Germany

Privatisation in Eastern Germany

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After the collapse of the Berlin Wall, the Government of West Germany empowered the *Treuhandanstalt* to administer the privatisation of businesses and the sale of state property in the former German Democratic Republic. The process of privatisation was like an ongoing play with an international cast. Bad press reviews of the Treuhand's policy of privatisation had only made frustrated investors even more leery of investing in what is now eastern Germany. Legal and practical guideposts were scarce. In this article, the authors demonstrate the relative ease with which investors can invest in the new *Bundesländer*. A case study of an actual purchase in eastern Germany is analysed. The purchase is first set in its original legal environment, establishing the prior uncertainty of purchasing and investing in the unchartered economic territory of the former German Democratic Republic. The analysis then juxtaposes the old legal environment with new legislation, showing that investing and purchasing in eastern Germany has become easier. Their conclusion, as with any good purchase, or good play is "all's well that ends well".

Introduction

Those Involved in the Study

The Treuhand

All negotiations for the purchase of a former East German company must be made with the *Treuhandanstalt* ("Treuhand") in mind. The Treuhand is the well-known

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Germany

governmental trust agency established shortly after reunification. It acts as shareholder and short-term controller of former East German enterprises. These enterprises were generally organised as a *Volkseigenbetrieb* (People's Enterprise, or "VEB"), generally a smaller part of a larger *Kombinat* (integrated plant). The Treuhand's board of management makes all decisions regarding the sale of these businesses.[1]

The Target Company
Initial negotiations for the purchase of a former East German company should be conducted with the management of the target company. The potential buyer and the target company should agree to a broad purchase and investment plan. Cooperation between the prospective buyer and the target company's management and labour representatives is essential for two reasons. First, as the Treuhand has final approval of any sale, such cooperative efforts would allay the Treuhand's fears of a hostile takeover by a foreign investor. Secondly, it allows the prospective buyer to obtain more complete information about the target company, as the Treuhand itself often does not have immediate access to complete data about the target company. Thirdly, the current management of the target company naturally has vested interests to protect in the intended purchase.

The Purchaser
In this case study, several potential purchasers (collectively, "the foreign investor") with little investment experience in East Bloc countries were interested in purchasing the group of companies comprising the target chemical and pharmaceutical enterprise.

The Matchmakers
In this case study, a major Anglo-Saxon international investment banker ("the Banker"), acting on behalf of the Treuhand, presented an offer to purchase the target company to several foreign investors. These foreign investors were interested in purchasing the group of companies comprising the target enterprise. The Treuhand also asked the German law firm of Droste Killius Triebel to manage the sale of part of a large East German plant. The plant was organised as a Kombinat, and the part being sold was a VEB.

Technical Difficulties

The Pollution Problem
East German environmental standards were woefully below those considered acceptable in most western countries. Prospective buyers should always insist on contractual protection from future environmental pollution liability. Currently, decontamination costs are upwards of DM 500 per cubic meter. In their negotiations, prospective buyers should attempt to persuade the Treuhand to make an environmental pollution survey, including an estimate of the likely cost of decontamination. In practice, the Treuhand has tended to share the risk of environmental pollution liability with the prospective buyer.

Accordingly, one important financial component of the total purchase price is the obligation of the foreign investor to assume part of the costs of environmental decontamination. Although the Treuhand is prepared to contribute to decontamination costs, it will, as a rule, demand some participation on the part of the foreign investor. In the chemical and pharmaceutical industry, these environmental problems are particularly daunting. Contract provisions relating to environmental cleansing require considerable attention, not only when submitting the offer but also in the course of negotiations.

The Identity Problem
In western Germany, the Commercial Registers and Land Registers provide highly accurate and reliable information about businesses and real estate. In some parts of the new *Bundesländer*, however, the Commercial Registers and Land Registers are not fully updated. Until these registers are complete, information about the target company can be found as a rule from three sources: (a) the target company itself, (b) the old company registers in eastern Germany, and (c) the Treuhand. Nevertheless, several problems arise:

(1) The target company may have intentionally kept inaccurate records of performance and assets to comply artificially with unreasonable state-imposed production goals. In any event, the socialist valuation of costs, productivity, prices, and sales in East Germany varied vastly with valuation typical in western market-oriented countries. As a rule, the balance sheets of former East German enterprises were particularly unreliable indications of the actual financial status of the company in question.

(2) The registration of companies in East Germany was done sporadically if at all. As all businesses and their assets were owned by the State, there was no compelling reason to document individual incorporations, reorganisations, or capital portfolios.

