PwC International Business Reorganisations Network – Monthly Legal Update

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Welcome

Welcome to the fifth edition of the PwC International Business Reorganisations (**IBR**) Network Monthly Legal Update for 2015.

The PwC IBR Network provides legal services to assist multinational organisations with their cross-border reorganisations. We focus on post-deal integration, pre-transaction separation and carve outs, single entity projects, and legal entity rationalisation and simplification as well as general business and corporate and commercial structuring.

Each month our global legal network brings you insights and updates on key legal issues and developments relevant to multinational organisations.

We hope that you will find this publication helpful, and we look forward to hearing from you.

In this issue

In our October 2015 issue:

- PwC Legal Spain highlights the changes under regulations on criminal liability of legal entites in Spain;
- PwC Legal Germany considers the treatment of shareholder loans in an M&A context; and
- PwC Luxembourg examines a new law relating to electronic archiving which was recently adopted in Luxembourg.

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PwC Legal Spain – Amendments to regulations on criminal liability of legal entities

At a glance

Spain's Criminal Code reform has entered into force on July 1, 2015. It has been enacted by Organic Law 1/2015, of 30 March, which amends Organic Law 10/1995, of 23 November. According to past regulations legal entities may be exonerated from criminal liability if it is proven that they have exercised "due control". Current reform specifics what is meant by "due control" and which are the requirements for legal entities to be exempt from criminal liability. Thus, companies may be exempt from criminal liability if they have put in place, in an effective way, corporate defence or other preventive programmes that substantially reduce the risk of the companies of committing criminal offences within the course of their business.

In detail

Legislative background

In Spanish criminal law it was well settled the principle that legal entities cannot be criminally liable (*societas delinquere non potest*) until 2010. 2010's reform introduced for the first time the concept of criminal liability of legal persons (with the exception of government-owned entities) under two scenarios:

a criminal offenses committed by directors and legal representatives on behalf of the entity and for its benefit; and

b criminal offenses committed by employees, for the account and benefit of the company, attributed to the entity, due to the latter's lack of "due control" over them.

Under such rules, the criminal liability of the individual and that of the company remained absolutely independent from each other. This means that a company could still be held criminally liable even if the individuals involved were not. Likewise, both, individuals and company could be found guilty for a given criminal offence.

The aim of the reform

2010's reform opened a new path of discussions over what meant "due control" and a number of issues of interpretation emerged with regard to the exemption of legal entities from criminal liability.

The reform aims to bring to an end such legal uncertainty. Reformed Article 31 bis of the Spanish Criminal Code contains a detailed description of appropriate compliance management systems, also known under the names of corporate compliance, corporate defence and crime prevention plan which serve as objective elements, which if followed, may lead to a company to be exempt from criminal liability.

The reform **reduces uncertainty** for the judiciary and businesses as to when a company could be exempt from criminal liability.

Corporate defence

a Requirements for the exemption to apply

- Before the offence is committed, the management body of the company should have had adopted corporate defence programmes including measures intended to prevent in an effective way or substantially reduce the risk of the company of committing criminal offences;
- that a body responsible to look after criminal defence controls' compliance (so called "Compliance Officer") had been appointed. This is a person or body with powers to initiate, control and supervise internal measures;
- that the criminal offence had been committed circumventing the management and prevention measures; and
- that such commission had been done without any omission or failures of the body designated for supervision, vigilance and control.

b) Requirements of the corporate defence programmes

- They shall identify those activities of the company in which criminal offenses are most likely to be committed;
- they shall implement appropriate procedures for decision-making within the legal entity;
- they shall provide financial resource management systems suitable to prevent crimes;
- they shall establish communication channels that allow efficient reporting of non-compliance or law violations;
- they shall establish a disciplinary system that punishes failure of compliance; and
- they shall carry out periodic reviews and audits of the system when changes occur in the organization or infringements on the programme arise.

The figure of the Compliance Officer

The appointment of a Compliance Officer, this is a person or body with powers to initiate, control and supervise the functioning of and compliance with the corporate defence controls, has become a key figure provided that the law establishes such as a pre-requirement for the exemption of criminal liability to apply for companies.

Consequences of an inefficient corporate defence

If committing a criminal offence and finding that a legal entity has not followed reasonable internal controls and measures to prevent criminal offences following the requirements to allow criminal liability exemption, consequences contained under Article 33.7 of the Spanish Criminal Code might apply, including the following:

- imposition of criminal fines;
- compulsory dissolution of the legal entity;
- temporary suspension of the company's activity;
- temporary closure of establishments;
- prohibition on carrying out certain activities which have been likely to encourage or hide the criminal offences;
- temporary disqualification from receiving subsidies, public aid, tendering process, eligibility to tax and social security benefits; and
- judicial intervention as to ensure workers and creditors' rights.

