

13

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M&A IN GERMAN TECH

A PLAYBOOK FOR BUYERS AND SELLERS

"AND YES,
WE WILL ALSO
TALK ABOUT
AI..."


orrick

VC & TECH BRIEFINGS GERMANY

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Abbreviations Used in this Guide

Acqui-hire	A transaction in which the Buyer's primary (if not sole) objective is the acquisition / hiring of a Target Company's employee talent, usually comprised of its engineering team.
AO	German Fiscal Code (<i>Abgabenordnung</i>)
BGB	German Civil Code (<i>Bürgerliches Gesetzbuch</i>)
BGH	German Federal Court of Justice (<i>Bundesgerichtshof</i>)
Buyer	means the party interested in acquiring a Target Company respectively its business, whether via a share deal with Sellers or an asset deal with the Target Company. A Buyer can be both a financial investor (a private equity investor) or a strategic acquirer (a larger corporation or occasionally a scale-up). As we will see, both investor groups come with their own particularities.
cic	culpa in contrahendo
CP	Condition precedent
DPO	Data protection officer
ESOP	(equity-based) employee share option programs
EStG	German Income Tax Act (<i>Einkommenssteuergesetz</i>)
FDI	Foreign direct investment
FSR	Foreign Subsidies Regulation
FTO	Freedom to operate
GDPR	General Data Protection Regulation
IM	Information memorandum
IPO	Initial public offering
InsO	German Insolvency Code (<i>Insolvenzordnung</i>)
MAC / MAE	Material adverse change / Material adverse effect
M&A	Mergers and acquisitions
SEC	Securities and Exchange Commission
Sellers	means the existing shareholders of a Target Company. They may hold common shares (founders) or preferred shares (existing investors such as angel or VC investors).
Target Company	means a young technology company. We will focus on companies with innovative technology offerings that will often be "IP heavy."
VC	Venture capital
VAT	Value added tax
VDD	Vendor due diligence
VSOP	Virtual share option program
W&I Insurance	Warranty & indemnity insurance
W/C	Working capital

ORRICK LEGAL NINJA SERIES



About the Orrick Legal Ninja Series - OLNS

In substantially all of the major world markets, we have dedicated technology lawyers who support young German technology companies on their growth trajectory through all stages. As one of the top tech law firms in the world, we are particularly committed to bringing the American and German entrepreneurship ecosystems closer together.

For this purpose, we launched the Orrick Legal Ninja Series ("**OLNS**") back in 2019. With this series, we provide overviews on current legal trends and take deeper dives on certain legal topics particularly relevant for German start-ups and their investors.

OLNS editions are co-authored by a multidisciplinary team of lawyers from our national and international offices. It is our goal to tap into the rich reservoir of the venture capital, corporate venture capital and technology know-how of our international platform and make it available to the exciting German entrepreneurship and innovation scene.

Why "Ninja Series?" This title might simply reflect the fact that some of us watched a little too much TV in the 1990s. But, seriously, "Ninja" has come to signify "a person who excels in a particular skill or activity." That's what the Orrick team strives for when it comes to providing tailored advice to growing tech companies and their investors. We hope that OLNS also empowers you to be a Ninja entrepreneur.

If you'd like to discuss further, please contact us. We would love to learn about your experiences with the topics discussed in this publication, so please share them with us. We constantly strive to evolve and grow to best serve our clients.

We hope you enjoy this thirteenth edition of OLNS.

On behalf of the Orrick Team,

Sven Greulich

Orrick - Technology Companies Group Germany

A. M&A in German Tech: A Playbook for Buyers and Sellers

I. Preface

The focus is shifting for founders and investors in German tech. Venture capital ("VC") funding has returned to pre-pandemic trendlines. Valuations have normalized across many sectors and stages and most recently we heard from the investor community that early-stage valuations are already again approaching unhealthy territories in some sectors (but who would call these market participants biased observers...). As the ecosystem matures, attention is gravitating from raising funds to also achieving exits – arguably one of the last missing ingredients to supercharge the German tech ecosystem.

In a stubbornly difficult IPO market, mergers and acquisitions ("M&A") often offer the only practical route to liquidity for high-growth companies. This playbook provides buyers and sellers a guide to approaching M&A transactions involving German tech.

"It's great to innovate — I have full respect for that — but it's also great to get a return on all the innovation and all the investment you make."

Hock Tan, CEO of Broadcom

It explores data on German and European M&A deals, walks you through the stages of preparing and executing an exit and dives into the economic aspects of the deal. This Guide covers everything from share purchase agreements and distressed M&A deals to IP, privacy & cybersecurity as well as regulatory considerations.

4 THINGS TO KNOW ABOUT GERMAN TECH M&A



#1 The German M&A Market is Diverse:

- Institutional investors are acquiring significant stakes in late-growth German start-ups. They're also purchasing majority positions in start-ups as part of buy-and-build strategies.
- Larger corporations use start-up M&A to grow, expand services, access new tech and / or enhance their competitive edge.

#2 Evaluating Start-ups for a Potential Acquisition can Pose Challenges:

- Potential acquiring companies must determine the "right" valuation.
- They also must structure deals to preserve value, allocate risk and rewards and align incentives beyond closing.
- Careful review pays off: Well-prepared beats well-intentioned every time.

#3 The Focus on Exits Signals a Maturing Ecosystem:

- The links are well-documented between venture capital, entrepreneurship and innovation – and how exits via acquisitions foster dynamic innovation.
- Promising recent developments in the German VC and start-up ecosystems can only continue if a deeper and richer exit market evolves to allow founders and investors to realize the value they have created.

#4 The Rising Tide in AI M&A will have Consequences:

- 2024 was not the year many in the deal-making world hoped for. One reason: An increasing need for investors to find liquidity. AI start-up deal-making, however, gained momentum amidst a slight upward trend in overall M&A (at least in the U.S.). 65 global venture-backed AI start-ups were acquired in Q2 2024 alone. 145 AI start-ups were acquired in the first half of 2024, representing a 55 % uptick from Q2 2022 and 15 % from Q1 2023. Notable M&A transactions involving AI start-ups include Nvidia's acquisitions of Run:AI for \$ 700M and Deci AI for \$300M, as well as JFrog's purchase of Qwak for \$ 230M and SAP's acquisition of WalkMe for approx. \$1.5B (data taken from Crunchbase).
- Two factors drove the surge in AI deals:
 - Strategic considerations on the buyers' side ("We need to do something and building it inhouse takes too long, so let's buy something").
 - Potential cash flow challenges faced by AI start-ups due to high infrastructure costs and slow revenue growth ("We better sell now before things turn south").
- We expect these U.S. trends to impact the German M&A market soon. Generative AI has evolved so quickly that many companies haven't had time to adjust. Buyers and sellers should update M&A playbooks to address AI challenges.

How This Guide Can Help

Negotiating a start-up exit involves addressing and resolving key transaction processes – commercial, legal and liability issues.

M&A agreements are often heavily negotiated. Poorly prepared transaction structures or documents can result in significant risks to sellers, including with respect to the certainty of closing and potential post-closing liability risks.

Against that backdrop, this Guide will:

- provide an overview of German tech M&A deals in general, present exit processes and deal structures while also outlining a number of hotly contested acquisition agreement issues; and
- pay special attention to what we call "start-up M&A," the sale of a young tech company that usually will have received financing from outside investors.

Start-up Specifics in M&A Deal-Making: Assessing tech start-ups for a potential acquisition, finding the "right" valuation and structuring a deal in a way that preserves value, adequately allocates risks and rewards and aligns incentives beyond closing can prove challenging. With this Guide, we want to give Sellers and Buyers of Target Companies (we will define these terms later in this introduction) an overview and a playbook on how to approach these crucial transactions. Well-prepared beats well-intentioned every time. "The secret of getting ahead is getting started" (Here you go, another quote from our beloved author Mark Twain whom we sneak into every publication of OLNS as we stubbornly believe it makes us sound smarter than we are. By the way, he left us a couple of hundred quotes so we will likely run out of ideas for OLNS well before running out of Mark Twain's nuggets of Stoicism...).

Start-up M&A deals can differ in important aspects from "classic" M&A transactions:

PARTIES

Many VC-backed start-ups raise multiple financing rounds. That creates a multitude of shareholders that might have different economic and strategic interests. Even if their interests align, coordinating with as many as 20+ parties can prove challenging.

ACQUISITION OBJECTIVES

Often, the goal is less about immediate financial gains and more about access to innovative technologies, products or talent. As we will see, the Buyers' risk profile and approach to due diligence and negotiating will differ significantly from that of the VC funds that invested in the Target Company in its prior financing rounds.

VALUATION UNCERTAINTY

Valuations based on "classic" financial metrics such as revenue, profit and cash flow are often of limited use. Rather, valuation in start-up M&A is frequently based on future potential, technology or the team.

- Earn-out structures can bridge the "valuation gap."
- The valuation the Buyer envisions may depend on the founders and / or other key personnel staying on board, at least during a transition.

NON-CASH DEALS

To preserve precious liquidity and ensure Sellers maintain some skin in the game, non-cash transactions are more common among start-ups, such as when a Buyer pays with shares rather than cash.

DUE DILIGENCE

Start-ups frequently lack a multi-year track record. They pose a higher risk, as the business model is often nascent and the market uncertain or evolving. This makes the financial due diligence difficult. Given the innovative business models of many Target Companies, a Buyer's legal due diligence will often focus on intellectual property, cybersecurity and AI-related matters.

REGULATORY SCRUTINY

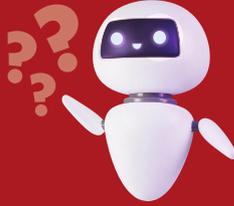
In addition to general merger clearance requirements, acquiring a deep tech or other innovative start-ups often triggers regulatory scrutiny under German foreign direct investment rules when the Buyer is from outside the EU/EFTA.

POST-MERGER INTEGRATION

Integration exercises often require flexibility to preserve innovation and culture. Sometimes the start-up continues to operate as an independent entity. Retaining key employees is often more prevalent than in traditional M&A deals.

And What About AI? We know how overused statements sound that these days everything is disrupted by AI. But do you know what is actually quite entertaining? Asking large language models (LLMs) to make fun of all start-ups these days claiming to be AI companies. Here is a selection of what the future masters of the universe had to offer:

“ **Why did the start-up claim to be an AI company?**
Because 'Algorithmically Inspired' sounds better than 'Almost Intelligent.'



“ **Why did the start-up say they're an AI company?**
Because 'Adding Innovation' sounds more impressive than 'Attempting Ideas.'

“ **Every start-up now claims to be an AI company?**
It's like saying your cat is a tiger – sure, it sounds impressive, but it's still just knocking things off the counter.

But seriously, given the importance of this rapidly evolving technology and its business implications, we will also take a look at some of the emerging consequences of AI for M&A deal-making. To properly address the new AI workstream in transactions, both sell- and buy-side must consider appropriate inquiry and risk mitigation measures at each stage of the deal.¹

Terminology Used in this Guide: To make our lives a bit easier, let's agree on a few definitions we will use throughout the remainder of this publication:

- **"Buyer"** means the party interested in acquiring a Target Company respectively its business, whether via a share deal with Sellers or an asset deal with the Target Company. A Buyer can be both a financial investor (a private equity investor) or a strategic acquirer (a larger corporation or occasionally a scale-up). As we will see, both investor groups come with their own particularities.
- **"Sellers"** means the existing shareholders of a Target Company. They may hold common shares (founders) or preferred shares (existing investors such as angel or VC investors).
- **"Target Company"** means a young technology company. We will focus on companies with innovative technology offerings that will often be "IP heavy."

"Please don't do anything stupid or kill yourself, it would make us both quite unhappy. Consult a doctor, lawyer and common-sense specialist before doing anything in this book."

Tim Ferriss, Tools of Titans

1. If this sounds like a shameless promotion of our amazing capabilities in the technology space, we suggest you trust your instincts. You can find our growing library of AI law trackers, insights and AI-related updates here: <https://ai-law-center.orrick.com/>.

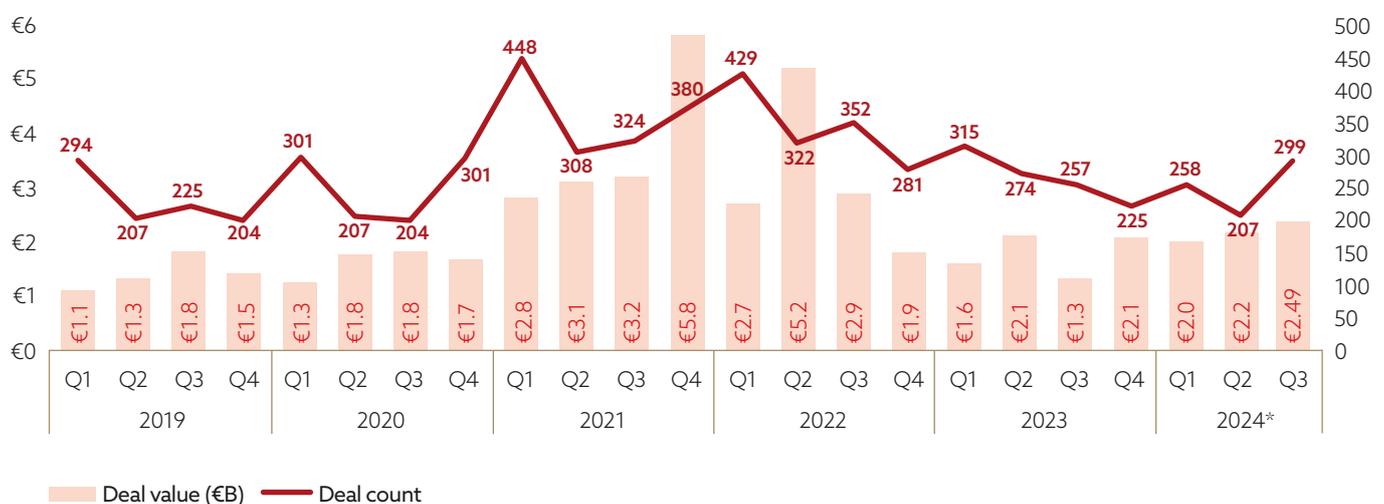
II. By the Numbers – Some Deal Stats on Start-up M&A in Germany

1. INTRODUCTION

Quick tour down memory lane. Remember the fifth edition of our OLNS that we published back in March 2020²? During that first lockdown, we painted a rather gloomy picture, filled with dark clouds and an ominous economic outlook. Well, our crystal ball must have had a smudge on it because the VC world was about to explode minting the once mythical creature unicorn by the

dozens every month while we were bracing for stormy weather and practiced social distancing. During the pandemic peak in 2021 and (at least) the first half of 2022 (what seasoned entrepreneurs now refer to as "the good old days") saw VC activities, valuations and deal volumes rise to record-breaking heights.

VC Deal Activity by quarter



Source: PitchBook | Geography: Germany | *As of 4 Dec 2024

Once more there – apparently – was proof to the fact that disruptive ideas have a knack for turning chaos into opportunity, even defying a global pandemic. While some of us used the freedom of the imprisoned to develop our banana bread recipes to perfection, start-ups were rewriting the rules of the game. With adaptability as their superpower and investors supporting them, they managed to not only survive but thrive. While there is a general correlation between VC investments and M&A exit activities, the patterns do not always align perfectly as M&A activity usually lags the overall funding trends. M&A activities can continue to thrive even during periods of reduced VC investments, driven by the maturation of previously funded start-ups and the strategic needs of larger companies. At the same time, when VC investors pushed forward innovative new business models, established players sometimes turn to acquiring young companies in order not to fall behind. So it was no surprise, when in late 2020 and during 2021, start-up M&A markets in Germany were very active.

Just as we were getting used to this unending bonanza, the party came to a crashing halt. Increasing investor skepticism, tumbling public markets, inflation and increasing interest rates combined with geopolitical uncertainties (wars in Ukraine, the Middle East and heightening trade conflicts) were the main contributors to a perfect storm.

Against this dynamic and challenging background, in this Chapter we will take a quick look at the current and recent technology M&A landscape and the factors that shaped it. While we will focus on Germany, we will occasionally take a step back and also present the wider European or U.S. market perspective. In the final part of this Chapter, we will briefly discuss the road that may lay ahead (spoiler alert – it doesn't look too bad after all – that is lawyers' Latin for "there will be a new boom, ...eventually").

2. See OLNS#5 – Venture Financings in the Wake of the Black Swan, the Guide can be downloaded here: <https://media.orrick.com/Media%20Library/public/files/insights/olns-5-venture-financings-in-the-wake-of-the-black-swan.pdf>.

2. CURRENT MARKET ENVIRONMENT

Current market conditions have led to notable declines in VC deal activity and exit transactions. The focus has shifted from a frantic chase driven by fear of missing out accompanied by a mantra of growth at all costs towards a more measured approach emphasizing capital efficiency and returns on investments. Beyond the early stages (where most recently deal-making activities have picked up substantially), investors and founders often faced increasing impediments to raise growth capital and achieve liquidity. Lengthier due diligence processes, slower growth rates and rising costs continue to hamper capital flows.

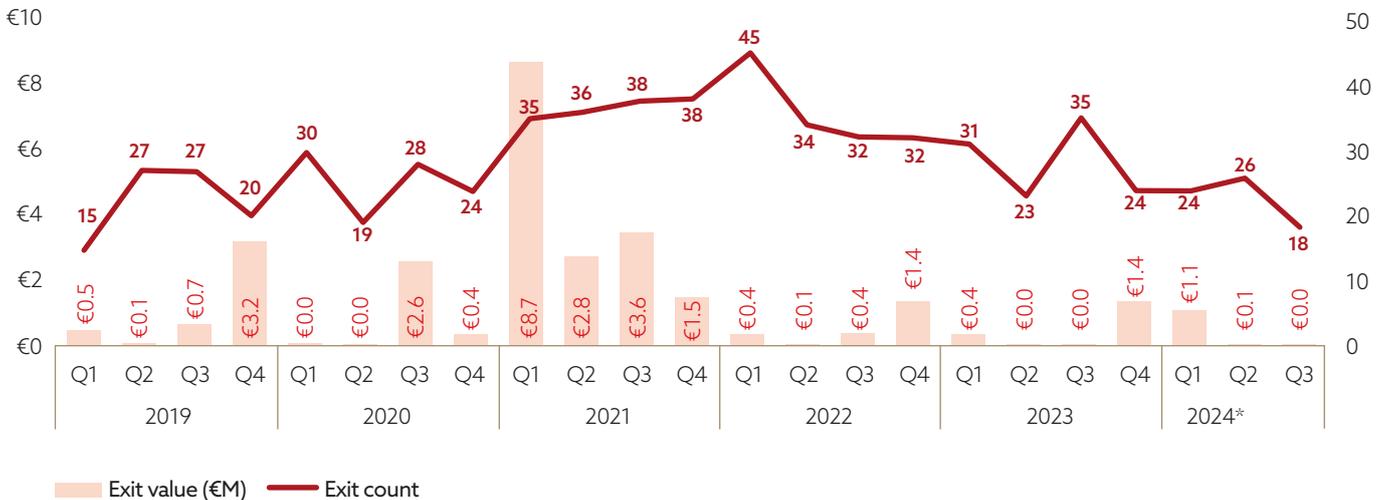
Following this overall trend, the start-up M&A market in Germany has experienced a noticeable slowdown over the past two years. Exit activity in 2024 was still rather subdued, with only a handful of exits taking place. This quiet trend has persisted in Germany since early 2022, as founders, management teams and investors have been wary of taking the plunge into public listings. Over the past 10 quarters, quarterly exit values have exceeded EUR 1 billion on three occasions only. In contrast, from Q3/2019 to Q4/2021, this figure was surpassed in six quarters, with a staggering EUR 8.7 billion exited in Q1/2021 alone.

M&A Deal Activity: Top five VC-backed exits by exit value since 2023*

Company	Date	Exit value (€M)	Exit type	Industry group	Industry code
LeanIX	November 7, 2023	€1,231.0	M&A	Software	Business/productivity software
Cardior	March 25, 2024	€1,025.0	M&A	Pharmaceuticals & biotechnology	Drug discovery
YFood	March 1, 2023	€215.0	M&A	Consumer nondurables	Beverages
pure-systems	October 4, 2023	€87.7	M&A	Software	Business/productivity software
Torqueedo	January 19, 2024	€77.4	M&A	Commercial Products	Electrical equipment

Source: PitchBook | Geography: Germany | *As of 4 Dec 2024

M&A Deal Activity: VC exit activity by quarter



Source: PitchBook | Geography: Germany | *As of 4 Dec 2024

While historical trends often provide valuable insights, this time the landscape appears to be less predictable. For dealmakers, it's crucial to understand the various forces at play to better assess risks, plan scenarios and develop effective strategies. According to our assessment, the following aspects are the main factors which shaped the current environment:

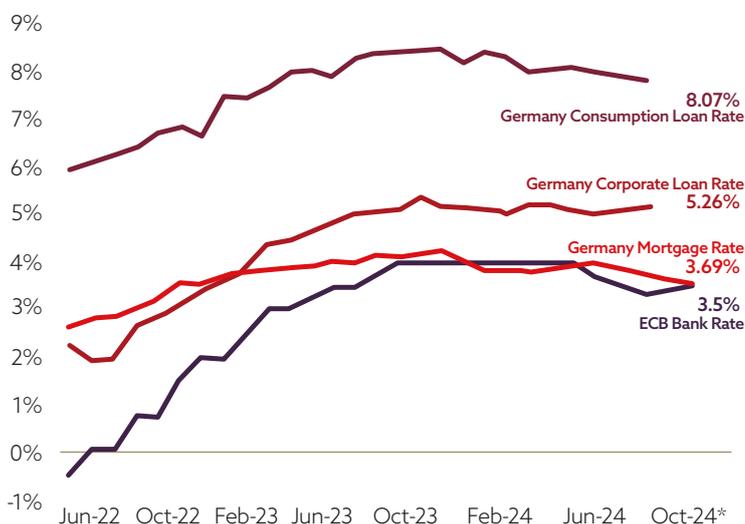
Interest Rates - The Highs and Lows of M&A: Interest rates have been a major talking point, particularly with U.S. Treasury bond yields being inverted for almost two years. An inverted yield curve, where short-term bonds yield more than longer-term ones, has historically predicted an impending recession. However, despite this signal, no widespread recession has materialized. Larger economies like the United States have managed to stay afloat, thanks to ongoing government stimulus measures and a robust labor market. Recently, countries like Switzerland, Sweden and Canada as well as the European Central Bank have announced interest rate cuts, which could be a sign of more cuts to come. These anticipated cuts are eagerly awaited by dealmakers looking to fund acquisitions through debt, as lower interest rates reduce borrowing costs. However, today's higher interest rates are squeezing returns, making it even more important for dealmakers to focus on the value-creation potential of any acquisition.

Valuations - A Tough Nut to Crack: The gap between what Buyers are willing to pay and what Sellers expect remains wide in many sectors. This discrepancy is partly due to the fact that the assets changing hands last year were probably the stronger ones, trading at high multiples. This has created unrealistic expectations among some owners (investors and even founders) about the multiples they can get for "their" assets. The buoyant stock market, driven partly by the promise of generative AI, adds another layer of complexity. Financial markets seem to have central bank rate cuts priced in before they have even happened, creating a testing environment for M&A. The combination of uncertainty and high valuations is currently proving to be a significant obstacle for dealmakers.

Elections - The Political Chess Game: 2024 has been packed with elections, and more are on the horizon (including an unexpected one in Germany). Dealmakers and markets tend to be cautious around election times due to the political uncertainty they bring. Central banks also tend to avoid making moves on interest rates around elections to avoid any appearance of political motivation. In the United States, this means the Federal Reserve did hold off with further rate cuts until after the recent election, frustrating those who have eagerly awaited a more accelerated approach to bringing interest rates down.

Geopolitics - The Global Wild Card: Global tensions, such as the ongoing conflicts in Ukraine and the Middle East, continue to add to the uncertainty. The risk of escalation in these conflicts is ever-present, making the geopolitical climate unpredictable. Another factor is the fraught U.S.-China relationship. Trade tensions, tariffs and geopolitical maneuvering between these two superpowers can have significant ripple effects on global markets. All these geopolitical issues contribute jointly to an unpredictable climate for dealmaking.

Interest Rates by type



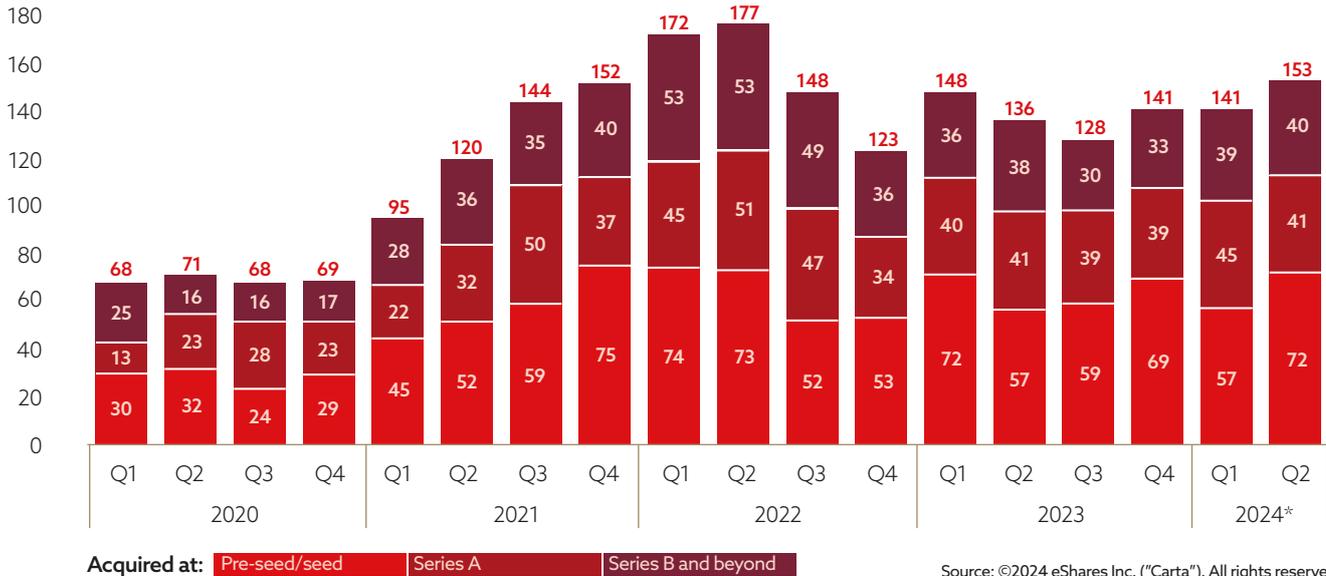
Source: ECB | Geographv: Germany | *As of 4 Dec 2024

3. THE ANATOMY OF THE ACQUIRED START-UPS

In this Chapter, we present some key characteristics of Target Companies beyond just the price point. Reliable and comprehensive data points for German start-up M&A or even European start-up M&A are hard to come by so we are drawing on several sources to provide a richer picture.

Which State Are Most Start-ups in When They Get Acquired? For U.S. deals, the service provider *Carta* found that (Pre-)Seed start-ups are the most frequently acquired across all funding stages, based on quarterly measurements since 2020.

Pre-seed/seed start-ups are the most common M&A targets M&A transactions on Carta by most recent funding stage | Q1 2020–Q2 2024

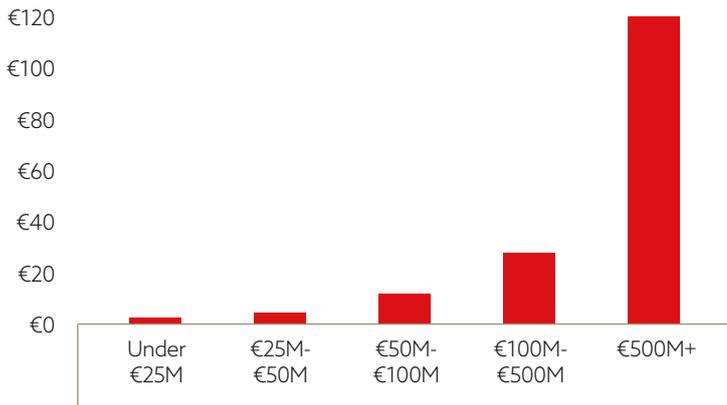


This trend highlights a key phase in start-up growth where acquisitions peak. We identified four main causes explaining these patterns (the first three are of a structural nature, the last one reflects recent funding trends):

- When looking at the overall start-up and financing funnel, only a fraction makes it to Series B and beyond.
- Prior to Series A is often an inflection point where some start-ups take a sober look at their growth prospects and maybe better head for an (acqui-hire) exit.
- Seed companies may be attractive targets for strategic Buyers who are more interested in feature grabs or acquiring technology rather than in the growth potential of a Target Company.
- Valuations for later-stage start-ups have come under significant pressure since the last hype that ended in early 2022. This might make existing investors in these companies reluctant to tap the M&A market before their portfolio companies had a chance to regain some lost ground.

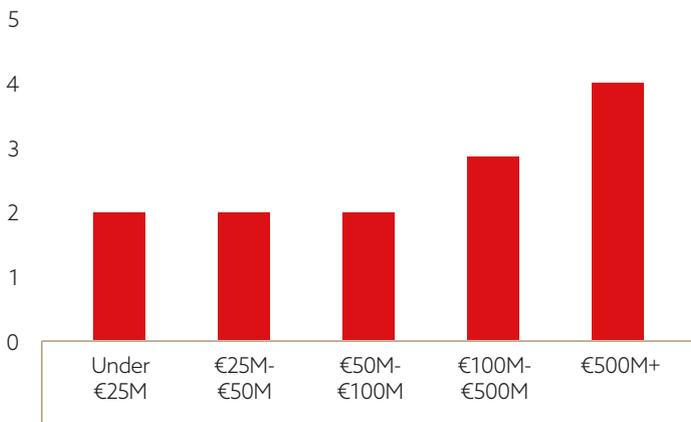
For Europe we are not aware of such a comprehensive dataset – when looking at the M&A exits our European team was involved over the last four years we find, however, similar patterns with a slightly larger number of Seed stage companies. That being said, there is some interesting data available about how European VC-backed start-ups exit the deal funnel.

Median total capital raised (€M) by exit size



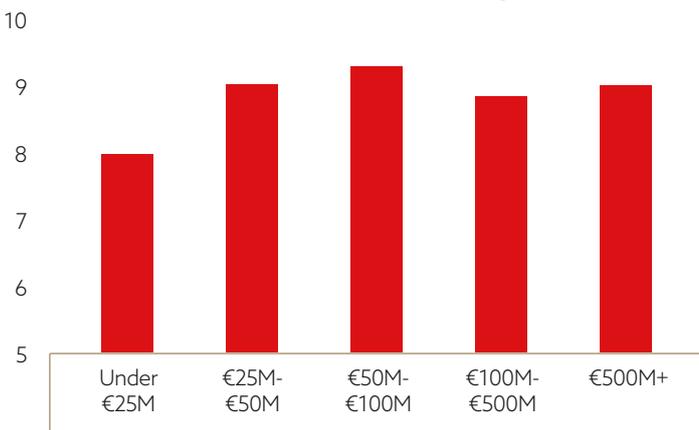
Source: PitchBook | Geography: Europe | *As of March 31, 2024

Median number of VC Rounds by exit size



Source: PitchBook | Geography: Europe | *As of March 31, 2024

Median time (years) since founding by exit size



Source: PitchBook | Geography: Europe | *As of March 31, 2024

European Deal Funnel - Target Companies'

Characteristics: In its recent Analyst Note "Evaluating the Europe VC Dealmaking Funnel," the data service provider *Pitchbook* evaluated the attributes of exited VC-backed European technology companies and examined how much capital exited companies have raised, how it is structured and timings involved. While again the analysis is to some extent limited by the size and quality of the underlying data set, its findings are in our experience at least directionally correct. The underlying data set included the period from 2013 until end of Q1/2024:

- **Capital Requirements by Exit Size:** *Pitchbook* analyzed capital going into start-ups versus their exit value to determine benchmarks for capital requirements to build companies across exit sizes. However, these findings have to be taken with a grain of salt as capital demands differ considerably depending on industry, location, business model and further factors such as the bootstrapping capital used.

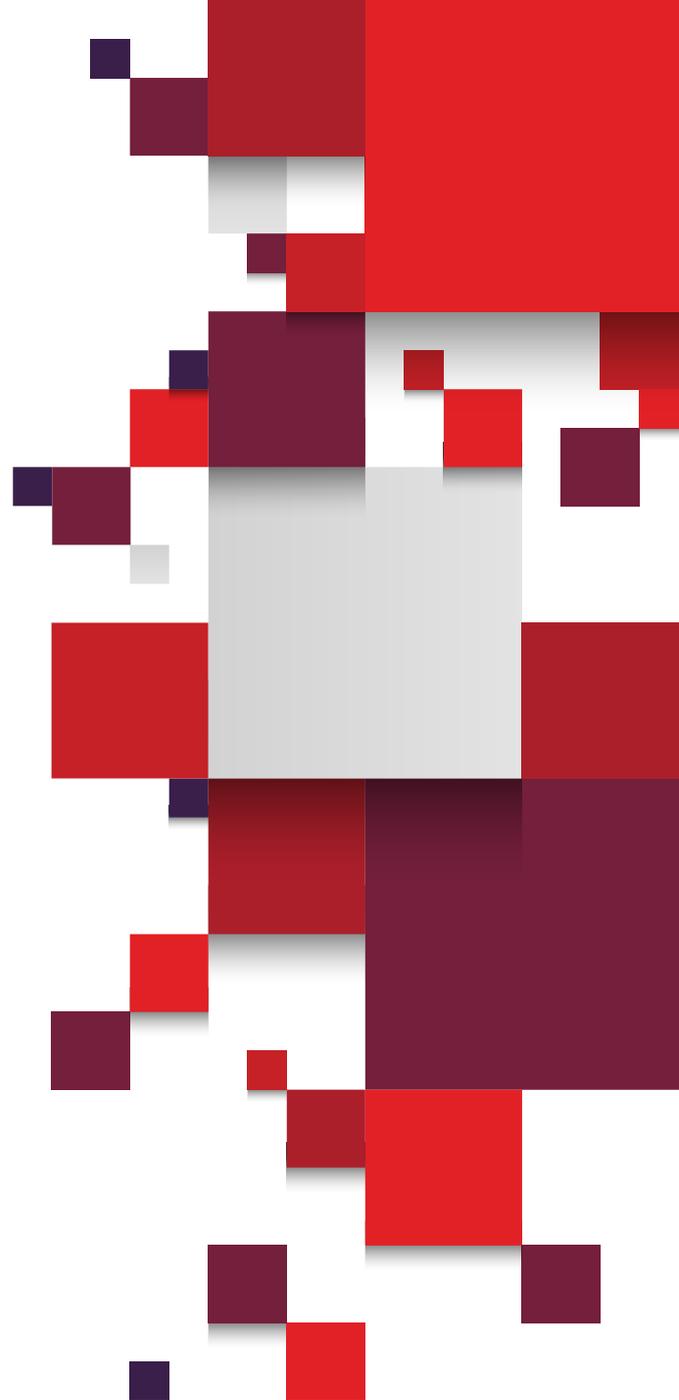
The median total capital raised by a company has a direct correlation to its exit size. Exits between EUR 25 and EUR 50 million have a median total raised amount of EUR 5.0 million. Exits between EUR 50 and EUR 100 million and between EUR 100 and EUR 500 million have median capital raised figures of EUR 11.1 million and EUR 27.0 million, respectively. For EUR 500 million+ exits, the median total capital raised is EUR 114.0 million.

- **Number of Financing Rounds Prior to an Exit:** *Pitchbook* also looked at the number of financing rounds that a European start-up completed before it got acquired. It found that since 2013, the median quantity of rounds was two for companies that exit at a valuation under EUR 100 million. For exits at EUR 500 million+, the median number of rounds completed was four. At the top of the ecosystem, the median number of rounds completed for active unicorns yet to exit stands at five.
- **Time Periods Until an Exit:** According to the *Pitchbook* analysis, exit sizes and holding periods have limited correlation with annual data points displaying volatility due to outliers each year. Median holding periods for VC-backed entities are clustered around 7.9 years to 9.2 years across all exit sizes, and longer holding periods do not necessarily result in bigger exits. From 2013 to Q1/2024, the median holding period was 8.8 years for the 126 exits at EUR 500 million or more.

4. THE ROAD AHEAD

There are some reasons to be slightly more optimistic for M&A deal-making in the German technology sector over the next quarters:

- Valuation expectations have come down and the valuation gap seems to get smaller.
 - It looks that an IPO window will open in the course of 2025 and prior deal patterns indicate that this will have positive effects on the broader exit markets.
 - There is increasing pressure from the limited partners of VC funds who made investments about 3-5 years ago to see a return of liquidity (which might then be redeployed into the next generation of funds that the respective VC investor seeks to raise). For example, a *Carta* analysis of more than 1,800 VC funds found that as of the end of Q1/2024, only half of all funds of the 2018 vintage had any DPI five years after the fund's inception, at the six-year mark that number had only risen to 57 %. On the other hand, many private equity investors have still a lot of dry powder that needs to be deployed or returned to limited partners at some point. Similarly, according to *Atomico's* 2024 "State of European Tech Report", one in three LPs surveyed cited the lack of liquidity and distribution as a key barrier to making their first investment in European VC.
 - Supportive macroeconomic factors, in particular lower inflation rates, yield a more stable backdrop for decision making. In addition, in Q3/2024, the first central banks began a cycle of interest rate cuts, which should make debt financing for acquisitions cheaper. Rate cuts should also support the valuation of publicly listed tech companies, which in the past boosted boardroom confidence in M&A and expanded the general start-up exit landscape.
 - The race to gain access to AI and other emerging technologies (including decarbonization and the broader energy transition) will likely motivate many transactions in the coming years. Particularly strategic Buyers seek to acquire capabilities, technologies and other assets that advance their goals.
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III. Preparing for an Exit Process

In this Chapter, we look at some important steps in the preparation of an exit process. We use the standard exit process with either a one-on-one transaction or – usually even more value-creating – an auction process as baseline. These exit processes usually take several months and require careful planning. Later in this Guide, we will look at the usually more time-compressed distressed M&A exits and their particular challenges.

At the same time, pressure to exit an investment can also build at the other end of the success spectrum (That is Latin for start-ups going south or sideways; in venture-speak these companies are referred to as "lemons.")

"Lemon harvesting" is part of the venture business. The home-run approach described above requires VC investors to make lots of (hopefully) educated bets and identify and nurture their winners. On the flip-side, this means VC investors cannot (or should not) let the lemons in their portfolio soak up much energy and capital for so little return. Likewise, while lemon harvesting is primarily an investor's job, tending a rotten lemon is not a good entrepreneurial investment either.

Against this backdrop, key to any decision to pursue an exit should be the liquidity objectives of the company's shareholders, the investors' and entrepreneurs' assessment of the Target Company's prospects with the current set-up and the market conditions for M&A. Shareholders pursuing an exit strategy should also be attuned to the dynamics of the Target Company's cap table (in terms of the "waterfall" and the motivations of its early and later-stage investors) and track M&A activity in the relevant market. Consider the nature of potential Buyers in the context of the Target Company's stage of growth and potential. For example, consider whether the Target Company is likely to attract strategic acquirers, *i.e.*, bigger players that operate in the same or similar market and see the Target Company as a strategic acquisition. Or will private equity investors back the Target Company's leadership team to take the company to the next stage of growth? The answer will help determine what an exit will mean for the Target Company's business, management team and employees. In this context, founders should also consider whether they want a role in the Target Company after its sale (see Chapter A.XI.2.).

2. GETTING YOUR DUCKS IN A ROW – A.K.A. STAKEHOLDER MANAGEMENT

The nature and timing of an exit process has the potential to cause disruption. You should consider the pattern of communications with the most relevant stakeholders, notably (other) shareholders, key executives and other constituents (e.g., certain material customers and suppliers). It is important to establish a project team to run the exit process, which will be responsible for developing and implementing a communication strategy to ensure timely communication to key stakeholders.

Obviously, no deal will be the same so we will limit ourselves to general observations and guidance for the most relevant stakeholder groups that we derived from having worked on countless tech M&A deals.

"We learn geology the morning after the earthquake."

Ralph Waldo Emerson, U.S. Author

1. THE DECISION TO EXIT THE COMPANY – UNDERSTANDING THE VC INVESTORS' LOGIC

As mentioned above, when we are talking about Target Companies, we often refer to start-ups that have received venture funding, either from angels, institutional VC funds or corporate investors with a predominantly financial focus.

While VC funding only goes to a narrow slice of potential innovators, the VC sector has arguably become the dominant source of financing for high-potential start-ups commercializing risky new ideas and technologies. VC has fueled the rise of some of the largest businesses in the world. This proportionally small asset class produces huge social and economic impact. For example, some studies for the U.S. market found that VC investors fund less than one percent of companies started in the U.S. each year, yet they account for the backing of nearly half of the companies that enter the public markets.

The success of VC investors follows a strict power law logic, *i.e.*, a small number of big "hits" can drive a fund's success despite numerous other failures. Not only must VC investors aim to invest only in potential grand slams, but they also need start-ups to find an exit within a timeframe that roughly corresponds with the term of their fund. There are only two main paths to a successful exit: sell the company or go public. As funds typically have a term of ten years that can be extended twice by one year each. This dynamic shapes the type of companies they invest in and the way that they govern them. Venture-backed start-ups must grow fast and there is a need for an exit on a relatively short timeframe. Ultimately, if a VC-backed start-up survives past its early stage, cap table and governance complexity often increase, and pressure builds for the start-up to find an exit path. These factors distinguish venture capital, and the types of start-ups VC investors will fund from other businesses or stages of a business life cycle.

