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Germany

PRIVATE EQUITY

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This country-specific Q&A provides an overview of private equity laws and regulations applicable in Germany.

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GERMANY
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1. What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?

According to leading deal surveys, the percentage of M&A transactions that involved a financial sponsor on at least one side increased over the last three years to almost 40% in the year 2021 and again approx. 40% in the year 2022 despite a general slowdown in the year 2022.

2. What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?

A private equity seller generally aims for a 'clean exit' to be able to distribute exit proceeds to investors without undue delay. Therefore, financial sponsors aim to limit post-closing exposure. Escrows, backstop guarantees, broad seller warranties and indemnities are rarely seen in private equity deals and are more likely to be found in trade seller transactions. This is particularly true if the fund has reached the end of its lifetime. The locked box pricing mechanism is predominant in German private equity deals, which may make the auction process more efficient as it simplifies bid comparison and avoids post-closing disputes around purchase price adjustments. Many trade sales involve a need for the separation of the sold and the retained business or even more complex carve-out measures so that the locked box is often not the appropriate concept in trade seller transactions. Carve-out measures, separations and pre-closing reorganisations often play an important role in a trade seller deal. The scope of business warranties and the scope of fundamental warranties tend to be broader in acquisitions from a trade seller. W&I insurance and the 'insured deal concept' is still customary in both private equity and trade seller transactions. Where the seller is a sponsor-backed entity, it is very likely that the sponsor has implemented a management equity program so that the expectation often is that the buyer also offers attractive terms of a future management equity investment.

3. On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?

The transfer of shares in a German limited liability company (GmbH) requires the execution of a deed of transfer between the transferor and the transferee before a German notary. Technically, shares can be transferred in the SPA subject to certain defined conditions precedent (in particular, payment of the consideration) or the seller and the buyer enter into a separate transfer agreement at closing. Legal title passes upon the notarization of the share transfer agreement (and satisfaction of the conditions, if any) whereas the update of the shareholders list kept with the competent local court is not a prerequisite. The transfer of shares in stock corporations (AG) may require additional formal steps or alternative steps while a transfer of shares in a listed company typically occurs through an electronic clearance system. There is no stamp duty or approval requirement – taxation rather follows the applicable rules if and to what extend the seller must pay tax on gains resulting from the sale. The acquisition of shares in a company is in principle also not subject to German value added tax or any other German transfer taxes except German real estate transfer tax. German real estate transfer tax at a rate of 3.5% to 6.5% (depending on the federal state the property is located) is levied on the acquisition of shares in companies owning German real estate if 90% or more of the shares are directly or indirectly transferred to new shareholders within a period of 10 years.

4. How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?

The buyer will provide equity commitment letters and debt commitment letters. Although it is doubtful that the ECL needs to be notarized, this is standard procedure nowadays where the target is a GmbH. The equity commitment letter is typically directly addressed to the purchasing entity and the seller, and the seller is explicitly named as third-party beneficiary. Under the equity commitment letter, the buyer undertakes to provide the purchasing entity with the equity required for the payment of the purchase price (subject to the fulfilment of the closing conditions under the purchase agreement and a commitment cap) or damage claims for closing not occurring due to a breach of the purchase agreement by the buyer. If there is debt financing involved, the acquisition vehicle usually also needs to submit a debt commitment letter (sometimes accompanied by a binding term sheet, sometimes by an interim facility agreement that the parties to it agree to sign, if required). The amount of debt funding reduces the equity funding amount. It should be noted though that – absent deal specific circumstances – the seller will typically not accept that the equity commitment is conditional upon the actual debt funding. 'Certainty of funds' is a key principle in German private equity transactions and (except in very specific circumstances) there is no walk away or reverse break fee concept. Under a customary 'certainty of funds'- concept, it is usually ensured that the required equity and debt amounts will be funded, and the purchase price can and will be paid at closing to the seller, unless an event of a 'certain funds'- default (being only such event/default which is under the full control of the seller and the target) has occurred between signing and closing.

