Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

What DT3 Means For German Private Equity Exits

Law360, New York (February 07, 2013, 10:45 AM ET) -- In 2011, the German Federal Court of Justice (FCJ) issued a judgment regarding the legal basis and scope of prospectus liability for selling shareholders in equity offerings of German corporates, which significantly changed the legal structuring of such transactions in Germany. More than a year later, with equity capital markets in Germany showing signs of increased activity going into 2013, shareholders, issuers, bankers and legal practitioners still are trying to define the new market standard for secondary share placements in Germany.

Background

In 2000, the German government (through its state-owned development bank Kreditanstalt für Wiederaufbau, KfW) implemented the third tranche of its privatization of Deutsche Telekom (DT) through a global share placement (the DT3 offering), including public offerings of DT shares in Germany and the U.S. on the basis of a prospectus.

The transaction was structured as a secondary offering of DT shares only, without any placement of newly issued shares resulting from a capital increase of DT. In other words, KfW (as shareholder of DT) received all proceeds of the transaction. In the underwriting agreement relating to the DT3 offering, DT assumed the entire prospectus liability risk (i.e., DT indemnified the underwriting banks without receiving a back-to-back indemnity from KfW).

Between 2001 and 2005, DT was the target of several prospectus liability lawsuits on the basis of allegedly wrong and/or omitted information in the DT3 offering prospectus. In 2005, DT agreed to settle the lawsuits for approximately $120 million and to pay a significant amount of related legal fees. DT requested reimbursement of the settlement amount and legal fees from KfW, but they and the German government rejected it.

DT subsequently brought a claim against the German government and KfW for reimbursement of the settlement amount and legal fees. The company stated that the assumption of prospectus liability in the DT3 offering constituted an impermissible repayment of equity contributions to KfW, since the DT3 offering was for KfW's benefit only; DT received nothing.

Court Decisions

District Court of Bonn

In 2007, the District Court of Bonn ruled in favor of DT and confirmed that the company had a claim for the repayment of benefits received by KfW up to the value of the assumed prospectus liability risk. Contrary to the prevailing view at the time, nonquantifiable benefits for the issuer such as increased free float, broadening of the international investor base, and publicity and marketing benefits in connection with a secondary share offering

were not viewed as sufficient compensation to justify the assumption of prospectus liability by DT for the DT3 offering.

Higher Regional Court of Cologne

On appeal in 2009, the Higher Regional Court of Cologne ruled in favor of KfW and found that the nonquantifiable benefits to DT from the DT3 offering constituted a permissible compensation, in line with past practice, for the assumption of prospectus liability in a secondary share offering.

Federal Court of Justice

In its ruling in May 2011 (the DT3 Decision), the FCJ agreed with the District Court of Bonn in principle and ruled that (1) nonquantifiable benefits for a German corporation are not suitable compensation for the assumption of prospectus liability in connection with a secondary share placement, (2) such compensation must comprise objectively quantifiable and financial benefits to avoid an impermissible repayment of contributions to shareholders, (3) the assumption of prospectus liability can, in principle, only be compensated by an enforceable and substantiated indemnification granted by the selling shareholder to the corporation, and (4) controlling selling shareholders also may be subject to claims for damages on the basis of the rules applicable to so-called de facto groups.

Scope of DT3 Decision

Pursuant to the DT3 decision, the indemnification of the issuer by the selling shareholder against prospectus liability in connection with a secondary share placement must be for value and enforceable. The compensation of the issuer must be quantifiable on the basis of a balance sheet analysis.

While it is unclear how this test can be implemented in practice, the substantiated "full-value" analysis requires a prognosis that possible prospectus liability claims can be paid when due, which means in order for an indemnifying selling shareholder to satisfy the DT3 decision requirements, tangible assets must be available, money must be kept in escrow, a liability insurance policy must be available or similar actions must be taken to establish "value."

Notably, the FCJ did not distinguish between transactions that only involve a secondary share placement (such as the DT3 offering) and transactions that involve both a capital increase and a secondary share placement. It also did not distinguish between IPOs and transactions involving already publicly listed corporations.

Consequences for German Equity Capital Markets Transactions

The DT3 decision has significant implications for the way equity capital markets transactions are structured and executed in Germany.

Corporation/Issuer

In the event that a German corporation assumes prospectus liability in connection with a secondary share placement, its management and supervisory board members may be held personally liable in the event that no enforceable indemnity is given, or costs are not reimbursed, by the selling shareholder.

As a result, a German corporation preparing a prospectus in connection with a secondary share placement must enter into an indemnification agreement with the selling shareholder

with respect to any potential prospectus liability.

Selling Shareholder

Following the DT3 decision, selling shareholders in a German secondary share placement are obligated to assume the prospectus liability risk and reimburse the issuer for all related costs and expenses.

Such indemnity is less of an issue for corporations that have an operating business and a sufficient asset base. However, selling shareholders with no operating business — such as private equity investors — may find it difficult to demonstrate that the indemnity to the issuer required by the DT3 decision is substantiated.

