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Expert Analysis Chapter

1 2023 and Beyond: Private Equity Outlook for 2024
Siew Kam Boon, Sarah Kupferman & Sam Whittaker, Dechert LLP

Q&A Chapters

4 Australia
MinterEllison: Kimberley Low, Michael Wallin & Nick Kipriotis

14 Austria
Schindler Attorneys: Florian Philipp Cvak & Clemens Philipp Schindler

25 Brazil
Mello Torres Advogados: Carlos José Rolim de Mello, Roberto Panucci & Rafael Biondi Sanchez

33 Canada
McMillan LLP: Michael P. Whitcombe, Brett Stewart, Enda Wong & Bruce Chapple

42 Cayman Islands
Maples Group: Julian Ashworth, Patrick Rosenfeld, Lee Davis & Stef Dimitriou

50 China
Han Kun Law Offices LLP: Charles Wu & Hanpeng (Patrick) Hu

57 France
Vivien & Associés AARPI: Lisa Becker, Julie Tchaglass, Marine Pelletier-Capes & Julien Koch

65 Germany
Weil, Gotshal & Manges LLP: Andreas Fogel & Benjamin Rapp

73 Hungary
Moore Legal Kovács: Dr. Márton Kovács, Dr. Áron Kanti & Dr. Zsigmond Tóth

83 India
Shardul Amarchand Mangaldas & Co.: Iqbal Khan & Devika Menon

91 Italy
Legance: Marco Gubitosi & Lorenzo De Rosa

105 Japan
Tokyo International Law Office: Dai Iwasaki, Yusuke Takeuchi & Tomo Greer

113 Korea
Barun Law LLC: Min Hoon Yi & Si Yoon Lee

121 Luxembourg
Eversheds Sutherland (Luxembourg) S.C.S.: Holger Holle, José Pascual & Rafael Moll de Alba

130 Mexico
González Calvillo, S.C.: Jorge Cervantes Trejo, Bernardo Reyes Retana Krieger, Daniel Guaida Azar & Jerónimo Ramos Arozarena

138 Nigeria
Banwo & Ighodalo: Ayodele Adeyemi-Faboya, Mavis Abada & Ibiyemi Ajiboye

149 Norway
Aabø-Evensen & Co: Ole Kristian Aabø-Evensen

173 Singapore
Allen & Gledhill LLP: Christian Chin & Lee Kee Yeng

182 Spain
Garrigues: Ferran Escayola & María Fernández-Picazo

192 Switzerland
Bär & Karrer Ltd.: Dr. Christoph Neeracher & Dr. Luca Jagmetti

201 United Kingdom
Dechert LLP: Mark Evans & Sam Whittaker

213 USA
Dechert LLP: Allie Misner Wasserman, Dr. Markus P. Bolsinger, Soo-ah Nah & Marie Mast

Germany

Andreas Fogel

Benjamin Rapp

Weil, Gotshal & Manges LLP

1 Overview

1.1 What are the most common types of private equity transactions in your jurisdiction? What is the current state of the market for these transactions?

The majority of private equity transactions were private sales. However, P2P activity has increased, although only a limited number of takeover offers were ultimately launched. In addition, there have been a number of marketed minority investments. Growth transactions, i.e., acquisitions of shares in later stage financing rounds have slowed down compared to previous years.

Since the second half of 2022, all types of private equity and M&A transactions have slowed down in Germany, particularly large-cap private equity transactions in light of the higher debt financing costs. The number of equity-financed transactions also decreased, but not to the same extent, mainly due to lower valuation levels. Investments in distressed situations and transactions in which shares are used as transaction currency increased. Further, strategists continue to market carved-out business units that provide for private equity investors a primary situation.

1.2 What are the most significant factors currently encouraging or inhibiting private equity transactions in your jurisdiction?

Market activity and valuations have been negatively affected, both in Germany and globally, by not only macro-economic uncertainties and unfavourable financing conditions resulting from higher interest rates, but also the increasing global tension due to the war in Ukraine.

1.3 Are you seeing any types of investors other than traditional private equity firms executing private equity-style transactions in your jurisdiction? If so, please explain which investors, and briefly identify any significant points of difference between the deal terms offered, or approach taken, by this type of investor and that of traditional private equity firms.