2.1 Shareholders – Preferred and Common

When a start-up prepares for an exit, especially with a diverse shareholder base that includes both common and preferred shareholders with varying rights and preferences, several process considerations and potential issues can arise. Here are some key considerations, potential problems and tips on how to identify and address these issues.

2.1.1 Confidentiality and Process Considerations

Confidentiality: Both Buyer and Target Company usually have a strong interest in keeping the talks confidential. The Buyer does not want to jeopardize deal security or attract potential competitors. The Target Company will fear uncertainty among its own employees or customers and suppliers if the sales talks become public too early. The Sellers, in turn, may fear that if the talks with a prospective Buyer leak and later fail, this could be interpreted by the market as meaning that something is "wrong" with the Target Company.

If a Target Company has many shareholders, it can increase the risk of a leak if all shareholders are informed early and comprehensively.

In such a case, the sales talks are often conducted by one or two shareholders as negotiators and the other significant shareholders (groups) are kept informed by means of a close-knit advisory board, while the other shareholders are initially only kept very generally informed (if they are informed about the process at this stage at all).

It Takes a Majority (or Even More than One Majority):

The uninformed might think that the biggest advantage of the U.S. corporate law is the absence of any notarization requirements for M&A transactions (chasing dozens of powers-of-attorney and KYC forms while the clock is ticking to get the deal signed is something you will remember). However, the availability of the so-called "reverse triangular merger" is a close contender. Jokes aside, in the U.S., instead of a share deal exit, an acquisition of a technology company (or other targets) is often implemented through this form of a merger scheme because it can usually be accomplished quicker and with lower approval thresholds compared to a classical purchase of stock in the target. The reverse triangular merger allows the acquirer to acquire the target with all its assets and liabilities (unlike an asset sale where third-party consents might be required). More importantly, this merger is administratively simpler because it only requires approval from a requisite percentage of the target's stockholders. Once obtained, this approval is binding on all stockholders, subject to dissenters' or appraisal rights (unlike a stock sale, which would require each of the stockholders to individually agree to sell their shares).

In Germany, the exit process is often significantly more cumbersome as most shareholders' agreements include provisions regarding a (share deal) exit that must be considered when planning the transaction process. Below is a brief summary of the key considerations.

Restricted Transferability as the Rule: Under the German Limited Liability Companies Act (*GmbHG*), shareholders in a GmbH can, in principle, freely transfer their shares to third parties, provided that the shareholders' list in the commercial register names them as holders and if the parties of the transfer adhere to the requirement of notarization of the share purchase (and transfer) agreement. This obviously does not align with the interest of most shareholders in a GmbH, especially of founders and investors of a start-up after the company has received venture financing. In fact, they have a legitimate interest in having a say in the decision of any change of shareholders, as all shareholders have inalienable statutory rights, such as the right to information and, even more importantly, voting rights enabling them to exert influence on the start-up (except in the rare cases where the start-up has also issued non-voting shares). For this reason, the articles of association and shareholders' agreements of basically all Target Companies in Germany provide for restrictions regarding the transferability of shares (in German: *Vinkulierung*). These provisions usually make any share transfer subject to the consent of the shareholders' meeting (with either a simple majority or – more often – some form of qualified majority).

However, the shareholders are often not free to decide on a share transfer approval request in their sole discretion. Rather, the shareholders' agreement will usually stipulate certain conditions under which the parties shall be obliged to vote their shares in favor of a transfer. Such cases generally include a group of permitted transfers (e.g., transfers to an affiliated company or in case of institutional VCs to other funds of the same fund family) as well as cases where the transferring shareholder has complied with the rules stipulated in the agreement regarding the right of first refusal or right of first offer, the drag-along and the tag-along right or similar provisions.

Right of First Refusal vs. Right of First Offer: Under a right of first refusal (*Vorerwerbsrecht*), if a shareholder receives an offer from a third-party and wishes to sell their shares, they must first offer the shares to the other shareholders who have the benefit of the right of first refusal, on the same terms and conditions.

An alternative to a right of first refusal is a right of first offer (*Andienungspflicht*). In this case, the shareholder intending to sell their shares to a third-party must first offer them to their co-shareholders, without needing to have already secured a third-party offer. The selling shareholder may accept or reject, in their sole discretion, any offer made by their co-shareholders.

If the offers are rejected, the selling shareholder will be free within a certain period of time to sell and transfer the respective shares to any third party, provided that the terms agreed with the acquiring third party may not be more favorable to the acquiring party as those that were offered by any co-shareholder in their first offer; most notably, the acquiring third party may not be offered a lower price for the shares than the price offered by the co-shareholders. With a right of first offer, the co-shareholders have the *de facto* option to set a floor for the share price but can ultimately not prevent a third-party from acquiring the shares.

In most German start-ups, the shareholders' agreement includes a right of first refusal rather than a mere right of first offer as the former is an effective way to prevent an unwanted third-party from becoming a co-shareholder. But it comes at a price. The requirement to go through a right of first refusal process may add several weeks to the sales process. This can negatively affect the third party's willingness to engage in a due diligence exercise and make an offer for the sale shares in the first place unless the interested party can be reasonably sure that the right of first refusal will not be exercised. In start-up land, rights of first refusals are more common as the shareholders usually give more weight to preventing an unwanted party from becoming a shareholder as this might diminish the exit prospects for all parties and instill some discipline amongst all shareholders to work towards a more or less coordinated joint exit.

Considering the chilling effect of a right of first refusal on a Buyer's appetite and to incentivize a coordinated exit, there is usually an exception from the right of first refusal when the Sellers want to sell a majority (usually a simple majority suffices, occasionally a higher threshold, e.g., 75 % is agreed) of the Target Company's share capital. Alternatively, the interested party may request a cost compensation undertaking before commencing due diligence and engaging outside advisors.

Tag-Along Rights: A tag-along right (sometimes also referred to as a "co-sale right")³ refers to a mechanism that ensures that if one shareholder or a group of shareholders has an opportunity to sell shares to a third party, the other shareholders are also given that opportunity on a *pro rata* basis. The other shareholders can join the deal on the same terms and conditions that apply to the selling shareholder(s). Sometimes tag-along rights apply only if other shareholders sell a majority of the company's nominal capital, particularly in cases where the selling shareholder(s) are only entitled to a drag-along right if they sell a majority of the nominal capital of the company.

The rationale behind this is that the tag-along is the flipside of the drag-along and is intended to protect the minority shareholders from being left behind if the majority shareholder(s) do not exercise the drag-along right. In many cases, the tag-along right does allow for not only a *pro rata* co-sale but a sale of all shares held by the tagging shareholder if the selling shareholders intend to sell shares that amount to more than half of the company's share capital (full tag-along right in case of a change of control) or if shares are about to be sold to a competitor.

Drag-Along Rights: Buyers will often want to acquire 100 % in a Target Company to have more flexibility and freedom to run the company as they see fit without having to pay attention to minority shareholders with certain unalienable minority protection rights. Keep in mind that German law does not provide for a squeeze-out option for a GmbH (for a German stock corporation (*Aktiengesellschaft*), squeeze-out options exist). So, the question arises: What can the Sellers do if not all minority shareholders want to sell their shares, especially when they stand to gain little to nothing from the exit proceeds once the holders of preferred shares' liquidation preferences have been satisfied? Enter the drag-along right.

A drag-along (sometimes called "bring-along") is a contractual arrangement that gives one or more shareholders who

- hold either alone or together a certain percentage of the entire share capital of the company (usually more than 50 %) and in many start-ups the majority of the preferred shares and, as the case may be, the majority of the common shares, and
- wish to sell their shares or a portion thereof (but in total more than 50 % of the entire share capital) to a third-party,

the right to request all other shareholders to sell a *pro rata* portion of their shares to such third-party.

Drag-along rights come in a variety of forms and have different prerequisites, so the Sellers need to analyze them in the beginning of the exit process to understand their options. Below is a summary of what we would consider some customary elements of drag-along provisions.

3. Bear with us, but a co-sale right and a tag-along right are not the same (though in practice these terms are often used synonymously). A co-sale right is a right to sell a *pro rata* portion of one's own shares if a co-shareholder sells its shares, while a tag-along right usually allows a shareholder to sell all of its shares in case of a change-of-control transaction.

Under a simple drag-along provision, the dragged shareholders are obliged to accept the same terms and conditions (both legal and economic) that the dragging shareholder is willing to accept. However, as a matter of precaution, the shareholders might also contemplate certain conditions for the drag-along right when negotiating the shareholders' agreement, including the following:

- Dragged investors may mention that they were not involved in the day-to-day operations of the company. As a result, they may say they should be obliged only to give certain fundamental representations and warranties (title to share, no third-party rights and capacity to enter into the acquisition agreement) or make operational representations and warranties only to their positive knowledge or request that their liability is limited to a certain portion of the purchase price paid into an escrow account.

In this case, the shareholders willing to support the deal would have to shoulder the burden of operational and financial representations. Here, taking out a warranties and indemnities (W&I) insurance can help (see also Chapter A.VI.3.8.).

- Investors will usually insist that they cannot be requested to accept a non-compete and non-solicitation undertaking. Founders should consider whether and under what circumstances they shall be required to accept such restrictive covenants.
- Often, the drag-along right will require the underlying exit to provide for a consideration to be paid in cash or publicly traded securities. This restriction can come back to haunt the Sellers in certain scenarios. That is particularly true in cases of distressed M&A where the Buyer wants to preserve liquidity and pay for the acquisition by their own (non-listed) shares (see also Chapter A.V.4.). It is thus advisable to build some flexibility into the shareholders' agreement and give the drag-majority a right to waive the "cash only" requirement under certain circumstances.
- Drag-along rights are one of the topics where the interests of investors may differ. Investors in financing rounds will usually invest at different price points, *i.e.*, valuations of the start-up. Hence, even if their classes of preferred shares would otherwise have a *pari passu* liquidation preference, their views on an exit might differ. For early-stage investors (they will often still hold a substantial portion of preferred shares) a certain exit opportunity might look appealing. Later-stage investors typically have more time for an exit and prefer to wait until the Target Company's valuation has bumped up, ensuring they make a certain minimum return (for many 3x is kind of an unspoken threshold, though in later-stage financings we also see smaller thresholds of 1.5x-2x).

Thus, especially after a significant uptick of the company's valuation from the last financing round, new investors in the current financing round will often request a veto on being dragged into an exit for a certain period (e.g., 12 to 18 months) unless the exit occurs at a valuation that is a certain multiple of the current financing round's valuation.

In general, the Sellers should use their best efforts to come to a mutually acceptable agreement with all shareholders as exercising a drag-along right is a very second-best option for several reasons.

- First, it sends a signal that cooperation is either not wanted or considered achievable. This can damage relationships and lead to a hostile environment, which may not be conducive to a smooth sale.
- Enforceability: While drag-along provisions are designed to compel minority shareholders to sell their shares if a majority agrees to a sale, enforcing these provisions can be legally complex.

Minority shareholders may challenge the enforceability of the drag-along provision in court, leading to potential delays and legal costs. Courts will scrutinize whether the provision was exercised fairly and in accordance with the shareholders' agreement and applicable laws.

- But even if the dragged shareholders do not challenge the enforcement of the drag-along right, just being passive might be enough to put the transaction at risk. The drag-along rights will usually not be "self-executing." This means they will establish a contractual obligation for the dragged shareholders to participate in the exit. However, the dragged shareholders will still need to take action, such as granting the lead Seller(s) a power-of-attorney to enter into the share sale and transfer agreement, as well as ancillary agreements, on their behalf. If a dragged shareholder does not comply with their obligation, the dragging shareholders can sue them but given the short timeframes of most exits that is not a viable option. Against this backdrop, some drag-along provisions also include a contractual penalty provision under which a defaulting dragged shareholder would owe a contractual penalty (for example its *pro rata* share of the proceeds disregarding any liquidation preferences and floored at a certain fixed penalty amount) to provide strong financial incentives to observe the drag-along obligations. However, in our experience such contractual penalty guardrails for a drag-along provision are rare.

2.1.2 The Beauty (of a Deal) Lies in the Eye of the (Common or Preferred) Beholder

Different classes of preferred shareholders may have varying interests and priorities based on their investment terms (in particular the "purchase price" they paid for their preferred shares), liquidation preferences and expected returns.

Most investors who came on the cap table during the investment bull markets of 2020-2022 saw their hold period in a particular company as three to five years, but that has changed. More often than not, there will be tension in the cap table with early-stage investors who have been holding for a very long period of time while later investors might still hope that their portfolio companies might grow into the projected valuation or at least recoup some of the valuation it lost compared to the peaks of the recent past.

The order and amount of liquidation preferences can significantly impact the distribution of proceeds from the sale. Senior-ranking preferred shares will be paid out before junior-ranking preferred shares and common shares.

Apart from these economic considerations, some holders of preferred shares might merit special attention during an M&A process for other reasons. Here are just some examples:

- **Investors Without a Personal Profit Motive of the Decision Maker:** Business angels and institutional venture capital investors are usually quick in making decisions and their decision criteria are usually also very straightforward (did we mention carried interest...).

But what about, for example, a university transfer office that has granted the target company a license to its IP and received some shares in the start-up⁴? Here, the relevant decision-maker will personally stand to gain little economically when it comes to an exit but there might be reputational considerations and the fear of subsequent scrutiny. Couple that with a general reluctance to take any risk and limited in-house capacities when it comes to M&A deals, and you can see that it is probably not a good idea to send this special kind of shareholder a few-hundred-page transaction document with a request to issue and release a power-of-attorney in three days or less.

- **Corporate Investors:** Corporate investors can also show the characteristics of slow internal decision-making process involving multiple in-house functions staffed with decision-makers whose incentives are not tailored toward embracing risk in hope for personal financial benefits. In addition, the corporate investor may have motives other than purely financial ones, especially when the Target Company is about to be sold to another strategic investor that might compete with that strategic investor or when the strategic investor might fear losing access to the start-up's technology as a customer.

2.2 Key Executives

In addition to the parties on the cap table, the Target Company's workforce and particularly its key employees (other than the founders) will require attention and stakeholder management.

Maintaining Confidentiality: Since the Sellers will usually prefer the transaction to remain confidential, it is essential to limit the number of people who are aware of the sale process. It is often helpful to assemble a small transaction team that can prepare the data room, make management presentations and run the Q&A process. The team members need to be explicitly instructed to maintain confidentiality and adhere to a centralized communication strategy.

A Committed Team Drives Value: When you talk to experienced M&A advisors, they will often confirm that the 80/20 rule applies equally to the workforce of a technology company. About a fifth to a quarter of employees are responsible for most of the value created. It is also a feature (some might call it a bug) of many start-ups that responsibilities and relevant know-how are concentrated in a few individuals. Any Buyer will seek to identify these key employees as part of their due diligence exercise. The Sellers can anticipate and prepare for questions such as:

- Who are the top producers? Who shoulders most of the workload?
- Who designed and is responsible for the top-selling products and services?
- Which three to five employees should never work for the Target Company's competitors?
- If you could only retain a quarter of your workforce, who would you keep and why?

4. We have dedicated an entire edition of the OLNS to university IP spin-outs, how to set them up and how to obtain relevant IP from the university, see OLNS#10 - University Entrepreneurship and Spin-offs in Germany, the Guide can be downloaded here: <https://media.orrick.com/Media%20Library/public/files/insights/2022/olns10-print-english.pdf>.

Anticipate and Manage Emotions: Any sales process has the potential to disrupt daily operations and cause anxiety and speculations amongst employees:

- Employees might speculate about the motives for the sale and what impact it will have on them. They might question "Buyer fit." Financial Buyers are known to focus on the financial performance and growth potential. They also might offer a greater chance for the Target Company to maintain its independence. A strategic Buyer, on the other hand, might offer synergies while seeking to integrate the Target Company, which might make some employees redundant.
- Early employees are often emotionally attached to the Target Company and its mission or to the founders who hired them. For them, the question will then often be, "Are the Buyer's and Target Company's cultures compatible?"

Managing the workforce and key employees during an M&A process requires careful planning, clear communication and strategic alignment of interests. The Sellers should consider the timing of disclosures, retention plans, and the fit between the potential Buyer and the Target Company's culture. The Sellers should prepare a clear and consistent message to communicate to the employees, highlighting the reasons for the sale, the potential benefits, and how it aligns with the Target Company's strategic goals and what might be in for the employees. In this context, the Sellers should develop a retention plan for key employees to ensure they remain motivated and committed during the transition period and beyond. At some point, the potential Buyer will need to be brought into this as, for example, the expectations and needs of a strategic acquirer might differ substantially from that of a Buyer with predominantly financial motivations such as a private equity fund.

2.3 Other Constituents

When selling a Target Company in an M&A process, effective stakeholder management might extend beyond just the Target Company's shareholders and employees. Other key constituents that may require attention and management include:

Customers and Suppliers: In some cases, the Target Company's customer or supplier side might be heavily concentrated. The Target Company might depend on suppliers for which no alternative sourcing options are available. On the customer side, a few players may be responsible for the lion's share of the revenue. Those players also may have status as a customer that lends credibility to the Target Company's nascent products and services. Their perception of the acquisition can impact their loyalty and future business with the Target Company. Also important: Transactions where the Target Company's customers might be concerned about the continuity of service if a strategic Buyer acquires the Target Company's business. Again, such concerns need to be identified, assessed and addressed if needed.

Lenders: In addition to the Target Company's shareholders, other (non-equity) investors may have a stake in the Target Company, notably lenders. In start-ups, classic bank loans are rare, but the company might have taken out a venture debt loan. The lender might at least have a right to be informed about the upcoming exit. Often, the venture debt provider will also have warrants or some other form of equity kicker or an exit fee that will need to be considered.

Media and Public Relations: The media can shape public perception of the acquisition. Effective PR management can help maintain a positive image and manage any potential negative fallout.

3. DATA ROOM AND VENDOR DUE DILIGENCE MATERIALS

As soon as an exit opportunity becomes realistic, the Target Company should begin compiling a data room of financial, technical, commercial and legal information for potential Buyers. We recommend appointing a project team familiar with the company business' intricacies. This allows other staff to continue their roles without distraction during the sale process. If the Target Company is to be sold in a structured auction process (more on that later), the data room will also be the basis for the preparation of vendor due diligence materials to help get potential Buyers up to speed. Finally, sell-side advisors should carry out a 'health check' to spot gaps in the data room, identify legal issues and shore up weaknesses as needed.

As we will see in Chapter A.IV.3., the Sellers should expect every aspect of the Target Company and its business to be subject to detailed diligence. They should use preparation time to identify gaps and weaknesses as early as possible. Intellectual property is one of the critical areas that get examined during diligence, especially in innovative businesses. Uncertainty around IP ownership or deficiencies in protecting IP rights can delay or derail a transaction or result in a lower valuation. It is advisable to undertake a timely review to identify areas of concern. Given the importance of IP in technology M&A deals, we have dedicated an entire Chapter to these aspects (see Chapter A.VII.).

3.1 Seven Tips to Prepare the Data Room

When selling a Target Company, one of the most important steps during the preparation phase is to create a well-organized and comprehensive data room. A data room is a secure online repository where key documents and information about the Target Company can be stored and shared with potential Buyers and other parties in the transaction. A comprehensive and well-structured data room can significantly streamline due diligence, minimizing advisor fees and ensuring a Buyer has the information needed to make an informed decision.

Here are seven steps the Sellers should take to set up and maintain a data room for a potential acquisition:

#1 Set up a Data Room Early: The M&A process takes time, so we recommend establishing the data room early. This allows the Sellers to identify and rectify issues before a potential Buyer carries out due diligence. If the start-up has prepared a data room for a financing round, it keeps the information there updated.

#2 Follow Guidelines on What Information to Include – And How to Structure It: The Sellers should observe the following guidelines:

- Organize the contents of a data room in a logical and user-friendly manner.
- Adopt consistent and descriptive file naming and numbering convention.
- Label and number folders and subfolders so documents or groups of documents can be easily cross referenced later.

Due diligence questions from a potential Buyer (or their advisors) are typically far more extensive in an M&A deal than during equity financing rounds (we will come back to this in Chapter A.IV.3.). In case of a one-on-one exit negotiation, where a prospective Buyer provides a list of questions, consider structuring your files and folders to follow the structure of these questions (if time permits).

Typically, documents are grouped into categories such as:

- **Commercial:** Business and strategy plans, sales and marketing materials, customer information, supplier and customer agreements, product information and operational data.
- **Technical:** Product specifications, software details and documentation, source code development records, IT infrastructure and cybersecurity details.
- **Financial:** Statutory accounts, audited financial statements, management accounts, budget and financial projections and debt or credit agreements.
- **Tax:** Returns and filings, assessments and audits, correspondence with tax authorities, tax credits and incentives documents and correspondence.
- **Insurance:** Policies, details of claims and correspondence with insurers.
- **HR:** Employee and contractor information, payroll records and benefit plans.
- **Legal:** Constitutional documents, shareholders' agreements, statutory books and records, capitalisation tables, structure charts, material contracts, intellectual property documentation, details of disputes, employment agreements, real estate documents, environmental assessments (as the case may be) and data privacy and cyber matters.

#3 Protect the Data: In M&A transactions, potential Buyers will often ask for information containing personal data, which is broadly defined as any information relating to an identifiable individual. This can include HR information about employees, as well as shareholder data in cap tables and registers, information relating to customers and suppliers and even signatory and witness information on historic contracts. As the German supervisory authorities recently stressed again, sharing personal data in an M&A transaction is nothing one should take lightly. The sharing is subject to the General Data Protection Regulation ("**GDPR**") and requires taking protective measures to inform the parties involved and, potentially also, to obtain consent. This can lead to challenges for the M&A process, as transparency may conflict with confidentiality interests of the parties involved in the transaction, and the implementation of protective measures can entail practical challenges. Taking data protection considerations into account at an early stage of the M&A process can significantly reduce the required effort and potential for sanctions. Find further details and tips for minimizing GDPR compliance risks at the end of this Chapter.

#4 Strive for Accuracy: The Buyer and their advisors will scrutinize information in the data room, so it is important to ensure all documents are accurate, up-to-date and complete. Inaccurate or missing information can delay and potentially jeopardize a deal. The Sellers and the Target Company should adhere to the following:

- Review corporate and financial documents for accuracy and consistency.
- Update outdated information.
- Ensure that all contracts and agreements provided are fully executed, dated, up-to-date and not expired.
- "Flatten" any PDF documents that have been signed electronically. This will ensure that metadata stripping software does not remove signatures.

#5 Consider Creating a "Clean Room" for Potential Buyers in the Same Industry: For a potential Buyer, particularly a strategic Buyer, that already participates in the Target Company's sector, the Sellers may want to consider establishing a "clean room" – a folder or folders containing competitively and / or commercially sensitive information accessible only to a limited group of individuals on the buy-side (often referred to as the 'clean team') subject to a special clean team arrangement (for details, please see Chapter A.IV.3.2.).

#6 Maintain Confidentiality and Security: Confidentiality is paramount in any M&A process.

The Sellers should use a professionally hosted secure data room that offers robust security features such as encryption, two-factor authentication, activity tracking and access controls. Such solutions offer a better and more secure user experience than free multi-purpose solutions such as *Google Drive*. A professional virtual data room typically will:

- have a built-in indexing function – particularly helpful for tracking documents added to the data room later;
- offer an integrated Q&A function allowing parties to set question limits and direct questions to specific team members; and
- leverage artificial intelligence tools. It's imperative that the relevant transaction team is trained to use these tools (these tools can for example help with the redaction of personal information).

#7 Prepare for Follow-up Questions: A potential Buyer with access to the data room will likely have follow-up questions or request additional information (this is usually referred to as the "Q&A process").

Using a professionally hosted data room platform may allow for these follow up questions to be integrated into the Q&A function. Designating a point person or team to handle the Q&A from the Buyer will ensure a smooth process. The point person is responsible for delegating the incoming questions to the relevant persons within the Target Company's organization. The point person may help draft responses, loop in outside counsel, ensure a high-level of quality of the answers and track that questions get answered in a timely manner.

In more complex processes, it is also advisable to train the Q&A team at the outset and provide them with written guidelines on how to answer Q&As and deal with questions and problems that might come up in the process.

The Sellers should regard a data room as dynamic until it is closed, usually a day or so before the signing of any definitive documents.

GDPR AND THE M&A PROCESS

As promised, here are a few tips for minimizing GDPR compliance risks:

- Involve M&A-experienced data protection experts early in the planning of the process.
- Enter into a data sharing agreement with a potential Buyer as well as the data room provider. Among other things, this agreement will:
 - Set out the parties' obligations regarding shared data.
 - Define shared data and the purposes for which it may be shared.
 - Outline security measures and protocols to safeguard data integrity.
 - Detail steps to follow in a security incident and any remedies.
- Where the data is being transferred internationally (especially outside the European Economic Area / UK), an agreement may need to contain standard contractual clauses prescribed by the GDPR.
- Keep in mind: A mere access is also considered a data transfer.
- Consider anonymization: Even with data sharing agreements, keep any sharing of personal data to a minimum. Where possible, avoid disclosing personal data in the virtual data room. The Sellers should remove any personal data that does not need to be shared before the other party gains access. Some data room providers / legal tech start-ups leverage artificial intelligence tools that automatically redact personal data, saving the time and expense of having to manually redact documents.
- As a rule of thumb and as recently highlighted by German supervisory authorities, employee data should generally not be shared before "signing." Employee information

should be anonymized, and this doesn't just mean taking out an employee's name and address. Most often, true anonymization can only be achieved by providing aggregated data, i.e. one builds group of employees and shares their data altogether. Particular care is required when considering whether to share special categories of personal data, such as information about an individual's race, ethnicity, political opinions, religious beliefs, trade union membership, genetic or biometric data, health data or sexual orientation. A Buyer will eventually require access to certain personal data relating to employees to prepare for the post-acquisition integration. However, a Target Company should only share particularly sensitive data if and when needed after relevant transaction documentation have been signed.

- If disclosure is necessary from a transaction perspective, ensure you have a legal basis to transfer the data. In limited cases (and for limited persons) this can be a weighing of legitimate interests. This may include, for example, personal data relating to the main contractual partners, managers or persons with key expertise for the business. Even if one has limited the sharing of personal data, often one needs to obtain consent from the individual whose data shall be shared. This consent must be given on an informed and voluntary basis and for the individual case. Finally, the data room should have sufficient security measures: Access to the electronic data room should – nothing new in this respect – be strictly regulated and on a "need to know" basis and in stages according to the progress of the transaction. In addition, data should only be transmitted in encrypted form and the deletion of the relevant data after the end of the transaction should be contractually secured.
- What should have become clear by now: Don't just open a share drive and let everyone have access to personal data. Such an obvious violation of privacy law can lead to significant fines and potentially damage claims from the individuals concerned.



3.2 Vendor Due Diligence Materials

3.2.1 Overview

In particular in structured auction processes where the sell-side has sufficient time to prepare the exit, they will often prepare a variety of vendor due diligence ("VDD") materials. The goal is twofold:

- In a first step to provide potential bidders an overview of the Target Company (usually focused on key financials and growth potentials) to get them interested in the Target Company and engaged in the process and submit an initial bid. The main document shared at this stage is often the so-called information memorandum (see below) which might be accompanied by additional financial information.
- In a second step (after interested bidders have confirmed their interest to participate in the auction), the sell-side will often provide additional VDD materials regarding financial health, operations, legal standing and other critical aspects. That can streamline the sale, create a level-playing field amongst bidders and build bidder confidence. It also may increase the sale price by reducing uncertainties and accelerating due diligence, leading to faster decision-making and potentially quicker deal closure.

3.3.2 The Information Memorandum

The Information Memorandum ("IM") is a critical document in a structured auction process to sell a Target Company. It serves as a comprehensive overview of the Target Company and can help potential Buyers understand the business, evaluate its potential and decide whether to proceed with further due diligence and submit a bid. The IM lays the groundwork for due diligence by providing a detailed overview of the company's operations, financials, market position and other key aspects. It helps the Buyers identify areas that require deeper investigation.

The IM provides potential Buyers with information to make an initial assessment of the Target Company's value and strategic fit. It helps them decide whether to invest time and resources into a more detailed evaluation. Against this background, the IM is designed to present the Target Company in the best possible light, highlighting its strengths, growth opportunities and competitive advantages. It aims to attract interest from potential Buyers and generate competitive pressure.

While IMs are always tailored to the specific case at hand, they will often contain the following:

- **Executive Summary**, *i.e.*, a brief overview of the Target Company, including its mission, vision and key highlights.
- **Overview of the Target Company**, this section contains detailed information about the company's background, ownership structure and corporate governance. It may also include information about the management team and key personnel.
- **Products and Services**, *i.e.*, a brief description of the Target Company's products or services, including key features, benefits and competitive advantages as well as IP protection. This section may also cover the product development pipeline and future offerings.
- **Market and Industry**, *i.e.*, an analysis of the Target Company's market, including size, growth trends and competitive landscape. It may also include information about key customers, market share and industry dynamics.
- **Financial Information**, this section often contains historic financial data and summaries on projected numbers, forecasts and cash flows. It also may discuss key drivers and financial KPIs as well as information on revenue streams and (as the case may be...) profitability.
- **Operational Overview**, this section is less relevant for software companies, but for Target Companies in other industries, it will contain information about the company's operations, including production processes, supply chain and logistics. This section may also cover facilities, equipment and technology infrastructure.
- **Sales and Marketing**, *i.e.*, an overview of the company's sales and marketing strategies, including distribution channels, pricing and promotional activities. This section may also include information about key customer relationships and sales performance.
- **Human Resources**, *i.e.*, information about the company's workforce, including employee numbers, key roles and organizational structure. This section may also cover HR policies, compensation and benefits as well as an overview of the Target Company's employee participation program.
- **Strategic Opportunities**, finally, there is usually a discussion of potential growth opportunities, strategic initiatives and future plans. This section aims to highlight the Target Company's potential for value-creation and attract interest from strategic Buyers.

3.2.3 Other VDD Materials

Types of other VDD materials and their main contents include the following:

Financial VDD Report: Among other things, this report usually contains:

- details about the historical financial statements (income statement, balance sheet, cash flow statement);
- detailed discussion about the financial projections and forecasts;
- analysis of revenue streams and profitability;
- working capital analysis;
- as the case may be, debt and financing arrangements; as well as
- key financial ratios and metrics (tailored to the usances of the Target Company's industry).

Commercial VDD Report: This report usually contains:

- market analysis and competitive landscape;
- customer base and key customer relationships;
- sales and go-to-market strategies;
- product or service offerings and pipeline;
- SWOT analysis or discussion of differentiators; and
- growth opportunities and strategic initiatives.

Tax VDD Report: A separate Tax VDD Report is relatively rare in auction processes where a start-up is sold (relevant tax information might then be included in the Financial VDD Report). If there is a separate Tax VDD Report, it usually contains:

- tax compliance history and filings;
- tax liabilities and contingencies;
- tax planning strategies and structures;
- transfer pricing arrangements; as well as
- analysis of tax risks and opportunities.

Legal VDD Report and Legal Fact Book: This report usually will focus on:

- corporate structure and governance documents;
- material contracts and agreements (customer contracts, supplier agreements, leases);
- IP matters (patents, trademarks, copyrights and material in- and outbound licenses as well where relevant a discussion of AI legal topics);
- litigation (legacy and current ones) and overall compliance system;
- regulatory compliance and licenses;
- employment matters (contracts, key employees, employment participation program etc.); and
- privacy and cyber matters.

The law firm preparing the VDD material will often also be the firm negotiating the acquisition agreements. That firm will often prefer to prepare a Legal Fact Book rather than a Legal VDD Report. The Legal Fact Book will be limited to factual information in a structured way that will facilitate the buy-side legal advisors' due diligence. It will refrain from providing its own assessment, expressing an opinion on legal matters or making recommendations in this respect. For example, if the Target Company is involved in a legal dispute, a Legal Fact Book will limit itself to summarizing the state of the dispute and maybe the main arguments but will not comment on the merits of the case. In many sectors, Legal Fact Books have replaced fully-fledged Legal VDD Reports. When negotiating transaction documents, the law firm will need to argue that there is no need to give Buyers extended representations or indemnifications for certain matters. It might undermine their position if the Buyer can then point to a Legal VDD Report where the sell-side law firm provided a legal assessment of a certain situation and concluded that there is a legal risk. By "only" providing a Legal Fact Book, the Sellers can retain some negotiation leverage. Detailed Legal VDD Reports might also create an overly pessimistic picture (remember, these are lawyers preparing the documents ...) upfront, giving potential Buyers grounds to negotiate the price down or seek comprehensive contractual protection.

IV. The Exit Process

In the context of selling a Target Company, the Sellers may choose between two general approaches when it comes to the overall process: a one-on-one transaction and an auction process (that is of course, if the circumstances permit an auction process, *i.e.* usually not if the Target Company is in troubled waters). Each method has its own characteristics, advantages and disadvantages.

1. THE ONE-ON-ONE TRANSACTION

1.1 General Observations

A one-on-one transaction involves negotiating directly with a single potential Buyer. This Buyer is often a strategic acquirer, such as a company in the same industry looking to expand its capabilities, market share or product offerings through the acquisition.

This method is suitable for situations, where

- confidentiality and speed are paramount;
- there is a "natural" Buyer, *i.e.*, a scenario where there is a strong strategic fit with the potential Buyer; and
- the Target Company is not suitable for an auction process. This can be because the expected transaction value does not justify the costs and complexity of an auction process. It also can be because the Target Company is in a distressed situation and the Buyer is more interested in acquiring talent than in paying a substantive amount to acquire an ongoing business.

In some instances, the direct negotiations also allow for stronger relationship building between the Buyer and key employees of the Target Company and those founders who are supposed to stay on board. This can facilitate smoother post-sale integration and cooperation.

Obviously, building and maintaining relationships in time will help with a successful exit through a one-on-one transaction. Especially for the founders, having a solid connection at a senior level can unblock impediments during the deal process and smooth the transition into the post-acquisition phase when pre-signing strategic discussions morph into your new employer's operational imperative.

"One of the most important things for founders to understand is that you are selling something to an executive, who has a problem. And as the start-up CEO — you are that solution. [...] Before a meeting at Salesforce, I spent time with one of my designers to design what our start-up (Rypple) would look like inside of the Salesforce UX. So when we went in for the meeting, it wasn't imaginary. I was able to say that we've thought the acquisition all through, this is what it would look like, let me take you through the steps of how this can be used for your customers and what value can be added."

Daniel Debow, co-founder of Rypple, which was acquired by Salesforce in 2011

1.2 The Letter of Intent

Letters of intent, term sheets, memoranda of understanding, and the like are common in the M&A landscape. Before investing heavily in due diligence and negotiating detailed transaction documents, the Buyer and Sellers typically employ these preliminary, largely non-binding documents to memorialize their mutual understanding of all or some of the material deal terms. These documents are more common in one-on-one exit negotiations. In structured auction processes, the bid letters and mark-ups of the template share purchase agreement that is provided to all bidders in the virtual data room will substitute for them.

Signing a letter of intent signals that both parties are serious about the transaction and are willing to invest time and resources to move forward. Although these letters are generally labelled 'non-binding', it is difficult to revisit terms once you have agreed to them with your prospective Buyer.

In addition, even generally non-binding letters of intent usually have a few binding clauses, including an exclusivity period of often 30-60 days, occasionally up to 90 days. Since a grant of exclusivity by the Sellers shifts negotiating leverage considerably in favor of the Buyer, the Sellers will desire to nail down as many major deal terms as possible at this stage. Customary key elements of a letter of intent include:

SCOPE OF THE ACQUISITION

- how much of the Target Company is acquired; and
- do some Sellers (e.g. active founders) must reinvest or roll over some of their shares;

COMMERICAL CORNERSTONES

- (enterprise) valuation of the Target Company and sometimes main elements of the equity bridge;
- purchase price method (locked box or closing accounts);
- whether the deal includes an earn-out or a vendor note;
- details on how the purchase price will be paid, *i.e.* in cash or Buyer's equity or a combination of both; and
- information whether there will be an escrow payment;

RISK ALLOCATION

- who shall give what kind of representations and warranties and what shall be the key terms on the remedy side (de-minimis, basket, caps, limitation period); and
- shall the Buyer take out W&I insurance;

OTHER

- roadmap to signing (including due diligence, who will prepare initial drafts of the transaction documentation and when the parties intend to conclude their negotiations);
- confidentiality; and
- exclusivity and, as the case may be, break-up fee or reimbursement of a party's costs for outside advisors if the other party walks away from the deal before signing.

2. STRUCTURED PROCESSES

The term "structured processes" in a start-up exit refers to well-organized and multi-step approaches designed to maximize the value and success of the transaction. These processes involve clear stages, timelines and strategies to ensure the exit is conducted efficiently and effectively. The most common method is the auction process. It is designed for maximizing the sale price and ensuring that the Target Company is exposed to a broad market of potential Buyers, although it requires careful management to handle the complexity and maintain confidentiality. If a classical auction process is a marathon, the dual track is like an Ironman (that peculiar form of self-torture where after 3.86 km swimming and 180.2 km bicycle ride, one is supposed to finish the day with a marathon). In case of the dual track, the Sellers will seek to explore two exit routes in parallel, *i.e.* run an auction process while at the same time preparing for an IPO to preserve optionality and further maximize valuation.

2.1 Auction Process

An auction process involves inviting multiple potential Buyers to bid for the Target Company. This is designed to create competitive tension among bidders, potentially driving up the sale price and increasing deal certainty. Compared with a one-on-one transaction, the auction process is typically more structured, with defined stages and timelines. It also comes with increased complexities and costs.

Characteristic for an auction process is a staged process that usually involves the following phases:

Stage / Round One: In this phase, the Sellers will work with a professional M&A advisor or investment bank to engage in:

- **Market Scanning:** Identify a broad list of potential Buyers, including both strategic and financial Buyers.
- **Initial Interest Testing and Teaser:** Prepare a teaser document that provides a high-level overview of the Target Company without revealing its identity.
- **Compilation of Relevant Long List:** After potential bidders have confirmed interest and entered into a non-disclosure agreement, they receive the Information Memorandum.
- **Indications of Interest:** Potential Buyers who show initial interest in the Target Company are asked to submit initial bids, outlining their preliminary offer and terms.

Stage / Round Two: Once the first stage is completed and assuming sufficient interest in the Target Company, the typical process will continue as follows:

- **Due Diligence Phase:** Based on the Indications of Interest, a short list of potential Buyers is invited to do more in-depth due diligence and provided with further vendor due diligence materials (as the case may be). The shortlisted Buyers are invited to management presentations and site visits.

Some Sellers organize the auction process in three stages. The crucial difference is the additional structuring of a third stage and staggering of information sent to potential Buyers. The second round/stage only gives potential Buyers access to the vendor due diligence materials as the basis of an educated offer after the second round. Access to the data room, management presentation, expert meetings and site visits are reserved for a smaller group in the third round. The submission of an educated offer after the second round provides an additional gauge of interest and price level monitoring.

- **Share Purchase Agreement:** The data room usually provides for a template share purchase agreement the shortlisted Buyers are asked to use.

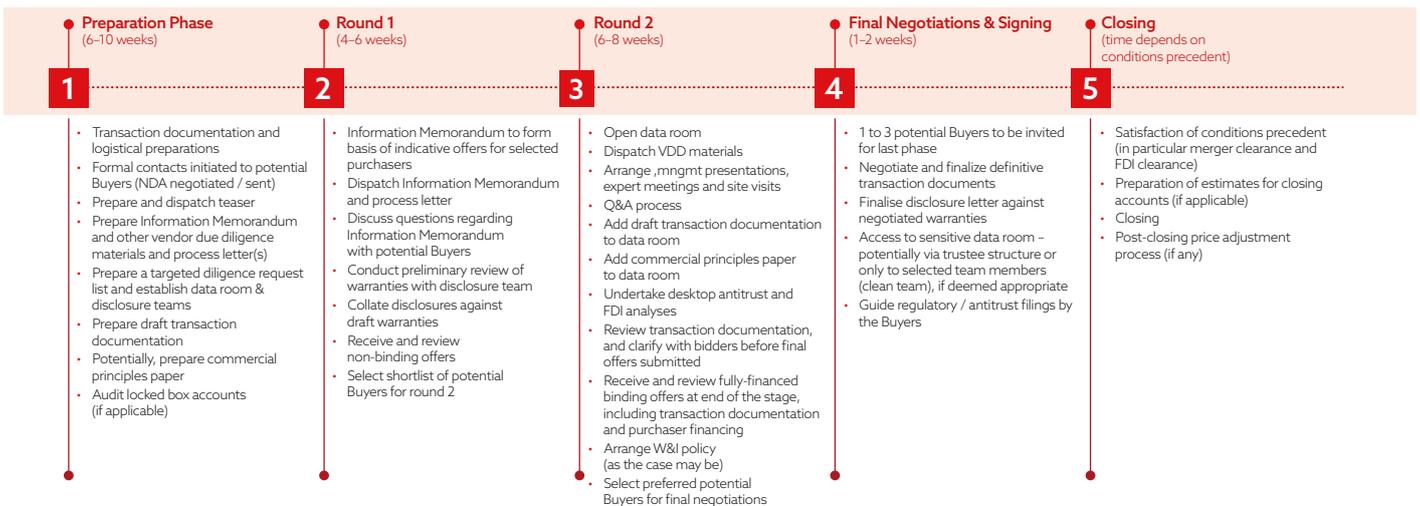
- **Final Bids:** The potential Buyers that remain interested after due diligence are asked to submit a final bid with a markup of the data room share purchase agreement they would be prepared to sign.

