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German Aspects of Acquisition Financing

International financial investors are increasingly discovering the German market as a playing field for interesting investments and are achieving attractive returns on investment. After streamlining their portfolios, strategic investors have also rediscovered their interest in strengthening their core business via acquisitions.

Underlying Structure

In the majority of M&A transactions, a company either acquired off the shelf or newly incorporated in the form of a limited liability company (GmbH) functions as the purchaser of the target and as borrower under the acquisition financing. These acquisition vehicles are to a certain extent funded with equity by the shareholders, while the remaining purchase price of the target is financed with bank debt.

The funds required for the subsequent debt service are to be generated from the cash-flow that the operational business of the target company produces. Furthermore, extensive securities are generally granted to the lenders. In the context of acquisitions by strategic investors, payment guarantees issued by the parent company, which is the ultimate economic beneficiary behind the transaction, may be considered. Especially in the case of financial investors, the lenders also tend to concentrate on the target company and their operative subsidiaries as grantor of securities and issuer of guarantees.

Simultaneously with the actual acquisition financing, the existing bank financing of the target group is often paid and refinanced and a new working capital facility is granted. This generally takes place within the framework of a separate

credit agreement, the so-called "refinancing facility" or the "working capital facility" respectively. The lenders often request largely identical security packages for all loans. Moreover, the destinies of the loans are usually linked with one another through so-called cross-defaults. A breach of the borrower's obligations under one credit agreement simultaneously results in the acceleration of the other loans and may lead to demands for immediate repayment. The relationship among the group of lenders and the priority by which enforcement proceeds are applied to the debt is governed by the so-called intercreditor agreement.

Tendencies in Legal Practice Regarding Acquisition Financing

From a German perspective, there are two particularly interesting developments as far as the practicalities of acquisition financing are concerned. On the one hand, acquisition financing agreements have more frequently become tended subject to German law. In the past, English law had dominated. On the other hand, potential target companies are nowadays predominantly offered for sale in auction processes. This means that the potential purchaser is faced with many difficult strategic questions even at an early procedural stage. An efficient coordination of the transaction with the financing banks is of paramount importance.

Acquisition Financing under German Law

In the past, any investors who required a loan to finance the acquisition of a German company were almost inevitably faced with Anglo-American law. With syndication in mind, lenders across Europe would regularly insist that English law be applicable to the credit agreement. On the other hand, as far as granting security on the assets was concerned, the applicability of the principles of lex rei sitae was universally accepted.

More recently, a clear trend has been noted in legal practice for acquisition financing agreements to be governed by German law if the target company is head-

quartered in Germany. Irrespective of the choice of law, the credit agreements customary throughout Europe are normally based on the sample agreements issued by the London Loan Market Association (LMA). The LMA has only just recently responded to the trend to apply German law. In September 2007, it published a German law adaptation of its English sample documentation for credit agreements for the first time.

The expressed objective of the development of a German version of the LMA sample agreement was to create a standard form of contract that accommodates the specifics of German law (e.g. the prohibition of compound interest) without straying too far from the formal and substantive requirements reflected in the standard English sample documentation that was routinely used before. It can be expected that bank representatives will be prepared to accept the deviations from English practice which are contained in the German sample agreements when negotiating with German borrowers. However, it will be rather more arduous for borrowers to insist in negotiations on further reaching special conditions by making reference to German law. The general underlying tendency towards the use of German law is likely to be reinforced by the LMA's initiative.

From a psychological point of view, the choice of German law as substantive law and Germany as venue, as provided for in the LMA sample agreements, should make it easier for German managing directors to participate in acquisition financing in the future. Going forward, it seems fair to assume that, for instance, the limitations on permissible upstream guarantees agreed upon in credit documentation will be duly taken into account in the case of litigation or enforcement measures. Such cases would be heard by German courts that apply German law. If English law were chosen in combination with a foreign venue, there would be cause for considerable doubt in this respect. English will, however, continue to be the main drafting language as far as the credit documentation is concerned. For this reason it makes sense to inform the management of the target company at the earliest possible opportunity about the proposed involvement of the target company and to give the relevant people a chance to review the credit documentation, unless management of the target has already been involved in negotiating the refinancing facility.

The adaptation of the LMA sample agreements to German law requirements has also meant that a number of documents, which were routinely requested as a condition precedent to disbursing the loan, have been tailored to local customs and requirements. Various superfluous certificates, which do not fulfill any real purpose under German law, are no longer required.

