SHARE PURCHASE AGREEMENTS IN THE GERMAN PRACTICE

STANDARDS AND RECENT DEVELOPMENTS

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Munich

June 2017

1. Introduction

Germany, as most European countries, has a long history of business, trade and industrialization. The sale and purchase of businesses therefore also has a long tradition. German industry is largely shaped by a massive number of privately held medium size enterprises (having revenues of between MEUR 50 – 1,000), many of them highly successful on a global scale in niche markets. The German M&A landscape is therefore dominated by transactions involving these type of companies with private equity investors playing a major role as buyers or sellers (secondary transactions).

Being one of the largest expert nations, Germany traditionally has been a very open country for foreign investment and has profited in many ways from entrepreneurs and investors from around the world making investments in German businesses. Like in many other countries German law does provide for certain rules protecting sensitive German businesses from foreign (i.e., non EU) control. The standards for governmental intervention, however, are very high, so German "public order" or national security must be at stake for the government to be allowed to prevent a transaction. Sec. 55 of the German Regulation on Foreign Trade and Payment (*Außenwirtschaftsverordnung*) provides:

> "The Federal Ministry of Economics and Technology can examine whether the public order or security of the Federal Republic of Germany is endangered if a non-EU resident acquires a domestic company or a direct or indirect participation within the meaning of Section 56 in a domestic company."

Recently, Chinese investors have been very active in the German market and a number of investments by such (mostly state-controlled) players in German companies have been subject to intensified scrutiny. However, none of the transactions has ultimately been disapproved.

As one of the continental European civil law countries, German law is mostly based on codified regulations. Most importantly, the German Civil Code provides for a set of rules applicable to sale and purchase transactions involving goods or rights which, generally can also be applied to the sale of a business by way of asset (goods) or share (rights) deal. In theory, one would therefore, still today, be able to sell a business without the need of a lengthy agreement, simply by observing some formal rules and otherwise in reliance on the provisions of the Civil Code, the Commercial Code and other statuary (mostly corporate and tax) law. This notion is, however, far away from today's practical approach to the purchase or the investment into a business of any major size. The reasons therefore are mostly twofold:

First, the German Civil Code and the Commercial Code, dating back from the late 1900's do not specifically address the issue of the sale of a business. Statuary law therefore would approach any problem coming up following an M&A transaction under the general rules applicable to the sale of goods and/or legal rights (such as corporate rights, vested in shares sold). Since a business is a very complex, and ever-changing "good" it is easy to imagine that for more than half a century (mostly starting after WW II) German courts have struggled with applying general rules of the Civil Code to problems arising following the sale of a business. The German concept of express or implied warranties in a sale is e.g., based on the concept of a certain "standard quality" a good can be expected to have when sold. It is therefore, e.g. quite an interesting discussion whether or not the correctness of a balance sheet can be considered such a “quality” attaining to shares in a company which have been sold.

Although a certain amount of case law has evolved over the years, practitioners still felt left with a huge amount of uncertainty and ambiguity in advising their clients entirely on the basis of the codes and the limited amount of applicable case law. It has therefore become common practice over a long time to put considerable effort into the drafting sale and purchase agreements modifying or replacing the statutory rules by an individually agreed regime applicable to the typical problems and issues arising in M&A transactions.

Another highly influential trend started around the late 1980-ies when US private equity investors first started to do major investments in German businesses and expected to be able to rely on generally the same set of rules they would apply in US transactions. To accommodate their needs, German practitioners started to work on the basis of the general pattern of US type share purchase agreements (“**SPA**”), adapted to the specifics of German law. Today US and other international investors will typically feel easily familiar with purchase agreements they are confronted with in a German transaction since it will reflect for the most part the issues and typical items they would expect to be addressed in a US type agreement. Even if the agreement is subject to German law, it will most typically be drafted in the English language or bilingual.

However, there still are differences and German style SPAs still tend to be considerably shorter documents than US style agreements. For a considerable amount of matters, to be addressed, the German Codes do provide appropriate rules and therefore many times a reference to the relevant code section will suffice without reiterating the statutory language. Also, German law provides for a concept of supplementary interpretation of contracts and analogy, i.e. even lacking very specific wording, courts will apply rules set forth in an SPA to similar situations (e.g. a warranty that shares sold are sold without any "pledges" will be interpreted to also include other like encumbrances).

