GUIDE TO MERGERS & ACQUISITIONS IN CHINA AND GERMANY

VOLUME II: M&A IN GERMANY – GERMAN CONTRIBUTION

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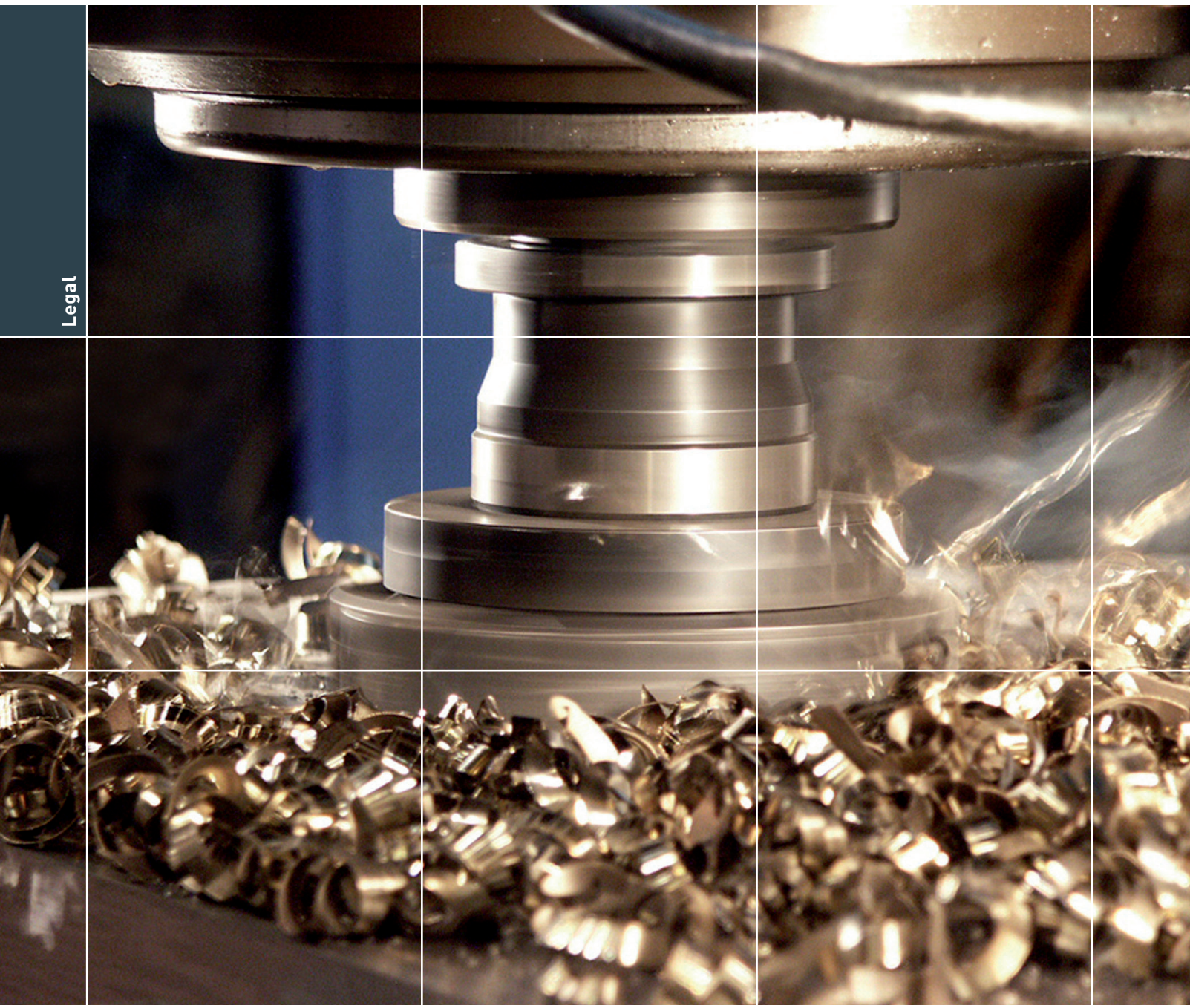

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CONTENT

Section A

Mergers and Acquisitions in China and Germany

Preface

Top 10 Specifics Germany and China

Preface

The “Guide to Mergers & Acquisitions in China and Germany” (“Guide”) was developed in several years of work by the Working Group on Legal Issues of Trade and Economic Cooperation for the Sino-German Joint Economic Commission.

In the Ministers’ Joint Declaration of 26 May 2013, the Ministry of Commerce (MOFCOM) of China and the German Federal Ministry for Economic Affairs and Energy emphasized their mutual interest in the preparation of this publication, which was seen as a further instrument for the promotion of investments on both sides.

The publication is officially recommended for use by the relevant business circles.

The Guide has been designed in two parts intended for the respective target groups in the two countries. Volume I addresses German investors envisaging the acquisition of shareholdings or assets in China. It was prepared by the Chinese Delegation. Volume II addresses Chinese enterprises contemplating investments in Germany by way of the acquisition of shareholdings or assets. This part of the Guide, focusing on investments in Germany, was prepared by members of the German Delegation, i.e. representatives of enterprises and associations (including VDMA) with a track record of longstanding experience with business in China. In the process of redacting the two Volumes, the opinions of relevant enterprises and associations from both countries are solicited. While Volume I appears in English, Volume II is presented in a bilingual English and Chinese version so as to be accessible to as many Chinese readers as possible.

Both volumes contain, in a common section A, a preface as well as an introductory survey of the most important features of the respective target country as detailed in the text section of the Guide. Section B describes the legal, administrative and economic characteristics of the respective country.

The development of German investments in China since their beginning in the early eighties has now reached a stage where it is much more frequently the case that German investors acquire shareholdings in or assets of Chinese companies, rather than establishing “greenfield foreign invested enterprises” alone or together with a Chinese partner. In recent years Chinese investment interests abroad, notably in Germany, have undergone an enormous development

spawning a steadily increasing number of projects where Chinese investors acquire shareholdings in or assets of German enterprises in order to take over the relevant companies in Germany or to participate in their management.

The present publication was created in the parties' common intent of assisting in this new stage of German investments in China and in the positive development of investments by Chinese companies in Germany, and of providing investors with guidelines for the structure of the associated transactions. In light of the features of the investment environment in each country, the Guide covers the issues of common concern to investors, focuses on the legal framework relating to M&A activities, and introduces the process and caveats for equity M&A and asset M&A separately.

Foreign investment is an important part of China's fundamental state policy of opening up. In order to adapt to the trend of economic globalization, China is speeding up the construction of an open economy, unifying the laws and regulations applying to domestic and foreign investment, and further relaxing the restrictions on foreign investment. China's legal system on foreign investment will also go through great changes. In January 2015, the Ministry of Commerce, P.R.C. published the *Foreign Investment Law of the People's Republic of China (Draft for Public Opinions)* in its official website to solicit public opinions. The Draft, referring to the common international practices, adopts the approach of negative list for foreign investment administration, constructs uniform administration for the market access of foreign investment as well as supervision in the post-market access stage, improves the regime for national security review, and reinforces the investment promotion and protection, so as to create a more stable, transparent and predictable legal environment for foreign investors to invest in China.

The German and Chinese delegations trust that this Guide will contribute to the facilitation and simplification of M&A transactions in their respective jurisdictions.

The Working Group

on Legal Issues of Trade and Economic Cooperation

under the Sino-German Joint Economic Commission

Top 10 Specifics Germany and China

A. Top 10 Specifics Germany

1. Germany welcomes Chinese investment. Foreign investment is subject to very few restrictions, only (see Section I. 9.1.1 and Section I. 9.2), such as for sensitive (mainly military) sectors and in very few other cases also for non-sensitive sectors.

2. The legal vehicle most commonly used for foreign investments in Germany is the limited liability company (*Gesellschaft mit beschränkter Haftung*, *GmbH*). Agreements for the transfer and assignment of shares in a German *GmbH* require notarization in front of a German notary public.

3. Company's management personnel or directors can also have other nationality than German. To hire and train competent, reliable and appropriate management personnel to be working abroad should be the task prior to the strategic tasks of Chinese enterprises planning to undertake any M&A transaction in Germany.

4. With a few exceptions, such as in the banking sector where specific business licenses are required, generally, companies in Germany do not need a Government approved business license, but are free to operate for as long as they do not operate unlawfully.

5. With the exception of certain approvals (such as under cartel law and for national security), M&A in Germany as such does not require administrative approvals for being permissible and effective (see Section II. 4.4).

6. M&A transactions as such are not subject to approvals from trade unions or other employees associations. Still, German labor law foresees certain rights for company work counsels to involve and to discuss the company's business matters, which involvement, has proven over the past to help building a stable and harmonious relationship between the employer and the employees.

7. Complex German tax law requires aside accurate tax due diligence procedures, a customized acquisition structure. Therefore, tax advice should be sought early in the process.

8. Timing – M&A-Process, in particular auction processes in Germany often require quick decision.

9. Like in other jurisdictions an asset deal allows to specifically select assets and liabilities while the share deal is less complex (please refer to Section I. 8) .

10. Real Estate – ownership of land in Germany is different from China (please refer to Section III. 1.3.2).

The difference in cultural and transactional practice may be challenging for investors.

B. Top 10 Specifics China

1. China welcomes foreign investment and foreign M&A. The legal regime in these respects is continuously liberalized.

2. China established Pilot Free Trade Zones ("FTZ") in Shanghai, Guangdong, Tianjin and Fujian to further reform and open up, and in particular to deepen administrative system reform and to expand the opening up in the area of investment and trade (see Section I.1.1 and Section I.1.2).

3. M&A of domestic companies by foreign investors are generally subject to approvals, examinations and registrations requirements (see Section I.7.3, Section I.8 and II.6). The M&A transaction and certain transaction documents (including share transfer agreements, joint venture contracts, Articles of Associations, etc.) will become effective upon approval by the Ministry of Commerce (MOFCOM) or its local counterparts (see Section II.7.1).

4. Any foreign direct investment in China, either by way of greenfield investment or M&A transaction is subject to the *Catalogue of Guidance of Foreign Invested Industries* ("Industrial Catalogue"). The latest version of the Industrial Catalogue as amended in 2015 has significantly reduced the numbers of restricted industries and further liberalized the market entry for foreign investments (see Section I.7.1). The Company's/Target's Business License and sometimes qualification permits or licenses for certain businesses play an important part of the deal as it defines the allowed/in-scope business activities.

5. China has established an anti-monopoly review regime for concentration of undertakings. Any M&A transaction that meets the statutory notification thresholds is required to be notified to MOFCOM for anti-monopoly review (see Section I.7.4). A national security review regime on M&A of domestic enterprises by foreign investors is also established (see Section I.7.5).

6. M&A Transactions involving State-invested Enterprises (SIEs) or state-owned assets are required to comply with certain mandatory requirements and procedures, including approval from the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) or its competent local counterparts, mandatory valuation, minimum transfer price, and undertaking public auctioning process (see Section I.4.3, Section II.4.2 and Section II.6.1.3).

7. Like in other jurisdictions, foreign investors are permitted to structure M&A transactions in China through either share acquisition or asset acquisition. Upon approval, the domestic company acquired by foreign investors through share acquisition will be formed as a foreign-invested enterprise (FIE). Under the assets acquisition, foreign investors shall establish an FIE to operate the acquired assets (see Section I.10).

8. A careful due diligence review is important. Certain legacy risks uncovered in due diligence exercises (such as on tax, employees, missing or incomplete licenses and permits) should be taken into consideration when defining the appropriate deal structure (asset deal or share deal) (see Section II.3).

9. Under both share acquisition and asset acquisition, foreign investors are required to pay consideration within the statutory time limit (see Section II.2.3.1).

10. Under asset acquisition, the requirements and procedures for the transfer of titles of different types of properties vary. The transfer of employees is implemented via termination/rehire (possibly using a tripartite agreement) and may trigger severance payments (see Section III.5.2).

The difference in cultural and transactional practice may be challenging for investors.

Section B

Mergers and Acquisitions in Germany - German Contribution

I. M & A Environment

1. Investment Climate

Germany is one of the world’s most competitive business locations. The export strength of German companies makes the country the world's third-largest exporter. A "Made in Germany" label is considered a mark of quality on every continent and is a major factor in Germany’s popularity as an investment location. In 2013, the country recorded almost 800 new investment projects from abroad, putting it in fourth place worldwide.

The domestic importance of Foreign Direct Investment (FDI) has increased significantly. Between 2002 and 2012, foreign investment stock in Germany more than doubled to nearly EUR 600 billion, according to the Deutsche Bundesbank. Cross-border mergers and acquisitions (M&As) have also grown in significance. In 2013, Bureau van Dijk recorded nearly 540 M&A transactions by German companies with foreign participation, with an overall volume of around EUR 37.5 billion. The total of 55,000 foreign companies play a vital role: They are responsible for around 20 percent of German economic output. In addition, they directly secure three million domestic jobs.

Germany regularly enjoys the praise of foreign companies in international markets. This has been reconfirmed by the 2014 EY Attractiveness Survey, in which more than 800 international managers rated Germany as the most attractive investment location in western Europe. Only China, the USA, and Russia scored better. The study clearly highlighted Germany’s strengths as the stability and transparency of the political and legal environment, the transport infrastructure and the high level of education of German workers - three characteristics repeatedly mentioned for Germany in other surveys and location rankings.

The World Economic Forum Global Competitiveness Report 2014/2015 highlights Germany’s dense network of suppliers, strong innovation framework, and progressive cluster landscape in particular. In the competitiveness ranking, Germany placed fifth out of 144 countries.
In Germany, around three percent of economic output is now invested in research and development. German research expenditure is the fourth-highest worldwide. The high quality of products with a "Made in Germany" label means German companies are very successful in world

markets. One in four jobs in Germany depends on exports. No country in the world has more hidden champions than Germany - meaning world market leaders in often less conspicuous niche markets.

2. Industrial Policy

Germany's large, medium and small industrial companies provide a strong foundation for a robust macroeconomic development. Their innovative capacity and strong export performance are making a substantial contribution to growth and prosperity. A forward-looking industrial policy has been developed to boost the competitiveness of Germany's industrial enterprises in a sustainable manner.

In this endeavor, the German industrial policy follows the principles of the social market economy. The government creates a policy environment that promotes innovation and investment to ensure a dynamic economic development and fair competition ("level playing field"). Moreover, the government intervenes in the competitive economy only as far as is necessary to ensure a stable, transparent and predictable regulatory framework. In particular, private monopolies and cartels are prohibited. Moreover, the market mechanism, i.e. the balancing of supply and demand, is largely essential for entrepreneurial activity. Competitiveness and competition are interdependent.

3. M & A History

Though Germany developed quickly into a global economic player after the Second World War, M&A activities became relevant fairly late in comparison to the Anglo-Saxon jurisdictions. Only as recently as the mid-1980s has M&A played a major role in Germany's economic processes as well as rapidly developed into quite a common business practice of market participation.

Driving factors for such development were and are different. Following the reunion of East and West Germany, a large number of former state-owned enterprises in East Germany were privatised by the government in a controlled process involving many M&A transactions. The political and economic integration of Europe – and in particular Europe's enlargement towards

the East – further aided the M&A activities in Germany, given its central location within Europe and economic strength as one of the biggest exporters in the world. Parallel trends, such as the restructuring of many German market participants from partnerships into capital companies and the disentanglement of the crossholding of the leading private industry conglomerates due to corporate governance campaigns, remarkably increased the M&A potential. The owners of small- and medium-sized enterprises (SME) which dominated the economic development of the German market have long since recognized the advantages of equity investors as an alternative source of financing, and in terms of legal succession and mergers. Though SMEs tended to primarily rely on bank financing for their development and growth, financing was procured increasingly from the capital markets as well. Last but not least, the nature of the German industry as leaning more towards engineering and production than service attracted a number of foreign investors including strategic investors and private equity funds. With the development and appearance of the information technology of the European market, other forms, such as venture capital, further matured.

Given Germany's mature jurisdiction, detailed public and civil law as well as the legal certainty, all legal conditions relevant for a functioning and well-structured M&A market were available from the very beginning of M&A activities occurring in Germany. However, attributes of M&A transactions already in use and engineered in the Anglo-Saxon jurisdictions, such as bidding processes and performance of different forms of due diligence, have been introduced to the German market comparably late, i.e. towards the end of the 1990s. The German legislators, as well as the German jurisdiction, quickly responded to such developments in practice resulting in a high legal security for all, be it investors, targets, vendors or competitors.

4. Targets

4.1 Corporate Forms

4.1.1 Introduction

Any private individual, partnership or corporation, irrespective of nationality or place of residence, can set up a company in the Federal Republic of Germany or acquire shares in an existing company in the Federal Republic of Germany. The Federal Republic of Germany does

not have any specific investment legislation. A company in the Federal Republic of Germany does not need a minimum percentage of German shareholders.

Please note, however, that due to a recent revision of statutory law, the Federal Ministry for Economy and Energy is entitled to review and - in extraordinary cases - prohibit the (direct or indirect) acquisition of 25% or more of the voting rights in a German company by private individuals or legal entities seated outside the territory of the European Union, Iceland, Liechtenstein, Norway or Switzerland if the transaction would endanger public order or safety (cf. Sec. 9.3 below for more details).

Some restrictions and/or specific requirements may apply with regard to businesses acting in certain sectors, including the following sectors:

- defence;
- pharma, and
- offering of financial services and banking.

The choice of the corporate form usually depends on various factors such as e.g.

4.1.2 Overview corporate forms

Corporate forms of companies available under German law:

	Corporations		Partnerships
No. of shareholders	At least **one** shareholder		At least **two** partners
Involvement of shareholders in the management of the company / **control** over the management	Stock Corporation: Very **limited involvement** of shareholders in the management; shareholders' meeting appoints member of the Supervisory Board, and the Supervisory Board appoints and supervises the management.	Limited Liability Company: The shareholders' meeting is entitled to give binding **instructions** to the management and, as a consequence, can **control** the management.	Limited Partnership: The **general partner** is responsible for the **management**; the rights of the limited partner with regard to management are (usually) rather restricted (depending on the partnership agreement).
Liability	Stock Corporation: The liability of the shareholders is limited to the **duty to pay in their contributions** (minimum share capital: **EUR 50,000**).	Limited Liability Company: The liability of the shareholders is limited to the **duty to pay in their contributions** (minimum share capital: **EUR 25,000**).	Limited Partnership: The **general partner** is exposed to **unlimited** liability; the **limited partner** is exposed to liability up to the amount as registered in the commercial register (no minimum amount required).
Taxation	**Corporations** are subject to **corporate income tax**. The shareholders are subject to tax on dividends, and on capital gains in connection with the sale of shares.		**Partners** (not the partnership which is "transparent" for tax purposes) are subject to **tax**.
Financing	**No duty** of the shareholders / partners **to make additional payments** to the company (in addition to their capital contributions) provided by statutory law. If the company is financed by funds provided by third parties (e.g. banks or investors) the form in which the funds are provided may have an impact on the choice of corporate form (e.g. with regard to the possibilities to increase the share capital of the company etc.).		
Changes and/or exit of shareholders	Corporations can **continue to exist** with only one shareholder.		Partnerships are **dissolved** if all partners except one leave the partnership.
	Stock Corporation: The sale and transfer of shares does **not** require **notarization**.	Limited Liability Company: The transfer of shares requires notarization.	Limited Partnership: The transfer of partnership interests does **not** require **notarization**.
	Shares are generally **freely transferable** (exceptions if the articles of association provide for transfer restrictions).	Changes of shareholders / partners usually are subject to the **approval of the shareholders' / partners' meeting** (or the company). In case of an exit, the leaving shareholder / partner is usually entitled to receive **compensation**.	

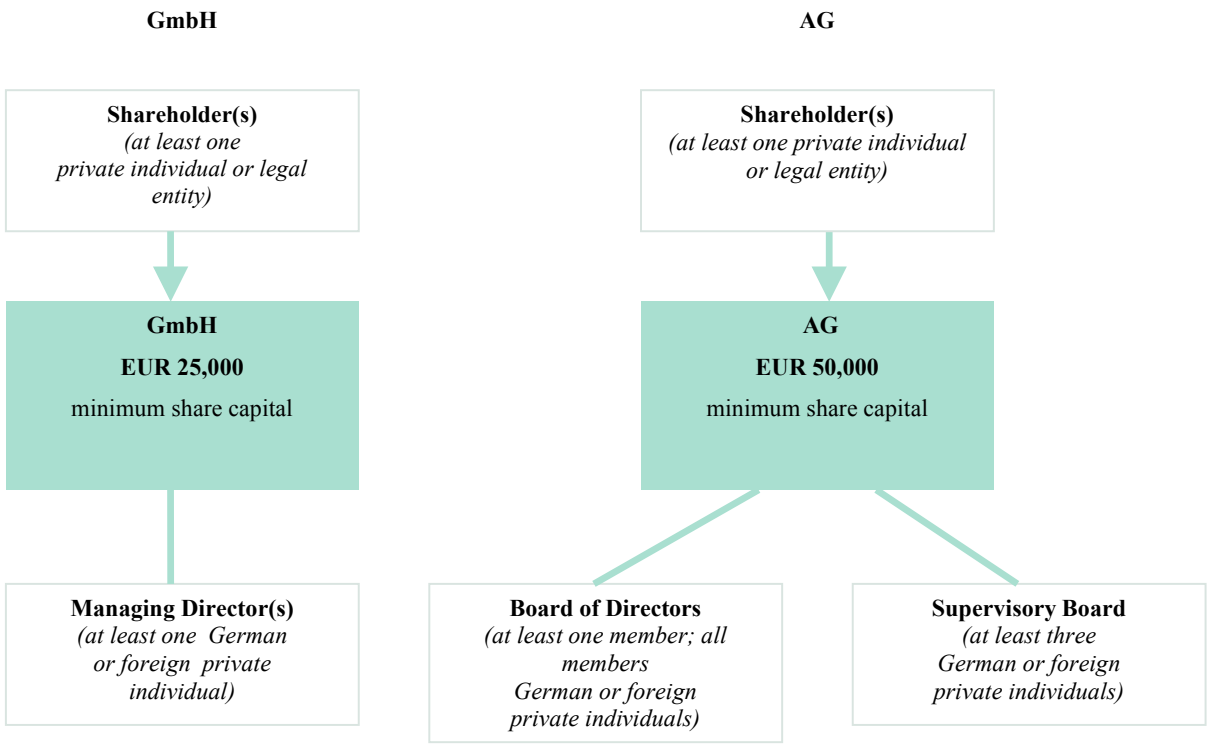
4.1.3 Corporations

Generally, corporations are the best choice for larger businesses. German law offers, amongst others, the following forms of corporations:

- Limited Liability Company (Gesellschaft mit beschränkter Haftung; GmbH), and
- Stock Corporation (Aktiengesellschaft; AG).

One of the main advantages of corporations is the limited liability of its shareholders. Setting up a corporation usually requires a minimum share capital which is provided for by statutory law.

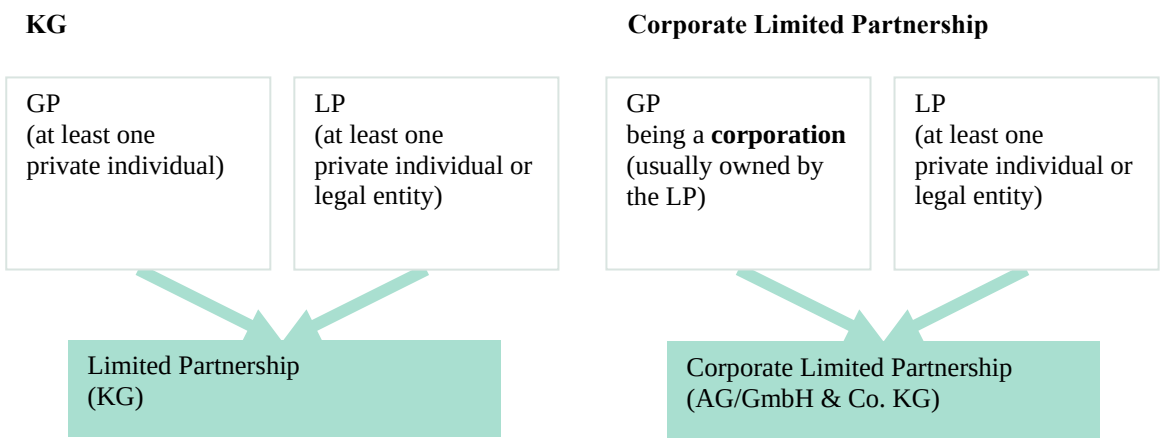
Whereas GmbHs usually have a one-tier structure (consisting of at least one managing director) and a minimum share capital of EUR 25,000, AGs have a two-tier structure (consisting of at least one director and of a Supervisory Board formed by at least three members), a minimum share capital of EUR 50,000 and are subject to more formal requirements compared to a GmbH.



