Acquisition of an insolvent life sciences business in Germany

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The German life sciences sector is currently at the beginning of a phase of consolidation. Numerous life sciences companies, in particular biotech companies, face financial difficulties or have already filed for insolvency. Many of them may be attractive targets at bargain prices for competitors or other investors interested in establishing or reinforcing their presence in Germany. This update briefly outlines some important aspects in connection with the acquisition of an insolvent life sciences business in Germany: the recommended timing, certain particularities of the purchase agreement and a possible acquisition structure involving financial contributions of third-party investors, including shareholders of the insolvent target company.

Timing

Insolvency proceedings governed by German law are divided into two stages: the preliminary insolvency proceedings and the main insolvency proceedings, which commence upon the formal opening of insolvency proceedings by the insolvency court. The two stages serve different purposes: during the preliminary proceedings, the insolvent estate is preserved while during the main proceedings, the insolvency administrator disposes of the estate (either by liquidation or by sale of the business or parts thereof as a going concern) in order to satisfy the creditors to the largest extent possible.

The insolvency court will usually formally open the main proceedings several weeks after the filing for insolvency. A sale of an insolvent life sciences business during the preliminary insolvency proceedings would give rise to significant risks for both parties: a preliminary insolvency administrator could be held personally liable for not having properly preserved the estate and the purchaser would face the risk that the validity of the transaction is challenged under the German insolvency laws. Further, the purchaser would not benefit from certain privileges applicable during the main insolvency proceedings only, such as the relief from existing tax liabilities and from liabilities based on the continued use of the company name (if applicable) as well as the limitation of liability, vis-à-vis employees of the business to amounts accruing as from the date of the opening of the main insolvency proceedings. It is therefore advisable for the parties to wait until the main insolvency proceedings open before ▸▸

entering into the purchase agreement. In order to accelerate the sales process, the potential purchaser and the preliminary insolvency administrator should negotiate the terms of sale before the opening of the main proceedings and also enable the persons who will presumably be appointed by the court as members of the creditors' committee to participate in the final stages of the negotiations. The deal can then be signed by the purchaser and the administrator, and the required creditors' committee consent be obtained, after the opening without delay.

Purchase Agreement

Share and asset deal

The insolvency administrator has the power to dispose of the assets of the insolvent estate in his own name, acting in the capacity of administrator. In order to dispose of the estate he can, depending on tax and other considerations, either sell and transfer assets to the purchaser or set up a special purpose vehicle ("SPV", so-called Auffanggesellschaft), transfer assets to it and sell the shares in the SPV to the purchaser. Regarding the second alternative, it is in the interest of the purchaser to work closely together with the administrator on the determination of the assets to be transferred to the SPV. The following focuses on the direct acquisition of assets by the purchaser; in connection with an asset transfer to an SPV, similar issues would be likely to arise.

Consent requirements

The sale and transfer of the business, either by way of an asset deal or by using an SPV, requires the consent of the creditors' committee. This usually consists of representatives of the biggest creditors and an employees' representative. Alternatively, the consent by the creditors' meeting is also possible, but calling a creditors' meeting is often a time-consuming process. The consent requirement is of an internal nature only. The sale and transfer would be effective even if the consent was missing or invalid; however, the administrator could then be held personally liable.

Identification and transfer of assets

The assets being acquired should be identified as specifically as possible. For instance, detailed asset lists may be attached to the purchase agreement. It is also possible to state in the purchase agreement that all assets of a certain type belonging to the insolvent estate are acquired – any exceptions may be listed in exhibits.

The purchaser and the insolvency administrator are free to agree which assets shall be acquired and which shall be excluded from the transaction – cherry picking is possible. The administrator has a statutory extraordinary termination right for all contracts and is therefore unlikely to insist that the purchaser assume any contracts (subject to the other party's consent) it does not wish to assume. Existing liabilities are usually expressly excluded from the acquisition and remain with the insolvent estate. If intellectual property rights are to be acquired, the purchaser should thoroughly investigate the insolvent company's title to them, as well as the existence of any encumbrances. In some cases, employee inventions have not been properly claimed by an insolvent company and consequently there is a risk that employees will assert claims regarding their inventions.

It is in the purchaser's interest to obtain all information regarding employee inventions before entering into the purchase agreement, especially since the administrator is often more likely to be able to agree with the relevant employees on a waiver of their ensuing rights. The purchaser should be aware of mandatory ongoing payment obligations under the German Employee Inventions Act in connection with employee inventions that have been properly claimed by the insolvent life sciences company; these cannot be avoided under German law.

If the purchaser wishes to assume any contracts, it must be aware that (i) in many cases the other contractual party may exercise extraordinary termination rights if, for instance, there is a change of control or a cessation of payment prior to the formal commencement of the insolvency proceedings – this is especially relevant regarding intellectual property license agreements, and (ii) the assumption of contractual relationships by the purchaser is subject to the other party's consent, unless stipulated otherwise. The purchaser should therefore ascertain before entering into the purchase agreement whether the other party to any material contractual relationship can and will terminate such contract and/or will refuse to give its consent to the assumption of the contract by the purchaser. If appropriate, the purchaser should request a condition precedent to be included in the purchase agreement that certain specified agreements that are of major importance to the business being acquired have not been terminated and the other party's consent to the assumption thereof by the purchaser is granted.