(3) The Treuhand is a government agency empowered primarily to administer the sale of former East German business. As a result, it is not in a position to gather, sort, and analyse financial data about the businesses it intends to sell. The Treuhand will, of course, provide what information it has. Such information can be obtained from its *Dokumentation* department.

Clearing Title, Rebuilding, and Lots of Laws

Competing Title Claims
The tedious process of determining who holds title to the land and buildings has thwarted rapid investment in eastern Germany. The often slow resolution of competing title claims has hampered rapid purchase of and investment in East German business. Three major title issues must be resolved:

(1) Claims by former German citizens or their heirs, primarily Jewish citizens, who were dispossessed of their property between 1933 and 1945 during Hitler's Third Reich;
(2) Claims to property seized by the occupying Soviet forces between 1945 and 1949;
(3) Claims to property seized by the East German government after 1949.

[1]As of 1 June 1992, the Treuhand has privatized 7,613 enterprises, or over half of the former state industries of the former German Democratic Republic. In addition, over DM 138.5 billion has been secured in investments in those enterprises, *Treuhandanstalt Informationen*, 14 June 1992, Seite 1.

Germany

The three problems often overlap. For example, the former Government of East Germany may have requisitioned a building after 1949 that was once used by the occupying Soviet forces which after the war had seized the property from a Nazi, who in turn had seized the property between 1933 and 1945 from a Jewish citizen.[2]

The Need to Rebuild

Unified Germany has been struggling to rebuild the economic shambles in eastern Germany as quickly as possible. Balancing human needs and economic growth has been a daunting task. On the one hand is the moral obligation to restore property to its rightful owners or their heirs, particularly in light of the circumstances in which it was first expropriated. On the other hand, having borne the ravages of World War II as well, endured four years of Soviet strictures, and suffered under 40 years of socialist misrule, the society and economic infrastructure of eastern Germany is desperate to make the leap into modern western society.

The Legal Environment in Pre-Unification East Germany

(a) Conversion Resolutions. Before unification, the Government of East Germany had undertaken measures that were designed to facilitate privatisation when the countries unified. The East German authorities recognised that the existing centrally planned economy had to be abolished and converted into a market economy. As a result, it planned to privatise the Kombinate and VEBs. The Conversion Order of 1 March 1990 was enacted in East Germany, which provided that a typical East German state VEB could be converted into a West German *Gesellschaft mit beschränkter Haftung* (a private limited company or "GmbH"), or an *Aktiengesellschaft* (a stock corporation or "AG"). A VEB could convert into a GmbH under the Conversion Order simply by declaring its secession from the Kombinat.

Under the terms of the Conversion Order, the Treuhand would become owner of the shares of the newly formed company. As is typical in many civil code jurisdictions, the conversion resolution had to be executed before a notary. In the case study, the conversion resolution had in fact been undertaken in notarial form. However, upon examining the resolution more carefully, it was discovered that the excecution had been done by a western notary in East Berlin. However, up until 3 October 1990, the date of reunification, the Federal Republic of Germany was still legally distinct foreign territory in relation to the German Democratic Republic. As a result, the West German notary had no legal authority to notarise a transaction in East Germany.

Despite the illegality of such notarisations, the majority of the conversion resolutions were attested by western notaries because Germans then didn't place much trust in the public notaries in East Germany, who generally had no experience with western corporate law. These notarial executions were simply void.[3]

(b) The Old Treuhand Act in East Germany. The former Government in East Germany also provided for a conversion of the Kombinate and of the VEBs by operation of law. In the Act for the Privatisation and Reorganisation of the People's Assets of 17 June 1990 ("the Old Treuhand Act"), East German Kombinate were to be converted into West German AGs. Similarly, East Germany VEBs were to be converted into West German GmbHs.

Under the Old Treuhand Act, the Treuhand Agency became the owner of the shares of the AGs that had been created from the Kombinate, and of the shares of the GmbHs that had been created from the VEBs. Simultaneously, the Treuhand itself became owner of the shareholdings in the GmbHs that had declared their secession from the Kombinate prior to the enactment of the Old Treuhand Act. Conversion under the Old Treuhand Act, however, became legal only upon registration of the newly converted enterprise in the appropriate commercial register. Such registrations occurred in East Germany, if at all, at an extraordinarily slow pace. Given the legal and economic circumstances in East Germany, no judges or court clerks had experience with commercial registers because none had existed in the former German Democratic Republic. As a result, although the conversion was planned to occur by operation of law on 1 July 1990, no valid GmbH in fact was actually converted because the required registration in the appropriate commercial register had not occurred. Further, if the VEB had not separately declared its secession from the Kombinat prior to the enactment of the Old Treuhand Act, then the VEB still legally belonged to the Kombinat, not the Treuhand.

