Distressed M&A on the rise

Markus Fellner and Paul Luiki of Fellner Wratzfeld & Partners analyse the Austrian M&A market after the latest downturn

In line with many other jurisdictions, the Austrian M&A market has suffered from the financial crisis both in terms of volume and number of deals. Most estimates and statistics have shown a drop-off in 2008 of between 20% and 30% as compared to 2007.

One of the sectors that has been hit hardest is the Austrian banking sector. Austria's banks traditionally have played a key role in M&A. This role goes well beyond providing financing for transactions. Austria's banks also act as buyers and sellers in transactions, both domestically and in a cross-border context. One of the biggest growth areas over the past five years has been Austrian banks acquiring target banks in central and eastern Europe. This expansion activity for now has come to a virtual halt.

Despite the overall down-turn, there have been some bright spots. Last year for example saw a large increase in energy sector transactions. In addition, while cross-border M&A activity is expected to continue to suffer, domestic transactions are expected to remain fairly stable. Times of crisis often result in choosing acquisition targets close to home since cross-border M&A is viewed as riskier from the buyer's perspective.

For all the down-sides associated with the financial crisis, it has spawned growth in one core area: distressed M&A. Companies in financial difficulty must be sold on extremely tight time frames. This presents a myriad of challenges to lawyers. Time for reflection is a rare commodity. Transaction documents are sometimes negotiated overnight. In extreme cases due diligence is squeezed from what otherwise would have been done over months into a time frame of weeks or even days. Distressed M&A is also characterised by the need to find a resolution among the varying interests represented by shareholders, lenders, management, suppliers, customers and employees. A basic issue often quickly arises as to securing short-term financing to stabilise the target.

The financial sector

The trend towards distressed M&A in Austria is expected to continue. Therefore advisers to sellers and buyers will need to be aware of the legal parameters in Austria within which such transactions can be successfully carried out.

The earliest example of a bank rescue in 2008 was the saving of Constantia Privatbank in the fall. Five major Austrian banks (Bank Austria, RZB, Erste Bank, BAWAG and Volksbanken) jointly purchased all the shares in Constantia Privatbank via a jointly-held holding company for a symbolic purchase price, and also injected fresh liquidity into Constantia Privatbank. The Austrian National Bank also provided funds to Constantia Privatbank. This all took place prior to the enactment of bank rescue legislation.

Austria then passed the Financial Market Stability Act in October 2008 to set out the parameters for the recapitalisation of Austrian banks in need of financial assistance. For this purpose Austria established the company *Finanzmarktbeteiligung AG des Bundes* (FIMBAG) in November 2008 to implement recapitalisation measures in line with the Austrian Banking Act. FIMBAG is wholly-owned by the Austrian state holding company ÖIAG. Apart from its role as an acquirer of shares under the Financial Market Stability Act, other key tasks of FIMBAG are to monitor compliance of the banks with the requirements imposed by the Austrian state in acquiring shares and ensuring an orderly divestment of the state's shares at the appropriate later point in time.

Some of the most spectacular and recent examples of distressed M&A in Austria have taken place as part of the bank rescue package. In November 2008 the Austrian state purchased the shares of Kommunalkredit AG, a leading public finance bank, from an Austrian and Belgian bank for a symbolic price of €1.

Austrian banks have also lined up for state funding and support under the Financial Market Stability Act. One mechanism that is being used is the concept of participation capital (*Partizipationskapital*). Participation capital is a special category between share capital and debt. The primary advantage for banks in issuing participation capital is that this capital form is clearly recognised as constituting core Tier-1 capital if properly issued. This instrument thus strengthens the capital basis of the banks. At the same time, the Austrian state as holder of participation capital does not have any voting rights. It is important to note that participation capital must not only meet Austrian Banking Act requirements, but also EU state aid requirements.