4.1.4 Limited Partnerships

The corporate form of the Limited Partnership (Kommanditgesellschaft, KG, Sec. 161 et seqq. of the Commercial Law (Handelsgesetzbuch (HGB)) can primarily be recommended for smaller enterprises where some partners are actively involved in the business and others participate in the profits without being involved in the management. The corporate form of a KG is, among other reasons, used for tax purposes (cf. Sec. I.6 below). From a corporate law perspective, the main feature is the personal commitment of the partners. Each KG requires at least two partners, the general partner (GP) and the limited partner (LP). The GP assumes unlimited liability for the debts and liabilities of the KG. On the other hand, no minimum share capital is required for setting up a KG and running its business. Accounting obligations and publication requirements tend to be less extensive as compared to corporations. German law knows the following variations of a KG:

- KG, and
- Corporate Limited Partnership (KG with a corporation as general partner, AG/GmbH & Co. KG).



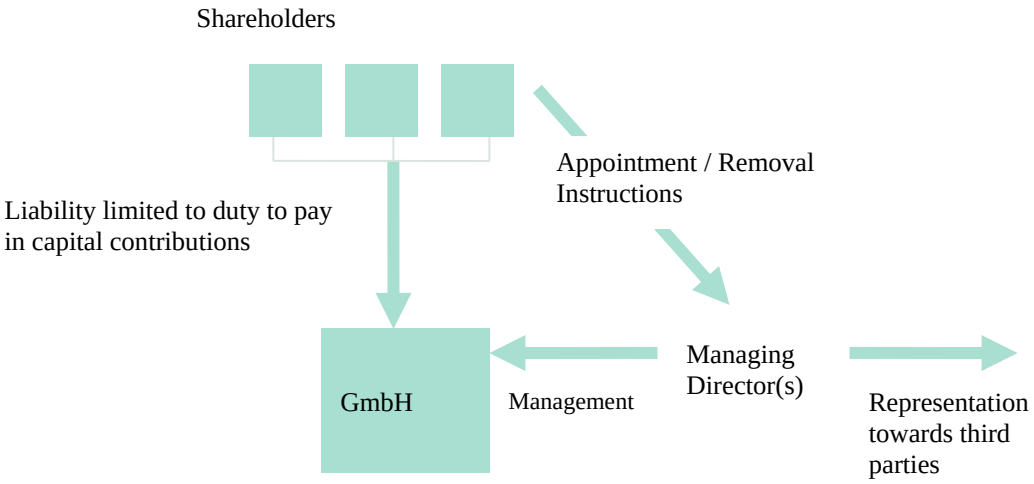
4.2 Corporate Structure

4.2.1 Limited Liability Company - Gesellschaft mit beschränkter Haftung (GmbH)

4.2.1.1 Structure of the GmbH

The GmbH (being the most frequently used corporate form in the Federal Republic of Germany) is a corporation and as such a separate legal entity which is liable towards its creditors with its assets. It can have one or more shareholder(s) (private individuals or legal entities) whose liability is limited to the duty to pay in the respective capital contributions either in cash or in kind. The GmbH is governed by the German Limited Liabilities Company Act (GmbHG).

In general, the GmbH has two corporate bodies: the shareholders' meeting and the managing directors. A supervisory board is, in general, not mandatory, its establishment may, however, be provided for in the articles of association.



4.2.1.2 Shareholders' Meeting

The shareholders' meeting is the supreme body of the GmbH. Unless otherwise provided for by statutory law or the articles of association, its powers cover all business matters. These include, in particular, the approval of the annual financial statements, the use of profits, the appointment and removal of managing directors as well as the control and approval of their management performance.

A shareholders' meeting must be held at least once a year in order to approve the annual accounts set up by the managing directors within eight months (11 months for small companies) after the end of each business year.

4.2.1.3 Management / Representation of the GmbH

One or more managing directors who do not need to be shareholders are in charge of the management and represent the GmbH towards third parties. The scope of such statutory power of the managing director(s) to represent the GmbH cannot be limited with legal effect towards third parties. Internally, however, the shareholders' meeting is entitled to give instructions to the managing directors. The competencies of the managing director(s) may be restricted by internal regulations (set forth e.g. in rules of procedure).

The managing director(s) grant upon respective instructions by the shareholders' meeting a commercial limited statutory power of representation, the "*Prokura*", to employees of the company, entitling them to represent the company with regard to the daily business. Prokura is registered with the commercial register.

Duties and Liability of Managing Director(s)

Apart from being responsible for the overall management of the GmbH, managing director(s), inter alia, have the following duties:

General Duties

- Prepare and convene shareholders' meetings
- Provide **information** relating to the GmbH to shareholders on demand
- Maintain and update the **shareholders' list**

Duties relating to Finances of the GmbH

- Set up proper **accounts** in accordance with German GAAP
- Prepare the annual financial statements
- Ensure that the GmbH files **tax returns** timely and correctly

Duties relating to the Protection of the Share Capital of the GmbH

- Confirm that the **initial contributions** of the shareholders were made correctly and are at the disposition of the GmbH
- Undertake all measures necessary to **protect the share capital** and prevent the share capital being paid back to the shareholders
- Call a shareholders' meeting in case **50 % of the share capital is lost**

Duties in case of Insolvency of the GmbH

- Make sure that a **petition for the opening of insolvency proceedings** in case of over-indebtedness or insolvency is filed timely and correctly in accordance with statutory law
- **Prevent certain payments** in case of over-indebtedness or insolvency of the GmbH

Liability and Sanctions

A breach of the aforementioned duties of managing director(s) may give rise to a claim for damages of the GmbH, shareholders, and/or third parties against the managing director(s) personally and may justify a dismissal of the managing director(s) for cause. In addition, non-compliance with certain duties may lead to further sanctions, e.g. authorize the courts or governmental authorities to impose fines in order to enforce compliance with statutory law. The GmbH may also be subject to administrative and/or criminal penalties. A conviction of a managing director for certain crimes relating to breaches of the duties of the managing director(s) (e.g. the duties relating to the insolvency of the GmbH, fraud or embezzlement) leads to a disqualification to exercise the office of a managing director.

4.2.1.4 New Sub-Form: Limited Liability Entrepreneurial Company - Unternehmergesellschaft (haftungsbeschränkt)

Since 1 November 2008, a GmbH can be set up as limited liability entrepreneurial company (Unternehmergesellschaft (haftungsbeschränkt); UG, Sec. 5a GmbHG). The UG is a sub-form of the GmbH that has low minimum capital requirements, since the registered share capital can be any amount between EUR 1 and EUR 24,999 as opposed to a minimum registered share capital of EUR 25,000 in case of a GmbH. The UG is primarily designed to help start-ups with limited funds to take up business in the corporate form of a GmbH. The UG is the German answer to the UK Ltd.. The intention of the underlying legal concept is that the shareholders of an UG accrue enough earnings to convert the UG into a GmbH over time. Statutory law provides that ¼ of the annual net profit is (mandatorily) attributed to a statutory reserve of the UG until the share capital of the UG is increased to an amount of EUR 25,000.

4.2.1.5 Setting up a GmbH or Purchasing a Shelf GmbH

When a new GmbH is set up, it usually takes up to three weeks from the incorporation date until the GmbH is registered with the commercial register (pursuant to statutory law, a GmbH starts to legally exist only upon registration with the commercial register).

Instead of setting up a new GmbH, investors may choose to acquire an already existing (but commercially inactive) shelf GmbH from one of the various shelf company providers. The main advantage of a shelf company is that the company already legally exists and the operative business can be started immediately.

Shelf companies are frequently used in connection with M&A transactions (e.g. as acquisition vehicles) or as general partners of AG/GmbH & Co. KGs.

The costs of acquiring a shelf GmbH amount to approximately EUR 27,500 and comprise the following amounts:

- EUR 25,000 share capital of the GmbH (which stays within the GmbH and is, therefore, commercially transferred to the new shareholder(s)), and
- EUR 2,500 fees to be paid to the shelf company provider.

In addition, notarial fees and fees for registration (which, in a standard case, do not exceed a total amount of EUR 400 - 600) with the commercial register become due.

Furthermore, cost for (legal and/or tax) consultants may be generated.

4.2.2 Stock Corporation (AG)

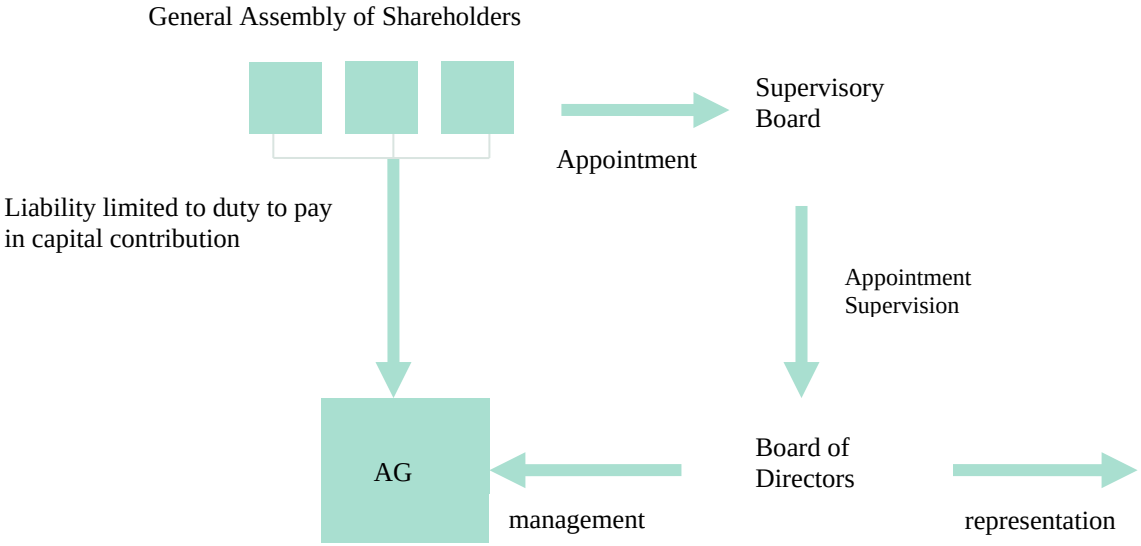
4.2.2.1 Structure of the AG

The AG (being used for rather large or listed companies) is a corporation and as such a separate legal entity which is liable towards its creditors with its assets. It can have one or more shareholder(s) (private individuals or legal entities) whose liability is (apart from exceptional cases) limited to the duty to pay in the respective capital contributions either in cash or in kind. The share capital of an AG is divided into par value or non-par value shares (in the form of either registered or bearer shares).

In general, there are no restrictions of the transfer of shares (exceptions if the articles of association provide for transfer restrictions). AGs can thus approach a large investing public, including the stock market. Share transfers are not subject to notarization.

Unlike the law governing the GmbH, the Stock Corporation Act (Aktiengesetz; AktG) is relatively inflexible and to a large extent mandatory. The articles of association can deviate from the AktG in limited cases only. The AktG is rather formal concerning administration compared to the GmbHG.

The AG mandatorily has three corporate bodies: the General Assembly of Shareholders, the Board of Directors and the Supervisory Board.



4.2.2.2 General Assembly of Shareholders

The General Assembly of Shareholders has limited powers such as, in particular, amending the articles of association and modifying the corporation's capital basis, discharging members of the Board of Directors and of the Supervisory Board, appointing the members of the Supervisory Board etc. Resolutions of the General Assembly of Shareholders must be notarized to a large extent.

4.2.2.3 Board of Directors

The Board of Directors is in charge of the management of the AG. The members of the Board of Directors have the statutory right to jointly represent the AG, unless the articles of association provide the power of sole representation. The Board of Directors is not subject to any instructions from the Supervisory Board and/or the General Assembly of Shareholders. Accordingly, the statutory powers of representation of the Board of Directors vis-à-vis third parties are unlimited and its management authority is generally not subject to any resolutions of the other corporate bodies. The approval of the General Assembly of Shareholders may, however, be required for decisions of fundamental importance. Some decisions are subject to prior approval of the Supervisory Board pursuant to mandatory statutory law. The members of the Board of Directors can be appointed for a maximum term of five years.

Duties and Liability of Members of the Board of Directors

Apart from being responsible for conducting the business of the AG in the best interest of the AG, the Board of Directors and each of its members have, inter alia, the following duties:

General Duties

Prepare and execute resolutions of the **General Assembly of Shareholders**

Provide **information,** report to the Supervisory Board and establish a **monitoring system**

Non-compete and non-disclosure duties

Duties relating to Finances of the AG

Set up proper **accounts** in accordance with German GAAP

Prepare the annual financial statements

Ensure that the AG files **tax returns** timely and correctly

Duties relating to the Protection of the Share Capital of the AG

Confirm that the **initial contributions** of the shareholders were made correctly and are at the disposition of the AG

Undertake all measures necessary to **protect the share capital** and prevent the share capital from being paid back to the shareholders

Call a shareholders' meeting in case **50 % of the share capital is lost**

Duties in Case of Insolvency of the AG

Make sure that a **petition for the opening of insolvency proceedings** in case of over-indebtedness or insolvency is filed timely and correctly in accordance with statutory law

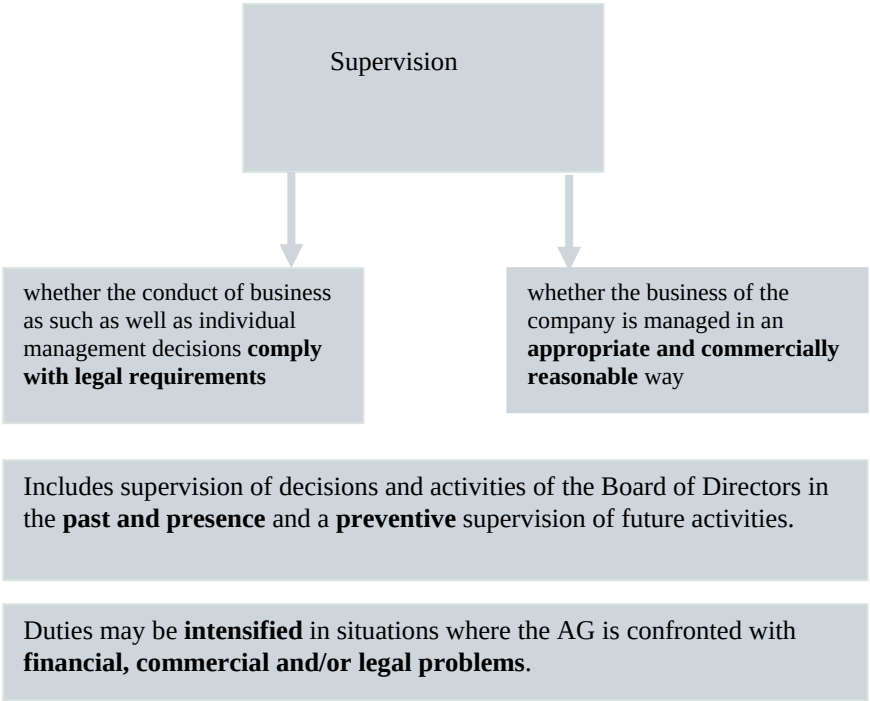
Prevent certain payments in case of over-indebtedness or insolvency of the AG

4.2.2.4 Supervisory Board

The Supervisory Board appoints the members of the Board of Directors and is responsible for their supervision. Certain types of management decisions usually internally require a prior approval of the Supervisory Board. The Supervisory Board must consist of at least three members. The members of the Supervisory Board can be appointed for a maximum term of five years.

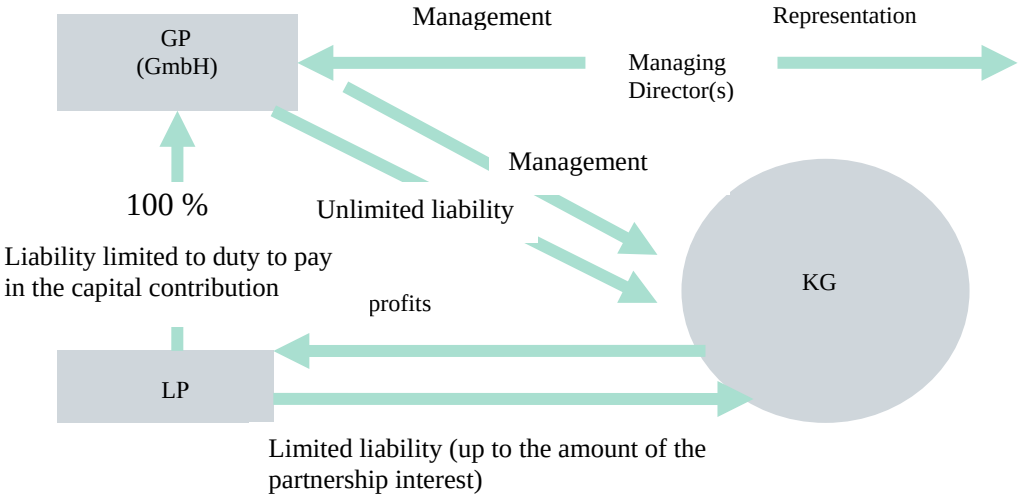
Duties and Liability of Members of the Supervisory Board

The main duty of the Supervisory Board and each of its members is the supervision of the management activities of the Board of Directors:



4.2.3 Limited Partnership (KG) with a GmbH as General Partner

4.2.3.1 Structure



The Limited Partnership (KG) with a GmbH as general partner (GmbH & Co. KG) is a special form of a KG.

The advantage of a GmbH & Co. KG is that none of the private individuals participating in the KG has unlimited liability. As the general partner (GP) is responsible for the management of the KG, the managing directors of the GmbH are also the managing directors or managing body of the KG. The disadvantage of this corporate form of enterprise is its comparatively complicated structure due to the interlocking of two legal entities of different corporate forms. Definitions, rules and provisions pertaining generally to the KG and the GmbH are equally and simultaneously applicable to the GmbH & Co. KG.

4.2.3.2 Limited Partner

From the date of registration with the commercial register the liability of the limited partner (LP) is determined by the amount of their partnership interest ("Hafteinlage") registered with the commercial register. Generally, the LP have fewer rights (in particular with regard to management, participation in profits and voting rights) than the GP.

Usually the LP are shareholders of the GmbH in which case the KG is a GmbH & Co. KG with identical participation.

4.2.3.3 General Partner

The GP of a KG has unlimited liability for the debts and liabilities of the KG. If the KG is set up in a form that the only GP is a GmbH, the - unrestricted – liability of the GP is limited to the assets of the GmbH due to the corporate form as a GmbH.

The GP is responsible for the management of the KG.

5. Legal Framework

Merger and acquisition activities in Germany are regulated by a framework of laws related to corporate, tax and merger control.

The relevant corporate regulations, as described in I.4 above, are primarily:

- the Limited Liabilities Company Act (GmbH - Gesetz);
- the Stock Corporation Act (Aktiengesetz (AktG));
- the Commercial Law (Handelsgesetzbuch (HGB)) and
- the Civil Code (Bürgerliches Gesetzbuch (BGB)).

The most important laws in tax matters are the Corporate Income Tax Law, the Individual Income Tax Law, and related laws and implementation regulations. As the German tax system is notorious for its complexity, professional advice is indispensable.

Most aspects of merger control are regulated by the Foreign Trade and Payments Act (Außenwirtschaftsgesetz - AWG) and the Foreign Trade and Payments Ordinance (Außenwirtschaftsverordnung - AWV) as well as the Act against Restrictions of Competition (ARC).

The German Ministry of Justice and Consumer Protection provides translations of the most important German laws on its website "Gesetze im Internet" (http://www.gesetze-im-internet.de/Teilliste_translations.html).

6. Taxation

When considering an acquisition in Germany, careful attention should be paid to the tax environment in which the target company operates as well as to the tax policy of target management.

6.1 Business Taxation of Corporations

Corporations are treated as taxable entities and are subject to corporate income tax (CIT), the municipal trade tax (TT) and solidarity surcharge. Withholding Tax (WHT) may have to be withheld at source in clearly defined circumstances. Privately held companies are typically organized in the form of limited liability companies (GmbH) whereas as listed companies are organized in the form of stock corporations (AG) or European Companies (SE).

Business Taxation of (Limited) Partnerships

For foreign investors, the most relevant partnership in Germany is the limited partnership (Kommanditgesellschaft, KG) which is a common legal form for German family owned businesses. In addition, KGs can also be used for tax planning purposes by foreign investors.

From a German tax perspective, partnerships are transparent entities for CIT purposes. Therefore, for CIT purposes, the income of the partnership is only determined at the level of the partnership. The income, including the income sourced from assets and liabilities at the level of the limited partners which are effectively connected to the business of the partnership, is completely allocated to the partners where it is subject to tax.

Corporation Income Tax

CIT is based on the taxable income at a rate of 15%. No preferential rates are available.

Solidarity Surcharge

On CIT and WHT, there is a solidarity surcharge of 5.5% of the tax amount, therefore effective CIT rate is 15.83% and the effective WHT is 26.38%.

Trade Tax

For all corporations and partnerships, TT is a municipal tax based on the trade income at a rate of between 7% and up to more than 17% depending on the municipality where the business is executed. The TT rates for the most important cities are 14.35% (Berlin), 15.4% (Düsseldorf), 16.1% (Frankfurt), 16.45% (Hamburg), 16.63% (Cologne) and 17.15 (Munich). The calculation of the TT is based on the CIT base which is adjusted by reductions and add-backs. Main additions include the add-back of 25% of the interest expenses and the add-back of 12.5% of lease expenses for immovable property. There is only an add-back to the CIT base if a threshold amount of EUR 100,000 is exceeded. Main reductions are for real estate, where 1.2% of the value according to Valuation Tax Act is considered, certain dividend income and income from foreign permanent establishments.

Value-added Tax

Goods or services delivered within Germany are subject to VAT. The general VAT rate is 19% whereas certain goods and services (for example books and food) are subject to a lower rate of 7%. There are several exemptions from VAT, for example Intra-EU-deliveries or exports. Although Intra-EU-deliveries or exports are VAT exempt, any input VAT may be claimed. This is not possible, e.g. for VAT exempt leasing. Preliminary VAT returns are usually filed monthly with a final year-end filing.

Withholding Tax

Corporations are required to withhold taxes at source in particular for the following types of payments and to remit such taxes to the tax authorities:

- Dividend distributions are subject to WHT at a rate of 26.38% (incl. solidarity surcharge).

- WHT is imposed on interests from certain debt instruments such as profit-sharing bonds, participation loans or on interests paid by banks. Plain vanilla loans granted by a company (not banks) are not subject to WHT.

- Royalties paid to non-residents are subject to a WHT rate of 15.83% (incl. solidarity surcharge).

WHT rates may be reduced according to a double taxation agreement (DTA) in place. The present agreement between Germany and China for the avoidance of double taxation is in force since 1986. A new DTA has been concluded on 28 March 2014 though. It is expected to find

application as of 2017. Under the present PRC-Germany DTA, the applicable WHT rate for dividends may be reduced to 10% (or 5% after the new DTA enters into force) and 10% for royalties, provided that the substance requirements of the German anti-treaty shopping rules under the German Income Tax Act are satisfied.

Stamp Duties

No stamp duties as such are levied.

Transfer Taxes

No transfer taxes on shares, bonds or other securities are levied. Transfer of immovable property, including an exchange of immovable property for shares, in a contribution to a company, a merger, a division, and some other transactions with immovable property are subject to 3.5% - 6.5% of Real Estate Transfer Tax (RETT).

General Principles for the Determination of Taxable Income

As an underlying principle in Germany, tax accounting is based on commercial accounting. Therefore, the results shown in the annual accounts are the starting point for the determination of the taxable income. The adjustments of the results shown in the annual accounts consist of balance sheet adjustments (e.g. different values of provisions or different depreciation methods) and off-balance sheet adjustments (e.g. non-deductible expenses or tax exempt income).

Participation Exemption

Dividends received by a (German or non-German) corporation are tax exempt with a 5% add-back (as deemed non-deductible expenses) provided that the recipient of the dividend holds at least 10% (for CIT purposes) and 15% (for TT purposes) since the beginning of the calendar year, and, in case of a foreign participation, the foreign subsidiary meets certain substance requirements for TT purposes. Otherwise, the dividend is fully taxable.

Capital Gains Taxation

Capital gains are, in general, treated as ordinary income and taxed at ordinary rates. Gains from the sale of shares are tax exempt with a 5% add-back. A respective capital loss cannot be deducted.