Signing

- **Negotiation and Selection:** The Sellers will identify one or very few frontrunners who are invited to a final negotiation. That phase will usually last a few days and end with the selection of a winning bidder and signing of decisive transaction documents.

The graphic below maps the auction process and provides an indicative timeline as well as some typical process steps:

Auction Process



Here is a look at the main pros and cons of the one-on-one transaction and the auction process.

Auction Process: Pros and Cons

	✓ Pros	✗ Cons
One-on-One Transaction	<ul style="list-style-type: none"> • Confidentiality: The process is typically more confidential, as fewer parties are involved. • Speed: It can be faster than an auction process because it involves fewer parties and less complexity. • Customization: The terms of the deal can be more easily customized to meet the specific needs and interests of the parties involved. 	<ul style="list-style-type: none"> • Potentially Lower Price: Without competitive pressure, the sale price might be lower than what could be achieved in an auction. • Limited Market Testing: The Sellers may miss out on potential Buyers who could offer better terms or a higher price. • Single Point of Failure: If negotiations with the single Buyer fall through, the Sellers may have to start the process over, leading to delays and potential loss of momentum.
Auction Process	<ul style="list-style-type: none"> • Market Testing: The Target Company is exposed to a broader market, increasing the chances of finding the best possible Buyer. • Competitive Bidding: Multiple potential buyers are invited to submit bids, creating a competitive environment. The competitive nature of the auction can drive up the sale price. 	<ul style="list-style-type: none"> • Complexity: The process is more complex and time-consuming, requiring careful management. • Confidentiality Risks: With more parties involved, there is a higher risk of leaks and loss of confidentiality. • Potential for Disruption: The longer and more public process can be disruptive to the Target Company's operations and employee morale.

2.2 Dual-track Process

You have our word, in one of the next issues of OLNS we will finally do a deep dive on the options for German start-ups to go public in the U.S. For this reason, we are largely ignoring the "exit via IPO" option in this Guide. However, as we are discussing structured exit processes herein, we will have to briefly discuss arguably the best (and one might add most stressful) way of all exit processes, the dual-track process. While we will use a U.S. listing as point of reference, the process outlined in this Chapter will be similar for listings in Germany and other places.⁵

2.2.1 What is a Dual-track Process?

The "dual-track process," broadly defined, means that a company planning on an exit has chosen to conduct an initial public offering ("IPO") while also pursuing a possible M&A exit. Traditionally favored by private equity firms with respect to their portfolio companies, the dual-track process has gained currency amongst fast-growing, venture-backed technology companies, especially as de-SPAC transactions guided more exits for a relatively brief period in 2020 and 2021. The M&A side of the dual-track process is most typically structured as a full-blown auction involving multiple strategic and financial bidders (rather than a direct one-on-one negotiation with a single bidder). However, there can be many variations within the dual-track framework, and companies should consider the process before kick-off.

If managed and executed successfully, a dual-track process can provide a company seeking an exit with the best prospects for completing such an exit, potentially achieving a higher valuation than if either alternative were pursued independently.

This is particularly the case in times of capital market volatility, as there is no guarantee a Target Company will come to the market at the right time.

While traditionally the M&A sale process has been seen as a backstop in case an IPO process is unsuccessful, that perception is fading as emerging growth companies stay private for longer, and an IPO may not necessarily deliver an increased valuation over the most recent private financing round. Moreover, as the dual processes are run in tandem, the Sellers and the Target Company retain the flexibility to opt for one path versus the other until late in the process.

However, a dual-track process is quite difficult for many leanly-staffed technology companies. It can tax the limited resources of the team tasked to run both processes while also keeping the company functioning.

2.2.2 Key Events in the Dual-track Process

As noted above, a dual-track process will vary to fit the needs of the Target Company. In some cases, for example, the private equity or venture capital investors in a Target Company may prefer the full exit promised by an M&A deal rather than the partial or gradual exit offered by an IPO and subsequent offerings that are likely to take place over a period of years. On the other hand, a company that believes it has significant long-term prospects may prefer an IPO, with the M&A path as a backstop in case the markets are not receptive, or some strategic acquirer is willing to pay a significant premium. And sometimes the investors and founders have different views about the preferred outcome. The dual-track process offers a way to better understand the company's prospects under either scenario.

5. This Chapter is based on a blog post from our capital market partners Bill Hughes, Jamie Evans, Albert Vanderlaan and Marsha Mogilevich that can be found here: <https://www.orrick.com/en/Insights/2018/06/Dual-Track-Process>.

If an M&A deal is preferred, the auction sale process may be the lead driver in the dual-track process, with the IPO taking a secondary role. In some cases, however, the Target Company may focus on the IPO path, forgo a formal auction sale, and instead focus on one or two motivated acquirers with whom previous discussions have been held to see if there is sufficient interest to make it worthwhile to abandon the IPO process. In short, there is no "one size fits all" formula that governs a dual-track exit process.

However, as a general rule, every dual-track process will begin with selecting M&A legal, financial and accounting advisors and the underwriting syndicate managing the IPO process. In conjunction with these advisors, the Target Company management will begin preparing for the IPO and M&A process by collecting, centralizing and categorizing a vast array of due diligence materials required by both processes. While the IPO and M&A processes run in tandem, generally the Target Company management, legal advisors and underwriters will begin working on the paperwork for the IPO process. For example, in case of a U.S. listing this includes producing a draft registration statement before the auction sale process starts owing to the significant lead time required to produce a document that can be filed with the Securities and Exchange Commission ("**SEC**").

Customarily, the auction sale process kicks off at the same time as the initial filing of the registration statement. With the JOBS Act allowing emerging growth companies to submit confidentially, the company must decide whether to issue a press release about the filing or just to contact potential Buyers. In either case, the IPO filing gives bidders a clear signal that the Target Company is ready and willing to pursue this strategic alternative, and hence, practically introducing a background "bidder" into the process. However, the Target Company may, for a variety of reasons, delay filing the registration statement until the auction sale process has begun and at least a preliminary assessment of the bidders' interest can be obtained. The calculus of when (or even whether) to make the filing is usually a function of the Target Company's assessment of which path is more promising.

Assuming the dual-track framework remains, the IPO process and M&A auction sale process are conducted in parallel, with each proceeding according to their customary individual-tracks. In an M&A auction sale, there are a number of due diligence and other meetings / presentations between management and other key personnel of the Target Company and bidders. If the auction sale is run as a two-stage process, a round of initial bids will narrow the scope of the field and be followed by final bids. After that, a final bidder will be selected to conduct exclusive negotiations with management and its advisors to reach a final definitive sale agreement.

At the final stage of the dual-track process, assuming both paths have been followed to their ultimate conclusion, the Sellers and the Target Company's management will be able to compare the relative valuations offered by an IPO versus an M&A exit. Equally important, at this point, a definitive agreement with the prospective acquirer should be close to final, and the Sellers' legal advisors will be able to assess closing certainty (*i.e.*, whether there are regulatory or other approvals to closing that may present an obstacle). It is unusual to run all the way to the end of the IPO process and then sell. Usually, a company will decide whether to sell prior to launching the road show. Once the road show has begun, the most usual path would be to complete the IPO (although a potential Buyer may launch a final bid during the road show).

2.2.3 Complexity, Management Bandwidth and Costs

From the onset, it is important to remember that a dual-track process will naturally be more complicated and time-consuming for the Target Company than a single exit strategy. One of the most critical decisions the Target Company must make early, prior to choosing the dual-track process, is a realistic assessment of whether its management will have sufficient bandwidth to devote its energies to preparing for an IPO and an M&A exit at the same time.

If the Target Company intends to undertake the IPO process as a legitimate avenue to exit, it will need to prepare and file the necessary paperwork (registration statements and / or IPO prospectus etc.) and engage with the competent regulator(s) on multiple rounds of comments. Similarly, an M&A auction process will involve engaging with multiple bidders and responding to due diligence questions, conducting a series of management presentations, evaluating auction bids and, once a final bidder (or bidders) has been selected, engaging in negotiations with respect to the definitive terms of the transaction. Inevitably, the same members of management will need to be involved in key decisions relating to both processes. The Sellers as well as the Target Company and its management will need to consider whether the management will be able to manage the demands of these dual processes while still devoting the necessary time and resources to the day-to-day operational needs of a late-stage emerging growth company.

Finally, a dual-track process will be more expensive, since there will be fees paid to lawyers, bankers, accountants and other advisors on two different streams of work.

2.2.4 Due Diligence / Synergies

Although a dual-track process is more time-consuming and complex than pursuing an IPO or M&A exit alone, significant synergies can be found in the due diligence process. In this regard, it is critical that the Target Company's management and advisors lay out a clear and systematic due diligence roadmap to ensure that the process is both efficient and coordinated between the two streams of work.

Generally speaking, there is a great deal of overlap in the due diligence materials that must be identified, consolidated and categorized by the Target Company for due diligence undertaken by the underwriters in an IPO process and potential Buyers in an M&A auction sale process.

2.2.5 Advantages / Disadvantages

In this Guide, we do not seek to discuss the respective merits (and drawbacks) of an IPO exit versus M&A exit for a Target Company's management and investors in depth. However, it suffices to say that venture capital and private equity investors, as well as management, will each have their preferred path as the dual-track process proceeds. In other words, the interests of each constituency may be different, and it is not unusual in a dual-track process for each group to attempt to drive the process one way or another.

For example, private equity or venture capital investors may favor a full exit in the absence of a very compelling valuation offered by an IPO, particularly as they are often required by applicable law or the underwriting syndicate (and the expectations of public investors) to relinquish their control rights post-IPO. Equally, management and founders may each favor an IPO versus a sale to a strategic acquirer since, in the latter case, there is a greater potential for changes to senior management and founders often wish to retain substantial equity in the company after the transaction. Ultimately, the decision-makers should be cognizant that the advantages and disadvantages of an IPO versus M&A sale will not be uniform across the various groups whose cooperation and / or approval will be necessary for the exit to take place.

The principal disadvantages of a dual-track process have already been discussed, although it is worth re-emphasizing that a dual-track strategy is a substantial undertaking for management. Resources and time will be spread thin, and there are risks that the operational side of the business will suffer from management's attention to the IPO and M&A sale processes. Moreover, in opting for a dual path and spreading resources accordingly, there is always a degree of risk that neither path will be pursued with the necessary determination to ensure a successful outcome.

The advantages of a dual-track process are intuitive and are particularly important to recognize in a time where investor appetite for IPOs may have ebbed. For one, the dual-track process presents the Sellers that are motivated to partially or fully exit with the best prospects of achieving this result. IPO windows open and close, and Target Companies can be caught amidst periods of market volatility or lack of investor demand through no fault of their own. Unfortunately, and whether rightly or wrongly, a failure in this process often leads to negative market sentiment about the Target Company's prospects. In this sense, an M&A process (whether a full auction sale or negotiations with a motivated front-runner Buyer) can be a valuable alternative for an emerging growth company seeking an exit.

While a dual-track process can be longer, it also affords the Sellers and the Target Company with the luxury of waiting until both processes have unfolded, and a comparative valuation emerges between IPO and M&A exits. The ability to delay a decision and to cross-reference valuations is an immensely valuable tool for exit proceeds maximization. Finally, an IPO process can, if orchestrated and messaged to bidders properly, increase the Sellers' leverage in an auction sale process and potentially motivate potential Buyers to expand the multiple they are willing to pay. Obviously, a key factor in whether this dynamic comes to fruition is whether the IPO alternative is realistic.

3. THE DUE DILIGENCE PHASE

3.1 General Considerations

M&A due diligence is significantly broader, deeper and more forensic than anything the Target Company encountered during financing rounds.

VC investors are playing the home-run game and seek to acquire a significant stake in a start-up with a lot of equity upside potential. VC investors usually pursue a lighter touch due diligence. While they will also perform financial and legal due diligence, their focus is more on understanding the financial health and growth trajectory rather than uncovering every possible risk. While VC investors also look at operations, their focus is on scalability and growth potential. They are interested in how the start-up can grow independently and in a capital efficient manner. Financially motivated, these investors are concerned with the capability and vision of the founder team to drive growth and the strength of their execution muscles. Keep in mind that most term sheets for financing rounds provide for an exclusivity period of 30 days. Now throw in the often lamentable low cost coverage that VC investors will get (No, we are not biased, why are you asking?) and you can imagine investors' limited appetite for in-depth due diligence.

Potential Buyers, however, play a very different game. Their investment thesis will usually differ significantly from that of a VC investor. Strategic Buyers in particular will aim to assess the business comprehensively through various lenses and also consider strategic synergies and post-acquisition matters.

"Due diligence is a lot like a colonoscopy. It's a necessary evil that can be uncomfortable, but it's better to find out early if there's something wrong."

Anonymous

A (strategic) Buyer aims to acquire the start-up to integrate it into their existing operations, enhance their product offerings or gain a competitive edge. They are looking at long-term synergies and strategic fit. Thus, they will conduct a deep dive into the start-up's operations, including technology, processes and integration potential with their own structures, processes and tech stack. (Strategic) Buyers will conduct exhaustive financial and legal due diligence to uncover potential liabilities, compliance issues or financial discrepancies that could affect the acquisition or the price. In addition, cultural fit and management team alignment often are important for strategic Buyers. They need to ensure the Target Company's culture and leadership can mesh well with their own to avoid post-acquisition conflicts.

To put it bluntly, while some VC investors may hope for the best or think some issues can be addressed along the way, the Buyer of a majority stake in a technology company will be significantly more risk averse and, for them, the reputational risks will be significantly higher. For the Sellers, this underscores the importance of well-organized documentation, a dedicated project team and uncovering and addressing potential issues in time.

3.2 Staged Access and Clean Team Arrangements

The Sellers will often stage the disclosure of due diligence materials. As we have seen above, in an auction process, disclosure is staged according to the respective round of the process (teaser stage, initial bidding phase, confirmatory and final bidding phase). Staged disclosure is also often applied in one-on-one transactions when certain information is only disclosed after the prospective Buyer has confirmed its interest and signed a term sheet or similar. In both cases, the tension between preserving confidentiality and supporting the Buyer's evaluation of the Target Company will tip towards the latter only with an increasing degree of deal certainty.

However, besides these transactional considerations, special attention must be paid when the Target Company and potential Buyer are competitors and the Buyer seeks access to commercially sensitive information. The need to observe antitrust rules might require special procedural steps and safeguards. This is the realm of the so-called clean team arrangements, which usually feature a clean room and a clean team agreement. The clean room is an area of the data room that is accessible only to a very limited group of people based on a separate (confidentiality) agreement (the clean team agreement). Let's have a closer look at both:

The Content of the Clean Room: Clean team arrangements are most used in deals that raise competition or antitrust questions. However, this structure may also be used to maintain the confidentiality of highly sensitive information, such as trade secrets or proprietary technology. Here is an incomplete list of matters that might qualify as clean team information warranting special protection (note that the identification depends on the specific case at hand and should be done with the assistance of a qualified advisor):

- recent, current or future legal or commercial trading terms with individual customers or suppliers;
- current costs and agreements with individual suppliers, as well as non-public details of joint purchasing or other cooperation agreements;
- recent, current or future pricing / pricing strategies for products and services or individual margin information per customer or product or product type, and product-specific input costs and supplies information;
- recent and current sales volumes, prices or margins per product type, individual customer or supplier;
- customer or supplier individual details including lists / names of customers and suppliers, sales by volume and product type broken down by customer or supplier;
- strategic, business or marketing plans, including information on current or planned plant and facility capacities as well as unannounced capital expansion or closure plans;
- forward looking budgets, projected revenues and gross sales information per customer or product type;
- recent, current or future planned production or sales amounts; and
- secret technology and proprietary technical know-how.

Who Can be a Member of the Clean Team: The clean team may include individuals from the Buyer's internal team as well as external service providers. The first group requires special attention.

The Buyer will want some of its employees on the clean team. The Buyer will claim they are best suited to evaluate the strategic value of the Target Company, assess synergies or identify post-merger integration challenges etc. However, the Buyer's in-house clean team should not include anyone who:

- is involved in the day-to-day commercial or strategic operations or decisions in relation to the parts of the Buyer's business that compete with the Target Company;
- oversees or determines the commercial strategy of such competing business; or
- is involved in other commercially sensitive areas of a business that competes with the Target Company.

It should be possible to include the head of corporate development or M&A, provided that person does not "also have an operational role similar to those mentioned above.

We have come across cases where a Buyer that did not have a separate M&A team struggled to find suitable clean team members in-house. Note that in case of a financial Buyer, members of the Buyer's organization who are on the board of another portfolio company of the Buyer might not be able to serve on a clean team if that portfolio company competes with the Target Company.

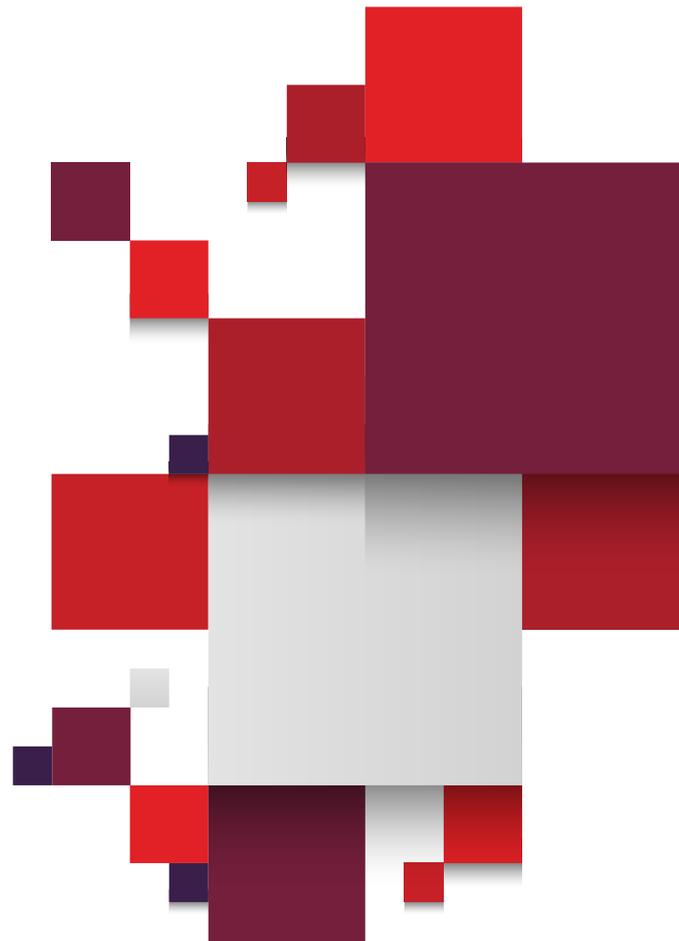
Generally, less problematic as clean team members are external service providers that, for example, analyze the technology and software architecture, the product development process as well as dependencies and scalability and who (may) only report on the results of their audit along the guardrails described below.

The Content of the Clean Team Agreement: A separate agreement will usually set out who the Buyer can appoint to the clean team as well as the basis on which the clean team can share information from the clean room with other Buyer representatives and what procedural steps need to be observed.

Note that the clean team agreement augments any general non-disclosure agreement the parties will likely have entered into with respect to the potential transaction at the beginning of the sales process. Here are some key elements of many clean team agreements:

- **Purpose:** Clear definition of the purpose for which the commercially sensitive information might be used, e.g., analyzing synergies and integration planning and conducting financial or technical due diligence with respect to the contemplated acquisition.

- **Clean Team Members:** List of the employees, officers and advisors of the Buyer that will be part of the clean team. The parties also should agree on a process detailing how the Buyer can add people to the clean team.
- **Clean Team Information:** The parties should define the relevant information to be shared under the clean team agreement (usually competitively sensitive information). For other sensitive information, the non-disclosure agreement the parties entered into at the beginning of the process will continue to apply. In addition, the Buyer typically will instruct its clean team members about the sensitive nature of the clean team information and procure acknowledgements by the clean team members of the restrictions set forth in the clean team agreement.
- **Disclosure Process:** The parties need to agree how to disclose information to clean team members. That could be through a physical data room or a limited-access folder in the virtual data room.
- **Clean Team Report:** The Buyer will be asked to ensure that clean team members only report conclusions drawn from clean team information to the Buyer's employees who are not members of the clean team in a sufficiently aggregated or anonymized and summarized form. The clean team agreement will stipulate a process how draft reports based on clean room information need to be reviewed and approved by the Sellers, or – the Buyer might insist on this – the Sellers' legal counsel who in turn will usually be prohibited from sharing the draft clean team report with the Sellers.



4. THE TWILIGHT PHASE AND CLOSING

In many instances, there will be a gap between the signing of the share purchase agreement for the sale of the Target Company and the actual consummation or closing.

Several factors can cause such a gap:

- **Regulatory Approvals and Clearances:** The transaction may require approval from competition authorities, such as the German Federal Cartel Office (*Bundeskartellamt*) or the European Commission. If the Buyer is a non-EU/EFTA entity, the transaction may require foreign direct investment (FDI) clearance from the German Federal Ministry for Economic Affairs and Climate Action (*Bundesministerium für Wirtschaft und Klimaschutz*) to ensure it does not threaten to national security or public order. We will discuss these and certain other clearance requirements in Chapter A.IX.
- **Financing Arrangements:** The Buyer may need time to finalize financing arrangements, whether through debt, equity or a combination of both. This can involve negotiations with lenders, investors or other financial institutions. The Sellers will usually insist that the Buyer complete such discussions and secure financing prior to signing the decisive agreements. A "financing CP" (In financing speech "CP" is short for "condition precedent") might give the Sellers a "walk away right" after signing, unless accompanied by appropriate contractual penalties or break fees.
- **Contractual Conditions and Covenants:** The share purchase agreement may include conditions that must be met before closing. Those conditions could include obtaining necessary consents from third parties (e.g. the waiver of a change-of-control termination right for particularly relevant commercial contracts of the Target Company). They also could include the completion of certain actions by the Sellers or the Target Company (e.g. the carve-out of the Target Company from Sellers such as major corporations).
- **Operational Transition:** Both parties may need time to prepare for the operational transition, including employee communications, customer notifications and integration planning.

For obvious reasons, the gap between signing and closing for the sale of a German start-up involves risks for the Sellers and the Buyer. To mitigate these risks, the parties should agree on specific rules and address key issues in the share purchase agreement, including:

- **Regulatory Approvals:** Please refer to Chapter A.V.3.2.
 - **Other Conditions Precedent:** Similar to obtaining regulatory approvals, the share purchase agreement should include provisions that outline the steps to be taken by the respective parties and timelines for doing so. It also should include the relevant standards for the efforts to be taken and what consequences the non-fulfilment of the respective condition precedent shall have (compensation payment, reduction of the purchase price or termination right).
 - **Restrictions on Actions:** A conduct of business covenant usually will prohibit the Sellers and the Target Company from taking certain actions without the Buyer's consent, such as incurring new debt, entering into significant contracts or making substantial changes to the workforce.
 - **Access to Information:** The Buyer will request access to the Target Company's books, records and operations to monitor performance and compliance with the aforesaid covenants.
 - **Representations and Warranties:** Will the Sellers be required to repeat (bring down) all or some of the representations and warranties given to the Buyer as of the date of actual closing? If so, what might this mean for the disclosure process? For answers, please see the explanations in Chapters A.VI.3.3 et seq.
 - **Material Adverse Change (MAC) Provisions:** Please refer to Chapter A.V.3.3.
 - **Long-stop Date:** There will usually be a right for a party that is not responsible for the non-fulfilment of relevant closing conditions or closing actions to terminate the share purchase agreement if closing has not occurred by a certain date after signing of the share purchase agreement (usually a couple of months). This is the so-called long-stop date.
-

V. Valuation Considerations and Price Mechanisms

1. OVERVIEW

The price and type of consideration payable in the acquisition of a Target Company will need to be addressed early. In one-on-one transactions, this is often a focus of the letter of intent, and this should go beyond agreeing on the "headline" price. A potential Buyer will often have concerns about its ability to properly value the Target Company in an environment marked by rapid technological developments, ever-changing markets and an unusual level of macroeconomic uncertainty. Valuations from comparable companies or comparable transactions, even those entered into very recently, are less helpful from a precedential perspective.

Drawn with a broad brush, the key issues are:

- Coming up with the "right" valuation of the Target Company.
- Shall the (initial) purchase price be fixed upon a certain point in time in the past? Or will it be recalculated and finalized as of the closing of the transaction? (This is usually referred to as the "locked box vs. closing accounts" question (see Chapter A.V.2. for details).)
- Shall a portion of the purchase price be structured as an earn-out and be subject to the occurrence (or non-occurrence) of certain events or fulfillment of certain target figures and KPIs (see Chapter A.V.3.)? What protections will the Buyer offer to the Sellers to enhance the likelihood of the earn-out being paid? What information and inspection rights will the Sellers have? Earn-outs are complex to negotiate and tend to be the source of frequent post-closing disputes and, sometimes, litigation. It is essential to draft these provisions with precision and agree on how to resolve disputes.
- Will the purchase price be paid in cash up-front or will a portion be paid in Buyer's shares? In the case of the latter, what will be the underlying valuation of

the Buyer? And what kind of preferred or common shares are issued? What rights will they have (see Chapter A.V.4.)?

- Will a vendor loan (also called a promissory note) be part of Buyer's consideration? If so, what are the interest and repayment terms? Will the vendor loan be secured or unsecured? And what are the events of default and acceleration (see Chapter A.V.5.)?
- There might be cases where the Target Company has raised convertible loans (often as exit bridge financings) that are still outstanding at the time of an exit. What shall happen to these convertible loans when the Target Company is sold? Are there any risks the lenders under the convertible loans (often these are the VC investors amongst the Sellers) should be aware of (see Chapter A.V.5.)?

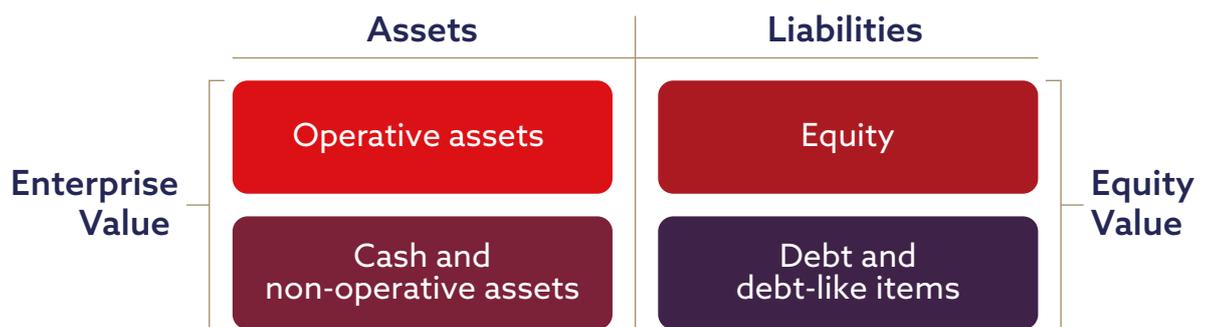
2. PURCHASE PRICE MECHANISMS

2.1 Introduction

We need to start this Chapter with a caveat: We are of course aware that in practice, the parties might engage in a more hands-on and freestyle negotiation of the numbers they want to plug into the acquisition agreement compared to the theoretical concepts we will present. However, we think it is helpful to understand the underlying concepts so one can better anticipate and address important negotiation and drafting topics.

Although agreeing on the valuation is a major milestone, the work is not yet done. What has been determined at this stage is usually "only" the company's enterprise value, in other words, the price the Buyer would pay if it acquired the company free of any debt and only with those assets that are strictly needed for conducting its business.

Enterprise Value



$$\text{Equity Value} = \text{Enterprise Value} + \text{Cash} - \text{Debt}$$

To find out what the company is worth to the Buyer, the enterprise value needs to be converted into what is called the equity value, *i.e.*, the price that the Buyer would be willing to pay when acquiring the entirety of the Target Company's assets while also having to assume all of its debts. The equity value is derived from the enterprise value by adding available cash and deducting existing debt (the so-called "enterprise value to equity value bridge" or simply the "equity bridge").

(Simplified) Equity Bridge

		Price Component	
Enterprise Value	Enterprise Value	X	<ul style="list-style-type: none"> • Purchase price base amount
+	General approach	X	<ul style="list-style-type: none"> • Calculation of present value of free cash flows based on full business case and historic financials, if available • Non-operating assets that can be commercialized in the future
	Start-up specifics	X	<ul style="list-style-type: none"> • Valuation drivers that are not based on free cash flow analysis (for examples see above)
Cash			
-	Adjustments	(x)	<ul style="list-style-type: none"> • Might "hard-wire" some adjustments into valuation • Examples: pension deficit, capital expenditure requirements or (unless settled otherwise) VSOP liabilities
Debt			
	Net Debt Amount	X / (X)	<ul style="list-style-type: none"> • Cash free / debt free
+/-	Cash & cash equivalents	X	<ul style="list-style-type: none"> • Cash • Marketable securities
	Interest-bearing debt & equivalents	(x)	<ul style="list-style-type: none"> • Traditional debt • Debt equivalents such as capital spent vs. budget, operating leases, pensions, specific types of provisions • Hybrid claims such as employee stock options and convertible bonds
Working Capital			
	W/C Adjustment	X / (X)	<ul style="list-style-type: none"> • Debt free / cash free mechanism does not provide full protection from changes in balance sheet positions. Therefore, working capital adjustments are often combined with the debt free / cash free mechanism
=	Working capital	X	<ul style="list-style-type: none"> • Trade receivables • Operating expenses • VAT
	Normal working capital	(x)	<ul style="list-style-type: none"> • Factors as seasonality, lumpiness in the business (e.g., a business characterized by large and infrequent transactions) mitigated by "average" net working capital (NWC) over last 12 months to be considered.
	Equity Value	x	<ul style="list-style-type: none"> • (final) purchase price
Equity			

Equity Bridge

This leads us to one of the key questions in the purchase price calculation. On what basis do we determine the amounts of cash and debt to be applied in the equity bridge? This question has two nuances:

What is Cash and Debt? Firstly, we need to know what exactly will count as "cash" and what will be considered "debt." The answer is, "it depends." Ultimately, the definitions of cash and debt are subject to negotiations. It used to be common to include abstract definitions in the agreement. This practice has been changing in recent years, though. In more and more deals, cash and debt items are defined by reference to specific accounting ledgers of the Target Company.

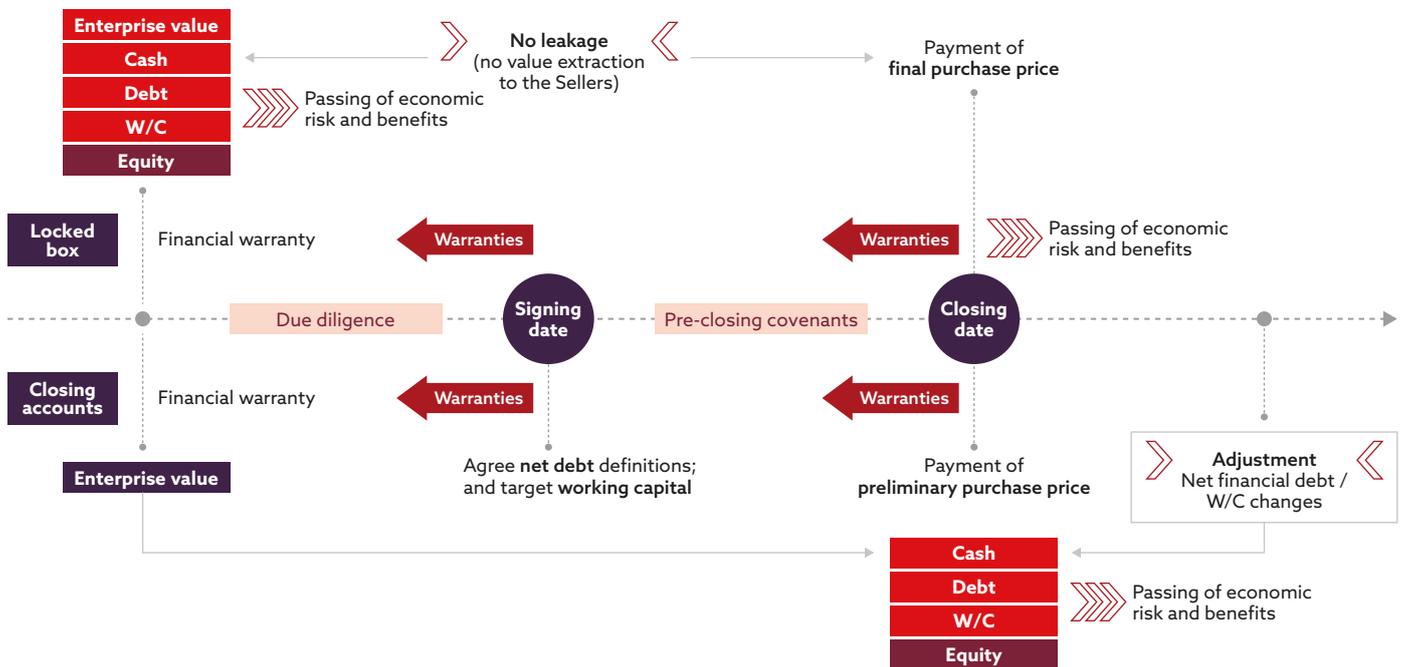
The Sellers need to take care to avoid a 'double dip': any contingent liabilities, off-balance sheet items or risks identified in due diligence should only be considered in the equity bridge if they have not already been factored into the calculation of the enterprise value.

What is the Relevant Point in Time? The second part of the question concerns the relevant time on which the Target Company's cash and debt are determined. The two most commonly used approaches are the "locked box" and the "closing accounts" mechanisms.

- In simple terms, "locked box" means that the equity value is determined based on historical data at an agreed date in the past, typically the date of the most recent financial statements (see Chapter A.V.2.2. for further details).
- "Closing accounts" describes a mechanism where the parties use historical data "only" for agreeing the enterprise value. The equity value will be determined at a future date (in most cases, the date the sale closes). See Chapter A.V.2.3. for further details.

The main difference between both mechanisms is the economic effective date of the transaction. When a locked box is applied, the parties act as if the Target Company has economically been "owned" by the Buyer already since the locked box date. In a closing accounts scenario, the "economic ownership" will transfer to the Buyer only on the closing date. The key characteristics of both mechanisms are illustrated in the graphic below.

Locked Box vs Closing Accounts Overview



2.2 The Locked Box Mechanism

The defining feature of the locked box approach is that the equity bridge calculation is made outside the transaction agreements. In addition, the parties agree on a fixed price in the transaction agreement, *i.e.* there are generally no adjustments or post-closing true-ups (with certain exceptions as described below). The values applied in the equity bridge are typically drawn from the Target Company's last financial year-end balance sheet. The reason is that the parties usually consider (audited) financial statements a meaningful point of departure for purchase price negotiations. This also minimizes effort on the Sellers' side because no additional balance sheet needs to be drawn up. The resulting equity value is then hard-wired into the share purchase agreement, thereby "locking the box". To incentivize everyone to work towards a speedy closing, this 'base purchase price' typically bears interest for the time period between the locked box date and closing (often referred to as the "ticking fee").

The "locked box date" is typically also the economic effective date on which the risks and benefits associated with the Target Company's business pass to the Buyer.

It is not difficult to see the obvious source of dispute: The base purchase price that has been "locked in the box" will not change, regardless of the business' performance after the economic effective date. At the same time, the Buyer will not legally own the Target Company until closing.

This means that, after signing, the Sellers will continue to run the business, but will neither participate in an increase of value nor bear the risk of a value decline. From the Buyer's perspective, the clear aim is to ensure that the assumptions underlying its valuation will still be valid at closing. The Sellers, on the other hand, want an incentive to conduct the business on the Buyer's behalf and at the same time avoid any liability in case the Target Company's situation deteriorates before closing. The question is now how to address the parties' diverging interests in the share purchase agreement. Typically, the key negotiation points in locked box deals are:

- The Buyer's main source of protection is reliance on the locked box accounts and the correctness of the information provided in due diligence. For the Sellers to push hard for a locked box structure, they should be ready to deliver audited financial statements or at least high-quality accounts the Buyer can review and (hopefully) rely on. In case of a long period between locked box date and signing, the Buyer may also request interim management accounts to validate the numbers and such updated numbers to be warranted by the Sellers in the share purchase agreement as well.
- For any developments since the locked box date that cannot be verified in due diligence, the Buyer will request warranties on the state of business from the Sellers. In particular, the Buyer will want to ensure that there has been no "leakage" of value from the Target Company to the Sellers or their affiliates or related persons after the effective date that has not been reflected in the equity bridge. If there is still leakage, the Buyer will request to be indemnified on a euro-for-euro basis. From the Sellers' perspective, it needs to be clear what will be considered leakage, so that payments by the Target Company in the ordinary course of business, such as service fees, loan interest payments or salaries will not result in a purchase price reduction.
- After signing, the Buyer's main goal is to "keep the box locked" and avoid the Sellers extracting any value until closing. The Sellers will be reluctant to give any business-related warranties as of the closing date so the Buyer will be keen to exert as much influence as possible before closing. The share purchase agreement will typically include a covenant that the Sellers will use their corporate powers to run the Target Company's business in the ordinary course. Depending on the parties' negotiation power, this can be accompanied by a more or less detailed list of actions the Sellers are prohibited from taking without the Buyer's explicit consent (particularly including certain material actions and measures by the Target Company's management). But be warned: if merger control clearance is a closing condition (more on that in Chapter A.IX.1.), there is a thin line between protecting the Buyer's interests and "jumping the gun."

2.3 The Closing Accounts Mechanism

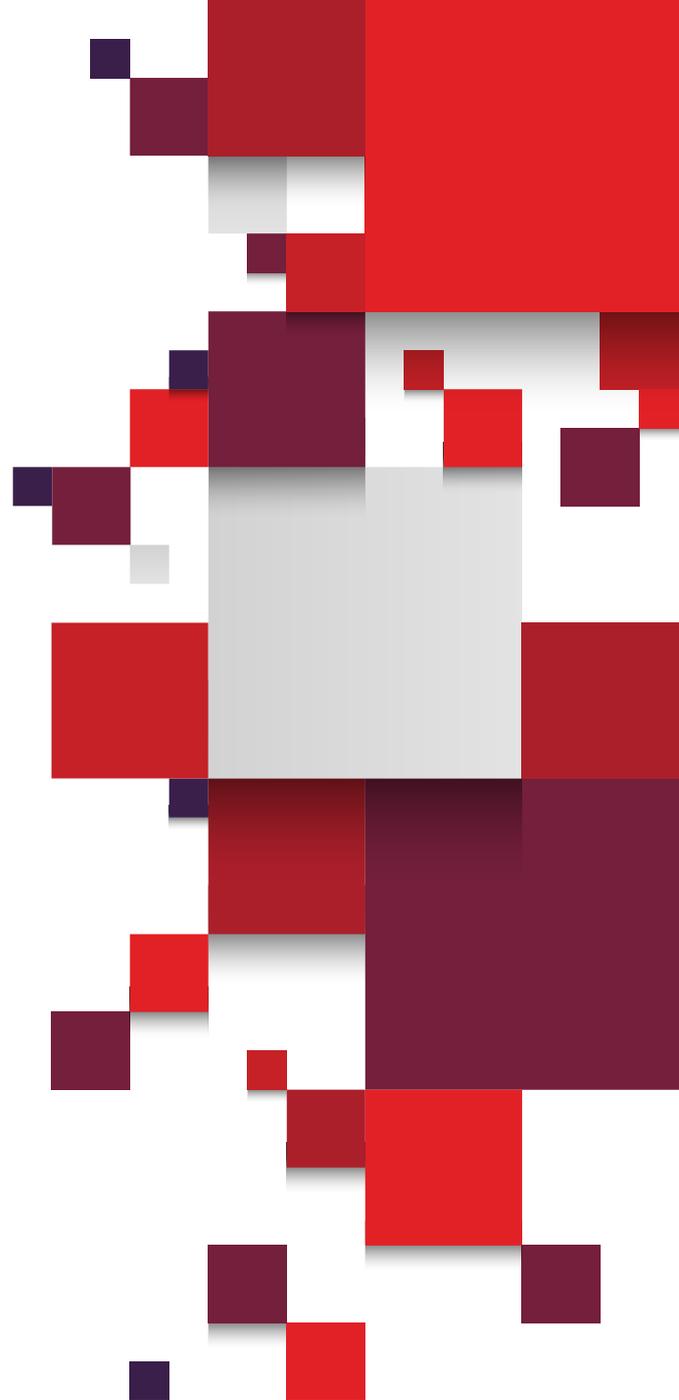
The defining feature of closing accounts transactions is that the base purchase price agreed in the share purchase agreement represents what the parties agreed to be the Target Company's enterprise value. The parties will determine the equity value – and thereby the final purchase price – in "real time" on the basis of accounts prepared to the date of closing. The closing date is also the effective date so the Sellers will continue to operate the business for their own benefit in the period after signing until closing. In simple terms: the better the company performs financially until closing, the higher the purchase price.

On one hand, this incentivizes the Sellers to run the Target Company in an efficient way to create value – which is obviously in the Buyer's interest. However, there is a caveat: the parties' interests are of course still not fully aligned.