5. How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?

The 'locked box' concept is the most common purchase price mechanism in German private equity deals. In a competitive M&A market, the seller prevails with his preference for deal certainty from a pricing perspective, unless there are specific circumstances that cut across the locked box approach. Additionally, compared to completion account structures, locked-box structures may be advantageous for private equity investors both on the sell-side and the buy-side, as they provide for purchase price certainty, allowing investors to calculate the needed funds for the purchase price paid (buy-side) and facilitate the immediate distribution of funds (sell-side), as no post-closing adjustment will be required. Typically, transactions that require pre-closing business reorganisations or carve-out measure are not suitable for a locked box deal. The same may be true if there are no reliable recent financial statements available. Additionally, a completion accounts mechanism may be more appropriate if the target's proceeds are subject to high volatility (eg, due to the effects of seasonality). While the box is generally locked from the effective date, it has become market practice to ask that the equity value determined as of the locked-box date bears interest from the effective date until closing (equity ticker). Details on the exact time period, the (potentially staggered) amount and whether or not the ticker includes a penalty element for a late closing are often heavily negotiated and subject to the final commercial agreement between the parties.

6. What are the typical methods and constructs of how risk is allocated between a buyer and seller?

In a private equity transaction, the seller usually proposes seller-friendly terms that ensure that risk passes to the buyer to the greatest extend possible. The key concepts are the following: The locked box concept provides certainty on pricing. The buyer will need to make sure that the leakage protection is robust and that there is a clear understanding and agreement on permitted leakage positions as well as the enterprise value to equity value bridge. Risks associated with operational matters of the business are usually only covered by warranties which are backed by W&I insurance so that – absent fraud and intentionally false warranties – the buyer can take recourse solely against the insurance for a breach of business warranties. The seller will only stand behind fundamental warranties, eg title to sold shares and authority (and very often only to the extent not covered under the insurance policy). A trade seller in turn may give more and broader business warranties due to an increased involvement in the day-to-day business of the target group and hence a potentially better risk assessment. Any bring-down of business warranties as of the closing date would only be accepted by the seller to facilitate that the relevant warranties will be insured as of signing and the bringdown date, but a seller will explicitly exclude any liability associated with the bring-down. Material adverse change/effect clauses, which enable the buyer to terminate or adjust the SPA in cases of material adverse changes to the target group in the period between signing and closing of the transaction, walk away rights in case of covenant or warranties breaches and financing-outs are usually not accepted by the seller. Indemnities are difficult to accept for a private equity seller (save for a tax indemnity which, however, also falls into the W&I concept so that the buyer needs to take out insurance for it as well). Escrows, hold-backs or any contingent liabilities are normally strongly resisted by the seller and proposing them can be a material disadvantage in a competitive auction.

7. How prevalent is the use of W&I insurance in your transactions?

The use of W&I insurance has become "market standard" in M&A transactions as it is a concept that allows a 'clean exit' for the seller with limited liability exposure. Buyers may enhance the warranty protection by extending the duration and scope of warranty coverage (eg by disapplying materiality thresholds or by way of "knowledge scrapes") and/or by taking out specific insurances, eg for tax matters or other risks that are not customarily covered under standard W&I insurance policies, including identified/known risks. In auction processes, it has become market practice that the seller sets up a soft stapled W&I process where it obtains non-binding indications (NBI) from potential insurers via a broker, submits the NBI report to the buyer and facilitates a smooth flip-over to the buyer and an accelerated underwriting procedure. Policy terms largely depend on the insurer, target industry and countries involved, quality of diligence, and availability of the management, the term and deductible/retention, and the liability cap. W&I policy can be set irrespective of the management/warrantor liability under the SPA which is typically capped at EUR 1 for a breach of business warranties. The cost of the insurance is often in the region of 1% to 1.3% of the amount insured. Policies will provide for certain exclusions due to either general insurability or known risks and gaps in diligence.

8. How active have financial sponsors been in acquiring publicly listed companies?

Today, many financial sponsors view public-to-private (P2P) transactions as an alternative way to invest even though the vast majority are still private deals. Companies listed on a German stock exchange are often considered as an attractive target, especially in the current market situations and take-private transactions are seen as a way to unleash the growth potential absent the capital market radar. The German takeover law, however, imposes several restrictions and strict formal requirements on the acquisition process, which need to be complied with in the course of the takeover process and there are no efficient rules for competing offers. The management board of a listed German stock corporation must also comply with its fiduciary duties during the takeover process by acting solely in the interest of the company and its stakeholders (as opposed to a pure shareholder value model). The investment case may require that the bidder achieves a certain acceptance level of its offer to ultimately pursue a taking-private (including to implement a debt push down and/or a domination and profit transfer agreement or to pursue a delisting and/or squeeze-out); in most deals, the takeover was conditional upon a defined acceptance thresholds being reached. There are possibilities to provide for additional deal security, eg by irrevocables or voting proxies.

9. Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?