The Legal Environment in West Germany

(a) Current Law. A rash of post-unification legislation confronted these problems. One law in particular addressed the title issues described above.[4] In its attempt to address the

[2]Some descendants of former citizens of Germany, now scattered throughout the world, find that they now have legal claims to property underlying some of the most valuable real estate in Germany, a most newsworthy example of which are claims to land underlying the bustling city centre of *Alexanderplatz* in eastern Berlin. As of 1 January 1992, over 2 million claims for restitution had been filed, *Frankfurter Allgemeine Zeitung*, 24 January 1992, Wirtschaft, Seite 1.

[3]In a test case, the German courts have held such notarisations invalid, reasoning that before unification, the authority of the West German notaries was valid only in West Germany, 2 *Deutsch-Deutsche Rechtszeitung* 92 (44A, 58R). This decision created another legal problem for potential investors who had purchased real estate and relied on the notarisations. Future legislation cured notarial defects in these transactions, discussed *infra*.

[4]The *Gesetz zur Regelung offener Vermögensfragen* (Law Regulating Unsettled Property Questions) was originally part of a *Gemeinsame Erklärung der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik* (Joint Declaration of the Federal Republic of Germany and the German Democratic Republic) of 15 June 1990, Anl. II Kap. III Sachgeb. B Anbschn. I, Nr. 2 Einigungs V, BGBl II 1990, 1159 ff. This Law later became Attachment III to the *Vertrag zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik über die Herstellung der Einheit Deutschlands – Einigungsvertrag* (Treaty Between the Federal Republic of Germany and the German Democratic Republic on the Creation of a Unified Germany – Unification Treaty), concluded on 31 August 1990, Anl. III Einigung V, BGBl II 1990, 1237 ff. The Law Regulating Unsettled Property Questions came into effect on 3 October 1990, the date on which the former East German states became a part of West Germany.

Germany

human need, this law favoured restitution of the property rather than compensation for it. Another law addressed the stimulation of investment in East Germany.[5] Sometimes these two laws worked at cross purposes.

(b) Application of Current Law.

(i) The Property Law empowers the Treuhand to issue a property certificate to a prospective buyer. This certificate terminates all claims if the issuance of such a certificate is necessary to prevent the collapse of the business or for some other justified economic reason.

(ii) If a formerly dispossessed citizen or his heirs has claims on what has become business property, the claimant has the option to continue the business. In that case, the claimant in effect becomes another party to the negotiations, but only receives the profits from the sale of the land rather than restitution of the property.

(iii) Section 1 of the Investment Law permits the sale of land and buildings even if claims for restitution exist. These sales are contingent on the issuance of an investment permit granted by independent judges of the Treuhand.

The Case Study

A Lair of Problematic Purchases in East Germany

This case study involves a purchase in the industrial sector of the former German Democratic Republic, in which problems of privatisation typically manifest themselves in a seemingly insurmountable form. Specifically, the problems associated with the purchase of the particular industry in question are invariably very large. These problems include the existence of legally related nationalised companies, restitution problems for prior landowners on which the company is built, environmental contamination occasioned by woefully inadequate environmental safeguards, and the volatility of the real estate market.

The Scope of Negotiations

A purchase and investment plan must include at the minimum a business operation plan, reinvestment plan, and a job retention programme. The purchase offer should reflect the prospective buyer's efforts to revitalise the target company, which has invariably suffered under 40 years of mismanagement. Specific conditions must be met by the purchaser/investor, including:

1. Provision for a post-contractual revision of the purchase price if no job or investment guarantees are made. Under such circumstances, this is normally done five years after the date of the contract;
2. Investment guarantees, the breach of which will entail a concomitant increase in the purchase price;
3. Job guarantees, the breach of which will entail liability for liquidated damages of approximately DM 30,000 per lost job;
4. Provisions that the application of reserves will lead to an increase in the purchase price on a retrospective basis;
5. Full exclusion of liability for the Treuhand for administrative mistakes and oversights, including inaccuracies in balance sheets, environmental assessment, *etc.*

In addition, section 613a of the German Civil Code stipulates that the purchase of substantial assets of the company (80 per cent or more) assumes all rights and duties under existing employment contracts. Most former East German enterprises were overstaffed. Prior to agreeing to the purchase price, it is imperative to obtain a warranty from the target company regarding the number of employees, their functions, and their salaries. It is also suggested that an indemnity should be obtained from the Treuhand for legal disputes arising from the termination of needless positions within the company.