Because the Sellers benefit from closing accounts showing less debt and more cash, there is an incentive to run the business with a focus on short-term effects on the financial statements rather than long-term growth. As mentioned above, the definitions of "cash" and "debt" are typically subject to the parties' agreement. This opens the door to working capital optimization: by delaying the payment of short-term liabilities (which typically do not qualify as debt) or by collecting short-term receivables (which typically do not qualify as cash) early, the Target Company's cash position – and thereby the purchase price – can be increased. This can be avoided by including a working capital adjustment in the purchase price formula and limiting the Sellers' room to maneuver by adequate conduct of business covenants.

Another typical point for negotiation is the responsibility for preparing the closing accounts. The Sellers will want to ensure that the accounting principles follow past practice. The Buyer, though, as the party controlling the Target Company after closing, will also claim the right to prepare the closing accounts. Either way, the final purchase price will only be known after the closing accounts are available (and, as the case may be, no longer disputed). That may take several months. The Sellers are of course not willing to transfer the business and having to wait months – or even years if a dispute is resolved in court or by arbitration – until the purchase price is paid. Therefore, a preliminary purchase price is usually pre-agreed or estimated by the Sellers and paid upon the closing date (maybe with a portion paid in an escrow to protect the Buyer if the closing accounts ultimately result in a lower equity value), with a "true-up" payment after the closing accounts are available.

Since the Sellers will operate the business on their own account, the Buyer will usually have less influence on the day-to-day business when compared to a locked box scenario. This means the fiercest negotiations usually revolve around the question of who bears the risk of deterioration of the business. The Buyer will push hard for the Sellers' warranties being given also as of closing to reflect the state of the business when it is transferred. In many cases, the Sellers will agree to repeat at least those warranties qualified by knowledge (see Chapter A.VI.3.5.8. for details).



2.4 Choosing the Right Mechanism

The choice between the locked box and the closing accounts approach largely depends on the parties' risk appetite and negotiation power. Market studies over the last several years have consistently shown that locked-box mechanisms for purchase price provisions remain popular in the DACH region. In contrast, the vast majority of private deals in the United States include post-closing purchase price adjustments. These findings align with our observations in the technology sector.

In any case, it is essential to be aware of the principles of the different mechanisms and their nuances, as they can significantly impact the outcome of a transaction. The better your understanding, the easier to navigate the negotiation and secure a deal that aligns with your strategic goals. To wrap things up, the table below provides a snapshot of the main pros and cons of the locked-box and the closing accounts from the Buyer's and the Sellers' point of view.

Locked Box vs Closing Accounts Comparison

	Locked Box	Closing Accounts
Accuracy of financial data	<ul style="list-style-type: none"> • Warranty on locked box accounts ("true and fair view") • Warranty on complete and correct due diligence information 	<ul style="list-style-type: none"> • Specification of accounting principles for preparation of closing accounts • Implementation of dispute resolution mechanism
Protection against adverse sell-side transactions	<ul style="list-style-type: none"> • No-leakage warranty for time between effective date and signing • No-leakage covenant between Signing and Closing • Ordinary course of business covenant 	<ul style="list-style-type: none"> • Net working adjustment • Ordinary course of business covenant
Recognition of contingent liabilities	<ul style="list-style-type: none"> • Disclosure of equity bridge to avoid "double dip" objection 	<ul style="list-style-type: none"> • Exact definition of debt(-like) items

The approach regarding purchase price mechanism is a noticeable difference between the market practices in Germany and the U.S. While in Germany, locked box deals are common, in its 2024 SRS Acquiom M&A Deal Terms Study, the service provider SRS found that U.S. market M&A deals over the last four years featured some form of closing account mechanism in approx. 9 out of 10 cases.

3. EARN-OUT STRUCTURES

Technology companies can be particularly difficult to value since their value often relies upon projected growth in markets defined by innovation and disruption. It's no wonder that Buyers and Sellers often struggle to find common ground on the price. Even after the prospective Buyer has completed thorough due diligence, differing views may persist. Here, contingent and deferred payments might help parties to share risks and align interests. Earn-outs have always been a feature of technology M&A and they are increasingly common in the Sellers' markets. Depending on the sector and stage, we estimate that between 20 % and 25 % of all tech M&A deals have an earn-out element (in the life science / pharma space, these numbers are much higher).

3.1 Elements of the Earn-out

An earn-out is a structure where Sellers

- receive an initial consideration upon closing of the exit
- while another portion of the consideration is paid at some point in the future
- with the amount of the earn-out payment depending on achieving certain milestones or metrics (which are often of a financial nature but don't have to be).

Earn-outs come as parties on both sides of a transaction attempt to address some form of uncertainty that affects their valuation of the transaction or willingness to pay. The earn-out is a risk-balancing tool that through a subsequent increase of the deal consideration returns value to the Sellers if the Target Company performs at or above expectations. The earn-out also protects the downside for the Buyer and de-risks the transaction by hedging against uncertainties. Such uncertainties can come in a variety of forms, and they will influence the earn-out methodology. In start-up land, an earn-out may also have a cosmetic effect. It may allow a Target Company to preserve a headline valuation they previously achieved by including some contingent purchase price elements.

Against this backdrop, let's look at each component of an earnout in more detail:

Percentage of the Overall Consideration: The amount of the earn-out payment as a percentage of the overall deal consideration depends on many factors, notably the (perceived) risk regarding the Target Company's development and the bargaining powers of the parties involved. Earn-out sizes also change with the overall M&A market. In boom times, with a sellers' market, the Buyer might find it harder to push for an earn-out. That being said, earn-outs can represent between 20-30 % of the (potential) overall purchase price to be paid to the Sellers. In some instances (often distressed or other special situations), we have seen earn-outs exceeding 50 %.

Time Horizons: While this will obviously depend on the relevant milestones underlying the earn-out (see below), the time period for measuring earn-out milestones usually ranges from twelve to thirty-six months. This period should not be too short so that Buyer may be tempted to run the Target Company in a way that prioritizes avoiding the earn-out over the long-term prospects for the Target Company. At the same time, the earn-out period needs to be long enough to allow the Target Company to achieve the milestones but not so long that it creates uncertainty or complicates integration. Earn-out periods can be much longer in transactions involving Target Companies in the life science or biotech space.

Relevant Metrics or Milestones: We are not as pessimistic as Vice Chancellor J. Travis Laster of the Delaware Court of Chancery, who in 2009 remarked in the *Airborne Health Inc. v. Squid Soap* decision, that "an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome." We fully agree, however, that these clauses require attention. That holds especially true for defining the relevant metrics or milestones and determining what needs to be done to achieve them.

In our experience, financial metrics predominate in earn-out structures involving German start-ups. In these instances, the earn-out is linked to the Buyer's financial model for the acquisition.

- If the value of the start-up is mainly driven by its growth rates, measures might include revenue (notably ARR and MRR numbers) or daily and monthly active users.
- If the emphasis is more on profitability, the earn-out will often depend on the achievement of certain EBITDA targets or other profit milestones.

In some instances, non-financial metrics may be more adequate to align the parties' interests.

- In the life science and biotech space, for example, earn-out payments may be triggered by timely regulatory approvals or a new drug going into the clinical trial phase, which can be combined with royalties on net sales, measured over several years.
- In fintech, the emphasis may be on regulatory approvals to enter a new line of business or a new geographic market.
- For deeptech start-ups, we occasionally find technical milestones, including
 - in the AI space: product integration, algorithm performance, scalability targets for handling larger data volumes, or regulatory approvals;
 - in quantum computing: achieving a specific level of qubit coherence time or error rates, successful development of quantum algorithms, product hardware development targets;
 - in robotics or automation: successful prototype development or field testing, customer deployment, meeting autonomy specifications or manufacturing scale-up; and
 - in energy and cleantech: efficiency improvements and emission reduction targets, completion of pilot projects or securing a certain number of commercial deployments or installations.
- As mentioned above, earn-out triggers can be very diverse. In addition to the ones above, we occasionally see the Target Company being awarded a follow-on or new contract from a particularly important customer or public agency. We have also seen the retention of a certain number of (key) employees by the Target Company following closing of the transaction as an earn-out trigger.

3.2 Protecting the Earn-out

In roll-over / re-investment structures, the Sellers don't sell 100 % of their stake in the Target Company but only a portion. They roll over their remaining shares or re-invest a portion of their proceeds into the post-exit equity of the Target Company (often via a newly established single purpose vehicle acting as a holding company). Earn-outs are easier to structure and implement. They do not require the negotiation of call- and put-arrangements and a shareholders' agreement. However, earn-out arrangements bring their own challenges.

FOUR RULES OF ENGAGEMENT FOR EARN-OUTS



#1 One Size Fits No One: Earn-outs are case specific and should be approached that way.

#2 No Ambiguity: Be as precise as possible, use detailed sample calculations or illustrative examples, and avoid room for subjective interpretation. The latter, for example, includes the use of "best efforts", "best reasonable efforts", "commercially reasonable efforts", or any other creative combinations that lawyers can come up with. Such provisions might leave it unclear what a party actually has to do by not including some form of contractual yardstick or method to measure efforts.

#3 Timing Matters: The parties should be very precise on timing requirements for the earn-out triggers. They also should be clear about their determination and review and the time one party has to challenge calculations presented by the other parties before they become binding.

#4 Have a Dispute Resolution Mechanism: "And ideally one that is suitable for the case at hand," one might add. This might include referring certain disputes to a subject matter expert (e.g., for technical milestones). At the same time, the agreement needs to be precise about which types of disputes are referred to the expert and when they can be submitted to them. All other disputes should be settled by the courts or by arbitration (whatever the parties agree to in the acquisition agreement).

The Buyer will insist on autonomy in running the acquired business as they see fit. In cases where the Buyer is a strategic investor and their valuation model assumes the realization of synergies, there is often a need to begin post-merger integration as early as possible. The Sellers, however, will be rightfully concerned that the Buyer may have an incentive to find ways to avoid or reduce the earn-out payment.

The Sellers need to anticipate subjective areas or areas that may present opportunities for some kind of manipulation and address them through contractual safeguards. The possible design variants here are manifold and require precise analysis in each individual case. To illustrate the point, we will present a non-comprehensive list of safeguards the parties should consider if they agree on financial metrics to be derived from the Target Company's annual financial statements or from its bookkeeping and management accounts (such as revenue or EBITDA):

- **Clear Definitions and Recognition Policies:** Precisely define how revenue and EBITDA will be calculated. Specify accounting standards (e.g., GAAP, IFRS) and any adjustments or exclusions. There should be clear revenue and EBITDA recognition policies. For example, the Buyer should be prevented from deferring or accelerating revenue to manipulate earn-out calculations. The parties will also need to address how to deal with revenue from new or unrelated business activities when it comes to the earn-out calculations.
- **Cost Allocations:** Specify how shared expenses (e.g., overhead, administrative costs) will be allocated to the Target Company to prevent the Buyer from disproportionately allocating expenses to reduce EBITDA. Where appropriate, set caps on certain expenses (e.g., management fees, intercompany charges) the Buyer can allocate to the Target Company.
- **Consistent Accounting Practices:** After the acquisition, maintain the accounting principles and practices used pre-acquisition to avoid discrepancies in financial reporting.
- **Operational Continuity:** Include covenants that require the Buyer to operate the Target Company in a manner consistent with past practices. It might be helpful to specify which integration measures are allowed or how certain integration measures shall result in the adjustments of the revenue and EBITDA calculation relevant for the earn-out.
- **Resource Allocation:** Specify that the Buyer must provide adequate resources. This might include adequate personnel, capex and opex allowances as well as a certain marketing budget to achieve the earn-out milestones.
- **No Divestitures:** The Buyer should be prohibited from divesting the Target Company's key assets or parts of the business, respectively shifting business to other parts of the Buyer's organization in a way that could obscure the financial performance of the Target Company.

EARN-OUT PAYMENTS IN LIFE SCIENCES AND HEALTHTECH M&A: SELLER BEWARE⁶



Earn-out provisions are common in life sciences and healthtech mergers and acquisitions, particularly when an acquired company may add significant value after closing. This can occur if the acquired business has a product in Phase 3 clinical trials or a new product with an uncertain sales ramp. To bridge the valuation gap, the parties frequently negotiate earn-out payments. As a recent case demonstrates, earn-out payments can be tricky. Faced with losing control of the business, sellers often seek assurances that a buyer will work to achieve the milestones that trigger payment. Buyers may worry that unforeseen circumstances will change plans for the acquired business. Disputes often wind up in court.

The Delaware Court of Chancery recently decided a case that highlights the need for sellers to consider the language of earn-out provisions thoughtfully and thoroughly. Here is a simplified summary:

- **The Case:** Fortis Advisors, LLC v. Medtronic Minimed, Inc.
- **The Acquisition:** In 2020, global health care tech company Medtronic acquired Companion Medical, which had developed a smart insulin pen system.
- **The Claim:** Shareholder representative Fortis Advisors sued Medtronic on behalf of former Companion Medical shareholders. The suit alleged Medtronic breached the merger agreement by failing to make a \$100 million earn-out payment. The merger agreement contained buyer-friendly language giving Medtronic considerable discretion to develop and commercialize the milestone product. It prohibited Medtronic from acting for the primary purpose of frustrating payment for achieving a milestone.
- **The Outcome:** In July 2024, the Delaware Chancery Court dismissed claims against Medtronic for failing to make a \$100 million earn-out payment. The court zeroed in on language in the merger agreement that prohibited Medtronic from actions intended for the primary purpose of frustrating a milestone payment. The court found that the allegedly improper actions of Medtronic were not actionable if they were not for the primary purpose of frustrating efforts to achieve the milestone – even if the actions adversely affected whether those milestones would be achieved.

Other cases have focused on the precise wording of "commercially reasonable efforts" clauses, including language about what factors the buyer could or could not consider in evaluating those efforts, such as whether other corporate objectives or the development of competing products could be factored in.

The Bottom Line: Focus on precision in wording! It's important for a seller to invest time upfront to clarify the meaning of terms in earn-out payment provisions of a merger agreement. That can help protect a seller's ability to receive the value they've negotiated. In the Medtronic case, the word "primarily" had a major impact. Other times, the precise definition of "commercial reasonable efforts" and the allowable considerations can sway the outcome.

4. CASH AND NON-CASH CONSIDERATIONS

Where the Buyer of a start-up is itself a growing technology company, the Buyer might propose "paying" a portion of the purchase price for the Target Company in the form of shares in the Buyer.

Arguments for a Combined Cash and Non-cash Purchase Price:

This way, the Buyer can preserve precious cash reserves and simultaneously "sweeten" the deal for the Sellers as the shares in the Buyer have a theoretically unlimited upside. The Buyer will often argue that a mixed consideration creates alignment between the parties when they believe in the overall synergies and future growth potential of the Target Company in the hands of its new owners. Offering equity in the Buyer can serve as a powerful incentive for key employees and founders of the Target Company to stay with the combined entity and contribute to its success. Under certain circumstances, particularly if the Buyer is an EU resident entity, the Sellers may benefit from deferred taxation on the equity portion of the consideration until they sell the shares, potentially reducing their immediate tax liability. Finally, a combined cash and equity deal can signal to the market that both parties are optimistic about the future synergies and growth potential of the combined entity. It can enhance the transaction's credibility, as both parties are seen as sharing the risks and rewards. However, if the Buyer is a private company, the share portion of the transaction will often be illiquid for the Sellers. The Buyer may impose lock-up periods during which the Sellers cannot sell their shares. Dilution questions can also arise. For example, issuing new shares to the Sellers can dilute the ownership of existing shareholders of the Buyer, which may require careful negotiation and approval from the Buyer's (advisory) board and shareholders. Sellers may worry about future dilution if the Buyer issues additional shares in subsequent financing rounds.

Negotiation Considerations: In a combined cash and equity purchase price scenario, it is crucial for both the Buyer and the Sellers to include specific terms in the acquisition agreement. Here's a breakdown of key items each party should focus on:

- **Valuation:** Unlike in a simple "cash only" transaction, the parties will need to agree on the value of the Target Company and the fair value of the Buyer's shares. The latter will depend, among other things, on what shares the Buyer is prepared to offer. Remember: If the Buyer is a scale-up, it will likely have raised various financing rounds and issued different classes of preferred shares, so the question arises where to place the Sellers in the Buyer's equity hierarchy and, consequently, in the liquidation waterfall.

6. This Ninja Box is based on a blog post from our life science partners Stephen Thau and Mike O'Donell and that can be found here: <https://www.orrick.com/en/Insights/2024/09/Earnout-Payments-in-Life-Sciences-and-HealthTech-MA-Seller-Beware>.

- **Warranties and Compensation In Shares:** As the Buyer will usually receive warranties regarding the Target Company's business and financial situation, the parties need to address how to remedy a breach, notably whether or not the Sellers need to make the Buyer whole out of their cash portion or return a certain number of shares that the Sellers have received. Likewise, the Sellers will often get at least some warranties from the Buyer regarding its business and financial situation. That can protect the Sellers' assumptions regarding the value of the shares in the Buyer. The Buyer and its shareholders will often require that, in case such Buyer warranties are breached, the Sellers' sole remedy shall be a valuation adjustment for the shares in the Buyer and thereby the issuance of further shares in the Buyer to the Sellers, but not a cash compensation.
- **Governance and Control:** Depending on the size or value of the Buyer and the Target Company, the Sellers (respectively the largest shareholders in the Target Company) may seek board representation at the Buyer's level. They may also seek other governance rights to protect their interests, which can complicate negotiations.
- **Other Rights and Obligations:** The Sellers will usually be asked to adhere to the Buyer's shareholders' agreement or similar documentation, e.g. the various documents that a U.S. entity will have after raising a priced round. These documents are typically based on the NVCA template documentation, including the Buyer's "investors' rights agreement," "voting agreement" and "right of first refusal and co-sale agreement." These documents will usually equally apply to the Sellers and their (preferred) shares in the Buyer and might include pro-rata rights, information rights, tag-along rights, etc.

5. VENDOR LOANS

What is a Vendor Loan? Vendor loans, also known as "seller financing" or "vendor financing," are loans provided by the Sellers to the Buyer to help finance an acquisition. A vendor loan allows the Buyer to defer a portion of the purchase price. The loan is paid back to the Sellers over time, typically with interest. Unlike an earn-out, which is also a deferred portion of the purchase price, the purchase price portion financed by a vendor loan is fixed in advance. If the Buyer has received third-party debt funding (e.g., a bank loan or venture debt), the parties will need to agree whether the vendor loan shall be subordinated to the external debt funding.

Why are Vendor Loans Used? Vendor loans can help bridge the financing gap if the Buyer cannot secure sufficient external financing or prefers to preserve cash reserves. Offering a vendor loan can make the deal also more attractive to the Buyer, potentially leading to a higher overall purchase price while bridging a potential valuation gap.

Besides these financial aspects, vendor loans can also help align the interests of the parties. By providing a vendor loan, the Sellers share some of the financial risk with the Buyer who might have to rely on cash generated by the Target Company to repay the vendor loan.

What are Typical Terms of Vendor Loans? Typical terms for a vendor loan are:

- **Loan Amount:** Vendor loans typically cover a portion of the purchase price, often ranging from 10 % to 20 %. This can vary depending on the specifics of the deal and the financial strength of the Buyer.
- **Interest Rate:** Depending on the parties' negotiation power, the interest rates are often slightly lower than those offered by banks and specialized debt funds for M&A acquisition loans. They frequently fall in the range of 5-10 % p.a.
- **Repayment Terms:** The repayment schedule can be structured as regular installments (e.g., monthly, quarterly) over a specified period, often eighteen to forty-eight months. In our experience, vendor loan repayments are less often structured as a balloon payment that becomes due only upon the end of the loan term. There are usually a number of acceleration events that trigger immediate repayment, such as a sale of the Target Company by the Buyer.
- **Security and Collateral:** While vendor loans can, in theory, be secured by the Target Company's assets or other collateral, in our experience, unsecured loans are more common. The Sellers may agree to subordinate the vendor loan to other senior debt (in particular, an acquisition loan granted to the Buyer by a bank or debt fund), meaning the vendor loan will be repaid after other debts in the event of default.
- **Covenants and Conditions:** The loan agreement may include financial covenants the Buyer must adhere to, such as maintaining certain financial ratios or performance metrics.

6. TREATMENT OF OUTSTANDING CONVERTIBLE LOANS UPON THE TIME OF AN EXIT

When the Target Company has raised a convertible loan that is still outstanding at the time the Sellers decide to sell the company, several scenarios could unfold depending on the terms of the convertible loan agreement (and the preferences of the involved parties). Here are the main possibilities:

Conversion to Equity Before Sale: The convertible loan agreement may contain a clause that triggers a right (or obligation) of the lender to convert their loan into shares of the Target Company. Those shares would then be sold in the exit. If the lender is not already a shareholder, they will have to adhere to the Target Company's shareholders' agreement, which will usually provide for a drag-along right. The financial return for the lender will largely depend on one of two factors:

- whether the Target Company's exit valuation is the relevant value for determining the lender's entitlement to shares in the Target Company minus the usual discount of often 15-25 %; or
- whether the relevant valuation shall be subject to a cap (which is a standard feature of most convertible loan agreements in Germany).

Repayment of the Loan: Converting the convertible loan in the often very ambitious timeframe of many exit transactions can prove challenging. Thus, many convertible loans will give the parties (or one of them) the option for a cash settlement in lieu of a conversion. The lender is then usually entitled to an immediate repayment of the outstanding principal amount and the accrued but unpaid interest as well as an "exit kicker" in the form of an additional cash payment that frequently ranges from 0.5 - 2 times the principal amount of the underlying convertible loan.

Assumption by the Buyer: The Buyer may agree to assume the convertible loan as part of the purchase agreement. This means the Buyer takes on the responsibility for the loan, including any future conversion into equity or repayment obligations.

If the lender is a shareholder of the Target Company and holds more than 10 % of the company or is a managing shareholder (*geschäftsführender Gesellschafter*), the lender needs to be aware of risks under German insolvency law associated with the repayment of a shareholder loan or the acquisition of such a loan by a purchaser in a company sale.

These risks primarily revolve around the potential for claw-back claims (*Anfechtung*) in case the Target Company faces insolvency proceedings after the exit transaction. Under certain circumstances, German insolvency law allows an insolvency administrator to challenge and potentially reverse certain transactions that occurred before the insolvency proceedings began. The relevant provisions are found in the German Insolvency Code (*Insolvenzordnung* - "InsO"). Most notably, sec. 135 para. 1 no. 2 InsO can void repayments on a shareholder loan that occurred during the one-year period before the borrower company applied for the opening of insolvency procedures.

The German courts have ruled that these principles cannot be circumvented by structuring the transaction as an acquisition of a shareholder loan by the purchaser of the borrower rather than a direct repayment of the loan by the borrower. Consider the implications if the Target Company seeks to open insolvency procedures before the first anniversary of the acquisition of the shareholder loan. If the Buyer as the purchaser of the shareholder loan, has received a repayment from the Target Company, the respective Seller will become subject to claw-back claims as if they had remained a shareholder and received repayments on the shareholder loan.

VI. The Share Purchase Agreement

1. OVERVIEW

In the complex world of start-up M&A, the share purchase agreement (SPA) serves as the cornerstone document that outlines the terms and conditions of the transaction.

Understanding the key components of a share purchase agreement is crucial to navigating the intricacies of the deal and protecting the interests of all parties. This Chapter provides an overview of the main contents of a share purchase agreement, structured into three distinct sections to facilitate a clear and organized understanding of the various provisions.

The first section focuses on provisions related to money, encompassing the critical aspects of the purchase price modalities and components, as well as provisions related to locked box and closing accounts. This Chapter is of course augmented by the preceding Chapters on valuations and price considerations (see in particular Chapter A.V.).

The second section addresses the allocation of risks, a pivotal element in any M&A transaction. This includes detailed discussions on merger and FDI clearance requirements, material adverse effect clauses, sell-side representations and warranties and remedies in case of a breach, tax and other indemnifications, escrow accounts and holdback amounts, and the use of W&I insurances as a mitigation tool.

The third section covers other essential provisions typically found in a share purchase agreement, such as dispute settlement mechanisms, non-compete and non-solicitation obligations of the Sellers (or some of them), and some of the most common "boilerplates."

2. PROVISIONS AROUND MONEY (RECAP)

When acquiring a German technology company, particularly a start-up, it is crucial to understand the various financial provisions that a share purchase agreement might include. These provisions ensure that the transaction is executed smoothly and that both sides are clear on the financial terms and conditions. This section provides a brief overview of these provisions, complementing the detailed explanations of purchase price mechanisms found in Chapter A.V.2.2. (locked-box), Chapter A.V.2.3. (closing accounts) as well as Chapter A.V.3. (earn-out structures).

Overview of Purchase Price Mechanisms: As detailed in Chapter A.V.2.2. and Chapter A.V.2.3., the purchase price mechanisms are fundamental to determining how the final purchase price is calculated and adjusted.

In a locked-box mechanism, the purchase price is fixed at a specific date before closing, with no post-closing adjustments (except for breaches of warranties or payments under (tax) indemnities, which for German tax purposes are usually treated as purchase price reductions per the terms of the share purchase agreement). This approach provides certainty and simplicity but requires robust warranties regarding the conduct of business after the effective date and indemnities to protect against value leakage.

In contrast, the closing accounts mechanism involves calculating the final purchase price based on the financial statements prepared as of the closing date. This method allows for adjustments based on the actual financial position of the Target Company at closing, providing a more accurate reflection of its value.

Due Dates and Default Provisions: The share purchase agreement must outline the due dates for the payment of the purchase price and the consequences of default. In case of a closing accounts mechanism, where the final purchase price can only be determined after the preparation of closing accounts, the agreement should include provisions for a preliminary purchase price. Usually, the Sellers will make a good faith calculation a few business days prior to the scheduled closing date. If the Buyer agrees, this will be the preliminary purchase price. If there is no agreement, the share purchase agreement will usually provide for a default amount to be paid as preliminary purchase price. In each case, this preliminary amount is paid at closing, with the final purchase price adjusted once the closing accounts are finalized. The share purchase agreement should specify the timeline for preparing and agreeing on the closing accounts, as well as the process for resolving any disputes that may arise.

Bank Accounts and Payment Provisions: The share purchase agreement will need to detail the bank account(s) to be used for the payment of the (preliminary) purchase price. This includes specifying the account details, ensuring compliance with Know Your Customer (KYC) regulations, and addressing any requirements for joint accounts when there are multiple Sellers. Clear instructions on the payment process help prevent delays and ensure that funds are transferred securely and efficiently.

Additionally, the agreement may include provisions for escrow accounts to hold the purchase price until certain conditions are met, providing additional security for both parties (for details see Chapter A.V.3.7.).

Interest Provisions: Interest provisions can come into play in both locked-box and closing accounts mechanisms.

In a locked-box approach, the purchase price is fixed at a specific date, and interest may be due on the purchase price to compensate the Sellers for the time between the locked-box date and the closing date. This interest is typically calculated at an agreed-upon rate and added to the purchase price at closing.

In a closing accounts approach, interest provisions can play a crucial role in incentivizing the parties to agree on a realistic preliminary purchase price. A relatively high interest rate on the delta between the preliminary and final purchase price encourages both parties to ensure that the preliminary amount closely reflects the expected final price. This helps minimize significant adjustments post-closing and ensures a fair and efficient transaction process.

Currency and Exchange Rate Provisions: In cross-border transactions where the purchase price may be denominated in a different currency than the local currency of the Target Company or certain Sellers, the share purchase agreement should specify the currency in which the purchase price will be paid and include provisions for handling exchange rate fluctuations.

Value Added Taxes: In the sale of a German Target Company, it is generally assumed that no value added tax ("VAT") will apply to the purchase price, as the transfer of shares is VAT-exempt unless the Seller waives such VAT-exemption. To ensure clarity, safeguard the VAT-exemption and address any potential VAT-related issues, the share purchase agreement usually includes specific provisions regarding VAT.

Firstly, the share purchase agreement will typically include a clause stating that all parties assume and agree that the transaction is exempt from VAT. Additionally, the agreement will often include an obligation for the Sellers not to opt for VAT on the transaction, possible under certain conditions under VAT law in Germany and other EU-jurisdictions. This ensures the Sellers do not take any action that could inadvertently trigger a VAT liability.

In the event that, despite the parties' expectations, tax authorities deem VAT applicable to the transaction, the share purchase agreement should outline the procedures and responsibilities for handling this situation. Typically, the agreement will specify that the Buyer is responsible for paying any VAT that becomes due and payable by the Seller to the tax authorities, and the purchase price will be adjusted accordingly to reflect this additional cost. The share purchase price may also include provisions for cooperation between the parties to contest or appeal any VAT assessments, ensuring both parties work together to resolve any unexpected VAT liabilities. These provisions help to mitigate the risk of unforeseen tax liabilities and provide a clear framework for addressing any VAT-related issues that may arise.

3. PROVISIONS AROUND RISK ALLOCATION

3.1 Overview

In any M&A transaction, the allocation of risks between the Buyer and the Sellers can significantly impact the success and smooth execution of the deal. This Chapter delves into the most important provisions that address how to manage and distribute risks, ensuring both sides are protected from potential uncertainties and liabilities. By clearly defining responsibilities and remedies, these provisions help create a balanced and fair agreement, fostering cooperation between the parties.

IN BRIEF: REPRESENTATIONS AND WARRANTIES, COVENANTS, AND INDEMNITIES - WHAT IS WHAT?



Representations and Warranties: A representation and warranty, irrespective of fault, is a contractual assurance provided by the Sellers about specific facts or conditions related to the Target Company, regardless of whether the Seller was aware of any inaccuracies or issues. These representations and warranties cover various aspects, such as financial statements, compliance with laws, and the condition of assets. If a representation or warranty is breached, the Buyer can claim damages without needing to prove that the Seller was at fault or had knowledge of the issue (exceptions are statements that are qualified by "seller's knowledge"). With respect to the typical scope of representations and warranties as well as the remedies in case of a breach, see Chapter A.VI.3.4. and A.VI.3.5.

Indemnities: An indemnity is a contractual obligation by the Sellers to compensate the Buyer for specific losses or liabilities that arise post-closing, often related to pre-closing events or conditions. Indemnities are designed to provide the Buyer with financial protection against identified or generally presumed risks, such as tax liabilities, environmental issues, or legal disputes. Unlike representations and warranties, the Sellers must cover the losses and liabilities under an indemnity irrespective of the Buyer having knowledge of a certain matter. With respect to typical tax indemnity matters see Chapter A.VI.3.6.

Covenants: A covenant is a promise or undertaking by one party to perform or refrain from performing certain actions before or after the closing of the transaction. Covenants can be affirmative, requiring specific actions, such as the Sellers agreeing to maintain the business in the ordinary course until closing, or restrictive, prohibiting certain actions, such as the Sellers agreeing not to solicit employees or customers of the Target Company post-closing. Covenants are crucial for ensuring that both parties adhere to agreed-upon behaviors and conditions that are essential for the successful completion and integration of the transaction. With respect to the typical non-solicit or non-compete covenants see Chapter A.VI.4.2.

3.2 Merger and FDI Clearance Requirements

Merger and Foreign Direct Investment ("FDI") clearance rules can play a critical role in the acquisition of a German start-up. These regulations are designed to ensure that mergers do not create anti-competitive market conditions and that foreign investments do not threaten national security or public order.

The German Federal Cartel Office oversees merger control, requiring companies to notify and obtain approval for transactions that meet certain turnover thresholds. This process can delay the acquisition and may result in conditions or prohibitions if the merger is deemed to significantly impede effective competition. Simultaneously, the Federal Ministry for Economic Affairs and Climate Action reviews FDI transactions involving non-EU investors acquiring significant stakes in German companies in sensitive sectors, such as defense, critical infrastructure, and technology. This review aims to protect national security and strategic interests.

Failure to obtain necessary clearances can lead to the transaction being blocked or unwound. Therefore, the parties must carefully navigate merger and FDI clearance processes to ensure a smooth and compliant acquisition of a German start-up.

Considering the growing importance of these regulatory challenges for technology M&A we will explore them in more detail in a separate regulatory Chapter further below (see Chapter A.IX.).

In the following paragraphs, we limit ourselves to a short description of key topics the Buyer and Sellers need to address in the acquisition agreement when it comes to applying for and obtaining merger clearance and FDI clearance. It's important to address these issues, as obtaining a merger or FDI clearance will then become a closing condition for closing the acquisition of the respective Target Company.

Responsibility and Cooperation: Clearly specify which party will be responsible for preparing and submitting necessary filings. Include provisions requiring both parties to cooperate fully and provide information and documentation to support the clearance applications. The Sellers may need to use their corporate powers to ensure the Target Company cooperates.

Timelines and Deadlines: The acquisition agreement should establish deadlines to submit required filings. It should also define a period within which the parties expect to receive the necessary clearances, including rules around extensions if initial clearances are not obtained within the expected timeframe.

Process Matters: The transaction agreement will usually provide for a number of more procedural provisions, including progress updates, notification of issues (including requests for additional information from the authorities) and which information shall be shared on a "counsel only" basis, etc.

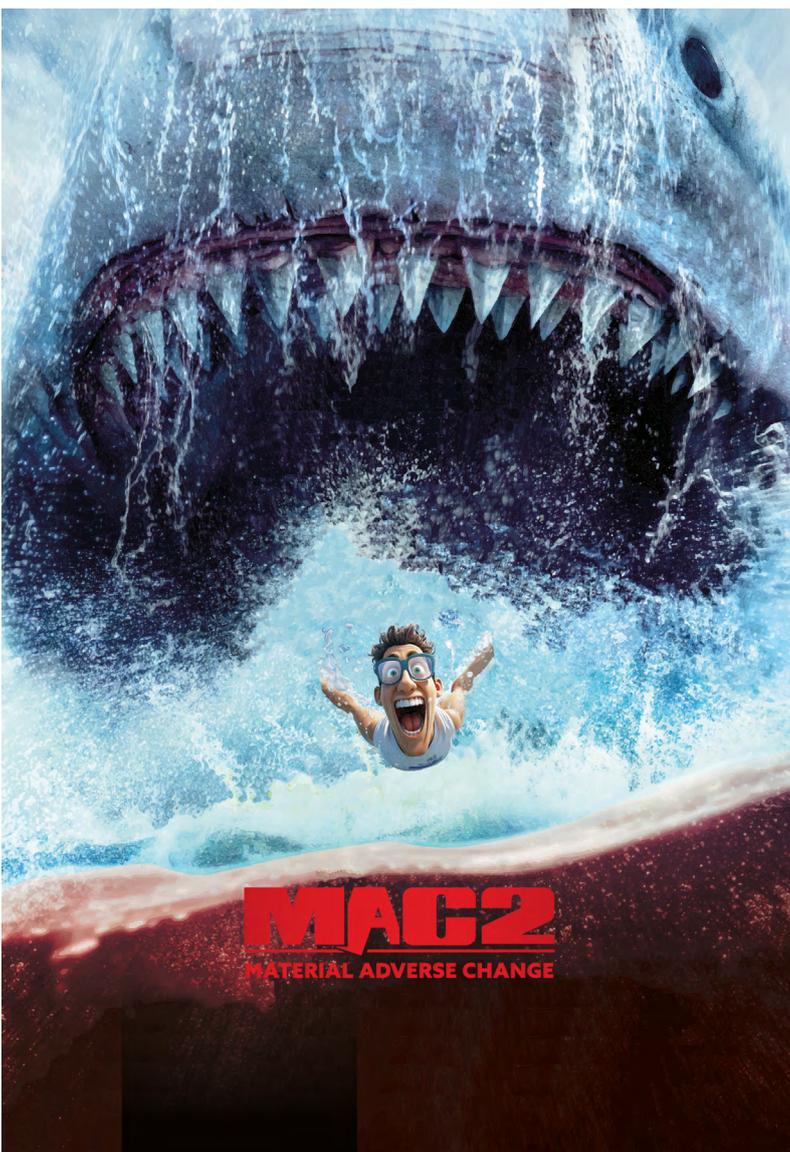
Efforts to Obtain Clearance and Commitments: What standard of effort shall be required by the Buyer to obtain the relevant clearances, e.g. best efforts vs. commercially reasonable efforts? In particular, if the parties' assessment of the legal situation indicates that obtaining clearance might not be smooth sailing, the agreement will need to outline the commitments (if any) the parties are willing to make to obtain clearance, such as divestitures, behavioral remedies, or other conditions imposed by regulatory authorities. The acquisition agreement will usually also have provisions that specify if a party shall be required to challenge any decision by the authorities to refuse a requested clearance or grant it subject to conditions and modifications.

Termination Rights: Include provisions that allow either party to terminate the agreement if the required clearances are not obtained within a specified period (longstop date). Clarify what the respective consequences (if any) shall be, e.g. contractual penalty (break fee), cost reimbursement or similar.

3.3 Material Adverse Effect Clauses – The MAC

What is it? A "material adverse change" (MAC) or "material adverse effect" (MAE) clause is a provision that gets sometimes agreed in M&A agreements (they are, however, more common in the U.S. and the UK compared to Germany). It allows a Buyer to back out of the deal or renegotiate terms if significant (and usually unexpected) negative changes occur in the Target Company's business, financial condition, or prospects between the signing of the transaction agreement and the closing of the transaction. Technically, a MAC clause can be structured as a condition precedent for Buyer's obligation to proceed with closing or as a unilateral termination right. Especially where the parties anticipate a significant delay between signing and closing due to complex merger or FDI approval requirements (or where a Target Company's business will first need to be carved-out from a Seller's organization), the Buyer might insist on such a provision. The Buyer wants to protect itself from unforeseen events that could substantially reduce the value of the Target Company before the Buyer has a chance to exercise full control.

Obviously, the Sellers will beg to differ and argue that a MAC clause will undermine deal certainty as it could provide a loophole for the Buyer to exit the transaction. Depending on the scope of the MAC definition (see below), the Sellers will also argue that some developments will be outside their influence. They may argue that changes in the macro-environment or market fluctuations are "normal" and should not be grounds for terminating or changing the deal.



MAC Clauses In Practice: One example from the world of big-ticket M&A is the (abandoned) acquisition of Akorn, Inc. (Akorn) by Fresenius Kabi AG (Fresenius). In 2017, NASDAQ listed Akorn agreed to be acquired by Fresenius for \$4.3 billion. Before closing, Fresenius terminated the M&A agreement. Fresenius asserted its right to terminate the merger agreement on the basis that Akorn's regulatory compliance representations and warranties were so inaccurate as would reasonably be expected to result in a MAC. Fresenius also said Akorn failed to comply in all material respects with its obligation to use commercially reasonable efforts to operate in the ordinary course pending consummation of the merger. Fresenius' arguments were based principally on:

- the dramatic and sustained decline in Akorn's financial performance;
- Akorn's failures to comply with U.S. Food and Drug Administration data integrity and other regulatory requirements (which were flagged for Fresenius in two whistleblower letters from an Akorn employee); and
- Akorn's failure to take reasonable actions to rectify such regulatory deficiencies.

In a 2018 decision, the Delaware Chancery Court, while reaffirming the heavy burden that Delaware courts place on a Buyer asserting that a MAC had occurred, found Fresenius had met this burden. Four consecutive quarters of revenue, operating income, and earning-per-share declines were severe and enduring. Statements by Akorn's management supported the finding of a prolonged effect. The issue affecting Akorn was specific to the company. There was evidence Akorn's submissions to the U.S. Food and Drug Administration were potentially fabricated. Akorn also stopped audits and inspections that would have revealed ongoing violations, contrary to their representations and warranties. The Court analyzed MAC in two separate contexts: (i) the "stand-alone" MAC closing condition, which entitled Fresenius not to close if a MAC had occurred and the "representation bring-down" closing condition, which entitled Fresenius not to close, and to terminate the merger agreement, if any of Akorn's representations were so inaccurate as to reasonably be expected to result in a MAC.

During the last Plaque (occasionally also referred to as the COVID-19 pandemic), MAC clauses became the M&A equivalent of hand sanitizer – suddenly in high demand but with questionable effectiveness. The Buyers requested such clauses to protect themselves. The Sellers, already dealing with a rather unfavorable M&A environment, saw these clauses as yet another complication in their quest to close deals, especially given that pandemic-related MACs usually had nothing to do with the specifics of the Target Company and were outside the Sellers' control.

The Anatomy of a MAC Clause: A MAC clause usually starts with a rather general definition that stipulates what constitutes a MAC, *i.e.* events (coming from inside or outside the Target Company) that have a material negative impact on the Target Company's financial or operational situation (sometimes, the qualitative assessment is augmented by a threshold for the negative effects on earnings or profits). Often, MAC definitions are also forward-looking and cover events that have had – or are "reasonably expected to have" – a material adverse effect on earnings, profits, operations etc. This allows a Buyer to declare a MAC based on reasonably anticipated negative development, even when such effects have not yet occurred.

Then, there is usually a set of carve-outs. These are exceptions within the MAC clause that specify certain events or conditions that will not be considered a MAC. Examples include general economic downturns, industry-wide issues or general fluctuations of capital and credit markets, natural disasters and relevant changes in the political conditions of a country or in legislation.

Finally, there can be "carve-out exceptions", *i.e.* provisions that stipulate when an event falling into a carve-out category would nevertheless constitute a MAC. For example, if the exceptional situation's impact on the acquired company is disproportionate to the impact on all other companies in the relevant market.

3.4 Representations and Warranties

3.4.1 Introduction

A key component of a share purchase agreement are the Sellers' "representations and warranties" or "guarantees" about the legal and economic aspects of the Target Company and their shareholdings in the Target Company. Leaving the legal nuances aside, in practice, these provisions require the Sellers to assume liability irrespective of fault that certain circumstances exist or don't exist. For simplicity's sake, we will hereinafter simply refer to them as "**warranties**".