Asset deals

Any buyer of assets in a distressed M&A transaction will be keenly interested in not taking over any liabilities associated with the company it is purchasing. This is one of the main potential advantages over a share deal, where liabilities from the past remain with the target. Achieving this result is not always so easy in Austrian asset deals.

Austria is fairly unique in Europe in that it has wide-reaching provisions imposing successor liability on purchasers in asset deals for pre-existing liabilities of the business sold. Provisions on purchaser liability for asset deals are contained in both the General Civil Code as well as the Company Act and apply cumulatively. Provisions of the Austrian Company Act were changed in 2007 and thereby substantially altered the parameters of purchaser successor liability. It is thus key for buyers to be aware of the implications and interplay between these two separate statutory liability successor regimes. Austrian law also has further successor liability provisions in tax and social security law.

The General Civil Code

Under Section 1409 of the General Civil Code, a purchaser in an asset deal generally is jointly and severally liable with the seller towards the seller's creditors for any pre-existing liabilities of the acquired business. This is mandatory law. To trigger successor liability, the assets sold must represent either substantially all the assets of the seller or at

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Author biographies

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Markus Fellner regularly advises on high-profile M&A and real estate transactions as well as complex corporate restructurings. His areas of practice also include banking and finance (structuring of syndicated loans, mezzanine financing and project finance). Recently, Fellner advised OMV Refining & Marketing on the largest optimisation process of its gas station network in the history of OMV, including the sale of approximately 130 gas stations in Austria and the sale of its Italian subsidiary with more than 90 gas stations. He also advised the Austrian bank BAWAG P S K in the sale of L Bösendorfer Klavierfabrik to Yamaha in a structured-auction process. Moreover, Fellner has been extensively involved in the bank rescue of Constantia Privatbank and in the restructuring of the entire Immofinanz Group, one of the largest real estate groups in the central eastern European region.

Markus Fellner is a founding partner of Fellner Wratzfeld & Partners. He is a member of the supervisory board of numerous renowned Austrian companies. He is the author of books and numerous articles mainly on the subject areas of banking and finance, company, insolvency and real estate law. He also regularly speaks at symposiums and seminars.

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Paul Luiki has extensive expertise in cross-border M&A transactions with a strong focus in central eastern Europe. His areas of practice also include private equity, corporate law, banking and finance and investment funds.

Recent transactions he has worked on include representing the Austrian private equity fund EK Mittelstandfinanzierungs on its 34 % acquisition of the leading Czech paper mill equipment manufacturer Papcel. He also advised Laverna, a Russian company, on the private equity entry of Troika, a leading Russian private equity fund. He further advised shareholders of a major Austrian information technology company on the sale of all shares to a US private equity fund. He also has represented a major alternative energy company on the sale of solar farms in Greece.

Paul Luiki is a partner at Fellner Wratzfeld & Partners. He also practiced for many years as a lawyer in the US prior to moving to Austria, where he is also admitted to the bar. He is the author of numerous articles and regularly holds seminars on the topics of M&A, joint ventures, syndicated loans and contract law.

Professional Memberships
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least be a separable business unit. The rationale behind this rule is to protect creditors, which it is argued are better-off enforcing claims against a seller where the seller has not yet turned the assets into cash. Cash can be hidden from creditors easier than other assets.

Purchaser liability applies under Section 1409 of the General Civil Code if the purchaser knew or should have known at the time of the purchase of the pre-existing liabilities. In order to minimise the purchaser's exposure, it generally is regarded as prudent to undertake a detailed due diligence review instead of relying upon representations and warranties. In the distressed M&A environment, however, time is a rare commodity so that focus often will need to be limited to key specific areas.

The purchaser's liability, however, is limited in amount to the value of the assets actually acquired. Under the General Civil Code, there is a further important limitation to purchaser liability. If the purchaser has agreed with the seller that the purchase price funds are to be used to pay off debts of the seller, liability is reduced on a Euro-for-Euro basis.