Apart from merger control and regulated sectors (insurance companies, banks, hospitals, etc) as well as the most recently implemented EU Foreign Subsidies Regulation, foreign direct investment control has become a focus area in Germany over the years with several changes in foreign investment control laws and regulations and a general shift to a stricter interpretation by the competent German ministry. Transactions by non-German investors in highly sensitive industries (such as arms, military equipment and IT security products) or by non-EU/EFTA investors in specific sectors classified as 'critical' (such as critical infrastructure, cloud computing, medical devices, artificial intelligence, cyber security, robotics, autonomous driving and flying, quantum and semiconductor technology) require mandatory clearance by the German Federal Ministry for Economic Affairs and Climate Action. Most of the relevant cases giving rise to concerns involved buyers from the People's Republic of China. A voluntary notification regime runs in parallel in relation to certain acquisitions that fall outside the mandatory regime but which nonetheless may give rise to national security concerns.

10. How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?

The process letter typically requests a (preliminary) merger control analysis from the bidder in connection with the submission of the binding bid. The sell-side and the buy-side normally exchange relevant information (where required on a counsel-to-counsel basis) to come to a joint conclusion of the filing requirements and allow the seller to assess the bid and the risk profile from a deal certainty point of view. Contractually, there is (i) almost always a 'hell or high water' clause in the purchase agreement the scope of which varies depending on the target business, the nature of the buyer, its existing portfolio investments (with commitments often limited to the buyer and the current target structure and thereby limiting the risk for unrelated portfolio investments) and the negotiation powers of the parties and which is accompanied by close monitoring rights of the seller's counsel during the clearance process, (ii) very often a 'no interference undertaking' (which typically extends to the funds' level) and (iii) sometimes a break fee/liquidated damages clause.

11. Have you seen an increase in (A) the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside; and (B) 'continuation fund' transactions where a financial sponsor divests one or more portfolio companies to funds managed by the same sponsor?

The number of minority investments has recently increased both in deals where a sponsor sells a majority stake and reinvests in the business and in minority investments from the outset, often in "big corporates". Both cases are structured as equity investments with minority protection rights. There is also an increasing number of minority investments in the growth equity sector, where financial sponsors sometimes invest in debt-like instruments with the right to participate in the equity upside, sometimes also in combination with a 'true' equity investment. The teaming up of two financial sponsors in large cap deals is another scenario where a sponsor does not have a controlling stake in the target business. There is also a substantial increase of GP-led secondaries in the form of 'continuation fund' transactions. Those transactions can be very complex given that the transaction touches both the funds level and the portfolio investment.

12. How are management incentive schemes typically structured?

Unlike in U.S. style management incentive plans, for example, where profits interests and options are the dominant form of equity awards, management typically invests as co-shareholder in the holding structure via a management pooling vehicle. In most cases, the pooling vehicle is a limited partnership whose sole general partner is a GmbH (GmbH & Co. KG). The sponsor owns the general partner while the managers are limited partners. As limited partners, they legally own limited partnership interests while economically (and from a tax point of view) they 'hold' instruments in the relevant holding entity. The management equity investment (or a meaningful portion if a manager invests in both the 'institutional strip' and the 'sweet equity') is 'sweet', either because management only holds ordinary shares or because the ratio of ordinary shares and preference shares (or similar instruments such as shareholder loans) is different when compared to the sponsor's ownership of instruments. 'Hurdle' shares or 'ratchets' are less common than in other jurisdictions due to (potential) detrimental tax effects. The size of the sweet equity pot for allocation is deal specific but often in the range from 8% to 15%. Vesting provisions (often cliff (time) vesting over four to five years) and leaver provisions are very common. Exit bonus letters tend to be issued only later in the investment period and often only to selected managers, especially those who join shortly before exit if an additional incentive is required for those who play a key role in the exit process.

13. Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?

To achieve the capital gains tax treatment, certain rules apply to the set-up and terms of the management equity investment. The sole purpose of the pooling vehicle must be the administration of its own assets and it must not conduct any trade business; one of the limited partners needs to assume responsibility for the (internal) management of the vehicle. The managers need to pay fair market value for their participation in the management equity program and, as a rule of thumb, specific features of an instrument that is solely allocated to management (eg 'ratchet shares' or 'super return' shares) can be tax detrimental.