Warranties in a share purchase agreement are essential for addressing information asymmetry, allocating risk, building trust, and ensuring transparency. They provide a structured way for the Sellers to assure the Buyer of the Target Company's condition, thereby facilitating a fair and balanced transaction. To put it philosophically, the best way to predict the future of your Target Company as a Buyer is of course to create it and the second best is to ensure your warranties cover all the bases (is this already worthy of a meme...).

Information Asymmetries: Warranties in a share purchase agreement serve a fundamental role in bridging the information gap between the Sellers and the Buyer. When acquiring a company, the Buyer often lacks complete visibility into the Target Company's legal, financial and operational status. Warranties help mitigate this asymmetry by providing assurances from the Sellers about the condition and status of the Target Company. These assurances cover a wide range of aspects, from the accuracy of financial statements to the absence of undisclosed liabilities, enabling the Buyer to make an informed investment decision. Warranties ensure that what the Buyer will get is actually worth what the Buyer pays.

Risk Allocation: The primary philosophy behind warranties is risk allocation. By agreeing to warranties, the Sellers assume liability for the accuracy and completeness of certain statements made with respect to the Target Company. This allocation ensures that the Sellers are accountable for any discrepancies or undisclosed issues that may come to light post-closing. This accountability helps protect the Buyer from unforeseen risks and potential losses, enhancing the overall (perceived) fairness and balance of the transaction.

Trust: Warranties serve as a mechanism to build trust between the parties. In the context of an M&A transaction (one might argue that in some instances they also substitute for a lack of trust). Trust is essential for a smooth and successful deal. Warranties provide a formal and legally binding way for the Sellers to demonstrate their confidence in the Target Company's condition and their commitment to transparency, or otherwise to bear the financial consequences.

Deterrent: In addition, warranties can act as a deterrent against misrepresentation and fraud. Knowing they will be held liable for material inaccuracies or omissions, the Sellers are incentivized to disclose relevant information accurately and comprehensively. This ensures the Buyer has a clear(er) and (more) truthful understanding of what they are acquiring.

Given the liability risks stemming from these warranties, the Sellers usually aim to limit their scope and their own liability as much as possible. A broad set of warranties the Sellers can't thoroughly verify poses significant risks. Therefore, Sellers prefer to craft these warranties in a way that ensures the statements can be verified. On the flip-side, offering reasonable warranties can build trust with potential Buyers, much like a well-organized data room, and can even drive up the purchase price, especially in a tough sale with few interested parties. Hence, a clear and manageable set of contractual warranties, supported by proper disclosures (we will explain what "disclosures" mean shortly), can be in the Sellers interest, too.

In this Chapter, we're diving into some of the standard warranties you would typically encounter in M&A deals. Just remember, these catalogs are like a lawyer's version of a gourmet menu – subject to intense discussion and debate, with a pinch of negotiation drama on the side. This list may not cover everything, but it gives you a sense of what might be expected when the exit is near.

3.4.2 Corporate and Shareholder Matters

These warranties are like the bedrock of any deal, aiming straight at the heart of the transaction. They shall provide rock-solid assurance that the sold shares or assets are free from legal defects and encumbrances. Essentially, they protect the Buyer by confirming that the Sellers have rightful ownership, the authority to transfer the shares, and that the shares are not tangled up in third-party claims or legal snafus. Hence, legal defect liability in share sales covers not only that the shares are free from encumbrances and freely transferable, but also that there are no outstanding contributions and no insolvency or liquidation proceedings pending. Legal defects also include restrictions on voting rights or profit participation and the existence of pre-emptive or pre-purchase rights.

Today's typical warranty catalogs contain detailed and conclusive provisions on the above points. Common are also warranties on the existence of the Sellers and their legal capacity. For foreign contracting parties, such warranties have a preventive function; they become practically significant when a holding company acts as the seller, and the parent company involved in the contract guarantees its existence. Guarantees for obtaining the necessary internal approvals from the responsible shareholders and supervisory bodies are also recommended. From the Buyer's perspective, it makes sense to include the non-existence of corporate agreements, silent partnerships, and similar contracts under foreign legal systems. Finally, common warranties make clear that no insolvency proceedings have been opened or applied for and that no grounds for insolvency exist.

3.4.3 Financial Matters

Warranties regarding the annual financial statements of the Target Company hold significant importance for Buyers in M&A transactions. Typically, the most recent (audited) financial statement, which often serves as the pivotal point of departure for the Target Company's valuation, is guaranteed. In some cases, the last two or three financial statements (if available) may also be included. This warranty becomes even more critical if a fixed purchase price is agreed upon (*i.e.* a locked box with an effective date as of the date of the last financial statements). It shields the Buyer from financial risks such as the overvaluation of inventories or unrecorded write-downs on receivables, which are not covered by purchase price adjustments. The wording of these warranties often closely follows the auditor's confirmation note, ensuring that the financial statement is prepared in accordance with legal provisions and proper accounting principles, maintaining valuation and balance sheet continuity. However, this does not guarantee the objective accuracy of the financial statement but rather its careful preparation, considering risks recognizable at the time of preparation. If the last available annual financial statement dates back some time, the Buyer may seek warranties for interim financial statements or at least the management accounts, which, although based on the same principles as the annual financial statement, do not have to comply with all of the requirements under German GAAP or IFRS standards.

In practice, there is a difference between a "hard" or objective financial statement warranty (*harte oder objektive Bilanzgarantie*) and a subjective financial statement warranty (*subjektive Bilanzgarantie*). Why does it matter? Well, the objective warranty version guarantees that the financial statements comply with applicable accounting standards (*e.g.*, IFRS or German GAAP) and present a true, fair and accurate view of the financial situation, assets and earning situation of the Target Company. It is an absolute assurance that the financial statements reflect the true situation.

On the other hand, the so-called subjective version of a financial statement warranty, only guarantees that the financial statements present (in all material aspects) a true, fair and accurate view of the financial situation, assets and earning situation of the Target Company in accordance with German GAAP or IFRS and the underlying accounting principles (*Grundsätze ordnungsmäßiger Buchführung*). For example, if there are hidden liabilities of the Target Company that did not need to be recorded in the financial statements, *e.g.* an unknown series defect of the Target Company's products, the Sellers might be liable while the financial statements are in line with German GAAP and IFRS. Under an objective version, the Sellers guarantee that the financial statements show an accurate picture of all liabilities of the Target Company.

The subjective version is the standard. The Sellers should carefully review the exact wording of the text of the warranty. Empirical studies show that if W&I insurance providers make payments under such policies (for more on W&I policies see Chapter A.VI.3.8), in most cases this is because of a violation of a financial statement warranty. Such warranties are rightly considered one of the most important warranties.

A financial statement warranty is usually coupled with a warranty that the Target Company has operated within the ordinary course of business since the date of the last annual financial statement. This general assurance is often detailed with extensive lists of specific significant actions and transactions the Sellers may consider to be outside the ordinary course. These can include corporate actions like transformations and dividend payments, company-related measures such as acquisitions or disposals and special business events like the loss of key customers or employees, or unusual damage incidents.

3.4.4 IP and IT Matters

IP Matters: For the acquisition of technology companies, IP-focused warranties are essential to ensure the Target Company's intellectual property assets are secure and uncontested. These warranties tend to be one of the focus areas during any negotiation.

Common IP-focused warranties typically include assurances that the Target Company owns or has valid licenses for all intellectual property necessary for its operations. This includes patents, trademarks, copyrights and trade secrets as well as other IP rights (and occasionally know-how). The warranties often guarantee there are no pending or threatened claims of infringement or misappropriation of third-party intellectual property rights. Additionally, the Sellers may warrant that all IP registrations are valid, enforceable, and in good standing, and that the Target Company has taken appropriate steps to protect its intellectual property as well as know-how and trade secrets.

Another important aspect of IP-focused warranties involves the Target Company's freedom to operate. This includes assurances the company's products and services do not infringe on third-party intellectual property rights and that no disputes or litigation could impact the Target Company's ability to use its IP. The warranties may also cover the company's IP policies and procedures, ensuring they are adequate to protect its intellectual property and comply with relevant laws and regulations.

If the Target Company is a software company, the Sellers should expect special warranties regarding its source code and the use of open-source software. The Sellers might have to warrant that the source code is original, has been developed by the Target Company or its employees or third parties engaged based on written agreements with robust IP transfer provisions, and does not infringe on any third-party rights. Additionally, the Sellers may need to provide assurances that the source code is free from any undisclosed defects or vulnerabilities that could affect its performance or security. When it comes to open-source software, the Sellers should warrant that any open-source components in the company's software comply with the relevant open-source licenses. This includes assurances that the Target Company has adhered to the terms of these licenses, such as providing proper attribution and making any required source code available. The Sellers may also need to confirm that the use of open-source software does not impose any restrictions or obligations that could impact the company's ability to commercialize its software or transfer its IP rights.

Obviously, given the potentially far-reaching nature of these warranty statements, the Sellers will seek to add materiality and / or knowledge qualifiers, *i.e.* that they should only be liable if they had known or could reasonably have been expected to know a certain circumstance.

IT and Cyber Matters: IT-focused warranties are meant to ensure that the Target Company's technological assets and infrastructure are sound and reliable. Common IT-focused warranties typically include assurances that the Target Company owns or has valid licenses for all necessary software and technology used in its operations. Additionally, warranties often cover the functionality and performance of IT systems, ensuring they can support the Target Company's current and anticipated business activities without significant issues or interruptions.

Another critical area of IT-focused warranties involves the security and integrity of the Target Company's IT systems. This includes assurances that the company has implemented appropriate cybersecurity measures to protect against unauthorized access, data breaches and other cyber threats. The warranties may also cover the regular maintenance and updating of IT systems to ensure they remain secure and effective. Furthermore, the Sellers might warrant that – to their knowledge – there have been no significant security incidents or breaches that could affect the company's operations or reputation.

The Sellers should try to avoid making unqualified warranties that they have a safe and secure IT environment and have never been hacked. They may consider giving such a warranty subject to a knowledge qualifier. As one can read in the daily news, even large and sophisticated companies get hacked, and often, such a hack may not even be known by the company for quite some time.

3.4.5 Privacy Matters

Furthermore, share purchase agreements often include warranties regarding the Target Company's data protection and security practices, as well as compliance with associated laws. The Buyer will typically request broad warranties concerning compliance with all applicable data protection laws. Given the complexity of data protection laws and the significant effort required to achieve full compliance, such comprehensive warranties may not accurately reflect the Target Company's actual level of compliance.

During the due diligence process, it is crucial to provide an accurate picture of the Target Company's data protection compliance. This allows the parties to limit warranties to what is truly necessary. For example, the Buyer often demands a warranty confirming that the Target Company has executed data processing agreements with all its vendors or, where applicable, its customers, as required by law. In such cases, the Sellers should verify whether they have disclosed all such agreements and made additional disclosures if this is not the case (which is not uncommon in early-stage companies).

3.4.6 AI Matters

These days, Buyers are enhancing traditional IP warranties by adding new ones that focus on core considerations in the context of AI. These warranties typically address the use of training data, internal governance and risk management policies, contractual commitments and allowances, confidentiality terms, and data use restrictions with third parties, including vendors. They might also cover the adoption and compliance with internal policies and impact assessments.

The EU AI Act will impose additional requirements on Target Companies⁷, and we anticipate that Buyers will expand their playbooks on AI-focused warranties. However, these warranties often exceed what Target Companies have in place. Similar to data protection matters, full disclosure of implemented measures is essential to allow both parties to address AI compliance and risk mitigation measures implemented by the Target Company.

7. You can find a comprehensive overview of the scope and consequences of the EU AI Act here: <https://www.orrick.com/en/Insights/2024/10/The-EU-AI-Act-A-Comprehensive-Overview>.

One of the most crucial representations in this area concerns the use of data for training. For potential Buyers, it is important to know whether the Target Company is authorized to use its data for training. To address potential risks regarding the use of training data, the Target Company must have provisions in their legal terms. They should also verify the terms of AI vendors, ensuring they have options regarding the use of data for training.

Another critical warranty relates to the risk of disclosing trade secrets. It is important that the Target Company provides clear instructions to its employees, vendors, and management on how to prevent the loss of its trade secrets or the infringement of third-party IP rights when using AI. Companies that do so, have a distinct advantage. Obviously, even the best policy is insufficient if it is not enforced or if people are not properly trained.

Even if certain AI-targeted warranties somewhat overlap with other warranties (notably IP and privacy warranties), their inclusion forces the Sellers to make targeted disclosures and assess specific risks arising from the Target Company's adoption of AI.

3.4.7 Employment Matters

In both share and asset deals, a potential Buyer will seek fair risk distribution and robust warranties for the Target Company's labor law-related obligations.

The most important and commonly negotiated employment law-focused warranties typically include assurances regarding the accuracy and completeness of employee records, including employment contracts, compensation details, and benefits. The Sellers may warrant that all employees have valid and enforceable contracts, and that there are no outstanding disputes or claims related to employment matters, such as wrongful termination, unpaid wages, or discrimination.

Another key area of employment law-focused warranties involves compliance with labor laws and regulations. This includes assurances that the Target Company has adhered to all relevant employment laws, such as those governing working hours, minimum wage, health and safety standards, and employee rights. The Sellers might also warrant that the Target Company has fulfilled all obligations related to social security contributions, tax withholdings, and other statutory payments. Additionally, warranties may cover the company's compliance with collective bargaining agreements and the proper handling of any works council or union-related matters (if relevant for the Target Company).

During negotiations, parties often focus on the scope and detail of employment law warranties. A potential Buyer will typically seek comprehensive warranties to protect themselves against potential employment-related liabilities, which could have significant financial and operational impacts.

The Sellers may aim to limit the scope of these warranties to avoid extensive liability, e.g. when it comes to the qualification of freelancers as *de facto* employees.

Furthermore, special attention might be given to warranties related to key employees and retention plans. The Sellers may need to warrant that there are no pending resignations or terminations of key personnel and that appropriate measures are in place to retain critical talent post-transaction. This can include assurances that retention bonuses or incentive plans have been properly disclosed and that no undisclosed agreements or commitments could affect the Target Company's ability to retain its workforce.

However, when it comes to employment warranties, share deals and asset deals have distinct differences. In a share deal, the Buyer acquires the company as a whole, including all existing employment contracts and obligations. This means the Buyer takes on all labor law responsibilities in this respect and aligns the request for warranties accordingly. Conversely, in an asset deal, the Buyer only acquires specific assets and may not automatically assume all employment contracts. Here, warranties (additionally) need to focus on the specific employees transferring with the assets, ensuring that their rights under sec. 613a BGB (*i.e.*, transfer of employment relations by operation of law) are respected (for details, please see in Chapter A.X.3.1). This includes declarations that the transferring business unit does or does not constitute a business change and that all relevant employment agreements and conditions are disclosed.

3.4.8 Contract Matters

The acquisition agreement will also provide for warranties related to material contracts and material contractual relationships of the Target Company. The purpose of these warranties is to ensure that the company's key agreements are valid, enforceable and free from significant issues. These warranties typically cover the existence, validity and enforceability of all material contracts, which include agreements crucial to the company's operations, such as major customer and supplier contracts, leases, financing agreements, material IP agreements, distribution agreements and partnership agreements.

The Sellers usually warrant that all material contracts are in full force and effect, that the Target Company is not in breach of any material terms and that no counterparty has threatened to terminate or materially alter any of these agreements. The Sellers may also warrant that no ongoing disputes or (threatened) litigation relate to any material contracts.

These warranties are crucial for the Buyer in two ways: First, they confirm Buyer's financial business model about costs and revenue with respect to material counterparties and assess the stability and reliability of the company's key business relationships. They also identify potential risks that could impact the company's future performance.

During negotiations, the main items of focus will typically include what constitutes a "material" contract, the level of detail required in disclosure of these contracts and the extent of the Sellers' liability for breaches or issues. Another key negotiation point is how to handle any change of control provisions in material contracts. These provisions may allow counterparties to terminate or renegotiate agreements upon a change in ownership, which could significantly affect the company's operations post-transaction. The Sellers may need to warrant that they have disclosed all such provisions and – though that would be an unusually broad statement – that they have taken or will take steps to obtain required consents or waivers from counterparties. To ensure accuracy, the Sellers would need to meticulously review all contracts. Moreover, a change of control clause doesn't always mean the contract is significant. The parties can agree on materiality thresholds, so only contracts with change of control clauses above a certain volume, involving essential and irreplaceable pre-products for the company, or granting usage rights to key assets (like IP) need to be disclosed.

3.4.9 Litigation and (General) Compliance Matters

Litigation Matters: Warranties related to litigation are a standard feature and usually are not controversial. These warranties typically cover the existence and status of current, pending or threatened litigation, arbitration or administrative proceedings involving the Target Company. The Sellers will request a materiality threshold (e.g. only litigation with a value in excess of a certain EUR amount needs to be disclosed). They also will seek to specify when litigation is threatened to distinguish it from disputes with third parties that can be considered part of the ordinary course of business. Additionally, the Sellers may warrant that no investigations or inquiries by any governmental or regulatory bodies could lead to litigation.

Note that depending on the scope and potential consequences of litigation, the Buyer may request an indemnification.

As we explain below, the (fair) disclosure of a certain fact means the Buyer cannot invoke the breach of a warranty with respect to that fact. If a Buyer wants to protect itself against a disclosed risk (here a pending litigation with potential substantive consequences), the Buyer will need to factor that risk into the purchase price it is prepared to pay or request an indemnification. The latter means that if the risk materializes post-closing, the Buyer will be made whole on a EUR-for-EUR basis despite it having knowledge of the risk. The parties may agree on liability caps or to somehow economically split the consequences of that certain risk materializing. In the case of known litigation matters, this could mean that the Buyer will only be entitled to an indemnification if the financial consequences of the litigation exceed the amount of legal reserves set aside for litigation matters in the latest available financial statements prior to signing.

Compliance Matters: From a Buyer's perspective, uncovering compliance violations can be challenging, even with thorough due diligence. The growing international landscape adds another layer of complexity, as compliance risks abroad may be even harder to spot than domestic ones. This makes warranties about necessary regulatory approvals and adherence to laws and regulations crucial. On the flipside, it is no surprise that the design of compliance warranties often sparks intense negotiations. The Sellers will (rightfully) fear the Buyer will seek an "umbrella" or "catch-all" warranty when requesting the Sellers to stand behind a statement that the Target Company has complied with all applicable law.

Common warranties include assurances that the Target Company holds all necessary public permits and approvals, for example such as those for key facilities under the Federal Immission Control Act (*Bundesimmissionsschutzgesetz*) or licenses in regulated industries (FinTech, InsurTech, Life Sciences, Aviation, etc.), and that these permits have not been revoked or annulled. These warranties can be limited to "material" permits or specifically listed ones, leaving it to the Buyer to verify their importance through due diligence. As mentioned above, warranties for disclosing significant legal and administrative proceedings are also standard, but they don't shield the Buyer from compliance risks not yet under investigation.

This brings us to (broad) warranties that the Target Company complies with applicable laws. One of the main issues with such a broad umbrella warranty is its extensive scope, which can make it challenging for the Sellers to provide absolute assurances. A common rhetorical tactic used by the sell-side lawyers would be to ask, "With such a broad compliance guarantee, why would you even need any specific guarantees?" Given the complexity and ever-changing nature of legal and regulatory environments, it is difficult for any company to warrant full compliance with every applicable law.

"The more the state 'plans' the more difficult planning becomes for the individual."

Friedrich August von Hayek, Austrian-British economist

Below are some common negotiation topics and compromises:

- **Only Sector Specific Broad Warranties:** During negotiations, one potential outcome is to narrow the scope of the compliance warranty to focus on specific areas of law that are most relevant to the company's operations and industry. For example, the warranty could be limited to key areas such as tax compliance, employment law, environmental regulations and industry-specific requirements. This approach can help balance the need for buyer protection with the Sellers' ability to provide reasonable assurances.
- **Limiting the Geographic Scope:** Further discussion points include the jurisdictions covered (whether just Germany, the EU/EFTA, North America, or other operational regions). With such a distinction one can find a balance between the economic importance of certain regions for the Target Company (important for the Buyer's valuation) and the Sellers' confidence in the existing compliance policies and procedures given where the Target Company is on its growth trajectory.
- **Materiality Thresholds and Knowledge Qualifier:** The most common tools used to scale back the scope of a broad compliance-with-law warranty involves limiting them to Sellers' knowledge and excluding minor violations that do not result in negative consequences for the Target Company in excess of a certain amount. This approach can help limit the Sellers' liability by acknowledging they may not be aware of every potential compliance issue or that some violations have simply not that much of an impact on the Target Company. However, the Buyer may seek to ensure the Sellers have conducted reasonable inquiry to identify known or likely non-compliance issues.
- **There are Laws and There are LAWS:** Where negotiations often land is to limit the broader general compliance-with-law statements by materiality thresholds and knowledge qualifiers, while the Sellers are asked to stand behind the "(legal) cardinal sins" without such limitations. The latter group includes warranties regarding the Target Company's compliance with antitrust law, money-laundering laws, sanction and embargo laws and laws combating the financing of terrorism.

3.4.10 Disclosure and Information

The so called "fair-disclosure" warranty aims to protect the Buyer from the risk that their purchase decision and / or purchase price calculation was based on information provided by the Sellers or the Target Company that proves to be incorrect or misleading. This includes documents provided in the data room, information memoranda and verbal statements made during management presentations, Q&A sessions and contract negotiations.

In addition, the Buyer will often request a statement that goes beyond the correctness of the information actually provided. Such statements typically ask the Sellers to guarantee they have fairly disclosed to the Buyer all relevant information that might reasonably be expected to impact the Buyer's decision to proceed with the transaction at these terms (in particular price).

These warranties aim to ensure that the Buyer has received accurate and complete information to make an informed decision. However, they come with several issues that need to be carefully navigated. The Sellers typically strongly resist broad statements on the correctness and completeness of information disclosures.

The obvious issue with these warranties is their broad scope and the subjectivity involved. The requirement that all information provided is correct and not misleading can be open to interpretation. This can lead to disputes about the accuracy and completeness of the information. Similarly, the warranty that all information relevant for the Buyer has been provided is particularly broad and can be difficult for the Sellers to fulfill. It requires the Sellers to anticipate what the Buyer might consider relevant. That can vary widely depending on the Buyer's perspective and objectives.

Below are some of the potential compromises we see:

- **Materiality Thresholds and Knowledge Qualifiers:** During negotiations, one common compromise is to include materiality thresholds in the warranties. This means that the Sellers only warrant that information provided is correct and not misleading to the extent that any inaccuracies or omissions would have material consequences for the Target Company. Another approach is to include knowledge qualifiers, where the Sellers warrant that, to the best of their knowledge, all information provided is correct and not misleading.

- **Seek a More Objective Standard:** With respect to a statement that all relevant information has been disclosed (whether the Buyer asked for it or not), the parties – other than limiting this statement to Sellers’ knowledge – can stipulate what the relevant perspective should be to reduce the level of subjectivity. Common language includes limiting the statements to what the Buyer has specifically asked for and to information that, in the reasonable judgement of the Sellers, can be expected to be of material importance to the acquisition decision of the Buyer and which might reasonably terminate or materially affect the willingness of a typical investor comparable to the Buyer to acquire the Target Company at the terms and conditions set forth in the acquisition agreement.

For deals in Germany, one thing needs to be kept in mind: German law provides for a concept of "culpa in contrahendo" ("**cic**") that has potential consequences for an acquisition of a Target Company irrespective of what the parties stipulate in the acquisition agreement. Here is what this means in a nutshell: *cic*, which translates to "fault in contracting," is a legal doctrine in German law that imposes pre-contractual duties on parties during the negotiation phase of a contract.

Initially developed by the courts, this concept is now codified in the German Civil Code (*Bürgerliches Gesetzbuch* – "**BGB**"), specifically in sects. 311 and 241 BGB. The doctrine aims to ensure fairness and transparency in contractual negotiations by obligating parties to disclose material information that could influence the other party’s decision to enter into the contract. The information that must be disclosed is considered "material" if it is relevant to the other party’s decision-making. This includes facts that could substantially affect the value, risk, or feasibility of the contract. Under *cic*, a party must actively disclose material information even if the other party has not specifically asked for it. This means parties cannot withhold information they know or should reasonably know is important to the other party’s decision to enter into the contract. The duty to disclose applies to information the party knows or should have known through reasonable diligence. This includes actual knowledge and information that could have been discovered with proper investigation. The obligation to disclose does not extend to information the other party already knows or could easily discover on its own. Most recently, the German Federal Court of Justice (*Bundesgerichtshof* – "**BGH**") added to the body of case law (see the Ninja Box below for more details).

"BUT THAT MATTER WAS DISCLOSED IN THE DATA ROOM..."



In its judgment of 15 September 2023 (V ZR 77/22), the BGH decided that there may be cases where a seller is subject to a separate disclosure duty even if the buyer has had the opportunity to take notice of a certain matter in a virtual data room, provided the matter may cause the buyer considerable financial loss and is not readily recognizable from the data provided.

The BGH had to decide about a transaction that involved the acquisition of a commercial property. The acquisition agreement was signed on a Monday. On the preceding Friday, the seller uploaded to the virtual data room the parties had used for the transaction process a collection of documents reflecting decisions taken at owners’ association meetings since 2007. Among these documents were the minutes of an owners’ association meeting in 2016 according to which the owners decided to claim payment of EUR 50 million from the majority owner at the time due to extensive alterations to the jointly owned property. The buyer later claimed not to have been adequately informed about the risk of a special allocation of up to EUR 50 million, to which the buyer as the new owner of the real estate would be required to contribute proportionately. The buyer alleged that while the potential liability was mentioned in documents provided in the last upload to the virtual data room on that Friday it was placed in the virtual data room in a way so that the buyer could be expected to overlook it. The BGH sided with the buyer after the lower courts had dismissed the action. Due to the amount at stake, the seller had a responsibility to separately inform the buyer about the possibility of a special allocation of this amount. Given the specific circumstances of the case at hand, the seller did not fulfill its duty by simply uploading the relevant documentation shortly before signing.

The decision provides important generally applicable guidelines for the disclosure of documents and information in virtual data rooms. While disclosure of material information for which a disclosure obligation under *cic* exist can generally be made in a data room, whether a buyer can be expected by the seller to become aware of the relevant information depends on the volume of the data room and its organization, the correct designation of the documents and systematic sorting and, for example, also whether the buyer is advised of documents added subsequently. In case of doubt and if it is apparent to the seller that the issue in question is of considerable importance to the buyer, the seller has to inform the buyer separately.

Did we mention the importance of properly collecting all relevant information and professionally setting up a data room in the run-up to the transaction? Yes we did. See Chapter A.III.3.

3.4.11 Tax

Typically, a Buyer insists on tax warranties concerning the tax and tax compliance status of the Target Company. Tax warranties regularly include a timely submission of tax returns, payment of all due and payable taxes, maintenance of books and records as legally required, maintenance of appropriate documentation, and no ongoing or pending tax audits or tax disputes. Additionally, the Sellers may warrant that the Target Company has not engaged in any tax avoidance or evasion schemes and that all transactions have been conducted at arm's length and in accordance with transfer pricing regulations.

These warranties provide the Buyer assurances about the Target Company's tax status and help mitigate potential risks associated with historical tax issues. Note that the share purchase agreement will usually include a tax indemnity for the period prior to the effective date for the transaction (for details, please see Chapter A.VI.3.6.). This tax indemnity is augmented by the tax warranties described herein.

With a tax indemnity, the Sellers agree to compensate the Buyer for any Target Company tax liabilities that arise from events or periods before the transaction's effective date. A tax warranty is a statement or assurance provided by the Sellers regarding the Target Company's past tax compliance and current tax status. Unlike a tax warranty, a tax indemnity does not require the Buyer to prove a breach. Instead, the Sellers must cover any tax liabilities that fall within the scope of the indemnity, regardless of whether the Sellers were at fault.

3.4.12 Other

Industry- and company-specific nuances often call for tailored warranties to protect other aspects of the Target Company's situation and business (prospects). For example, for manufacturing companies that produce products with high liability risks, warranties around product safety and absence of product defects are particularly important. In the case of an automotive supplier, the spotlight will be on such supply contracts with customers. For companies in plant engineering, the focus will be on additional contract-specific warranties that go beyond the usual topics to include project status and the scope of guarantee obligations. When selling a company in the energy supply sector, the Buyer will pay close attention to warranties related to usage rights for facilities (like pipeline rights), the approval situation and key supply contracts. Again, despite all creativity, the aim remains to craft the most specific formulations possible based on the due diligence findings.

3.5 Remedies

This Chapter provides an overview of the remedies available in the event of a breach of warranties in a share purchase agreement. It covers various aspects, including:

- the right to compensation in kind;
- the right to compensation in cash;
- notification requirements;
- de-minimis and basket amounts;
- liability caps;
- handling of third-party claims;
- sandbagging and anti-sandbagging provisions;
- limitation periods;
- the exclusion of other remedies; and
- other provisions.

Each section explains the typical provisions in a share purchase agreement, the aspects that are often heavily negotiated, and the potential compromises available. By addressing these aspects comprehensively, the share purchase agreement can provide a robust framework for managing breaches of warranties, balancing the interests of both the Buyer and the Sellers, and ensuring a smooth transaction.

3.5.1 Introduction

There are significant differences between venture financing of a start-up and the acquisition of that start-up through M&A when it comes to the consequences of a breach of a warranty, as well as the interests and incentives for the investor in a financing round compared to those of a buyer in an M&A transaction.

We would not go so far to say that the remedy section in (early-stage) venture financings does not matter, but it certainly matters way less than it does in M&A transactions.

The consequences of a breach of warranty in a venture financing round might include the right for the investors to demand corrective actions, such as the issuance of additional shares to compensate for any overvaluation or misrepresentation or compensation in cash. However, such remedies are rarely enforced. The investor often focuses on maintaining the ongoing relationship and ensuring the future success of the company, rather than seeking immediate financial compensation. Their primary incentive is to see the company succeed and increase in value, leading to a profitable exit through an IPO or acquisition. As such, their approach to warranties and breaches may be more collaborative, seeking to resolve issues in a way that supports the company's long-term success.

In an M&A transaction, the warranties are usually more comprehensive and the consequences of a breach of warranty are typically more severe, as the Buyer's incentives are more immediate and transactional. The Buyer seeks to acquire a Target Company that meets its strategic and financial objectives and assumptions. As such, the Buyers are typically less tolerant of risks and more focused on ensuring all warranties are accurate and comprehensive. The Buyer's approach to breaches of warranty is often more stringent, with a greater emphasis on financial compensation and legal remedies to protect their investment.

Against this backdrop, the provisions discussed in this Chapter are often fiercely negotiated and post-closing disputes in M&A transactions are not uncommon. Later in this Guide, we will discuss some compromises to address the different interests of the parties, notably escrow and retention amounts (see Chapter A.VI.3.7.) and the W&I insurance (see Chapter A.VI.3.8.).

3.5.2 Compensation in Kind

In the event of a breach of warranty, the share purchase agreement will outline the remedies available to the Buyer. One key aspect is whether the Sellers shall be given the right to compensation in kind (*Natural restitution*). This means that the Sellers would rectify the breach by restoring the situation to what it would have been if the warranty had not been breached. For example, if the breach involves a defect in a tangible asset, the Sellers might be required to repair or replace the asset.

This remedy is often applicable in cases where the breach can be remedied without significant disruption or cost. However, it is usually limited to specific types of breaches and the share purchase agreement will stipulate that the Buyer may seek damages in cash if the respective breach cannot be remedied due to its nature, compensation in kind would not be sufficient to make the Buyer whole or where the Sellers are unwilling to rectify the breach or have not done so within a certain period of time, often around one month.

3.5.3 Compensation in Cash

When compensation in kind is not feasible, sufficient, rejected or not done in a timely manner, the Buyer can resort to claiming damages in cash. The share purchase agreement should clearly define the relevant losses to be considered, specifying which damages are included and which are excluded.

Typically, direct losses such as actual financial losses and costs incurred due to the breach are included, while indirect or consequential damages, such as lost profits or reputational harm, are often excluded or only included to a certain extent, e.g. foreseeable indirect damages or damages against which the respective warranty is meant to protect given its intent and purpose (though lost profits and lost business opportunities may still be excluded here as well). This distinction helps limit the Sellers' liability to foreseeable and quantifiable losses.

Multipliers should not be used in calculating damages. They can lead to disproportionate compensation amounts.

Lastly, the calculation of damages may differ depending on whether they are assessed at the level of the Target Company or the Buyer itself, affecting the definition of relevant losses. The share purchase agreement should provide clear guidelines on how damages are to be calculated and the methodology to be used, ensuring that both parties have a mutual understanding of the potential financial implications of a breach.

3.5.4 Notification Requirements

The share purchase agreement typically includes notification requirements that the Buyer must follow in the event of a (suspected) breach of warranty. The Buyer is usually required to notify the Sellers of the breach within a specified timeframe (often around two to four weeks) and provide sufficient details to allow the Sellers to assess the claim.

The consequences of a late or omitted notification can vary. In extreme cases, the share purchase agreement may stipulate that the relevant claims shall be excluded entirely if the Buyer fails to notify the Sellers in a timely manner. More often, the Sellers may only be partially relieved of liability if they can demonstrate that the delayed or omitted notification resulted in additional damage being caused or deepened. This approach balances the need for timely communication with the recognition that not all delays are within the Buyer's control.

3.5.5 De-Minimis and Basket Amounts

De-minimis and basket amounts are mechanisms used to limit the Sellers' liability for minor breaches and allocate a certain risk for minor breaches to the Buyer as part of the overall transaction.

De-minimis and basket amounts are usually applied for the breach of operational or financial warranties but not for the so-called "fundamental warranties". The latter usually includes title to shares, no encumbrances on shares, capacity and no insolvency of the Sellers and similar warranties.

De-minimis: A de-minimis threshold sets a minimum amount for individual claims, below which the Sellers are not liable. These provisions help prevent the Sellers from being overwhelmed by numerous small claims and focus on more significant breaches. These de-minimis are usually structured as thresholds and not as deductible. For example, if the share purchase agreement sets forth a de-minimis amount of EUR 25,000, the Buyer may only bring a claim if the alleged damage exceeds EUR 25,000 but can then claim the entire amount and not just the excess above EUR 25,000.

In practice, the de-minimis thresholds are set as EUR-amounts and depend on the overall purchase price, the bargaining powers of the parties and the perceived risks of the transaction, among other things. A typical range for de-minimis provisions is around 0.05 % to 0.5 % of the purchase price.

Basket Amounts: A basket amount aggregates multiple small claims and only triggers liability once the total exceeds a specified threshold. The philosophy behind basket provisions is to establish a certain overall minimum number for the relevant damages suffered that must be met before the Buyer can claim indemnification for breaches of warranties. There are two types of basket mechanisms:

- **Tipping Basket / Threshold:** In a tipping basket (threshold), once the threshold is exceeded, the Sellers are liable for the entire amount, including the initial claims. The underlying philosophy is to ensure that only claims of a certain significance are brought forward, focusing on material issues that genuinely impact the value of the transaction. This helps streamline the claims process and avoids the administrative burden and potential disputes over inconsequential matters.
- **(Real) Deductible:** In a real deductible, the Sellers are only liable for the amount exceeding the deductible amount.

In German technology M&A transactions, basket thresholds are typically set at a higher percentage of the purchase price compared to de-minimis provisions. The range for basket provisions usually falls between 0.5 % and 2 % of the purchase price whereby real deductibles are usually set lower than tipping baskets as deductibles shift a certain portion of the financial loss ultimately to the Buyer.

3.5.6 Liability Caps

Caps are provisions that set an upper limit on the Sellers' liability for breaches of warranties. Caps provide a clear limit on the Sellers' exposure, helping to manage risk and facilitate negotiations.

There are notable differences in the amount of the liability cap between German and American market practices. In the U.S., it is common to set the liability cap at the purchase price, which is justifiable as the Seller would refund no more and no less than what they received from the Buyer.

In German transaction, the cap is typically expressed as a percentage of the purchase price and varies depending on the nature of the warranties. For example, operational and financial warranties might have a cap of 10-30 % of the purchase price, though there is usually a correlation between the purchase price and the caps, *i.e.*, the higher the purchase price, the lower the cap on this kind of warranties.

In addition, experience shows that in particular private equity Buyers often accept lower caps compared to corporate Buyers. Fundamental warranties, such as title and ownership, may have a cap of 100 % (standard) or (rare in Germany) no cap at all.

3.5.7 Handling of Third-Party Claims

The share purchase agreement should address how to handle third-party claims against the Target Company that might trigger a liability under the Sellers' warranties. Typically, the Sellers may be allowed to take over control of these procedures to defend against the claims, provided they act in good faith and duly consider the interests of the Target Company. However, the Buyer will want to ensure that its interests are protected, including by retaining the right to be informed and consulted throughout the process and to approve any settlements. This balance helps ensure that third-party claims are managed effectively while protecting the Buyer's investment.

However, the Buyer might be reluctant to give control to the Sellers over third-party claims in several scenarios. One primary concern is the potential conflict of interest. The Sellers, aiming to minimize their liability, could prioritize their interests over those of the Target Company, especially if the claim involves sensitive or strategic business matters. Another scenario where the Buyer might be hesitant is when the third-party claim could have long-term implications for the Target Company's reputation or operations. The Buyer, now owning the company, would be more invested in preserving its reputation and ensuring that any resolution aligns with the company's long-term strategic goals. Here, a potential compromise could involve a joint control arrangement, where both the Buyer and the Sellers have a say in the defense and resolution of the third-party claim. This could include provisions for regular updates and consultations, with major decisions requiring mutual agreement. Quite often, for particularly sensitive topics, a Buyer might insist on staying in the driver seat altogether.

3.5.8 Sandbagging and Anti-sandbagging Provisions

Sandbagging provisions allow the Buyer to claim for breaches of warranties even if they were aware of the breach before closing. Anti-sandbagging provisions, on the other hand, prevent the Buyer from making such claims if they had prior knowledge of the breach. These provisions are often heavily negotiated.

In German market acquisition agreements, it is commonly agreed that with the exception of the so-called fundamental warranties (title to share, capacity, no encumbrances, no third party rights, no insolvency and similar) the Buyer cannot bring a claim if they had knowledge of the matter. Relevant knowledge includes positive knowledge and usually also the knowledge the Buyer could have gained from information provided in the disclosure schedules to the share purchase agreement or the data room, provided such disclosure complies with a fair disclosure standard (which then needs to be defined in the agreement).

Here is another noticeable difference between the market practices in Germany and the U.S. While in Germany, anti-sandbagging provisions in form of a data room disclosure with a fair disclosure standard are common, in its 2024 SRS Acquiom M&A Deal Terms Study, the service provider SRS found that the majority of U.S. market M&A deals over the last three years featured a so-called pro-sandbagging clause according to which remedies based upon any breach of the Sellers' warranties and representations will not be affected by any knowledge of the breach acquired by the Buyer or capable of being acquired by the Buyer before the signing or closing date. This is why in U.S. market M&A transactions the Sellers usually provide the Buyer with a very extensive and detailed disclosure letter or disclosure schedules under the merger or share purchase agreement, as according to U.S. market practice usually only the disclosures contained in the disclosure letter or disclosure schedules are relevant for excluding the liability of the Sellers for breach of the warranties and representations.

Indemnities and Disclosure Concepts

Item	M&A Transaction	VC Investment
Losses	<ul style="list-style-type: none"> • More or less broad definition 	<ul style="list-style-type: none"> • Same, sometimes even broader (U.S. investors sometimes insist on lost profits to be included)
De-minimis and Basket	<ul style="list-style-type: none"> • De-minimis often 0.1 % of the purchase price and basket often approx. 1 % of the purchase price • Basket can be a threshold or deductible 	<ul style="list-style-type: none"> • In principle, we see similar provisions. Sometimes investors reject a basket
Consequences	<ul style="list-style-type: none"> • Primarily restitution in kind, otherwise compensation in cash 	<ul style="list-style-type: none"> • Primarily restitution in kind • Thereafter, often either compensation in cash or through shares (compensatory capital increase). Often intense discussions about who can make the choice
Limitation Periods	<ul style="list-style-type: none"> • Title reps often 5+ years • Business and financial reps often 12 to 24 months • Special provisions for tax reps 	<ul style="list-style-type: none"> • Often similar provisions • However, in reality, more often than not the timing of the next financing round will determine the <i>de facto</i> limitation period (except maybe for the title reps)
Disclosure Concepts	<ul style="list-style-type: none"> • Disclosure schedules • Often content of data room shall also be considered disclosed (if fair disclosure standards are fulfilled) 	<ul style="list-style-type: none"> • Disclosure schedules / disclosure letter • Many U.S. and UK investors resist disclosure of the data room and insist on specific disclosures

3.5.9 Limitation Periods

Limitation periods specify the timeframe within which the Buyer can bring claims for breach of warranties. These periods vary depending on the type of warranty.

- **Fundamental warranties** (see above) often have limitation periods of up to five to seven years.
- **Operational and financial warranties** usually have shorter limitation periods, typically one to two years. During negotiations, it is common to agree that the Buyer's claims will only expire after the Buyer has had the chance to independently prepare and audit at least one, if not two, annual financial statements for the Target Company's complete fiscal years.
- **Tax-related warranties** often have limitation periods of three to six months after the final and conclusive/non-appealable assessment (*formelle und materielle bestandskräftige Feststellung*) of relevant tax. That is sometimes combined with a provision that the maximum limitation period shall be five years (plus/minus one year).