We see an increasing number of co-investments of LPs in private equity-led transactions as well as family offices and industrial holdings that execute private equity style transactions. Key differences are a long-term investment approach as they often follow a co-entrepreneurial approach to develop the company together with founders/current owners and have no obligation to sell, more flexibility regarding majority or minority investments, and no or low level of debt financing. Usually, investments are sought in a few core areas in which the family office or industrial holding has significant industry expertise.

2 Structuring Matters

2.1 What are the most common acquisition structures adopted for private equity transactions in your jurisdiction?

The acquisition of privately held companies is typically carried out by means of a share deal. If the target is a German limited liability company (GmbH), the underlying transaction documentation requires notarisation. For listed companies, the acquisition will be carried out on the basis of an offer document published by the bidder. If the shares are listed on an organised market such as the regulated market of the Frankfurt Stock Exchange, the offer document needs to be approved by the German Federal Financial Supervisory Authority (BaFin).

2.2 What are the main drivers for these acquisition structures?

Each individual acquisition structure is developed on a case-by-case basis. Key drivers are not only accounting and tax implications, but also legal and regulatory aspects as well as certain requirements from debt providers. Private equity sponsors further want to ring-fence each investment and, typically, already take the future exit and potential cash repatriation mechanisms into account at the time of the acquisition of the target.

2.3 How is the equity commonly structured in private equity transactions in your jurisdiction (including institutional, management and carried interests)?

Private equity funds typically establish an acquisition structure comprising several special-purpose vehicles (SPVs) incorporated in Germany and/or countries with a favourable regulatory and tax environment. These tailor-made acquisition structures are typically driven by accounting, tax, legal and regulatory aspects as well as the requirements of debt financing. They allow private equity sponsors to ring-fence their investments and facilitate future exit options and cash repatriation. While implementing different share classes at SPVs domiciled in typical holding jurisdictions such as Luxembourg and the Netherlands is common, equity of German holding companies usually comprises only ordinary shares, unless the economics of a management equity programme (MEP) require special shares such as preference, hurdle, or growth shares. Carry interest vehicles are usually established outside of Germany.

2.4 If a private equity investor is taking a minority position, are there different structuring considerations?

The structuring of the investment vehicles typically remains the same. In these situations, it is common that the private equity investor requires certainty on governance rights (e.g., representation on the relevant boards, veto rights, etc.), the timing of a potential exit, valuation protection throughout the investment, and other minority protection rights, such as tag-along rights.

2.5 In relation to management equity, what is the typical range of equity allocated to the management, and what are the typical vesting and compulsory acquisition provisions?

The typical management equity pool can amount to up to 10% of the target's equity. Managers need to acquire their equity participation at fair market value to avoid upfront tax on fringe benefits. The management pool is usually subject to vesting rules. Common are time vesting schemes as well as, depending on the transaction, performance-based vesting rules. Private equity sponsors usually have the right to buy back the equity interests held by the management members once their employment or service agreements with the target group have ended or are terminated. Terms for such buy-backs, particularly the purchase price, usually take into account the circumstances triggering the exit of the respective manager (i.e., if the leaving manager is a good or bad leaver) and to which extent the manager's equity has actually vested.

2.6 For what reasons is a management equity holder usually treated as a good leaver or a bad leaver in your jurisdiction?

It is quite common to distinguish between a manager's exit triggered by the participant, which generally results in a qualification as a bad leaver, and the good leaver scenarios where the sponsor or target wishes to terminate the employment or the participant otherwise ceases to work for the target. In the case of a termination for cause, the manager is typically qualified as a bad leaver.

3 Governance Matters

3.1 What are the typical governance arrangements for private equity portfolio companies? Are such arrangements required to be made publicly available in your jurisdiction?

Although the holding structure of a portfolio company may include various holding levels, at least the purchasing entity in German private equity transactions is usually a German limited liability company (*Gesellschaft mit beschränkter Haftung*, "GmbH").

A company in the legal form of a GmbH has one or more managing directors that are representing the company together. It is very common that the articles of association provide for a representation of the company by two managing directors, by a managing director together with an authorised officer (*Prokurist*), or by each managing director individually. The articles of associations are required to be registered with the commercial register (*Handelsregister*) and are publicly available.

The duties and responsibilities of the managing directors are usually further carried out in rules of procedure (*Geschäftsordnung*), which regularly provide for a catalogue of restricted matters that require the prior approval of the shareholder(s) or an (in most cases voluntarily established) advisory board. The rules of procedure are not publicly available. The legal implementation, however, very much depends on the legal form of the target company, in particular, whether it is a limited liability company or a stock corporation.

