The benefits and potential pitfalls of a distressed M&A in Germany

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This article looks at the main scenarios for acquiring a distressed business under the German legal system. It points out the opportunities for buyers, but also shows the potential legal pitfalls to be avoided.

Acquiring a business in a distressed situation poses certain risks. There will be reasons for the distress, and key questions to answer as to what extent those reasons prevail and to what extent the buyer will be able to overcome them. However, there are also opportunities. The purchase price will be lower and, depending on the restructuring possibilities, the acquisition of a distressed business can allow the creation of value instead of merely preserving it. Depending on the structure of the deal, the legal risks can be minimised. To what extent the business will have suffered harm from the insolvency or the crisis must then be assessed in each individual case.

Acquisition pre-insolvency

When looking to buy a distressed company in an out-of-court scenario, the main focus is on the risks associated with the potential target. There will be an underlying reason for the company's distress, and in an out-of-court scenario the buyer cannot rely on the insolvency laws to fend off all of these risks.

Share deal

A share deal in this scenario is the riskiest way to acquire the business. All the business' "past sins" will have left their trace in the balance sheet and must be dealt with. In addition to the usual due-diligence when acquiring a business, there are certain areas which should be focused on in a distressed scenario:

- In the run-up to a crisis the business management is often under considerable pressure. This pressure may be caused by banks or investors. If the business is family-owned, the management and owners may be the same individuals, or be closely related. In these cases, banks often induce the owners to guarantee the company's debt, which adds to the pressure. The investor may be the last chance for the owners to avoid the company's insolvency, and personal insolvency as a consequence. This pressure increases the risk of fraud, which should be taken into account.
- The investor should also focus on the fate of the seller. If there is a risk that the seller will fall into insolvency after the sale, an insolvency administrator for the seller might try to void the transaction by using the avoidance rules under the German insolvency laws. In the past, the German courts have shown themselves willing to interpret the avoidance rules broadly in these situations.
- If part of the restructuring plan is to convince creditors to accept a haircut, this should be done before the acquisition for two reasons. Firstly, the leverage on creditors after acquisition is considerably lower than it is pre-acquisition. Secondly, the rules regarding the liability of managing directors in a crisis scenario are especially stringent in Germany. The managing director potentially incurs personal liability for all the

company's payments that occur after it becomes either cash-flow or balance-sheet insolvent. Both trigger an obligation for the managing director to file for insolvency at the latest within three weeks, and entail personal liability for the managing director if this obligation is disregarded. If post-acquisition negotiations with creditors take longer than the three weeks, the new managing director assumes a considerable risk if the negotiations fail. This risk should be avoided by finishing the negotiations pre-acquisition. If waivers are part of the restructuring, their tax consequences must be considered. The waiver will result in a profit and under German tax laws profits incurred in one year cannot be set off against losses carried forward to an unlimited extent.

Asset deal

It may be tempting to avoid all or some of these risks by agreeing on an asset deal. However, acquiring the assets pre-insolvency and leaving the liabilities behind creates risks of its own. If the purchase price for the assets is insufficient to pay for the selling entity's liabilities, its insolvency will only be a question of time, unless the seller reaches a settlement with the creditors. If there is a subsequent insolvency, an insolvency administrator will scrutinise any pre-insolvency deal involving the sale of all or substantially all of the assets. These deals can then be challenged on numerous grounds:

- The insolvency administrator may assert that the sale was below value and may try to avoid the deal altogether. In most cases, the insolvency administrator will not attempt to have the business returned to the insolvent company but will try to exercise enough pressure to induce the buyer to make additional payments.
- If there is a strong disparity between the value of the assets and the purchase price, the seller or its officers can be subject to criminal liability for breach of trust. This liability may extend to the buyer if the buyer knowingly supported the seller or its officers.

Therefore, when considering such a deal it is important that it is backed up by a dependable appraisal of the sold assets. This gives room to argue that the transaction was fair and at arm's length, but it will not create absolute security. The incentive for insolvency administrators to challenge such a deal is extremely high because they will always be keen to maximise the estate and therefore their fees. In addition, while useful, appraisals of sold assets are never sacrosanct. The insolvency administrator can commission another appraisal, which might come to completely different conclusions.