Presentation of the Purchase Offer in General

After agreeing to the general parameters of the purchase, the foreign investors inform the Treuhand. The Treuhand will then issue a draft of the purchase agreement, including conditions required by the Treuhand and German law, to the prospective buyer. Drafts of the purchase agreement can also be issued in English. The draft agreement is the basis of further negotiations between the contracting parties and the Treuhand.

The acceptability of the purchase price by the Treuhand is inversely proportional to the number of jobs guaranteed. In other words, a purchaser may decide to retain only 10 per cent of the existing job force. However, the purchase price will be much higher as a result.

Adherence to a strict timetable for negotiations is necessary to bolster the Treuhand's belief that the purchaser is serious about the intended purchase or investment. Information regarding current bidding procedures is available from the Treuhand's Investment Services Department.

Unduly long negotiations arouse the suspicions of two departments within the Treuhand. The Environmental Contamination Department and the Contract Control Department might then intervene in the negotiations, which could cause unnecessary frustration and further delay for the purchaser. Therefore, speed and accuracy are paramount on the part of the purchaser.

Of special concern is the fixation of a valuation date for the assets of the target company. Companies incorporated in East Germany after 30 June 1992 are more than likely properly incorporated under the laws of the Federal Republic of Germany. However, those East German companies incorporated before 30 June 1992 had to file an audited "DM Opening Balance Sheet" by 30 June 1992. This Opening Balance Sheet stated in West German marks the asset value of the East German company, and fixed land value as of the end of 1990. Those companies that failed to file such an Opening Balance Sheet will be liquidated.

On the basis of the Opening Balance Sheet, the prospective buyer may be subject to an adjustment in purchase price in at least four ways:

(1) If substantial investment will be required and business losses are expected to be high in the early

[5]The *Gesetz über besondere Investitionen in dem in Artikel 3 des Einigungsvertrages genannten Gebiet* (Law Regarding Special Investments in the Area Defined in Article 3 of the Unification Agreement) also came into effect on 3 October 1990, the date on which the former states of East Germany joined with the Federal Republic of Germany.

stages, a prospective buyer may be able to negotiate a considerable reduction in asset value;
(2) If the land value fixed in the Opening Balance Sheet is provisional, the asset value may have increased due to real estate speculation that has escalated since reunification on 3 October 1990;
(3) The Treuhand may insist on a 5-year revaluation clause in the contract and an adjustment of the purchase price on that basis. Prospective buyers should attempt to minimise the revaluation period, set a maximum limit on revaluation, and/or apportion the increase in value between the Treuhand and the prospective buyer.[6] Two years is an acceptable revaluation period in some cases;
(4) Valuation of fixed assets such as buildings and machinery are generally overvalued. Particular research should be made as to whether the target company made an application to the Treuhand for release of its debts. These factors can also be used to negotiate a purchase price.

The Banker, the Target Company and the Foreign Investor

The Banker Discovers the Checkered Past of the Target Company

In typical commercial purchases in western countries, virtually no problems exist with regard to determining ownership of land or shares of a company. With regard to the latter, the vendor has either acquired shares from third parties or by subscribing to the company at its incorporation or, as the case might be, at a time of increase in capital. Determining ownership is merely a function of tracing the shareholding back to the foundation of the company, and ascertaining the legality of those share transfers that have occurred since incorporation.

In the case study, shares were being sold in a GmbH (a former VEB). Concern was raised as to whether the Treuhand, as adminstrator of the target company, had acquired ownership in the shares of the target company at all. It was necessary to determine whether the business or businesses comprised within the target company to be sold under the auspices of the Treuhand had actually been converted into a GmbH, either as a result of a declaration of secession from the Kombinat under the Conversion Order, or as a matter of law under the Old Treuhand Act, with proper registration.

Representatives at the Treuhand appeared to be somewhat puzzled when asked this question. Treuhand representatives were of the opinion that potential purchasers and their attorneys never even perceived this problem as a rule, and concluded that no reason existed to provide an answer to the question as to whether the enterprise, or any portion, had been converted into a GmbH by declaration of secession or by law. To protect the interests of the potential investors, a private investigation of the matter was undertaken.