2. Formal Requirements

A “specialty” of German law, surprising to many foreign investors, is the requirement for certain share purchase agreements to be in a notarized form. This rules applies to the sale of shares in a German limited liability company (*GmbH*) and will therefore apply for the vast majority of transactions happening in the market. Sec. 15 paras 3 and 4 of the German Act on Limited Liability Companies provide:

> "(3) An agreement concluded in notarial form shall be required for the transfer of shares by shareholders.
> (4) An agreement establishing the shareholder’s obligation to transfer a share shall likewise require notarial form. However, an agreement concluded without such notarial form shall become valid once the transfer agreement is concluded pursuant to subsection (3)"

The rule is originally based on the notion, that a GmbH was designed to be the ideal form for family owned businesses and shares in such businesses should not be easily tradeable. The law therefore provides for a notary (being a highly qualified and seasoned lawyer) to be involved to advise the parties on the ramifications of such transaction. The question has frequently been raised whether this rule is still appropriate in our world today where the GmbH is typically used as the standard form of incorporation for most holding structures including those implemented by many private equity investors. However, there is no serious expectation among German scholars or practitioners that the rule will be subject to amendment or abolition anytime soon. It is mostly 2 reasons why foreign investors are sometimes surprised by the notarization requirement:

One is that a German notarization is different from what many other jurisdictions provide for in the sense that not only a signature is being certified. Rather the entire agreement (including all its annexes!) has to be read aloud to the parties. The original rationale was that only this procedural way would lead to the parties' comprehensive understanding of the transaction's terms and their consequences. In the practice of a modern type M&A agreement which (together with its annexes) many times adds up to several hundred pages it is easily understood that having very lengthy sessions of listening to text that has been drafted and negotiated over weeks and months or has no real significance to the parties in the course of the signing of a transaction (e.g. disclosure lists including annexes) is not a very desirable experience. There are certain ways to shorten the process, e.g. having the notary prepare a reference deed containing most of the annexes which has been read by the notary pre-signing and is only approved together with the agreement itself, however, the process still remains burdensome compared to signing procedures where notarization is not required.

The other aspect is that notarization fees can be very substantial (up to more than EUR 50,000 for each individual agreement in medium sized transactions). The notarization requirement can, however, not be waived and fees therefore have to be considered as part of the transaction cost.

3. Method of Share Transfer

The majority of transactions transferring shares in a German GmbH is done by a simple sale and assignment of the shares as part of the SPA. The assignment can be done either conditional upon the closing conditions having occurred and the purchase price (or any down payment, closing payment, etc. as agreed) having been received or the assignment can be effected by way of a separate assignment agreement at closing.

A physical handover of shares is not required or even possible in the case of a GmbH, since the GmbH does not issue physical share certificates. Only shares in a stock corporation (*Aktiengesellschaft*) sometimes need to be physically transferred. It therefore has to be reviewed in a Due Diligence whether or not the company has actually issued stock certificates. In such case, the stock certificates need to be handed over together with respective endorsement (*Indossament*).

4. Purchase Price

Purchase Price methodology in German SPAs for the most part follows international standards of either a calculation of purchase price on the basis of closing accounts or based on prior accounts (typically the most recent annual accounts). A true fixed price model (irrespective of the company's cash, debt or working capital position) is not typically used in any major transaction and among third parties.

Locked Box models have become very popular in recent years for transactions where the company sold has a history of reliable (audited) balance sheets and closing is expected to happen not too long from the balance sheet date, thus reducing the risk of major adverse effects having occurred. A rule of thumb might suggest that you see a greater number of locked box transactions in the first six months of a calendar year than in the second half of the year (with most German companies doing their annual accounts as of December 31st).

The precise mechanics of the Locked Box transaction are not always understood by all parties in the same manner. Mostly, the question whether or not the warranty on the balance sheet items considered as "equity bridge" used to calculate the purchase price should be subjected to a subjective standard (best knowledge as of the time of making the balance sheet) or an objective view and whether or not the liability for such representation would be subject to basket, cap and other limitation rules is sometimes under debate.

In closing account models, typically closing is effected by making a down payment in an agreed sum, typically estimating the final purchase price minus a discount thereon protecting the purchaser for higher debt positions or lower than expected working capital. The SPA will typically provide for the purchaser to draw up the closing accounts within a certain time period and the seller's right to review such accounts. In case of dispute, resolution is provided by binding arbitration by an independent accountant.