Thin Capitalization Rules

Interest expenses are generally deductible. Nevertheless, earning stripping rules are in place that generally limit the interest deduction to 30% of tax earnings before interest, taxes, depreciation and amortization (EBITDA). No limitation occurs if the net interest expense is lower than EUR 3 million per year.

Utilization of Tax Losses

Tax losses which cannot be offset in the current year may be carried back one year for CIT purposes, up to an amount of EUR 1 million. In this case, the prior year's tax assessment will be amended accordingly which may lead to a tax refund. For TT purposes, only a loss carry-forward is possible. Tax losses which cannot be carried back, may be carried forward for an unlimited period. However, due to minimum taxation rules, a loss carried forward may only be offset against profits up to an amount of EUR 1 million. Any loss carryforward in excess of that amount may be set off against no more than 60% of the taxable income (so called "minimum taxation"). Tax loss carry forwards are subject to German change-of-control rules.

International Aspects and Transfer Pricing

Germany has concluded double taxation agreements with about 90 countries. Typically, those tax treaties are in accordance with the OECD Model Tax Convention, for example, business profits derived from a permanent establishment in a foreign country are usually tax exempt in Germany. In the absence of a tax treaty, a corporation resident in Germany is subject to taxation on its income from foreign sources. However, the foreign income taxes paid on that income may potentially be credited against the German tax liability.

Intra-group services charges are allowed for tax purposes if they are at arm‘s length. German tax authorities generally accept as standard methods

i) Comparable Uncontrolled Pricing Method ("CUP");
ii) Cost Plus Method ("Cost+) and
iii) Resale Minus Method ("Resale-")

for determining arm's length prices. Detailed transfer pricing documentation is required if certain thresholds are exceeded. If transfer prices are not at arm's length, constructive dividend payments are considered which are not deductible for tax purposes and subject to withholding tax of up to 26.38%.

Fiscal Unity for CIT and TT Purposes

Germany allows fiscal unities (*Organschaft*) which allow to set off tax losses of one company with tax profits of other companies within this fiscal unity by attributing the tax base for CIT and TT purposes (profit or loss) of the controlled companies to the controlling entity. The fiscal unity is limited to companies resident within Germany, no cross-border group taxation is allowed (yet).

Fiscal Unity for VAT Purposes

The controlled companies and the parent company are treated as a single "entrepreneur" company with regard to VAT taxation. Therefore, in practice only one annual VAT return has to be filed by the parent company. The same filing procedures apply to the monthly or to the quarterly preliminary VAT returns. Sales and services rendered between the companies within the fiscal unity are not subject to VAT.

Binding Rulings

A German taxpayer is entitled to apply for a binding ruling in advance if the tax treatment of the facts would affect his business decisions for the future. The application must contain a comprehensive description of all facts. Binding rulings may not be granted in tax planning matters, for instance, in the case of a potential abuse of law. The advance ruling becomes ineffective if the tax law changes.

Anti-abuse Rules and Anti-treaty Shopping Rules

A general anti-abuse rule is applicable if an inappropriate legal structure is chosen that provides for any tax advantage for which the taxpayer cannot provide significant non-tax business reasons. There are also special anti-treaty shopping rules in place. If anti-abuse or anti-treaty shopping rules apply, the structure is generally disregarded for tax purposes.

7. Timeline

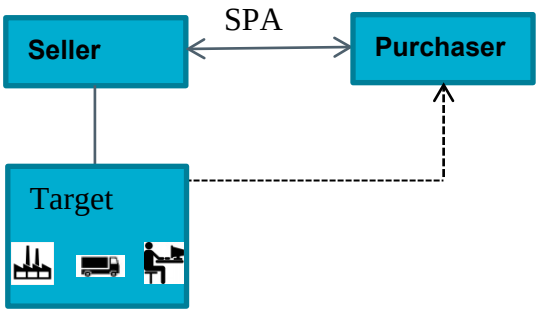
Please refer to II.2.2.1.

8. Share Deal versus Asset Deal

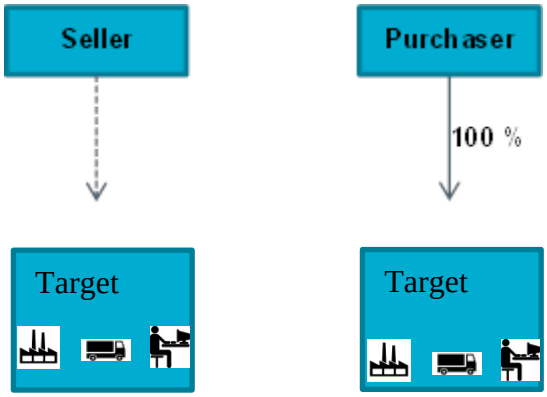
After the prospective purchaser has decided to acquire a certain business, such purchaser has two alternatives. The purchaser may either acquire the company running the business (the "Share Deal"), or acquire assets and assume liabilities comprising the business (the "Asset Deal").

8.1 Share Deal

In case of a Share Deal, the company running the business is the target. The purchaser acquires the company from the seller by acquiring the shares in the company. The shares are transferred by the seller assigning the shares to the purchaser. The seller and the purchaser consummate the acquisition by means of a "Share Purchase Agreement" or, more generally, a "Sale and Purchase Agreement" (both labeled SPA):



After consummating a Share Deal, the purchaser is the shareholder of the company running the business:



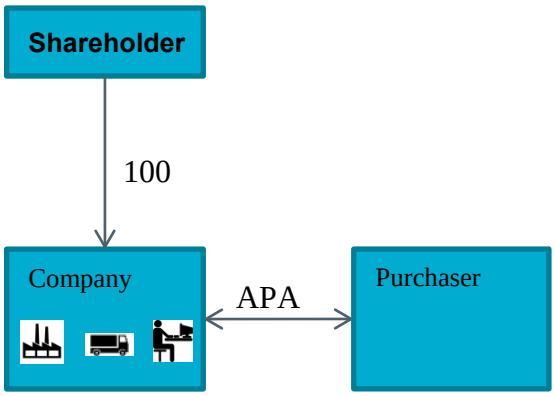
The purchaser acquires the company running the business "as a whole" with all assets and all liabilities, including employment relationships, commercial relationships, as well as unknown liabilities.

An important part of the SPA are the representations and warranties the seller is giving to the purchaser in relation to the business, in particular regarding the non-existence of unknown liabilities.

The formal requirements of an SPA depend on the corporate form of the company running the business. Please refer to Section I. 4.1.1.

8.2 Asset Deal

In case of an Asset Deal, the business itself is the target. The purchaser enters into a transaction with the company running the business, and not with the shareholder of such company. The object of such transaction is the acquisition of certain assets and the assumption of certain liabilities comprising the business. The seller and the purchaser consummate such acquisition by means of an "Assets Purchase Agreement" (the APA):



After consummating an Asset Deal, the purchaser is the owner of the assets and the debtor of the liabilities comprising the business:

By means of an Asset Deal – as opposed to the Share Deal – the purchaser does not acquire the desired business "as a whole", but only the assets and liabilities specified in the APA.

8.2.1 Asset Transfer

The seller transfers the specified assets to the purchaser individually as required by the legal provisions applicable to the transfer of each asset, e.g. objects need to be handed over, claims need to be assigned, and real estate needs to be transferred by notarized transfer agreement. Contractual relationships can also be transferred. Such transfer is customarily carried out in two steps: The first step is the agreement between the seller and the purchaser to transfer the respective contract, the second step is obtaining the consent of the respective other contract partner of the transferred contract which happens, as a rule, at a later stage, either expressly or impliedly.

8.2.2 Liabilities

With regard to liabilities, in the APA the purchaser can only assume liabilities from the seller (which means that the seller and the purchaser are jointly liable to the creditors), but cannot release the seller from liabilities. The release of the seller from any liability is only possible with the consent of the creditor. It depends on the circumstances, whether such consent can be obtained. The seller will customarily ask the purchaser for indemnities regarding such liabilities.

Depending on the circumstances, the seller may ask the purchaser to assume all liabilities of the business, including unknown liabilities, whereas the purchaser is interested to assume only specified liabilities. Unknown liabilities can be assumed by agreeing that all liabilities relating to the business, whether known or unknown, are assumed by the purchaser.

A statutory transfer of liabilities as a consequence of the acquisition of certain assets does generally not occur. However, certain exceptions apply under tax law, commercial law (continued use of the company name), or labor law. Liability risks may also arise due to certain features of the acquired assets (e.g. under environmental law for acquired real estate, product liability law for defective products).

Employees allocated to the desired business (and their employment contracts) transfer to the purchaser by law, including all liabilities allocated to the respective employment relationships (including pension commitments), provided individual employees do not object to the transfer.

8.3 Key Differences - Overview

	Share Deal	**Asset Deal**
Purchase Agreement		
Object of Purchase	Shares in the company running the business	Assets and liabilities comprising the business owned by the company running the business
Seller	Shareholder of the company running the business	Company running the business
Formal Requirements	Depends on the corporate form of the company running the business	Depends on the purchased assets
Transfer of…		
Assets	Transfer of all assets (to the extent still owned by the company running the business)	Assets can be cherry-picked (all assets need to be specified)
Contracts	Existing agreements are transferred (NTD: change of control clauses may allow for early termination)	Transfer of agreements requires other party's consent
Employees	Transfer of all employees employed at the company running the business	Transfer by law of all employees allocated to the business. However, transferring employees are entitled to object to the transfer and stay with the company selling the business.
Liabilities	Transfer of all liabilities	Assumption of liabilities with effect of joint liability only, transfer only with consent of creditor.
Commercial Implications		
Accounting	No step-up/adjustment of book values	Step-up of capital values for capital gains and depreciation purposes.
Taxation	Lower transfer taxes Carry-forward of past tax losses (except where change of control rules apply) Seller only pays capital gains tax Purchaser may be unable to offset interest expense against the company's taxable income (unless tax consolidation rules apply)	Higher transfer taxes No carry-forward of past tax losses Potential double tax charges for owner of the company running the desired business (tax may arise on asset sale and on transmission of proceeds to shareholders) Purchaser may offset interest expenses against taxable income derived from assets purchased

9. Restrictions - Limitation

9.1 Sector Related Restrictions

As Germany welcomes foreign investment, mergers and acquisitions by non-EU investors in Germany are subject to very few restrictions. Sector related restrictions only apply for sensitive (mainly military) sectors (see I. 9.2.1) and in very few other cases also for companies in non-sensitive sectors (see I. 9.3).

9.1.1 Companies of Sensitive Sectors

For acquisition of German companies whose field of business activity concerns sensitive sectors, reporting to the Federal Ministry for Economic Affairs and Energy (Bundesminsterium für Wirtschaft und Energie, hereinafter: BMWi) is required by the foreign investor if he plans to hold 25% or more voting rights. BMWi will examine the acquisition and can order any kind of prohibitions or restrictions if the essential security interests of the Federal Republic of Germany will be endangered by the acquisition or participation. Throughout the entire examination procedure the legal transactions are provisionally ineffective, meaning the purchase contract remains invalid until the competent authority has approved the acquisition explicitly or has not ordered any restrictions within one month following the receipt of all documents. Sensitive sector means that the company manufactures or develops:

- weapons of war within the meaning of Part B of the War Weapons List;
- engines or gears to drive battle tanks or other armored military tracked vehicles; or
- products with IT security functions to process classified state information or components essential to the IT security function of such products.

9.1.2 Conditions for Reporting Requirements (Voting Rights)

The foreign investor is obliged to inform BMWi immediately after having concluded a purchase contract to acquire 25% or more of the voting rights. In a public stock corporation (Aktiengesellschaft, AG) generally each ordinary share grants one vote at the annual general meeting (voting right). In a limited liability company (Gesellschaft mit beschränkter Haftung, GmbH) each Euro of a share grants one vote at the shareholder meeting.

9.2 National Security (other Companies in Non-Sensitive Sectors)

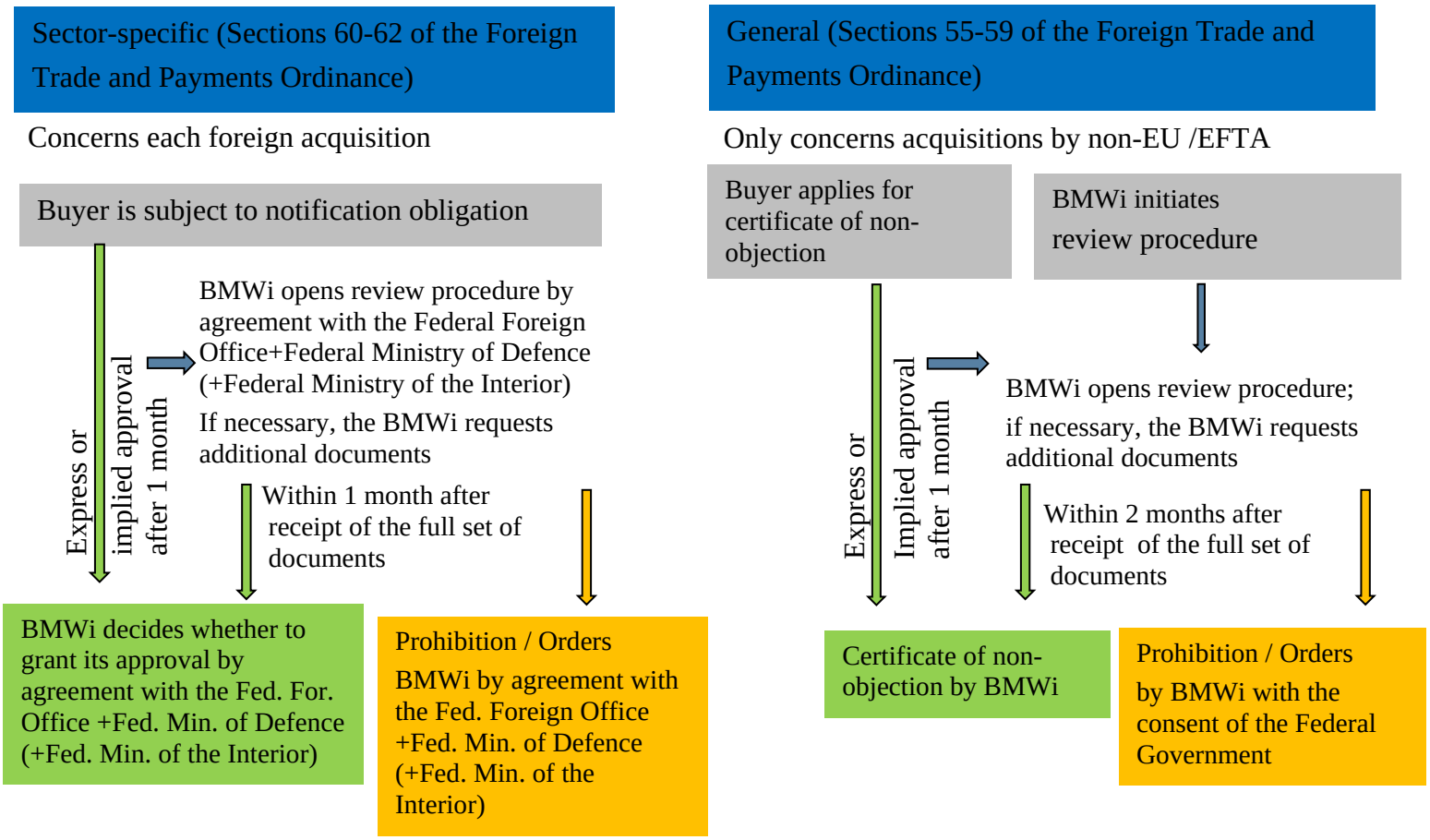
For all other companies whose field of business activity does not concern sensitive sectors (see I. 9.1.1) the investor is not obliged to inform BMWi. BMWi can, however, at its own discretion examine the acquisition and order any kind of prohibitions or restrictions if the public order or security of the Federal Republic of Germany will be endangered. BMWi will only examine transactions where an investor acquires 25% or more of the voting rights (see I. 9.1.2). In case of a cross-sector investment review the purchase contract remains valid throughout the entire examination procedure but the acquisition is subject to the resolutive condition of prohibition: should BMWi prohibit the investment the purchase contract will become void.

To avoid the contractual uncertainty the foreign investor can apply for a certificate of non-objection about the upcoming acquisition or participation in advance. The application shall cite the acquisition, the acquirer and the domestic company to be acquired as well as the basic features of the fields of business of the acquirer and of the domestic company to be acquired. The certificate will be granted if the public order or security of the Federal Republic of Germany is not endangered by the acquisition or participation. If BMWi does not start an examination within one month after it has received the application for the certificate of non-objection, the certificate is deemed to have been issued.

In existing rulings, regarding acquisitions in non-sensitive sectors, the European Court of Justice has expressly recognized that public security of a country is affected when it comes to safeguarding the provision of services in the event of a crisis in the field of important areas such as telecommunication, electricity or services of strategic importance. Therefore, foreign investors that invest in companies that are active in the field of telecommunication, electricity or services of strategic importance should consider applying for a certificate of non-objection.

The German Government assumes that only around ten investment projects are examined ex officio every year. However, the number of examination proceedings initiated at the request of the parties of the company acquisition will be significantly higher, since it can be assumed that in terms of legal security of the transaction the parties will often apply for a certificate of non-objection.

Review of company acquisitions ≥25%



9.3 Merger Control

9.3.1 Legal and Organizational Framework

Rules on merger control in Germany, as part of competition law, are set out in the seventh chapter of the Act against Restrictions of Competition (ARC). The ARC's last restatement was published on June 26, 2013. Besides merger control, the ARC's stipulations cover agreements among competitors, vertical agreements, abuse of market power, subsidies, public tenders, and the wholesale of gas and power as well as petrol. It is a federal law which is enforced predominantly by the Federal Cartel Office (FCO). While state cartel offices exist in the 16 federal states of Germany, they are only competent for competition law cases that do not extend beyond their respective state territories and only when the FCO is not exclusively competent as per the relevant provision of the ARC. § 39 (1) sentence 1 ARC makes provision for such an exclusive FCO competence, thereby making FCO notification necessary in any merger control-related case.

The FCO is an independent higher federal authority with its seat in Bonn. It is assigned to the Federal Ministry for Economic Affairs and Energy. It is headed by a President and consists of 12 decision divisions; three of which are assigned to the prosecution of cartels and other unlawful collaboration among competitors. The competency of the remaining nine decision divisions is subject to the economic sector a particular case can be assigned to. The 7th decision division, for example, takes care of telecommunications – meaning that the 7th division must be notified of any potential telecommunications enterprise acquisition activity.

The decision divisions are independent meaning that it is not possible for the Federal Ministry for Economic Affairs and Energy or the President of the FCO to order a certain decision division to clear or prohibit a certain transaction. The Federal Minister for Economic Affairs and Energy may authorize an FCO-prohibited anti-competitive transaction if "the restraint of competition is outweighed by advantages to the economy as a whole following from the concentration, or if the concentration is justified by an overriding public interest." (§ 42 ARC). This "ministerial authorization" has only been requested 20 times since the introduction of merger control in Germany in 1973, and only been granted eight times. It can lead to highly public and controversial debates.

9.3.2 Notification Requirements

Germany, like most jurisdictions, also requires the notification of transactions in cases where the parties meet certain turnover thresholds. The scope of transactions covered is far reaching in comparison to other jurisdictions.

The FCO examined 1,100 mergers in 2013. Phase II examination was necessary in just 18 cases. Of these 18 cases, six were cleared by FCO. It is therefore advisable to seek the advice of a qualified lawyer to determine whether the competent authority requires notification.

9.3.2.1 Turnover Thresholds

According to § 35 ARC, a concentration is in principle notifiable where (i) the aggregate global turnover of all companies concerned exceeds EUR 500 million and (ii) the domestic turnover of (x) at least one company concerned is more than EUR 25 million and (y) that of another undertaking concerned is more than EUR 5 million.

Exceptions

No filing obligation exists when these thresholds are met when a company that is not an affiliate or subsidiary of another company had a worldwide turnover of less than EUR 10 million in the last business year and the enterprise merges with another undertaking. The rationale for this is that private owners of small companies should be able to sell their business at the end of their working life in instances where there is no heir apparent. This does not apply to the sale of small businesses by major corporations.

Finally, if a concentration also fulfils the - quite high - turnover thresholds for a notification to the European Commission according to Art. 1 of the Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between companies (EUMR), it will not be reviewed by the FCO. However, exceptions do exist where the concentration has a very strong connection to Germany but not to other countries – which is often the case with transactions among the major German utility companies.

Calculation and Allocation of Turnover

§ 38 ARC stipulates rules for the calculation of turnover. For most transactions it provides that turnover equates to the sales derived from normal business activities relating to the sale of

products or the provision of services typical to the company. This would exclude the proceeds from selling businesses etc. from being considered. In addition, intra-group sales, rebates and other customer benefits, as well as value-added and excise taxes, are also deducted. Individual rules governing the calculation of turnover in specific industries – such as trading companies (e.g. the Metro Group), print media, radio, television broadcasting, and advertising – also exist.

When calculating turnover, the question of which companies participate in the transaction is relevant. While special cases do exist, in a normal acquisition scenario the acquirer's group turnover is taken into account. On the seller's side, only the turnover of the acquired company or business will be included - not the seller's turnover from remaining activities.

9.3.2.2 Concentration

§ 37 ARC explicitly sets out what constitutes a concentration. Besides the somewhat universal concepts of the acquisition of either (i) all or a substantial part of the assets of another company, or (ii) the direct or indirect control of a company (§ 37 (1) Nr. 2 ARC), there are two specific German law concentration types not present in many other legal systems:

Firstly, § 37 (2) Nr. 3 ARC provides that a concentration takes place where a company buys either more than 25% or more than 50% of the shares in another company. This is not dependent on the acquisition of control, i.e. acquisition must be notified even where a company buys 26% of the shares in another company but the seller (and former sole shareholder) maintains a 74% share and the right to decide on all major items alone as the decision quorum is 51%.

Secondly, and more peculiar to Germany, "any other combination of companies enabling one or several companies to directly or indirectly exercise a competitively significant influence on another company" is deemed a concentration. There is general consensus that this only applies in cases where there is a "corporate law foundation", i.e. either a share acquisition below the 25% threshold or special voting rights in the company. An example of this would be a scenario in which a company's most important supplier/customer acquires a 10% shareholding. This company's minority shareholding in the company would have more significance than any other 10% shareholding as a result of the company's important business ties to this shareholder. As such, this could be notifiable. The FCO is open to discussing cases of this nature beforehand.

9.3.3 Procedure

§§ 39-41 ARC govern the notification procedure. As with many other merger control laws, the ARC provides for an obligation to file and requires the companies to suspend the implementation of the transaction prior to clearance - unless a waiver to the suspension requirement is granted. The FCO's procedure is very efficient, requiring less information and documentation for a complete notification than is the case in many other jurisdictions with simple cases often being resolved within a matter of days.

9.3.3.1 Notification

There is no specific notification template. § 39 (3) ARC and informal guidelines of the FCO set out what is required in the notification which, by law, would not even have to be in writing. A notification has to contain:

- name or other designation and place of business or registered seat;
- type of business;
- turnover in Germany, the European Union and worldwide;
- market shares, including the bases for their calculation or estimate, if they overlap and exceed 20%;
- in the case of an acquisition of shares in another company, the size of the interest acquired and of the total interest held;
- named individual authorized to accept service in Germany if undertaking is not registered in Germany.

There is no need to submit any transaction documents, the value of the transaction, information on competitors, customers and suppliers in routine notifications. In practice, the companies usually provide market shares for overlapping activities as well as competitors – regardless of share size. In simple cases, the FCO normally requests an extra set of information, with the extent of information requested being made on a case-by-case basis.

9.3.3.2 Timetable

The FCO has one month to review the transaction upon receipt of the complete notification. The FCO may not prohibit the concentration should it fail to inform the companies that it will open an examination ("main examination" proceedings) of the concentration during this period

(§ 40 (1) ARC). Main examination proceedings are initiated in those cases where a closer inspection of the concentration is required. In practice, parties to a challenging transaction try to avoid this scenario by entering into discussions with the FCO prior to submitting the notification. In these meetings, the parties explain the details of the concentration and also provide market share and other competitively relevant information to alleviate any concerns that the FCO may have and/or recommend and negotiate conditions/obligations.

Should main examination proceedings be initiated, the FCO must issue a decision within four months of receipt of the complete notification, as the transaction will otherwise be deemed to be cleared. A recent feature in German merger control law is the advent of a "stop-the-clock-mechanism" in the event of formal requests during this second phase. However, this only applies to the extent that the parties are culpable in not responding in timely fashion or submitting incomplete information. The four-month period is prolonged by an additional month in cases where the companies offer remedies.