To minimise the risks in this scenario, the buyer should ascertain if the purchase price will actually be sufficient to pay for the company's remaining liabilities. If this is not the case, the purchase should be pursued differently.

An asset deal does not allow the purchaser to terminate the target's existing employment contracts. If the assets are sold and transferred to a new legal entity, the employment contracts transfer to the new entity by operation of law, including all rights and obligations.

Risks and benefits

Any pre-insolvency acquisition is a risky business decision. In a share deal scenario, the buyer must potentially assume all the risks of the acquired entity. In an asset deal, risks concealed in the seller can come to trouble the buyer after closing. Nevertheless, a pre-insolvency investor often faces much less competition than in an insolvency scenario. Distressed sellers have little incentive to make the crisis public knowledge by putting a company on the market and starting an M&A transaction. Potential buyers are normally strategic investors who are approached because they have a certain connection to the seller. Insolvencies, on the other hand, create publicity. All the market

participants know that the company is for sale, that the purchase prices are potentially lower and that the insolvency laws can be used to shed pre-insolvency risks and liabilities. Therefore, while buying pre-insolvency does pose risks, in many cases the investor will have an exclusive opportunity for the purchase.

Acquisition post-insolvency

The acquisition of an insolvent company, whether through a share deal or an asset deal, can be economically beneficial. The economic risks mainly depend on the reasons for insolvency. If the insolvency was caused by individual mistakes by the management, such as a failed attempt to penetrate new markets or something comparable, the risks and liabilities resulting from these mistakes can be left behind and the business can get off to a fresh start. An acquisition post-insolvency can also be used to cherry-pick the viable parts of an entity and makes it easier to reduce staff where necessary.

The insolvency procedure

There are two main parts to an insolvency procedure in Germany, a provisional insolvency administration and the administration itself.

Provisional administration starts with an insolvency filing. The insolvency court then issues an order initiating the provisional administration. The court may appoint a provisional administrator or allow the debtor to administer the provisional administration itself in a self-administration. While the debtor stays in possession of the assets in a self-administration, the court will appoint a provisional custodian to supervise the debtor. The provisional insolvency administrator or custodian then investigates the cause of insolvency for the court and determines whether the unencumbered assets will cover the costs of the procedure.

The debtor's employees can claim against the German social security for three months of wages before the opening of the insolvency procedure during provisional administration. It is therefore usually possible for the provisional insolvency administrator or the debtor in self-administration to continue the business operation during provisional insolvency for a three-month period. In most cases, after the three-month period is over, the insolvency administrator or the custodian will recommend the court to either:

- Drop the procedure because the funds will not cover the costs.
- Proceed from provisional administration to the final procedure.

In most cases, the provisional insolvency administrator or the debtor in a provisional self-administration will aim for a sale of the business in a share or asset deal. Ideally, they will find a buyer to take the business out of their hands immediately on termination of the provisional administration. In these cases, the business is sold on the first day of final administration, although a share deal would of course require the involvement of the debtor's shareholder(s).

If the unencumbered assets are sufficient to cover the costs of the procedure, the court will issue an order to open the main insolvency proceedings. It will either appoint an insolvency administrator or continue to allow the debtor to stay in possession of the assets under the supervision of the custodian. The administrator or the debtor in self-administration must then decide if business operations can be continued in the administration. Social security funds will no longer be available, so the economics are much more difficult as compared to the provisional administration.

Structure of the transaction

There are two ways of structuring a post-insolvency acquisition. The most common method is to buy the assets from the administrator or the debtor in self-administration. The other possibility is to buy the debtor's shares once it has reorganised through an insolvency plan, a procedure which compares broadly to a Chapter 11 reorganisation scheme under the US Bankruptcy Code. The insolvency plan procedure was introduced by the German Insolvency Code in 1999 and, in the beginning, was hardly used. It has gained greater importance in recent years, especially since a reform of the Insolvency Code in 2012 strengthened the possibilities for the debtor to stay in possession and reorganise through an insolvency plan. However, an asset deal is the prevailing method in both administration by a court-appointed insolvency administrator and self-administration by the debtor. In an asset deal, the investor buys the assets for a certain purchase price, and the administrator or the debtor in self-administration distributes the purchase price to the creditors. Consideration paid for encumbered assets goes to the secured creditors, with a share going to the insolvency estate. A purchase price paid for unencumbered assets goes to the insolvency estate and is used to pay for the costs of the procedure and to satisfy unsecured creditors. Under German law, there are no priorities among unsecured creditors and they all fall into the same class.