5. Equity Commitment Letters

Equity Commitment Letters are a frequently used instrument protecting sellers in transactions with private equity controlled buyers. Since the acquisition itself will typically be signed not by the private equity fund itself but rather by a special purchase vehicle, the seller will tend to look for at least some comfort in case the buyer refuses to close the transaction and recourse against the acquisition company is limited given its minimum capitalization (typically EUR 25,000).

It is therefore that sellers for a long time have requested the private equity fund itself to provide the seller with a certain comfort as to the acquiring company's equity position. However, a direct guarantee vis-à-vis the seller will typically not be feasible for a private equity investor without jeopardizing its tax neutral position in Germany. Drafting and negotiating equity commitment letters has therefore become quite a specialty of its own, the basic rule being that a commitment by a private equity investor can only be expected to be made vis-à-vis the acquiring company itself (enforceable by a trustee in bankruptcy), however, not directly vis-à-vis the seller.

6. Closing Conditions

In most transactions the simultaneous occurrence of signing and closing will not be possible due to necessary anti-trust clearances and other “homework” the parties agree to be done before closing. Most German SPAs will therefore provide for a number of conditions to closing.

The number and scope will typically vary a great degree based on the type of transaction. Whereas in secondary (private equity to private equity) transactions the only material item to occur is usually obtaining the required anti-trust clearances, a great number of other conditions may be required for corporate carve-out transactions. Frequently the “carve-out” itself is being effected following the signing of binding agreements only and oftentimes requires a corporate restructuring, the set-up of certain administrative functions at the target company, the transfer of agreements with customers and suppliers or similar items to be achieved before closing can finally occur. The CP catalogue and the time to be anticipated between signing and closing will therefore be significantly longer in such transactions.

MAC clauses protecting the buyer from significant negative changes in the target company’s business between signing and closing are largely the rule. With private equity investors being on the purchasing side in many transactions, this is not surprising since most debt financing arrangements do provide for non-negotiable MAC concepts and even “certain funds” arrangements are not entirely without loopholes. The negotiation over the precise scope and wording of a MAC clause can take a significant amount of time, mostly revolving around whether or not the scope will be wide (including changes in financial markets or the industry generally) or narrow. Most MAC-negotiations will try to narrow the scope to a "company-MAC" and to a minimum threshold of impact on EBITDA or other numbers or KPIs.

7. Reps and Warranties, Disclosure, Liability

Comprehensive Catalogue

Most SPAs will provide for a rather comprehensive set of reps and warranties in respect of the e.g., seller’s ownership to the shares, the company’ s financial situation, balance sheets, assets (including IP), employment situation, material agreements, customers, suppliers, compliance and litigation. The catalogue itself is typically supported by individual disclosures against certain warranties (“Expect as set forth in annex…..the company is not a party to any litigation”.).

The warranties will typically be given as independent warranties with a reference to sec. 311 para 1 of the German Civil Code. This language is important, as it helps to distinguish the contractual warranties from ordinary statutory warranties provided for by the Civil Code for the purchase of goods. An important practical aspect is, that for statutory warranties, liability cannot be limited or excluded (cf. sec. 444 of the German Civil Code) which will typically not be acceptable to the seller of a business.

Timing

Warranties are typically given as of signing and as of closing whereas certain exceptions will be agreed with respect to warranties referring to changing situations (e.g. litigation). The system of governance providing for information and approvals between signing and closing (see below no. 9) will in most cases provide for rules dealing with items occurring between signing and closing outside the ordinary course of business.

Thresholds and Caps

The seller will typically be liable for a breach of warranties having a financial effect exceeding certain thresholds and up to an agreed maximum cap only. The entire purchase price is typically agreed to be the overall cap for any liability on the seller's side following the transaction, with a lower cap being agreed for a breach of balance sheet or business representations and warranties. Caps are currently seen at between 5% and 30% of the enterprise value, lower caps often supported by insurance (see below).

Other Exclusions

Most agreements also provide for a number of other exclusions of liability, e.g., if the effect of a certain incorrectness has been taken into account in the calculation of the purchase price (e.g. a certain accrual or liability has been a deductible in the equity bridge) or the breach has been caused by later actions on the targets of the purchaser's side post-closing.