If any co-investors exist, the investors will most likely further conclude a shareholder agreement detailing the relationship between the investors and, in particular, outlining minority protection rights, exit scenarios, and conflict resolution mechanisms. The shareholders' agreement may require notarisation by a notary public, but is not publicly available.

3.2 Do private equity investors and/or their director nominees typically enjoy veto rights over major corporate actions (such as acquisitions and disposals, business plans, related party transactions, etc.)? If a private equity investor takes a minority position, what veto rights would they typically enjoy?

Yes, the implementation of restricted matters requiring the prior consent of representatives of the private equity investor is typical for private equity transactions. The catalogue of restricted matters in minority investments is usually shorter but also covers all measures that have a significant influence on the investment. Minority investors typically only have negative control rights such as veto rights on the restricted matters.

3.3 Are there any limitations on the effectiveness of veto arrangements: (i) at the shareholder level; and (ii) at the director nominee level? If so, how are these typically addressed?

In case of veto arrangements contained in rules of procedure, the managing directors are, in general, legally not restricted in their power of representation to commit to such transactions towards third parties. Although the respective managing directors would be liable for such actions, the underlying transaction would be effective. If the target has the legal form of a stock corporation, consent requirements on major corporate actions can generally only be established at the supervisory board level, not at the shareholders level, and veto rights cannot be assigned to an individual supervisory board member.

Veto arrangements on shareholder level are simply contractual arrangements but may be unenforceable to the extent unlawfully limiting the statutory rights of a shareholder.

General restrictions to veto arrangements apply on the basis of the shareholder's and managing director's duty of loyalty towards the company.

3.4 Are there any duties owed by a private equity investor to minority shareholders such as management shareholders (or vice versa)? If so, how are these typically addressed?

The shareholders of a GmbH have a duty of loyalty towards each other restricting them from harming each other. Other than that, the duties are being negotiated and contractually agreed, especially in the shareholders' agreement or in the management participation documentation.

3.5 Are there any limitations or restrictions on the contents or enforceability of shareholder agreements (including (i) governing law and jurisdiction, and (ii) non-compete and non-solicit provisions)?

Shareholder agreements relating to a German target would typically be subject to German law as well. In the case of the parties

agreeing to be governed by the laws of another jurisdiction, the provisions relating to the (transfer of) shares are at least required to be subject to German law.

Non-compete and non-solicitation provisions are, in order to be enforceable, required to comply with certain limitations in terms of scope, location and duration.

3.6 Are there any legal restrictions or other requirements that a private equity investor should be aware of in appointing its nominees to boards of portfolio companies? What are the key potential risks and liabilities for (i) directors nominated by private equity investors to portfolio company boards, and (ii) private equity investors that nominate directors to boards of portfolio companies?

The risks and liabilities of a managing director nominated by the private equity investor are exactly the same as for any other managing director. Each managing director is fully responsible for the (day-to-day) management of the company and needs to act in the best interest of the company and in compliance with the law, the articles of association, the rules of procedure, and the resolutions of the shareholder(s), which may issue binding instructions to the managing directors.

Managing directors nominated by an investor are often not directly involved in the day-to-day management and try to limit their exposure with respect to personal liability by an allocation of duties (*Geschäftsverteilungsplan*). Although such allocation prevents them from being primarily responsible for the task and responsibilities allocated to other managing directors, their general supervisory duty remains. Further, there are certain key responsibilities that may not be allocated and remain as joint responsibility of the managing directors (e.g., the preparation of the annual accounts). Given this liability risk, it might be advisable to take a more passive role (e.g., as a member of an advisory board).

In any case, it should be ensured that appropriate D&O insurance coverage exists.

3.7 How do directors nominated by private equity investors deal with actual and potential conflicts of interest arising from (i) their relationship with the party nominating them, and (ii) positions as directors of other portfolio companies?

In order to prevent the nominees from potential conflicts of interest, most private equity investors appoint their respective team members only to non-executive boards, such as the supervisory board or an advisory board. Supervisory and advisory board members are not involved in the day-to-day management and, thus, face fewer conflicts of interest.

As a result of the duty of care of a managing director towards the company, the managing directors must (always) act in the best interest of the company. Any potential conflicts of interest need to be disclosed to the shareholder(s) for evaluation.

