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PRIVATE EQUITY AND VENTURE CAPITAL

Private equity in Germany: market and regulatory overview

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MARKET OVERVIEW

1. How do private equity funds typically obtain their funding?

Investors in German venture capital funds (VC funds) and private equity funds (PE funds) in 2014 can be classified as follows (*Annual BVK Statistics 2014, German Private Equity and Venture Capital Association (Bundesverband Deutscher Kapitalbeteiligungsgesellschaften) (BVK)*):

- Private investors: 4.2%.
- Funds of funds: 11.9%.
- Insurance companies: 7.9%.
- Pension funds: 3.7%.
- Family offices: 7.6%.
- Foundations: 0.4%.
- Public institutions: 3.8%.
- Financial institutions: 2.2%.
- Private equity managers (GPs): 0%.
- Industrial companies: 5.8%.
- Other asset managers: 6.5%.
- Unknown: 42.5%.

2. What are the current major trends in the private equity market?

The BVK Statistics for 2014 show an increase of investments by more than a third compared to 2013. The buyout sector, which traditionally accounts for three quarters of the investment in volume, experienced a substantial increase to EUR5.59 billion compared to EUR3.9 billion in 2013.

The exit volume decreased from EUR6.167 billion in 2013 to EUR5.81 billion in 2014, with sales to financial institutions (31.5%) and trade sales (22.8%) being the most important exit channels.

2014 also saw an improvement in financing conditions, especially for German funds, according to the Private Equity Trend Report 2015 published by PricewaterhouseCoopers AG Wirtschaftsprüfungsgesellschaft in February 2014. 97% of the 200 funds interviewed for the Private Equity Trend Report 2014 were satisfied with the performance of their portfolio companies. Operational improvements and "Buy and Build" were on the top of the strategic agenda in 2014 and, according to the Private Equity Trend Report 2014, will continue to be the main focus in 2014.

The debt structure remained much more conservative relative to the pre-crisis level. Over half of the new investments made in 2014 were leveraged at less than 40%: a debt-equity-ratio of 1 to 2 seems to be the new norm.

3. What has been the level of private equity activity in recent years?

Fundraising

In 2014, the following amounts were raised in Germany for:

- Buyouts: EUR1.294 billion or 77.7%.
- Later stage venture: EUR138.4 million or 8.3%.
- Early stage venture: EUR105.71 million or 6.3%.

The total amount of fundraising of EUR1.667 billion increased by 25% compared to 2013.

The total amount of EUR1.667 billion in funds raised by the German private equity industry in 2014 is close to a 15 year low. However, fundraising for German private equity funds has always been cyclical with two absolute peaks during the boom years of 2000 (EUR5.164 billion) and 2007 (EUR4.532 billion). The current situation is less dramatic than the mere numbers may suggest for three reasons:

- The German funds have raised sufficient money as recently as 2011, a year which with an amount of EUR3.303 billion marked the third highest fundraising in 15 years.
- More than one third of the private equity investments made in Germany in 2014 were committed by international funds whose fundraising is not covered in the 2014 Annual BVK statistics.
- The total amount received by private equity funds and their investors through exits remained on a relatively high level with EUR5.81 billion in 2014, helping to improve sentiment on the return side.

Investment

Three years of steady growth in investments came to an end in 2013 with private equity investments in Germany totalling EUR4.68 billion, a 29% drop from the 2012 level of EUR6.63 billion. In 2014 the investments rose again to EUR7.06 billion.

In 2014 long-time leader Bavaria was the leading private equity region, 23% were invested into targets domiciled in the "laptop and lederhosen" region. Baden-Württemberg made it to second place in the regional rankings with 19% invested there. North Rhine Westphalia finished third with 17% of investments targeting companies based in the Rhine Ruhr region.

Companies from the industrial sector were the most popular targets in 2014, receiving 27% of all investments. The communication technology sector was the second most sought after sector accounting for 18% of investments, while 15% of private equity investments went into the consumer good sector.

Transactions

The distribution of investments by stage in 2014 did not change much. Buyouts were still the largest group by far while VC investments accounted for 9.1%. In detail, total investments in private equity in 2014 were subdivided as follows:

- Buyouts: 79.3%.
- Venture capital (seed, start-up and later stage venture capital): 9.1%.
- Growth: 9.7%.
- Replacement capital/turnaround: 1.9%.

Among the buyouts, the distribution for 2014 was as follows:

- Small buyouts (below EUR15 million): 4.9%.
- Medium-sized buyouts (between EUR15 million and EUR150 million): 35.3%.
- Large buyouts (between EUR150 million and EUR300 million): 30.3%.
- Mega buyouts (over EUR300 million): 29.5%.

The distribution among the buyout segments shows that the overall increase in investment volume in German private equity in 2014 was mainly caused by an eight-times increase in large buyouts, which went up from one transaction worth EUR184 million in 2013 to 7 transactions worth EUR1.698 billion in 2014.

Exits

Exit activities in 2014 slowed down marginally from EUR6.167 billion in 2013 to EUR5.810 billion in 2014. According to the BVK statistics for 2014, the split in exit routes in 2014 was as follows:

- Sales to financial institutions: 31.5%.
- Trade sales: 22.8%.
- Secondaries: 20.6%.
- Divestment through a stock exchange: 14%.
- Write-offs: 6.5%.
- Repayment of silent participations: 2.1%.
- Repayments of shareholder loans: 1.8%.
- Management buybacks: 0.6%.

REFORM

4. What recent reforms or proposals for reform affect private equity in your jurisdiction?

Act for the Promotion of Venture Capital Participations

Due to the fact that the Act for the Promotion of Venture Capital Participations (*Wagniskapitalbeteiligungsgesellschaft*) (WKBG) infringed the law of the EU, it was repealed with effect as of 24 December 2013.

Capital Investment Act

Since the implementation of Directive 2011/61/EC on Alternative Investment Fund Managers (AIFMD) through the German Capital Investment Act *(Kapitalanlagegesetzbuch)* (KAGB), PE funds and their managers are as Alternative Investment Fund (AIF) subject to supervision by the Federal Financial Supervisory Authority *(Bundesanstalt für Finanzdienstleistungsaufsicht)* (BaFin) and considerable obligations, in particular:

- Licence requirement for the fund manager of the AIF (AIFM).
- Internal organisation and risk and liquidity management requirements, including rules of good conduct, reporting requirements and restrictions on remuneration for the AIFM.
- Capital maintenance rules for the AIFM.
- Depositary requirements.
- Marketing requirements.

Besides these general rules applicable to any AIF, special requirements for PE funds were introduced, that is, the AIFM:

- Must fulfil specific notification requirements (thresholds) towards BaFin.
- Must comply with certain disclosure requirements.
- Are subject to detailed rules prohibiting "asset stripping" such as capital reduction or acquisition of own shares.

In summary, the KAGB greatly influences all aspects of the day-to-day business of PE funds active in Germany, in particular in the fundraising and structuring, marketing and fund management areas. It also imposes completely new ongoing compliance requirements for German funds and marketing and portfolio management rules for third party PE funds and fund managers.