What is sometimes overlooked in practice is that successor liability may also apply to a share deal if the shares sold represent substantially all the property of the seller. This risk is most relevant where private persons act as sellers. In M&A transactions purchasers also should seek to have the seller represent that its remaining property exceeds at least 10% of total assets (the higher the percentage the better).

Do these successor liability rules apply if the assets are purchased while the company is in bankruptcy? Pursuant to Section 1409a of the General Civil Code, the successor liability provisions set forth in Section 1409 are not applicable if a company or assets are acquired by way of a compulsory reorganisation (*Zwangsausgleich*), insolvency proceedings (*Konkursverfahren*), a court-controlled reorganisation (*Ausgleich*) or the supervision of the debtor by a trustee of the creditors. The non-applicability of Section 1409 generally is justified by pointing out that (*i*) in contrast to the acquisitions of assets in normal situations, unsecured creditors are limited in bankruptcy to the bankruptcy quota; and (*ii*) company reorganisations in bankruptcy only work if the purchaser is not responsible for old liabilities.

The Company Act

Even if there is no liability under the General Civil Code (for example the purchase price has been used to pay off debts of the business sold), a purchaser may still be liable under the Company Act. In contrast to the General Civil Code provision, Section 38 of the Company Act provides for liability which is not limited to the value of the assets taken over by the purchaser. In addition, an agreement between the purchaser and the seller that the purchase price funds will be used to pay off the debts of the business sold does not reduce the purchaser's liability under the Company Act.

Nevertheless, the purchaser and seller to an asset deal in Austria have an important mechanism at their disposal to allocate liability. The purchaser and the seller can provide explicitly that the purchaser is not to be liable at all under the Company Act. The validity of any such agreement *vis-à-vis* third-party creditors requires that (*i*) the agreement be entered into the commercial register at the time of the asset transfer; (*ii*) a public announcement be made that is customary in the market; or (*iii*) third-party creditors be individually notified.

An important change that came about in the 2007 amendments to the Company Act is that imposing successor liability on the purchaser no longer requires that the business name be continued. Continuing the business itself is required.

The Company Act also now makes it much easier to transfer contractual relationships from the seller to the purchaser. Most contractual relationships relating to the business sold now are transferred by operation of law to the purchaser unless the third party objects within three months of receiving notice of the transfer. However, since the third party does not need to justify its objection in any manner, the ease of objecting has been criticised as inviting an abusive exercise of this right. This can prove particularly relevant in the distressed M&A context where creditors may seek to exercise leverage.

Do these successor liability rules apply if the assets are purchased while the company is in bankruptcy? If a company is acquired by way of a compulsory reorganisation, insolvency proceedings, a court-controlled reorganisation or the supervision of the debtor by a trustee of the creditors, Section 38 of the Company Act, including its successor liability provisions, does not apply with the effect that the purchaser is not automatically liable for liabilities of the acquired business. It is also important to note that the purchaser does not automatically acquire all rights regarding the business.

"The Takeover Act also contains a special exception that may apply to distressed targets"

Purchase price challenges

Under the Austrian General Civil Code, there are a variety of legal bases to challenge a transaction such as the law of mistake. One basis that is fairly unique to Austria that cannot be found in most other jurisdictions is the Austrian doctrine of *laesio enormis*. This doctrine allows a purchaser to challenge a transaction if the true value of what was purchased is less than one-half of what was paid. Until the 2007 Company Act revision, *laesio enormis* did not apply to transactions between two business entities and therefore buyers did not need to deal with this issue in the transaction document.

Under the Company Act as revised this has changed. The new general rule is that a purchaser can now challenge a transaction based on *laesio enormis*. Fortunately, and very relevant for M&A practice, parties however can explicitly provide that the doctrine of *laesio enormis* does not apply to the transaction. This is particularly relevant for buyers in distressed M&A, who will purchase a company at a steep discount.