In general, German law provides for self-dealing restrictions prohibiting representatives from legally binding a third party (such as the managing directors representing the company) on the one hand and concluding agreements with oneself or another third party on the other hand. The managing directors can, however, be released from such restrictions by the shareholder(s).

4 Transaction Terms: General

4.1 What are the major issues impacting the timetable for transactions in your jurisdiction, including antitrust, foreign direct investment and other regulatory approval requirements, disclosure obligations and financing issues?

The key impacts on the timetable for private equity transactions in Germany are:

- The due diligence process by a potential buyer and the resources of the seller/company to provide the appropriate information.
- Any discussions and negotiations on the provision of debt financing by third parties.
- Tax/structuring considerations and the acquisition and/or incorporation of the entities of the intended acquisition structure. It is common to acquire shelf companies in Germany from service providers.
- The negotiations of the transaction documentation (in particular, share purchase agreements and shareholder agreements).

Any required regulatory approvals. This commonly entails antitrust clearances and foreign direct investment approval. From July 2023, another approval requirement under the EU foreign subsidies regulation (*Drittstaatensubventionsverordnung*) will also become relevant, which applies in cases where the target has received any "financial contribution" from a non-EU member within the last three years.

4.2 Have there been any discernible trends in transaction terms over recent years?

The recent shift of the overall market situation to a more buyer-friendly environment has outdated the trends we have discerned in the past years.

5 Transaction Terms: Public Acquisitions

5.1 What particular features and/or challenges apply to private equity investors involved in public-to-private transactions (and their financing) and how are these commonly dealt with?

German capital market laws provide for strict rules to prevent the secret acquisition of stakes in public companies. For target companies listed on a regulated market, acquirers must disclose their shareholding after reaching thresholds of 3%, 5%, 10%, 15%, 20%, 25%, 30%, 50% or 75%. In addition, an investor is obliged to inform the target company about investment objectives and fund origin by reaching 10% of the voting rights. Outside regulated markets, only a threshold of 25% and 50% triggers corresponding notification obligations.

Once an investor has acquired a stake of 30%, the obligation for a mandatory takeover offer is triggered. Exceptions to such obligation can be granted on a rare case-by-case basis by the German Federal Financial Supervisory Authority (BaFin). Practically, private equity investors seek to avoid mandatory takeover offers and launch voluntary takeover offers instead before the 30% threshold is hit, thereby being more flexible to ensure that their particular structuring considerations reflect, for example, minimum acceptance rates or material adverse change clauses. Any takeover offer requires proof of availability of sufficient funds to execute the offer in order to obtain the required BaFin approval.

5.2 What deal protections are available to private equity investors in your jurisdiction in relation to public acquisitions?

The private equity investor and the target can enter into a business combination agreement to support the takeover offer. Such agreements typically prohibit the target from soliciting competing offers ("no-shop" clause) or frustrating any offer conditions against the assurance of future management composition and employee retention.

In order to further enhance transaction security, it is common to seek agreements with major shareholders to irrevocably commit to tender their respective shares irrespective of competing offers, or not to tender their respective shares and sell them outside the takeover offer. These negotiations take place shortly before going public and are highly confidential in order to avoid any leakage.

6 Transaction Terms: Private Acquisitions

6.1 What consideration structures are typically preferred by private equity investors (i) on the sell-side, and (ii) on the buy-side, in your jurisdiction?

The various geopolitical uncertainties and the increased economic risks for companies have resulted in a comeback of closing account consideration mechanisms. In contrast to the locked-box mechanisms that have been standard for many years now in German transaction markets, closing accounts have the disadvantage that they lack purchase price certainty. Although this uncertainty results in increased complexity of the funding process of buyer's acquisition structure, they tend to prefer this administrative burden more and more as they are no longer willing to accept the risks associated with fixed purchase prices.

Sellers, however, perceive to achieve their desired considerations either in earn-out mechanisms that are strongly linked to the target company's economic performance in the years following the disposal or in an increasing number of a share consideration component.

6.2 What is the typical package of warranties / indemnities offered by (i) a private equity seller, and (ii) the management team to a buyer?

Naturally, any private equity seller that is seeking for a clean exit is trying to reduce the set of warranties and indemnities (W&I) as much as possible given the inherent liability risks. The minimum standard scope of warranties includes title to the shares, capacity of the seller and the unencumbered nature of the shares (fundamental warranties). The warranties relating to the business (business warranties) are subject to intensive negotiations.