9.3.3.3 Remedies

Besides clearance and prohibition, the FCO can also clear transactions with conditions and obligations (§ 40 (3) ARC). The ARC authorizes the FCO to accept remedies if they effectively resolve the competition problem, provided that they do not require a permanent monitoring of the respective parties’ behavior by the FCO. Consequently, a broad range of alternative business scenarios is possible as long as the company effectively remedies the competition concerns raised by the concentration. However the FCO, like many regulators, favors divestitures. This usually requires the parties to present a viable buyer. The transaction is only authorized subject to the FCO’s approval of the proposed buyer, subject to the divestment being completed with a period of time (typically six months) set by the FCO. It is also common practice for the parties to be required to appoint a divestiture trustee to ensure that all activities are fully compliant with the FCO decision.

9.3.3.4 Possible Fines

Personal fines of up to EUR 1 million and company fines of ten percent of total worldwide group turnover in the last business year can be imposed due to failure to notify, incomplete notification and closure before clearance. The FCO enforces this rigorously subject to company level of culpability. First-time failure to file by a non-German company will usually be met with a stern

letter and a request to file immediately, but repeat offenders and companies with substantial activities in Germany will usually receive fines - both private individuals and companies alike.

9.3.4 Material Merger Control

9.3.4.1 Substantive Test

According to § 36 ARC, the FCO must prohibit a concentration where it results in a significant impediment on effective competition (SIEC) - in particular by creating or reinforcing a dominant position unless certain exemptions apply. This SIEC test was introduced mid-2013. Prior to this, only the dominant position was relevant. The new criterion, which is very much in line with the EUMR, is especially aimed at effectively dealing with situations in which the market is characterized by an oligopoly, i.e. only a few players are active and the merger of two may create a situation for the remaining competitors where not competing is potentially more profitable than competing against each other. The test is also considered by the legislator to have more relevance in conglomerate and vertical merger situations, as such transactions do not directly result in an accumulation of market power. For instance, a powerful but not dominant player who acquires a key industry supplier would not necessarily enjoy a position of dominance but would nevertheless be in a position to inhibit competitors by indirectly raising supplier prices through the purchased company.

9.3.4.2 Dominance

Despite these changes, dominance still plays an important role in the permissibility of concentrations. § 18 ARC sets out rebuttable presumptions of dominance that also apply in the merger control area. According to these provisions, a single company is presumed to be dominant if it has a share of 40% or more. In those instances where a concentration leads to the acquirer obtaining or assuming control of a 40% market share, the companies usually provide detailed information in the notification to rebut the dominance presumption (e.g. strong fluctuation of market shares, new competitors, strong customers/suppliers, etc.). Market definition is extremely important. The FCO has its own history of decisions but usually adheres to or is at least receptive to the decisions of the European Commission. While only the FCO decisions taken during main examination proceedings are published, guidance on the FCO’s point of view can also be found in its activity reports. Moreover, the Monopolies Commission, an independent body tasked with making observations on inter alia merger control in Germany, publishes corresponding reports every two years and also reports on non-published decisions.

9.3.4.3 Defenses

The FCO must prohibit any transaction where a significant impediment to effective competition has been identified with the following exceptions:

- The companies concerned prove that the concentration will improve the competitive environment and that these improvements outweigh the impediments to competition caused by the concentration.

- The transaction is in a market in which goods and/or commercial services have been offered for at least five years and which has a sales volume of less than EUR 15 million in the last calendar year. This so-called “Trivial Markets Clause” also applies where the market in question may, for instance, be international in nature but the segment in Germany has a value of less than EUR 15 million. In some cases, the FCO has argued that several such trivial markets can be combined to form one larger market, making the exemption unavailable where the markets were geographically or substantively related.

- Special rules applying to publishers of newspaper and magazines.

9.3.5 Notification of the European Commission

Subject to the turnover of the respective companies and the markets affected by the transaction, merger projects have to be formally notified in writing to the European Commission (hereinafter “Commission”). For details on the turnover threshold levels that require notification to the FCO see I. 9.2.2 above.

The Commission has to be notified if either

(i) the combined worldwide turnover of the companies exceeds EUR 5,000 million, and
(ii) the EU-wide turnover of each of at least two participating companies exceeds EUR 250 million

or

(i) the aggregated combined worldwide turnover of the parties exceeds EUR 2,500 million, and

(ii) the EU-wide turnover of each of at least two participating companies exceeds EUR 100 million, and
(iii) in each of at least three EU member states the combined turnover of the participating companies exceed EUR 100 million, and
(iv) at least two of the participating companies exceed a turnover of EUR 25 million each in at least three of these member states.

The European merger control proceeding consists of two phases. In phase I, the Commission has to decide within 25 working days if the notified merger raises any competition concerns and whether to conduct an in depth phase II investigation. After the decision on commencing a phase II investigation has been made, the Commission has another 90 days to come to a conclusion. As a result of the investigation, the Commission can either prohibit, clear or clear the merger only subject to conditions and/or obligations.

If the decision of the competent authority is not submitted within the stated investigation period for phase II, the merger is deemed to be cleared. If the Commission requests further documents, the time limit will be suspended until the competent authority receives the documents. In all cases where a notification to the Commission is required, the transactions may only be enforced after the Commission has cleared them.

9.3.6 Summary

- The FCO has exclusive jurisdiction for merger control in Germany.
- Transactions with limited impact in Germany (target has sales of less than EUR 5 million) are not subject to German merger control.
- German merger control law also captures minority participations above and, in certain circumstances, even below 25%.
- The FCO’s procedure is very lean and efficient.

The FCO examined 1,100 mergers in 2013. Phase II examination was necessary in just 18 cases. Of these 18 cases, six were cleared by FCO. It is therefore advisable to seek the advice of a qualified lawyer to determine whether the competent authority requires notification.

9.4 Notarization

M&A Transactions can be subject to notarization that needs to be performed by an officially appointed German Civil Law Notary. Such notarization is not only a superficial “stamping activity” but a rather serious affair. The notary is – contrary to the legal counsels of the seller and the purchaser – strictly neutral and needs to balance the interests of the parties to the Sales and Purchase Agreement (SPA) and to make sure that their intentions are properly reflected in the notarized documentation.

If and to which extent a share purchase and transfer agreement needs to be notarized depends on the kind of participation to be acquired: Whilst participations in a stock corporation (Aktiengesellschaft, AG), a limited partnership (Kommanditgesellschaft, KG) and/or certain other company forms in Germany can be sold and transferred by a written or even an oral agreement, the sale and transfer of shares of a German limited liability company (Gesellschaft mit beschränkter Haftung, GmbH) is subject to a notarial recording. Notarization can also be required in case of an asset deal in which real estate property is part of the asset portfolio.

German law distinguishes strictly between the contractual commitment to transfer shares (the purchase agreement, so-called *Verpflichtungsgeschäft*) and the transfer of the shares itself (the so-called *Verfügungsgeschäft*). Both agreements need to be notarized in case shares in a GmbH shall be sold and transferred (cf. Sec. 15 para. 3 and 4 German Limited Liability Companies Act (GmbHG)). In order to be valid such agreements need to be recorded (*beurkundet*) by a German Civil Law Notary. Such notarial recording is performed by reading loud the whole content of the SPA by the notary (including all agreements, side-agreements and annexes of economic relevance) to all parties of such agreement. If such contract is or parts thereof are not recorded in such way by a German Civil Law Notary it is/they are invalid and unenforceable.

Notarization is also required for other contracts containing a commitment of one/two or several parties only, i.e. in case of contracts granting an option to sell (put option), an option to purchase (call option) or grant a pre-emptive right (*Vorkaufsrecht*). Such requirement also applies to pre-contracts (*Vorverträge*) which include a contractual commitment to enter into a final contract at a later stage and even for so-called letters of intent if these have a binding effect to transfer shares. Due to the jurisdiction of the German Federal Court of Justice (Bundesgerichtshof, BGH) the notarial recording is extended to any contracts that are connected with the SPA from an economical view of the parties (for example a loan agreement between the purchaser and the target company to be entered into in the course of the acquisition) (so-called *Gesamtzusammenhang*). A few exceptions exist for balance sheets, inventory lists etc. but

besides that the notarization of a larger transaction with extensive documentation will last for several hours until the signatures of the parties can be made as all documents have to be read out loud. Often the attachments to the SPA are notarized in advance with special representatives from the notarial office within so-called reference deeds (*Bezugsurkunden, Verweisurkunden*) and the parties ratify such reference deeds in the SPA.

The statutory requirement of notarial recording is mandatory and the articles of association of the target company cannot modify such requirement. However, the articles of association often contain additional formalities for the transfer of shares, i.e. the prior consent of the shareholders' meeting, of one or several specific shareholders, of a supervisory board if one has been set up or of the company itself (represented by the management board). The articles of association may furthermore provide certain pre-emption rights of the other shareholders or even third parties which need to be complied with. The notary also checks such pre-conditions and cautions the parties of any obstacles in this regard.

While the transfer of shares is valid vis-à-vis third parties upon execution of the SPA (or if conditions precedent incorporated in the SPA have been fulfilled) the rights and obligations vis-à-vis the target company itself may only be exercised by the purchaser if he is filed in the list of shareholders. The notary is also the person who is responsible for updating the shareholders' list. It has to be filed by him with the electronic commercial register immediately after a transfer of shares has become effective and he has to certify that the changes made correspond to the changes he has notarized and that the further contents of the list correspond to the last list of shareholders filed with the commercial register (Sec. 40 para 2 GmbHG). As such list has to be filed after the fulfillment of all closing conditions stipulated in the SPA the notary has to supervise such fulfillment of the closing conditions, e.g. it is often his obligation to notify the purchaser when the payment of the purchase price is due. The notary may also monitor payments and set up escrow accounts.

Notarial fees are based on a statutory fee schedule and are not negotiable. The fees are based on the economic value of the transaction determined by either the value of the shares or the purchase price to be paid. If the value of the transaction exceeds the maximum amount of EUR 60 million the notarial fees are capped at an amount of EUR 53,170 (plus VAT).

Given that, it is (for both parties (!)) always a good suggestion, in particular in case a notarization shall be performed in English or another foreign language, to find a German notary with a long standing experience in the field of M&A transactions who can handle the process swiftly and in a neutral way.

If a foreign party's representative is not able to attend notarization in person such party can be represented by an attorney during the notarization and reading process. The power of attorney needs to be signed by the representatives (e.g. the management board) of such party. According to German law there are – in most transactions – no formal requirements for such power of attorney (cf. Sec. 167 para. 2 German Civil Code, *Bürgerliches Gesetzbuch, BGB*). Nevertheless, in certain cases a certification of the signatures of the managers is required (e.g. if real estate properties are part of the portfolio of an asset deal). The certification can either be done by a German embassy/consulate (anywhere in the world) or by any other notary (anywhere in the world). If the power of attorney is certified by a notary than – depending on the country of signature – an apostille or legalisation will be required additionally (e.g. China = legalization whereas an apostille is sufficient in Hongkong and Macao). Also, further proofs of the existence of a foreign selling/purchasing company as well as the power of representation of the managers signing the power of attorney are required in certified and apostilled/legalized form (e.g. notarized excerpt from the local registry court where such company is registered, certificate of incorporation, certificate of good standing etc.). It is helpful to clarify prior notarization which proofs will be needed by the notary as the procurement of such proofs can be very time consuming (depending on the respective foreign country). As the respective clerk at the land register (*Grundbuchamt*) does not accept such proofs in a foreign language these documents need to be translated by a certified translator into German in advance.

9.5 Commercial Aspects

Please refer to I.8.

10. Structure of Relevant Authorities

10.1 General, Interface Aspects

Merger & Acquisition activities are regulated and supervised by different authorities, depending on the sector and the volume of the acquisition (c.f. I.9.1 to I.9.2). Other authorities on national and local scale are in charge of the regular operation of the company.

10.2 Sector Related

10.2.1 Authorities in Charge of the Approval of the Acquisition

The Federal Cartel Office (Bundeskartellamt, FCO)

FCO is to be notified if a merger reaches the respective turnover threshold and affects the German market. For details on the turnover threshold see I. 9.3.

The European Commission (Commission)

The Commission is the competent authority for all mergers that reach a certain turnover threshold and affect the European market. For details on the turnover threshold see I. 9.3.5.

The Federal Ministry of Economic Affairs and Energy (Bundesministerium für Wirtschaft und Energie, BMWi)

BMWi as competent authority has to be notified before an acquisition or participation of at least 25% of the voting rights in a sensitive sector, it might then review the planned transaction.

BMWi may also, at its own discretion, conduct an examination on whether an acquisition of at least 25% of the voting rights endangers the public security or public order of the Federal Republic of Germany.

BMWi also is the competent authority if an acquirer wants to apply for a certificate of non-objection.

Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungs-aufsicht, BaFin)

BaFin is responsible for the clearance of planned acquisitions or participations of at least 10% of the voting rights of a company from the banking sector.

10.2.2 Authorities in Charge for the Regular Operation of the Company

Local Trade Office (Gewerbeamt, LTO)

For some industries, for example in the security or catering industry, a trade-certificate has to be obtained. This certificate can be obtained at LTO. A new trade certificate only needs to be obtained if the general manager or members of the board of directors change due to an acquisition.

BaFin

BaFin is the competent authority for license for insurance companies of high economic importance. The license does not need to be renewed if the members of the board of directors change due to an acquisition, but BaFin needs to be notified in writing depending on the field of insurance the company is involved in. Economically important health insurance companies are obliged to notify BaFin, for example.

Other Local Authorities

For the license to produce medicine, to produce or trade weapons, to operate insurance companies which are not of high economic importance and for licenses to operate an installation that causes emissions different local authorities are competent depending on the State the business or installation is located in. For example in the State of Bavaria, the Bavarian government is the competent authority for a license to operate a power plant, a hot water supply installation and other installation of public supplies, for all other installations, the district administration is in charge.

10.3 Assistance to Foreign Investors

There are many service providers in Germany, public and private, which may assist Chinese investors who intend to enter the German market through M&A. Which one to approach will mainly depend on the Chinese investor's own capabilities, the status of preparatory work and his corresponding needs.

Often sought sources of information and assistance include:

- the department for outbound investment promotion of the Ministry of Commerce (MOFCOM);
- the MOFCOM departments of the Chinese Embassy and Chinese Consulates in Germany
- the German Chambers of Commerce in the People's Republic of China;
- GTAI Germany Trade & Invest;
- GIGA German Institute of Global and Area Studies;
- the German chambers of industry and commerce ;
- the business development associations of the various German countries (e.g. Invest in Bavaria, Business Development and Technology Transfer Corporation of Schleswig-Holstein, etc.);
- Chinese banks being active in Germany, in particular their M&A departments;
- German banks in the People's Republic of China and in Germany, in particular their M&A departments;
- Investment banks being active in Germany;
- Accounting firms being active in Germany;
- Corporate finance and M&A advisors being active in Germany;
- Law firms active in Germany.

Though the German market is a unified one, there is a tendency that certain industries concentrate in certain regions ("industry clusters"). In many cases this is due to the location of resources and infrastructure (e.g. steel business in North Rhine-Westphalia). Following the reunification of East and West Germany various regional infrastructure and business facilitation programs were introduced resulting in a disentanglement of historical clusters and the

establishment of new ones (e.g. in addition to Bavaria and Baden-Württemberg automobile production can be found in Sachsen nowadays).
It therefore may well be reasonable for Chinese investors to first get an overview and investigate where to invest and what aid may be received from the relevant locations. If it comes to the search for a target one will have to bear in mind that the German market is still dominated by small- and medium-sized enterprises (SME) which are often privately run, non-listed and publicity adverse (for which reason some are referred to as “hidden champions”). Without intimate knowledge of the market, it is difficult to identify and approach suitable targets. Professional service providers may facilitate the target search, negotiations and implementation of the M&A process.

10.4 Environmental

Please refer to II.3.5.

II. M&A Process - Share Deal

1. Identification of Targets

A successful M&A transaction requires the identification of a suitable acquisition target. Whether a target is suitable or not depends on the buyer's strategic outlook and expectations vested in the specific project. Based on these presuppositions, the buyer will develop a profile of possible target companies, looking at aspects such as the type of activity, company size, market position, production range, and other economic and specific company-related considerations.

It is especially important to acquire comprehensive and in-depth information when identifying suitable targets. Useful M&A-related services – mainly restricted to the provision of information (cf. Chapter 10.3) – are available in the public sector. However, M&A projects are typically implemented with the support of an M&A services provider. Particularly relevant services include strategy development, target finding, due diligence, transaction implementation, and post-merger integration. The specialist fields of law, tax, and financing are at the center of these services.

The question as to whether and to what extent such service providers are integrated in an M&A project depends on the internal professional resources available, experience levels, and the complexity of the project.

1.1 Who to Assist

Please refer to I.10.3.

2. Preparatory Activities

2.1 Options for Transaction Structure

2.1.1 100% Acquisition versus Joint Venture

Generally speaking, there is no ceiling on the proportion of shares held in German companies by foreign investors. However, restrictions apply for the acquisition of 25% or more of the voting rights if the target's business activities fall within certain sensitive (mainly military) sectors or where such acquisition endangers national security (please refer to sections I.9.2.1 and I.9.3 for details).

While upon the acquisition of all shares in the target company the investor is in full control of the target company, the acquisition of only a portion of the shares in the target company results in a joint venture among the investor and the remaining shareholder(s) of the target company. In a joint venture, the investor will have to leave a certain amount of control over the target company to the remaining shareholder(s) or, depending on the circumstances, may exercise joint control together with the remaining shareholder(s). At the same time, the remaining shareholder(s) still participate in the target company and therefore have an incentive to grow the target company.

Under certain circumstances it may be useful to combine the acquisition of a portion of the shares in the target company with the grant of a call option to acquire additional (e.g. all remaining) shares in the target company at a later stage. The remaining shareholder(s) may require the grant of a put option in return for the grant of a call option to the investor. However, since the development of the target company until the exercise of the option is hard to predict, it is difficult to agree on a fixed purchase price or a pricing formula for the option shares acceptable for both parties.

2.1.2 Technology / Trademarks

Sometimes technology and trademarks used by the target company do not belong to the target company but to the owner of the target company. In this case, to safeguard the continued use of technology and trademarks after the acquisition, the investor needs to in-license the relevant

technology or trademark from the owner of the target company (please also refer to section II.3.2).

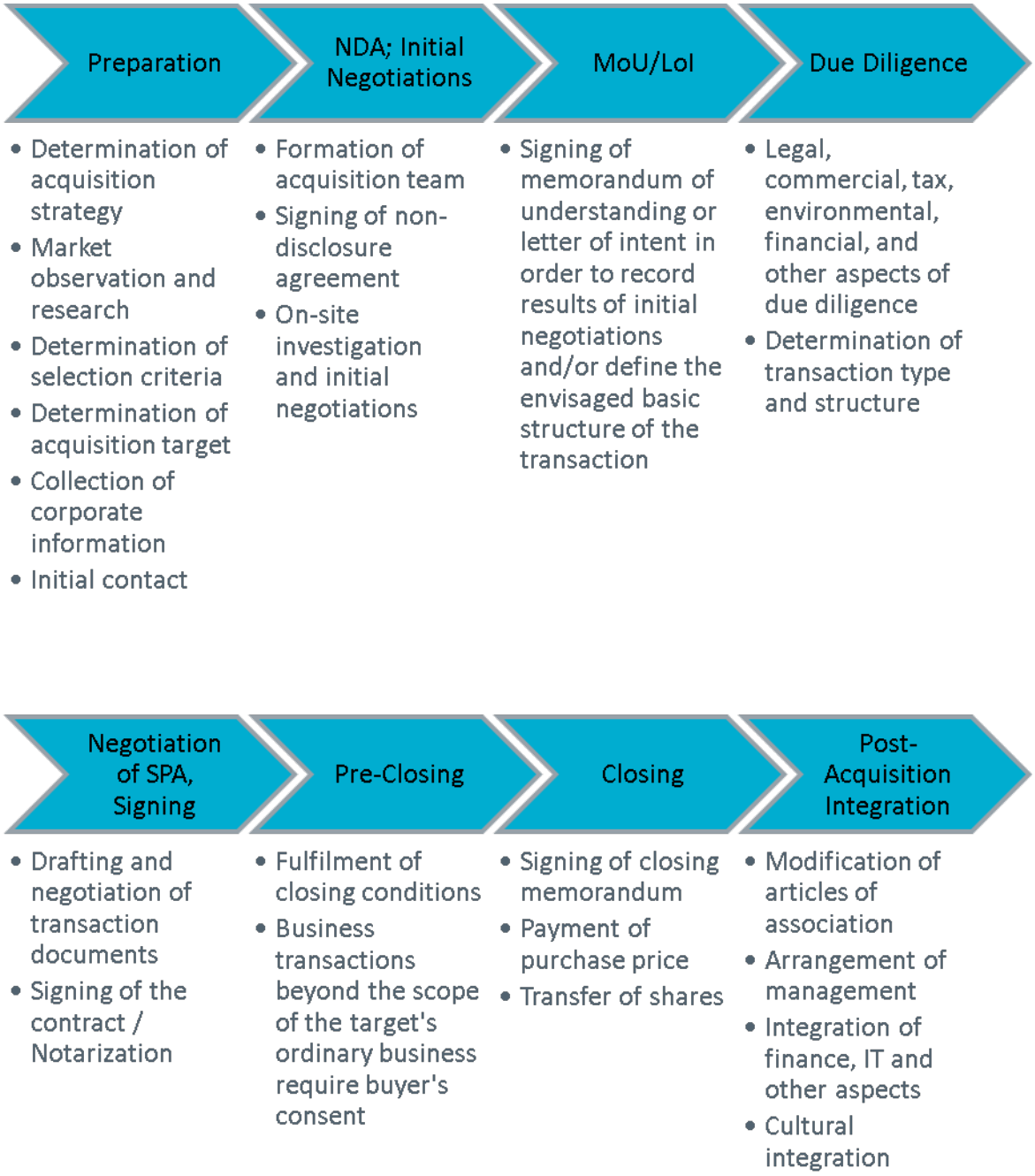
2.1.3 Direct Acquisition Versus Acquisition by Special Purpose Vehicle

Instead of directly acquiring the shares in the target company, the investor may choose to make use of a special purpose vehicle (the SPV), i.e. a subsidiary of the investor that acts as the acquiror of the shares. This way, the investor can try to insulate himself from the transaction risk.

Another benefit of the use of an SPV, in particular where shares in multiple target companies are to be acquired, is that the acquisition is bundled in the SPV. Whenever the investor wishes to resell the acquired shares at a later stage, he will be able to do so by simply transferring his shares in the SPV. The downside of an SPV structure, however, is that if the seller deems the capital resources of the SPV insufficient to bear the liabilities arising out of the transaction, he is likely to ask for additional security, e.g. in the form of a guarantee issued by the investor or a bank.

2.2 Establishing Transaction Structure

2.2.1 Timeline



2.2.2 Approvals

The closing conditions addressed in the timeline above under "Pre-Closing" often include the granting of approvals by public authorities, e.g. German, European, or other foreign merger clearances (please refer to section I.9.3 for details), or by corporate bodies, e.g. the shareholders' meetings or the supervisory boards of the parties. In addition, the acquisition is subject to review and, in exceptional cases, prohibition if as a result of the envisaged transaction the investor would acquire 25% or more of the voting rights in a German company and such acquisition would endanger public order or safety (please refer to section I.9.2 for details).

Of course, the investor must meet the requirements under Chinese law regarding foreign investments.

2.2.3 Memorandum of Understanding

The memorandum of understanding (the "MoU") or letter of intent (the "LoI") describes the envisaged basic structure of the transaction which may include the purchase price (fixed purchase price, price range or a price formula), a target closing date, post-transaction management changes, along with exclusivity provisions (clauses that prevent the seller from negotiating with other potential buyers for a specific period of time). Although a MoU or LoI will never cover all aspects of the transaction in full detail, it is an important step in aligning both parties’ expectations. This is of particular importance given that the due diligence that will follow as a next step (please refer to section II.3 for details) is an expensive and time-consuming exercise on the part of the investor. Whether or not the MoU or the LoI is legally binding depends on the wording of the individual document.

2.2.4 Preparing an Special Purpose Vehicle: Shelf Company Versus New Company

Where the investor chooses to make use of a SPV, he can choose between two different ways of obtaining an SPV that has so far not carried out any business activities. The investor may either decide to establish the SPV by himself (the "New Company" or NewCo) or he may acquire a ready-to-use shelf company from one of the specialist providers of such companies. While the acquisition of a shelf company will be slightly more expensive compared to setting up a NewCo, it can save the investor time as compared to a NewCo (for a more detailed comparison please refer to section I.4.2, subsection 1.5). Therefore, a shelf company is the SPV of choice whenever time is of the essence.