These periods provide a balance between giving the Buyer sufficient time to identify breaches and providing the Sellers with certainty about their potential liabilities.

3.5.10 Exclusion of Other Remedies

The parties will seek to agree on a comprehensive legal regime for warranties and remedies in their share purchase agreement. Thus, the Sellers will usually request provisions that exclude other remedies available under German law (other than the claims for specific performance (*primäre Erfüllungspflichten*)). The excluded remedies will comprise claims under the statutory representations and warranties (sects. 434 *et seq.* BGB), and any claims relating to statutory contractual, pre-contractual or quasi-contractual obligations (sects. 280 through 282, 241 and 311 BGB) or frustration of contract (sec. 313 BGB) or tort (sects. 823 *et seq.* BGB).

However, certain circumstances may still allow the Buyer to resort to statutory remedies. For example, if the breach involves fraud or intentional misconduct, the Buyer may have recourse to remedies beyond those specified in the share purchase agreement. One noticeable exception is also the case law existing around the disclosure obligations established by the courts under recourse of the culpa in contrahendo provisions in the BGB (see above under Chapter A.VI.3.4.10.).

3.5.11 Other Provisions

Other provisions related to remedies in the share purchase agreement may impose further limitations, including provisions that the Buyer cannot bring claims for matters for which it or the Target Company has other means of recourse (in particular under insurance policies), or matters that were (economically) reflected in the last financial statements, or a carve-out for future changes in the law or its interpretation by the courts.

3.6 Tax and Other Indemnifications

It should have come across that a smooth and secure transaction is paramount. A key element that contributes to this security is the tax indemnification clause. Start-ups often have intricate financial histories, including various rounds of funding, grants and tax credits. These complexities can lead to potential tax liabilities that may not be immediately apparent. A tax indemnification clause provides clear delineation of responsibilities regarding tax obligations between the Sellers and the Buyer. Allocating the risk of historic tax issues to the Sellers protects the Buyer from unforeseen tax liabilities that may surface after the deal is closed.

A tax indemnification clause typically specifies the types of taxes covered, such as income, sales and employment taxes. It also defines the period for which the Sellers are liable, often covering all tax periods ending on or before the effective date, *i.e.* usually the locked box date or the closing date of the transaction in case of a closing account mechanism. The Buyer will be responsible for any tax liabilities arising after the locked box date or the closing date, respectively. Consistent with the causation principle, a tax indemnification clause typically provides for tax refund provisions entitling the Sellers to claim tax refunds that arise from the period of time before the locked box date or the closing date, respectively. Alternatively, provisions are included that allow for the offsetting of tax refunds against a tax indemnification claim.

A key aspect that requires attention is the close alignment of the tax indemnification clause with the purchase price mechanism. To avoid financial discrepancies, it is crucial to prevent overlap between tax liabilities accounted for in the purchase price calculation and those covered by the tax indemnification clause. Double dipping occurs when the same tax liability is effectively covered twice – once in the purchase price calculation or adjustment and again through tax indemnification. Similarly, double dipping becomes an issue if the Buyer has paid for certain tax attributes of the Target Company that would generally entitle the Sellers to a tax refund.

A tax indemnification clause may, at times, come across as very technical and overly complex; nonetheless, it is advisable to address certain elements, for instance:

- the scope of defenses available for the Sellers against a Buyer's tax indemnification claim;
- cooperation clauses covering sharing of information and documents, filing returns, responding to audits, and handling disputes, among other things; and
- potential application of *de minimis* thresholds, baskets, and caps to tax indemnification claims (typically non-application unless a tax specific W&I insurance is in place).

3.7 Escrow Accounts and Holdback Amounts

Especially in cases where no W&I insurance is taken out, the parties will often negotiate an escrow or holdback of a portion of the purchase price to protect the Buyer from losses due to breaches of the Sellers' warranties, indemnities, covenants, or specified contingencies. We typically refer to "escrows" when the respective amount is deposited into a third-party bank account, whereas "holdback" means that the Buyer simply retains a portion of the purchase price and disburses it at a later date.

In cases where the purchase price is calculated by the closing accounts method, there sometimes is a second escrow or holdback to help protect the Buyer in the event of a post-closing price reduction based on a closing accounts mechanism. In certain transactions, there may also be a special escrow / holdback to protect the Buyer from specific matters, such as pending or threatened litigation.

In the U.S., banks offer escrow accounts. Law firms in Germany usually no longer offer escrow services, though specialized service providers do. More commonly, the acting notary offers escrow accounts.

Here are some of the key issues associated with escrow / holdbacks:

- The amount of the general escrow / holdback for indemnification claims by the Buyer and the period of the escrow / holdback. The typical negotiated outcome is a 5 % to 15 % escrow / holdback for a minimum period of twelve to twenty-four months. It sometimes includes a staged payout scheme, e.g., release / payment of 50% of the escrow / holdback amount after the first twelve months assuming the Buyer has not raised any claims by then.
- If a portion of the consideration paid in the transaction consists of Buyer's stock, the Buyer and Seller will need to agree on whether the the escrow / holdback will be cash, shares or some combination of both. They also will need to agree how and when the shares will be valued for purposes of the indemnity. The negotiation on this topic becomes more complicated if the Buyer's stock is not publicly traded or if the escrow / holdback will include both preferred and common shares.

3.8 Let's Cool Down the Temperature – W&I Insurances

The Concept: As negotiations between the Sellers and the Buyer inevitably heat up once the liability regime of the share purchase agreement is to be created, warranty & indemnity insurances ("W&I Insurance") can help the parties to come to an agreement. W&I Insurances serve as special insurance policies used in M&A deals to cover financial losses that may arise from the breach of a warranty or indemnity given by the Sellers in a share purchase agreement.

While initially introduced to (only) secure the agreed liability package granted by the Sellers to the Buyer, such W&I Insurances nowadays offer synthetic approaches, *i.e.*, they will ensure the risk far beyond what was agreed in the share purchase agreement, which will (of course as a mere side effect) earn the insurers and brokers larger fees.

W&I Insurances have proven to be expedient and helpful to get potential roadblocks and dealbreakers out of the way and facilitate the oftentimes tough negotiations with respect to the liability regime. The number of reported claims per W&I Insurances has increased over the last few years (*i.e.*, quintupled according to certain policy providers, with one of six policies becoming subject to claims). Yet the premiums have decreased to as low as 1 % of the insured amount (the usual range being 1 % to 2 %). The standard retention (*i.e.*, the amount to be borne by the insured party before claims can be recovered under the insurance policy) is as low as 0.25 % to 0.5 % of the Target Company's enterprise value. This is partly due to the increased competition from the many insurance companies that have entered the W&I game in recent years. Another factor: the emergence of new risk areas (e.g., ESG, AI, data privacy, cybersecurity etc.) that need coverage.

The Main Advantages: The goal of the W&I Insurance is to allocate the risks of the transactions between the Sellers and the Buyer safely. That can expedite the signing and closing of the share purchase agreement to get the deal done. The last several years have been a sellers' market. As a result, many Sellers are reluctant to grant extensive warranties, agree to high(er) liability caps, reduce de-minimis and basket amounts or agree on longer limitation periods. Such a "liability gap" caused by fragmental liability regimes for the Buyer can be closed by obtaining extensive W&I Insurance. The risks that will be insured must be doubly unknown, *i.e.*, they must have been unknown before and must remain unknown after due diligence by the Buyer. If they are not, so-called "Contingent Risk Policies" are available as well. Insurers will usually exclude risks of areas that were not examined during the due diligence or matters that the Buyer's deal team had actual knowledge of or that were disclosed by the Sellers during due diligence. This is why the insurer will need to participate in the due diligence process and review the Buyer's due diligence report (red flag being sufficient) shared on a non-reliance basis. The only prerequisite for the insurer's acceptance of the due diligence report is the confirmation by the Buyer that due diligence was carried out as if no W&I Insurance was to be entered into.

From our experience and given the current market situation, sell-side W&I Insurances are rare. We almost always see the Buyer obtaining the insurance. The Sellers can initiate auction processes with several potential Buyers and dictate that a W&I Insurance is to be obtained by the bidders to have a shot for the Target Company.

That way, their own liability can be reduced to a symbolic amount within the relevant clauses of the share purchase agreement (as the insurance will take over the Sellers' place from a liability perspective). Nonetheless, the W&I Insurance is not detrimental to the Buyer's interest. It avoids lengthy discussions about the Sellers' liability, provides for an extensive (synthetic) security and a solvent debtor, and upcoming claims will not strain the relationship between the Sellers and the Buyer (which can turn out advantageous for future transactions). Since the Sellers do not need to worry about liability claims, their lack of knowledge of the day-to-day business of the Target Company (in cases of private equity funds and venture capital funds as Sellers) will be of no further interest and terminated by a clean cut and cash inflow. That can give them peace of mind with respect to the transaction – no escrow accounts needed.

The possibility (or obligation) to obtain a W&I Insurance will help facilitate the transaction (if communicated in a timely manner, preferably up front). The Sellers whose liability will be assumed by the insurer, and the Buyer, whose risk is secured by the same insurer will not invest too much time and effort in negotiating a detailed liability regime. Nonetheless, such liability regime of the share purchase agreement will serve as a starting point for the insurer, subject to synthetic enhancements (*e.g.*, extensions of time limitations, increase of caps, de-minimis and baskets, scrapes of certain qualifiers or disclosures, extensions of remedies, *etc.*) demanded by the Buyer and customary exclusions by the insurer at the same time (*e.g.*, known matters, buy-side and sell-side fraud, forward looking statements, purchase price adjustments, collectability of debts *etc.*). The time saved on liability negotiations will, however, not result in a relief of cost or complexity for the Buyer. They will have to pay the premium, underwriting fee and (if applicable) broker commission while simultaneously conducting negotiations for the W&I Insurance policy with their advisors and the insurer. If the liability regime of the share purchase agreement is reduced to a rather symbolic liability of the Sellers, basically a fully synthetic W&I Insurance must be negotiated. That requires time, attention and money, especially when the Target Company is sold by an insolvency administrator (who is not willing to take any liability) or a large consortium of Sellers (who do not have the same level of knowledge of the day-to-day business of the target).

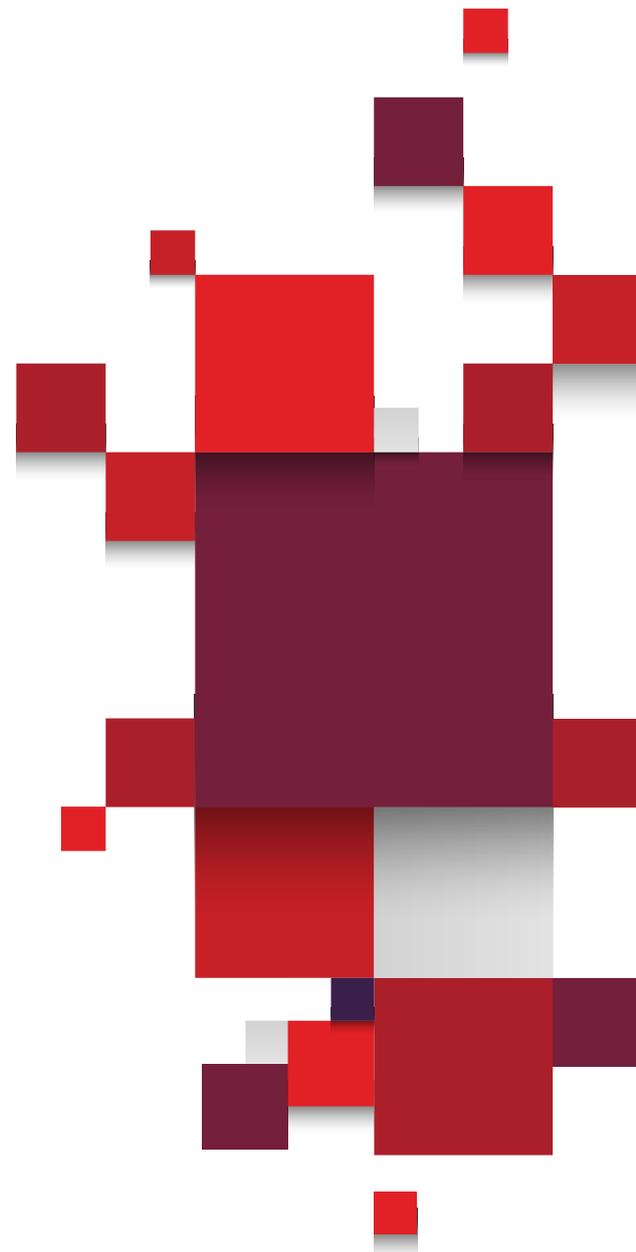
Process Considerations: To avoid jeopardizing the envisaged timeline, the relevant party should reach out to the broker for the W&I Insurance as soon as both sides agree on key transactions terms, such as share purchase agreement warranties, transaction value, and financial limit of cover sought. The broker will circulate a non-binding indications report summarizing the expected W&I coverage.

Shortly afterwards, the broker will approach one or several underwriters to review the underlying due diligence reports (including Q&A sessions with all due diligence advisors) and transactions documents. Next comes the offer of a tailored W&I Insurance policy, which will be placed upon signing of the share purchase agreement. The underwriters' review may take time and will be followed by some comments or adjustments to transactions documents. The W&I workstream should be started as early as possible, considering that a definitive W&I Insurance policy can only be finalized once the transaction documents are final. The coverage will most likely not be identical to the provisions of the share purchase agreement. Some risks may be covered more extensively, while a number of warranties might be limited or excluded. The Buyer will need to decide which risk to take, which provision of the share purchase agreement to re-negotiate with the Sellers, or which part of the W&I Insurance to fight for with the insurer.

Although W&I Insurances are still rather unusual in small-cap transactions (as they are usually capped at a percentage of the enterprise value, e.g., 10 %, while simultaneously providing a floored coverage sum, which makes it less attractive for underwriters to insure transactions below a certain amount), they can come in quite handy, especially for institutional Sellers, when the Target Company is a start-up. Why? Irrespective of the cost for the W&I Insurance, some exit terms in the share purchase agreement are problematic for institutional Sellers. Due to their lack of day-to-day knowledge, they usually have a strong aversion to granting operational or financial warranties or indemnities. They tend to limit themselves to fundamental guarantees (e.g., as in drag-along transactions), which leaves Buyers with less security (potentially reducing the purchase price).

Further, private equity and venture capital funds are eager to have a clean cut after the sale of the Target Company without any restraining potential claims by the Buyer. They have the pressure to provide financial returns to their limited partners. Any hold-backs or claw-backs after the consummation of the sale of the Target Company will keep the funds "hostage." Many funds may "recycle" up to 20 % of the exit proceeds realized in new investments, making escrow or holdback payments particularly unattractive. Even without reinvestment prospects, the delayed receipt of such portions of the purchase price may delay the liquidation of the fund.

Small risks with the potential of severe damages would oblige the funds to preserve large amounts of capital reserves. The W&I Insurance will take over most of these risks, providing the desired clean cut for funds (and the remaining Sellers) which ultimately enables all Sellers to re-invest the amounts received to develop further ideas, business and companies.





IN BRIEF: MAXIMUM SELLER PROTECTION - THE ZERO RECOURSE OR CLEAN EXIT

Given the advantages summarized above, W&I Insurances are a key element for the Sellers to achieve a so-called "zero recourse deal", also known as a "clean exit". This is a type of transaction where the Sellers aim to limit their post-closing liabilities to the greatest extent possible. In such a deal, the Sellers seek to ensure that once the transaction is completed, they have no further obligations or liabilities towards the Buyer. This can be done in particular by a combination of the following:

#1 Limitation of Liability for Warranty Breaches: The Sellers limit the liability for breaches of the warranties given by them under the share purchase agreement to a rather symbolic amount of usually EUR 1.00.

#2 No Subrogation by the W&I Insurance: The Sellers ensure by including a corresponding provision under the share purchase agreement and by reviewing the corresponding clauses of the W&I Insurance policy that the W&I Insurance policy contains an adequate subrogation clause according to which the W&I insurer is not allowed to bring subrogated claims against the Sellers except for fraud and willful misconduct.

#3 Limit Risk of Unsubstantiated Statements: The liability caps agreed under the share purchase agreement and the exclusion of subrogation by the W&I insurer do not apply in case of fraud and willful misconduct by the Sellers. Thus, it is crucial for the Sellers to avoid that any breaches of the Sellers' representations and warranties will be considered as being on basis of fraud or willful misconduct, as this would circumvent the entire liability protection negotiated by the Sellers. In this context, German case law on so-called statements "into the dark" (*Erklärung ins Blaue hinein*) might be a problem. In a nutshell, under such case law any warranties given by the Sellers without performing sufficient previous examinations or verifications might be considered as unsubstantiated statements running the risk of being considered as fraudulent (*arglistig*). The Sellers therefore may want to try to limit the risk that certain of the Sellers' warranties and representations are being considered as unsubstantiated statements by agreeing under the share purchase agreement that the Sellers' warranties are by definition subject to uncertainty and shall serve as a mere risk allocation between the parties only and that therefore under no circumstances any of the Sellers' warranties or representations shall be construed as an unsubstantiated statement under German law (*Erklärung ins Blaue hinein*). It must be noted though that it is not tested yet by German case law whether such clauses under share purchase agreements are actually enforceable as German law generally does not allow to limit the liability for willful misconduct. Further, Buyers may push back on such clauses by arguing that they expect a proper disclosure

process (which includes the exercise of examining and verifying the warranties) and also W&I insurers might be reluctant with respect to these clauses as they usually expect at least some "skin in the game" by the Sellers.

#4 Limit Scope of Sellers' Warranties: Given the uncertainties involved in the context of German case law on so-called statements "into the dark", the Sellers should therefore in any case try to (i) avoid warranties which are generally open to interpretation and difficult to handle from an examination and verification perspective (e.g., warranties on sufficiency of assets or completeness of information), (ii) avoid general warranties if specific warranties can be given (e.g., no general compliance with law warranty if the aim is to only cover anti-money laundering laws), (iii) make warranties subject to Sellers' best knowledge and limit the persons which are considered relevant for Sellers' best knowledge, (iv) include appropriate look-back periods and materiality thresholds, and (v) transfer risk back to the Buyer by agreeing on a data room disclosure and by (fairly) disclosing as much information as reasonably possible in the data room. Synthetic warranties and/or knowledge scrapes to be offered by the W&I insurer might be a solution to cover any resulting gaps regarding the scope of the warranties which will be given by the Sellers and the expectations of the Buyer.

#5 Exclusion of Deemed Knowledge: The Sellers should further aim to exclude under the share purchase agreement the liability for any actions by its performance assistances (*Erfüllungsgehilfen*) (according to sec. 278 sentence 2 BGB it is even possible to exclude liability for willful misconduct of performance assistances) and should also exclude the attribution of knowledge (*Wissenszurechnung*) of co-Sellers and/or third persons to the greatest extent legally possible.

#6 Reverse Indemnity and Waiver of Claims: The Sellers should aim for "locking" the warranty regime through reverse indemnities. This means that the Sellers exclude risks based on pre-closing circumstances which are only identified post-closing through waiver of claims against the Target Company's (former) management, no-claims undertakings and indemnities for claims brought by the Target Company and third parties post-closing (including governmental authorities and insolvency administrators).

#7 Avoidance of Purchase Price Adjustments, Escrows and Holdbacks: Any purchase price adjustments (particularly due to the closing accounts mechanism), escrows and holdbacks will keep the proceeds, which are to be re-invested or paid out to the Sellers' investors as soon as possible following closing of the deal, "hostage" and should therefore be avoided if the Sellers seek for a clean exit.

4. HOW LAWYERS FILL THE (OTHER) PAGES

As one famous investment banker from London once joked: "Why do German lawyers like to add pages to an SPA? Cause nothing spells "thorough" like the notary reading *War and Peace*." Well, nobody actually said that, but we wish someone would have (experience tells us that when the hour of the actual notarization has arrived, investment bankers tend to be noticeably absent). However, we are the first to admit guilt. Lawyers have a surprising and often undervalued talent to come up with a number of further provisions which fill the remaining pages of the share purchase agreement. In this Chapter, we will focus on two topics we consider to be of particular importance: The dispute settlement and the restrictive covenants. We will conclude with a brief discussion of other provisions often referred to as the "boilerplates."

4.1 Dispute Settlement

4.1.1 Resolution of Specific Business Disputes by Expert Determination

The desire to reach an agreement can encourage parties to try to solve problems collaboratively rather than through adversarial litigation, but that spirit disappears as a result of the exit. We see parties in M&A transactions turn to the courts or arbitration tribunals to resolve disputes more often than in venture capital financing rounds. Cases in which the Sellers and the Buyer argue in (arbitral) proceedings may in particular relate to the calculation of the closing accounts (see Chapter A.V.2.3), the calculation of any earn-out (see Chapter A.V.3.), the breach of warranties (see Chapter A.V.3.4.) and the calculation of corresponding damages (see Chapter A.V.3.5.).

For factual questions, like the aforesaid disputes about the "right" amount, the parties should consider having an independent expert make the determination, for instance, an expert nominated by the German Institute of Auditors – *Institut der Wirtschaftsprüfer in Deutschland e.V. – IDW*. It is our experience that expert determination prevents many disputes from escalating into actual litigation or arbitration because once the factual issues have been set aside, most parties can reach a joint understanding.

Under German substantive law, expert determination will be authoritative for any later litigation (or arbitration) between the parties to the extent to which this litigation (or arbitration) relates to the question of fact that has already been determined. This is because the expert determination qualifies as a specification of performance by a third-party (sec. 317 BGB). While the determination on the facts will be binding upon the parties, the expert does not decide on legal claims. The expert's decision will not contain a specific order to any of the parties (e.g., for payment), and also is not enforceable.

A court or arbitral tribunal can annul an expert determination only if it is found to be evidently inequitable or evidently wrong (analogy to sec. 319 BGB). This is a relatively high hurdle, but it may be overcome.

From a practical perspective, the scope of the determination and the expert's powers and duties should be defined as precisely as possible. The share purchase agreement should state that the expert is empowered to decide legal questions that underlie the factual question at hand (e.g., the interpretation and application of German GAAP to determine certain items of the financial statements). The expert should also be required to hear the parties, grant them an opportunity to present their views in writing and to give a reasoned decision. If the parties agree on arbitration proceedings, they should also clarify that the arbitral tribunal shall be competent to decide upon a potential annulment of the expert determination.

4.1.2 General Dispute Settlement and Arbitration Clause

The share purchase agreement should also specify how and where to resolve potential disputes. There are a number of dispute resolution mechanisms. The default option (if nothing else is agreed) is litigation before the ordinary state courts, if and to the extent to which they are competent (usually at the defendant's seat). However, the parties can choose from a variety of alternatives, ranging from mediation (where a mediator assists, on a nonbinding basis, in finding a settlement) to arbitration (where an arbitral tribunal bindingly decides in lieu of the ordinary state courts). In practice, the parties often agree on arbitration as it can offer a number of advantages over state court litigation:

- **Expertise:** Since the parties can select the (independent) arbitrators individually, they can ensure an extraordinary degree of expertise that the state courts will hardly be able to match. This advantage should not be underestimated.
- **Speed:** Arbitration proceedings can be conducted faster. Arbitrators can (and should) be chosen according to their availability. Many arbitral institutions define deadlines for the proceedings to be completed. Arbitral awards (the equivalent to state court judgments) can only be annulled on very limited grounds; there are no appeals on a point of law.
- **Language:** Before state courts, the parties must generally litigate in the local language(s). In arbitration, the parties can select the language of the proceedings and provide for the taking of evidence in various languages.

- **Costs:** Arbitration proceedings are not necessarily less expensive than state court litigations; in fact, in the case of small claims, they may be more costly. Yet, since arbitrations usually comprise only one instance, they may often end up more favorable in the long run compared to state court litigations that may be escalated through appeals.
- **Confidentiality:** Arbitrations are not open to the public, and often the parties agree on the confidentiality of the proceedings in their entirety. The arbitrators are also bound by confidentiality obligations.
- **Enforceability:** State court judgments can only be enforced if the country where enforcement is sought acknowledges and recognizes judgments from the originating country. For instance, Germany will not enforce judgments from India or Liechtenstein (and vice versa), and Austria does not enforce any U.S. judgment in a commercial law matter. Arbitral awards, on the other hand, are almost uniformly enforceable worldwide thanks to the widespread accession to the New York Convention in 1957 on the Enforcement of Foreign Arbitral Awards.

The parties should consider several aspects when drafting an arbitration clause. One involves the applicable rules of arbitration. In Germany, the DIS or ICC rules are usually applied, the latter more often in international technology M&A deals. Parties also must consider the number of arbitrators, the place of the arbitration and the ability to provide evidence in languages other than German.

4.2 Non-compete and Non-solicitation

4.2.1 Non-compete Undertakings

Usually, the Buyer under a share purchase agreement requests post-contractual non-compete undertakings by the Sellers. The goal is to protect the Buyer's investment by preventing the Sellers from starting or joining a competing business, which could undermine the value of the Target Company acquired by the Buyer. These clauses are designed to ensure business continuity and stability by retaining the Target Company's customers and aim at maintaining the goodwill and reputation of the acquired business.

To what extent the Sellers are willing to agree to such undertakings very much depends on the area of business activities of the sold business and the background of the Sellers. It is often also a matter of negotiation power. In fact, the scope of non-compete clauses are usually heavily negotiated by the parties. For example, larger investors who sell their shares in the exit and who did not engage in the day-to-day business operations of the Target Company will usually try to reject any non-compete by insisting on their fund's freedom to invest as it sees fit.

Such argument will be rather difficult for the founder of the Target Company, who has gained deep industry connections and knowledge when being in charge of the business operations of the Target Company.

The non-compete restrictions usually bans the respective Seller from:

- soliciting business from or canvassing any customers or prospective customers of the Target Company in respect of the Target Company's activities within the scope of its business;
- accepting orders from, acting for or having any business dealings with, any customers or any prospective customers in respect of the aforementioned restricted services;
- holding any shares or interests in any entity that is involved in dealing with such restricted services except for equity interests that are held as a financial investment only, *i.e.*, do not give the right, directly or indirectly, to control or exert material influence over the business or management of the respective entity; and
- otherwise operating in the same business activities of the Target Company.

To be valid, the non-compete must be limited to the geography in which the company has business dealings or concrete market-entry plans, among other things. The exact scope, both with respect to business activities and geography covered by the non-compete, is very often heavily discussed and negotiated between the parties and case law in this respect is rather complex. In general, it is important to draft the scope of the non-compete clause as clearly and specifically as possible to avoid ambiguities that lead to disputes and potential unenforceability.

The typical duration for non-compete clauses under German share purchase agreements is usually between twelve to twenty-four months after closing. In general, the duration must be reasonable and proportionate to the interests of the Buyer being protected. German courts will scrutinize non-compete clauses to ensure they do not unduly restrict competition and the Sellers ability to earn a livelihood. A duration that is too long may be deemed unenforceable. German courts have generally upheld non-compete clauses with durations of up to two years. The clauses can last up to three years if justified by the circumstances of a given transaction. An example could involve businesses with very specialized knowledge depending primarily on trade secrets and the know-how of its management and employees. Another example could be a case where the Seller is the founder or a key executive with deep industry connections and knowledge.

To give them teeth and to avoid the Buyer having to prove the exact extent of damages suffered (which might be difficult for the Buyer), breaches of a non-compete are very often also sanctioned by a contractual penalty. The amount of that penalty will depend on the size and nature of the acquired business, the purchase price and the potential damage a breach could cause (there is no fixed standard, but contractual penalties should be reasonable and proportionate to be enforceable in (arbitral) courts). The penalty is usually to be paid per breach of the non-compete, provided that often every two or four weeks of a continuous breach will be considered as a new breach, *i.e.*, triggering the contractual penalty again.

4.2.2 Non-solicitation Undertakings

The Buyer may also request the Sellers to give non-solicitation undertakings. Under such undertakings, the Sellers agree not to solicit and / or entice employees away from the Target Company unless the employee initiates unsolicited hiring discussions with the respective Seller or responds to a general public solicitation by the Seller that is not purposefully directed to the respective employee. The primary goal of such undertakings is to ensure the continuity and stability of the business post-closing and to prevent the Sellers from undermining the value of the business that the Buyer has acquired. Similar to non-compete undertakings, the duration of non-solicitation undertakings is usually limited to a reasonable period, often up to two years following closing, and the non-solicitation undertakings are safeguarded by contractual penalties.

4.3 The "Boilerplates"

We assume that from various venture capital financing rounds or from other venture capital or M&A related transactions, you are already aware that at the end of each long contract lawyers will make sure to add further provisions on general aspects which are (considered) essential for the proper functioning and enforcement of the contract. They are usually referred to as the "boilerplate clauses."

THE ORIGIN OF THE TERM "BOILERPLATES"



Looking for a nugget of wisdom to use at the next closing dinner? You are welcome.

The term "boilerplate" has its origins in the printing industry. In the late 19th and early 20th centuries, newspapers and other publishers used metal plates, known as "boilerplates," to print standard text that was used repeatedly. These plates were often used for syndicated columns, advertisements, or other content that did not change frequently. The term "boilerplate" itself comes from the steel plates used in the construction of boilers, which were durable and standardized.

Come to think of it, lawyers don't get invited to closing dinners a lot...

In share purchase agreements, these include clauses on costs, confidentiality and public disclosures, notices, entire agreement, amendments, assignments, governing law and jurisdiction and severability. We have discussed these provisions in another edition of our Orrick Legal Ninja Series in the context of investment and shareholders' agreements.⁸ Our explanations in that Guide largely apply to share purchase agreements for an M&A exit *mutatis mutandis*. The following two modifications are worth highlighting from our perspective:

- **Costs:** In German share transfer agreements, it is generally standard that any notary fees and other public charges and costs in connection with the signing of the share purchase agreement and the transfer of the shares are borne by the Buyer, while each party shall bear their own charges, costs and fees and those of their advisors. Depending on negotiation power and purchase price, the parties may also agree that notary fees and public charges and costs are borne by the Sellers (or at least a portion thereof), but this is very rare.
- **Governing law:** When agreeing on German law or making clear that German law applies, the parties should exclude the application of German conflict-of-law rules. They should also exclude the application of the United Nations Convention on Contracts for the International Sale of Goods (CISG), sometimes also referred to as the Vienna Convention.

8. See our Guide OLS#9 – Venture Capital Deals in Germany, which can be downloaded here: <https://media.orrick.com/Media%20Library/public/files/insights/2021/OLNS9-VC-Deals-in-Germany.pdf>.

VII. IP and AI Aspects in M&A Transactions

1. THE IP DUE DILIGENCE

As the value of many Target Companies lies to large extent in their IP rights, the Buyer's due diligence of the Target Company's IP landscape is particularly important. The purpose of IP due diligence is to assess the Target Company's IP situation and identify and address potential IP-related risks. This process has two main components:

- **Legal IP Due Diligence:** Typically conducted by lawyers, this focuses on IP ownership, IP licenses and IP infringement risks.
- **Technical IP Due Diligence:** Usually handled by the Buyer's in-house or external technical experts, this may include assessments of the technical merits of the IP, freedom to operate (FTO) searches, validity assessments of patents or software audits.

Being lawyers, we will focus on the legal IP due diligence, leaving the technical aspects to experts with relevant degrees in fields such as physics, biochemistry, mechanical engineering, software engineering or business administration.⁹

The relevant types of IP depend on the Target Company's business. For example, for companies manufacturing and selling innovative hardware, patents, manufacturing know-how, and sometimes design rights are often a top priority. However, for software companies, these types of IP may be irrelevant, with the focus instead on copyrights (e.g., regarding proprietary software, third-party software components, training data for AI models, etc.). Trademark protection can be important for any business with a strong brand and reputation, regardless of the industry.

One of the first items on any Buyer's due diligence request list will be a complete and up-to-date list of all registered IP rights (patents, trademarks, etc.) of the Target Company, as well as a description of all other IP assets that are material to the Target Company's business (e.g., copyright-protected assets such as proprietary software). Providing these lists in reasonable detail early on is generally advisable. Depending on the complexity of the Target Company's IP portfolio and business, proactively providing additional notes explaining the relevance of certain IP assets, the strategy behind the IP portfolio, and the connection between the IP assets and specific products (e.g., a patent-product mapping) can help speed up the diligence process and guide the Buyer's counsel.

1.2 Ascertaining IP Ownership

Once the Target Company's (purported) IP assets have been identified, the Buyer will seek to confirm that those assets are actually owned by the Target Company. This requires establishing a chain-of-title for each asset from the original creators (inventors, software developers, creative designers, etc.) to the Target Company. This exercise is often more complex than it sounds and is where most problems arise in practice.

For registered IP rights (e.g., patents, trademarks), it is important to note that, in most jurisdictions, recording someone as the applicant or owner in a public patent register does not establish actual ownership by itself. Put differently, the Buyer generally cannot rely on the Target Company being recorded as the applicant or owner but will need further proof of ownership in the form of valid assignments from the original inventors or prior owners of the IP rights. You should therefore expect questions about the inventors and their relationship with the Target Company (e.g., founder, employee, freelancer, contractor) and be prepared to provide relevant proof of assignment (e.g., corresponding assignment or purchase agreements).

"In venture capital, we look for start-ups with innovative and defensible IP. A solid IP strategy can be the difference between a successful exit and a missed opportunity."

Brad Feld, U.S. investor and co-author of one of the best books on VC deal making that is out there: "Venture Deals – Be Smarter than Your Lawyer and Venture Capitalist" – a book that has lawyer bashing in its title! Seriously, it is a great resource and highly recommended.

Now that the scene is set, we will delve into the key topics of legal IP due diligence to give you a better understanding of what to expect.

1.1 Identifying the Target Company's IP Focus and Portfolio

Identifying the types of IP most relevant to the Target Company and what IP the Target Company claims to own is the first and fundamental step of any IP due diligence. This sets the groundwork for all further assessments. Any ambiguities can complicate the process, causing the Buyer to ask redundant questions or its advisors to flag non-issues as potential problems. Therefore, we recommend being proactive and transparent in identifying the relevant types of IP and IP assets for the potential Buyer early on.

⁹ You may think that there is no objective justification whatsoever for including business administration in that list, and we cannot blame you for that. However, in our experience, a disproportionately high percentage of company representatives responsible for engaging and arranging for the payment of us lawyers have a BBA or MBA degree. As such, they are absolutely mission critical and deserve every shout-out they can get. They are truly great achievers!

For unregistered IP rights, particularly copyrights, potential Buyers will similarly seek to establish a chain-of-title, except that they will need to rely exclusively on information and supporting documents from the Target Company for lack of any information on public registers. If copyright-protected material such as software is materially important to the Target Company's business, the Buyer's counsel will emphasize identifying who developed that material and ascertaining that there is a comprehensive and well-documented assignment of rights to the Target Company.

Note: Many jurisdictions, including Germany, have specific, complex laws regulating the assignment of rights in copyrights or copyright-protected materials. The contract language required to navigate these requirements and ensure a valid and comprehensive assignment of rights is often elaborate and "legalese." A simple statement like "Company shall own all rights in the software developed by freelancer X" will very often be insufficient and leave the company without critical rights. Therefore, when dealing with copyright-related assignments, especially in connection with external software developers, it is highly recommended to involve specialized legal counsel. Otherwise, you risk facing critical red flags later that may be difficult or impossible to resolve at that point in time.

1.3 IP Licenses and Related Risks

As part of IP due diligence, the Buyer will scrutinize IP license agreements entered into by the Target Company, including both inbound and outbound licenses.

Inbound License Agreements: These agreements grant the Target Company rights to use third-party IP. Due diligence will focus on ascertaining that the license scope fits the Target Company's needs, the license term is sufficiently long for business continuity, the license cannot be terminated due to the contemplated exit (*i.e.*, no change-of-control termination rights) and there are no disproportionate liability risks. The exclusivity of the license and its scope may also be crucial, especially if it relates to the Target Company's core products and technology.

Outbound License Agreements: These agreements grant third parties the right to use the company's IP. Legal due diligence will examine whether the license could negatively affect future commercialization of the licensed IP (especially if rights are granted exclusively), whether the IP remains adequately protected (*e.g.*, in the case of software, whether there is a risk that the third party may get access to source code), and whether the license entails unusual liability risks, such as broad indemnities granted to the third party.

1.4 IP Infringement Risks and Disputes

The legal IP due diligence will also seek to identify IP disputes or potential infringement risks that may pose material financial or operational risks to the Target Company. The Buyer will typically inquire about the Target Company's measures to ensure it does not infringe third-party rights, *i.e.*, its "freedom to operate" (FTO).

Usually, the Buyer will not expect a young technology company to spend tens of thousands of Euros on specialized IP counsel to identify and analyze all conceivable third-party rights. Instead, the Buyer wants to confirm that the Target Company understands the market from an IP perspective, has a good sense of potential risks and risk factors and has implemented policies and procedures to mitigate risk. This may include policies and training for new employees to prevent the unlawful use of trade secrets from former employers or targeted patent searches relating to specific products or technologies before launch.

1.5 A Few Closing Words to our Founder Friends

While mastering legal IP due diligence at the Target Company is not rocket science, it does have its pitfalls. The good news is that these can all be avoided.

The obvious advice is to familiarize yourself with general IP concepts and key dos and don'ts early on to avoid relatively simple but nevertheless painful mistakes, such as using insufficient assignment language with external software developers or not seeking at least basic legal advice when dealing with core IP.

Additionally, taking stock of your company's IP situation to identify and resolve potential issues before the actual due diligence starts makes a lot of sense. However, if you do this, seek guidance from your friendly neighborhood lawyer and curb the "do first and figure out the details later" attitude from your early start-up days. Otherwise, the consequences may be painful, as illustrated by this final real-life example:

Several years ago, a start-up in the field of additive manufacturing solutions (no names mentioned) had grown rapidly into a medium-sized company with international subsidiaries. When major strategic investors showed interest, the management and founder-shareholders decided to clean up and streamline the IP structure, consolidating all IP rights (including a significant patent portfolio) in the parent holding company. They drew up a one-page document assigning all IP rights from the subsidiaries to the parent holding free of charge and began recording the change in ownership in the relevant patent registers. Unfortunately, by agreeing on a free-of-charge assignment, they violated arm's-length principles and created a major tax issue, which was discovered during the due diligence of the preferred investor, causing the investor to withdraw.

2. NEW IN TOWN – THE AI DUE DILIGENCE

The surge in the use and development of AI systems and products, particularly generative AI, has increased interest in investing in and acquiring companies that offer AI solutions or that have integrated AI into their operations.

The EU has recently enacted laws to regulate AI, and many countries are following with their own regulations. However, legislation that has been in place for some time, for example regarding IP, data and trade secret protection, as well as the outcome of lawsuits against generative AI providers, also may impact nascent business models and product development strategies.

Augmenting the other Chapters of this Guide that address due diligence issues, here are seven steps to consider when conducting due diligence on a company that uses AI technologies¹⁰.

#1 Analyze the Target Company's (Use of) AI Technology or Products: Start with some basic questions:

- **It is Artificial; but is it Intelligent?** Determine whether a company's products actually constitute AI. Some (certainly uninterested) industry experts proclaim that every company will soon become an AI company ("A bakery? No, this is a smart AI-enabled ingredients-combination business ready to hyperscale..."). Yet not even all data processing or analytics solutions qualify as "artificial intelligence." For instance, product recommender systems and chatbots can be developed without artificial intelligence. The Sellers should be able to explain if and to what extent a product qualifies as AI. Given the rapid evolution of AI, companies should also evaluate the long-term viability of a Target Company's products and the product roadmap. Consider making this assessment from a strategic and legal perspective.

- **What is the Role of the Target Company:** Ok, so you have determined it really *is* AI. Legal requirements will differ depending on whether a Target Company develops, markets, imports, sells or merely uses AI. While even the mere use of AI by a Target Company can pose risks for a Buyer, the requirements are higher for providers or distributors of AI products. Therefore, check how the Target Company uses AI. A few things to keep in mind:

- Think about integrations of third-party AI. Even if a Target Company does not develop their own AI, it could be considered a provider and thus subject to the full suite of requirements under the EU AI Act if it:
 - ♦ includes third-party systems in its product (e.g. an in-app chatbot supported by GPT) and markets the AI under its own name,
 - ♦ substantially modifies a so-called "High Risk AI System" or
 - ♦ uses it for a different purpose so that it becomes a High Risk AI System.
- A Target Company can take more than one role. While a company may develop an AI solution, it is very much possible that it also uses AI within the meaning of the applicable law.

#2 Protecting Ones' Own: Using AI can pose risks to a company's trade secrets, IP and personal data. Large third-party providers usually reserve the right to use the input themselves to train their AI – and to keep the information for a long (often unlimited) time. Once information has been incorporated into the training data pool in this way, it is theoretically possible for third parties to replicate it randomly or deliberately, or just benefit from the outcome by way of the AI suggesting business activities based on your secrets. This means relinquishing control over the data, potentially losing the protection of your confidential business information as trade secrets. It can lead to legal violations of applicable privacy law. The due diligence will therefore also focus on how the Target Company protects its assets and personal data. Ideally, this should be done by limiting data input. In addition, the use of input by third parties should be contractually excluded.

As with any software, it must be ensured that IP rights for in-house developments actually lie with the Target Company. Remember: In some jurisdictions, algorithms are not protected as copyrights, but only as trade secrets.