The Banker is Cautious

The Banker erred on the side of caution and assumed that no effective conversion occurred under the provision of the Conversion Order because no evidence existed of a declaration of secession. The Treuhand, on the other hand, simply proceeded on the assumption that by reason of the Conversion Order alone, the Treuhand had become shareholder of the purported converted enterprise.

Determining whether secession had in fact been validly declared was difficult. Prior to purchase negotiations, the former Kombinat existed in practice only on paper. After extensive investigation, the management of the supposed newly-converted GmbH provided a copy of the minutes of meeting of the representative bodies of the former VEB, in which a resolution to declare the VEB's secession from its parent Kombinat had been made.

However, no evidence could be found that the secession resolution had been declared and delivered to the Kombinat. The secession resolution had been directed by name to the director of the Kombinat. In the interim, however, this director had been dismissed as a result of his obvious collaboration with the communist regime. A liquidator assumed his role as director of the Kombinat; however, this liquidator was conversant neither with the business documents nor the business transactions of the Kombinat. Moreover, the dismissed communist director of the Kombinat and his secretary, who might possibly have been able to confirm delivery, could not be found. Even when found, the director would not respond to questions regarding receipt of the declaration.

With no other choice available to the parties, shares in the newly-formed GmbH were sold, although the actual legal owner of the shares was unknown. It was possible that the Treuhand was the shareholder. It was equally possible that the Kombinat, which had been converted into an AG, was the owner on the basis of the old Treuhand Act. Explaining this dilemma to the legal counsel of the potential investors led to one of the many understandable situations in which purchase negotiations ceased; no reasonable purchaser is prepared to acquire a company from a vendor when there are obvious doubts as to whether the vendor is the actual owner of the shares to be sold.

Ultimately, a solution was found. The newly-formed AG (the former Kombinat), would dispose of any shares it might possibly have in the newly-formed GmbH (the former VEB affiliated with the Kombinat) by executing an additional purchase and transfer agreement. In that agreement, the Treuhand could dispose of the shareholdings of the GmbH (the former VEB) as direct owner of the AG (the former Kombinat). The purchase and transfer agreement stipulated that the shares of the AG were in fact validly transferred to the Treuhand by the former Kombinat, and that the Banker received written notification of this transfer. In addition the Treuhand obligated itself to undertake all steps necessary to cure any defects in the transfer.

Accordingly, in addition to the purchase and transfer agreement between the Banker and the target company, another purchase and transfer agreement between the Treuhand and the AG (the former Kombinat) had to be drafted. Complications arose. It was not

[6]The prospective purchaser will have contributed to some extent to the increase in asset value by its subsequent investment in and commercial operation of the business.

Germany

possible to transfer the shares and set no consideration for them. As the shareholding of the AG (the former Kombinat), in the GmbH (the former VEB), was not represented in its financial records, a capital gain would have to be posted to the AG upon sale of the shares, which, in the normal course of business, would be taxed in the hands of the AG. Apparently, this was not the first time that such a scenario had arisen. The West German Government provided a mechanism in the form of the "DM [German Mark] Opening Balance Sheet Act" to set a financial valuation date of the newly-converted companies. This Act provided certain rules for the intitial balance sheets (the "DM Balance Sheet") of companies in former East Germany, which formed the basis for the new companies which had been incorporated in East Germany under the Conversion Order, discussed *supra*.

The Balance Sheet Difficulties

The basis for every tax aspect of a commercial transaction of a capital company in a market-oriented system is the company's balance sheet. Thus, it was only by means of the DM Opening Balance Sheet that this basic principle was even introduced in East Germany. As soon as the DM Opening Balance Sheet was drawn up, postings could be made in the manner typical of western accounting practices. However, in the absence of accurate market values for the fixed and current assets of the former East German enteprises, the law had provided that the balance sheet would be adjusted accordingly after a certain period of time. For example, the balance sheets could be assigned an increased value if it was determined that the earlier balance sheet postings were too low.

In the case study, money from the sale of shares of the affiliated GmbH (the former VEB), which might possibly be realised by a newly-converted AG, would in practice lead to an adjustment of the balance sheet. Specifically, a capital gain on the sale of shares of the affiliated GmbH would therefore be avoided because the adjustment in the balance sheet would be an exchange of asset-postings. The effect of this adjustment would be to eliminate ramification on the sale of the GmbH. Of course, this conclusion was tentative because it was not certain that the AG was in fact the shareholder of the GmbH, discussed *supra*.