Indemnifications in favour of the buyer are often provided with respect to tax matters or specific items that have been identified as risks during the due diligence process (e.g., environmental, compliance, or litigation risks).

The management team usually offers the same catalogue of warranties. In light of the future relationship, it is common to cap their overall liability to EUR 1 subject to W&I insurance coverage.

6.3 What is the typical scope of other covenants, undertakings and indemnities provided by a private equity seller and its management team to a buyer?

The typical scope includes interim covenants for the time period between signing and closing as well as no leakage covenants for locked-box consideration mechanisms. Other covenants are negotiated on a case-by-case basis, in particular, in light of due diligence findings or regulatory requirements. The management team would typically provide non-compete covenants.

6.4 To what extent is representation & warranty insurance used in your jurisdiction? If so, what are the typical (i) excesses / policy limits, and (ii) carve-outs / exclusions from such insurance policies, and what is the typical cost of such insurance?

W&I insurance is very commonly used. The strong competition between insurers has led to the availability of favourable terms at a moderate price level (0.8% to 1.5% ratio of the premium to the recoverable loss (ROL)).

The retention amounts typically vary in a range between 0.25% and 0.5% of the enterprise value. Policy limits vary between 10% and 30%. The policies exclude known risks identified in the due diligence or exclusions made in the scope of the due diligence.

6.5 What limitations will typically apply to the liability of a private equity seller and management team under warranties, covenants, indemnities and undertakings?

The share purchase agreement typically provides for various limitation periods with respect to different types of claims. Liability is further limited by *de minimis* amounts and thresholds/baskets. Typical limitation periods for fundamental warranties are two to five years, and the liability for fundamental warranty breaches is in the aggregate limited to the purchase price. Claims for breach of business warranties are typically limited to one or two years and capped at a certain percentage of the purchase price (or EUR 1 in the case of a "clean exit" with W&I insurance coverage). The common time limitation period for tax warranty claims is seven years.

6.6 Do (i) private equity sellers provide security (e.g., escrow accounts) for any warranties / liabilities, and (ii) private equity buyers insist on any security for warranties / liabilities (including any obtained from the management team)?

Given the fact that the use of W&I insurance has become common practice with private equity sponsors being on the sell-side as well as buy-side, the prevalence of escrow accounts or other security in such cases has decreased. Private equity buyers would typically only require an escrow component to mitigate a specific uninsurable risk that has been discovered in the course of the due diligence process.

6.7 How do private equity buyers typically provide comfort as to the availability of (i) debt finance, and (ii) equity finance? What rights of enforcement do sellers typically obtain in the absence of compliance by the buyer (e.g., equity underwrite of debt funding, right to specific performance of obligations under an equity commitment letter, damages, etc.)?

It is customary for private equity transactions in Germany that the sell-side will be provided with equity commitment letters and debt commitment letters to demonstrate the availability of "certain funds" required for the payment of the purchase price as well as any damage claims/break fees that may potentially be paid in the case of a broken deal after signing of the transaction.

6.8 Are reverse break fees prevalent in private equity transactions to limit private equity buyers' exposure? If so, what terms are typical?

They are not and have been rare, particularly before the COVID-19 pandemic. However, we have seen a growing number of reverse break fee provisions lately. The terms are typically a result of the negotiations on a case-by-case basis and heavily depend on the facts and circumstances of each transaction.

7 Transaction Terms: IPOs

7.1 What particular features and/or challenges should a private equity seller be aware of in considering an IPO exit?

It is customary in Germany that "lock-in" and "orderly market" periods prevent a swift and complete exit of a private equity seller. The high degree of regulation within the European regulatory framework further demands a significant preparation for several months. In addition, tax considerations pose a common challenge since private equity investments typically rely on Luxembourg or Dutch holding structures that prove unfavourable if sellers pursue the admission of a German entity. Before an IPO, tax-neutral reorganisation measures may therefore be required such as a tax-neutral merger of the previous foreign holding company with the German. In the event of a dual-track process, if the private equity seller shares more in-depth information with a bidder than provided in the prospectus published at a later stage, such bidder must be excluded from participating in the IPO.

7.2 What customary lock-ups would be imposed on private equity sellers on an IPO exit?

On average, the underwriting banks demand a "lock-in" period of 180 calendar days following the listing. Carve-outs to such agreements are customary and provide private equity sellers with sufficient flexibility during the "lock-in" period. Transfers of shares to affiliates and pledges in connection with financing transactions, for example, are typically allowed.