¹⁰. Parts of this this Chapter are based on the great blog post "AI in M&A: 10 Things to Consider in Acquisitions" that our partners Julia Apostle, Alexis Marraud des Grottes and Zac Padget published and that can be accessed here: <https://www.orrick.com/insights/2023/09/AI%20in%20MA%2010%20Things%20to%20Consider%20in%20Acquisitions>.

#3 Respecting Others': Vice versa, the due diligence will deal with the question of whether the Target Company may infringe the rights of third parties. With regard to the use of AI, the following questions can arise:

- How does the Target Company ensure the results output by the AI and their use do not infringe on the IP of third parties? This can be done by means of post-checks, the way the results are used or contractual guarantees with the provider.
- How does the Target Company ensure that its own contractual agreements are adhered to? This may relate to compliance with the contract with the provider of the AI, which may prohibit certain types of use. In some cases, however, contracts with customers may also prohibit the use of AI for the services to be provided, or there may be confidentiality obligations.
- How does a company protect customer and other third-party data? The measures are the same as those under #2.

If the Target Company develops or distributes AI, questions also arise about the underlying data:

- Was it acquired legally, *i.e.*, with a sufficient legal basis, and can it legally be used for training?
- Is there a possibility that third parties have rights to this data, and what measures are in place to respect these rights?
- Were systemic risks considered, for example, preventing bias, ensuring sufficient quality of training data, etc.? Depending on the product and the scope of the due diligence, this point may require a more in-depth examination of the product.

#4 Be Aware - No IP Rights for AI-generated Content: It is also important to know that court rulings already state that AI-generated content is not a human creation and therefore does not enjoy copyright protection. Similarly, inventions made by AI generally cannot be patented either. It is therefore important to pay attention to which products, knowledge or (supposed) IP have emerged from AI and whether IP protection has been or can be achieved in other ways.

#5 Checking the Contracts: There are also some special requirements with regard to contracts related to AI.

If the Target Company itself is the user of the AI, the following are particularly important and should be considered as the minimum scope of a due diligence exercise:

- Does the contract oblige the provider to comply with the requirements of the EU AI Act, especially regarding the risk classification and any requirements arising thereof?

- Does the contract or its appendices contain statutory minimum requirements, for example with regard to processing personal data?
- Does the provider guarantee it will not use the input data for itself or others, in particular not for training?
- What representations does the provider give in relation to the results of the AI? What limitations?

Here, too, it is relevant whether the Target Company met contractual obligations.

If the Target Company itself is the manufacturer or distributor of the AI, similar questions arise in terms of content, only these must be considered from a different perspective. However, this depends very much on the specific product or service.

#6 EU AI Act Essentials: The specialty of the house: the EU AI Act¹¹. Even if the contracts ensure that the providers of AI systems comply with all the regulations, a few requirements also apply to the users of AI.

Assuming that the AI in question is not particularly critical, this primarily involves training employees. According to the law, they must have "AI literacy" – they must be aware of the most important contexts, dangers and security measures.

For certain AI-generated content, further transparency obligations must be observed. This applies in particular to AI-generated images and videos, but the use of AI must also be disclosed with regard to certain texts.

When a Target Company is involved in developing or distributing AI, additional checks are necessary. It is crucial to first assess the risk level. Depending on the outcome of this assessment, further obligations may arise. Given the significant risks, and the potential consequences, it is advisable to seek professional legal advice from the outset.

#7 Take into Account Cybersecurity, Performance and Sector-Specific Risks: AI systems pose unique cybersecurity risks (*e.g.*, in the form of software vulnerabilities or susceptibility to attacks). Often, the Buyer will request and review security audits and information on risk mitigation measures the Target Company has adopted.

Similarly, the Buyer is likely to request reports of assessments in relation to AI tools used or developed by the Target Company tied to accuracy, reliability, robustness and bias testing.

Finally, it should be assessed whether any sector-specific laws apply to the use or development of AI tools by the Target Company (for example, specific regulations exist with regard to the financial sector).

11. You can find a comprehensive overview of the scope and consequences of the EU AI Act here: <https://www.orrck.com/en/Insights/2024/10/The-EU-AI-Act-A-Comprehensive-Overview>.

VIII. Privacy and Cyber Aspects in M&A Transactions

1. AVOIDING RED FLAGS

When it comes to privacy and cyber issues, the primary concern in a transaction is assessing and reducing risks. Non-compliance can lead to fines, damage claims, reputational harm, and – in some cases – the inability to offer the Target Company's products and services on the market. Naturally, the Buyer will try to avoid significant privacy and cyber risks. Therefore, having solid compliance measures will simplify negotiations. On the flip-side, a lack of compliance can lead to more due diligence, added contractual complexity and potentially a reduced purchase price. In the worst-case scenario, it might derail the entire transaction.

As part of due diligence, a potential Buyer will pay particular attention to whether the Target Company is on top of its data protection compliance. The risk exposure will depend on the size of the Target Company and how sensitive its activities are regarding data protection. It makes a huge difference whether a company operates in the B2B or B2C sector and whether the business model is data-driven or only processes data of employees and some business partners (such as suppliers). There are also special compliance requirements (and risks) for international businesses.

From a European perspective, it is primarily the GDPR that sets out the requirements, which are then partially supplemented by national data protection laws. These laws are all about personal data.

Remember: this is all information that can be used to directly or indirectly identify a person.

One of the GDPR's requirements is to properly document the steps taken to comply with data protection requirements.

Depending on the size of the Target Company, the following items can serve as a general guideline for a data privacy due diligence.

The Essentials: When engaging in data privacy due diligence, an experienced professional might start with the following basics:

- **First Impressions Matter:** The data protection documents linked on the Target Company's website, visible to the public, hold significant importance. These documents are easily accessible to customers, competitors and authorities, serving as a "figurehead" for the Target Company's compliance. Particular importance will be given to the privacy notice and its quality, as well as the website and the tools used, such as cookie banners. A poorly crafted privacy notice can quickly attract scrutiny from authorities, leading to further inquiries and investigations. It may also deter potential Buyers.
- **Is There a Record of Processing Activities?** This document contains detailed information on all data processing activities, such as the purposes of data processing, categories of data involved, recipients and storage periods. While the GDPR does offer an exception to this requirement for smaller companies, the exemption is tied to additional criteria that are rarely applicable. Consequently, almost every company is obliged to create a record of processing activities.

This record demonstrates that the Target Company is knowledgeable about its data processing practices and serves as a foundation for GDPR compliance, contributing to a positive "first impression." Moreover, the record of processing activities often forms the basis for a Buyer's data protection due diligence, providing an overview of processing operations to assess before acquiring the company.

"The companies that do the best job on managing a user's privacy will be the companies that ultimately are the most successful."

Fred Wilson, U.S. investor

In this Chapter, we present some particularly important aspects of a typical data privacy and cyber risks due diligence. This Chapter builds on and augments other passages on data privacy aspects in M&A transactions (see in particular Chapter A.III.3.1.).

2. DATA PROTECTION

Start-ups do not have a "probation period." They must instead integrate data protection compliance into their business from the beginning. When a company processes the first personal data (of the first employee or the first customer etc.), legal obligations to protect that data come into effect. The more the company grows, the bigger the risk exposure will be. In our experience, data protection authorities typically give a bit more leeway to smaller companies, whereas the larger the company, the stricter the approach of the authorities will become.

- **Review of Existing Contracts:** It's essential to examine to/from which third parties (service providers or customers) personal data is transferred. Do the necessary contracts exist to facilitate these data transfers? Whenever a third party gains access to personal data through the Target Company, or the Target Company obtains data from another party, a data sharing agreement must be in place. This agreement outlines the purpose of the data transfer, regulates the handling of personal data, and specifies the data protection standards that a company must follow. Our attentive readers will remember that at the beginning of this Guide we pointed out that such contracts must also be concluded for the due diligence itself.

If the third party receiving the personal data is located outside of Europe, the GDPR requires one of several "transfer tools" to ensure transferred data maintains the same level of protection as within the EU. It's important to note that access to data from a third country, such as for backups, maintenance and service functions, may already qualify as a third country transfer. In such cases, additional regulations may need to be included in the agreements, unless another transfer tool is in place.

- **Data Protection Impact Assessments:** Are any data processing operations particularly risky for the rights and freedoms of natural persons? In this case, a special assessment may be required, and special protective measures may need to be defined.

- **As Uncle Ben (a wise man from the Marvel universe) put it:** "With great power comes great responsibility." Once a company starts to grow in size, additional requirements become important, including the following:

- **Data Protection Officer ("DPO"):** According to German law, companies with 20 or more employees must appoint a DPO. For this purpose, a suitable individual must be selected who can independently ensure that data processing complies with data protection regulations. Companies have the option to appoint an employee or external expert as the DPO.

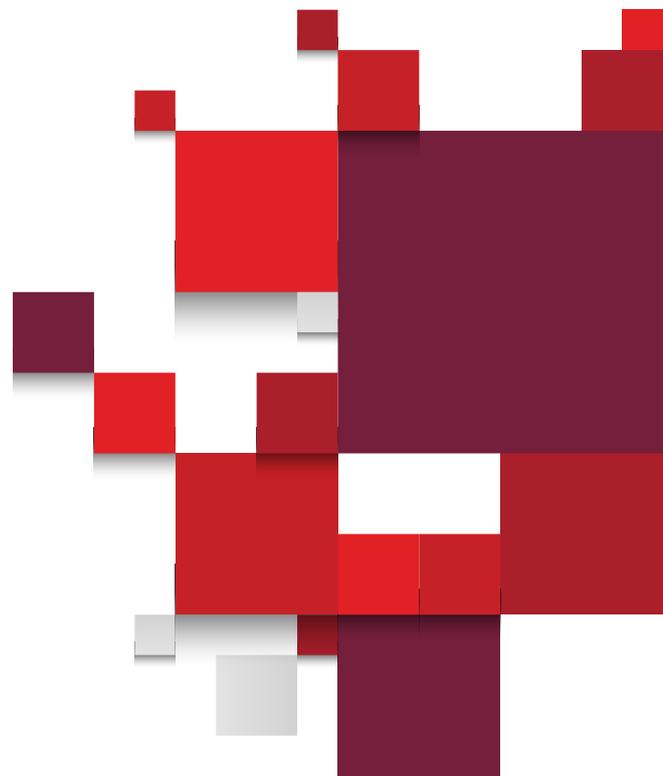
A DPO must possess verifiable technical and specialist knowledge, primarily in data protection law and practice. Additionally, expertise in IT and data security is required. However, such knowledge can also be obtained "on the job" and via training. Importantly, the DPO must not hold a position that could lead to a conflict of interest, as they need to be able to perform their duties independently. For instance, the head of the IT department or a member of the management board cannot serve as the DPO due to their lack of independence.

- **Employee Data Protection:** The larger a Target Company, the more Buyers will pay attention to how it protects employee data. Key points of interest include:

- **Data Protection Training:** Are employees regularly trained on data protection, and is this training adequately documented?
- **Employee Privacy Notice:** Is there a privacy notice for employees? Is this notice provided to new employees at the start of their employment, and is the receipt of this information documented with their signatures?
- **Consent:** Obtaining valid employee consent can be tricky. Where does the Target Company rely on such consent, and how is it obtained?
- **Policies and Procedures:** What policies are in place regarding data protection, such as the handling of personal data by employees? Are these policies up to date?

- **Intra Group Data Flows:** If the Target Company has subsidiaries, the data flows between group companies become relevant: What are the legal bases? Who has access? Are required agreements in place?

- **Rights of Data Subjects:** The GDPR (and also the EU Data Act to some extent, see below) provides for a variety of rights and claims that individuals have against companies processing their personal data. Among others, these include rights of access, rights to erasure, rights to object and the right to withdraw consent to data processing. On a day-to-day basis, larger companies may find it difficult to respond to this volume of requests in a timely and appropriate manner. From a Buyer's perspective, it is therefore important that the Target Company's operating procedures ensure that data subject requests are handled in a compliant manner (correctly and on time) and that appropriate mechanisms are in place.



3. CYBER

General Observations: Given the ever-rising threats in the field of cybersecurity, Buyers are highly cautious about cybersecurity risks, so it is crucial for a Target Company to integrate robust cybersecurity measures from the outset. Measures should be well-documented and clearly defined to demonstrate that the Target Company has thoughtfully implemented appropriate security protocols.

"In today's digital landscape, cyber risks are a critical consideration in M&A deals. Buyers must ensure that the target company has robust cybersecurity measures in place to protect their investment."

John Chambers, Former Executive Chairman and CEO of Cisco Systems

The selection of necessary measures depends on the specific data processing activities. Factors such as the likelihood and severity of risks, as well as the cost of implementing security measures, are considered. These measures can be both technical and organizational.

- **Technical Measures:** Examples include pseudonymization and encryption of personal data.
- **Organizational Measures:** Examples include establishing authorization concepts to ensure employees only access data necessary for their work. Creating awareness of cyberattacks among employees is another critical measure. Employees are often targets of cyberattacks, making regular training and education essential. This training must be clearly documented, allowing the Buyer to easily verify compliance.
- **Incident Response Plan:** Target Companies should also possess a robust incident response plan outlining what to do in case of an incident, and, in particular, who to reach out to. Most mistakes are made during the first phase of an incident, simply because companies don't know what to do, and who to reach out to.

Past Incidents and their Handling: Potential Buyers will also focus on whether the Target Company has experienced any security or data protection incidents. If so, it's crucial to analyze what went wrong. Such analysis allows the Target Company to adapt existing measures and demonstrate to the Buyer that similar incidents are less likely to occur again.

Furthermore, a potential Buyer will pay attention to whether the legal requirements, for example, regarding reporting obligations, have been met in the event of an incident. It is also important to know whether the incident has been closed or whether proceedings are still pending. This information enables a Buyer to realistically assess any remaining (fine) risk and, if necessary, to hedge against it.

By showing it has learned from past incidents and implemented robust measures to prevent recurrence, a Target Company can reassure Buyers of its commitment to security and data protection.

Heads up, Cloud Service Providers: Depending on the business area or offered services, additional compliance obligations may arise from European Cyber Legislation, such as the EU Data Act. This is especially relevant for Software as a Service (SaaS) providers.

Focusing on the EU Data Act: Its aim is to promote a data economy and reduce barriers to switching between data processing services, thereby preventing vendor lock-in effects.

The EU Data Act seeks to make it as easy as possible for customers to change providers. To achieve this, companies will be required to include specific contractual terms in their customer agreements that guarantee the right to switch providers, such as short notice periods for customers. Additionally, technical capabilities must be established to facilitate provider changes and support customers in making the transition.

Most provisions of the EU Data Act will come into force in September 2025. As this date approaches, Buyers are increasingly checking whether customer agreements and technical capabilities align with the EU Data Act's requirements. To stay ahead, Target Companies should regularly review which additional laws may apply to them and implement measures to comply with upcoming legislation from the outset.

4. POST-CLOSING

A Buyer will often want access to the data of the Target Company. Depending on the type of transaction, the data may be sold as an asset, or the Buyer may want to obtain access as a new shareholder. However, the data transfer regulations must be observed. Among other things, a legal basis, transparent information and, if necessary, contractual arrangements are required. Data protection specialists should be consulted to ensure that the data can actually be used.

IX. Regulatory Aspects in M&A Transactions

1. OVERVIEW

Since regulatory filings are usually submitted after signing, some Buyers and Sellers pay little attention to regulatory aspects in an M&A process until late. This can become a problem as regulatory clearances are often required prior to closing of the transaction. Therefore, obtaining these approvals marks a cornerstone on the way to completion of the transaction and could greatly affect its timing.

The primary purpose of regulatory filings is to ensure compliance of the transaction with specific economic or political interests of the relevant jurisdictions.

- Merger control filings are meant to prevent anti-competitive practices and market dominance.
- The FDI review has a political approach and intends to protect the national order and security of a state.
- Finally, a new review based on the Foreign Subsidies Regulation ("**FSR**") can also be mandatory.

The regulatory review process(es) can significantly impact the timing of a transaction, as it is a condition precedent for closing of the deal. Depending on the regulatory filing a clearance may be obtained within one month for merger clearance and two months for FDI clearance. However, if there is an in-depth investigation due to the complex nature of the transaction or insufficient information, the investigation may take significantly longer and closing may only occur "in a land far, far away".

In the worst case such an in-depth investigation bears the risk that regulatory authorities may prohibit the transaction if it is deemed to harm competition or national interests. Such a prohibition can derail the entire deal or at least lead to time-consuming discussions with the authorities about remedies. As you can see, such setting makes it imperative for the parties to carefully navigate regulatory requirements and engage with the respective lawyers early in the process (again, if this sounds like shameless self-promotion, trust your instincts).

2. TOO BIG TO BE ALLOWED – MERGER CLEARANCE

Merger control proceedings mainly determine the economic effects of a transaction on the market. More specifically, competition authorities typically assess the impact of the transaction to avoid a distortion of competition through impediment of competition and / or dominant market positions. Thus, it is necessary to define the relevant markets before assessing whether the transaction may lead to any effects on the respective market. On the other hand, competition law only applies if specific thresholds are exceeded to take into account the size of the parties or the transaction, among other things.

Therefore, the first step is to determine whether the transaction meets the thresholds that necessitate a merger control filing. These thresholds typically involve criteria such as the combined turnover of the merging entities or their market shares. For instance, in Germany, the thresholds are based on the turnover of the companies involved and the value of the transaction¹². A filing is required if the following requirements are met:

- the combined worldwide turnover of the parties involved exceeds EUR 500 million;
- one of the parties has a turnover in Germany exceeding EUR 50 million; and
- another party has a turnover in Germany exceeding EUR 17.5 million or the value of the transaction exceeds EUR 400 million and the target has substantial activities in Germany.

If a merger control filing is required, the process begins with submitting the merger control notification. This comprehensive document includes detailed information about the parties involved, the structure of the transaction, market definitions, competitive landscape, and any potential efficiencies. Upon receiving the filing, the German Federal Cartel Office conducts an initial review. In Germany, this Phase I review takes up to one month starting from the submission of the filing. During this period, the authority assesses whether the merger raises any significant competition concerns and may ask any follow-up questions. These queries aim to clarify aspects of the filing and gather more detailed data for the case team's assessment. It should be noted that any questions from the Federal Cartel Office will not stop the clock meaning that the one-month deadline for a Phase I decision will not be affected by the questions.

¹². Besides turnover or market shares, other factors may kick in as well such as assets, or value of the transaction. Please see p. 42 et seq. of our Guide OLNS#9 – Venture Capital Deals in Germany, which can be downloaded here: <https://media.orrick.com/Media%20Library/public/files/insights/2021/OLNS9-VC-Deals-in-Germany.pdf>.

At the end of the one-month review period, the authority will either clear the merger, allowing it to proceed, or open a more in-depth investigation. The Phase II investigation can extend the review process by several months. This is also why you should think about this topic well before signing to have a sufficient long-stop date.

A closing before clearance of the transaction from the relevant competition authorities (so-called "Gun-Jumping") is prohibited and may lead to severe fines and even unwinding of the transaction. Therefore, a closing condition for merger control clearance is essential to ensure that the deal complies with the relevant laws and regulations. This condition mandates that the transaction cannot be closed until the regulatory authorities have approved it.

3. TOO SENSITIVE TO BE ALLOWED – FDI CLEARANCE

The FDI proceeding is another major regulatory filing to keep in mind. Although this regulatory requirement is not (yet!) as prominent as the merger control proceeding, it has gained more and more weight in recent years (and our experts expect this to be even more important in the future). Several large deals have been canceled due to missing FDI clearance. In addition, the FDI proceeding does not depend on turnover thresholds, but is determined by the activities of the Target Company. Therefore, even a small cap transaction or an investment in a start-up with minimal or even no turnover may require an FDI clearance.

The assessment of whether an investment may threaten the public order or security in Germany is made by the German Federal Ministry for Economic Affairs and Climate Action.¹³ It may be subject to political considerations and the geostrategic interests of several states.

As the FDI proceeding serves the purpose to protect the public order and security of the Federal Republic of Germany, it typically only applies in case of an investment from a non-EU/EFTA investor that acquires more than 10 % of the voting rights in a German company. As already mentioned, the FDI regime also requires one of the sectors listed in the German Foreign Trade and Payments Ordinance (*Außenwirtschaftsverordnung*) to be affected. Such sectors might, *inter alia*, be:

- manufacturing or developing military goods or defense technology (even non-German EU investors are covered in this case);
- critical infrastructure and related software;
- cloud computing services;
- medical products or pharmaceuticals;
- goods that use artificial intelligence;
- motor vehicles or unmanned aircrafts;
- robots;
- IT products; and
- goods for wireless or wired data networks.

These categories are partly applied very broadly. For example, even software theoretically capable of being used in critical infrastructure may be covered by the categories above.

In addition, the Federal Ministry for Economic Affairs and Climate Action has the power to review any transaction leading to the acquisition of 25 % or more of the voting rights and to start an in-depth investigation. Even in this case, the Federal Ministry for Economic Affairs and Climate Action can order parties to unwind the transaction. To avoid this and secure the transaction, it may be advisable to apply for a so-called certificate of non-objection stating that the transaction does not threaten the public order or security of Germany.

Although obtaining FDI clearance may take up to two months, our general experience is that the Federal Ministry for Economic Affairs and Climate Action reviews the filing in a reasonable time. In several cases, the merger control and the FDI clearance are issued at nearly the same time, *i.e.*, within one month after submission of the filings. However, in the case of a Phase II review, this proceeding may take much longer.

Despite this timing, gun jumping of the FDI clearance is not advisable and is even more dangerous than in case of a merger control proceeding. While closing without a clearance may lead to the fines already mentioned above (*i.e.*, monetary fines, unwinding of the transaction or structural interim measures), in case of an FDI proceeding this even constitutes a criminal offense that may lead to a prison sentence for the responsible individuals of the investor¹⁴.

¹³. Please note that other ministries will also be asked for their views, e.g., the Ministry of Defense for any defense related transaction.

¹⁴. Sounds scary? True! But you go to jail only in case of intent (*Vorsatz*). Thus, if you listen to us and are not like Charles Barkley regarding our advice ("I don't care what people think. People are stupid."), you will be fine.

4. TOO MUCH PAMPERED TO BE ALLOWED – FSR CLEARANCE

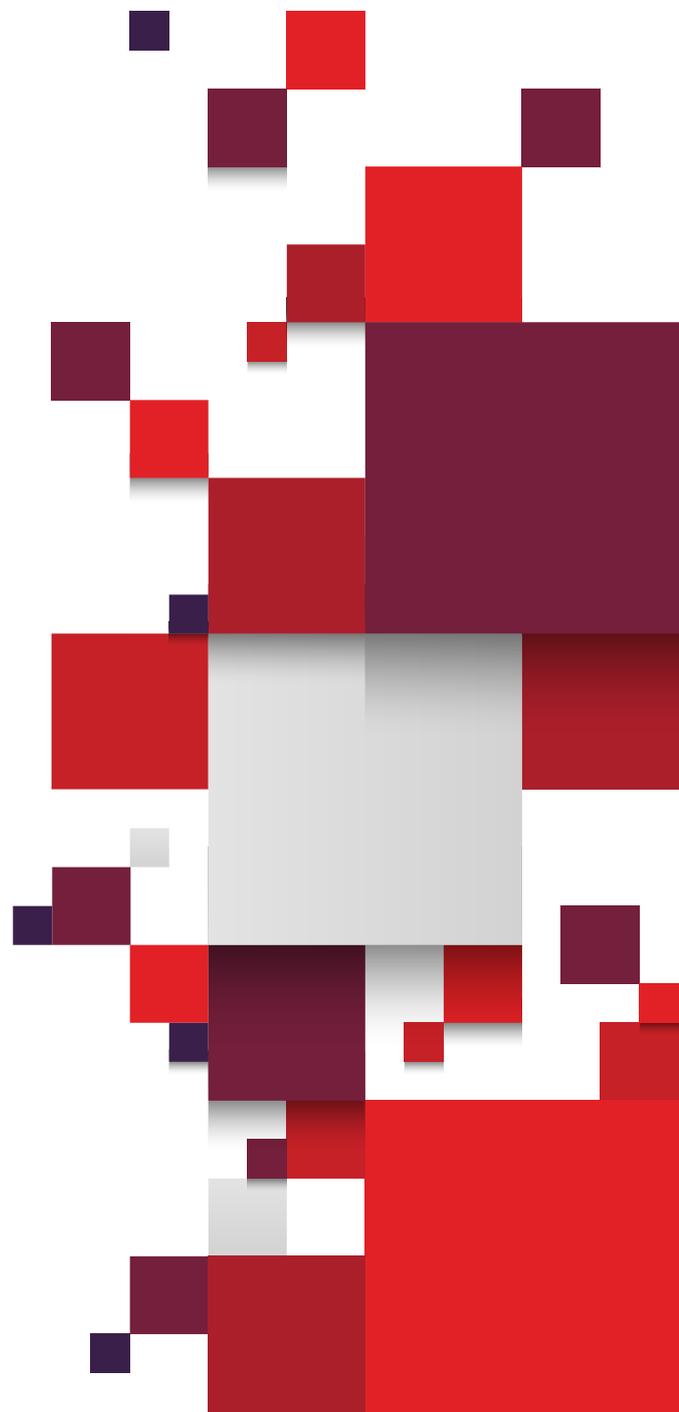
Recently, with the FSR review, the EU has implemented another regulatory filing requirement. As the name suggests, the FSR aims to prevent distortion of the internal market through subsidies provided to companies by non-EU countries. The FSR sets out different instruments for investigating the market. A notification of the transaction is, among other things, mandatory prior to closing if the Target Company generated a turnover in the EU of at least EUR 500 million and the acquirer received financial contributions from third countries of more than EUR 50 million in the last three years.

Along with this requirement for a notification, the European Commission may initiate an *ex officio* review of the transaction and inspects the information related to the transaction. In case of any indication of distortion of the market, this review may be initiated even if the above-mentioned thresholds are not exceeded.

Now, if you think such a decision of the EU would not be relevant for you, beware that the term "subsidies" can have a broad meaning (and gathering the information may really take time...). Also keep in mind that the European Commission may impose fines of up to 1 % of the aggregate turnover of the parties or periodic penalty payments of up to 5% of the average daily aggregate turnover of the parties.

5. OTHER REGULATORY REQUIREMENTS

Unfortunately, the above-mentioned types of regulatory filings are the most common, but not the only ones. For example, in the FinTech and InsurTech space, German law provides for additional approval requirements. In addition, other countries have implemented sector-specific restrictions for investments – for foreign as well as domestic investors. Activities of the Target Company may relate to telecommunication, media, energy, agriculture or other sectors that have been identified as critical for the individual country. However, there are as many different requirements as countries; thus, an exhaustive list cannot be provided here.



X. The Not-So-Fun Exit – Distressed M&A

1. THE INTERESTS INVOLVED

Success for start-ups is often framed as reaching a liquidity event, or exit, that provides financial returns for investors, founders, and sometimes the start-up's employees. On the path to building great companies, entrepreneurs raise rounds of venture financing and assemble a team to develop an innovative product or service that can grow fast. There are two main ways to achieve an exit: go public or sell the company. Most venture-backed start-ups, however, never reach either of these paths; or if they do, it is in a state of distress. While exact numbers are hard to come by, there is widespread consensus that most start-ups fail, *i.e.*, go out of business or are sold for an amount that doesn't provide a return to all shareholders. Founders and investors may not expressly call this a "failure" and indeed may work mightily to find a "soft landing" that allows them to characterize it otherwise.

Selling a Target Company through an M&A deal is generally the first preference for most start-up participants in a venture that does not have a likelihood of continued lifespan as an independent VC-backed start-up.

- Founders and employees might at least be enticed by some deal "carrots" (more on that later) or employment at the Buyer. Some kind of "start-up exit" other than outright bankruptcy will also allow these individuals to craft a narrative of success for their individual career paths.
- Investors might be able to recoup at least some of their investment and redeploy their time and capital into more promising ventures. In addition, investors are repeat players in a dense network, and this form of exit preserves their reputation and relationships in the overall ecosystem better than sending the start-up into liquidation – or even worse, insolvency.

However, such a distressed deal is the end of a journey that may pose some particular challenges to the parties involved. In this Chapter, we will shed light on some of the most relevant issues.

Aligning the interests of all major stakeholders, including common shareholders, early-stage investors and later-stage investors, is critical. This may require extensive communication and negotiation to ensure all parties understand the financial realities and agree on the sale process. Enforcing a drag-along right provided by the Target Company's shareholders' agreement is a legitimate option but one that should come only after the failure of negotiations to align all of the sell-side stakeholders.

2. BRIDGE FINANCINGS PRIOR TO A DISTRESSED EXIT

More often than not, the Target Company will still be loss-making and have negative cash-flows. Thus, securing sufficient liquidity until the deal can close can become an issue when heading into the exit process. However, existing investors might be reluctant to provide a bridge to an exit when the expected exit proceeds will be underwhelming. Major investors will also be aware that smaller or earlier investors might have an incentive to look to them for writing another cheque while themselves adopting a free-rider approach. On the other side, investors who still have the means to keep investing might realize that, while their liquidation preferences will only give them some downside protection, a bridge financing might juice up returns.

Against this background, major investors might be willing to provide bridge financing but only on terms others might consider onerous at the very least. The goals are twofold:

- Incentivize the other existing investors to "do their share." Similar to a pay-to-play down-round, investors who want to benefit from the exit (keep playing) need to pay.
- Even if their prior investments in the Target Company are economically "under water," investors can secure a decent return on the bridge financing round through a multiple liquidation preference on that final investment.

Such exit bridges can come in the form of a straight equity financing against the issuance of senior-ranking preferred shares or in the form of a convertible loan instrument. Irrespective of the form of investment, bridge investors will request special conditions for what they consider an above-average risk with a limited equity upside. This might include, among other things:

- Staged financing depending on the Target Company's financial needs or progress with and status of the exit process.
- 3-5x preferred return for the bridge investors on their investment in the exit bridge.
- The bridge investors may also request that a *pro rata* portion of their existing preferred shares be pulled up into a higher class of shares so that they have a higher chance to participate in the distribution of the exit proceeds through the waterfall.

It will not come as a surprise that experience tells us that discussions about exit bridges can get intense and require careful stakeholder management. Founders and early investors might ask themselves what is in it for them when they must anticipate a large chunk of any exit proceeds flowing to investors of the last bridge financing. In addition, any special treatment of the bridge investors will need to be reviewed from a legal and tax perspective to avoid unpleasant surprises.

In addition, when opting for an exit bridge via a convertible loan agreement, the equity bridge investors need to be aware of the special risks associated with shareholder loans and their repayment and *de facto* repayment. Those risks can arise in the case of a subsequent insolvency of the Target Company within at least 12 months from the date of the repayment or *de facto* repayment (for a more detailed explanation of the underlying issues, please refer to Chapter A.V.6.).

3. ASSET DEAL STRUCTURES

3.1 Asset vs. Share Deals

As always, a distinction must be made between share deals and asset deals in tech transactions. In a share deal, shares in the Target Company are acquired by the Buyer. In an asset deal, the Buyer acquires some or all assets of the Target Company and usually seeks to only assume selected of its liabilities (if any).

A share deal is particularly suitable if the focus is on acquiring all rights and contracts quickly and smoothly. Unlike an asset deal, it does not require the transfer of individual assets (such as IP rights) or contractual relationships. Instead, the legal entity is acquired with all rights and obligations. In general, the processes and day-to-day business are significantly less affected by a pure change of shareholder than an asset deal. It is also not necessary to obtain the consent of contractual partners of the Target Company for the transfer of contracts (although relevant license agreements or R&D contracts may contain change-of-control clauses that might require special attention). The share deal can also be advantageous from the perspective of employee retention, both for the Buyer and the Sellers. On the one hand, the identification of employees with "their" company is usually less affected by a pure change of ownership than in the case of an asset deal. Secondly, a share deal does not involve a transfer of business, meaning employees have no right to object to a transfer of their employment relationship in accordance with sec. 613a para. 6 BGB (more on that in a minute).

An asset deal, on the other hand, can be the method of choice if the Target Company contains business areas or risks that the Buyer does not wish to take over. The asset deal allows cherry-picking, at least to a large extent. This is also associated with increased expense. For example, the assets to be sold must be sufficiently specified and delimited with regard to the principle of certainty under property law. In addition, the consent of the creditor or contractual partner must be obtained for liabilities and contracts assumed in an asset deal, so the takeover is also effective in the external relationship.

3.2 (Distressed) Asset Deal Process Considerations

Acquiring the Target Company's business (or parts thereof) via an asset deal becomes particularly strategic when the Target Company is facing impending or ongoing insolvency. In these scenarios, assets can often be snapped up at bargain prices. If the Buyer swoops in before insolvency proceedings are officially opened, the debts may remain with the Target Company. But beware: there's a catch. If the Target Company still ends up in insolvency proceedings, in particular because the proceeds from the sale don't cover all its creditors' claims, the insolvency administrator could challenge the asset acquisition for disadvantaging creditors and reclaim the assets if they haven't been bought at their fair value. The Buyer would then only get back the purchase price according to the insolvency quota – not exactly a ninja move. So, the Buyer might wait until the insolvency proceedings are underway. In this scenario, the asset deal is handled directly with the insolvency administrator. While the opening of insolvency proceedings can delay the transaction, destroy value in the Target Company's business or cause important talent to move on, it has some advantages, too: In particular that the Buyer won't be on the hook for employee claims that arose before the insolvency proceedings began and that insolvency law provides tools for simplifying personnel reductions.

Given that asset deals, especially in distressed situations differ significantly from "ordinary" M&A transactions, we want to highlight a few key differences and a few challenges of asset deal processes. We start with some general considerations that characterize many asset deal exit processes before presenting some particularities in asset deal transaction agreements.

Time Pressure: Often, distressed asset deals must happen under extreme time pressure with little time or financial possibilities to properly prepare a divestment process with respect to data room, due diligence process or draft transaction agreements. The time constraints will create a lot of pressure to move into full due diligence right away. That often leaves little room for a staged process that seeks to preserve confidentiality unless the bidder is really interested in the acquisition. This can put a lot of pressure on the Target Company's organization and personnel, especially when several business units are meant to be sold to different Buyers more or less in parallel.

(Rationally) Uninterested Shareholder Groups: The purchase price will often not be what parties had hoped for and chances are that most or even all the proceeds will go to the holders of the most senior preferred shares or investors who provided the latest "bridge to exit" financing, often with multiple liquidation preferences (see Chapter A.X.2.). So, if the founders have little to gain and investors will at best get their money back or make a modest return, the question arises: Who shall take the lead on the sell-side and drive the transaction to conclusion?

The problem is that, for most shareholders, doing nothing might seem like a sound strategy, a phenomenon described in organizational behavior as "rational apathy." Where ownership is highly dispersed and no meaningful exit consideration can be expected once the money flows through the waterfall, the perceived costs of involvement outweigh the anticipated benefits. The small shareholders or those with shares at the bottom of the preference stack will rely on others to take on the burden of searching, organizing and negotiating a deal. They assume that other, more significant shareholders or institutional investors will protect their interests, allowing them to "free-ride" on the efforts of others. The problem is that the large VC investors will also have little incentive to dedicate scarce management resources to an activity that will create little value for their LPs (not to mention the general partners' carried interest...).

Depending on the specific circumstances, mitigation strategies might include:

- **Financial Incentivization:** Determining how to allocate proceeds among various stakeholders, especially given the liquidation preferences, is essential. In some cases, it might become necessary to adjust the existing waterfall to bring all relevant stakeholder groups along. This is particularly true for those whose participation in a sale cannot be enforced via drag-along provisions that are standard in most German start-ups' shareholders' agreement, notably the key employees (see Chapter A.X.5.).

- **Concentration of Decision-making:** We consider it essential for shareholders to have at least a tacit agreement on who will lead the negotiations. This will often include the largest institutional investors on the cap table, who will be perceived as the "professionals in the room." Depending on the circumstances, the founders might also play a vital role as they can best present and explain the Target Company's business or play a role in the Buyer's post-acquisition plans.
- **Enhanced Communication:** To the extent the particularities of the exit process (time pressure, confidentiality concerns etc.) allow this, the small shareholders should receive regular information. Comprehensive communication makes it easier for them to stay informed and at least somewhat engaged. It can also reduce potential mistrust of shareholder groups accused of unduly extracting value from the transaction.
- **Reducing Participation Costs:** Participating in the exit process should be as painless as possible for small shareholders. This might include a centralized process to obtain powers-of-attorney. It also might include template powers-of-attorney and administrative support to get them executed in a proper form.

Form Requirements: Unlike the transfer deed for shares in a Target Company organized as a GmbH or an UG (*haftungsbeschränkt*), an asset purchase and transfer agreement usually does not require notarization unless the asset deal extends to (i) real estate or (ii) substantially all assets of the Target Company.

3.3 Asset Deal Contract Issues

Purchase agreements in distressed M&A transactions follow their own rules. As economic considerations have already been discussed before (see Chapter A.V.), we will limit ourselves here to some key considerations around the transaction scope and provisions around risk allocation and some additionally important provisions.

3.3.1 Transaction Scope

In any asset deal, the transaction scope is critical. It is necessary to outline exactly what assets are sold and transferred and what contractual relationships the Buyer will (economically) assume. These sections of the agreement must be meticulously detailed to avoid ambiguity and ensure both parties understand what is included in the transaction.

Assets: The agreement should specify all tangible and intangible assets being sold and transferred. Tangible assets might include equipment, machinery, inventory and real estate. Intangible assets could encompass IP (patents, trademarks, copyrights), software, customer lists etc. Each asset should be clearly identified, and any necessary documentation or registration (e.g., for IP rights) should be addressed. "Catch-all" provisions are possible provided that the acquired assets are identified/identifiable.

Contractual Relationships: The scope should also cover existing contracts and business relationships that are meant to be (economically) assumed (technically, this is not a transfer). This includes customer and supplier contracts, leases, licenses and any other agreements essential to the ongoing operations of the business. The agreement should outline the process for obtaining any required consents from third parties to assign these contracts, as well as the consequences if such consents cannot be obtained. If a consent is rejected, the asset deal agreement can provide for a "synthetic transfer," i.e. that the Buyer shall economically be put in the position the Buyer would be if the consent had been granted. That can also enable the Target Company to fulfill its obligation under the respective contract (the Target Company is still the contractual counterparty but may after the asset deal closes no longer have the means and employees required to fulfill its obligation).

Employment Relationships: If a "business unit" of the Target Company (referred to as a transfer of undertaking or in German "*Betriebsübergang*") is acquired by means of an asset deal, all employment relationships dedicated to that business unit will be transferred to the Buyer by operation of law according to the Acquired Rights Directive (implemented in Germany in sec. 613a BGB).

According to sec. 613a para. 1 s. 1 BGB, a transfer of undertaking is triggered if:

- a whole operation or a separate, organizationally identifiable part thereof;
- is transferred from the seller (note that this would be the Target Company) to the purchaser by means of a legal transaction;
- thereby enabling the purchaser to pursue the same or a similar business purpose without changing the identity of the operation.

Under German labour law, a transfer of undertaking is always subject to the requirement that the economic unit is transferred without losing its identity. The definition of an economic unit normally refers to an operation or part of an operation. The Federal German Labor Court (*Bundesarbeitsgericht*), under the guidance of the European Court of Justice, has developed a test to determine whether a transaction represents a transfer of business under sec. 613a BGB. The test considers seven criteria:

- nature of the business;
- transfer of tangible assets (e.g., buildings, furniture and equipment);
- transfer of intangible assets (e.g., intellectual property rights, good will and know-how);
- takeover of the major part of the employees;
- takeover of customers or suppliers;
- degree of similarity between the products or services before and after the transfer; and
- duration of any interruption of the business.

In each individual case, all these criteria must be considered comprehensively. This means that single criteria may be weighted differently depending on the type of the business in question and not all of them need to be fulfilled.

To enable the employees to consider whether they want their employment relationships to be transferred to the Buyer or to remain with the Target Company, German labour law provides an obligation to inform the affected employees. Either the Buyer or the Target Company, or both jointly, have to inform them in writing prior to the transfer of:

- the date or intended date of the transfer of undertaking;
- the reason for the transfer of undertaking;
- the legal, economic and social consequences of the transfer for the employees; and
- any actions intended to be taken with regard to the employees.

To inform employees, it suffices to send a standardized letter to all employees which as a matter of principle must state the specific circumstances of the transfer of undertaking. Though the employees must be informed in writing, no handwritten signature is required for each letter. Such notification should take place before the transfer of undertaking. After being informed, concerned employees may object to the transfer of their employment relationship within one month upon receipt of the information without giving grounds. As a result of such objection, their employment relationship would remain with the Target Company. The Target Company may terminate the employment relationship for operational reasons if it can prove that the requirements for such termination are met.

The primary purpose of correctly executed notification is to trigger the commencement of the objection period.

Public Permits and Licences: As a general rule, public licences and permits relating to the operation of the business (e.g., building permissions) will be transferred to the Buyer. On the other hand, licences and permits relating to a specific person, especially if a certain kind of knowledge or expertise was a precondition to granting the licence, cannot easily be transferred from the Target Company to the Buyer but might well need to be reapplied and reissued.

3.3.2 Provisions Around Risk Allocation

Risk allocation is a crucial aspect of an asset deal agreement, as it determines how various risks associated with the transaction are distributed between the Target Company (and thereby economically ultimately the Sellers) and the Buyer. This section typically includes representations and warranties, indemnities, and specific risk allocation clauses. By addressing these key aspects in the asset deal agreement, the Target Company and Buyer can ensure a clear understanding of the transaction terms, effectively manage risks and facilitate a smooth and successful transfer of the business.