What do you need to do?

Although many Spanish companies were already using internal compliance programs, now they are looking into adapt their practices to more closely ones as to align them with the requirements of the Spanish Criminal Code. Thus, following analysis proves highly advisable:

a understand and analyse the activity of companies as to evaluate the degree of risk exposure to be held criminal liable under current Spanish Criminal Code;

b evaluate current measures and procedures adopted by such companies;

c identify gaps on such measures as to design procedures and suitable measures to avoid the risks;

d establish protocols and mandatory guidelines of how steps should be taken as to implement efficient corporate defence controls; and

e introduce efficient supervision systems.

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PwC Legal Germany – Beware of the shareholder loans: protecting the seller in M&A transactions

At a glance

When it comes to the financing of companies, shareholder loans are of outstanding importance, whether for mid-tier companies, (inter)national groups or venture capital or private equity investors. When companies financed by shareholder loans are sold, the seller does not usually wish to continue his financial engagement. By the same token, the purchaser regularly wishes to end any kind of financial dependence between the target company and the seller. Taking account of these interests, share purchase agreements have, up until now, usually provided for the sale and assignment of shareholder loans together with the shares in the target company. Since 2013, there has been a great discussion about whether or not this approach can remain standard procedure.

In detail

Background

According to s. 135 ss. 1 no. 2 German Insolvency Act (Insolvenzordnung - InsO) any payments on shareholder loans (principle amount and interest) can be contested by the insolvency administrator if insolvency proceedings are opened over the assets of the company within one year after payment. In 2013, the German Federal Court of Justice (*Bundesgerichtshof*, or *BGH*) decided that if a shareholder loan is assigned and repaid after assignment not only the assignee but also the assignor is liable (as joint and several debtor) for restitution pursuant to s.135 ss. 1 no. 2 InsO. That effectively means that the assignor has to repay funds it has never received. Clearly, the underlying case demonstrated strong signs of collusion. However, the BGH emphasized that collusion was not proven and not required to order the assignor to repay the full amount of the shareholder loan.

There are grounds for rejecting this judgment. It is, for instance, doubtful whether s. 135 ss. 1 no. 2 InsO provides a basis for a claim against the assignor although the assignor never received a payment. Quite the contrary: s. 143 ss. 1 InsO expressly states that assets received by virtue of the contested transaction have to be returned, meaning that someone who did not receive anything cannot be obliged to return it. It is also questionable whether the insolvency administrator should benefit from a duplication of debtors just because the shareholder loan was assigned, or even multiplication of debtors, in the event of several assignments of the same loan.

Furthermore, there are grounds to argue that this judgment should not apply to the transfer of shareholder loans in M&A transactions. In contrast to the case decided by the BGH, the assignment of shareholder loans is, in M&A constellations, a mere annex to the sale and transfer of shares. The seller loses his position as shareholder and, in consequence, his responsibility for the fate of the company (*Finanzierungsfolgenverantwortung*).

Nevertheless, as long as there is no deviating judgment by the BGH, the seller is well advised to insist on contractual protection against repayment claims asserted by a potential insolvency administrator.

Protecting the seller

The M&A practice has, in essence, found two ways of shielding the seller from claims pursuant to s. 135 ss.1 no.2 lnsO. One option is to sell the shareholder loan but to include clauses in the sale and purchase agreement dealing with potential claims by the insolvency administrator. The other option is not to sell the loan and instead provide for an economically equivalent solution.

Clauses shielding the seller from risks

If option one is chosen, there are several ways to protect the seller: (a) a binding letter of comfort by the purchaser, (b) an indemnity against claims by a potential insolvency administrator and (c) an obligation by the purchaser not to collect the shareholder loan for (at least) one year after closing. As outlined as follows, these solutions feature different advantages and disadvantages.

A binding letter of comfort avoids (as long as the purchaser is solvent, see below) the insolvency of the target company and, hence, any risk of contestation pursuant to s. 135 ss. 1 no. 2 lnsO. However, the purchaser will not usually be prepared to agree to such wide-ranging obligations.

The indemnity is more precise. It provides the assignor with a recourse claim against the purchaser only if and to the extent the insolvency administrator actually brings claims against the assignor. If the indemnity is secured and drafted in a way that suits the sellers and the purchasers needs, for example with regard to caps and time-limitations, then the indemnity is usually a good solution to the question at hand. It is often used in practice.

However, once in a while a purchaser objects to the indemnity because it bears the risk of paying twice for the same loan: initially at closing when paying the purchase price for the loan and later, after a potential contestation, when the indemnity is invoked. The seller's argument that this will happen only if the target company falls insolvent within the rather short period of one year after closing and at a time when the company is under the sole control of the purchaser is sometimes countered. Some purchasers fear that the insolvency could be triggered by risks already set by the seller in the past that surface only after closing and without sufficient coverage by seller's guarantees.