AIFMs can raise and manage funds on a cross-border basis in other EU countries under the "passport option", if the respective fund qualifies as "Special AIF" (that is, its interests or shares can only be held by professional investors as defined in Directive 2004/39/EC on markets in financial instruments (MiFID) or (for marketing in Germany only) semi-professional investors within the meaning of the KAGB). Semi-professional investors must fulfil at least one of the following criteria:

- They commit to invest at least EUR200,000 and can prove in relation to the AIFM that they have the necessary market knowledge, expertise and experience for the investment.
- They are staff members of the AIFM who have influence on the risk profile of the AIFM or the AIF, that assume control functions or have a comparable status, and members of the board of directors of the externally managed AIF.
- They commit to invest at least EUR10 million in the specific AIF.

AIFMs only managing Special AIF are exempt from the full licence requirements (registration only) and most other KAGB requirements if the total funds volume is lower than either:

- EUR100 million (including assets acquired through the use of leverage).
- EUR500 million if the portfolio only includes unleveraged funds with no redemption rights within five years following the date of initial investment.

Such "sub-threshold" funds from other EU countries can market to professional and semi-professional investors in Germany, provided that the AIFM fulfils all of the following criteria:

- The AIFM is registered as a sub-threshold AIFM in its respective home member state.
- The marketing of the respective AIF is permitted under the rules of the respective home member state and is not subject to stricter rules than the KAGB rules for marketing of AIFs managed by sub-threshold AIFMs.
- The AIFM has formally notified the intended marketing to the BaFin.

Further, the KAGB is not fully applicable (only the registration requirement applies) if the PE fund's management is an internal AIFM which manages a domestic fund both:

- Whose assets do not exceed EUR5 million.
- Which does not comprise more than five individuals as investors.

European Venture Capital Fund Regulation

Regulation (EU) 345/2013 on European venture capital funds (EuVECA Regulation) which is applicable from 22 July 2013 provides a specific regulation for AIFMs which fall under the exemption in Article 3(2)(b) of the AIFMD.

The EuVECA Regulation applies to managers of PE funds if:

- The assets under management in total do not exceed EUR500 million (if no leverage is applied).
- They are established in the EU.
- They manage portfolios of qualifying venture capital funds (EuVECA).

In addition, the management of an EuVECA requires a specific registration in its particular home member state. If German managers of PE funds are registered as EuVECAs they only have to comply with a manageable number of provisions under the KAGB.

However, the EuVECA Regulation also provides specific provisions with regard to the selection and management of the assets, regular valuation, liability of the management, handling of conflicts of interest, protection of the investors, and so on. After a successful registration as an EuVECA according to the EUVECA Regulation, the EUVECA managers can distribute EUVECAs in each member state of the EU. An EuVECA can only be marketed to professional investors under the MiFID or to investors who invest at least EUR100,000 and declare in a separate document that they are aware of the risks associated with the envisaged investment.

Investment Regulation for Institutional Investors

The German Finance Ministry has published a draft of an amendment to the Investment Regulation for Institutional Investors *(Anlageverordnung)* (AnlageVO) to adopt the new rules of the KAGB. These institutional investors include insurance companies and pension funds. To date, German insurance companies and pension funds can invest in OECD-based vehicles if certain requirements are fulfilled (*see Question 12*). The new draft of the AnlageVO sets out a new investment quota for PE funds and limits the investment possibilities to AIFs which are managed by:

- A fully licensed AIFM pursuant to the AIFMD domiciled in the EEA.
- A fund manager domiciled in a member state of the OECD and that is subject to public supervision for the purpose of protecting the investors and that has been granted a permit comparable to the AIFM licence under the KAGB.

As a consequence, PE structures which are not subject to any comparable investment supervision will not qualify as eligible assets. It is expected that the new AnlageVO will come into force in the first quarter of 2015.

INVEST - Grant for Venture Capital Directive

The Federal Ministry of Economy and Energy has renamed its funding action for investments in venture capital to INVEST – Grant for Venture Capital and adjusted its regulations to the characteristics of the German venture capital market in effect from 22 April 2014 to improve the funding conditions for new and innovative companies via venture capital. To qualify a company must:

- Be active in one of the listed innovative sectors.
- Own a patent which is no older than 15 years and is related to its sector.
- Have been granted public funding during the last two years before the application.

Therefore, common PE funds may benefit from this type of funding only in particular cases.

TAX INCENTIVE SCHEMES

5. What tax incentive or schemes exist to encourage investment in unlisted companies? At whom are the incentives or schemes directed? What conditions must be met?

Incentive schemes

In contrast to the former WKBG, which was repealed with effect as of 24 December 2013, there are currently no specific tax incentive schemes for private equity investors. However, there are certain general rules of, and exemptions from, taxation which are of essence for PE funds, their managers and their investors.

However, in accordance with the INVEST - Grant for Venture Capital Directive (*see Question 4*) a new tax exemption (*section 3 (71), Income Tax Act* (*Einkommensteuergesetz*) (EStG)) was recently established. Under this tax exemption a public grant for the purchase of shares might be tax exempt up to 20% of the purchase price of the respective shares but is limited to EUR50,000. Usual investments of PE funds may not benefit from the exemption as the target must be a new and innovative company.

Capital gains tax exemption

Any capital gain realised by the sale of shares in a corporation by a corporation is, as a rule, 95% exempt from German corporate income and trade tax (*section 8b, Corporate Income Tax Act (Körperschaftsteuergesetz) (KStG)*). The remaining 5% are treated as non-deductible business expenses. As a result, the effective tax rate on capital gains is only about 1.5% (although there is discussion as to whether this exemption might be amended with regard to shareholdings amounting to less than 10%, so the sale of these minor shareholdings may not benefit from the exemption in the future). This exemption applies to:

- PE funds which qualify as non-transparent entities for German corporate income and trade tax.
- Any investor organised as a corporation, if the PE fund is qualified as tax-transparent but holds shares in corporations. A non-tax-transparent fund or an investor corporation in a transparent fund may, in addition, seek the protection of an applicable treaty on the avoidance of double taxation (*Doppelbesteuerungsabkommen*) (DTT).

If an individual invests into a tax transparent fund which holds shares in corporations, 40% of the capital gains are tax exempt, resulting in an effective tax rate of about 28.5%. In certain circumstances, a flat tax rate of about 26.4% on capital gains may apply (income tax rate including solidarity surcharge, plus potential church tax).

Tax-free carried interest

Generally, the carried interest distributed to the PE fund managers is qualified as taxable income from a commercial activity and is, therefore, subject to the full income tax rate of up to about 47.5%.

However, under certain conditions only 60% of carried interest realised is subject to income tax (that is, 40% of the carried interest is tax free).

Loss deductibility

In general, tax losses can be carried forward for an indefinite period of time.

However:

- They can only be set off without limitation up to EUR1 million per business year.
- For tax loss carry forwards exceeding EUR1 million, the set-off against taxable income is only possible up to 60% of the taxable income. The remaining tax losses carried forward are deferred.

Tax losses carried forward and current tax losses are forfeited completely or partly if shares in the corporation are transferred. If more than 25%, but no more than 50%, of shares are acquired the tax losses are extinguished pro rata (*section 8c, KStG*). If a PE fund acquires more than 50% of the shares in a target, the tax losses are forfeited entirely. However, tax losses carried forward and current tax losses can, in particular, be preserved to the extent of hidden reserves of the target in Germany.