Risks and benefits

Assets. In both types of transaction, it should be determined whether the purchase allows the continuation of the business. The buyer should investigate very thoroughly which assets are necessary for the business and where those assets are located. Groups of companies in particular have a tendency to act as one entity and to be careless about assets going from one entity to another. Buying the assets or shares of an entity that seems to be undertaking business operations does not necessarily ensure the correct assets are included. This is especially true for trade marks, patents and other forms of intellectual property. These are often held by a holding company, even if they are essential for the business of a subsidiary.

Purchase price and financing. When determining the purchase price in an asset deal, it is extremely beneficial for the investor to know the security interests of the creditors. The investor can usually make a much better and more attractive offer because banks or vendors do not necessarily think in terms of ongoing business but know that break-up value is a threat. The offer has a better chance of being accepted if it gives the secured creditors more than the break-up value. The offer should also allocate a part of the purchase price to unencumbered assets because this money will go to the insolvency estate and secure the support of the insolvency administrator or custodian. Accounts receivables are hardly ever sold in these deals.

In the insolvency plan scenario, an offer must be made for the debtor's shares. German insolvency law does allow a debt-to-equity swap, but these rules are hardly ever used. The insolvency administrator or the debtor in possession cannot dispose of the shares unless they are also in charge of the shareholder. If this is not the case, and a debt-to-equity swap is not feasible, the shareholder will have to be involved in the negotiations.

An insolvency plan will often contain a provision that the creditors will receive payments for several years from any excess cash flow after reorganisation. This liability remains with the reorganised company and would remain enforceable.

A share deal has considerable advantages on the financing side. The only payments that are immediately necessary are those to acquire the shares, if a purchase price is paid for the shares at all. The payment to the creditors can in many cases be stretched out over several years.

In an asset deal, the assets must usually be paid for without delay, and cash and accounts receivables are not transferred. For this reason, the financing must include not only the purchase price but also a good part of the working capital.

Warranties. Insolvency administrators are usually very reluctant to give any form of warranty. This is true for both share and asset deals. Administrators will point out that they do not know the business as well as a normal seller and will make investors aware that they are not paying the full purchase price and are getting an especially good deal because of the insolvency. A purchase from a debtor in possession will not be any different.

Once the insolvency administrator or the debtor in possession has paid out to the creditors, the insolvency estate is no longer a good debtor for warranty claims. Therefore, it often does not help to have a large warranty claim against the insolvency administrator or the debtor in possession because both can declare deficiency of the estate if the warranty claims exceed the amount left in the estate. Absent fraud or gross negligence on the part of the insolvency administrator, the warranty claim will not be enforceable. To truly gain security against the seller, the investor would have to insist on withholding part of the purchase price or putting it in escrow and releasing those monies only according to certain milestones or conditions or other post-closing developments. However, these provisions are extremely difficult to achieve and will not go down well with creditors. If creditors compare offers they usually deduct any withholdings from the offer and treat it as a final reduction as a matter of precaution. To insist on withholdings or monies going to escrow may therefore prevent the offer from being successful.

Pre-insolvency liabilities. In an asset deal, one of the major advantages is the fact that pre-insolvency liabilities are left with the insolvent debtor, including any tax liabilities. Buying assets from the insolvency administrator or the debtor in possession enables the investor to buy a business free and clear of all encumbrances.

However, the investor should be aware that if the insolvency administrator or the debtor in possession continued to trade after the opening of the insolvency procedure, they will have incurred administrative expenses. There is no rule that forces the buyer to assume these liabilities, but the seller will try to convince the buyer to do so in any case.

