception affects circumstances which are not of equal value to both parties (such as facts that affect the future profits of the company). If the purchaser has only paid an average value for these circumstances and not the purchaser company's value, the difference to the purchaser company's value may not be used. However, if the disputed fact has approximately the same value for the purchaser and the vendor (e.g. a liability that was not mentioned, or non-operating real estate), these items are considered to be reflected to a 100 percent level in the purchase price. These should therefore be included in full in calculating the residual trust damage.

CONCLUSION

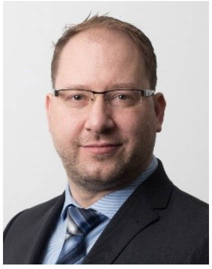
The Vendor must inform the Purchaser about such things as the loss of customers and/or suppliers or insolvency risks, and not only in times of Corona. In case of a breach, there is a risk of the reversal of the SPA (share purchase agreement) or a claim for damages for the amount of the residual trust damage. Purchasers should keep copies of the information received during the transaction, e.g. in the form of meeting minutes and data room contents. They form the core evidence in M&A disputes.

FOR FURTHER INFORMATION, PLEASE CONTACT



Cyril Prengel
EMBA (M&A), Certified Valuation Analyst (CVA)
Partner

T +49 911 9193 3350
cyril.prengel@roedl.com



André Heuer
Business Degree, Certified Valuation Analyst (CVA)
Associate Partner

T +49 911 9193 3358
andre.heuer@roedl.com

→ M&A Vocabulary – Explained by the experts

“Deed” under Common Law

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

If contracts are subject to the laws of England & Wales, they can be concluded informally (“under the hand” deals) in writing or as a formal deed. This means that not all written contracts are automatically deeds. A deed is a written document that is prepared in the required form and which grants a right. You could therefore also define this term of English contract law as being a qualified written form with special legal consequences.

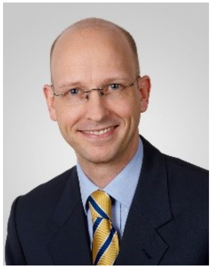
Firstly, every deed must be prepared in writing. However, both parties do not necessarily have to sign on the same physical document, but it is also possible to sign on several identical copies (referred to as counterparts). It may also suffice to exchange only the signature pages. Further form requirements depend on the individual deed. An individual must generally sign in the presence of and with the confirmation of a witness. For a limited company under British law, generally either one director and one witness, or two directors must sign, unless - although rare in practice - use is made of the option of a special company seal. For companies based outside the UK, the respective law of incorporation must be taken into account; in the case of a German GmbH, for example, only one managing director with sole power of representation can sign a contract as a deed. If a witness is needed, by law this may be any individual who is not a party to the contract. However, it is best practice for the witness to have at least a certain level of independence and to be of age.

In addition, a deed must be handed over (“delivered”). This occurs when the clear intent of the parties to be bound by the deed is demonstrated, without there necessarily being a physical handover. In this process, it must be unambiguously stated that the document should have the effect of a deed ("face value"). In practice, standard formulas such as "executed as a deed" are used. If a deed is not to be effective immediately, further options are available. The term "escrow" is used when a deed is irrevocable, but is still subject to a condition precedent. Alternatively, the handover can be delayed by assigning an agent, normally a solicitor, the task of handing over the already signed deed at a later point in time.

In certain cases, execution as a deed is legally required. These include, for example, the transfer of land, specific lease contracts, provision of certain securities (mortgages, charges), appointment of a trustee or a power of attorney. For some types of contract, a written document is required without the special characteristics of a deed, for example for certain legal transfers or personal securities (guarantees). If the prescribed form is not complied with, an agreement may not be legally effective.

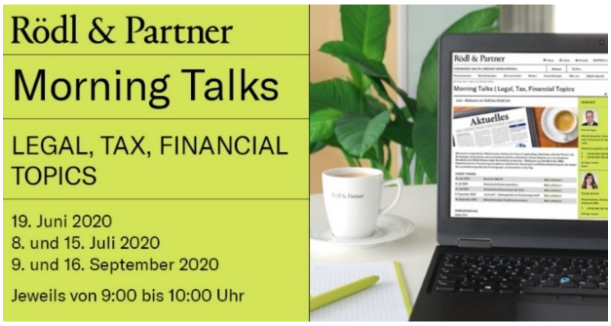
However, the execution as a deed is not only a prerequisite for its validity in certain cases, but also entails special legal consequences. This includes in particular, that claims arising from a deed can be enforced without the requirement of a consideration. In addition, the statutory period of limitation generally doubles from six to twelve years. Thus, it can also be beneficial to prepare a contract optionally as a deed.

FOR FURTHER INFORMATION, PLEASE CONTACT



Jan Eberhardt
Rechtsanwalt (German Lawyer)
Solicitor (England & Wales)
Partner

Birmingham, UK
T + 44 121 2278 963
jan.eberhardt@roedl.com



Our experts from various Rödl & Partner locations would like to invite you to live webinars on the areas of M&A, capital market law, financing, compliance, labour law, tax law and auditing. Benefit from what our experts have learned from first-hand experience. The detailed programme for our webinar series, and more detailed

information about registration, can be found at www.roedl.de/morningtalks.

We hope to welcome you online at one or more of our LIVE webinar(s). All sessions are free of charge.

Publisher’s details

M&A Dialogue |
June 2020 Issue

Publisher
Rödl GmbH Law Firm
Accountancy Firm
Auditing Company
Denninger Strasse 84
81925 Munich
Germany
T +49 89 9287 800
www.roedl.de

People responsible for content
Michael Beder, Dr Dagmar Möller-Gosoge, Cyril Prengel, Jan Eberhardt

michael.beder@roedl.com
dagmar.moeller-gosoge@roedl.com
cyril.prengel@roedl.com
jan.eberhardt@roedl.com

Layout/Presentation
Franziska Stahl
franziska.stahl@roedl.com

This newsletter provides information which is non-binding and is intended as general information. It must never be regarded as legal, tax or business consultancy, nor can it take the place of individual advice. Rödl & Partner always takes the utmost care when preparing this newsletter and the information it contains, but Rödl & Partner accepts no liability for the information being accurate, up-to-date and complete. The information included herein does not relate to the specific situation of any individual natural person or legal entity, and professional advice should always be sought for any specific case. Rödl & Partner accepts no liability for any decisions readers may take on the basis of this newsletter. Our advisers are available to meet with you on request.

The entire content of the newsletter and the professional information provided on-line is the intellectual property of Rödl & Partner and is subject to copyright protection. Users may only download, print or copy the content of the newsletter for their own personal use. Any amendments, reproduction, distribution or publication of the contents or any parts thereof, whether online or offline, require the prior written approval of Rödl & Partner.