2.3 Corporate Structure

2.3.1 Internal Corporate Structure of the Target Company: Ensuring Sufficient Control Rights

If the investor does not acquire 100 % of the shares of the target company, he needs to ensure that the articles of association of the target company (and, if applicable, the shareholders' agreement / joint venture contract) provide him with a sufficient amount of control over the target company. Where the target company is a GmbH, a simple majority of the voting rights in the shareholders' meeting is sufficient to pass resolutions pertaining to the day-to-day business. Fundamental decisions require a 75% majority in the shareholders' meeting. For information on the position of the shareholders' meeting within the governance structure of a GmbH please refer to section I.4.2, subsection 1.2.

2.3.2 Integrating the Target into the Investor's Existing Corporate Structure

If the investor exists in the form of a group of companies that share centralized services (such as accounting, IT, etc.) and / or that are parties to a cash pooling agreement, the investor must decide whether the target company shall be integrated into the existing structure of the group. The degree of such integration will have impact on crucial aspects such as accounting and taxation.

Investors should also take into consideration that any repatriation of profits from Germany to China is subject to Chinese capital control.

2.4 Financing

There are different types of financing an acquisition. The investor could fund its acquisition by its money (equity). It could also borrow money from one or more third parties for funding its acquisition or it combines its own funding with borrowings to finance the purchase price. If the acquisition is financed through borrowings (debt), it is called leverage or acquisition finance depending on whether the amount of debt raised is significant in the context of the overall business. Typically, banks are involved either by lending to the sponsor or investor directly or

indirectly to entities held by the investor. Such entities only used for the acquisition purpose are so called special purpose vehicles (SPVs).

The investor could benefit from leveraged financed transactions in two ways. First, the investors may only need to partially fund a transaction which means the investor could split its investment risk by investing in different entities or the investor could invest in larger entities. Secondly, assuming the economic internal rate of return on the investment exceeds the weighted average interest rate on the borrowings, the returns on investment are considerably enhanced. Larger funding of leverage finance is typically raised through syndicated loans and / or high-yield-bonds where smaller acquisitions may also raise funding through mezzanine debt and / or vendor loan notes. Additionally, there are many more types of financial instruments which can be combined.

Legally, the above mentioned types of financial instruments need to be documented. The content of such documentation should mirror the common understanding of the parties. Such agreements do not only refer to the financial mechanisms but also to the risk allocation between the contracting parties.

Naturally, the finance documentation varies from transaction to transaction. The Loan Market Association (LMA), however, has established a certain market standard for such finance documentation. The LMA is a private organization founded by banks in December 1996 and is the trade body for the European, Middle East and African (EMEA) syndicated loan market. Many of the major deals are originally based on the LMA documentation. With respect to German related transactions, either German or English law is commonly used as the governing law for the contractual finance documents.

The typical documentation for a leveraged acquisition finance transaction would consist of the following documents:

- the (senior) facility agreement setting out the individual terms and conditions on which the borrowings (the facilities) are made available to the borrowers;
- the underlying security documents creating, or expressing to create, any security over all or any party of that obligor’s assets as agreed in the facility agreement;
- the intercreditor agreement structure the relationship between creditors, especially when creditor rights in accordance with the facility agreement could be enforced.

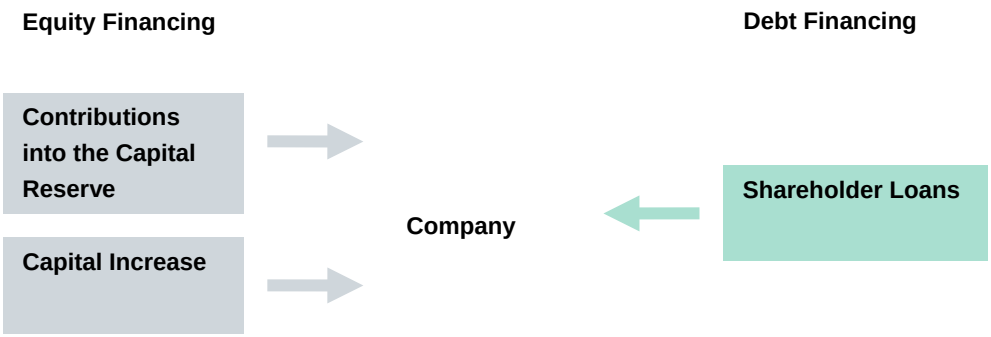
Additionally, there are further documents like structural intra-group loan agreements, mezzanine facility agreements, hedging letters and other documents such as the genuine acquisition

documents (any public offer documents or share / asset purchase agreement); corporate authorizations etc.

The aforementioned types of documents should only be named as an example to provide an understanding that the pure contractual financial documentation is sophisticated and needs careful drafting. Beside the aspect of careful drafting, overall legal aspects shall be considered. For example, although legally and contractually possible, intra-group guarantees may be voidable in an insolvency scenario, subject to specific requirements.

If a German publicly listed entity is the acquisition target, there are frequent overlaps between the finance requirements by the financial sponsors and the public offer. In such cases, the transaction becomes subject to material regulatory impact. For example, already when announcing the public offer, the offering investor will inter alia be required to submit a financing confirmation issued by a recognized financial institution confirming investor's availability of sufficient funds (debt / equity) for the offer.

2.5 Special Requirements - Financing a German Subsidiary



Equity Financing

Unlike Chinese investment and company law, German law does not provide for a certain ratio between the total investment and the registered capital (equity) of a company. German statutory

law does not provide for a duty of the shareholders of a corporation (GmbH and AG) or the partners of a limited partnership to inject additional equity. However, such obligations can be established by agreement between the shareholders or partners.

Generally, the equity of a company can be increased e.g. by way of

- attributing (a part of) the annual profits to the capital reserve of the company;
- contributing assets or cash into the capital reserve of the company, or;
- increasing the registered capital (corporations only).

Pursuant to statutory law, contributions to increase equity are not interest-bearing.

The measure of choice to increase equity depends on the specific needs of the company and the shareholders as well as requirements imposed by third party investors or creditors requesting e.g. a certain debt/equity ratio.

The increase of equity by way of attributing annual profits to or contributing assets or cash into the capital reserve tends to be easier compared to an increase of the registered capital of a corporation. Such equity injections do not require the involvement of the commercial register and do not require the amendment of the articles of association. Furthermore, the capital reserve may be released and the injected funds may be paid back relatively easily – provided, of course, that the funds are still available.

The increase of the registered capital is only possible for corporations. Such measure is more time consuming and cost intensive (a notarized shareholders’ resolution is required and the capital increase becomes legally valid only upon registration in the commercial register). Furthermore, the shareholders are entitled to subscribe to new shares which are issued due to such increase of the registered capital and, therefore, must either subscribe to such new shares or waive their respective rights to subscribe to such new shares. The respective contributions to the equity cannot be paid back easily. Such contributions become part of the registered capital which is protected by specific provisions of statutory law against being paid back to the shareholders. The registered capital needs to be decreased, which also requires a notarized shareholders' resolution and registration in the commercial register and is subject to further legal requirements.

2.6 Investment Protection

Since 2006 China and Germany have mutually offered investors of the other state investment protection according to the "Agreement on the Encouragement and Reciprocal Protection of Investments". This agreement safeguards the property and investment of investors in the other country by guaranteeing protection against expropriation, the free transfer of capital and profits, and the right to be treated in the same way as a national of the host country. The investment protection agreement stipulates the possibility of arbitration proceedings in the investor's state in cases where the investor considers his or her protected rights to have been violated by the host state.

The current agreement between China and Germany will be repealed once the investment protection agreement between China and the EU, which has been negotiated, is signed and ratified.

3. Due Diligence Items

3.1 Corporate Formation

For the purpose of reducing the scope of the information provided hereunder, the following outline refers to stock corporations (Aktiengesellschaften, AG) and limited liability companies (Gesellschaften mit beschränkter Haftung, GmbH) under German law only.

The review of the corporate formation of the relevant target company or target group of companies is an essential element of any legal due diligence. Such review has to focus, in particular, on the following items:

- formation of the target company itself;
- business scope and business license (if any);
- (major) changes in the corporate structure, including acquisitions, disposals and restructurings;

- chain of title in the target company's shares;
- dominating and profit and loss transfer agreements pursuant to Sec. 291 et seq. AktG (P&L- Agreements).

Any such review of the target company has to extend to the target company's subsidiaries and/or its affiliated companies which are an (indirect) part of the acquisition. In practice this requires quite often the review of companies existing under the laws of foreign countries. Any buyer has to check with its German legal counsel whether the due diligence on such foreign companies may be undertaken by this counsel itself (if it is an international law firm) or by an independent law firm and, in the latter case, whether such independent law firm is directly mandated by the buyer or indirectly mandated by the (German) law firm.

3.1.1 Formation of the Target Company Itself

The initial questions in a corporate law due diligence have to focus on the validity of formation of the target company itself. The shareholder of the target company has to provide information on the formation as such, in particular the articles of incorporation (*Gründungssatzung*). Further, it has to be checked whether the target company's shares have been validly subscribed by the founding shareholders. In that context it has to be evidenced that the initial share capital has been effectively paid in and that the shares have effectively been subscribed. Some of this information is generally available in the German commercial register (*Handelsregister*), however, not all.

3.1.2 Business Scope and Business License

It is important to note that there is, unlike in China, no general obligation of a company to obtain a business license from any authorities in order to be effectively established and to conduct its business operations. There is a general economic freedom (*Gewerbefreiheit*) under German law.

Further, there is no ultra vires rule under German corporate law pursuant to which any acts attempted by a corporation that are beyond the scope of powers granted in particular by its articles of association are void or voidable. Therefore a due diligence need not to focus specifically on acts (in particular contracts) which may be beyond such powers granted, even though the target company's management may have violated its obligations towards the company by conducting acts falling outside the scope provided for by the articles of association. The target company's business scope is, however, of particular importance in business areas regulated by law (e.g. military sector). If the business scope indicates that the conduct of the

target company's business has to be approved by certain authorities, the buyer should pay specific attention to the fact whether any necessary approvals have been obtained, are still valid etc.

3.1.3 (Major) Changes in the Corporate Structure

Any buyer has to validate whether (major) changes in the target company's corporate structure have taken place. This includes, in particular, acquisitions, disposals and restructurings. A buyer has to check whether any changes to the target company's articles association are valid and, in particular, whether such changes have effectively been undertaken in front of a notary and validly registered in the commercial register. Notably with regard to a contemplated acquisition of a (publicly listed) stock corporation it may be checked whether such company was initially established as a limited liability company and whether the conversion to a stock corporation is valid pursuant to the German law regulating the transformation of companies (Umwandlungsgesetz, UmwG). If so, a corporate due diligence has to be extended to the accomplishment of the provisions of this law.

3.1.4 Chain of Title in the Target Company's Shares

A further essential element of a corporate due diligence is the review of the target company's chain of title as regards its current shareholders. It has to be checked whether any transfer of shares has taken place (either in the context of an increase of the target company's share capital or by virtue of a transfer of existing shares) and whether such transfer is valid. Even though the buyer should always seek for a guarantee in the share purchase agreement that the to-be-acquired shares in the target company do exist and that the seller is the lawful owner of these shares, such guarantee does not render a careful determination of the target company's chain of title superfluous.

With regard to GmbHs it is important to note that although a GmbH has to have a list of shareholders (*Gesellschafterliste* pursuant to Sec. 40 GmbHG), such list is only an indication for the accuracy of the current shareholding structure, but not an evidence of the chain of title in any given case (cf. Sec. 16 GmbHG). If the target company is a stock corporation it may have bearer shares (*Inhaberaktien*) and/or name shares (*Namensaktien*). Transfers of such types of shares follow different rules and, thus, have to be reviewed separately in the due diligence. A buyer has to note that stock corporation's shares do not have to be chartered (*verbrieft*).

3.1.5 Profit and Loss Transfer Agreements

German law allows for the conclusion of dominating and profit and loss transfer agreements (cf. Sec. 291 et seq. AktG, P & L-Agreements). The conclusion of profit and loss transfer agreements primarily serves the purpose of establishing a fiscal unity (*Organschaft*) among the parties to such agreement. Given that issue it is of particular importance to review the validity of such agreements in a due diligence. Besides the valid registration in the commercial register of such agreements the due diligence notably has to focus on the duration of such agreements for tax purposes; only if the relevant profit and loss transfer agreement has a certain duration, a fiscal unity will effectively be established.

3.2 Intellectual Property

Depending on the industry and relevance for the target business, evaluating the scope and quality of intellectual property (IP) assets may be a very important part of the due diligence review. Such review usually involves the examination of the ownership, confirmation of the registration status and analyzing the scope of protection, including remaining duration of the terms and applicable countries. Further it may be appropriate to include an assessment of possible risks of invalidation/ cancellation (in particular, pending proceedings, payment of renewal fees, actual use of trademarks) and potential infringement of third party rights (freedom-to-operate analysis).

As other countries, Germany has a number of laws governing intellectual property rights which cover, amongst others, patents (Patent Act, PatG), utility models (Utility Model Act, GebrMG), trademarks (Trademark Act, MarkenG), copyrights (Copyright Act, UrhG), design protection (Design Rights Act, GeschMG). IP legislation in Germany has been influenced by harmonization efforts under European and other international treaties. The terms of protection are: for patents up to 20 years, for utility models up to 10 years, for trademarks 10 years and can be renewed indefinitely, for copyrights (for which no registration system exists in Germany) the life of the author plus 70 years, and for design protection up to 25 years.

It has to be noted that the IP registration with the competent German authority (in respect of German IP rights), the German Patent and Trade Mark Office (DPMA), may not reflect the true substantive ownership of the IP right. While registration is generally a prerequisite for the validity of the IP right, IP assignments may not necessarily be registered (only if applied for). There is no protection of a bona fide purchaser with regard to the ownership of the IP holder

registered with the DPMA. Also, there is in general no registration of a pledge, any other security rights or licenses granted. Therefore, it might be advisable to request all relevant documentation including assignment contracts or other agreement with third parties in respect of the IP assets to understand the “chain of title” from which the target company derives ownership of the IP rights. Although it is, in general, not legally required to agree on an assignment of German IP rights in writing (no specific form requirement), in practice documentary evidence would usually be available. In many cases, though, buyer relies on title guarantees regarding the relevant IP in the transaction agreement.

In particular, where the target company is part of a company group, the relevant IP rights may be held by the parent company or other specific IP holding company of such group and thus would need to be transferred to the target company before the business is acquired.

It is also noteworthy that Germany has a specific law on employee inventions (*Gesetz über Arbeitnehmererfindungen*) which, in particular in the past, sometimes caused errors with regard to IP protection registered by employers. In principle, any invention made by an employee in connection with his employment is attributed to the employer. However, the employer has to compensate the employee by paying an adequate consideration. In addition, before October 1, 2009 the employer had to formally claim the invention within a specific period; otherwise the invention was the sole ownership of the employee. Following an important amendment to the German Act on Employee Inventions, as of October 1, 2009 there is a presumption that the employer claims the ownership in the invention, unless otherwise is notified to the employee. For important IP assets it should be verified that the target company has followed those requirements to exclude defects in title regarding patents or utility models and/or financial risks.

In case the target business is believed to have valuable know-how in the form of trade secrets (unregistered intellectual property), the review of the target company’s approach as to confidentiality agreements with employees and relevant parties should be considered.

Moreover, as additional part of the IP due diligence, license agreements (license-in or -out) should be checked – including scope of rights granted (exclusive or non-exclusive, scope of permitted use, geographic scope), royalty conditions and termination rights. In particular it would be reviewed whether any change-of-control clauses are included which may constitute a risk for the continuity of the business following the intended share deal transaction. A specific license-related issue in Germany consists in the risk that, under certain circumstances, a license might be terminated under German insolvency law in case of bankruptcy of a licensor.

3.3 Labor

3.3.1 Collective Labor Arrangements

German labor law provides that in Germany employment relationships are based on three pillars: the employment contract, applicable collective-bargaining agreements (CBAs – *Tarifverträge*) as well as works agreements (i.e. agreements between company works council and employer – *Betriebsvereinbarungen*). All three tools influence the relationship between employee and employer in a different way, depending on the actual contents, and quite often they are not easily reconcilable.

The employment contract between employer and employee is concluded in accordance with Sec. 611 of the German Civil Code (BGB), based on the principles of private contracting autonomy, and it is the starting point for the employment relationship. It establishes a duty to work and specifies the conditions of work. Yet, the latter are often further elaborated and modified through CBAs and works agreements. Normally things that are covered by CBAs include remuneration, vacation, working time, notice periods, capital accumulation benefits or measures safeguarding employment (Sec. 1 Collective Agreements Act, CA Act).

With respect to CBAs, a differentiation is made between a so-called Associational CBA (*Verbandstarifvertrag*) concluded between an employers' association and a union, and a Company CBA (*Firmentarifvertrag*) concluded between an individual company and a union. In addition there are also Group CBAs (*Konzerntarifverträge*) that are concluded between a union and a group of companies and that are effective for all the individual group companies.

Works agreements pursuant to Sec. 77 (1) of the Works Council Constitution Act ("WCC Act") are agreements that are concluded between the employer and the company's works council. The scope of a works agreement may address questions such as internal company rules and, in addition to a CBA, also aspects of the internal remuneration structure, social benefits, use of company cars, et cetera.

3.3.1.1 Relationship between Employment Contract and CBA

Pursuant to Sec. 4 (1) CA Act, a CBA takes precedence over an employment contract. Hence, collective bargaining rules are directly binding and mandatory for companies participating in the collective-bargaining system. The rules have priority over the stipulations of the employment contract, unless the CBA allows deviations in the specific context or unless the stipulations of the employment contract would be more favorable for the employee than the rules of the CBA (Sec. 4 (3) CA Act, "favorability principle"). Where a company is not bound by a CBA (i.e. if they are no member in an employers' association or if there is no company or group CBA) it is usually not necessary to observe CBAs. This exception does not apply to the extent that CBAs or parts thereof have been declared generally binding by a legislative act. And also irrespective of any affiliation to collective bargaining systems, employers and employees may, voluntarily, agree that collective bargaining rules apply and provide for a so-called reference clause ("Bezugnahmeklausel"). It is worth noting that the legislator usually prefers CBAs over employment contracts. Other than in the case of individual contracts, CBAs may often deviate substantially from the statutory framework. Partly the law only allows for deviations if and when agreed under a CBA.

3.3.1.2 Relationship between Employment Contract and Works Agreement

Also the rules of a works agreement are directly binding and mandatory for the employment relationship (Sec. 77 (1) WCC Act), and in principle independent of the individual stipulation in the employment contract. In the event that the employment contract and the works agreement cannot be reconciled, the favorability principle applies. Individual contractual stipulations may exceptionally take precedence over works agreements to the extent that they contain a provision that is more favorable for the employee. Yet, an employment contract may specifically disapply this principle and the less favorable works agreement would then be applicable in the first place.

3.3.1.3 Relationship between Works agreement and CBA

The relationship between a works agreement and a CBA is covered by the provisions of Sec. 77 (3) WCC Act. Accordingly the remuneration and other work conditions that are (usually) provided for in a CBA cannot be the subject-matter of a valid works agreement. In this respect collective-bargaining or collective-bargaining-like provisions have a barrier affect. The favorability principle does not apply in this case. Yet, many CBAs do provide for so-called

“opening clauses” that allow for amendments or modifications of collective bargaining provisions within the framework of works agreements.

3.3.2 Transfer of Personal and other Labor issues

3.3.2.1 Consequences of a Company Acquisition

From a labor law perspective, the acquisition of a company is first of all assessed by determining whether the purchase was an asset deal or a share deal. In the case of the share deal the employer remains the same. The legal entity representing the contracting partner of the employees remains identical, despite the change in the ownership structure. This is different in the case of an asset deal (cf. III.1.2).

3.3.2.2 Share Deal

The share deal usually has no consequences on the respective employment relationship. Employment contracts, works agreements and CBAs remain effective and unchanged. A change of shareholders does not give the employer or the employee extraordinary rights whatsoever, including the right to termination. Existing agreements remain effective without exception. Only in the case of senior management, it may be possible that employment contracts contain a change-of-control clause. Such a clause usually makes it possible to leave the company when the majority shareholder is replaced, against valuable consideration.

The interdependencies between employment contracts, CBAs and works agreements remain unchanged. Following an acquisition of the share deal type, the purchaser may try and pierce the collective bargaining veil by e.g. leaving the employers' association that has concluded the collective-bargaining agreement. But also then, the binding effect of the CBA will not cease to apply forthwith. In actual fact, the leaving employer and the union will be bound to the provisions of the CBA until the CBA expires by way of termination through either the employers' association or the union (so-called “subsequent commitment” pursuant to Sec. 3 (3) CA Act). Following the commitment phase, the so-called “subsequent effect” pursuant to Sec. 4 (5) CA Act may apply. This means that the work conditions stipulated in the CBA will apply unchanged until a new agreement is reached. This is meant to bridge gaps. Provisions to prevent or put an end to the subsequent effect can be agreed either in the framework of a new CBA or through new employment contracts.

3.4 Tangible Assets

The main focus of the assets due diligence is typically to establish whether the target company is owner of the material assets of the business or has the right to use such assets as well as whether there are any third party rights or encumbrances that restrict the use of the material assets. As a starting point, the buyer should get an overview of the scope of assets belonging to the target business based on the balance sheet and assets lists provided by the seller as well as site visits.

3.4.1 Real Estate

Land forming part of business assets in Germany is typically held either under ownership, hereditary building right (*Erbbaurecht*) or under lease. Land ownership in Germany is characterized as full private ownership, generally unrestricted in duration, and consolidates both the title to the land and to the buildings and structures on such land. Title to the buildings and land can only be legally separated in special cases such as, for example, in case of flat ownership (*Wohnungseigentum*) or if hereditary building rights are used.

The hereditary building right, as well as the full ownership, is an absolute right (*right in rem*) binding to third parties – and not only to a contractual partner. It grants a long-term right to use land owned by another party (a term between 75 to 99 years is not uncommon) with the right to have buildings and structures on such land.

Alternatively, the use of real estate may be based merely on a lease contract – either in the form of a regular lease (*Miete*) or of a usufructuary lease (*Pacht*), whereas under a usufructuary lease, in addition to the mere use, the tenant is allowed to derive the typical profit or benefits from the utilization (e.g., in case a fully furnished hotel building is let).

The key source for the real estate due diligence is the land register (*Grundbuch*) kept at the relevant local court. Land ownership as well as rights of third parties in the real property such as security interests (e.g., mortgage (*Hypothek*) or land charge (*Grundschuld*) – often granted as loan security) or easements (e.g., right of way or pipeline easement), have to be recorded in the land register to become effective. Accordingly, current excerpts of the land register in respect of the relevant properties are a standard item of the due diligence questionnaire.

A bona fide purchaser is protected with regard to the ownership record in the land register as well as the absence of in-rem rights not recorded in the land register. However, it is important to

note that this protection does not apply in case of a share deal since the properties themselves are not transferred but remain owned by the target company. But the “bona fide purchaser” protection may still be relevant in respect of property transactions entered into by the target company.
Likewise, it has to be noted that mere contractual rights (as opposed to rights in rem), such as a lease or other use right, granted by the target company to a third party cannot be entered into the land register and are generally not covered by the aforementioned bona fide protection. Therefore, robust representations and warranties regarding title and absence of third party rights and other encumbrances remain usually an important element of the contractual framework for the transaction.

In addition to land register excerpts, cadastral maps (*Kataster*) may be requested in order to identify the relevant land plots, in particular their location and size. The cadastre is a public registry kept by the real estate surveying offices (*Liegenschaftsämter*). However, the information included may only serve as reference and does not enjoy bona fide protection.

For more detailed information on German real estate law, please refer to Section III.1.3.2.

3.4.2 Movable Assets

The scope of due diligence review with regard to the moveable assets has to be carefully defined. A comprehensive title analysis would be a disproportionate effort. In Germany there is no public registry in respect of rights and encumbrances in movable assets and which may enjoy good faith protection (similar, for example, to the registration of a mortgage on production equipment in the PRC). Also, the possession of assets is not a reliable indication of title or other interest in assets. While a bona fide acquisition of ownership may generally be possible, this protection does not apply in case of a share deal as far as the indirect “acquisition” of the relevant assets by the buyer is concerned (see Section “Real Estate” above). Accordingly, an in-depth review would usually be limited to selected assets which are of significant importance for the continuation of the target business. Apart from this, the buyer would rely on the information given by the seller as well as contractual warranties in the share purchase agreement.