FUND STRUCTURING

6. What legal structure(s) are most commonly used as a vehicle for private equity funds in your jurisdiction?

The most common legal domestic structure for PE funds is the limited partnership (*Kommanditgesellschaft*) (KG) with at least one general partner whose liability is unlimited. Usually, the general partner is a private limited company (*Gesellschaft mit beschränkter Haftung*) (GmbH) and the investors are the limited partners. For tax reasons, a second GmbH usually acts as a managing limited partner.

Other domestic legal structures are used less frequently, such as GmbHs, stock corporations (*Aktiengesellschaften*) (AG) and partnerships limited by shares (*Kommanditgesellschaften auf Aktien*) (KGaA), mainly for evergreen funds and funds that receive funding from public stock or bond markets.

Before the implementation of the KAGB, only two categories of VC/PE funds were specifically regulated:

- Equity investment companies (*Unternehmensbeteiligungsgesellschaften*) licensed under the Equity Investment Companies Act (*Unternehmensbeteiligungsgesetz*) (UBGG).
- VC investment companies licensed under the former WKBG, which has already been repealed.

The UBGG regulates funds' organisation and capital structure rather than legal form. The aim of the UBGG is to provide certain tax reliefs for PE funds (only). It also provides provisions that aim to prevent misuse of these tax reliefs.

Equity investment companies

An equity investment company must be approved by and registered with the Ministry of Economics of the federal state where it is domiciled.

To be recognised as an equity investment company, a company must:

- Pursue the object of buying, holding and selling company shares (*Unternehmensbeteiligungen*) in terms of equity capital under section 1, paragraph 1a of the UBGG.
- Be located in Germany.
- Have a minimum share capital of EUR1 million.
- Avoid holding structure (for example, a UBG that is a subsidiary of another company is in general not allowed to hold majority interest (>49% of the voting rights) in any target company).

VC investment companies

A VC investment company must be licensed by and listed with the BaFin. To be recognised as a VC investment company by the BaFin, a company must:

- Pursue the object of purchasing, keeping and selling venture capital investments (*Wagniskapitalbeteiligungen*) in terms of equity capital (section 2, paragraph 2, WKBG).
- Be located in Germany.
- Have a minimum share capital of EUR1 million.
- Be managed by at least two qualified individuals subject to a separate registration at the BaFin.

There are currently about 80 equity investment companies. VC investment companies have not been established under the former WKBG.

Foreign legal structures, mostly limited partnerships from Guernsey and Jersey (profiting from the European passport) and Delaware, as well as the Luxembourg SICAR (*Société d' Investissement à Capital Risque*), are also commonly used for PE funds investing in Germany.

7. Are these structures subject to entity level taxation, tax exempt or tax transparent (flow through structures) for domestic and foreign investors?

If a domestic fund structure is used, the tax consequences depend on whether or not the fund is deemed to be tax transparent.

Transparent structures

A domestic PE fund organised as a KG is usually qualified as tax transparent for German income and trade tax purposes, if it:

- Is managed by one or several of its limited partners.
- Does not hold a direct participation in a commercial partnership.
- Qualifies as a non-commercial partnership under the guidelines of the tax jurisdiction and tax authorities, in particular by the German Finance Ministry (*Bundesfinanzministerium*) (BMF) in its statement of 16 December 2003 (PE Decree). To qualify as an asset-managing partnership (*vermögensverwaltende Gesellschaft*) (that is, to be tax transparent for German corporate income and trade tax purposes under the PE Decree), a fund must usually, among other things:
  - not use external financing (except for limited short-term bridging loans);
  - use its expertise only for trading for its own account;
  - only manage and realise investments for its own account;
  - normally hold its investments for a minimum of three to five years;
  - not be actively involved in the management of its portfolio companies.

If the German PE fund is deemed to be tax transparent, German tax resident investors are taxed on capital gains resulting from the sale of both:

- Their partnership interest in the PE fund.
- The PE fund of a participation held in a portfolio company.

Non-transparent structures

German corporate fund structures such as GmbHs and AGs (corporate funds) are never tax transparent for German corporate income and trade tax purposes, irrespective of the identity and tax residency of their shareholders. Corporate funds are mainly used for evergreen PE funds and funds which (at least partly) rely on public stock or bonds markets for their fundraising. Therefore, the following general rules apply to the taxation of proceeds distributed to their investors:

- **Dividends received by a corporate fund.** Dividends received and capital gains derived from divestments are, in principle and subject to the particular cases below, 95% exempt from corporate income tax unless, in particular, the:
  - shareholding was acquired by the corporate fund to generate a profit by way of short-term trading; and
  - acquiring corporate fund is a mere holding company without any operative activities.

- **Corporate income tax exemption.** Dividends received by the corporate fund are subject to corporate income tax and commercial trade tax if the corporate fund holds less than 10% of the portfolio company's nominal share capital at the beginning of the respective calendar year.
- **Commercial trade tax exemption.** As a rule, dividends are only 95% exempt for trade tax purposes if the corporate fund holds at least 15% of the portfolio company's nominal share capital from the beginning of the relevant assessment period (that is, usually, from the beginning of the calendar year).
- **Withholding tax.** When the corporate fund distributes to its investors, dividend withholding tax and an eventual relief under an applicable DTT or the EU Directive 90/435/EEC on the taxation of parent companies and subsidiaries (Parent-Subsidiary Directive) may be applicable.
- No withholding tax is levied in cases where the payment can be qualified as a payback/return of paid-in capital rather than a distribution of profits (dividend). However, if the distributing entity has accrued distributable profits (*ausschüttbare Gewinne*), they are generally deemed to be distributed before a repayment of paid-in capital can be claimed.

AIFM tax rules

A PE fund can be covered by the special rules for open-ended funds in the Investment Tax Act (*Investmentsteuergesetz*). Since the implementation of the AIFM Directive, the Investment Tax Act now applies to:

- Undertakings for collective investment in transferable securities (UCITS).
- Alternative investment funds (AIF), such as PE or VC funds.

The Investment Tax Act provides for a special tax transparent regime for open-ended investment funds. The income of an open-ended investment fund is exempt from corporate income and trade tax. Taxation only takes place at shareholder level. To qualify as a tax-transparent investment fund, the fund must, among other things, meet the following criteria (*section 1(1b), Investment Tax Act*):

- The UCITS or AIF is subject to supervision at its registered office.
- The shareholders have a right to return their shares at least once a year.
- The business purpose of the fund is restricted to investment on behalf of the shareholders. There is no entrepreneurial management of the assets.
- The asset management must be based on the principles of risk diversification. There are limits for certain categories of assets.

If these conditions are not met, a fund is an investment company (*Investitionsgesellschaft*). In this case, the general tax rules apply (see above). Some special rules can apply which possibly lead to disadvantages for investors. However, this relates more to participations of German investors in foreign investment companies which are subject to a low tax regime. Most PE funds are covered by the AIFM tax rules.

Foreign structures

8. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as being tax inefficient (whether by not being recognised as tax transparent or otherwise)? What alternative structures are typically used in these circumstances?

If a foreign fund structure is used, the tax treatment of its investors depends on whether the foreign fund structure is comparable to the domestic German equivalent (that is, the tax authorities apply a "comparison of legal form" (*Rechtsformvergleich*)). Foreign limited partnerships are generally recognised as tax transparent by the German tax authorities provided they fulfil the PE Decree's set of criteria for asset-managing entities.