With the increasing use of the German law LMA sample agreement, the following issues will gain future relevance: to what extent will the sample agreement in its entirety or at least individual clauses contained therein have to be qualified as general terms and conditions? To what extent will it actually be possible to discuss them on an individual basis in contract negotiations? The future developments regarding the applicability of the general German law clause, pursuant to which the contents of general terms and conditions can be controlled in the context of trade between businesses, will have to be watched with interest.

The Influence of Auction Processes on Acquisition Financing

The option of selling companies to the highest bidder in an auction process increasingly offers an opportunity to prospective sellers to analyze the market and maximize their profits. Auctions prepared, staged and coordinated by investment banks have almost become today's norm.

Such auction processes, however, also mean that the bidder has to make considerable financial commitments that also affect the subsequent acquisition financing. The lender's commitment letter already has to accompany the bidder's "binding offer" for the target company in the auction process. This means that all the relevant decisions regarding the loans themselves and the security structure, as well as the credit agreement's other key terms, already have to be negotiated and determined in a so-called term sheet behind the scenes of the transaction, even though it is still open at the time whether or not the potential purchaser makes it through to the final round of bidding, when detailed negotiations on the purchase of the target start in earnest.

Even if the bidder can avoid the payment of a commitment fee at this stage, significant costs usually accrue for setting up the legal and tax structure of the deal and for determining the key parameters of the later credit agreements.

The scope of feasible securities, the evaluation by the banks of such securities and the proposed acquisition structure all have repercussions on these financing costs and the amount of the required financial commitment. This, in turn, indirectly influences the purchase price that the bidder is prepared to offer. In light of the subprime loan issues in the American property market, it can be expected that the banks will in future analyze potential weaknesses of the security structure even more carefully and that these weaknesses will be reflected accordingly in the prices and conditions they offer.

The Parameters for Granting Security under Corporate Law

In general, the lender expects the target company and its subsidiaries to also grant security for the liabilities of the acquisition vehicle resulting from the acquisition financing.

Without prejudice to any tax implications, which are not discussed here, from a German perspective, the loan and security structure, including the level of involvement for the target company, largely depends on the limitations provided for by the rules on maintenance of capital, financial assistance in the context of acquiring own stock and the shareholder liability for endangering a company's continued existence. These rules are often considered to be relatively strict and non-transparent by Anglo-American investors when compared to international standards.

■ Financial Assistance

German corporate law forbids a German stock corporation (AG) to support the acquisition of stock in the AG with assets of the respective AG. The consequence of any legal transaction that is qualified as prohibited support is that the respective measures are, as a rule, null and void. An assumption of debt, a payment guarantee or upstream security by the target AG or its subsidiaries for liabilities arising from the acquisition financing through the pledging of shares in subsidiaries or through liens on real estate would all be examples of such undue support. If an AG is the target of the acquisition, this is one of the reasons for separating the acquisition financing facility from the refinancing

facility in respect of already existing liabilities of the AG or from new working capital loans. The refinancing of a company's own debt and working capital loans as such are not within the scope of the prohibition of financial assistance. For target companies organized in a legal format other than that of a stock corporation this prohibition of financial assistance is not applicable. In such cases the granting of further reaching security might be possible.

Maintenance of Capital

The rules on maintenance of capital are also more far reaching for an AG when compared to a limited liability company (GmbH) or a limited partnership with a GmbH as a general partner (GmbH & Co. KG). An AG is barred from distributing any of its assets to shareholders outside of the regular distribution of profits or if no domination and profit and loss pooling agreements exist. This strict preservation of assets also applies to upstream securities that the acquired AG has granted to third parties for the benefit of its new shareholders (i.e. the acquisition vehicle), although the exact limitations of permissible upstream loans and collateral are not entirely undisputed.

The rules on maintenance of capital in a GmbH prohibit the company from distributing to shareholders any assets which are required to maintain the nominal share capital of the company. The granting of upstream guarantees or other upstream security for liabilities of the shareholders can, depending on the circumstances, be qualified as an undue distribution of assets. Notably, the German Supreme Court's (BGH) case law has strengthened the maintenance of capital requirements for a GmbH in the past few years. At the same time, the Supreme Court did not manage to define the exact scope of the capital maintenance rules with sufficient legal certainty.

This development has had repercussions on the scope of permissible security. In particular, the lenders were prepared to accept further reaching restrictions (via so-called limitation language) regarding payment guarantees in the credit agreement and in the local law security agreements. These clauses are meant to limit the subsequent enforcement of securities to assets that are not covered by the strict maintenance of capital rules regarding protected assets. It is undeniable that such enforcement limitations somewhat decrease the value of the security

from a bank's point of view. The LMA German law sample agreement does not contain any suggested language for these limitations, but instead simply uses a blank place holder. Moreover, until now such limitation language has only provided for limitations regarding the enforcement of guarantees or other security. There are other accepted mechanisms in the credit agreements, which could also affect the preservation of the registered share capital, that are largely overlooked. This applies in particular to the application of pre- or repayments made during the term of the loan. Typically, any loan pre- or repayments are applied first and foremost to the acquisition financing facility and only in second priority to the other loan facilities once the acquisition facility has been repaid in full. This mechanism might also result in the repayment of nominal share capital to the shareholders. The limitation language which is currently in common use would not cover such a scenario due to the fact that pre- or repayments are not enforcement measures.