Further, it is quite common in Germany, especially in respect of mass goods, that supply is made under retention of title (*Eigentumsvorbehalt*). In such case the supplier retains title to the goods delivered until payment of the purchase price or other events defined in a contractual agreement or under statutory law. It should be considered, in order to support the valuation of the business, to review whether the target company’s typical sales or procurement processes involve such arrangements. In addition, movable asset acquisitions, especially investments in fixed assets, are

often done based on a transfer of title for security purposes (*Sicherungsübereignung*). Such transfer of title is used for securing a debt – often the debt incurred for financing the respective item – and allows the debtor to use the item instead of being required to transfer possession to the creditor (like in the case of a pledge (*Pfandrecht*), which is therefore of minor practical relevance in Germany). In order to analyze the use of such arrangements by the target company, all credit contracts, other financing agreements as well as security agreements should be requested for review.

3.4.3 Lease Agreements

In case important assets of the business – immovable or movable – are leased by the target company, a thorough review of the relevant lease contract is required to identify potential issues for business continuity and financial risks. Such review typically focuses on:

- rent conditions, including right to increase the rent;
- particular use restrictions;
- maintenance and repair obligations;
- rights and obligations upon termination (e.g., removal of fixtures and fittings, obligation to restore the original condition, compensation etc.); and
- very importantly, the duration of the lease as well as termination rights.

As for all long-term contracts, it is in particular of utmost importance to review whether the relevant agreement includes a change-of-control clause, which would allow the counterparty to terminate the contract (or to exercise other special rights or options) in case of an ownership change in the target company resulting from the intended share deal. Such change-of-control clauses may pose a particular risk for the business continuity and should, in such case, be resolved through arrangement with the relevant contract partner or appropriate safeguards in the transaction contract.

3.4.4 Permit Situation

Depending on the risk profile of the relevant business and assets, it may be appropriate to include an in-depth review of the permit situation in the due diligence exercise.

With regard to the real estate, it should be verified that zoning regulations including the zoning plan (*Bebauungsplan*), if applicable, are complied with. The land must be properly zoned (e.g., as commercial zone or industrial zone, as applicable) to allow for the activities conducted by the

target business. It may also be reviewed whether the existing buildings comply with the conditions of the building permit. If an expansion of the business needs to be considered, construction or other regulatory restrictions that may hinder such plans would be carefully reviewed based on the construction permit, the zoning plan and other relevant regulations. Moreover, especially with respect to production facilities and machinery, it should be reviewed whether all required operating permits have been obtained by the target company (in particular under the Federal Immission Control Act (*Bundesimmissionsschutzgesetz – BImSchG*) or construction law) and whether the operation of such assets complies with applicable fire or other safety regulations, emissions regulations and other regulatory requirements.

3.5 Environmental Due Diligence

Environmental due diligence is both a combined legal and technical exercise that is performed to assess liability risks which can be very substantial. If appropriate based on the risk profile of the target business, the technical evaluation usually involves a comprehensive investigation into both historical and current environmentally sensitive activities of the target company, review of relevant documents (including on the use of the properties and machinery, reviewing environmental files maintained by the site owner and regulatory agencies as well as relevant correspondence), on-site visits and interviews as well as, if deemed necessary, an in-depth site evaluation including, for example, soil and groundwater sampling.

The relevant liability provisions under German law are still scattered throughout various acts, *inter alia*, the Federal Soil Protection Act, the Water Resources Act, the Environmental Damage Act and the German Civil Code. Liability can in particular arise in case of contamination of or other harmful impacts on soil, water and the atmosphere as well as in case of other (imminent or actual) environmental damage involving environmental resources (e.g., animals, plants, water, soil, etc.) not privately owned but in the public domain, including so-called biodiversity damage. Generally, there is joint and several liability of different parties for necessary damage prevention measures, remediation measures or, under certain circumstances, even the cost of investigation measures: in particular the party that caused the (imminent or actual) contamination or pollution and the owner of the relevant property or the party who is in actual possession (irrespective of whether they caused the contamination or not) may be held liable. Even former owners could be held liable if they knew or should have known about the contamination. With regard to the due

diligence scope, it should be kept in mind that the target company might also be liable for their legal predecessors (e.g., in case of a merger) as well as for subsidiaries under its control.

The competent authorities have broad administrative discretion in choosing the party that shall be held accountable. However, the party who was required to bear the cost of the relevant measures under applicable environmental law may take recourse and claim compensation from other liable persons. In view of this environmental liability framework, the buyer has a strong interest in including strict indemnification provisions in the share purchase agreement ensuring that solely the seller shall be responsible for any environmental issues that have been caused or occurred prior to the closing of the transaction. However, such arrangement is only binding among the parties of the transaction and does not affect the governmental agency's discretion to require any of the relevant parties to conduct the necessary measures or bear the associated costs.

In order to evaluate the practical risk of environmental liability, apart from the technical audit results, usually relevant environmental files, in particular documents regarding past or pending investigations or proceedings of authorities or in respect of relevant third party claims, should be requested for due diligence review. In addition, most of the states of the Federal Republic of Germany maintain a Register of Contaminated Sites (*Altlastenkataster*) containing factual information on identified contamination or land with identified risk potential. However, this register is not intended to be an exhaustive list of relevant risk areas; and a party reviewing the register does not enjoy any bona fide protection with regard to the absence of a registration.

3.6 Taxation

General Tax Due Diligence Requirements

Generally, in a share deal scenario all historic tax risks of the target entity will remain with this company. Therefore, a full tax due diligence on the target is highly recommendable. Furthermore, the transfer of the target itself triggers certain tax consequences for the target company. The following paragraphs illustrate the most relevant tax considerations arising from a share deal.

Purchase of Shares and Step-up of Tax Basis

A share deal does not offer the buyer a step-up of the assets (capitalization of assets at fair market value) of the purchased company to increase the depreciation base. Furthermore, no goodwill can be considered.

Change-of-control Rules for Tax Losses

In general, tax losses carried forward and/or current year tax losses will be forfeited pro-rata if more than 25% of a corporation's shares or voting rights, but no more than 50% would be directly or indirectly transferred within a period of five years to a purchaser, related parties or a group of purchasers. A transfer of more than 50% of the shares/voting rights would result in forfeiture of the entire losses carried forward and current year tax losses.

However, the tax losses carried forward will be not forfeited if an exemption applies, for example, to the extent they are covered by unrealized built-in gains in the corporation’s operating assets if such built-in gains are subject to tax in Germany. This provision is applicable for both, share acquisitions from third parties as well as related parties. If not more than 50% of the shares in a loss company are transferred, the built-in gains shall be determined on a pro-rata basis. Additionally, an intra-group restructuring clause exists. According to this clause, a transfer of shares is not assumed to be detrimental if a person/company directly or indirectly holds all of the shares in the transferee and the transferor.

Other Tax Attributes and Change-of-control Rules

Interest and EBITDA (Earnings before interest, taxes, depreciation and amortization) carryforwards could also be limited by the German change-of-control rules as described above.

Value Added Tax

The transfer of shares is generally tax free in Germany (or even not subject to VAT). However, seller may opt for VAT which may allow him to deduct the input VAT, in particular, from his transaction costs. In this case, the VAT is generally payable by the buyer in addition to the purchase price for the shares. Depending on the deal structuring it might be possible that buyer is not able to benefit from a (full) input VAT refund. Therefore, in practice, the share purchase agreement should oblige the seller not to waive the VAT exemption for the shares to be sold.

Transfer Taxes

There is no stamp duty in Germany. However, The direct or indirect sale of at least 95% of the shares in a German target corporation will trigger German RETT if German target or any of its subsidiaries own any real estate properties situated in Germany. The current RETT rate is ranging from 3.5% to 6.5%, depending on the location of the real estate property. Typically, a share purchase agreement allocates the RETT as transaction costs to the purchaser.

Secondary Level Tax Liability within a Tax Group

If the target was subsidiary in a fiscal unity for income tax and/or VAT purposes, sec. 73 General Tax Code provides for a secondary liability, i.e. the target may be held liable for all tax liabilities of the tax group head.

However, target may only be held liable if the parent (Seller) is not able to pay its taxes by itself, e.g. due to insolvency (secondary level liability). Therefore, it is important to analyze the financial situation of the Seller and to potentially secure any tax indemnification claims under the SPA by an appropriate escrow amount.

Structuring Considerations

A foreign buyer may invest in a German target through different vehicles. The tax implications of each vehicle may influence the choice.

A German holding company is typically used when the purchaser wishes to ensure that tax relief for interest (e.g. resulting from the acquisition financing) is available to offset the target’s taxable profits or taxable profits of other German companies already owned by the buyer within a fiscal unity.

A direct investment by a non-German buyer may be beneficial to shelter its own taxable profits with the financing costs related to the investment in the German target. Where the German target is a partnership, the financing costs of the foreign parent company in connection with the acquisition of the partnership interest are generally tax-deductible at the level of the German partnership, subject to restrictions of the German earnings stripping rules and a 25% add-back for TT purposes. Thus, investments in German partnerships by a foreign parent company may potentially provide a double dipping opportunity where debt-financing is taken out at the level of the foreign parent company (however, subject to specific anti-abuse provisions since 2013).

A non-Germany intermediate holding company may be an option where the investor's country of residence taxes capital gains and dividends received from abroad. An intermediate holding company resident in another territory could be used to defer this tax and take advantage of a more favorable tax treaty with Germany. In terms of WHT relief, using a non-resident intermediate holding company is only more tax-efficient than a direct investment where the intermediate holding company meets the requirements of the German anti-treaty shopping rules.

Top five Tax Advantages of a Share Deal

- Debt-pushdown strategies available;
- Sale of shares is VAT exempt unless seller waives this exemption;
- Tax attributes may partly or fully be preserved if an exemption rule applies;
- Potential 95% capital gains tax exemption for the seller;
- Existing tax registrations of target can be continued.

Top five Tax Disadvantages of a Share Deal

- Assumption of historic tax risks of the seller, full tax due diligence required;
- Application of change-of-control rules, i.e. generally all tax attributes are forfeited;
- No step-up to a higher tax depreciation base and no goodwill amortization;
- Real estate transfer tax is triggered if at least 95% of the shares are acquired;
- Pre-deal carve-out of non-target assets may be complex.

3.7 Financing

The legal due diligence on financing should be differentiated from the economic financial due diligence. Latter typically focuses on the evaluation and verification of the profit - / loss account, the balance sheet and the cash flow of the target company. Generally, the economic financial due diligence is undertake by accounting firms. The legal due diligence verifies and evaluates the legal validity and legal risks in respect of the financing of the reviewed company. Looking at the balance sheet, the asset side needs to be financed by debt and / or equity. The legal financial due diligence verifies the origin and the legal validity of such financing. For example, whether the granted loan facility is enforceable respectively the underlying securities have been duly granted. The same approach is taken when focusing on the debt side of the balance sheet.

4. Approval and Filings

4.1 Required Approvals and Fillings

Compared to the current legislation and practice in China, no government approval of any level is required in case of acquisition of shares in a German company in general. There are only a few exceptions with respect to merger control (see I.9.3) and national security (see I.9.2) where an approval of the acquisition itself is required. For the regular operation of the acquired company special licenses might be required depending on the type of business (see I.10.2.2).

Additionally to the aforementioned approvals for the acquisition itself, further licenses might be required for the regular operation of a company depending on the type of business. For example, for the security industry, pharmaceutical industry, weapons production and trade, private hospitals or the catering industry (restaurants) a personal license is required. Personal licenses are connected to an individual person or in case of a limited liability company or stock company to the board of directors or the general manager. For example, in a stock company that is active in the security industry, every member of the board of directors needs to fulfill the requirements (such as being trustworthy and having no criminal record) for the business license. If a member of the board of directors or the general manager changes, a new application for the license is required.

Licenses that are required for the operation of an installation that causes emissions such as noise or pollution are subject-related licenses and therefore not connected to an individual person, but to the company that had been acquired. Such licenses will not be affected by an acquisition or participation of a foreign investor. Nevertheless, the acquirer has to make sure to comply with all duties arising from the license such as the yearly report about emissions of the installation.

4.2 Competent Authorities

Merger & Acquisition activities are regulated and supervised by different authorities, depending on the sector and the volume of the acquisition (c.f. I.9.1 to I.9.2). Other authorities on national and local scale are in charge of the regular operation of the company (cf. I.10.2).

4.3 Timeline

Please refer to the relevant sections (cf. I.9.1, I.9.2 and I.9.3).

4.4 How to Challenge Authorities

Item 4.1 above describes approvals and filings forming part of a share transfer in Germany. Each Government action and each administrative act has to be issued on a legal basis and can be made subject to judicial review. The right to challenge authorities is part of the principle of the rule of law, which implies that also the authorities are bound by the law and the courts are independent.

There are basically two steps for challenging the authorities' decisions, firstly in an administrative and, if not remedied, secondly in a court proceedings: In the **first step**, the applicant can formally object to the administrative act. Doing this, the relevant authority has to review again its own decision and to submit the proceedings to the superior authority, in case it does not want to remedy. While being under review, the administrative act is generally

suspended. If the superior authority confirms the original decision and does not remedy, then in a **second step** this decision can be made subject to judicial review at court.

The proceedings for challenging cartel decisions of the Federal Cartel Office or the EU Commission differ in detail (for Federal Cartel Office first formal objections to the Higher Regional Court in Düsseldorf and for EU Commission objections and actions to the specific EU courts), but follow in substance the same principles, i.e. can also be challenged in a two- step proceedings.

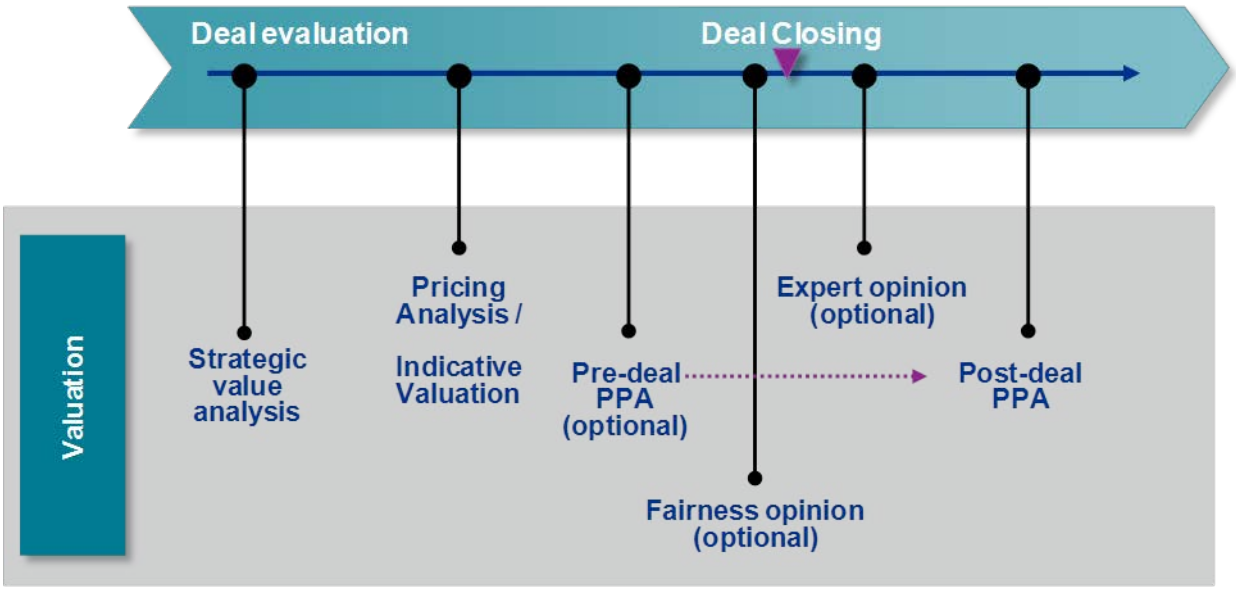
While German courts are perceived to operate independently and impartially, proceedings may be time consuming. In any event, starting a court action against an authority is not viewed as an aggressive or negative behavior of an investor in Germany, if the investor obviously wants to pursue its rights.

5. Valuation - Qualifications / Requirements

5.1 Introduction

The valuation is a key element of every M&A transaction and is, in general, based on widely accepted standard valuation methods like the income based approach of the Discounted Cash-flow Method (DCF), the market based approach of the multiples based method or an asset based valuation. The methods are regularly applied by buyers or sellers to develop their own view on the value of the target company. At the beginning of an M & A-transaction buyers and sellers are usually focusing on the enterprise value (EV), the value of the assets without taking into account the characteristics of the asset financing, i.e. with debt or equity. During the process the value of equity becomes more which is derived from the EV.

Sometimes the acquirer engages third party experts providing a fairness opinion or an expert opinion to get an external verification of the own assessment. This is of particular relevance in the capital market environment. Finally, post-acquisition the acquirer usually has to perform a purchase price allocation (PPA) as part of the financial statement preparation. The PPA has to be based on the generally accepted accounting principles (GAAP) relevant for the acquirer.



The relevance of the methods during an M&A-transaction varies depending on the status of the targeted business. Mature businesses with a moderately growing outlook are usually valued by a combination of discounted cash-flow method and the multiples based method. Start-ups, businesses with strong sales growth and a low profitability in the first years tend to be valued based on the multiples method. The asset based valuation method has a high relevance in valuing distressed or even insolvent businesses.

5.2 Discounted Cash Flow Valuation

The discounted cash flow valuation can be based on several theoretical approaches to arrive at the same valuation of the enterprise and equity value. The Weighted Average Cost of Capital (WACC) approach is the most commonly used approach and will be explained in more detail below. The starting point of the WACC approach is the forecasted Free Cash Flow to the Firm (FCFF) being the basis for calculating the EV:

Free Cash Flow to the Firm (FCFF)

EBIT x (1 – Tax Rate)

+ Depreciation and Amortization (D&A)

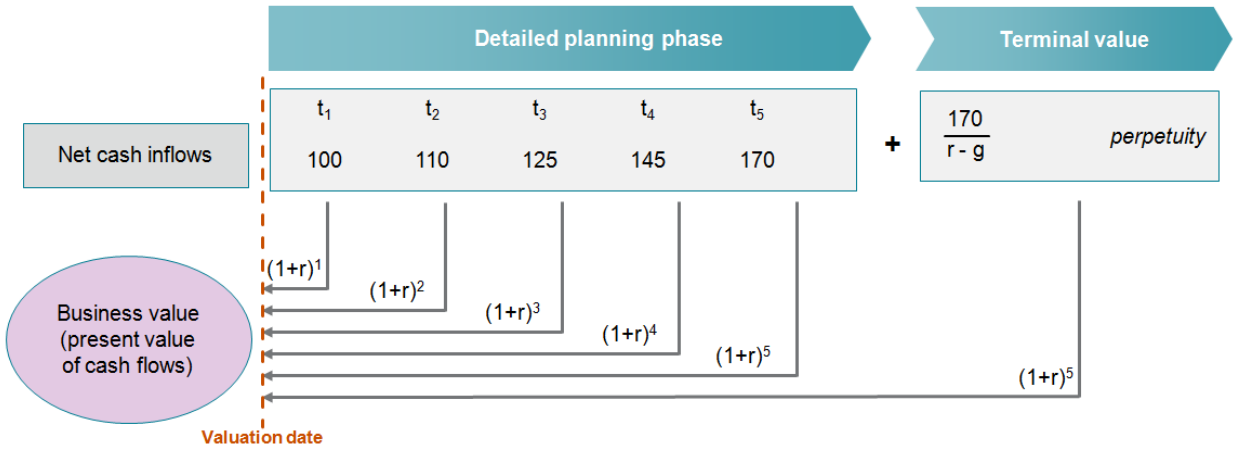
- Δ Net Working Capital (NWC)

- Capital Expenditure (CapEx)

+/- Other Non Cash Expenses / Income

= Free Cash Flow to the Firm

Typically, the detailed planning phase for the FCFF forecast ranges from three to five years. For the time beyond the detailed planning phase a terminal value (TV) is calculated assuming that the business is in a steady state at that point in time, for example that the CapEx equals D&A in the terminal year. In addition, it is assumed that the last FCFF planned in detail will grow with a perpetual growth rate g until eternity. The perpetual growth rate g is the major driver of the TV which in turn represents often a large portion of the EV. Hence, as a general rule, the level of the perpetual growth rate g should be close to the current inflation rate. The FCFF of the detailed planning period and the TV have to be discounted to get a present value.



The FCFF forecasts including the TV are discounted with the WACC. The WACC reflects the expected returns of both, equity and debt investors being the appropriate discount rate to arrive at the EV. The WACC is calculated as follows:

WACC

$$WACC = c^D(1-t)\frac{D}{V} + c^E\frac{E}{V}$$

c^D = Cost of Debt
c^E = Cost of Equity
t = Tax rate

The target company's cost of debt is either derived from public sources, e.g. publicly traded bonds of the target company, or by taking the rate of a risk-free bond with a duration which matches the term structure of the corporate debt of the target (for example a 10 year government bond), and by adding a spread which reflects the default probability of the target company. Furthermore the tax effect of the financing costs has to be taken into account when calculating the cost of debt being in line with the FCFF which is also calculated after tax. This is achieved by reducing the cost of debt for the tax effect expressed in the marginal tax rate *t*.

The cost of equity is derived on the basis of the Capital Asset Pricing Model (CAPM), typically using the same risk-free rate as for the calculation of the cost of debt plus the average return rate of the appropriate market index multiplied with the company specific beta. The beta is an expression of the volatility of the target company share in relation to the average market portfolio, e.g. the DAX 30. In the case of listed companies the beta is publicly available (for example from Bloomberg). For private companies the beta is calculated by applying an average beta of comparable listed companies which has to be unlevered before used. The unlevered average beta has to be relevered on the basis of the target company capital structure to arrive at the assumed beta of the target company. For the purpose of unlevering and relevering, the Hamada Equation is used:

Hamada Equation

$$\beta_u = \frac{\beta_l}{(1 + D/E \ x \ (1 - t))}$$

β_u = unlevered Beta

β_l = relevered Beta

D is the market value of debt, which typically equals the book value under the assumption of credit risk absenteeism. E is the equity value either taken from the stock exchange or as a book value for private companies. V is the sum of D and E.

The EV is calculated by discounting the FCFF forecast and the TV with the WACC and then adding up the discounted values, i.e. present values. To arrive at the equity value the following items have to be deducted from the EV:

Equity Value

- Interest bearing debt *- Minority interests and preferred stocks* *- Capital leases and unfunded pensions* *+ Cash and cash equivalents (e.g. readily disposable financial assets held for sale)*	*Net*
	Debt
= equity value	

5.3 Multiples Based Valuation

Generally, there are two different types of multiple methods: Comparable Company Analysis (CCA) and Comparable Transaction Analysis (CTA). The CCA is based on the average of multiples from listed companies which are comparable to the target company. The CTA is based on the average of multiples from previously conducted transactions in the sector of the target company.

Both valuation methods derive their multiples from relative figures, e.g. EV/EBITDA. The nominator and the denominator have to have a corresponding origin, i.e. the EV, which includes the value of debt and equity, has to be brought into relation with a profit number before any financing costs, e.g. EBITDA or EBIT. If the equity value is in the nominator, the denominator has to be a profit number after any financing costs for debt as the equity value does not include the value of debt, e.g. net profit. Commonly used multiples are: EV/Sales; EV/EBITDA; EV/EBIT; Price (equity value) to Earnings (net profit) Ratio.

In the CCA the data for EV and equity value as well as the various profit numbers are usually publicly available, e.g. from Bloomberg. In the CTA this data has to be researched in general public sources which is sometimes more difficult to get.

To arrive at the EV or the equity value of the target company the respective multiple has to be multiplied with the corresponding profit number of the target company, e.g.:

Equity Value
Average EBITDA multiple (based on CAA or CTA) x EBITDA of the target company
= EV – net debt (see above) = equity value

5.4 Asset Based Valuation

The asset based valuation method typically starts by looking at the book value of all assets and liabilities on the balance sheet of the target company. In a second step the balance sheet items together with any off-balance sheet items are assessed by using either reproduction costs or liquidation values to arrive at a value range. The formula for the asset based valuation method is as follows:

Asset Based Valuation Method

Value of the company's assets (off- and on-balance)
- Value of the company's liabilities (off- and on-balance)

= Net asset value of the target company

Generally, the asset based valuation calculated with liquidation values determines the minimum value of the company.

5.5 Conclusion

Although in Germany the valuation of a targeted business in an M&A transaction is not regulated it is market practice to use a combination of the DCF and the multiples method with a tendency to simplify the initial assessment by only focusing on EBITDA and EBIT multiples.