In such situations, the obligation not to collect the loan for at least one year after closing can provide a way out. BGH-jurisdiction clearly indicates that a collection later than one year after closing excludes the risk of contestation pursuant to s.135 ss. 1 no. 2 lnsO towards the seller. At the same time, as long as the shareholder loan is not repaid, the purchaser does not run into danger of paying twice.

As a result, the secured indemnity will regularly constitute the preferred solution. Only in certain cases will the parties choose a comfort letter or a non-collection obligation.

An alternative approach

If the second option is chosen, the parties have decided against an assignment of the loan and terminate the loan prior to closing.

One possibility to achieve this aim is by repaying the loan at closing. While the repayment can be structured in different ways, the only really promising method is the direct payment of the amount of the shareholder loan by the purchaser to the seller at closing immediately after the shares have transferred to the purchaser, this repayment qualifying in between the purchaser and the company as contribution to the free capital reserves of the company and in between the purchaser and the seller as repayment of the loan. However, given that, from a civil law perspective, even in this situation wherein the company makes a payment to the seller, there remains a certain residual risk of contestation.

Therefore, it seems advisable to refrain from repaying the loan. Rather, before the share transfer takes effect, the seller should contribute the loan to the free capital reserves of the company immediately at closing. As a consequence, the loan lapses by way of confusion of rights (*Konfusion*). At the same time, the share purchase price increases because the financial debt that is to be discounted from the share purchase price according to the usual cash-free / debt-free formulas is reduced. The contribution therefore regularly constitutes an economically neutral and rather elegant possibility to eliminate the risk of contestation. The only material downside: the contribution is, generally speaking, tax-neutral only if the contributed loan is fully recoverable (*werthaltig*).

Conclusion

It is open to discussion whether the BGH-jurisdiction regarding the contestation of payments on assigned shareholder loans also applies to assignments in the course of M&A transactions. As is often the case, legal certainty will be achieved only once this question has been finally answered by court judgment. Until then, the seller will have to contractually protect himself against potential risks. The rule of thumb is: if the shareholder loan is fully recoverable the seller should contribute the loan to the capital reserves of the target company at closing in exchange for an accordingly increased share purchase price. If the shareholder loan is not fully recoverable the seller should seek protection by a secured indemnity or at least a secured obligation of the purchaser not to collect the loan.

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PwC Luxembourg – New electronic archiving law in Luxembourg

At a glance

On July 25, 2015 a law relating to the electronic archiving was adopted in Luxembourg (hereafter the **Law**). This new law aims at modernising the legal framework applicable to the dematerialisation and electronic storage of documents by setting:

- the requirements for the dematerialisation of originals and for the storage of digital copies;
- the requirements under which digital copies can benefit from a presumption of conformity to the original document; and
- the rules applicable to the newly created activity of dematerialisation and storage service provider.

In detail

1. Digital copies benefit from the same legal value as originals

The Law establishes a legal presumption of conformity of a digital copy to the original document under the condition that the copy was made by a certified dematerialisation and storage service provider.

The Law will benefit to all private deeds and documents listed in article 16 of the Luxembourg Commercial Code such as accounting records, invoices, employment contracts, contracts letter and similar documents.

Notarial deeds or administrative documents issued by public bodies are not in the scope of the Law.

2. A new status of dematerialisation and storage service provider

To ensure the reliability and security of the storage and digitalisation procedures, the Law has created a new status of dematerialisation and storage service provider (*Prestataire de Services de Dématerialisation ou de Conservation* hereafter "PSDC"). To benefit from this specific status the service providers aiming to become PSDC has to comply with extensive technical and organisational rules derived from ISO 27001 and it must be certified. It will then be registered and supervised by ILNAS (the Luxembourg Institute for Standardization, Accreditation, Security and Quality of Products and Services).

An additional agreement from the Luxembourg financial sector regulator (CSSF) is required for PSDC providing services to professionals of the financial sector.

Only digital copies processed by a service provider benefiting from the PSDC status benefit from the presumption of conformity to the original. Non-certified companies are still authorised to produce and store digital copies but they will have to demonstrate that their copies are true to the original documents (as the legal presumption of conformity to the original is not applicable in such case).

PSDC's may operate for their own needs only and/or for third parties.

Thanks to this new Law, Luxembourg is perfectly aligned with the digital single market ambition of the European Commission and the provisions of the eIDAS regulation (EU 910/2014) related to the acceptability of digital evidence and to the preservation of the digital documents further strengthening its ambition to be a "European Safe of digital data".

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