The foreign investor would thus only be obliged to make payment of the purchase price to the AG if the AG were the actual owner of the shares in the GmbH. As this remained legally unclear, it was decided that a professor from a renowned law faculty should definitively decide on behalf of the Treuhand and the newly-formed AG who the actual shareholder of the GmbH was. If the Treuhand was determined to be the owner, then the foreign investor would not be required to make payment of the purchase price to the AG, but rather to the Treuhand on the basis of the second purchase and transfer agreement between the Treuhand and the AG.

A compromise was reached that allowed the Treuhand to pursue negotiations for the sale of the shares in the GmbH with the potential investors. The foreign investor demonstrated a great degree of patience and goodwill because it was interested in the acquisition of the target company and was not prepared to see the deal spoiled because of legal complications not specifically addressed by the current laws of West Germany or the former German Democratic Republic.

The Offer Memorandum

The Banker had drawn up an Offer Memorandum in minute detail. In the Offer Memorandum, the Banker described the target company's commercial, technical, and financial data, as well as detailing the Bank's own financial, corporate, and legal status to meet the formal requirements of the Treuhand Agency.

The Bank had originally convened a meeting of many potential investors, most of which were investment bankers. At the conclusion of this meeting, a handful of companies remained with sufficient interest and commercially viable investment programme most likely to be accepted by the Treuhand. All potential investors had the opportunity for on-site inspection of the target company and its holdings, in order to satisfy any requirement of due diligence of the foreign investors.

Even before the purchase occurred, life imitated art. Much like the problems of producing a play, competing administrative details in the purchase of a business in eastern Germany make the best efforts seem inadequate. For example, in the case study, the draft of the purchase offer comprised a few pages. However, the final document was five times as long. Together with the schedules and additional provisions in the schedules, the purchase offer resembled the length of Shakespeare's *Hamlet*. When notarising the share transfer agreement that was part of the purchase offer, the notary public had to read all documents, as required by German law. This process took eight hours.

In the case study, several associated businesses appeared separately in the offer memorandum which the foreign investor had no intention of acquiring. It was anticipated that these associated businesses should be split off prior to the conclusion of the purchase agreement so that they would not be included within the share transfer to the foreign investor. The problems with this procedure were so great that it was impossible to split off the businesses in time. As a consequence, a provision was included in the purchase agreement that these associated businesses would be disposed of at a net zero cost to a third party to be designated by the Treuhand following conclusion of the contract. Consequently, it had to be provided for that the purchase price agreed would accordingly increase or decrease in the event that the company actually obtained a positive consideration, or, on the other hand, had to pay a "negative purchase" price to the purchaser in the course of selling the individual associated businesses.

It was suggested that these associated businesses should be sold for the nominal purchase price of one German mark to the Treuhand or a company controlled by the Treuhand. Tax problems arising from this suggestion could not be overcome. It was possible that the director of the company selling the associated business for such a small amount might be subject to criminal charges as a result of tax evasion, if the associated business were sold for less than fair market value. Independent of that consideration, the director would have been personally liable to the Treuhand as a shareholder of the

Germany

company. From a tax point of view, the procedure would have been regarded as a disguised distribution of profit. However, the money would ultimately have ended up with the government in any event, either as taxes to the tax authorities or as purchase price to the Treuhand.

In this regard, the Treuhand regularly approached tax problems very naively because legally there is no difference whether the purchase price is paid to the Treuhand or corresponding taxes are paid to the tax authorities for the same transaction. All potential purchasers are well advised to investigate all tax questions, and in particular to exclude any circumstances that could lead to criminal prosecution.

For those associated businesses acquired, but undesirable from a commercial point of view because of pending restitution claims lodged by third parties, care had to be taken to prevent the AG from exercising any powers of disposal over the other assets of the associated businesses following the share transfer without first obtaining the consent of the Treuhand. Furthermore, it was obvious that the disposal of the unwanted associated businesses was made "as is", *ie*, under exclusion of any guarantee.

Unwanted Land

Early in the negotiations with the foreign investor, it became apparent that some of the almost 100 pieces of commercial land were of no interest to the foreign investor because they were unnecessary to the business operations at the time or to planned investment measures. It was planned, as was the case with the associated businesses, that those pieces of land unnecessary to the operational requirements would be disposed of prior to the share transfer. It was impossible to dispose of these unnecessary pieces of land in time for at least two reasons.