14. Are senior managers subject to non-competes and if so what is the general duration?

Non-competes (often together with non-solicitation undertakings) are customary provisions in management investment agreements as well as a manager's service agreement. Non-competes in investment agreements typically apply for the duration of a manager's investment and sometimes have a tail of 12 to 24 months after a manager's departure from the business or transfer of the management equity. Since the enforceability of post-contractual/post-investment undertakings in equity documents is not certain under German law, management service contracts typically include non-competition clauses. Any post-contractual non-compete in the service contract requires the payment of a compensation to be valid and enforceable. There are statutory rules and established case law on the amount to be paid, the prerequisites of a waiver of non-competes, the scope and their duration (in practice often twelve months).

15. How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?

The sponsor will in most cases have a majority of voting rights in the shareholders' meeting. A number of significant matters require shareholders' approval under German statutory law (eg mergers, amendments of the articles of association, dividends etc). In a German limited liability company (the vast majority of private equity investments in Germany), the shareholders' meeting can give instructions to the management of the portfolio company, either with regards to a specific matter or by way of so-called rules of procedure for the management. Among other things, such rules of procedure contain reporting obligations and a catalogue of defined reserved matters which require shareholder(s) approval before the management may implement any such reserved matter. If the sponsor holds a minority stake in the business, the investment agreement typically contains provisions on reserved board matters and reserved shareholder matters. The exact scope and majority requirements are deal specific but there is typically a limited number of matters which are not subject to a majority voting but require the sponsor's individual consent. It should be noted that the control rights are weaker in case of a German stock corporation as the management board is independent and any rules of procedure and reserved matters need to be adopted by the supervisory board – the body which is also competent to appoint and (under certain circumstances only) remove the members of the management board. However, following the implementation of a domination (and profit and loss transfer) agreement, instructions can be given to the management board of a stock corporation by the dominant entity (usually BidCo).

16. Is it common to use management pooling vehicles where there are a large number of employee shareholders?

A management pooling vehicle is standard even where only a few managers invest in the business. There are no employee benefit trusts or similar trust arrangements in a German management equity program.

17. What are the most commonly used debt finance capital structures across small, medium and large financings?

Larger financings usually involve a mix of instruments, typically a syndicated together with a revolving credit facility each secured on a first ranking pari passu basis. Larger financings may also involve New York law governed high yield bonds in addition to a 'term loan B' or as a replacement. In smaller to medium deals there is an increased activity of private credit fund providing 'unitranche' or 'first out' structures, where a credit fund provides the vast majority of the financing in the form of senior term loans and a commercial bank provides a revolving credit facility.

18. Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?

While there is financial assistance legislation that applies to a German stock corporation (ie a prohibition to provide financial assistance for the direct or indirect acquisition of own shares), no financial assistance regime applies to a German GmbH. There are capital maintenance rules though that impose certain restrictions on measures that could be considered financial assistance. In practice, there are established debt-push-down procedures (including for instance mergers as well as profit and loss transfer agreements), which ultimately ensure that debt service and profit generation are combined at the same level.

19. For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?

There is no standard form of credit agreement that is used in substantially all or even a meaningful number of debt financings. Typically, a sponsor prefers to use precedent documentation where it deviates from The Loan Market Association standards. Negotiation is material around economic terms in different performance scenarios and nowadays again on covenants. In times of narrow financing markets, the negotiations have become more significant, and terms of the final agreement can be quite bespoke (depending on the size of the deal, the debt portion, the business, the shareholder base, the number of interested underwriters etc.).

20. What have been the key areas of negotiation between borrowers and lenders in the last two years?

Negotiations tend to be centered on the definition of EBITDA both in the loan and high yield bond markets. The ability to incur additional debt is also one of the main negotiation points, where borrowers focus on increased flexibility whilst lenders focus on key protections (eg debt caps, intercreditor accession thresholds etc). Another main area of negotiations remain pricing terms including margins.

21. Have you seen an increase or use of private equity credit funds as sources of debt capital?

Credit funds have substantially increased their share on the loan market in Germany (as across Europe generally), particularly (but not exclusively) in the mid cap market. To some extent, some credit funds frequently collaborate with a group of underwriting banks. Credit funds are also a source of debt financing where additional subordinated debt is needed. The financing made available by credit funds will frequently have the form of a 'unitranche' or 'first out' structure, where a credit fund provides the vast majority of the financing in the form of senior term loans and a commercial bank provides a revolving credit facility. On larger deals there have also been 'clubs' of credit funds, ie a group of credit funds which forms prior to signing of the financing or its syndication and which together underwrite and provide the financing for the transaction. Given current market conditions, during this year, there were several debt-to-equity swap transactions involving private credit funds.

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