INFORMATIONEN FOR MANAGING DIRECTORS AND
MEMBERS OF THE SUPERVISORY BOARD

MANAGEMENTLTR

#01

DUE DILIGENCE

Economic, legal, tax, and financial circumstances — thoroughly reviewed by us

FOR BUYERS

Thorough, reliable due diligence conducted by our consultants prior to a planned acquisition

FOR VENDORS

Preparation for sales process through appropriate measures by our consultants

DUE DILIGENCE

Identifying and Responding to Risks in Corporate Transactions

BUYER DUE DILIGENCE

Buyer due diligence refers to a thorough examination of a potential acquisition target conducted by the buyer or the buyer's advisors prior to a planned corporate acquisition. As a rule, the potential buyer of a company already has specific ideas about the target. However, by its very nature, not all information is publicly known or accessible. Furthermore, even facts that are presumed to be known may not actually be accurate.

The goal of due diligence is therefore to determine whether the potential acquisition target is a "good fit." In particular, the process involves identifying risks associated with the target that, in the worst-case scenario, could prevent the acquisition from going through ("deal breakers") or that would then be reflected in the purchase price through a corresponding discount.

The scope of any due diligence review can be freely agreed upon. This should be worked out in detail in advance through collaboration between the buyer or seller and the advisor to ensure that the desired objective is actually achieved.

In practice, financial, commercial, tax, and legal due diligence are particularly relevant.

Depending on the size and business model of the target company, however, more specific areas — such as technical, IT, environmental, or insurance due diligence — may also be examined.

Legal Implications: Is there a (de facto) obligation for the buyer to conduct due diligence?

In principle, every buyer is free to decide whether to conduct a due diligence review. This applies in particular to the owner of a company or the sole shareholder. The situation may be different for the managing director of a GmbH, who must make decisions in accordance with statutory requirements or existing bylaws.

Under certain circumstances, due diligence prior to a business acquisition has now come to be regarded as a customary practice. This should be taken into account as a contributing factor in the interpretation of legal norms if a due diligence review is not conducted. In fact, due diligence reviews are now widespread in practice. However, it is debatable whether they have, for this reason, now attained the status of a customary practice.

In any case, however, the managing director of a GmbH is required under § 43(1) GmbHG to exercise the diligence of a prudent businessperson. Managing directors who breach their obligations are jointly and severally liable to the company for the resulting damage (§ 43(2) GmbHG). Although § 93(1), second sentence, of the German Stock Corporation Act (AktG) generally applies only to stock corporations, it also has a spillover effect on the GmbH. This so-called “business judgment rule” states that a breach of duty does not exist if, when making a business decision, the member of the executive board could reasonably assume that he or she was acting in the best interests of the company based on adequate information. The managing director of a GmbH must therefore ensure that he has an adequate basis of information before making a decision regarding the acquisition of a business. This is generally achieved through a due diligence review, even if such a review is not strictly required. Impact on the warranty: Section 442 of the German Civil Code (BGB) also applies to business acquisitions. According to this provision, the buyer’s rights arising from a defect are excluded if the buyer was aware of the defect at the time the contract was concluded or was unaware of it due to gross negligence.

If the due diligence review prior to a business acquisition is considered standard practice, failing to conduct due diligence would constitute gross negligence within the meaning of § 442 BGB.

This would consequently result in an exclusion of warranty claims. However, this issue has not been conclusively resolved in the legal literature. Furthermore, after a due diligence review has been conducted, the buyer may, under certain circumstances, be deemed to have knowledge of all data made available in the data room. Thus, the buyer would also be aware of any defects arising from this information. In this case as well, the rights arising from a defect would be excluded under Section 442 of the German Civil Code (BGB). Incidentally, proving which documents were made available in the data room is relatively straightforward, particularly in the case of a virtual data room, since a log is kept of when which files were uploaded and who accessed them at what time. In practice, buyers therefore often attempt to exclude the application of Section 442 of the German Civil Code (BGB) in the purchase agreement.