7.3 Do private equity sellers generally pursue a dual-track exit process? If so, (i) how late in the process are private equity sellers continuing to run the dual-track, and (ii) were more dual-track deals ultimately realised through a sale or IPO?

If private equity sellers pursue an IPO at all in the current market environment, a dual-track exit process is typical, particularly for large-cap transactions. The "point of no return" is not determined by law but rather individual circumstances. Generally, an IPO is abandoned more reluctantly after presenting information to a larger audience (e.g., after a roadshow). Yet, synergies for sellers substantially decrease once the due diligence process has been completed. Sellers indeed rarely disclose dual-track processes to avoid jeopardising the IPO by either demonstrating weak demand or a low likelihood of completion. Still, a trade sale remains the most common exit, without the latest drop in IPO activity.

8 Financing

8.1 Please outline the most common sources of debt finance used to fund private equity transactions in your jurisdiction and provide an overview of the current state of the finance market in your jurisdiction for such debt (including the syndicated loan market, private credit market and the high-yield bond market).

The most common source of third-party debt used to fund private equity transactions remains the debt financing by way of a non-amortising term loan. The term loan financing is typically combined with a revolving credit financing. The revolving credit financing is available for general corporate and working capital purposes of the target group and is often treated, by the terms of an intercreditor agreement, as being super senior. In addition, where necessary for the ongoing business of the target group, capex and acquisition facilities are made available on a *pari passu* basis.

The term loan and capex/acquisition facilities are currently mainly provided by credit funds. Banks have significantly reduced their activities in relation to the term loan financing of private equity transactions. However, banks remain the main source for the revolving credit financing.

The term loan financing is often structured as a unitranche club deal where a wider loan syndication is not intended. Secondary loan syndications remain at a low level compared to previous years.

Compared to 2022, secured bond financings have increased and are mainly used to refinance maturing acquisition term loans.

8.2 Are there any relevant legal requirements or restrictions impacting the nature or structure of the debt financing (or any particular type of debt financing) of private equity transactions?

Compared to previous years, where transactions had been structured by using Luxembourg vehicles, private equity investors now prefer to use local vehicles for their acquisitions (in Germany, usually GmbHs). Creditors, on the other hand, remain focused on having a single point of enforcement. A single point of enforcement allows them to sell or to take control over the entire target group by the enforcement of one single security (typically a share pledge) at the level of one single security grantor. Since the enforcement of a German share pledge requires that the secured obligation have become due and payable, it is preferable for the creditors to obtain a single point of enforcement that is under the German borrower. In case the German borrower itself would be the single point of enforcement, a standstill would have to be granted or other measures would have to be taken in order to prevent the insolvency of the German borrower. Such an insolvency would significantly reduce to potential enforcement proceeds in relation to the pledged shares of the German borrower.

When acceding to the acquisition financing as additional guarantors and security grantors, the management of the target group companies will have to observe German law capital maintenance (*Kapitalerhaltung*) and liquidity maintenance (*Liquiditätserhaltung*) rules, which also apply to the granting of upstream guarantees and upstream security for the benefit of creditors of a shareholder. A violation of these rules can trigger a personal liability of management. In order to mitigate/exclude the described liability issue, it is market practice in German finance transactions to provide for contractual enforcement limitations in relation to the upstream guarantees and upstream collateral. Pursuant to such limitations, the enforcement is excluded to the extent that it would constitute a violation of the relevant rules.

8.3 What recent trends have there been in the debt-financing market in your jurisdiction?

Due to macro-economic headwinds, the origination of new acquisition financings has slowed down significantly in the first quarter of 2023. Private equity investors have been focused on the amendments and extensions of their existing acquisition financings. In that context, we have seen an increased willingness by private equity investors to provide fresh money in order to prevent or cure financial covenant breaches.

Since the beginning of the second quarter of 2023, we have seen a significant increase in relation to the origination of new acquisition financings.

Apart from pricing, which is higher than in previous years, private equity investors continue to benefit from favourable loan terms, which provide them with a high level of flexibility.

9 Alternative Liquidity Solutions

9.1 How prevalent is the use of continuation fund vehicles or GP-led secondary transactions as a deal type in your jurisdiction?