First, it was impossible to ascertain which plots of land were under the ownership of the pharmaceutical company. In East Germany, as in other East Bloc countries, no proper land registers were kept. In any event, everything belonged to the State: the land and the company which used the land. Ownership was never transferred by means of a formal, notarised, and registered document, as is typical in West Germany. Rather, ownership in East Germany was transferred to another business or to a state institution merely by internal operational or administrative instruction.

Secondly, no land register existed in which ownership allocation was recorded. The land registers which had existed in proper format prior to 1949 were abandoned. However, it was possible to glean from those pre-1949 land register files evidence of prior owners. Nevertheless, even these old land registers were less than complete, making research extremely difficult. As a rule, the evidence unearthed in this research was extremely unreliable. It was assumed, however, that the manufacturing and warehouse installations of the pharmaceutical company were under its ownership. Additionally, leases existed in a number of departments and branches of the company, from which one could conclude that the company was either the owner or, as a result of lease contracts, at least a lessor.

In the meantime, the target company had been urged to establish a property administration procedure in which the details of all known leases and ownerships were collected. An employee of the target company who was knowledgeable about the land used and the methods in which it was used was eventually in a position to complete a list of the properties owned, to the extent that there were clues from which the ownership of the target company could be inferred.

Even today, however, it is not certain whether in fact each and every piece of land is under the ownership of the company. It is possible that there are still plots belonging to the target company which are not recorded in the land register and of whose existence nobody is aware. For instance, it was only at a very late stage that it was ascertained that certain social facilities, such as rest homes and holiday homes in different geographical regions were, in fact, owned by the target company. As late as the date of closing, it was further ascertained, following inquiries from the employees of the target company, that certain local gas and water pipes and distributors situated in the middle of the firm's premises were on property that did not belong to the company.

From a practical point of view, land sales after the conclusion of the share transfer agreement were structured in such a manner that the Treuhand obtained power of attorney from the target company to sell the unwanted properties. The bank did not want to have anything to do with these property sales. Accordingly, it was provided in the contract that the agreed purchase price should increase or reduce to the corresponding extent that the target company made a profit or loss out of the property sales. In connection with the future sales of properties unnecessary for the operational requirements, considerable additional problems will arise. For example, the issue of entitlement to possible lease income and of liability for costs and expenditure for the maintenance of the buildings, *etc*, must be regulated outside the share transfer agreement.

The Current Financial Situation

It was agreed in our case study that the vendor should leave the profit from the current financial year within the company. This provision is typical in Treuhand contracts. The purchaser is acquiring a company whose future yield potential cannot be predicted with as much accuracy as is generally the case with western companies, due to the change in the commercial and political circumstances of East Germany. The potential risk on the part of the purchaser supports the view that any profit arising in the financial year prior to the share transfer should also remain with the purchaser. This provision is also acceptable to the Treuhand because the vast majority of the privatised companies have in any case been operating at a deficit. In many cases, the Treuhand is only able to sell the company at all if the Treuhand assumes the prior debts of the company to be sold. Few purchasers are prepared to buy a company which is operating at a deficit and is practically insolvent.

The prospective buyer must determine if the Opening Balance Sheet reflects debts contracted by the target company prior to the currency union in July 1990. Under the Debt Release Order of 1990 (*Entschuldungsverordnung*), a company may apply to the Treuhand to have its debts released if such release will promote the rehabilitation, restructuring, and competitiveness of

Germany

the target company. Although the Treuhand makes the final determination, it generally releases debts in most cases.

Prospective buyers should also note that section 419 of the German Civil Code provides that a transfer of shares imposes liability on the transferee for all business debts, even if incurred prior to the transfer. German courts have held that a transfer of 85 per cent or more of the shares falls under the purview of this section of the code.

The Purchase Price

Although the offering memorandum offered the target company as part of a "job lot', it was anticipated that certain associated businesses which were unrelated to the core business or which were to be closed down as a result of non-viability, would be split off. As a consequence of this, a "starting purchase price" was established as a basis from which the purchase price resulting from the later disposal of the operationally unnecessary properties would have to be deducted.

The purchase price itself was based neither on the intrinsic value nor on the yield value. Here, the sale was being conducted by means of a type of auction in which the offerers were given several options to pay a considerable "strategic premium". Yield value calculations were conducted. However, from these calculations no absolute company valuation could be inferred because the target company had been active on a market which had been radically altered as a result of the political changes in the East. The target company therefore operated at a "higher profit" during the sales negotiations.