If a foreign fund structure is considered as tax inefficient under German tax law (that is, non-transparent), a tax transparent limited partnership fulfilling the criteria of the PE Decree is often used as a parallel vehicle (*see Question 7, Transparent structures*).

With regard to German resident taxpayers investing into foreign non-transparent fund structures the complex provisions of the German Foreign Tax Act (*Außensteuergesetz*) (AStG) or the German Investment Tax Act (*Investmentsteuergesetz*) (InvStG) may apply.

INVESTMENT OBJECTIVES

9. What are the most common investment objectives of private equity funds?

The main objective of PE funds is to realise a healthy rate of return for their investors. The return is generally measured by the internal rate of return (IRR) achieved by the fund over its life cycle. Closed-ended PE funds investing in Germany usually have a maximum life cycle of eight to 12 years. However, some funds are evergreen (that is, with an unlimited holding period). Due to the current market conditions and negative climate for IPOs, evergreen funds are considered more flexible.

PE investors usually expect an average annual IRR of 20% to 25%. However, these "pre- financial-crisis-level" IRRs require the sale of several portfolio companies through favourable trade sales or IPOs after holding a participation of not more than three to five years. They also require higher leverage (that is, debt financing which exceeds the 40% to 50% currently granted by LBO financiers). Also, due to capital markets in Europe and in Germany in particular (which have not offered favourable exit conditions in recent years), both:

- Typical holding periods now range from five to seven years.
- PE fund managers place more emphasis on operational improvements and implementing "buy and build" strategies in their investee companies.

Therefore, it is likely that the IRRs achieved by funds raised in recent years will be more in the range of 15 to 20%.

FUND REGULATION AND LICENSING

10. Do a private equity fund's promoter, principals and manager require licences?

Until 22 July 2013, when the KAGB implemented the AIFMD (*see Question 4*), the most common domestic legal PE fund structures or their managers did not require licensing. Only two categories of PE funds were specifically regulated (*see Question 6*). Depending on the service scope and the structure of a PE fund, its manager may now require a licence under the KAGB or needs to register according to the EuVECA Regulation, or rather the KAGB (*see Question 4*).

In addition, the Federal Administrative Court (*Bundesverwaltungsgericht*) (BVerwG) ruled in 2008 (contrary to the BaFin's legal opinion) that a limited partnership investing in financial instruments did not conduct a finance commission business (*Finanzkommissionsgeschäft*) requiring a licence under the Banking Act (*Kreditwesengesetz*) (KWG). However, the brokerage of units in funds through third parties generally requires a licence under the KWG or the German Code of Trade and Commerce (*Gewerbeordnung*).

11. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Equity investment companies

A PE fund may qualify as an equity investment company under the UBGG, granting it certain tax and financing advantages (*see Question 6*). However, PE funds usually do not apply for recognition as an UBG because UBGs are not allowed to acquire majority participations in their investee companies.

Public offering requirements

As of 22 July 2013, the KAGB (*see Question 4*) applies to any alternative investment fund and to UBGs (in addition to the regime under the UBGG).

If the PE fund qualifies as an investment fund under the KAGB, the PE fund's prospectus is exclusively regulated by the specific provisions of the KAGB.

If the participations of the PE fund qualify as securities according to the Securities Prospectus Act (*Wertpapierprospektgesetz*) (WpPG) and are distributed in a public offering, the prospectus must also comply with the WpPG.

Even if the shares of the PE fund qualify as securities, the WpPG does not require a prospectus if, for example:

- The offer is exclusively addressed to qualified investors.
- The offer is addressed to not more than 150 non-qualified investors in each member state of the European Economic Area (EEA).
- Investors may only acquire shares to the minimum amount of EUR100,000 at each issuance.
- The minimum denomination is EUR100,000.

In addition, the WpPG provides further exemptions depending on the concrete issuance of the shares of the PE fund.

However, if the PE fund does not qualify as an investment fund and its shares do not qualify as securities under the WpPG, the prospectus must comply with the German Investment Products Act (*Vermögensanlagengesetz*) (VermAnlG) if the shares are distributed in a public offering (that is, not only to professional investors). The VermAnlG does not require a prospectus if, for example, one or more of the following conditions are met:

- The share price exceeds EUR200,000 per investor.
- No more than 20 shares of the same kind are offered.

It is unclear whether the public offering of a duly registered EuVECA requires a prospectus. Even if the EuVECA qualifies as an investment fund under the KAGB, the KAGB does not include provisions requiring a prospectus for EuVECAs. However, the VermAnlG does not apply, as the EuVECA qualifies as an investment fund under the KAGB. The explanatory memorandum of the KAGB does not provide clarification in this regard. Nevertheless, it cannot be ruled out that BaFin will also require a prospectus for EuVECAs.

12. Are there any restrictions on investors in private equity funds?

No general restrictions apply under German law to investors in PE funds, except for the general civil law restriction which protects the assets of minors (that is, persons under the age of 18).

German insurance regulations applicable to insurance companies and pension funds (institutional investors) stipulate special terms which must be granted by the PE fund to the institutional investor:

- The institutional investor must be able to transfer its interest in the PE fund organised as limited partnership without the consent of the general partner.
- The PE fund can use leverage. However, on the level of a holding company, short-term borrowing is limited to 10% of the fund's value.
- The PE fund must be based in an OECD country.
- Additional liability of the investors must be excluded.
- The PE fund must provide annual financial reports which must be set up and audited in accordance with the rules stipulated in the German Commercial Code (*Handelsgesetzbuch*) (HGB) for corporations (*Kapitalgesellschaften*).

It is likely that in future only PE funds managed by an AIFM or comparably regulated manager will be an eligible asset for German insurance companies (*see Question 4*).

13. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

There are no statutory or other limits on maximum or minimum investment periods under German law. However, to be treated as an asset-management entity (as opposed to a commercial entity) under the PE Decree, the PE fund must hold its participations for three to five years (*see Question 7, Transparent structures*).

INVESTOR PROTECTION

14. How is the relationship between the investor and the fund governed? What protections do investors in the fund typically seek?

Generally, the relationship between the fund and its investor(s) is regulated by the partnership agreement (if the fund is a KG) or the company's articles of association (articles). However, if the PE fund qualifies as an AIF or as an EuVECA, the particular articles do also have to comply with the regulatory requirements of the KAGB or the EuVECA Regulation. In addition, the relationship between the investor and the AIF or the EuVECA is regulated by the investment requirements (*Anlagebedingungen*), which must be provided for every AIF and EuVECA. Further, the KAGB and the EuVECA Regulation provide a variety of provisions which have a specific impact on the relationship between the PE fund and its investors.

Investors commonly seek the following protection:

- Investment guidelines. Binding investment guidelines, particularly on the portfolio's diversification and the maximum investment term in a target to minimise the risk.
- Preservation of tax efficiency. Provisions safeguarding the fund's tax efficient structure to avoid double layers of tax, at fund level and at investor level. The fund should be structured so the investors, as limited partners, are treated fiscally as if they had invested directly in the underlying targets. Due to the transparent fund structure, returns are only taxed at investor level. The fund itself is not subject to taxation.
- Information and control rights. Information rights, participation rights and certain control rights, for example, defined investment types, or payments on extra management bonuses being subject to prior approval of an advisory board representing the investors.
- Payment obligations. Calculable and feasible payment obligations to the fund.