In an insolvency plan scenario, a degree of doubt may remain in relation to pre-insolvency liabilities. In general, these liabilities are covered by the plan and paid off according to the plan. Therefore, for example, if there are claims for EUR1 million and the plan proposes to pay 20% to the creditors, the investor knows quite clearly how much the debtor will have to pay to the creditors. However, there may be uncertainty in relation to claims that have not been lodged. According to §254b of the Insolvency Code, plan provisions also cover creditors who have not lodged their claims. Those creditors would therefore also be entitled to 20%, even if they have not filed their claim. Under §259b of the Insolvency Code, such creditors are time-barred one year after the insolvency plan is confirmed. This confirmation is unappealable.

Employment issues. Dealing with the employment issues is often the most difficult issue when negotiating a purchase of an insolvent company. When buying a business in Germany, the buyer must assume all the employment contracts whether it is a share or an asset deal. These rules apply inside and outside of insolvency and, in principle, cannot be circumvented. There are only limited possibilities for an insolvency administrator or the debtor in possession to reduce staff during provisional administration or in the ongoing insolvency procedure, because the insolvency itself does not create good cause for termination of an employment contract. Buying the company from an insolvency administrator or the debtor in possession therefore transfers all the employment contracts to the new investor, or, in the case of a share deal, they remain with the acquired debtor.

However, two factors facilitate staff reduction in an insolvency. The employer can make use of shorter termination periods, and social compensation plans are limited to a certain extent. In addition, and more importantly, the buyer can develop a specific business model for the purchase (Erwerberkonzept) that allows for the termination of

employment contracts without having to abide by the stringent social criteria rules. While employees who are most vulnerable in relation to a termination of their employment contract must normally be kept, these rules do not apply if the buyer explains why employees must be made redundant and who these employees are in the new business model. However, this can be challenged in the labour courts and the seller will typically try to reach a settlement with the employees who are to be laid off. A reduction of staff is always costly, and these costs must be covered either by the investor or by the insolvency estate.

For the investor, there are two consequences:

- If the investor makes an offer that includes the transfer of all employment contracts, the offer will be very attractive to the insolvency administrator or the debtor in possession because the estate will not be burdened with the costs involved in terminating employment contracts. An offer proposing a higher purchase price as compared to a competing offer might not be the better offer if the competing offer calls for fewer redundancies, because the costs of the staff reduction will be factored in.
- If a staff restructuring cannot be avoided, the investor should let the insolvency administrator or the debtor in possession do the restructuring before purchasing the business. Even if the estate needs to be financed to do this, it is normally cheaper to have the seller deal with the staff reduction, while the investor will avoid potential negative publicity.

Tax issues. In an asset deal the investor will want to pay most for those assets with the shortest depreciation periods. There are usually no other tax issues in an asset deal.

In a share deal, after the company is reorganised under an insolvency plan, tax law treats the waivers that are usually included in an insolvency plan as extraordinary profits. Under German tax law, losses carried forward cannot be unlimitedly set off against profits. This "minimum taxation" only allows the unlimited set-off of EUR1 million per fiscal year of losses carried forward against profits. The consequences of these rules were alleviated by a restructuring decree issued by the German fiscal authorities. According to this decree, taxes would not be assessed on these profits if the profits were incurred in a restructuring scenario. However, this decree was declared void by the highest German fiscal court, for constitutional reasons. The court held that these rules could not be contained in a decree but required the passing of a formal law. Plans to replace the restructuring decree by a formal law will have to be considered against the background of EU law, especially the laws prohibiting subsidies. There has been no replacement to date.

In addition, with a transfer of more than 50% of the shares, losses carried forward will be deleted altogether. A share deal therefore poses risks in relation to tax consequences, as it does not allow the preservation of losses carried forward.

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Areas of practice. Distressed M&A; restructuring and insolvency.

Recent transactions/activities

- In charge of a Dornier-Fairchild subsidiary for over a year during its Chapter 11 Proceedings in the US.
- Liquidator to two Enron companies in Germany.
- Active in advising investors when they want to purchase a business from an insolvency administrator or in other distressed situations.
- Working with financial institutions to improve their collateral portfolios and enforcing the banks' position in insolvency.
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Publications

- German Insolvency Law, European Restructuring und Insolvency Guide 2005/2006 (White Page London 2005), together with Robert Munn.

- The debtor has assets in Germany – Now What? Dealing with German cross border In-solvency Law, ABI Journal 2016.
- German restructuring market is at a crossroads. Global Turnaround 2017.

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