The relevance of secondary transactions in Germany is increasing in line with the global trend. Continuation funds have become a way for GPs and their investors to hold on to companies longer rather than selling them in depressed market environment. Contrary to their reputation as "zombie funds", the sale of strong assets particularly provides an attractive benefit/risk profile economically.

9.2 Are there any particular legal requirements or restrictions impacting their use?

In general, continuation funds are subject to the same legal framework as other alternative investment funds. Legal restrictions may, in particular, arise in connection with the permanent conflict of interest that exists in the context of transactions in which the private equity sponsor acts on both the buy-side and the sell-side.

10 Tax Matters

10.1 What are the key tax considerations for private equity investors and transactions in your jurisdiction? Are off-shore structures common?

Investors typically use an acquisition structure comprising several special-purpose vehicles incorporated in Germany and/ or countries with a favourable investment environment for private equity and M&A investments (typically Luxembourg, the Netherlands or the Channel Islands). Typical tailor-made investment structures for German deals allow for a tax-efficient acquisition of a target group considering the following key tax aspects:

(i) Exit considerations (sale of shares, IPO, etc.) and optimised capital gains treatment as part of an exit scenario.
(ii) Tailored repatriation mechanisms together with a financing structure (considering a mixture of equity and debt financing) serving the investor's needs.
(iii) Optimised overall tax position by allowing to offset target group's operating profits with acquisition financing costs by implementing tax grouping schemes.
(vi) Survival of tax attributes (such as tax loss carry forwards and current year losses) to protect against historic tax risks and to reduce the future target group's tax burden.
(v) Optimised real estate transfer tax position.
(vi) Investment opportunities to incentivise management (MEP, virtual share programme, etc).
(vii) Opportunity to on-board co-investors to share the investment risk and to further leverage the investment structure.

Besides structural needs, W&I coverage for historic tax risks becomes more and more popular in German deals. Having said this, a sophisticated and aligned tax due diligence scoping is required to allow for sufficient historic tax risk coverage. Identified tax risks as part of tax due diligence are more often covered by special tax insurance to the extent there is no recourse against sellers under special tax indemnities.

10.2 What are the key tax-efficient arrangements that are typically considered by management teams in private equity acquisitions (such as growth shares, incentive shares, deferred / vesting arrangements)?

Management incentivisation through participation in the future value creation of a target group plays a crucial role in most private equity transactions. Such incentive schemes can be structured either as co-investments through (indirect) participation of the management in the target's equity or as simple contractual arrangements, essentially entitling management to a bonus payment or virtual share options should certain key milestones be achieved. While contractual arrangements are easier to implement and more standard in M&A transactions, it is more common for private equity sponsors to offer (senior) management the opportunity to co-invest in the target with own money (MEP).

In an MEP, typically a mix of preferred instruments and ordinary shares (indirectly) held by management will usually govern the management's risk and return profile. So-called growth shares (only entitling holders to the value creation after their acquisition), hurdle shares (providing holders with value participation once a certain hurdle is achieved) or ratchet shares (entitling holders to a certain return) could be considered. Tax risks associated with these kinds of special shares are, however, even higher than in a common structure comprising a mix of preferred and ordinary instruments only. In any case, the treatment of the underlying MEP returns under the tax preferential capital gains regime is key for management.

Management's investment is regularly pooled in vehicles in the form of a tax-transparent partnership being controlled by the sponsor. This kind of indirect investment structure allows sponsors to establish, among other things, appropriate governance.

Sponsors regularly have the right to buy back the equity interests held by the management members once their employment or service agreements with the target have ended or have been terminated (leaver schemes differentiating between good leaver and bad leaver). Such leaver schemes are usually aligned with the overall vesting scheme and tag-along/drag-along rights of the MEP.

10.3 What are the key tax considerations for management teams that are selling and/or rolling over part of their investment into a new acquisition structure?

Sale and roll-over of management (*pari passu*) investments/ equity must be considered carefully by an in-depth upfront structuring on the management's sight. Typically, the management re-invests based on net profits after tax to the extent a tax-neutral re-investment/roll-over mechanism is not available or compliance efforts and resulting holding periods attached to such tax neutral roll-over are too burdensome.

The most common way to entitle management to a later tax-efficient sale or tax-neutral roll-over into the new sponsor's structure is to bundle management's equity in a German corporation. Such pooling allows, on the one hand, benefitting from

the tax-preferential German capital gains exemption (*c.* 1.5% tax on capital gains), in the case of an exit scenario and, on the other hand, benefitting from tax neutral roll-over schemes (share-for-share exchange).