Diligent planning and coordination of the separate steps is very important in order to properly protect each of the parties against possible risks.

Transfer and termination of employees

German law provides for an automatic transfer to the acquiring entity of the employees of a business that is being transferred, regardless of whether the business is insolvent or not. If the purchaser of an insolvent business does not wish to take over all employees, the purchase agreement should provide for a duty of the administrator to terminate the employment relationships of the employees not intended to be transferred, and to bear the costs of employment until the effective date of the termination as well as severance payments to be agreed with the employees, at least up to a certain amount. Notice of termination should be served by the insolvency administrator after the opening of the main insolvency proceedings, because the risks regarding the validity and financial consequences of a dismissal will then be reduced. However, an employee is not precluded under German law from challenging his/her dismissal, even if a severance payment is offered. There are various grounds on which a claim for re-employment with the acquiring business can be based, such as deficient social selection of the dismissed employees, pregnancy or status as a disabled person. In practice, a settlement providing for a severance payment is usually reached.

Representations; comfort letter

As a rule, the insolvency administrator will not be inclined to give many representations and warranties. Unless part of the purchase price is paid to an escrow account, these would probably not be of much value anyway. The purchaser should therefore be very careful in his ▸▸

determination of the assets. Together with its advisers, it should conduct a proper due diligence review. On the other hand, the administrator will often request a guarantee or comfort letter, especially if the acquiring entity is an SPV and the purchase price is not paid in full at the closing, e.g. because milestone payments depending on the future performance of the acquired life sciences business, or on the progress in connection with the acquired intellectual property rights, are agreed.

Participation of third party investors

Transaction structure

A life sciences company interested in acquiring an insolvent business in the same sector may not always be prepared to use its cash for the acquisition. In this case, there are interesting deal structures available involving third party investors who contribute to financing the acquisition of the insolvent company's assets, (or the shares in the SPV set up by the administrator) against receipt of shares issued by the life sciences company. This may prove an attractive option for shareholders in the insolvent company wishing to protect their original investment. Such shareholders may welcome the opportunity to participate in a familiar business while leaving their company´s existing liabilities with the insolvent estate. One possible way to structure such an acquisition can be outlined as follows:

- The investors set up an SPV and provide it with sufficient funds to pay the purchase price for the assets of the insolvent company (or of the shares in the SPV set up by the administrator) to the insolvency administrator and possibly also the costs for the integration into the life sciences company and/or ongoing business expenses for a certain time period. Before the conclusion of the purchase agreement, the insolvency administrator might in some cases request a loan from the investors ranking prior to existing liabilities of the insolvent entity (so-called Massedarlehen) in order to be able to continue to run the business. The amount of such loan plus interest can be repaid at closing, using funds from the purchase price. It is important for the investors that it is established prior to granting such loan, that the administrator will be in a position to repay the loan even if the envisaged transaction is not closed.
- The investors' SPV acquires the assets of the target business (or the shares in the SPV set up by the administrator) from the administrator as soon as possible after the formal opening of the insolvency proceedings. The life sciences company as future owner of the investors´ SPV should lead the negotiations of the acquisition agreement on the purchaser´s side.
- The investors contribute the shares in their SPV to the life sciences company against issuance of new shares.

If the life sciences company is a German stock corporation (Aktiengesellschaft / "AG"), a common way to issue the new shares is a capital increase using the authorised capital: in such case, no decision by the general shareholders' meeting has to be obtained; it is sufficient that the management board, with the supervisory board's consent, adopts the resolution on the capital increase. An auditor appointed by the court has to formally confirm that the value of the shares in the SPV contributed is at least equal to the nominal value of the shares issued. The management board of the stock corporation may have to explain to the shareholders in the next general meeting that the fair market value of the shares contributed is not materially less than the market value of the shares issued to the investors.

Lock up

In a case where shares in a listed AG are issued to the investors, a lock up period should be agreed. This is in the interest of the AG´s old shareholders as a sale of the newly issued shares, only a short period of time after the closing of the transaction, could have an adverse effect on the share price. The lock-up would also protect the investors from possible accusations of insider trading as it is likely that they have received confidential information that is not in the public domain and a sale of the shares within a short period after the issuance of the new shares could therefore be interpreted as prohibited use of insider information.

Conclusion

The coordination of the agreements and transactions necessary to implement an acquisition structure as outlined above (purchase agreement, subscription agreement, board resolutions on capital increase against contribution in kind, transfer of assets, payment of purchase price, application to and monitoring of the registration in the commercial register etc.) is a challenging task. Diligent planning and coordination of the separate steps is very important in order to properly protect each of the parties against possible risks, especially since deals of this nature must often be completed under considerable time pressure. ■

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