Although there is no obligatory review by the tax authority, a review may be performed if the valuation was used for tax purposes, e.g. for a purchase price allocation.

A valuation is always a snapshot at a certain point in time. It will always be a range and not a single number, due to the many input variables, despite the fact that the paid purchase price usually is a single number. Hence, price is what you pay, value is what you get!

6. Implementation Issues and Contractual Documents

Once the due diligence exercise has confirmed the acquirer's interest to move forward with the transaction, the parties proceed to the negotiation phase which is dominated by negotiating the definitive agreements for the transaction, first and foremost the share purchase agreement. During this phase, the parties will start considering items relevant for the implementation phase of the transaction.

6.1 Necessary Transaction Documents

In share deals in Germany, the parties usually sign or exchange all or some of the following documents between the start of the transaction process and the completion of the transaction:

- Confidentiality Agreement;
- Letter of Intent/Offer Letter;
- Share Purchase Agreement;
- (Local) Share Transfer Agreements;
- Ancillary Agreements (e.g. Transitional Services Agreement).

It is customary in Germany that the seller prepares a first draft of the contractual documentation. This is in particular true for transaction processes conducted as an auction, which usually have multiple interested parties participating until the final stages of the process. Otherwise, the seller would not be able to adequately compare the different offers, as an important part of the offer is the contractual documentation. In individual deals – usually in a situation where a small to medium sized seller sells a business to a larger, more seasoned acquirer – the investor, who often has the capacity to prepare the documentation in-house, may request to prepare the first drafts, as this gives it an advantage over the seller. There appears to be a tendency that a smaller to medium sized seller accepts such request, mainly in order to keep its transaction costs down.

English is widely accepted as the contract language for M&A transactions in Germany, in particular in larger transactions, in auction processes or if the seller intends to attract foreign investors as well. This may differ in cases of a small to medium sized, not very seasoned seller who feels more comfortable negotiating the contractual documentation in German. In most cases, however, such transactions are pure domestic transactions (i.e. both German seller and acquirer). There is no legal requirement in Germany to have bi-lingual agreements which include a German language version of the text.

Under German law, most of the transaction documentation does not require notarization. However, there are certain significant exceptions to that rule, e.g. agreements with respect to the sale and transfer of shares in a limited liability company (GmbH). Please refer to I.9.4 for details.

6.1.1 Share Purchase Agreement / Share Transfer Agreement

The main contractual document of a share deal in Germany is the share purchase agreement which governs the relationship between the seller and acquirer, in particular the sale and transfer of the shares and the representations and warranties given by the seller in connection with the sale of the shares. Sellers will sometimes require that an additional share transfer agreement is signed at the time of the consummation of the transaction to actually transfer the shares. While this additional document is not necessary under German law, sellers often prefer this structure. They feel to have more control over the share transfer until the date the transaction is consummated, as the transfer requires an additional signature by the seller. If there is no separate transfer agreement, the transfer of the shares is triggered – after all conditions precedent are fulfilled – by the acquirer paying the purchase price for the shares on the date the transaction is completed. Sellers often dislike this “auto pilot” scenario when transferring their shares.

In more complex transactions, when not only the shares of one legal entity are transferred, the share purchase agreement is often structured as a master share purchase agreement with a number of (local) share transfer agreements. The typical scenario in which a master agreement concept is used is that of a larger group selling a business which is operated by multiple legal entities throughout the group with these entities being owned by different group companies. For tax reasons, the seller will often not consolidate these entities prior to closing into a sub-group solely being comprised of the business to be sold. In this case, the ultimate parent company signs the master share purchase agreement on the seller’s side. The master agreement sets out the rights and obligations applicable for the transaction and the transaction is implemented by the execution of multiple (local) share transfer agreements by the relevant group companies of the seller’s group. Those (local) share transfer agreement are designed to only implement what has been agreed on master agreement level and, in particular, do not contain any additional rights or obligations for the parties (e.g. separate representation and warranties).

6.1.2 Other Transaction Documents

Besides the (master) share purchase agreement and the (local) transfer agreement, the parties will sign or exchange some or all of the following documents:

Confidentiality Agreement

At the outset of the transaction, the parties will sign a confidentiality agreement. Besides the standard provisions that the acquirer keeps the information received in the course of the

transaction process confidential, a confidentiality agreement may contain provisions that prohibit the solicitation of employees of the target company or rules on how to conduct the transaction process.

The provisions on the conduct of the transaction process should not be underestimated. Under German law, negotiating in bad faith and terminating advanced negotiations without any grounds may under certain circumstance lead to a liability of the respective party for, generally, frustrated expenses and foregone opportunities of the other party. To preserve the greatest possible flexibility for the parties, the confidentiality agreement should explicitly provide for a right of the parties to terminate the transaction process at their sole discretion.

In addition, it has become more and more common in Germany that sellers try to agree with an acquirer already at the stage of the confidentiality agreement that all information contained in the data room will be deemed disclosed against the representations and warranties, thereby limiting the seller's liability accordingly. The sellers try to leverage the competitive situation in which most transaction processes will be in at the time of the confidentiality agreement. That concept is, with certain qualifications, market standard in Germany, but usually negotiated in connection with the share purchase agreement.

Expression of Interest

In sale processes conducted as auctions, in more complex transactions or in processes conducted by seasoned sellers, access to the data room is often conditioned on a non-binding written expression of interest by the acquirer based on some high-level financial information or an information memorandum. Such expression of interest usually contains an indication of the purchase price. This indicative offer letter is usually complemented by a final or binding offer letter after the completion of the due diligence. In the final offer letter, the acquirer is required to set out both the commercial and the legal terms (i.e. the acquirer needs to provide a mark-up of the draft share purchase agreement provided by the seller) on which it would be prepared to sign the transaction. The binding offer is generally the first binding commitment by the acquirer with respect to the terms and conditions of the transaction. Very rarely, the transaction is signed on the basis of a final offer letter. It usually sets the stage for the final negotiations.

Letter of Intent

In individual transactions, a letter of intent may be signed as an intermediate step in the transaction process. With its non-binding nature, the character of a letter of intent is similar to an indicative offer letter, except that the letter of intent is usually signed by both parties. In addition,

a letter of intent is usually more detailed than an indicative offer letter, as the letter of intent sets forth those topics for which the parties have reached an understanding (e.g., purchase price, transaction structure).

While the letter of intent is legally non-binding and, if signed prior to the due diligence, usually subject to the findings in the due diligence, it has a strong influence on the succeeding negotiations of the definitive agreements. In practice any deviation from the terms agreed in the letter of intent requires good arguments – usually material findings in the due diligence. Therefore, signing a letter of intent prior to the due diligence phase in a share deal will be more in the interest of the seller rather than the acquirer.

Ancillary Agreements

Finally, the parties in an M&A transaction often sign a significant number of ancillary agreements. The nature and the topics of these ancillary agreements are transaction-specific (e.g. retention agreements for key employees, license agreements etc.).

Among the ancillary agreements, transitional services agreements are quite common when the sale of the shares was preceded by a carve-out of the business from larger operations of the seller into a newly set-up company. In this scenario, the seller group will usually provide certain services or perform specific overhead functions (e.g. human resources, legal, treasury) until the transaction is consummated, as it is not an efficient allocation of (financial) resources to set-up the respective functions at the target company prior to the transaction being sufficiently certain.

In addition, if the shares are sold to a strategic investor, setting-up the overhead functions may not be necessary at all, as the target company usually uses the acquirer’s overhead functions going forward. To avoid any disruptions after the completion of the transaction and to bridge the time until the respective function is set-up at the target company or the target company is integrated into the relevant processes of the acquirer, sellers are often prepared to provide certain of these services at cost for the target company and the acquirer (in particular, human resources and payroll). The transactional services agreement will govern the rendering of these services. It should be noted, however, that not all overhead functions and shared services can be provided by the seller post-closing – e.g. the seller will not be permitted to continue as treasury function for, or provide legal services to, the target company after completion of the transaction.

6.2 Mandatory Content

German statutory law does not require any mandatory provisions to be included into the share purchase agreement. While technically not a mandatory provision, a condition precedent to closing that a required merger control clearance has been obtained is usually included in all relevant share purchase agreements due to the fact that a premature consummation of the transaction is subject to a fine and may lead to an unwinding of the transaction. The same may apply in case of similar regulatory regimes for specific industry sectors (e.g. healthcare).

For the share purchase agreement to be a valid contract, it needs to contain provisions on the object of the sale (i.e. the shares) and needs to set forth the purchase price for which the shares are transferred – so called essentialia negotii. Beyond that no other provisions are required for a valid agreement. German statutory law would provide a well-established regime for sale contracts which the share purchase agreement is. In German market practice, however, the share purchase agreement has developed into an Anglo-American style agreement with more and more details in the agreement and the parties relying less and less on German statutory law.

Therefore, a share purchase agreement under German law usually contains the following topics and issues in addition to the description of the sale and the stipulation of the purchase price:

Seller's Representations and Warranties

In addition to a guarantee covering title to the shares, the seller will usually give guarantees with respect to certain aspects of the business depending on the nature of the business (e.g. financial statements, material assets, intellectual property rights, certain employee matters etc.). Less common than in other jurisdictions is the blanket guarantee that the seller has provided all relevant information to the acquirer. In particular seasoned or well-advised sellers will vigorously resist a guarantee to this effect.

Seller's Liability

The provisions on seller's liability contain detailed provisions limiting the liability in case of a breach of the representations and warranties and provide specific procedural rules the acquirer needs to observe when claiming damages from the seller. Whether lost profits are to be reimbursed by the seller is often highly disputed. Under German law, seller's liability for fraud, intentional misrepresentation and the like is unlimited by statutory law and cannot be limited by contract.

Seller's Covenants

For the period between signing of the share purchase agreement and completion of the transaction, the acquirer has an interest that the seller is no longer free to conduct the business of the target company at its discretion, in particular that is does not act detrimental to the acquirer's interests. Therefore, the share purchase agreement usually subjects certain extraordinary measures with respect to the business to the prior consent of the seller. These restrictions need to be balanced against the prohibition to consummate a transaction prior to having obtained merger control clearance, as extensive influence on the day-to-day business by the acquirer is seen as a prohibited (premature) consummation of the transaction.

Separation Matters

The share purchase agreement will contain various clauses on items under this heading which are required to separate the target company from the seller group. The termination of corporate agreements with the seller or its affiliates is an important part of these provisions, as those contracts cannot or should not continue after the consummation of the transaction. They will be replaced, to the extent necessary, by newly executed transitional services agreements. In addition, if the target company is financed by the group (e.g. the target company is part of the group cash pool, a financing vehicle of the group has issued guarantees on behalf of the target company, etc.), the financing ties to the seller group need to be severed no later than closing.

6.3 Timeline

The transaction process is mainly steered by the parties to the transaction and third parties, in particular regulatory authorities, will come into play only after the signing of the share purchase agreement. Therefore, the timeline for the negotiation of the contractual documents heavily depends on the interests of the parties. Experience tells that negotiating definitive agreements can take from a couple of weeks – usually in competitive auction processes where the leverage of the acquirer is limited and the final offer letter provides a sound basis for the final negotiations – until well over a year if the target company is not a highly sought after asset.

6.4 Third Party Consent

6.4.1 Internal Consent Requirements

Depending on the corporate structure of the seller, its articles of association or internal rules of procedure may require that M&A transactions are approved by certain of its corporate bodies or internal committees. In smaller companies, the board of directors or the shareholder assembly may have to approve all sales of shares of a subsidiary. In larger companies, M&A transactions usually have to be approved at senior management level – for smaller transactions with a purchase price below a certain threshold, this may be an investment committee, for larger transactions this is usually the executive board and, in certain circumstances, the supervisory board. At least if the seller is a stock corporation, the shareholder assembly usually does not have to approve a M&A transaction, except in rare circumstances, e.g. the M&A transaction comprises a divestment of substantially all of the business of the seller.

At target company level, the articles of association sometimes provide that a sale of the shares requires the approval of the target company. While this requirement usually applies only to the actual transfer, any such requirement needs to be identified early on in the due diligence and taken care of in the negotiations of the share purchase agreement.

Different from the situation in other European countries, neither the works council of the seller nor the target company needs to approve a M&A transaction, but the employee representatives may have to be informed about the transaction process.

6.4.2 External Consent Requirements

Typically, merger control clearance is required for a M&A transaction. In addition, the German government may block a transaction for reasons of homeland security. Finally, for specific industries, e.g. healthcare, other regulatory requirements may apply. Those consent requirements are described in I.9 above.

In case the target company or the seller has a credit facility or other financing which is secured by the shares or the assets of the target company, the sale of the shares usually requires the consent of the financing bank, as the shares and/or the relevant assets need to be released no later than at the day of completion of the transaction. Any such requirements should be identified early on in the due diligence, as dealing with the bank may be burdensome and time consuming.

6.5 Liabilities

The seller and acquirer have opposite interests with respect to the liabilities of the business to be sold. While the seller wants to transfer all liabilities to the acquirer, the acquirer intends to assume none, or only a limited number, of the liabilities.

In a share deal, there is no choice. The transfer does not comprise individual assets and liabilities, but only the shares of the target company which operates the business. Therefore, the liabilities of the business stay where they were – in the target company – and the acquirer is stuck with the legacy of the target company, including all liabilities. To avoid this result, the acquirer would have to agree with the seller an indemnity that seller indemnifies acquirer for all pre-closing liabilities. While possible under German law, a general indemnity of this kind is almost none-existent in German M&A transactions in the form of a share deal.

The representations and warranties of the seller provide protection for the acquirer, as they cover liabilities arising from situations existing prior to the signing of the share purchase agreement (e.g. product liability claims for products sold during the period the seller was the owner of the business to be sold – for details see below). This protection is, however, significantly limited due to the limitations applicable to the liability of seller for a breach of representations and warranties, in particular the customary exclusion of the liability of the seller in case the acquirer is aware of the situation constituting the breach. Therefore, the most relevant situation – a finding in the due diligence – is not covered by the liability of the seller for a breach of the representations and warranties it has given in the share purchase agreement.

As an exception to the rule, an indemnity for pre-closing tax liabilities is very common. This indemnity usually leads to taxes levied on the target company for the period before the consummation of the transaction being borne by the seller and such taxes for the time after the day of completion being for the account of the acquirer. Less often, the seller will agree to an indemnity for environmental liabilities resulting from decontaminations stemming from the period prior to the completion of the transaction. This indemnity is usually heavily debated and contains various qualifiers, as environmental clean-up obligations are in most cases very costly. Beyond these two items, the parties may agree to different specific indemnities based on the facts of the individual transaction – often due to findings in the due diligence.

Depending on the characteristics of the target company, the treatment of product liability claims for products sold during the period the seller was the owner of the target company may become a fiercely negotiated issue. The seller will often take the position, product liability claims are part

of the general risk of operating a business and, therefore, should not be part of any representation, warranty or indemnity. There is no general practice in Germany how to allocate legacy product liability risk – it largely depends on the leverage of the parties. If the seller accepts liability for product liability claims for products sold prior to closing, the parties usually agree on a representation or warranty. An indemnity for such product liability claims is less frequent and, if at all, seen mostly in cases where there is a history of claims against the target company for product liability.

7. Signing and Closing

After the parties have agreed on the share purchase agreement, they will usually seek to proceed to signing as soon as possible after having obtained internal approval for the negotiation results (see II.6.4 for details). While the need for such internal approvals is generally accepted, a seller will much appreciate it, if the acquirer has obtained the required approvals on the basis of close to final documentation and is able to instantly proceed to signing, as this will shorten the “time of uncertainty” between finalization of the negotiations and signing to an absolute minimum.

The share purchase agreement is usually signed in written form by authorized signatories of the parties. Those authorized signatories may be officers of the parties (e.g. managing directors, board members), other generally authorized officers (e.g. *Prokuristen*) or employees or other persons specifically authorized by individual power of attorney. While a signing by electronic copies exchanged by fax or e-mail would be sufficient and is quite common for preparatory documents (e.g. confidentiality agreements or letters of intent), the share purchase agreement itself is usually signed by the signatories in person with physical originals being exchanged. Affixing a corporate seal next to the signatures is not required and usually not done in Germany. If notarization of the definitive agreements is required, different rule apply – please refer to I.9.4.

In case there are no conditions precedent which have to be fulfilled prior to completion of the transaction, signing and closing will take place at the same time. If conditions precedent have to be fulfilled (e.g. merger control clearance), the parties will reconvene for closing once all such conditions precedent have been fulfilled.

At closing, the transfer of the shares of the target company takes place either automatically if signing and closing happen at the same time or if so agreed in the share purchase agreement or

upon signing of a share transfer agreement (please refer to II.6.1.1 for details) against payment of the purchase price. Typically, the purchase price is paid in cash by wire transfer to an account of the seller without anything further to pay attention to. For any other form of consideration, e.g. shares, consideration in kind, specific transfer requirements may have to be observed.
After all actions at closing have been successfully taken, the parties will often record the fulfillment of the conditions precedent for closing and the completion of the closing actions in a closing protocol or closing confirmation. In this document, the parties also confirm for the benefit of each other that closing has taken place. A closing protocol/closing confirmation is required neither by statutory law nor otherwise for the transfer of the shares to take effect. Signing such a document is not market standard but nevertheless quite common in Germany, in particular in larger and more complex transactions with, e.g., a number of closing conditions like merger control clearances in multiple jurisdictions. The main purpose of a closing protocol/ closing confirmation is to have a confirmation that both parties consider the transaction completed. This may help in a post-closing litigation in case one of the parties then questions whether all closing conditions had been fulfilled prior to closing or that all closing action had been taken. In addition, a closing protocol/closing confirmation serves as a document of reference which contains the complete documentation for the transaction for the period after the signing date until the completion of closing.

8. Post Transaction Requirements

Please refer to I.10.2.2.

III. M&A Process - Asset Deal

1. Peculiars

1.1 Qualifications

Instead of going for a share deal, an acquiror should also consider the alternative of an asset deal. When deciding on share deal or asset deal as the preferred transaction structure, an acquiror should carefully analyze and balance the advantages and disadvantages of both transaction structures.

From the perspective of the acquiror, an asset deal has two main advantages: On the one hand, it gives the acquiror the possibility to do cherry picking and to limit his exposure to liabilities (e.g., product liability risks) or risks (e.g., tax risks, risk to repay subsidies granted in violation of EU law etc.) of the business and the selling entity. There are of course limitations to a complete cut of such exposure (see, most importantly, Section 25 of the German Commercial Code (acquiror remains liable for all liabilities of a business if he continues the business under the same branding), Section 75 of the German Fiscal Code (acquiror remains liable for taxes related to the business as such, in contrast to taxes related to the seller) and Section 613 a of the German Civil Code (employment agreements transfer to the acquiror upon transfer of the business operation)), but this is one key advantage compared to a share deal. On the other hand, an asset deal allows the acquiror - again, different from a share deal - to do a so-called "step-up". The "step-up" enables the acquiror to allocate the purchase price to the different assets and thereby reduce the future tax burden by increasing the potential for depreciation.

But an asset deal has also at least two main disadvantages. The most important disadvantage is in many cases (exception: sale out of an insolvency) a conflict of interest between seller and acquiror which makes it more difficult to strike a deal: While the acquiror prefers cherry picking, the seller normally wants to get rid of all liabilities and risks linked to the business that is sold. But an asset deal also creates more risk for transaction security. While in case of a share deal third party consents are normally limited to applicable government approvals (e.g. merger control) and third parties whose contracts contain a change of control clause, an asset deal multiplies the required third party consents. In an asset deal scenario, any transfer of a liability or

contract requires the consent of the counterparty - unless the underlying contract allows for such transfer. In case security interests on certain assets have been granted to a financing bank, consent of such bank also has to be granted. And, last but not least, employees can - different from a share deal - object to the transfer of their employment relationships to the new acquiror.

To summarize: An asset deal has a number of advantages for the acquiror, but it makes it normally (much) more difficult to strike a deal with the seller and potentially also increases the risk for transaction security - or underlying commercials.

1.2 Transfer of Personal and other Labor Issues

The consequences of a company acquisition regarding labor issues depend on whether the purchase was a share deal (cf. II.3.3.2) or an asset deal.

Although an asset deal indeed leads to a change in the identity of the legal entity, this does not mean that commitments resulting from employment contracts and/or CBA's and/or work agreements would simply expire or could be easily terminated.

The relevant statutory provision in this respect is Sec. 613 lit. (a), according to which existing employment contracts are transferred to the new owner. Hence the purchaser becomes the contracting partner of the employee by operation of law.

In the case of a share deal, the employee protection offered by Sec. 613 lit. (a) BGB is not required, because the mere change of the shareholder structure does not have any impact on the existing employee relationships in the first place.

In case of an asset deal an employee relationship is transferred according to Sec. 613 BGB with each and any pertaining rights and obligations, including previous employment periods, irrespective of the purchaser’s intentions. Yet, the individual employee may prevent a transfer of his or her employment relationship by notifying the previous or new owner of its dissent pursuant to Sec. 613 lit. (a) No. 6. Termination of an employment relationship by the seller or the purchaser solely by reason of the company transfer is ineffective, cf. Sec. 613 lit. (a) No. 4 BGB. There must be an additional factual reason that “out of its own accord” would suffice to justify the termination.

Provisions in CBAs and works agreements are, by operation of law, directly applicable to each employment relationship that is transferred to the purchaser (Sec. 613 lit. (a) No. 1 second sentence BGB), and it is not possible to make changes to the detriment of the employee, not even through a mutually agreed contract amendment, within a period of twelve months following the transfer. The provision applies irrespective of whether the purchaser is bound by a collective agreement or not and provides protection of the employee's prior rights. It is one of the most difficult questions in the event of a company transfer and entails various individual issues.

1.3 Transfer of Real Estate

1.3.1 Implications of the Sale of Real Estate on the Asset Purchase Agreement and the Deal Structure

Whenever real estate (meaning an interest in a plot of land) is sold in the context of an asset deal this has several implications on the asset purchase agreement (APA) and the deal structure:

- The fact that real estate is sold leads to the necessity to notarize the (whole) APA which means higher transaction costs as the notary public will charge fees.

- The real estate needs to be exactly described in the APA which is done by setting forth and referring to the information contained in the respective land register.

- Whenever real estate is transferred the APA will typically include specific representations and warranties relating to such real estate, in particular regarding encumbrances, pollution and contamination of the soil.

- Real estate can only be transferred by an agreement of conveyance which is an additional agreement distinct from the obligation to transfer real estate and which needs to be notarized as well. The agreement of conveyance may, however, be included in the same notarial deed/APA.

- In case of external financing of the acquisition, lenders might demand the encumbrance of the real estate as security for loans and the seller will usually grant his permission to do so in the APA ("Belastungsvollmacht").

- Real estate is only effectively transferred once such transfer is registered in the respective land register; such registration can take several weeks.

- As the transfer of real estate cannot, by law, be made conditional upon the payment of the purchase price, such payment is only made once a priority notice which secures the purchaser's claim to the transfer of the real estate is entered in the respective land register.

- Pre-emption rights in favor of the municipality in which the real estate is located might exist and thus one of the conditions for the payment of the purchase price must be the confirmation that no such right of pre-emption exists or it must have been waived.

- The sale and acquisition of real estate is subject to the "real estate transfer tax". This tax must be paid before the land register will register any transfer of real estate.

1.3.2 General Remarks on Real Estate Law

The above is due to the particularities of German property law (including the real estate law) which, for the most part, is codified in the Civil Code (Bürgerliches Gesetzbuch). The basic principles of German real estate law are:

1.3.2.1 Interests in Land

In Germany the interests in land are set forth and defined in the Civil Code. Apart from these interests in land no other interests are recognized. The interests in land are all rights in rem which have an absolute effect against third parties, meaning that all must respect such right.

The strongest interest in land is ownership (*Eigentum*) which, in principle, means the absolute and unfettered control over the land (not limited in time) with the right to exclude others from its use and access to it. German law recognizes different types of ownership: Apart from sole ownership (*Alleineigentum*), the concepts of Co-Ownership (*Miteigentum*) and Joint Ownership (*Gesamthandseigentum*) exist. Thus, if several persons own an undivided share of land they are co-owners and each of them can dispose of its share independently of the others. Joint ownership means that land is owned jointly with others; such an owner is entitled to a share of the joint property but cannot dispose of his share without the consent of the other owners. Another interest in land recognized under German law is the Hereditary Building Right (*Erbbaurecht*)

which is the transferable and hereditary right to have a building on another's land. The person holding the hereditary building right owns the building. Usually, a fee for the use of the land has to be paid and contracts for hereditary building right are long term with a duration of between 30 and 99 years.