- Fees and expenses. Regulation of the fund's expenses, particularly on management and performance fees.
- Key man clauses. Regulations on the commitment of key personnel or managers, to create confidence in the fund and align the different interest of managers and investors. This is commonly achieved by committing managers and key personnel to invest their personal capital into the fund at a certain percentage.
- Exit possibilities. Extensive and sufficient exit or disinvestment possibilities from an evergreen-structured fund, or, if the fund is closed-ended, regulations on the investment term and conditions concerning a possible prolongation.
- Hurdle rates. These clauses set minimum performance thresholds which must be achieved before the fund managers can receive an increased share in the proceeds of the fund.
- Escrow arrangements. These clauses authorise an independent third party to receive and distribute proceeds from divestments of and dividends distributed by portfolio companies.
- Removal of general partner clauses.
- Carried interest. These clauses aim at limiting fund managers' rights to receive proceeds without contributing to the fund capital.
- Conflict of interest clauses.
- Default clauses.
- Claw back clauses. These clauses limit the managers' share in distributions made by the fund. Recently, these have been expanded to require fund managers to pay back already received distributions in case of later realised losses.

INTERESTS IN PORTFOLIO COMPANIES

15. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? Are there any restrictions on the issue or transfer of shares by law? Do any withholding taxes or capital gains taxes apply?

Most common form

PE funds usually take equity interests (in the form of ordinary or preferred shares) in the target, often combined with a type of shareholder loan. Recently, a combination of equity investment and mezzanine interests has become common.

Other forms

Mezzanine interests generally come in three distinct forms:

- **Equity similar interests.** These in turn can be divided into:
  - usufructury rights (*Genussrechte*) entitling the holders to earnings and/or capital gains;
  - atypical silent participations granting the holders a contractual participation in the target's assets (including hidden reserves (*stille Reserven*), participation in the target's profits and losses, and relevant control and information rights (*atypische stille Beteiligung*).
- **Hybrid interests.** These comprise warrants or convertible bonds (*Wandel- und Optionsanleihen*) enabling the bond holder, at his discretion, to convert the bonds into share capital in the target.
- **Debt interests.** These comprise debt instruments such as shareholder loans (alternatively with or without equity kicker) and typical silent participations granting its holder only a fixed interest on the capital contributed but not a share in the target's profits and losses and hidden reserves (*typische stille Beteiligungen*).

Advantages and disadvantages

Mezzanine interests award holders with a more limited share in the upsides and the risks of an investment than the straightforward equity investments. They usually rank behind the senior debt but take priority over equity interests.

Shareholder loans and most mezzanine interests like equity interests are subject to strict rules on the conservation of equity. A shareholder loan is treated as subordinated debt in insolvency, unless it is granted by non-managing shareholders holding 10% or less of the company's shares. If a shareholder received repayments on a shareholder loan in a time of crisis during the period of up to one year before filing for insolvency, these payments can be contested and reclaimed. Security granted for a shareholder loan by third parties during a time of crisis can also be reclaimed, if granted within ten years before filing for insolvency. Since young innovative companies are usually considered to be in a time of crisis, shareholder loans given by the PE fund often hold no advantage over direct equity investment.

Expenses for mezzanine debt may be tax deductible. However, certain restrictions may apply. In particular, the restrictions under section 8a KStG and section 4h EStG (interest stripping rule (*Zinsschranke*)) must be observed when combining equity capital with mezzanine capital (qualifying as debt for tax purposes) or debt. As a rule, the deduction of interest on borrowed capital is limited to 30% of the taxable earnings before interest, taxes, depreciation and amortisation (EBITDA), particularly if the net interest expenses (interest expenses exceeding interest earnings) of the company exceed EUR3 million (and provided that no other exception to the interest stripping rule applies, such as the stand-alone exception).

Restrictions

Corporations (*Kapitalgesellschaften*). The subscription to and the transfer of shares in a GmbH requires notarisation to be valid under German law. Shares in both AGs and GmbHs cannot be issued below par value, with the current minimum being EUR1. In addition, share transfers in GmbHs and AGs can be restricted by adding consent requirements (*Vinkulierungen*) into the corporation's articles of association (*Satzung*). Regular consent requirements include prior consent by:

- The corporation.
- The shareholders' meeting.
- The supervisory board.
- Other non-mandatory boards, such as an advisory board (*Beirat*) or a shareholder committee (*Gesellschafterausschuss*).

Partnerships (*Personengesellschaften*). Usually, the admission of new limited partners and the transfer of partnership interests require the consent of the fund's limited partners. However, given the extreme statutory flexibility for limited partnerships, these consent requirements can be modified or excluded. This is usually required when an institutional investor (insurance company or pension fund) becomes an investor in a PE fund (*see Question 12*).

Taxes

See *Question 7* for taxation of proceeds derived from equity interests and above, *Advantages and Disadvantages*, for tax issues with regard to mezzanine interests.

BUYOUTS

16. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

Auction processes have become very common even for smaller and medium-sized buyouts. There are no specific rules for auction processes under German law. There are only general rules contained in the:

- German Act Against Restraints of Competition.

- Special rules contained in the applicable procurement laws in the case of the sale of privatisations or sale of publicly owned companies.

17. Are buyouts of listed companies (public-to-private transactions) common? If so, which legislation and rules apply?

If the target's shares are listed and the target has its corporate seat in Germany, the German Takeover Act (*Wertpapiererwerbs- und Übernahmegesetz*) (WpÜG) applies. The WpÜG provides, among other things, for a mandatory takeover offer if the potential buyer acquires 30% or more of the capital interest or voting rights of a listed target.

PE funds tend to avoid public to private transactions (private investment in public entities) (PIPE) which are not common due to their complexity. Also, while the target is still a publicly listed AG, the PE fund is legally not allowed to receive the usual buyer protection clauses (*see Question 19*). This is because such a grant of special rights to one shareholder violates the principle of equal treatment of all shareholders (*AktG*).

The Federal Court of Justice (*Bundesgerichtshof*) (BGH) has established the following basic conditions for a (voluntary) de-listing to be permissible under the AktG:

- The general shareholders' assembly (*Hauptversammlung*) must resolve on the de-listing.
- The target or its main shareholder must submit a public offer for the acquisition of all outstanding shares from the remaining shareholders as a compensation for the de-listing.

If the PE investor holds at least 95% of the target's shares, it can initiate a squeeze-out under the WpÜG or the AktG. Currently, the squeeze-out under the AktG is the more popular route chosen by majority shareholders.

Finally, a recent amendment to the German Transformation Act (*Umwandlungsgesetz*) (UmwG), has established a third squeeze-out route. This solution allows a shareholder holding 90% or more in a subsidiary to squeeze out the remaining minority shareholders through an upstream merger in which the subsidiary is merged with the parent company.