In particular, private equity funds distribute (and typically are required to do so under the constituting documents) the proceeds from a secondary share placement to their investors, leaving the selling shareholder following the closing of a secondary share placement typically with no significant assets (other than remaining shares held in the issuer in the event of a partial exit) to back up the indemnity in a manner required by the DT3 decision.

For such private equity investors, the purchasing of insurance cover, pledge of collateral and/or escrow arrangements are possible alternatives to manage the German prospectus liability risk in practice — all of which come at an additional cost. In most cases, the purchase of insurance will only support, but not replace, the indemnity obligations of selling shareholders, because obtaining insurance cover in excess of €200 million to €300 million is difficult in the German market.

If a selling shareholder controls a German corporation, it also may be held liable as a controlling shareholder pursuant to the rules for so-called de facto groups if it does not compensate the corporation through indemnification for any damages resulting from a possible prospectus liability relating to a secondary share placement.

Underwriters

Although the customary indemnity from prospectus liability granted by a German corporation to the underwriters in connection with a secondary share placement generally is viewed as being enforceable, the absence of an enforceable indemnity from the selling shareholder to the corporation also could affect the enforceability of such indemnity to the underwriters, if they are aware of the fact that the indemnity from the selling shareholder to the corporation is not for value or not enforceable.

To make sure the underwriters have a valid indemnity claim against the corporation, they are well-advised to conduct at least some due diligence with respect to the substance of the indemnity that runs from the selling shareholder to the corporation. As a result, it has become market standard that underwriting agreements relating to German equity capital markets transactions also involving a secondary share placement include a representation by the corporation with respect to the valid existence of an indemnification agreement with the selling shareholder that meets the requirements of the DT3 decision, as well as a condition precedent with respect to the execution and delivery of such agreement.

Legal Opinion Qualification

The legal opinions delivered by German counsel in secondary share placement transactions likely will include a qualification with respect to the enforceability of the underwriting agreement as it relates to the question whether the indemnity from the selling shareholder to the corporation is for value, since the analysis relates to a factual and not a legal issue.

Structural Alternatives for Selling Shareholders

To avoid the consequences of prospectus liability as defined in the DT3 decision, selling shareholders have few structural alternatives:

- In an IPO scenario, conduct the initial transaction as a primary share offering only, and follow up with an undocumented placement after the expiration of the lockup period. While possible as a legal matter, this IPO structure will be difficult to implement from a valuation and liquidity perspective. The transaction structure must not be viewed as circumventing the need for a documented offering.

- In a secondary share placement scenario, implement block trades — typically on the basis of accelerated book-buildings with institutional investors — without the public offering of shares and without any marketing documentation. These transactions do not fall within the scope of the DT3 decision.

- Reincorporate the issuer in another (European) jurisdiction with less stringent capital maintenance requirements (non-German holding structure). However, a foreign domiciliation of a previously German issuer will raise tax, governance and general market issues that need to be analyzed carefully on a case-by-case basis.

- Structure the transaction to distribute cash to shareholders prior to the IPO and refinance through proceeds from the primary-only offering.

Outlook

In connection with secondary share placements in Germany, selling shareholders (e.g., private equity firms) will need to evaluate their options for managing the prospectus liability risk on a case-by-case basis.

In transactions involving private equity investors as selling shareholders, it is to be expected that the issues presented by the DT3 decision will be addressed through some combination of an indemnification agreement between the selling shareholder and the issuer, the purchase of insurance cover and — depending on the size and structure of the offering — possibly the strengthening of the asset base of the selling shareholder (e.g., a portion of the proceeds to be held in escrow) for a certain time period following the closing of the transaction.

In addition, because of the increased prospectus liability risk in Germany, selling shareholders are expected to retain separate legal counsel and be more actively involved in the due diligence and prospectus drafting processes.

Because of the personal liability risk resulting from an impermissible repayment of contributions to shareholders, following the DT3 decision individual board members of German corporations also typically will retain their own legal counsel in connection with secondary share placements to ensure that the indemnification by the selling shareholders is enforceable and substantiated.

The DT3 decision is one of the most disputed court decisions affecting capital markets transactions in Germany in recent years. Due to its broad tenor, German legal

commentators and practitioners have been actively debating the DT3 decision's potential impact on transaction structures that differ from the structure of the DT3 offering (which involved a secondary share placement without any proceeds to the issuer), such as IPOs and mixed primary and secondary share offerings.

It remains to be seen whether the attempts by legal commentators, practitioners and other market participants to limit the scope of the DT3 decision — through applying a prorated liability scheme for mixed primary and secondary share placements — will be adopted and confirmed by the German courts.

--By Dr. Stephan Hutter and Dr. Katja Kaulamo, Skadden Arps Slate Meagher & Flom LLP

Dr. Stephan Hutter and Dr. Katja Kaulamo are both partners with Skadden in the firm's Frankfurt office.

This article was originally published in 2013 Insights, Skadden's fifth annual collection of commentaries on the critical legal issues businesses will be facing in the coming year. To see additional articles from Insights, including discussions on capital markets, corporate restructuring, financial regulation, global litigation, global M&A, governance and regulatory issues, please visit this link: http://www.skadden.com/newsletters/Skadden_Insights_2013_011613_web.pdf.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2013, Portfolio Media, Inc.