VENDOR DUE DILIGENCE

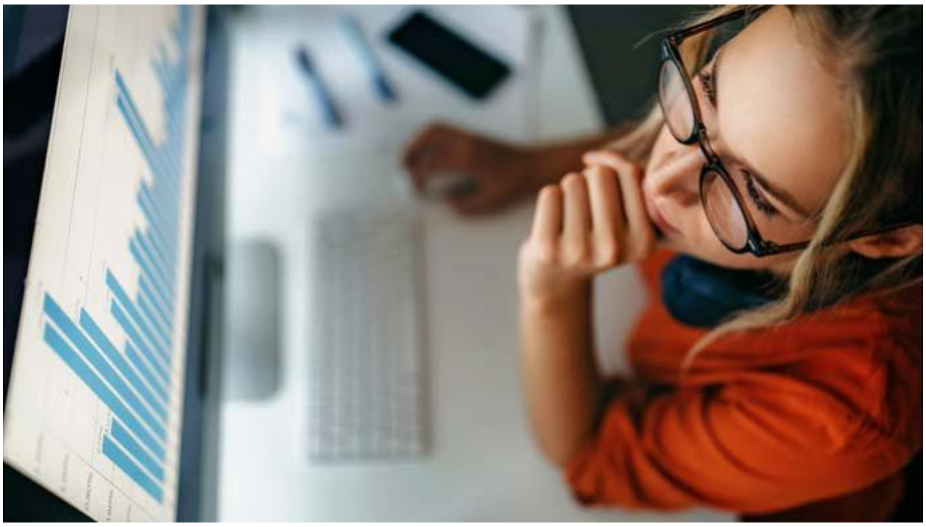
The term “vendor due diligence” refers to due diligence conducted by the seller or by advisors engaged by the seller. In the sale of owner-managed small and medium-sized enterprises, it is common to see negotiations taking place with only a few — or, in extreme cases, a single — prospective buyer. Even in these cases, it is strongly recommended that the seller prepare for the sales process by taking appropriate measures. This is particularly true when the seller’s own company is to be sold to a prospective buyer that is larger and, accordingly, has more experience with transaction processes.

By engaging advisors in a timely manner, the seller can protect themselves from surprises.

Weaknesses can be addressed before documents are disclosed to third parties. In particular, a consistent multi-year financial plan — consisting of a projected income statement, balance sheet, and cash flow statement — should be available or prepared. An expert advisor can also provide an early estimate of the purchase price. This allows for the development of an appropriate negotiation strategy. The seller can specifically prepare for any attempts the buyer might make to secure price concessions or guarantee commitments based on critical factors.

Another important consideration during due diligence is which documents should be made available to a potential buyer and at what point in the process.

Under no circumstances should the process consist of simply working



through a list of requests compiled by the prospective buyer. The seller must always retain the authority to decide which information is disclosed.

The seller must be aware that the prospective buyer(s) are generally also competitors who could make use of the information they obtain—especially if they do not win the deal. The seller should therefore always ask themselves what information they absolutely do not want to see in the hands of a competitor. If necessary, the due diligence process should also be divided into several phases, with business-critical information being provided only once the pool of interested parties has been narrowed down to a potential buyer who has submitted a binding letter of intent and an indicative purchase price offer acceptable to the seller. However, even during a so-called exclusivity phase, not all information may be disclosed in its entirety. For example, contracts with customers must never be shared in their unanonymized form as part of due diligence. This applies even if the prospective buyer has signed a non-disclosure agreement and has committed not to misuse the information. Even if the prospective buyer is in principle liable for damages, it would be difficult to prove a causal link between the due diligence process and the customer's defection to the prospective buyer in a protracted legal dispute.

The principle of confidentiality applies to the managing director of a GmbH. He or she has a legal duty not to disclose information if doing so could harm the company.

Furthermore, in the area of human resources, for example, there is information that, due to legal obligations (data protection), may not be disclosed at all or may only be disclosed in anonymized form.

CONCLUSION

Conducting a due diligence review prior to a planned corporate acquisition is standard practice today. However, the scope and specific structure of such reviews vary widely.

In any case, a potential buyer should carefully consider, prior to an acquisition, which information is relevant to their decision-making in order to ensure that the due diligence review is conducted efficiently.

The seller of a company is also advised to prepare for the sale well in advance. This will result in a stronger negotiating position — and thus a higher sale price.

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If you have any further questions, we are happy to assist you and will work with you to find the best possible solution.

When we conduct a due diligence review, you will not receive reports containing standard analyses. Instead, we always strive to clarify expectations and information needs with the client in advance to ensure a targeted and efficient approach.