Furthermore, it is well known that in the East Bloc, there was a certain division of labour in which certain products would be manufactured in one Comecon State, and others in another Comecon State, more or less on an exclusive basis, for further distribution to the other members of Comecon. The whole system of this interstate division of labour collapsed together with the political structure of the East Bloc.

A number of products supplied to other countries, in particular to the Soviet Union, achieved high profits. However, the economic difficulties in the Soviet Union led to its inability to pay for products from East Germany, in particular in the wake of the introduction of the West German mark to the former territory of the German Democratic Republic in conjunction with the Currency and Economic Union between East and West Germany.

Nevertheless, great value was placed on the "goodwill" of the target company, despite the fact that during the negotiation phase, turnover for the company declined for the reasons mentioned above. Of decisive importance was the opportunity to develop markets in the entire East Bloc, in particular in the former Soviet Union. On the other hand, western manufacturing standards were not maintained by the target company. Considerable investments were necessary to procure a market position in the West as well as in the East with the products manufactured in eastern Germany.

As a matter of course, the price negotiations focused to a great extent around the investment obligations which constituted a part of the actual purchase price. The East German pharmaceutical company was hardly viable in the long term. It was only in conjunction with a western company, a factor which would introduce western know-how and considerable investment, that the company's survival on the world markets could be secured.

To determine the purchase price as quickly as possible, it was provided in the share purchase agreement that the accountants of the target company would check the book values of the operationally unnecessary pieces of land in the DM Opening Balance Sheet and, if necessary, adjust them. Any difference between the DM Opening Balance Sheet and the interim balance sheet would then automatically imply an adjustment of the starting purchase price.

In addition, it was agreed in the purchase contract that there would be no reduction of the purchase price for later revaluation in which the level of the company's equity capital proved to be less than that equity capital shown in the DM Opening Balance Sheet as at 1 July 1990. This provision addressed the Treuhand's inability to know whether the DM Opening Balance Sheet actually showed correct values.

Approval From Treuhand

A prerequisite for the validity of contracts with the Treuhand is the consent of the shareholders' meeting of the target company, the administrative board of the Treuhand, and the Federal Ministry of Finance. The latter is only necessary in cases in which the target company employs more than 2,000 workers and is being sold at a price of more than DM 100 million.

The privatisation policy of the Treuhand is constantly subjected to criticism. Accordingly, the Ministry of Finance is ever more careful to investigate the economic components of the contracts. Thus, consent requires considerable time. In privatisation cases of great economic importance, the Minstry of Finance will probably impose conditions of its own. However, these conditions are usually of a formal nature, and are generally not so designed as to endanger a major commercial deal. The Ministry of Finance merely wishes to ensure that the job retention and investment commitments made by the purchaser do not merely appear on paper, but are also actually implemented.

In our case study, approval was granted, there was a successful outcome, and it is hoped the parties continue to prosper.

New Legislation

On 3 April 1992, the Federal Cabinet of Germany proposed legislation to correct problems that arose from the application of the laws and procedures described above. The proposed legislation attempts to strike a balance that is both humane and economically sound. The proposed legislation is the second *Vermögensrechtsänderungsgesetz* (Law of Changes in Property Rights), which has the following three goals:

1. To improve investment priority regulations in eastern Germany and extend the validity of those regulations to the end of 1995, in the interest of the economic recovery;
2. To accelerate simultaneously the return of property expropriated by the Nazis or seized by the former East German Government; and
3. To improve ownership protection for good faith

Germany

acquisition of homes built on the land of others.

The proposed legislation was published on 22 July 1992. The particular application of this law depends largely on the circumstances surrounding the intended sale, purchase, or investment in eastern Germany. In any event, the overall investment environment in eastern Germany will be greatly enhanced by such legislation.

Conclusion

Despite the seemingly insurmountable obstacles facing a potential purchaser of land or business in the former German Democratic Republic, the investment environment is not so bleak. In fact, one-half of all former East German enterprises have been sold since the inception of the Treuhand agency. The new legislation will make investment even easier and more secure.

Almost unitary law now exists within the entire Federal Republic of Germany (the territory comprised by former East and West Germany). New laws are drafted by those with a foundation in western legal systems as well as those who bring the benefit of their experiences in former East Germany.

Accordingly, the reluctance of prospective buyers and investors from the Anglo-Saxon world to invest in the new *Bundesländer* can best be attributed to unfamiliarity with civil code legal systems typical in continental European countries. This hesitation can easily be overcome with the assistance of experienced legal advisors in Germany.