German statutory law does provide for the purchasers' liability to avoid and mitigate damages with is why many agreements will refer to the provision of the code. Sec. 254 para. 1 of the German Civil Code provides:

> "Where fault on the part of the injured person contributes to the occurrence of the damage, liability in damages as well as the extent of compensation to be paid depend on the circumstances, in particular to what extent the damage is caused mainly by one or the other party."

While specific language is sometimes found in SPAs for explanatory purposes, a short reference to the code will suffice legally.

The German Civil Code also contains an anti-sandbagging rule in sec. 442 para. 1 which provides:

> "The rights of the buyer due to a defect are excluded if he has knowledge of the defect at the time when the contract is entered into. If the buyer has no knowledge of a defect due to gross negligence, the buyer may assert rights in relation to this defect only if the seller fraudulently concealed the defect or gave a guarantee of the quality of the thing."

In most transactions today sellers will be able to include such rule in the SPA (or rather, purchasers will not be able to exclude it). Since the code provides for exclusion of liability in case of actual and construed knowledge (on the basis of gross negligence) on the purchaser's side, it is, however, frequently modified to only apply to actual knowledge with the content of the electronic data room being deemed actual knowledge if fairly disclosed (i.e. in a manner from which a reasonable, diligent and knowledgeable purchaser or its advisers would have ordinarily concluded a potential breach). Again, as ever, the individual bargaining power will decide on the inclusion or exclusion of such concept, with in today's market the sellers being frequently in a position to implement their requirements.

Limitation Periods

Limitation periods for the breach of business warranties will typically stretch anywhere between 18 months and 3 years and for title and other fundamental warranties between 3 and 10 years.

The seller will frequently also wish to include an expiry of his liability following a change of control, i.e. once (ultimate) control over the target is being transferred on by the buyer. Also, the buyer will wish to be indemnified by the purchaser from being held liable for matters being covered by contractual warranties based on other causes of action (e.g. for breach of fiduciary duties as an officer or director).

Reps and Warranties' Insurance

Insurance for representations' and warranties' liability has become a relatively widely used instrument being available at reasonable prices in the European (typically London) market. The instrument is being used frequently in secondary transactions where it helps the selling private equity investor avoid in to provide the purchasing side with escrow accounts or other collateral, having a negative effect on their return rates. Insurance is typically taken out by the buyer with the seller sometimes being prepared to share in the cost.

8. Tax Indemnity

Tax indemnities protecting the buyer from respective liabilities arising from the target's business activities prior to closing (or, in locked box transactions, prior to the locked box date) would be considered absolutely typical in a German transaction. They will also typically provide for certain exceptions, e.g. if respective tax accruals have been shown in the closing accounts and being considered debt or from taxes rising on the purchaser's actions post-closing. The seller will have the right, to be adequately involved in the target company's later tax filings and the tax authorities field audits which might lead to his liability.

9. Covenants

Covenants are the typical instrument used to cover the cooperation between the seller and the buyer in the time period between signing and closing. As a general rule, German SPAs will contain certain duties to keep the buyer informed on a regular basis about the target company's developments and any extraordinary events having occurred. Most importantly the seller will have the obligation to inform the buyer without delay of any MAC having occurred.

In terms of operations, the seller will usually agree to run the target company's business in accordance with past practice only and to undertake extraordinary matters only after the buyer's specific approval. Usually a respective list of such consent matters is agreed in the SPA providing for certain thresholds. The buyers' influence must, however, not become controlling and therefore in violation of merger control rules. The SPA-language is therefore usually designed in the form of consent matters rather than instruction rights.

10. Others

Depending on the individual transaction SPAs might naturally contain a variety of other clauses and stipulations relevant in the individual case.

An area frequently covered on request of the buyer is a non-compete for the seller. Such non-competes are legally admissible under European law where there is a justifiable interest on the sellers' side. This is typically assumed in the context of the acquisition of a business where it is considered reasonable to protect the acquired company from competition by the seller having been active in the company's management or who controls knowledge or relationships crucial for the target company's future business (e.g. with respect to the company's IP or customers). European law would however still only allow non-competes providing for a reasonable scope, both geographically and in respect of products and markets in which the target company is actually active. Generally, a term of up to 3 years should be considered not excessive and a respective restriction would therefore be held valid in most cases.

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