Principal documentation

18. What are the principal documents produced in a buyout?

The principal legal documents used in a buyout are:

- **Acquisition documents.** The principal acquisition documents consist of one or several share and/or asset purchase agreement(s) (investment agreement).
- **Equity documents.** The main equity documents are the:
  - shareholders' agreement (often combined with the investment agreement);
  - target's articles;
  - service agreements for key personnel (managers and/or board members);
  - rules of procedure for the supervisory board/advisory board;
  - rules of procedure for the management;
  - shareholder loan agreements or similar instruments concluded between the NewCo as acquisition vehicle and its shareholder(s) (that is, the PE fund).
  -
- **Debt documents.** These are:
  - senior facility agreements;
  - mezzanine facility agreements;
  - security documents granting security over the shares and assets of NewCo and the target;
  - security trust agreements (if any), under which the security trustee is required to hold certain types of security on behalf of the lenders and to execute the security in its own name (but for the lender's account);
  - inter-creditor agreements, if any.

Buyer protection

19. What forms of contractual buyer protection do private equity funds commonly request from sellers and/or management? Are these contractual protections different for buyouts of listed companies (public-to-private transactions)?

The most common forms of contractual protection for PE investors are:

- **Representations, warranties and indemnities.** In the investment agreement, the company and the sellers and/or the management typically give detailed representations and warranties concerning, among other things:
  - the legal organisation of the company;
  - capitalisation, taxes and financial statements;
  - ownership of assets (particularly IPRs);
  - important commercial agreements;
  - employees;
  - litigation;
  - legal and regulatory compliance.
- **Information rights.** General information rights are provided by the target's articles. However, these rights generally only cover standard information rights for shareholders as a statutory requirement. Additionally, the shareholders' agreement usually requires the management to report to the investor (and other major shareholders) on a monthly, quarterly and annual basis.
- **Control rights.** The investment agreement usually contains a detailed list of business matters requiring the prior consent of the advisory board. The investor is usually granted the right to appoint a certain number of members of the advisory board.
- **Restrictive covenants.** The buyer usually asks the sellers to enter into covenants regulating the target's business operation between signing and closing of the investment. These restrictive covenants are usually used to preserve the target in the financial status of the last annual account date on which the PE buyer has based its purchase price calculation. These restrictive covenants are of particular importance in the case of the locked box purchase price method (that is, a case where purchase price adjustments are not based on specially prepared closing date accounts). In these cases, they are the only safeguard for the investor to prevent cash leakage between singing and closing.
- **Purchase price adjustments.** In the aftermath of the financial crisis, the target's net cash position has become more important for liquidity considerations. Consequently, PE buyers rejected lock box purchase price methods, while earn-out provisions became more popular. Earn-out clauses make a substantial part of the purchase price dependent on the target's financial performance after closing. They are often used to bridge the often considerable gap between the seller's purchase price expectations based on future earnings forecasts and the often much lower buyer's company valuation based on the target's past performance. The clear disadvantage of earn-out clauses is

that they are prone to provoking purchase price disputes after closing.

- **Liquidation preferences.** These apply in any case of distribution events such as liquidation, dissolution, trade sale, merger and IPO. They award the PE investor with a preference amount equal to his original investments, plus follow-up financings, plus interest of usually between 8% and 12%.

20. What non-contractual duties do the portfolio company managers owe and to whom?

Portfolio company managers:

- Owe fiduciary duties (*Treuepflichten*) to the portfolio company, such as confidentiality and non-compete obligations.
- Are generally required by law to act in the best interest of their company. The company interest is not to be confounded with the (majority) shareholder's interest. The managers must also take into account the interest of other stakeholders, such as the company's employees.

In the case of a proposed management buyout (MBO), the managers must use their best efforts to avoid potential conflicts of interest. If a manager plans to enter into negotiations with a PE investor backing the MBO, the manager must inform the competent body for negotiations with the manager (such as the shareholders' meeting in the case of a GmbH or the supervisory board (*Aufsichtsrat*) in the case of an AG) before starting these negotiations.

21. What terms of employment are typically imposed on management by the private equity investor in an MBO?

The service agreement requested by the PE fund usually contains restrictive covenants, including non-compete, non-solicitation and confidentiality obligations. These are usually contained in both the:

- Manager's individual service agreement (*Arbeitsvertrag*).
- Shareholders' agreement concluded between the manager(s) and the PE investor in the MBO.

The PE investor usually insists on:

- An incentive payment structure tying the level of employment compensation to the company's achievement of certain economic milestones.
- Clawback provisions. These grant the company and/or the investor the right to require the manager to re-transfer his shares in the NewCo to the company or the investor, if the manager leaves the company before the lapse of the period agreed between the parties for the implementation of the joint business plan for the target (usually at least four years). These clawback provisions usually differentiate between good and bad leavers.

22. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company? Are such protections more likely to be given in the shareholders' agreement or company governance documents?

Statutory control rights

The PE fund is usually the majority shareholder of NewCo which is organised as a GmbH. Unlike in an AG, the majority shareholder has far-reaching control and instruction rights in relation to the management of the GmbH, which is usually composed of the managers of the target. For example, the shareholders in a GmbH can:

- Instruct its managing directors to take or refrain from taking certain measures. The managing directors are bound to implement these measures unless they are evidently illegal.
- Remove the management of a GmbH at any time at their sole discretion.

Contractual control rights

The equity documents, namely the shareholders' agreement (*see Question 18*) usually contain a:

- Catalogue of operative measures requiring the prior consent of the shareholders' meeting or the shareholders' committee (if any).
- Set of rules of procedure for both the management of the NewCo and the target.

The articles of association of a GmbH must be filed with the commercial register (*Handelsregister*) and are therefore available to the public online. This is why contractual control rights are usually attached to the shareholders' agreement which, as an agreement *inter partes*, does not enter the public domain.

DEBT FINANCING

23. What percentage of finance is typically provided by debt and what form does that debt financing usually take?

Senior debt

The financial crisis has drastically reduced the number of sponsors for LBO financings. Previously very active players have withdrawn (such as HSH Nordbank) or disappeared completely from the market (such as WestLB), or have been forced by their shareholders to withdraw from the German market (such as Royal Bank of Scotland). Therefore, debt financing is hard to obtain in the current economic climate and, if available, the debt-equity ratio is much more conservative than before the financial crisis. It usually ranges between 1:1 and 1:2, depending on the:

- Risk assessment of the financiers for the individual acquisition.
- The industry sector in which the target is active.

Senior debt is regularly divided into long-term acquisition and short-term working capital facilities.

Mezzanine debt

Given the current financing climate, there is very little room for mezzanine debt financing in LBOs. The interest rate for standard mezzanine products is currently between 7.5% and 9% per year, while tailor-made financings are priced at interest rates between 10% and 12%. Second lien finance (that is, debt finance ranking between senior and mezzanine debt in its risk and return profile) is currently not relevant.

In the aftermath of the financial crisis, vendor loans have been widely used to bridge the gap between the:

- PE fund's valuation of the target and its financing abilities.
- Often much higher price expectations of the seller, which are based less on past performance than on projected future earnings of the target.

Lender protection

24. What forms of protection do debt providers typically use to protect their investments?

Security

Financing sponsors are usually granted a pledge of the shares and assets of the:

- NewCo.
- Target.
- Subsidiaries.

Depending on the business of the target, financiers place different importance on different asset pledges (for example, in the case of a software or IT company, particular attention is given to obtaining security over intellectual property (IP) rights such as patents and trade marks).

Due to the fact that NewCo is usually a special purpose vehicle (SPV) formed exclusively for the proposed acquisition, its pledgeable assets are usually limited to:

- The shares in the target.
- Rights arising out of and in connection with the acquisition agreement against the sellers or the target's management under the SPA's reps and warranties, indemnities and covenants.