10.4 Have there been any significant changes in tax legislation or the practices of tax authorities (including in relation to tax rulings or clearances) impacting private equity investors, management teams or private equity transactions and are any anticipated?

- Increased substance requirements and recent international developments such as the EU's second Anti-Tax Avoidance Directive (ATAD 2) and the so-called Unshell Directive (on rules to prevent the misuse of shell entities for tax purposes) have had a relevant impact on how funds as well as their investments are structured.
- Real estate transfer tax regulations have been tightened recently with additional compliance and filing requirements.
- Tax audits focus more and more on transactional tax matters such as transfer pricing aspects in the light of financing activities, substance requirements, treatment of transaction costs, and transaction bonuses.

11 Legal and Regulatory Matters

11.1 Have there been any significant legal and/or regulatory developments over recent years impacting private equity investors or transactions and are any anticipated?

The regulatory framework (in particular, relating to foreign investment control) has changed multiple times of the last years. The most recent example for additional regulatory requirements is the introduction of the EU foreign subsidies regulation (*Drittstaatensubventionsverordnung*) regarding the receipt of "financial contributions" from a non-EU member.

11.2 Are private equity investors or particular transactions subject to enhanced regulatory scrutiny in your jurisdiction (e.g., on national security grounds)?

Private equity funds (*et al.*) registered in the EU are subject to Directive EU 2011/61/EU, the Alternative Investment Fund Managers Directive (AIFMD), a regulatory framework established to protect investors and reduce the risks imposed by such funds to economies.

11.3 Are impact investments subject to any additional legal or regulatory requirements?

Impact investments, e.g., infrastructure projects, can be subject to various specific legal and regulatory requirements that are and will be dynamically changing in the current environment. The legal framework in the EU further provides for certain regulations and directives concerning ESG-relevant topics that have gained massive relevance in the past years.

11.4 How detailed is the legal due diligence (including compliance) conducted by private equity investors prior to any acquisitions (e.g., typical timeframes, materiality, scope, etc.)?

The comprehensiveness of each due diligence process varies a lot depending on the requirements of the concrete transaction such as size of the target, valuation, type of investment or needs of the buyer.

For complex auction sales, the conduction of a comprehensive vendor due diligence by sellers (through their advisors) is still very common in order to structure and simplify the process. As buyers will most likely not get reliance on the vendor due diligence report from sellers' advisors, they are typically conducting an additional buy-side due diligence in order to confirm its results.

In less complex or bilateral situations, private equity sponsors are regularly adjusting their due diligence to the requirements of debt providers or W&I insurance. It is not common to apply rather high materiality thresholds and focus on items with particular commercial relevance.

11.5 Has anti-bribery or anti-corruption legislation impacted private equity investment and/or investors' approach to private equity transactions (e.g., diligence, contractual protection, etc.)?

Legal compliance topics in general have become a standard due diligence item and are regularly covered in-depth within the business warranties. This applies not only to anti-bribery and anti-corruption laws, but also to anti-money laundering or other areas of legal compliance (e.g., data protection).

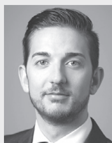
11.6 Are there any circumstances in which: (i) a private equity investor may be held liable for the liabilities of the underlying portfolio companies (including due to breach of applicable laws by the portfolio companies); and (ii) one portfolio company may be held liable for the liabilities of another portfolio company?

The liability risks of investors could be based on the grounds of contractual arrangements or fraudulent behaviour. Further, there have been court decisions by the European Court of Justice (EuGH) confirming the joint and several liability of an investment fund together with one of its portfolio companies for a violation of anti-trust laws. Although there have not yet been similar decisions by German courts referring to such EuGH decision, a similar ruling concerning a German investment could be possible in light of the European legal framework.

12 Other Useful Facts

12.1 What other factors commonly give rise to concerns for private equity investors in your jurisdiction or should such investors otherwise be aware of in considering an investment in your jurisdiction?

The environment for private equity transactions in Germany is still highly attractive. Private equity investors have significantly improved their reputation as responsible investors for the benefit of the economic viability of the companies, their respective employees, and the economic area. As private equity investors have been shown to achieve particularly strong returns in periods of economic uncertainties and Germany still has a large number of attractive technology leaders as well as small and mid-sized businesses, it is likely that private equity investors (both domestic and international) will remain very active in German transaction markets.



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