Other interests in land recognized by German law are easements, i.e. the right to use land that is owned by another person, security interests in land and the in-rem preemption right. These rights are also transferable.

1.3.2.2 Real Estate Property

According to German law the ownership of a plot of land comprises and includes (with some exceptions) the ownership of all things that are firmly attached to the soil (like buildings) or are permanently built into buildings as they are considered an indivisible part of the land (a deviation from this principle is the Hereditary Building Right, cf. above). Separate ownership of and title to a building does not exist (with some exceptions, e.g. the hereditary building right). Therefore, in principle, the ownership of and title to buildings, factories, offices and warehouses cannot be transferred independently of the plot of land on which they are erected.

1.3.2.3 Land Register

All interests in land are registered in land registers (*Grundbücher*) which contain, in particular, information on the owner of the land and its encumbrances. The land registers are administrated by the district courts (*Amtsgerichte*). The registration of an interest in land gives rise to the assumption that such interest exists and is held by the person stated in the register thereby making a bona fide purchase from a non-owner possible as long as he is registered.

1.3.3 The Transfer of Real Estate

Under German law the obligation to transfer an interest in land (the "obligatory contract") is separated from the actual transfer, the conveyance, of such interest (the "real contract"). Therefore, a seller and a purchaser must first enter into an APA (*Grundstückskaufvertrag*) which contains the obligation to transfer the respective interest in land. The actual transfer of an interest in land requires a (separate) agreement of conveyance (*Auflassung*) and a corresponding entry in the land register.

1.3.3.1 Asset Purchase Agreement

The APA must be concluded in a notarial deed which means its provisions must be read out by a notary public in the presence of both parties and it must then be signed by the parties and the notary public, otherwise it is invalid. Further, not only the contract itself needs to be notarized but also all other agreements which are closely linked to it (e.g. financing or construction agreements). The APA must contain an exact description of the plot of land (which is taken from the land register), the interest to be transferred and the purchase price. Usually, the APA will contain certain representations and warranties and a specific liability regime.

1.3.3.2 Agreement of Conveyance

The separate agreement by which the parties agree the transfer of the interest (and by which the seller discharges his respective obligation to do so) has to be declared with both seller and purchaser present at the same time in front of a notary. As the payment of the purchase price cannot, by law, be made a condition for the transfer of the interest, the payment is made conditional upon the registration of a priority notice (*Vormerkung*) in the land register for the benefit of the purchaser which leads to any (other) registration violating the secured claim (i.e. the claim to transfer the interest) being invalid with regards to the person trying to make a (conflicting) registration. After a priority notice has been registered, the purchase price is paid.

1.3.3.3 Entry in the Land Register

The interest which is subject to the agreement of conveyance is only transferred if and when the change of the interest (e.g. the transfer of ownership) is registered in the respective land register. Once the seller and the acquirer have entered into the agreement of conveyance and the change of interest is registered in the land register, the transfer is effective irrespective of the validity of the underlying APA. However, if the APA is invalid, the seller can reclaim the interest on grounds of unjust enrichment.

1.3.4 Administrative Permits and Restrictions

The municipality in which a plot of land that is subject to an APA is located might have a right of pre-emption. No registration can be made with the land register unless the respective municipality confirms that it either has no pre-emption right or does not exercise it.

1.3.5 Real Estate Transfer Tax

Real estate transfer tax (*Grunderwerbssteuer*) is regulated by a separate statute and is a certain percentage of the purchase price. As the federal states are free to determine the percentage, the real estate transfer tax is not uniform throughout Germany. The land register will only make an entry once they are provided with a clearance certificate confirming the payment of the real estate transfer tax (*Unbedenklichkeitsbescheinigung*) issued by the tax authorities.

1.4 Transfer of Licenses and Permits

With the exception of certain approvals (such as under cartel law and for national security), asset deals in Germany as such do not require administrative approval. However and other then in share deals, administrative approvals may factually impact the deal with regards the transfer of licenses and permits. Permits can be divided into the following two categories:

Object-related permits (*sachbezogene Genehmigungen*)
Object-related permits can be transferred together with the asset. Each such permit can be considered as an asset itself, being an ancillary right to an asset. In some cases the transfer of the permit has to be notified to the competent authority. Examples for object-related permits include (1) construction licenses; and (2) operating licenses for industrial facilities under the Federal Immission Control Act, including all relevant regulatory authorizations which are required to build and operate the facility. In this regard, the authority does not have to approve the transfer when the operator changes in an asset deal.

Personal permits / concessions (*personenbezogene Genehmigungen*)
Personal permits / concessions cannot be transferred. Instead the buyer has to apply for the necessary permits himself and anew as the permit often depends on certain personal and professional qualifications, skills, organizational set-ups and specific know how. Another very important personal aspect under certain laws is the reliability of the operator.

In most M&A transactions, both types of permits are relevant and, in fact, there are circumstances under which both types are combined, such as for the power generation in Germany: For those there are strict requirements in regard of the facilities (***object-related***) as well as the operator (***personal permits***).

1.5 Third Party Consents

As indicated above under III. 1.1 (Qualifications), an asset deal triggers a large number of consent requirements from third parties - going well beyond the consent requirements triggered by a share deal.

Third party consents may be necessary for an asset deal under mandatory law (cartel law, national security, cf. item I. 9.2), corporate law, contractual obligations, for the transfer/assignment of contracts and in case of certain encumbrances on the asset. To highlight some peculiar third party consents:

Most importantly, unless the underlying contract allows for transfer without consent, any contract will only transfer to the acquiror upon consent of the counterparty. The same applies for liabilities - if these are to be transferred to the acquiror.

The relevant asset(s) may serve as collateral, may not be (solely) owned by the seller or may be encumbered. Depending on the security right that has been granted, assets that have been provided as security interest to a financing bank may only be transferred with the consent of such bank. Consents from the secured party must be obtained prior to transfer (examples: title retention / transfer of ownership by way of security, mortgage). While the buyer may still lawfully obtain ownership in such assets under the good faith principle, it will not do so where it had or could have had knowledge over title defects or where securities were listed in public registers (such as for mortgages).

In insolvency proceedings the insolvency administrator has to obtain approvals from the meeting of creditors before disposing of assets from the insolvent company.

In family run businesses, spouses may have to consent to an asset transfer for the business, even if the spouse is not directly or visibly involved in the business. However, these statutory provisions can be waived by a marriage contract ("*Ehevertrag*").

The right of employees to object to the transfer of their employment relationship should also not be underestimated. While in most cases employees will have an interest to stay on board, such rule allows key employees an easy way out - without having to observe contractually agreed notice periods (please refer to III.1.2 (Transfer of Personal and other Labor Issues).
There are different ways how to deal with necessary third party consents. Of course, third party consents that are either legal prerequisites (e.g. merger control approvals) for closing the deal or

that are considered a must by the acquiror for commercial reasons should be agreed as condition precedents to closing. But such treatment will not be practical for most contracts and liabilities. For these cases, it is common to agree between the parties that, until the required consent has been granted, they will treat each other internally as if the consent had already been granted. In essence, this means that the seller will remain the contact person vis-á-vis the third party in question but that the seller will act upon the instructions of the acquiror. On the other hand, the acquiror will bear all commercial risks linked to this relationship, unless the seller acts in violation of instructions given.

To sum up: in case of an asset deal, the acquiror has to carefully scrutinize the business for necessary third party consents. Such consent requirements have then to be clustered according to their relevance for the deal, and contractual solutions have to be agreed upon protecting both sides against a scenario where required consents are not granted.

2. Contractual Documentation

Please refer to I.8.

3. Valuation

Please refer to II.5.

4. Taxation

General Tax Due Diligence Requirements

Generally, in an asset deal scenario, the buyer is not liable for historical tax liabilities of the seller. However, the buyer may be held liable by the tax authorities on secondary level (see below). Therefore, a full tax due diligence on the seller is generally not required, but a tax analysis of the asset deal itself. The following paragraphs illustrate the most relevant tax consequences and issues arising from an asset deal.

Purchase of Assets and Step-up of Tax Basis

In an asset deal, a new cost base is accorded to the assets purchased by the buyer, and the selling entity realizes a gain/loss amounting to the excess/shortfall of the purchase price over the book value of the assets. Generally, the allocation of such step-up/step-down is performed on an asset-by-asset basis.

Purchase of Partnership Interest and Step-up of Tax Basis

From a purchaser's tax perspective, the acquisition of a partnership interest is treated as a pro-rata acquisition of the partnership's assets. Consequently, the buyer can step-up the basis in their pro-rata share of partnership assets acquired to equal the full purchase price.

Goodwill

Goodwill generally is calculated as the difference between the purchase price and the sum of the stepped-up market values of the other assets and is capitalized at this value.

Depreciation and Amortization

The acquired tangible and intangible assets, including goodwill, are to be capitalized at their fair market values. For tax purposes, goodwill is amortized over a 15-year period. All other assets are depreciable over their useful lives.

Acquisition Gain at Level of the Buyer

The assumption of certain liabilities (for example, for contingent losses or pensions) that are not recognized in full in the tax balance sheet of the seller due to certain restrictions for tax accounting purposes results in a post-acquisition profit of the buyer in the business year of the acquisition as the purchaser must apply the original accounting restrictions. The resulting profit may be spread over a period of 15 years which may avoid taxation of the post-acquisition profit to some extent where, for example, the contingent tax loss is correspondingly realized in the same periods. In practice, material acquisition gains may be realized, in particular, in connection with assumed pension liabilities as those liabilities must be assumed by law if the employees are transferred.

Tax Attributes

Tax loss, interest and EBITDA carryforwards and other attributes are not transferred in an asset deal. They remain with the seller.

Value Added Tax

The transfer of single or several assets which do not represent a business as a going concern is subject to 19% VAT whereas the transfer of a business as a going concern as such is a non-taxable event for VAT purposes.

If the asset deal does not represent a business as a going concern, the VAT is generally payable by the buyer in addition to the purchase price. However, the buyer would generally be entitled to claim a corresponding input VAT refund if the buyer qualifies as entrepreneur for VAT purposes and does not provide certain VAT free services. However, in practice, it might take some time until the refund will be approved by the tax authorities and therefore the VAT becomes a funding/timing issue. This is due to the fact that the acquisition vehicle must be newly registered (inter alia for VAT purposes) with the tax authorities.

Transfer Taxes

There is no stamp duty in Germany. However, the acquisition of real estate property in an asset purchase is subject to RETT on the purchase price allocated to the real estate property. The RETT is between 3.5 and 6.5 % (depending on the German state in which the real estate is located). If an asset deal triggers RETT, the purchaser and seller are generally liable for the RETT. Typically, an asset purchase agreement allocates the RETT as transaction costs to the purchaser.

Tax Liability of the Purchaser in an Asset Deal Scenario

Generally, the purchaser in an asset deal is not liable for any taxes of the seller. However, sec. 75 of the German Fiscal Code provides for a separate liability rule of the transferee (for example, in an asset deal scenario) with regard to tax liabilities of the transferor which cannot be excluded, for example by contract. According to this rule, the transferee may be held liable on a secondary level for business tax liabilities (for example, TT, but not CIT) and withholding taxes of the transferor if a business unit is transferred.

The liability is limited to such taxes which have accrued from the beginning of the calendar year immediately preceding the year in which the transfer was performed tax effective and are assessed or declared until the end of one year after the notification of the business transfer by the purchaser according to sec. 138 of the German Fiscal Code. The liability is limited to the net asset value of the acquired business. In practice, the notification according to sec. 138 of the German Fiscal Code should be filed timely after closing in order to reduce the period of a potential secondary liability.

Structuring Considerations

In contrast to a share deal in an asset deal scenario the acquisition financing may be raised by the acquisition vehicle which directly acquires the business assets. Therefore, it is not necessarily required to interpose a further German holding company above the acquisition vehicle, for example in order to achieve a debt-push-down. In practice, it may be useful to establish such holding company if the deal does not only comprise an asset deal in Germany, but also share deal(s). In this case, a holding structure may provide for administrative benefits if group wide functions are established at holding company level whereas the German business is run by the acquisition vehicle.

Top five Tax Advantages of an Asset Deal

- Direct allocation of the transaction financing to the acquired assets;
- Step-up to a higher tax depreciation base and goodwill amortization;
- No assumption of historic tax risks of the seller, only secondary level liability;
- Limited tax due diligence requirements compared to a share deal;
- Only target assets can be acquired (i.e. no pre-deal carve-out of non-target assets required).

Top five Tax Disadvantages of an Asset Deal

- Tax attributes cannot be transferred to the buyer;
- Higher capital gains tax for the seller that may request a compensation from buyer;
- Purchase price is subject to VAT unless a business as a going concern is transferred;
- Real estate transfer tax base may be higher compared to a share deal;
- Acquisition gain may be triggered at the level of the buyer.

5. Signing and Closing

Please refer to I.9.4.

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Abbreviations

AG	Aktiengesellschaft (Stock Corporation)
AktG	Aktiengesetz (Stock Corporation Act)
APA	Asset Purchase Agreement
ARC	Act against Restrictions of Competition
AWG	Außenwirtschaftsgesetz
AWV	Außenwirtschaftsverordnung
BaFin	Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin)
BGB	Bürgerliches Gesetzbuch (Civil Code)
BGH	Bundesgerichtshof (Federal Court of Justice)
BImSchG	Bundesimmissionsschutzgesetz (Federal Immission Control Act)
BMWi	Bundesministerium für Wirtschaft und Energie (Federal Ministry of Economic Affairs and Energy)
CA Act	Collective Agreements Act
CapEx	Capital Expenditure
CAPM	Capital Asset Pricing Model
CBA	Collective Bargaining Agreement (Betriebsvereinbarung)
CCA	Comparable Company Analysis
CIT	Corporate Income Tax
CTA	Comparable Transaction Analysis
D&A	Depreciation and Amortization
DCF	Discounted Cash-flow Method
DPMA	German Patent and Trademark Office
DTA	Double Taxation Agreement
DTT	Double Taxation Treaty
EBIT	Earnings before interest and taxes
EBITDA	Earnings before interest, taxes, depreciation and amortization
ECJ	European Court of Justice
EFTA	European Free Trade Association
EU	European Union
EUMR	Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings

EV	Enterprise Value
FDI	Foreign Direct Investment
FCFF	Free Cash Flow to the Firm
FCO	German Federal Cartel Office (Bundeskartellamt)
GAAP	Generally accepted accounting principles
GmbH	Gesellschaft mit beschränkter Haftung (Limited Liability Company)
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung (German Limited Liability Companies Act)
GP	General Partner
IP	Intellectual Property
KG	Kommanditgesellschaft (Limited Partnership)
LoI	Letter of Intent
LP	Limited Partner
Ltd.	Limited Liability Company
LTO	Local Trade Office (Gewerbeamt)
M&A	Merger & Acquisitions
MoU	Memorandum of Understanding
NWC	Net Working Capital
P&L-Agreement	Profit and Loss Transfer Agreement
PatG	Patentgesetz (Patent Law)
RETT	Real Estate Transfer Tax
PPA	Purchase Price Agreement
SE	European Company
SIEC	Significant Impediment on Effective Competition
SIEC-Test	Significantly Impedes Effective Competition-Test
SPA	Sales and Purchase Agreement
SPV	Special Purpose Vehicle
TV	Terminal Value
TT	Trade Tax
UG	Unternehmergesellschaft (haftungsbeschränkt) (Limited Liability Entrepreneurial Company)
UmwG	Umwandlungsgesetz
WACC	Weighted Average Cost of Capital
WCC Act	Works Council Constitution Act
WHT	Withholding Tax

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I. M & A Environment	
1. Investment Climate	Germany Trade & Invest
2. Industrial Policy	Bundesministerium für Wirtschaft und Energie, Dörthe Mannsbarth
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4. Targets	Taylor Wessing Partnerschaftsgesellschaft
5. Legal Framework	Germany Trade & Invest
6. Taxation	KPMG AG, Wirtschaftsprüfungsgesellschaft, Dr. Holger Lampe, Philipp Reer
7. Timeline	Please refer to II.2.2.1
8. Share Deal vs. Asset Deal	Taylor Wessing Partnerschaftsgesellschaft
9. Restrictions	
9.1 Sector Related Restrictions	WZR Beijing Ltd., Dr. Florian Kessler
9.2 National Security	WZR Beijing Ltd., Dr. Florian Kessler
9.3 Merger Control	Bayer AG, Dr. Paul Fort
9.4 Notarization	Taylor Wessing Partnerschaftsgesellschaft, Roman Bärwaldt
9.5 Commercial Aspects	Refer to II.I.8
10. Structure of Relevant Authorities	WZR Beijing Ltd., Dr. Florian Kessler
10.1 General, Interface Aspects	WZR Beijing Ltd., Dr. Florian Kessler
10.2 Sector related	WZR Beijing Ltd., Dr. Florian Kessler
10.3 Assistance to Foreign Investors	Taylor Wessing, Partnerschaftsgesellschaft
10.4 Environmental	Refer to II.3.5
II. M & A Process (Share Deal)	
1. Identification of Targets - Who to assist	Refer to I.10.3
2. Preparatory Activities	
2.1 Options for Transaction Structure	Taylor Wessing Partnerschaftsgesellschaft
2.2 Establishing Transaction Structure	Taylor Wessing Partnerschaftsgesellschaft
2.3 Corporate Structure	Taylor Wessing Partnerschaftsgesellschaft
2.4 Financing	HSBC, Dr. Björn Büssen, Wulf Linzenich
2.5 Special Requirements	Taylor Wessing Partnerschaftsgesellschaft
2.6 Investment Protection	Germany Trade & Invest

3. Due Diligence Items	
3.1 Corporate Formation	Volkswagen AG, Dr. Jörgen Rubel
3.2 Intellectual Property	BASF, Mirko Bengel
3.3 Labor - Collective Labor Arrangements	VDMA, Christian Steinberger
3.4 Assets	BASF, Mirko Bengel
3.5 Environment	BASF, Mirko Bengel
3.6 Taxation	KPMG AG, Wirtschaftsprüfungsgesellschaft, Dr. Holger Lampe, Philipp Reer
3.7 Financing	HSBC Trinkaus & Burkhardt AG
4. Approvals and Filings	
4.1 Required Approvals and Filings	WZR Beijing Ltd., Dr. Florian Kessler
4.2 Competent Authorities	WZR Beijing Ltd., Dr. Florian Kessler
4.3 Time Line	Refer to I.9.2, I.9.3 and I.9.4
4.4 How to challenge authorities	Siemens AG, Dr. Lars Münch
5. Valuation	KPMG AG Wirtschaftsprüfungsgesellschaft, Moritz Freiherr Schenck
6. Implementation Issues and Contractual Documents	Linde AG, Dr. Harald Voigts
7. Signing and Closing	Linde AG, Dr. Harald Voigts
8. Post Transaction Requirements	Refer to I.10.2.2
III. Asset Deal	
1. Peculiars	
1.1 Qualifications	Metro AG, Dr. Ramon Sieveking
1.2 Transfer of Personal and other Labor Issues	VDMA, Christian Steinberger
1.3 Transfer of Real Estate	Thyssen Krupp AG, Dr. Martin Schlag, Peter Freitag
1.4 Transfer of Licenses and Permits	Siemens AG, Dr. Lars Münch
1.5 Third Party Consents	Siemens AG, Dr. Lars Münch / Metro AG, Dr. Ramon Sieveking
2. Contractual Documentation	Refer to I.8
3. Valuation	Refer to II.5
4. Taxation	KPMG AG, Wirtschaftsprüfungsgesellschaft, Dr. Holger Lampe, Philipp Reer
5. Signing and Closing	Refer to I.9.5

This Guide (German Part) contains a summary of major aspects relating to M&A transactions in Germany, based on the authors' experience in their specific area of professional occupation, and thus covers a representative scope of M&A relevant experience from market practitioners acting on all party levels concerned by M&A transactions. Within such scope, the Guide reflects issues, which the authors consider to be of particular relevance for the subject of M&A transactions. It is not a comprehensive summary of the contents of M&A agreements or related ancillary agreements that may be concluded in connection with, in particular, share purchase and acquisition agreements, merger agreements and joint venture agreements. This handbook should not be regarded as a substitute for seeking specific legal advice in connection with an M&A transaction, nor does it constitute legal opinions or specific legal advice on the matters covered. The Guide only addresses legal issues arising in the context and for the purpose of the major types of M&A transactions described herein. It is thus limited to the legal matters expressly set out in it and should not be read as extending by implication to any other matters. For example, it does not include an evaluation in relation to, without limitation, financial, operational and accounting matters, tax matters and actuarial matters.

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Germany Trade & Invest

About Us
Germany Trade & Invest is the foreign trade and inward investment agency of the Federal Republic of Germany. The organization advises and supports foreign companies seeking to expand into the German market, and assists companies established in Germany looking to enter foreign markets.

All inquiries relating to Germany as a business location are treated confidentially. All investment services and related publications are free of charge.

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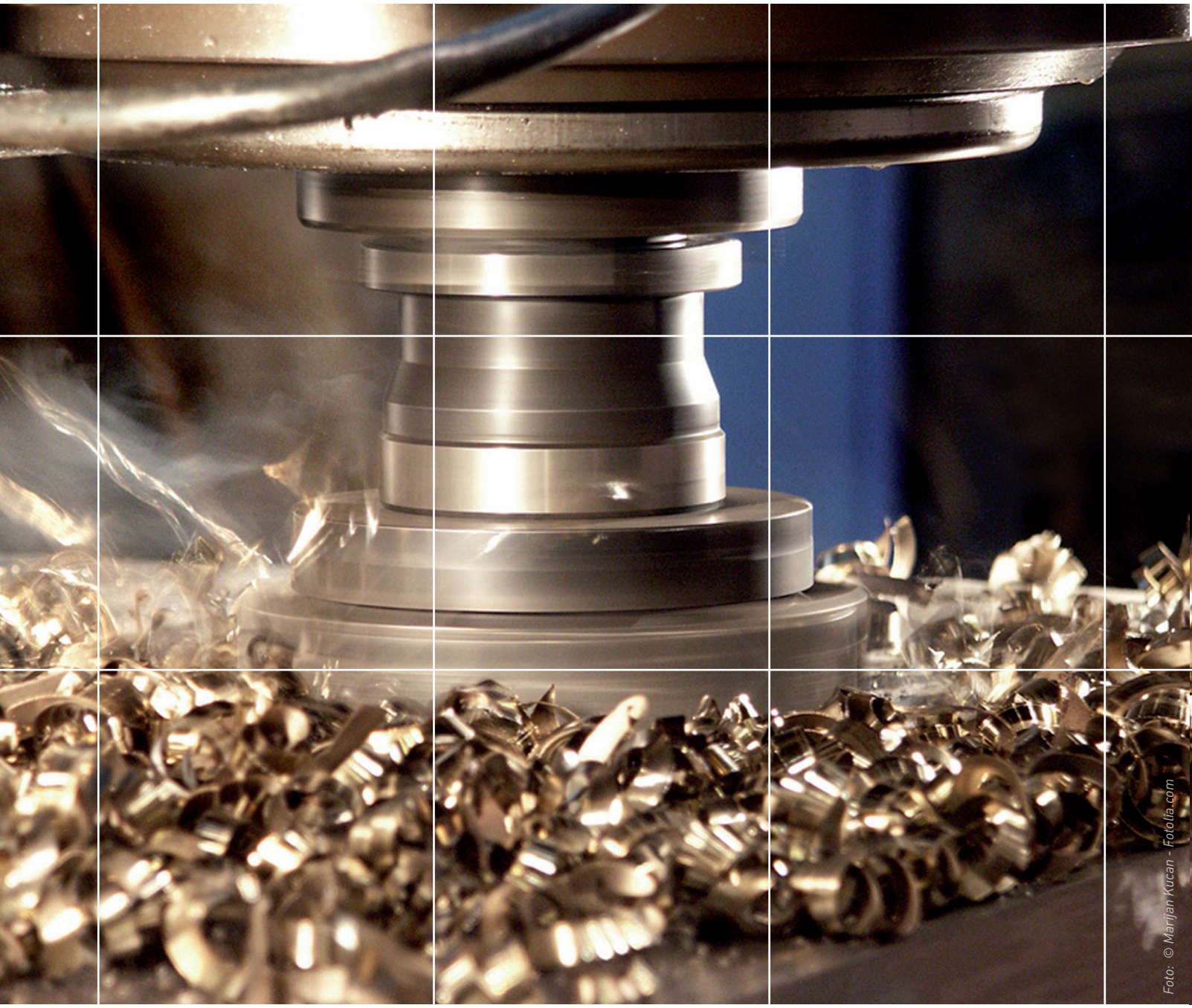

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