Germany: Attractive Opportunities for Distress Investors

Germany has more insolvencies than any other western European country, bar France; but that may be more its size compared to other countries. Consequently, the number of M&A deals involving insolvency administrators is increasing. Prominent recent distressed M&A transactions include the purchase of the department store chain Karstadt by Nicolas Berggruen or the purchase of a division of Karman by the Finish Valmet.

Due to the specific insolvency situation, an acquisition offers advantages not available in "normal" transactions.

When insolvency has been filed over the assets of a company, the salaries of its employees will be paid by the State for a maximum period of three months. During these three months, the preliminary receiver will try to keep the operations of the company afloat. The insolvency administrator will try to turn around the company and save its jobs by restructuring or by sale to an investor. Due to time constraints, the administrator normally has only "one shot" for his rescue effort, after the three-month funding period, he is likely to run out of money and thereby out of business. He is therefore forced to complete a sales process during this time.

An investment in a distressed company allows the investor "cherry-pick" assets

The acquisition of an insolvent company is nearly always done by means of an asset deal. The purchaser respectively the purchasing NewCo do not assume any liability of the insolvent company, unless expressly agreed. No involvement of the shareholders of the insolvent company is required since the administrator can dispose over its assets by virtue of law. An asset deal allows a fast, efficient and simple transaction. However, any non-transferable licenses of the old company can not be taken over by the investor.

Due to this deal structure, the investor can regularly chose which specific assets he intends to purchase. For example, an investor may choose to limit his investment to a certain division or location. The investor may also choose not to buy the real estate of the insolvent company but to rent it from the administrator or to move the purchased assets to a different site.

An investment in a distressed company allows the investor to restructure employees

Generally, under imperative German and European law, a purchaser of business operations takes over all employees attributed thereto. However, the specific insolvency situation provides certain techniques to restructure the employee basis of the insolvent company.

The purchaser can establish a concept about how he intends to continue the insolvent company profitably in the future. Naturally, this concept will include a reduction of cost by reduction of workforce. Such concept may include a detailed name list of employees that shall be taken over and of such employees that are not required in the future. Based on this "Purchaser's Concept", the administrator can exercise a special termination right before closing the deal.

Secondly, the purchaser and the administrator can chose to set up an SPV ("Employment and Qualification Company"), which will harbor those employees that are not on the name list and offer them limited continued payment, further training and support in their job search. The employees must agree with their transfer to the SPV, which is regularly the better alternative to an immediate termination. Such an SPV is funded partly by the State and partly by the administrator, which may have an impact on the purchase price. However, it decreases the risk of employment litigation and has a higher social acceptance.

The Purchase Agreement in a distressed M&A deal is simple and straightforward

The asset purchase agreement will be negotiated and signed between the administrator as seller and the purchasing entity as buyer. It is important to clearly define the sold assets (fixed assets, inventory, work in progress) which will ordinarily be done by referring to annexes listing each single item sold. It is also important to specify all contracts with suppliers and with customers that the purchaser wants to take over, which requires consent by such supplier or customer. The same applies to intangible assets such as software licenses, patents, trademarks and the like.

There is vast space for negotiating the purchase price, the lower limit is normally the market value of the sold assets. The valuation of intangible assets (patents, trademarks, domains) and the goodwill gives the parties flexibility for such negotiations. The asset purchase agreement, in particular the purchase price, must be approved by the creditors of the insolvent company and by the insolvency court.

Insolvency administrators are very reluctant in giving any warranties because they want to avoid liability of the insolvent estate. Therefore risks are generally taken into consideration in determining the purchase price. Representations generally acceptable to administrators are the existence and transferability of the material assets free and clear of title, the assumption of the risk of employee dismissal litigation and the proper conduct of business by the administrator ("best knowledge" clauses). The practical value of additional representations is questionable because only the insolvent estate is liable, unless the administrator has breached his legal duties.

Key factors for a successful deal

Timing: the deal must be completed within a time frame of 2 to 4 months. Limited due diligence is balanced by low price and limited assumption of liability.

Understanding the administrator: the administrator is not a "normal" seller, he must accommodate the interests of the secured and unsecured creditors of the employees, make money and keep the risk low. German law and language are imperative.

Use potential: The opportunity to "cherry-pick" assets and to restructure the employment situation of the company gives an investor a one-time chance to turn around the company and customize it for its own needs.

How we can help?

Our practice is highly recognized in the area of M&A. Our team has considerable experience in representing foreign investors (strategic and financial) in all kinds of M&A transactions, including the purchase of distressed companies.

Please contact Kai Graf v. der Recke at Haver & Mailänder who can help you with any queries on this topic.

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