The target and any subsidiaries usually grant the following types of security:

- Assignment of receivables.
- Bank account pledges.
- Assignment of intellectual property rights.
- Assignment of chattels.
- Charges on real estate.
- Pledges over shares in subsidiaries.

Contractual and structural mechanisms

Both the senior loan agreement and the mezzanine loan agreement usually provide for the contractual subordination of shareholder loans to all other debt instruments. The inter-creditor agreement usually grants the senior debt lenders priority over mezzanine debt and other debt providers.

Financial assistance

25. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

Rules

In relation to financial assistance, the capital maintenance rules applicable to AGs differ from the ones applicable to GmbHs:

- An AG cannot provide any loans or security to assist in the purchase of its shares by a PE fund.
- A GmbH cannot grant any benefits to its shareholders which, in the case of execution, would result in the book value of its net assets falling below the amount of its registered share capital (*Stammkapital*).
- The repayment claim of the GmbH against its shareholder is taken into account when calculating the GmbH's net assets, provided that the repayment claim is not impaired.
- The GmbH's managing directors must constantly monitor the economic status of the GmbH's shareholder. If impairment is indicated, the managing directors must terminate the up-stream loan immediately and claim immediate repayment of the loan from the GmbH's shareholder.

Exemption

Capital maintenance rules generally do not apply in cases where a GmbH has concluded a domination and profit pooling agreement (*Beherrschungs- und gewinnabführungsvertrag*). The domination and profit pooling agreement must be registered with the commercial register (*Handelsregister*) to be valid.

Insolvent liquidation

26. What is the order of priority on insolvent liquidation?

Statutory priority

Debt providers are granted statutory priority over holders of an equity interest in the insolvent company (*German Insolvency Code (Insolvenzordnung) (InsO)*). This also applies to claims for the repayment of shareholders' loans which are also subordinated by law to third party lender claims. The distinction between equity replacing loans and "normal" shareholder loans was scrapped in the 2008 reform of the German Act on Limited Liability Companies (*Gesetz über Gesellschaften mit beschränkter Haftung*) (GmbHG).

The insolvency administrator (*Insolvenzverwalter*) can:

- Deny repayment of an outstanding shareholder loan.
- Reclaim any amount which has been repaid under a shareholder loan during the one-year period preceding the start of insolvency proceedings.

In the distribution rankings in an insolvency, debt providers are insolvency creditors. Therefore, at best, they receive a fraction of their repayment claim under the loan agreement. This situation changes if the debt providers were granted preferential security over certain assets of NewCo or the target (*see Question 23*).

Contractual priority

Within the framework of a restructuring, creditors often subordinate their repayment claims to other third party claims by way of a qualified subordination agreement (*qualifizierter Rangrücktritt*). Subordination is often used to avoid a financial situation in which the managing directors would be forced to file an application for the commencement of insolvency proceedings with the district court (*Insolvenzantrag*). The InsO provides for various pre-insolvency instruments for contractual or statutory restructuring of a company's debt, among others, by way of a debt for equity swap.

Equity appreciation

27. Can a debt holder achieve equity appreciation through conversion features such as rights, warrants or options?

Equity appreciation is usually achieved through conversion features. Conversion features are easier to structure in cases where the debtor is an AG (as opposed to a GmbH or a GmbH&Co KG) because an AG can set aside a specific part of its share capital to service the appreciation rights exercised by convertible bond holders.

In both AGs and GmbHs, the shareholders' meeting can create authorised capital (*genehmigtes Kapital*) which can be issued to a debt holder in exchange for the debt holder waiving his repayment claim under the debt instrument. The waiver of the repayment claim is considered as a contribution in kind (*Sacheinlage*).

In distressed situations, conversion can lead to negative tax consequences. If the converted loan is impaired at the moment of conversion, the difference between the nominal value of the loan and its fair market value is qualified as taxable gain. Although this taxable gain can be set off with loss carry forwards, 40% of taxable gains exceeding EUR1 million cannot be set off with existing loss carry forwards.

PORTFOLIO COMPANY MANAGEMENT

28. What management incentives are most commonly used to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

The main management incentives are:

- Variable salary components.
- Equity-related schemes.
- Exit bonus arrangements.

Variable salary components

Variable salary components are linked to the fulfilment of certain key performance targets by the company. They are usually granted in the respective employee's service agreement. Income from variable salary components is fully taxed as employees' wage income and can be deducted as expenses by the company.

Equity-related schemes

Equity-related schemes consist of direct grants of shares in the target itself (for example, through performance equity ratchets) or the grant of share options. Due to the classification of shares earned through performance ratchets as wage income, performance equity ratchets have become less popular.

Share options (mostly on ordinary shares) are commonly granted as warrants or convertible bonds, and usually vest over a period of up to four years. Share option schemes usually provide for accelerated vesting in a successful trade sale or IPO of the target during the general vesting period.

Exit bonus arrangements

Management is often additionally incentivised by an exit bonus arrangement. The exit bonus may comprise:

- Payment of a fixed bonus on exit.
- A percentage of the proceeds in the case of a trade sale or an IPO.
- The grant of share options which are exercisable in the case of an exit.

Depending on the specific structure of a PE fund, the remuneration of the management in the target may also be regulated by the AIFMD and the KAGB. The effects this will have on the remuneration of the management in the target depend on the specific case.

29. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

Variable salary components

Income from variable salary components is fully taxed as employees' wage income and the company can deduct it as expenses.

Equity-related schemes

In relation to equity-related schemes, options are not usually taxed on issue, but on exercising the option. The difference between the value of the shares at the time of exercise and the strike price is fully taxed as wage income.

In the unlikely case of dividend payment during investment, the dividends are taxed according to the partial income system (*Teileinkünfteverfahren*) (*section 3(40), EStG*). This means that 40% of the dividends are tax free if the employee holds at least 1% of the company's share capital and opts for this treatment (that is, the personal income tax rate, which usually ranges between 14% and 45% applies to the taxable part (60% of the dividends)). If the employee does not opt for this treatment, a flat tax of 25% (plus solidarity surcharge and potential church tax) applies.

Capital gains from the sale of company shares are also taxed under the partial income system, provided that the employee holds at least 1% of the company's share capital. If the employee holds less than 1%, a 25% flat tax (plus solidarity surcharge and potential church tax) is applied.

If the partial income system applies, costs related to the dividends are also deductible by 60% (whereas, under the flat rate, tax deduction of these costs is not possible, apart from a certain general amount that is exempt from tax).

Exit bonus arrangements

Benefits for the employee arising out of exit bonus arrangements are fully taxed as wage income.

30. Are there any restrictions on dividends, interest payments and other payments by a portfolio company to its investors?