Legislation has reacted to the recent case law of the BGH and the lively discussion which was caused by the judgments. Within the framework of the GmbH reform, a new regime regarding upstream loans and securities was drawn up. The current Government draft legislation suggests that the interpretation of the maintenance of capital rules as developed by the BGH since 2003 should be discarded. In particular, the draft law advocates a return to the accounting perspective that states that even in times of under-balance, a fully valuable loan repayment or security release claim is sufficient compensation for the loss of liquid funds. The BGH had earlier abandoned this accounting perspective. If the Government draft in its current version were to become law, this would result in a welcome increase of legal certainty. It still remains to be seen whether or not the proposed changes will actually mean that the scope for permissible security granted as collateral for acquisition financing will increase.

Another option to help deal with the capital preservation rules is to involve other group companies as borrowers in the credit agreement. However, this is only possible in the context of working capital loans and, under certain conditions, when refinancing existing debt of the target companies. In this case it may be possible to qualify the granting of security at least partly as the collateralization of the company's own debt as long as the subsidiaries in question effectively

receive borrowed funds for their own purposes. To the extent that a subsequent enforcement serves to settle the security grantor's own debt, the issue of unduly distributing share capital to shareholders does not even arise.

Shareholder Liability for Endangering a Company's Existence

Another factor to be considered by the management of the target company and the purchaser is the prohibition of a so-called "existenzvernichtender Eingriff", i.e. the prohibition to ruin a company's continued existence. Directly detrimental intrusions without business rationale and compensation for the subsidiary, for instance a constant draining of liquidity or the granting of security in respect of key assets vital for business operations that normally serve to cover trade creditors' claims, may result in shareholder liability for damages if the subsequent insolvency of the subsidiary was foreseeable when such measures were taken. Thus, realistic and thoroughly researched liquidity forecasts of funds presumably needed for the company's own purpose have to be drawn up in all cases before payment guarantees and other securities for loans are granted to a shareholder. Presently, the customary limitation language used in credit agreements only contains rudimentary and rather generic restrictions that oblige the lender to take into account the interests of the respective subsidiaries and their creditors. Whether these rules would successfully prevent assets of the subsidiary being applied to liabilities of the acquisition vehicle in cases of litigation has not been tested as yet.

Restructuring

The objective of granting maximum security on the assets of the target companies often necessitates a restructuring of the group. The possible measures include, for example, the conclusion of domination and profit and loss pooling agreements, a conversion of the target company into a different legal form or the merger of the target company and the acquisition vehicle with the purpose of consolidating the acquisition vehicle's liabilities arising from the acquisition and the assets of the target in one company. An inter-company sale or contibution of participations in subsidiaries of the target into the acquisition vehicle may also be an option. Until these measures can be implemented, a bridge loan is often entered into. The term of such bridge loan can range from several weeks to several months, depending on the time line contemplated for the implementation

of the proposed restructuring. During this period, the purchaser will also assess whether the target company may lift hidden reserves and distribute profits or dissolve and disburse capital reserves either immediately or following the restructuring. Such funds may already be used to partially repay the acquisition financing facility.

Conclusion

The increasing attractiveness of German companies for international investors means that German law tends to play an increased role in acquisition financing. In this context it should be noted that the transfer of international sample agreements into national law does not only offer opportunities but also creates new challenges.

Despite the adaptation of the LMA sample agreements to certain specific requirements of German law, the sample agreements in essence still tend to mirror legal practice governed by English law. One might regret that the dictate of the actual facts have prevailed in an area of the law where both the harmonization of international law and independent domestic standards are missing. However, it seems almost inevitable in the context of syndication that the international acceptance of credit agreements concluded under German law could probably not have been achieved in any other way.

The one remaining area where there seems to be additional scope for purely domestic legal principles in acquisition financing agreements would be the border area where the lender's justified demands for collateral come up against mandatory limitations under German corporate law. It is to be hoped that the impending reform of the German GmbH law will bring welcome clarifications in terms of the scope of the applicable provisions on maintenance of capital, thus contributing to a higher level of legal certainty in the practical application of the law.

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