Voiding a transaction

A further primary risk that buyers have in purchasing distressed companies is the potential for the transaction to be unwound after the fact if successfully attacked in the bankruptcy of seller as a voided transfer. A primary factor is whether creditors have been disadvantaged as a result of the purchase price being too low. One way to provide some protection against such a claim is obtaining an arms-length third-party appraisal. This however will not always be a viable option in a distressed M&A situation that is particularly time-critical.

Liability exclusion clauses

From a seller's perspective in distressed M&A, the seller will want to exclude liability to the greatest extent possible. Often in such situations the distressed assets – whether in the form of a share or asset deal – will be sold at a price discount and thus perhaps already factor in certain liability risks. This makes it all the more important for seller to ensure that those liability exclusions that are agreed to between the parties are indeed enforceable. A recent Austrian Supreme Court decision emphasises the prudence that needs to be taken in drafting the transaction document to achieve such a result on the seller side.

On November 15 2007 (decision 2 Ob 209/07k) the Austrian Supreme Court held that the seller of a landfill was liable to the purchaser for the damage that resulted from an insufficient final capping of a landfill. The asset purchase agreement contained a general warranty exclusion clause, stating that the assets were transferred in their present condition and that no warranty was given for the fulfilment of permit terms in administrative orders the authorities had issued. The Court held, however, that the contractual exclusion of warranties did not extend to the fact that the seller had kept key information secret from the purchaser. The Court further noted that warranty exclusion clauses generally are to be interpreted restrictively against the seller.

In previous dealings with the administrative authority the seller had provided false information on the conforming of the landfill's cap to environmental provisions. Furthermore, the seller sealed and covered the landfill with a far too thin cap, which nevertheless gave the impression of the landfill being correctly sealed. The court held that due to the seller's intentionally not disclosing the non-conformity of the landfill's cap, the expansive warranty exclusion contained in the asset purchase agreement was not effective with regard to the resulting damage. Importantly, the court reached the further conclusion that the seller had implicitly warranted the conformance of the landfill's cap with the relevant administrative decree. The court justified this by reasoning that because the asset purchase agreement contained a clause that the landfill would be operated by the purchaser in the future, the parties could not be held to have intended the warranty exclusion clause to apply to this particular circumstance. This conclusion of the court demonstrates the importance of making sure that exclusion clauses are not in potential conflict with other clauses in the agreement.

This decision raises the issue of whether sellers need to be more pro-active in disclosing possible problem areas to purchasers, especially where a purchaser has undertaken a very superficial due diligence as was the case in the Supreme Court decision. In addition, particularly lawyers representing sellers in distressed M&A transactions will be increasingly challenged to make clear in the agreement that representations and warranties are not implicitly given as a result of other general clauses in the agreement. Warranty exclusion clauses thus can continue to be used as before by sellers, but with more attention to be paid to precise wording and disclosure of problem areas.

Public M&A

Falling stock market prices can wet the appetite of buyers to take over publicly-listed companies. In Austria, public takeovers are regulated by the Takeover Act. The Takeover Act is enforced by an independent takeover commission, which takes a proactive role in the takeover process.

Generally, where a buyer obtains a controlling interest (30%), it has to make a mandatory offer to buy the shares of the target. There is, however, an exception for publicly-listed companies in distress, which can be of interest to buyers which do not want to be forced to make mandatory offers for the shares of the publicly-listed target. Where the target company is financially distressed, there may be a possibility to take advantage of the Takeover Act's restructuring privilege depending upon the particular circumstances of the case.

Two main criteria need to be met to make use of the restructuring privilege. The target company must be in need of restructuring and the buyer must have a demonstrable restructuring intent. This restructuring intent also needs to be evidenced by a binding restructuring concept.

If the buyer on the other hand wants to make a public offer for all the shares, the normal rule is that the buyer cannot offer below the average stock price for the target over the past six months. The Takeover Act also contains a special exception that may apply to distressed targets. A buyer may be able to make the offer for a price below the six-month average if there has been a major unforeseeable change in the circumstances of the target over the last 12 months. This will require a fact-specific analysis.