Restrictions on payments by the portfolio company to its investors can broadly be divided into three different groups:

- **Corporate law restrictions.** These are:
  - an AG is restricted from making any payments to its shareholders other than regular dividend payments. These dividends can only be paid out of the AG's statutory surplus;
  - a GmbH can make payments to its shareholders provided that the book value of its assets does not drop below the GmbH's registered capital.
- **Tax law restrictions.** Payments to shareholders can be made as dividends or as repayment of capital. A return of capital is not subject to German withholding tax and does not lead to taxable income at the level of the investor/shareholder. Dividends can only be distributed out of accrued profits and are subject to German withholding tax at a current rate of about 26.4% (including solidarity surcharge, plus potential church tax). All payments including interest payments on a shareholders' loan must be made at arm's length. Any payments that are not in line with what third parties would agree to are usually classified as constructive dividends (*verdeckte Gewinnausschüttung*) by the German tax authorities and subject to withholding tax. In addition, the paying company is prohibited from deducting these payments as business expenses.
- **Regulatory restrictions.** Since the enactment of the KAGB on 22 July 2013, distributions to an AIF are generally prohibited if they occur within 24 months after acquiring control of the portfolio company and are either:
  - made when, at the end of the last financial year, the net assets are (or, following the proposed distribution, would be) lower than the amount of the subscribed capital plus reserves which cannot be distributed for statutory reasons;

- in excess of the profits at the end of the last financial year plus any profits carried forward and amounts drawn from reserves available for distribution (less any losses carried forward and reserves made in accordance with statutory provisions).

31. What anti-corruption/anti-bribery protections are typically included in investment documents? What local law penalties apply to fund executives who are directors if the portfolio company or its agents are found guilty under applicable anti-corruption or anti-bribery laws?

Contractual protection

Anti-corruption provisions are usually included in the warranties and restrictive covenants of the acquisition agreement. In addition, it is increasingly common to include principles of good governance into the rules of procedure for the management. These usually become an attachment to the shareholders' agreement. If the target's anti-corruption policy is out of date or insufficient, the PE investor should insist on including a post-closing covenant that the company will adopt an improved policy within a clearly defined period of not more than 12 months after closing.

Criminal law penalties

The bribing of a foreign official is a criminal offence which can be punished with up to ten years' imprisonment (*German Criminal Code*). Charges are usually dropped by the public prosecutors against the payment of a fine (*Geldstrafe*), the amount of which depends on the income of the manager charged with bribery.

EXIT STRATEGIES

32. What forms of exit are typically used to realise a private equity fund's investment in a successful company? What are the relative advantages and disadvantages of each?

Forms of exit

The following forms of exit are typically used to realise an investment in a successful company:

- Trade sale.
- Secondary buyout.
- IPO.

Trade sale

This is the most common form of exit for PE investments. It allows investors to exit immediately and completely. The investor is usually in control of the process and can extract maximum value in negotiations with the buyer. However, key employees may be concerned about the change of ownership. A trade sale can also involve business risks for the company, particularly when the potential buyer is a competitor.

Secondary buyout

Recently, secondary buyouts have become a more frequent form of exit. This method has the advantage of being less dependent on the climate of capital and financial markets, which influence opportunities for trade sales and IPOs. It also gives the investor the chance to realise its investment earlier, while the company still has potential for further development. However, the multiples realised in a secondary buyout are usually lower than in an IPO or a trade sale to a strategic investor.

IPO

This is the preferred form of exit for management as they generally remain in control of company operations. An IPO also gives the investor the opportunity to achieve higher returns if the value of the company's shares increases after the IPO. However, the investor cannot usually sell its shares at the time of the IPO, since both investors and key personnel must agree to a lock-up of their shareholding for at least six months after the IPO. In addition, an IPO usually involves greater risks, since capital markets, particularly for high-tech companies, are volatile. The process takes much longer than a trade sale and is usually more expensive.

33. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful/distressed company? What are the relative advantages and disadvantages of each?

Forms of exit

The most common forms of exit are:

- Sale of the company to the company's management.
- Sale of the company to another investor, especially a turnaround specialist.
- Sale of the company's assets to one or more third parties.
- Liquidation or insolvency.

Advantages and disadvantages

The advantages and disadvantages are:

- The majority of exits from an unsuccessful target are by liquidation or insolvency (exit by exodus).
- A sale of the company or its assets allows the investor to receive at least part of its investment.
- In liquidation, the company must satisfy all of its debtors, before making any distributions to its shareholders. The liquidation procedure is time consuming due to the extended publication periods.
- Management acquisitions are usually smoother and less disruptive to the company's business. They are usually done without substantive warranties granted by the seller. On the other hand, management acquisitions carry the risk that the acquiring managers over-emphasise the negative aspects of the business on sale. The aim of this is to reduce the purchase price with the intention to sell the company after a relatively short period to a third party investor, making a substantial profit. This risk can be mitigated by "anti-quick flip" clauses in the SPA which grant the selling PE investor a share in the short-term profit realised by the management in a secondary sale.

PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATIONS

German equity/venture capital association (*Bundesverband Deutscher Kapitalbeteiligungsgesellschaften*) (BVK)

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Status. The BVK is a non-governmental organisation.

Membership. The BVK currently has 206 full members (private equity and venture capital companies) and 106 associate members.

Principal activities. The BVK is responsible for:

- The development of public awareness of private equity.
- The improvement of the framework for private equity in Germany.

The BVK is the major organisation for the German private equity industry and for the representatives of foreign private equity/venture capital funds operating in Germany. It co-operates with other private equity institutions internationally.

Published guidelines. The BVK publishes the BVK-Yearbook, BVK-Directory and various other private equity related publications.

Information sources. The BVK collates its information through extensive surveys among its members (and a few non-members).

ONLINE RESOURCES

Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) (BaFin)

W www.bafin.de

Description. BaFin supervises banks and financial services providers, insurance undertakings and securities trading. It is an autonomous public-law institution and is subject to the legal and technical oversight of the Federal Ministry of Finance. It includes translated German statutes at www.bafin.de/EN/DataDocuments/Dokumentlisten/ListeGesetze/liste_gesetze_node.html for guidance only.

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Recent transactions

- Representing a leading European private equity fund in relation to an add-on acquisition of one of its portfolio companies in Eastern Europe.
- Advising a US private equity fund in relation to the German aspects of a world-wide acquisition of a supplier to the automotive industry.
- Advising an Indian buyer in its acquisition of a German chemical producer from a leading European LBO fund.
- Advising a strategic investor in the proposed acquisition of a German bank.

Languages. German, English, Italian, French

Professional associations/memberships. International Bar Association (IBA); INSOL Europe; German-Italian Lawyers' Association.

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Recent transactions

- Representing a venture company of a global group in relation to the participation in a Luxembourg fund.
- Advising a German private equity client referring to the set-up of a Luxembourg fund structure.

Languages. German, English, French, Spanish

Professional associations/memberships. International Fiscal Association (IFA); German American Lawyers' Association (DAJV).

Publications.

- Inbound Investment In German Real Estate, in: Ruchelman, Insights, Vol. 1 No. 8, 2014.
- New Provisions Enacted To Counteract Artificial Structures Implemented To Avoid Real Estate Transfer Tax, in: European Taxation 2014, p 34.
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- New Administrative Decree Regarding the German Reorganization Tax Act, in: European Taxation 2011, p. 334.
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Areas of practice. Banking regulatory; financial services/cross-border services; asset and investment management services; AIFMD; fund structuring; payment services; insurance supervision law; capital markets and prospectus law.

Recent transactions

- Advising several foreign fund managers in relation to the German requirements of marketing closed-ended funds in Germany and on the statutory investment criteria for institutional VAG-Investors.
- Advising several fund managers (private equity and real estate) in relation to the regulatory product requirements and the notification procedure under the KAGB.

Languages. German, English, French