Representations and Warranties: The Target Company usually provides representations and warranties about the assets being sold, such as their ownership, third-party rights and encumbrances. These assurances help the Buyer mitigate risks related to undisclosed liabilities or defects. The scope and duration of these warranties are often heavily negotiated, with the Target Company seeking to limit their extent and the Buyer aiming for comprehensive coverage.

Indemnities: Indemnity clauses are designed to protect the Buyer from specific risks by obligating the Target Company to compensate for certain losses or liabilities. For example, the Target Company might indemnify the Buyer against pre-closing liabilities, environmental issues or legal disputes related to the transferred assets (provided they are assumed by or can affect the Buyer). The agreement should clearly define the scope of indemnities, the process for making claims and any caps or limitations on the Target Company's liability.

Cherry Picking and Assumption of Risks and Liabilities:

With respect to the acquisition of assets and contractual relationships, the Buyer can "cherry pick," but, as we have described above, when it comes to the transfer of employment relationships, restrictions under German law need to be observed. With regard to the assumption of liabilities and risks, the Buyer will usually assume only those liabilities and risks pertaining to the acquired assets and contractual relationship to the extent they relate to the period after the effective date.

Note that there are certain exceptions under mandatory law. This applies in particular to sec. 75 German Fiscal Code (*Abgabenordnung* - "AO") which addresses the liability of a business acquirer for the tax obligations of the seller (note that this would be the Target Company). Specifically, it stipulates that if a business or a significant part of a business is transferred, the acquirer becomes liable for the seller's outstanding tax liabilities related to the transferred business.

This liability is limited to the value of the acquired assets at the time of the transfer. The provision aims to ensure that tax obligations are not evaded through the transfer of business assets and provides a mechanism for the tax authorities to recover unpaid taxes from the new owner.

3.3.3 Other Relevant Provisions

In addition to transaction scope and risk allocation, several other contract provisions are relevant in an asset deal. These provisions help ensure a smooth transaction and address various practical and legal considerations and include for example:

- **Transitional Services Agreement:** In some cases, the Buyer may require the Target Company to provide certain transitional services to ensure a smooth handover of the business sold to the Buyer. A transitional services agreement outlines the scope, duration, and cost of these services, which might include IT support, administrative services, or access to certain facilities. This agreement helps minimize disruption to the business during the transition period.
- **IP Licensing Agreement:** Licensing can be a strategic choice when the Target Company wishes to retain ownership of certain IP while still allowing the Buyer to use it. This can be beneficial if the Target Company plans to continue using the IP in other parts of its business or if the IP is integral to its core operations. By licensing the IP, the Target Company can generate ongoing revenue through royalties or licensing fees, while the Buyer gains the necessary rights to use the IP in its acquired operations.

4. TAX ASPECTS

A distressed M&A deal comes with its own typical set of additional tax topics. We have already discussed some of them, notably the Buyer's potential liability for certain tax liabilities of the Target Company pursuant to sec. 75 AO. We will limit ourselves in this section to a few others:

- An asset deal is only VAT-exempt if it qualifies as a transfer of a going concern (*Geschäftsveräußerung im Ganzen*); in all other cases, the transaction will be subject to German VAT.
- A very high preferred return on the exit bridge financing may qualify as a hidden profit distribution if and to the extent that the preferred return does not adhere to the arm's length principle. It is advisable to avoid hidden profit distributions as a standard practice, as they can increase the taxable profit of the Target Company and present tax compliance risks. However, in distressed scenarios, these effects may not manifest if the Target Company has a tax contribution account and did not report any distributable profit in the previous calendar year. Under such circumstances, non-arm's length returns may be classified not as a hidden profit distribution but as a tax-free return of capital contributions.
- In case of a distressed share deal exit, accrual of a debt forfeiture tax gain on the level of the Target Company due to a conversion or waiver of economically impaired receivables (resulting from convertible loan agreements, debt financing, etc.) at the time of or prior to the exit. To mitigate a debt forfeiture tax gain, the assumption of the payable by the Buyer and settlement on the Buyer's level may be an option.
- Adjusting the waterfall is a recurring issue in discussions between shareholders/investors of the Target Company. Topics of discussion include upgrades and / or downgrades of the share classes of shares or the reallocation of shares (transfer of shares among the shareholders), e.g., to establish pay-to-play structures or simulate their outcomes economically in a bridge financing. However, adjustments to the waterfall or the cap table lead to shifts in value between shareholders/investors, potentially subjecting them to gift tax. Mitigating gift tax risks often proves time-consuming and complex. Integrating the pay-to-play logic into the bridge financing instrument itself, meaning it is considered within the preferred return/preference of the bridge financing, might offer a favorable alternative risk mitigation strategy.

5. ACQUI-HIRE TRANSACTIONS

Generally defined, an "acqui-hire" is a transaction in which the Buyer's primary (if not sole) objective is the acquisition/hiring of a Target Company's employee talent, usually comprised of its engineering team.

Most acqui-hire targets are early-stage companies that have raised modest amounts of capital through friends and family, convertible debt financings and / or angel or venture capital rounds. They typically face a high degree of uncertainty and risk in developing, financing, and commercializing their technology offerings. Such Target Companies typically have a relatively small employee base comprised of one or two key founders and engineering teams comprised of 5-15 engineers. Most founders of typical acqui-hire targets are aspiring serial entrepreneurs for whom establishing and preserving reputation (within both the technology industry and investor communities) are key motivating factors. Having a transaction that can be characterized as an exit on their resume can provide a psychological reward and enhance reputations for founders and key employees alike. In fact, such founders typically feel a personal responsibility to provide at least a partial return of capital to their early investors or, through a share deal, to enable such investors to convert their investment into an equity interest in a more mature company to keep some "skin in the game" for a potential future return on investment.

- In its purest form, the Buyer has no interest in acquiring the Target Company itself, its assets or business. Instead, the Buyer is seeking to simply hire the workforce out of their existing employment relationships. Such a Buyer typically is willing to pay some consideration to the Target Company to enable it to winddown operations and return some consideration to the Target Company's investors. In exchange, the Target Company will cooperate with the employees' transition. It typically also will provide a general release and waiver of claims against the Buyer pertaining to its employment of the Target Company's engineers, among other things.
- However, in some cases, the Buyer also has an interest in acquiring the Target Company or some of its technology, IP, platform or other business operations.

Accordingly, among the key components of structuring an acqui-hire transaction are:

- determining which employees of a Target Company will be extended offers of employment with the Buyer as well as the salary and equity compensation;
- determining how much, if any, additional "above market" retention consideration will be offered to key employees; and
- the amount and form of consideration (cash and / or stock) that will be paid to the Target Company in consideration for its cooperation in the transition and a release and waiver, in the case of a pure acqui-hire, or in consideration for the acquired assets, in the case of an acqui-hire involving the acquisition of all or some portion of the Target Company's technology, intellectual property, platform or other business operations.

"The first thing to think about when considering selling businesses is that you don't actually sell your company to another company. There is no such thing as a company. It's an imaginary legal construct. There are people who work together as a group, and that means you're going to sell your company to a group of people who happen to work together in a company. [...] When you are sitting across the table from an executive, you have to make them want to like you. Because they might work with you for three years, It's a job interview, simple as that."

Daniel Debow, serial entrepreneur and angel investor

Given the extreme competition for engineering talent in the technology sector generally, acqui-hire targets may have simultaneous interest from multiple potential Buyers. In addition, acqui-hire targets might be open to considering a potential transaction as a "soft-landing" solution to insurmountable and time-sensitive financing, technology development and / or business strategy implementation risks, but have an extreme need for speed in executing on such a solution. Both factors put time pressure on the "acqui-hire" process and emphasize the need for the Buyers to develop efficient processes for identifying, conducting diligence, structuring, negotiating and implementing potential "acqui-hire" opportunities.

6. KEEPING KEY EXECUTIVES ON TRACK IN DISTRESSED EXIT SITUATIONS

In Germany, most employment participation programs have historically been designed as so-called virtual share option programs ("**VSOP**"), sometimes fancifully referred to as "phantom equity." We have dedicated an entire OLN edition to VSOPs and refer our interested readers to that edition¹⁵.

German market VSOPs usually tie the proceeds under the program to the amount received by a holder of a common share in an exit. As a result, "heavy" liquidation preferences can give management pause because their virtual shares are at the bottom of the liquidation waterfall (also referred to as the "liq pref stack"). If key executives can only expect little or nothing under their current VSOP allocations, this might severely impair their morale and eagerness to support the exit process. To have a meaningful chance to unlock any residual exit value, the elephant in the room might need to be addressed. As the late U.S. comedian *Joan Rivers* said: "People say that money is not the key to happiness, but I always figured if you have enough money, you can have a key made."

The considerations set forth below apply equally to a situation where the key executives hold growth or hurdle shares or shares and equity-like instruments (in particular profit participation rights (*Genussrechte*)) issued in accordance with the tax deferral provisions in sec. 19a German Income Tax Act (*Einkommenssteuergesetz* – "**EStG**"). Yet most or all of the exit proceeds typically will flow to the holders of preferred shares to satisfy their liquidation preferences.

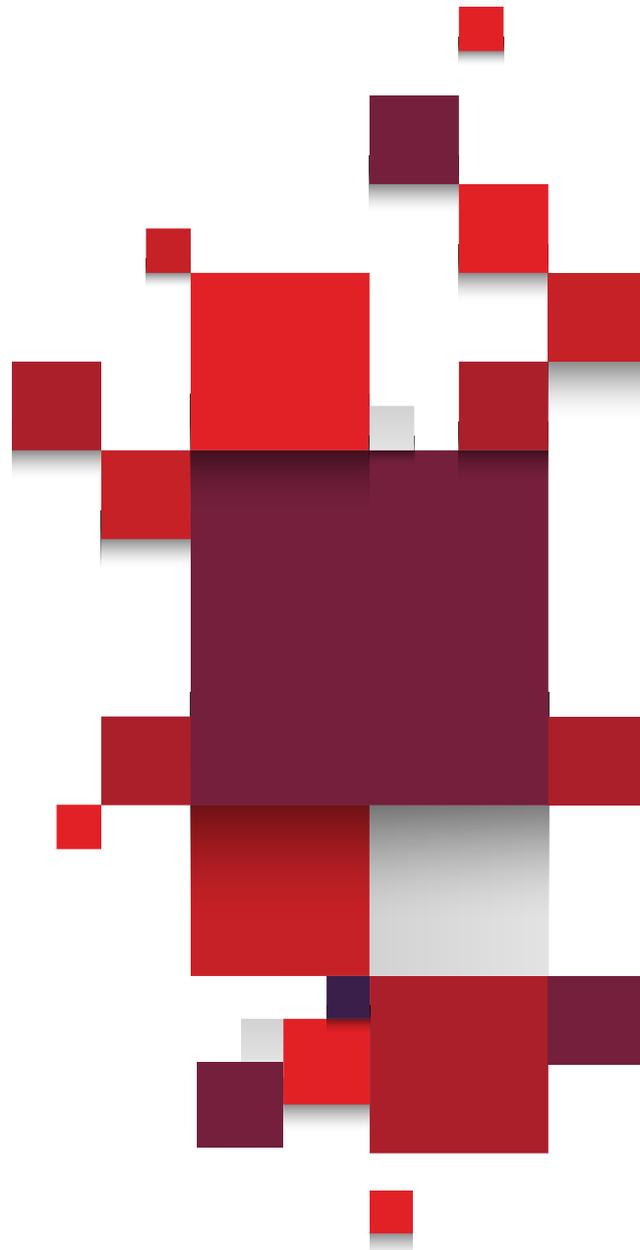
"Reloading" Virtual Shares: For a VSOP, one option could be to "re-load" or reprice the existing virtual shares by issuing additional virtual shares with lower base prices or reducing the base prices of existing virtual shares. However, if the virtual shares derive their value from the purchase price that trickles down to the holders of common shares (as they usually do), this reloading might not be enough if it stands to reason that common shareholders will not get much of the available exit proceeds (in severe cases, they may not get anything). Here are some other tools available in a distressed exit scenario to keep the core managers incentivized:

15. See our Guide OLN#7 – VSOPs, ESOPs and Co., which can be downloaded here: <https://media.orrick.com/Media%20Library/public/files/insights/2021/olns-8-esops-vsops-co.pdf>.

Management Carve-out Plans: One way to provide management an "up stack" incentive at the top of the waterfall is via a so-called Management Carve-out Plan. These plans sit below debt, but above equity or between the most senior equity and the next level(s). They effectively "carve out" value that otherwise would go to shareholders and transfer that value to designated key employees. This is done by providing participants in the plan a right to payments at, and contingent on, a sale of the Target Company or its assets. For reference, in its 2024 SRS Acquiom M&A Deal Terms Study, the service provider SRS found that in U.S. market M&A deals in 2023 about 6.1 % contained some kind of management carve-out plan with an median size of 6.8 % of the transaction value while for 2022 such plans showed up in 3.6 % of all cases but had a median size of 10 % of the transaction value.

Exit Bonuses: A straight-forward and flexible way to focus key executives' attention on the exit and the underlying process is a one-time bonus linked to the success of the exit. These bonuses can be based on targets such as the sale price, timing of the deal or other metrics. This ensures that key employees are motivated to work towards a smooth and successful exit. To accommodate for the famous "extra mile" efforts, we like to add a qualitative element, e.g., a discretionary right of the company's advisory board to increase the bonus amount by a factor of up to 2x or similar. The size of the bonus can correspond to their role and impact on the exit. The bonuses need to be substantial enough to make a meaningful difference to employees.

Retention Bonuses: In some cases, key personnel who are at risk (or financially struggling) may be offered retention bonuses to keep them inside the fold.



XI. Other Practical Issues in Start-up M&A

1. M&A AND EMPLOYEE PARTICIPATION PROGRAMS

1.1 Introduction

Employee participation is a standard feature in German start-ups, and the underlying programs need to be taken into consideration when planning and executing an exit transaction. The issue is that employee participation programs come in a variety of forms in Germany, each with different implications for the exit process.

Virtual Share Option Programs: So far, most German start-ups still rely on VSOPs to incentivize a wider group of employees. The few available surveys (and they date from a time when the tax deferral provisions in sec. 19a EStG were not yet available) indicate that more than 70 % of tech start-ups in Germany that have implemented some form of employee participation programs rely on a VSOP. VSOPs do not issue real shares but attempt to simulate equity-based programs by giving a cash payment claim against the Target Company. In simple terms, the beneficiary receives a payment from the company in case of an exit. The amount is based on, among other things, how much the holder of a common share receives in the respective exit event. These programs are easy to implement and come with lower maintenance and administrative costs. However, payments under VSOPs are subject to the high income / wage taxation and do not allow for capital gains taxation.

Equity-based Programs: More tax-advantageous but also more complex and costly to implement and operate are equity-based programs ("**ESOP**"). These are programs where the beneficiaries get (directly or indirectly) "real" shares in the start-up (or other equity instruments, including profit participation rights). For German start-ups in the legal form of a GmbH, these come primarily in two forms: growth shares and what we call "sec. 19a EStG shares."

Growth shares offer one alternative for key executives to provide beneficiaries with more favorable capital gains taxation while avoiding the dry-income tax issues with share issuances below fair value. They are often referred to as "hurdle shares" and sometimes as "zero shares," "negative liquidation preference (NLP) shares" or "management incentive program (MIP) shares." In general terms, the idea of this special share class can be described as entitling the employees to participate only in the future (incremental) increase of the company's equity value. Growth shares come with a negative liquidation preference. The holders of growth shares participate in dividends or liquidation proceeds only if a certain base valuation of the company (hurdle amount) is reached.

The same conditions apply to the participation of the holders of growth shares in exit proceeds. In practice, the hurdle amount for a growth share is often derived from the company's *pro rata* valuation in the last financing round prior to the issuance of the respective series of growth shares.

When growth shares are issued at their fair value and later sold, the spread between their exit proceeds and the initial acquisition costs ("price" paid by the beneficiary) is subject to favorable capital gains taxation. The (initial) tax burden can be reduced further by holding growth shares through a special purpose vehicle (SPV) in the legal form of a corporation (usually an UG (*haftungsbeschränkt*)), an option that is not available for sec. 19a EStG shares).

Effective 1 January 2024, the so-called Future Financing Act (*Zukunftsfinanzierungsgesetz*) amended sec. 19a EStG to address some, but not all, points of criticism relating to the previous version of sec. 19a EStG. In its revised form, we anticipate that equity-based programs utilizing the tax deferral scheme of sec. 19a EStG will become more popular and thus also play a bigger role in start-up M&A in the years to come.

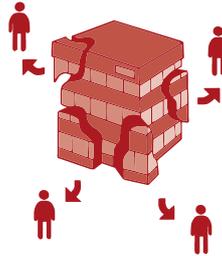
Let us zoom out for a second to provide some perspective. One of the main obstacles with granting "real" shares to employees of a GmbH (other than the persistent governance issues and notarization requirements) is the so-called dry-income taxation. In a nutshell, if employees are granted real shares below their fair value (which is what the parties desire as the beneficiary will usually not be able or willing to make a significant upfront cash investment), this will generally trigger wage tax on the spread between the acquisition price and the shares' fair value upon grant. The beneficiary would be taxed at a time when he or she gets no liquidity. To address the dry-income taxation, growth shares use the hurdle amount to reduce the initial investment requirement and allow beneficiaries to get real shares without triggering dry-income taxation (if they are acquired for their real (option) value).

Sec. 19a EStG offers an alternative. When shares or profit participation rights are issued under the framework of the recently amended sec. 19a EStG to the GmbH's employees, this will not trigger dry-income taxation upon issuance. However, unlike with growth shares, in this case such taxation is only deferred until a time when the beneficiary has (hopefully) received some liquidity. Any increase in value of the sec. 19a EStG shares / profit participation rights following their issuance to the beneficiary are then subject to capital gain taxation.

Employee Participation Models in Germany

Equity-based Programs

- "Real" shares with (usually) voting and information rights as well as right to dividend payments (beyond the hurdle, as the case may be).
- Risk of double liquid / dry and liquid / liquid taxation (except for growth (hurdle) shares and sec. 19a EStG shares).
- "Real" shares with (usually) voting and information rights as well as dividend payments. Notarization for grants of shares required if the start-up is a GmbH or UG. Note that the grant of "mere" options may (subject to certain exceptions) not require notarization. Risk of double liquid / dry and liquid / liquid taxation (except for hurdle or growth shares and sec. 19a shares – which can be tax advantageous). Such equity-based programs are still relatively rare, but recently gained momentum in the form of profit participation rights to be issued under sec. 19a EStG.
- Such equity-based programs are still relatively rare, with the exception of growth shares for a small group of beneficiaries. Sec. 19a EStG shares do increasingly get discussed.



Virtual Programs

- "Virtual" shares:
 - no actual shareholder position; and
 - only entitlement to an economic participation in a future liquidity event (exit or IPO).
- No form requirements for grants to beneficiaries.
- One-time liquid / liquid taxation (high wage taxation).
- In German start-ups, such virtual programs are still the standard as they avoid the governance issues of the equity-based programs and scale better.

ESOPs



Irrespective of their structure as VSOP or ESOP, employee participation programs need to be considered for a successful exit. They will have important consequences on the incentives of various key stakeholders and influence how the exit and in particular the payment of the purchase price should be structured.

1.2 Incentive Considerations for the Sellers

In many M&A transactions, the fact that a Target Company is for sale will eventually leak. There are usually too many people involved to keep an ongoing acquisition process secret for long. The Sellers, particularly the founders, need to have a clear communication plan addressing how to manage uncertainty among their employees. At some point, employees will start wondering what will be in it for them under the employee participation programs and what will come thereafter, i.e., what employee incentivization will look like in the post-merger integration.

VSOPs



Morale and Retention: A Target Company's ESOP and VSOP can be a crucial factor when preparing and implementing a sale of a Target Company. Here are some of the top considerations that should be kept in mind.

The Sellers must understand the vesting schedules, conditions for exit and any acceleration provisions that might be triggered by the sale. In particular, do any unvested shares or options accelerate by their terms as a result of the deal? Some may be subject to a "single trigger" (accelerate solely by reason of the exit deal closing).

Others may be subject to a "double trigger" (accelerate following the closing only if employment is terminated by the Target Company without cause or by the employee without good reason within a period of usually around twelve months following closing). Ensuring that employees perceive the payout as fair is essential to maintaining morale and avoiding disputes. Also, consider how much of the payout will be immediate versus deferred (assuming that a deferral is possible under the plan or can be agreed on a case-by-case basis). This can impact employee retention post-exit.

1.3 Incentive Considerations for the Buyer

The Buyer will also be interested in understanding the existing employee participation programs for a variety of reasons:

- The financial obligations triggered under the employee participation programs will be relevant for its valuation of the Target Company. For example, in the case of a VSOP, the beneficiaries hold cash compensation claims against the Target Company that the Buyer will need to factor into its calculation of the Target Company's equity value. That is true unless the existing shareholders (*i.e.*, the Sellers) have agreed to indemnify the Target Company for obligations under the VSOP (see below for more on the various options or treating VSOP liabilities in an exit).
- The Buyer will also want to understand how much money the Target Company's key employees will pocket in the acquisition. This will help the Buyer determine how to retain such employees. If the Buyer is a financial investor, such as a private equity fund, it will often offer key employees the option of reinvesting or rolling a portion of their proceeds from the employee participation program into a new incentive scheme the Buyer will set up.
- As discussed in another edition of the OLNS¹⁶, employee participation programs can come back to haunt the Sellers if they have a single trigger acceleration (in a sale of the Target Company) or a plan without a claw-back option (in a voluntary early departure of the beneficiary).
- The existing VSOP / ESOP may not align with the Buyer's compensation and incentive structures. This misalignment can lead to challenges in integrating the Target Company into the Buyer's broader organization and culture as the existing compensation packages will be the mental reference frame and point of departure for the Target Company's workforce. The integration plan should include a strategy for harmonizing these incentive structures.

"All-employee acceleration is bad practice because you are sending the message that an acquisition is the end of the road. Buyers would definitely disagree with that."

Dominique Vidal, Partner, Index Ventures

The Sellers also need to consider how the participation programs will integrate into the Buyer's structure and what incentives to offer to retain key employees.

Overall, clear communication with employees about how the exit will affect their participation plans is crucial. This includes timing, how they will be paid out, what will happen to unvested options or shares and what may be on offer from the Target Company's new owners.

Consider Alternative or Additional Exit Incentives:

Under certain circumstances, the Sellers should consider offering additional exit incentives to key employees. Such scenarios might include cases where the key employees have only a relatively small (vested) allocation under the ESOP / VSOP or where it can reasonably be expected that given the investors' liquidation preferences, there will be little to no pay-outs under the ESOP / VSOP (for details see Chapter A.X.5.).

Settlement and Retention Agreements: It's important to avoid arguments about payout sums and mechanisms and, as the case may be, to implement an economic roll-over of a portion of the exit proceeds to be paid out under the ESOP / VSOP or to implement other retention elements. Entering into adequate settlement and retention agreements with key employees is an effective way to achieve that goal.

16. See OLNS#8 – ESOPs, VSOPs & Co., the Guide can be downloaded here: <https://media.orrick.com/Media%20Library/public/files/insights/2021/olns-8-esops-vsops-co.pdf>.

1.4 How to Settle Employee Participation Programs in Case of a Sale

While the treatment of shares issued under an ESOP are relatively straight-forward, there are basically two options to deal with a VSOP.

1.4.1 Settlement of ESOPs

Sec. 19a EStG Incentives: When a Seller sells shares in a GmbH for which they have benefited from the tax deferral pursuant to sec. 19a EStG, there are specific tax implications to consider. We will limit ourselves here to cases where the ESOP beneficiary (directly or through a pooling partnership) sells real shares. The latest variation of sec. 19a EStG incentives, *i.e.* profit participation rights which mirror the economic rights of common shares, follow a similar logic but with some deviations in detail we will point out as we go along.

Sec. 19a EStG provides that taxation on the benefit derived from employee shares can be deferred until a later event, such as the sale of the shares. This deferral is designed to alleviate the immediate tax burden on employees when they receive shares treated as part of their compensation at a discount or free of charge (dry-income taxation). In the absence of the deferral, wage tax would be due on the difference between the amount the Seller paid to receive the employee shares (often the exercise price of the options or the nominal value of the shares) and the fair value of the employee shares at the time of issuance (referred to as "spread"). The Target Company should determine the fair value of the employee shares upon the time of the transfer to the respective beneficiary (the later Seller) carefully (ideally by obtaining a third party appraisal) to calculate the spread. The initial value of the spread represents employment income that has to be recorded in the payroll account. It serves as basis to calculate the amount of social surcharges (which the Target Company will have to pay immediately upon transfer of the shares to the beneficiary).

Profit participation rights suitable to make use of sec. 19a EStG operate similarly to employee shares within the scope of application of sec. 19a EStG. Employees typically need to make a modest cash contribution to the Target Company to obtain the profit participation rights (commonly an amount mirroring the nominal value of a common share with corresponding economic *pro rata* rights). The difference between the amount paid to the Target Company and the fair value of the profit participation rights is the spread referred to above in the context of employee shares.

Wage tax would become due on this spread but is deferred pursuant to sec. 19a EStG. As in case of employee shares, the Target Company has to determine the fair value of the profit participation right upon the time of the transfer to the respective beneficiary (ideally by obtaining a third party appraisal) to calculate the amount of deferred wage tax which has to be recorded in the payroll account and serves as basis to calculate the amount of social surcharges becoming due immediately upon transfer of the profit participation rights to the beneficiary.

The sale of the shares or the profit participating rights, respectively, is considered a triggering event for the deferred wage tax on the spread. This means that the deferred wage tax becomes due at the time of the sale. The wage tax is calculated based on the standard income tax rates applicable to the respective Seller, which can be progressive and reach up to 45 % for high-income earners, plus the solidarity surcharge thereon and potentially church tax. The applicable wage tax amount is subject to the wage tax withholding, *i.e.*, the Target Company is obliged to withhold the applicable wage tax amount from the remuneration paid to the Seller under the employment relationship. If no such withholding is possible (*e.g.*, because the respective Seller is not an employee at the time of the sale any more or the cash wage is insufficient to cover the wage tax liability), the Seller has to provide the Target Company with the applicable wage tax amount. If the Seller fails to do so, the Target Company will report the wage tax shortfall to the tax office to avoid liability. In practice for employee shares, the share purchase agreement will often stipulate that the Buyer, on behalf of the respective Seller by means of an abbreviated payment, shall pay a part of the purchase price that is equal to the amount of the Seller's wage tax liability to the Target Company with debt discharging effect. Employees holding profit participation rights participate in an exit by selling their profit participation rights to certain shareholders (not the Target Company itself) designated by the Target Company (such exit structure will regularly be backed-up by way of a call option to be granted by the respective employee). The Buyer will acquire the shares in the Target Company as well as the profit participation rights from the shareholders (or the profit participation rights will be settled in another form as part of the exit).

As in case of employee shares, the share purchase agreement may stipulate that the Buyer, on behalf of the respective Seller by means of an abbreviated payment, shall pay a part of the purchase price that is equal to the amount of the employee's wage tax liability to the Target Company with debt discharging effect.

Most recently, the law has been changed and the tax deferral privileges of sec. 19a EStG is no longer limited only to the employees of the entity issuing the shares or profit participation rights (*i.e.*, the employees of the Target Company). The legislator has now implemented a so-called "group privilege" and made sec. 19a EStG available for share transfers or transfers of profit participation rights by a Target Company to employees of its subsidiaries.

The incremental value of the shares or profit participation rights after its initial transfer to the Seller will be subject to the more favorable capital gain taxation.

Hurdle/Growth Shares: Growth shares only participate in the proceeds of a sale or liquidation beyond a certain hurdle amount. This means that these shares only receive proceeds after other shareholders have received a certain amount (economically, you can think of this as a negative liquidation preference). The share purchase agreement will usually stipulate a purchase price for each share in the Target Company that gets sold irrespective of what the Sellers have agreed internally regarding positive or negative liquidation preferences. In a second step, the Sellers will usually instruct the Buyer to make payments to them according to the distribution of the exit proceeds following the allocations of positive liquidation preferences (if relevant) and the negative liquidation preferences for the growth shares. The latter usually results in the holders of "normal" shares (or a sub-group) receiving their pro-rata portion of the hurdle amount to which the growth shares are not entitled. Only after the hurdle amounts are surpassed do the growth shares start participating in the distribution of exit proceeds.

German tax law shall recognize the limitation of the proceeds participation of the growth shares and subject the proceeds allocated to the growth shares to capital gains taxation. Likewise, the redistributed hurdle amount shall also be subject to capital gains taxation for the shareholders that stand to benefit from such reallocation.

1.4.2 Settlement of VSOPs

Under a VSOP, beneficiaries have cash payment claims against the Target Company in an exit. One option to deal with these claims is for the parties to treat them as a debt item and have the Buyer deduct such debt item from the equity value that determines the purchase price the Buyer has to pay for the shares in the Target Company. It would then be the Buyer's responsibility to ensure that the Target Company has sufficient liquidity to settle such claims after closing, including any wage tax amounts and social surcharges becoming due at the time of the settlement.

There is some uncertainty whether such treatment might give rise to tax concerns. One could argue that burdening the Target Company with payment obligations under the VSOP might be considered a hidden profit distribution (such payment obligations are triggered by the sale of shares in the Target Company, *i.e.*, a transaction only on the level of the Sellers). The Buyer is keen to avoid any hidden profit distribution by the Target Company since such distributions are not tax deductible as a business expense, which increases the taxable profit of the Target Company. Furthermore, hidden profit distributions are subject to German withholding tax and a non-compliance with this obligation can result in compliance issues. In practice, it is often advisable to have the Sellers assume the obligations under the VSOP with debt-discharging effect before the closing or at least to agree with the Target Company that the Sellers will indemnify the Target Company from all obligations under the VSOP. Economically, this should lead to the same outcome for the Sellers. In the latter case, the Buyer will not deduct the VSOP obligations from the purchase price. Rather, the Sellers will instruct the Buyer to pay a portion of their purchase price in the amount of the VSOP obligations on behalf of the Sellers to the Target Company, *i.e.*, such amount will not end up in the Sellers' coffers but will be received by the Target Company. That will give it sufficient liquidity to make the payments under the VSOP as paying agent for the Sellers and to fulfill its wage tax and social security contributions withholding obligations.

2. SHOULD I STAY OR SHOULD I GO? THE FOUNDER AFTER THE EXIT

There they are now – after years of working weekends, never spending time on vacation or at fancy Mediterranean hotels, missing out on private contacts and celebrations, the founder has finally reached the holy grail of the start-up world – the sale of their start-up, the exit. While some key employees begin pursuing their own business ideas or simply enjoy the afterlife, the Buyer works industriously on the seamless integration of the Target Company into its organization. Alone (and in the best cases, well-compensated) remains the founder, who has had years of purpose and identity snatched in the blink of an eye by signing transaction documents. Yes, we know we are exaggerating but want to make the point clear.

Once the dust of the deal has settled, our founder might be baffled by a new situation as their life – in contrast to other parties in the deal – turns upside down. The fully packed calendar, stressful meetings and short nights have all been replaced by tranquility and (sigh) emptiness. How to fight or even avoid this remorse before it evolves into an existential crisis? While some founders have new business ideas to spend their new earnings on (or have worked on some side projects already), others are just tired of their years of constant grinding. However, most founders are willing to be contractually bound to the Target Company and Buyer and remain active at the Target Company. This might be part of a deal to roll-over a portion of their shares or simply to increase the chances of triggering future earn-out payments. As experience shows, founders staying "onboard" after an exit is a double-edged sword.

Although this is not strictly a legal question, we have seen founders and Buyers have both, good and bad experiences when the founder stays engaged for at least a while after the exit and want to share a few observations in this Chapter.

Two things are certain: There is no "one size fits all" solution and if you start planning your post-exit life early on, you will save yourself a lot of headaches.

Deciding whether to stay on board after the Target Company is acquired is a significant decision. It involves considering multiple factors, both personal and professional as well as the strategic direction of the Target Company. The following factors have proven to be the most crucial when assessing whether to remain in an active management role with the Buyer. They should be considered (at best) during negotiations and (if applicable) reflected in the transaction documents:

- **Vision and Culture:** The parties should ensure that the Buyer's vision and culture align with the values of the founder and the Target Company. A significant cultural clash can lead to dissatisfaction and hinder the Target Company's culture. Shared goals are a must. Is there a commitment to further invest in the Target Company's development or will it be split up to use the desired parts while the rest fall by the wayside?

"Founders staying on can be beneficial if they are passionate about the acquiring company's vision. However, if they are only staying for financial reasons, it can lead to dissatisfaction and a lack of motivation."

Mark Suster, Entrepreneur and Venture Capitalist

- **Role Clarity:** The role and responsibilities of the founder post-acquisition should be laid out up front. Management styles should be addressed and constantly reviewed, although both sides need to adapt and learn from each other. Keep in mind, some founders might not have had a boss for many years or never at all and adjusting to the reality of the corporate world might not be easy.
- **Autonomy:** Will the Target Company remain independent? Are existing processes allowed to continue or will bureaucracy, complexity and hierarchy take over? This could lead to disengagement and frustration of the founder and their team in the larger organization.
- **Career Opportunities:** Potential advancement opportunities and the team integration in the new structure must be evaluated. Similar in-house expertise may lead to potential redundancy. Morale will suffer if valuable team members are excluded from future development.
- **Compensation and Incentives:** To be attractive, the compensation package should include a mix of salary, bonuses, stock options and other benefits. The share purchase agreement will often foresee an earn-out clause, ultimately compelling the founder to at least spend some time within the new structure to get their full piece of the pie.
- **Support and Resources:** The founder must assess the level of support and resources the Buyer will provide: will access to new markets, technologies or expertise that could benefit the Target Company be granted? Network expansion is key.
- **Stability:** After years of professional mayhem, a founder might simply enjoy the financial security of working in a larger organization.

The collaboration between the founder and the Buyer commonly fails if the expectations with respect to the abovementioned aspect are not met. Main reasons are lack of alignment, loss of autonomy and a cultural clash: Differences in growth targets, direction or management style can lead to friction. Founders accustomed to making quick decisions may feel stifled by new bureaucracy or lack of influence. The entrepreneurial spirit of a start-up, its values and priorities may clash with the old-fashioned corporate environment.

Occasionally, the founder is just tired or burnt out and desires new challenges – unpredictable shifts in motivation can never be ruled out.

To avoid a mismatch as much as possible, what measures should be taken when entering into negotiations for the sale and exit of the Target Company?

- **Self-assessment:** The founder must be brutally honest with himself or herself and ask what he or she envisions for his or her (personal and professional) and the Target Company's future. Not every interested Buyer is worth negotiating with. Not every actual Buyer is worth working for post-closing (well, maybe depending on the amount of connected earn-out ...). Not every high-paying contract should be signed at any price. The overall package has to be right.

- **Open Communication:** The founder and the Buyer must maintain open and honest communication to set clear mutual expectations for performance, growth and strategic direction. They should establish regular check-ins to address any misalignments and update the mutual vision and strategy.
- **Clear Contractual Agreements:** Detailed contractual agreements to define roles and responsibilities to (partially) obtain clear autonomy as well as performance metrics are a must. An exit strategy must be included – a clear path for leaving if things don't work out (predetermined timeframe, performance criteria, effect on retention package and earn-out) will most likely avoid lengthy litigation.

Ultimately, whether a founder should stay or leave depends on the founder's vision for their personal life and professional career, the future of the Target Company, and how strongly the founder believes he or she can navigate the corporate landscape while maintaining the spirit of their original venture. The potential benefits and risks must be weighed carefully. It is advisable to conduct a thorough due diligence, perhaps engaging in discussions with leaders of previously acquired start-ups, to understand the potential obstacles firsthand. This preparatory work is crucial to making an informed decision and considering the relevant scenarios when drafting the transaction documents.

As it is put quite perfectly on the website of *Helm*, a community of high-growth founders: "The message seems to be clear. Plan your life after exit as meticulously as you planned the growth of your business. See life after as a serious project that needs proper planning. Talk to others who have been there and done it. Learn the lessons they learned without having to make the same mistake. [...] While for many Founders life begins after exit, it doesn't begin by accident. Applying the same ruthless energy and determination you put towards growing a business to planning what to do after you exit is the best way to make sure you make your exit as successful as your business."

"The decision for founders to stay or leave post-acquisition should depend on their personal goals and the alignment with the acquirer's strategy. Sometimes, fresh leadership is needed to integrate the startup effectively."

Fred Wilson, Venture Capitalist

- **Due Diligence:** The founder has to thoroughly assess the cultural fit before the sale and discuss integration plans. The founder also has to engage in discussions to understand the Buyer's culture, values and leadership style and conclude whether there is a realistic chance to preserve (or at least not entirely lose very quickly) the culture of the company they have built.

3. THE LARGE CAP TABLE – SELLERS' REPRESENTATIVES

The Idea: In the years since incorporation, numerous financing rounds typically have been carried out. New investors became shareholders. Other shareholders have gone. The initial cap table usually included only the founders (or – preferably – their founder holding entities). It also may have included business angels and other early believers such as university professors and/or beloved family members like the proud grandma who wrote the very first check of EUR 10,000.00 to help give their favorite grandchildren the much-needed starting money (and to secretly reserve a spot in their soon-to-be-developed space capsule). Years later, the cap table of a well-funded start-up with financing rounds from seed to series [D+] can resemble a multi-faceted group of 50+ shareholders.

While it is already difficult to liaise with so many shareholders with respect to the occasional financing round during the Target Company's growth phases due to different time zones, personal schedules and cultural differences, at least in such situations, their interests should generally align. However, this might be different after the transaction has been signed and any Buyer will have a strong preference not to have to deal with (and potentially go after) numerous parties. To streamline the process, selling shareholders should appoint one "Sellers' Representative" to act on their behalf as a "middleman." So, what does a Sellers' Representative actually do? And who qualifies for the job?

Typical tasks include monitoring deal terms and key dates; negotiating with adverse parties in case disputes arise; tracking payments, milestones and individual (shareholder) allocations; adjusting and fine-tuning the purchase price based on updated accounts (in case of a closing account purchase price mechanism) and providing status updates to shareholders. In short: the Sellers' Representative makes sure the deal is pushed over the finish line while monitoring the Sellers' interests in the period thereafter.

If there are only a few shareholders or post-closing interactions with the Sellers seem unlikely (e.g. because the warranties are backed by a W&I insurance and there is a locked box purchase price), a Sellers' Representative might not be required.

Who should Become Sellers' Representative?

Traditionally, the role of a Sellers' Representative is filled by one of the Target Company's significant shareholders. However, shareholders often tend to hastily appoint one member of the management board or pick one of the institutional investors out of their cap table, as – apparently – they know the Target Company and the cloak-and-dagger game of tech company M&A and therefore should be a good fit. But is this really a good idea? Is this really what to look for in a Sellers' Representative? One thing is for sure: the person to be appointed should have experience in M&A deals, their dynamics and their technical set up. For founders, this may be the only sale during their lifetime. Apart from that, the interests of the various Sellers might not be fully aligned (e.g., holders of preferred shares and holders of common shares might be treated differently) and conflicts of interest might arise. And besides: what institutional investor has the time to deal with post-signing matters when the next ventures await?!

Choosing the founders as a representative may also present difficulties. When a Buyer decides to keep the Target Company's executives and management after the deal closes (including the founders), it's like mixing oil and water – a conflict of interest is practically guaranteed. Imagine this: a potential claim pops up about a breach of a warranty after the ink dries on the share purchase agreement. Now, those founders find themselves in a pickle. Do they champion the cause of the Sellers, or do they shy away from ruffling feathers with their new boss? Spoiler alert: they probably won't be too eager to bite the hand that feeds them.

Sellers in U.S. transactions have found it attractive to hire professional outside firms (such as Shareholder Representative Services or Fortis Advisors) that specialize in fulfilling the role of a Sellers' Representative and we have seen such structures in deals involving German Target Companies. Where such a professional representative is appointed, a special fund, established with a portion of the purchase price proceeds, is set aside to provide the representative with a source of funds in case the representative needs to retain counsel or other advisors (or expert witnesses or forensic accountants in pricing disputes) to defend an indemnification or price adjustment claim made by the Buyer post-closing. For a one-time fee (instead of the unholy hourly rates of greedy lawyers) these professional representatives offer to take over the administrative burden related to the post-closing phase.

They give an unbiased perspective, grant relief from time-consuming tasks and provide years of experience and security with their commitment, resources and unrestricted attention to the deal. They help maximize the Sellers' return while minimizing their need to personally engage. The fear of losing control of some restless shareholders is mitigated by integrating an advisory committee which is the binding element between the Sellers and the Sellers' Representative competent for certain important decision-making.

Terms of Engagement: When engaging with such professional Sellers' Representatives, a thorough read of the engagement agreement is a must. Look out for the following key terms:

- **Rights and Obligations; Power of Attorney:** The accuracy of specified rights and obligations of the Sellers' Representative varies from detailed catalogues to one broad clause within the recitals, granting the right to "pursue causes of action that arise in connection with the share purchase agreement." The exact scope of such rights and obligations is subject to trade-offs: While shareholders potentially desire to reduce the power of the agent to remain in the driver's seat to the greatest extent possible, this – obviously – interferes with the Buyer's general interest to talk to a Sellers' Representative with as much power as possible.

Parties should at least grant an explicit power of attorney to the Sellers' Representative by which a minimal scope of duties can be stated. Make sure to deal with the restrictions of sec. 181 BGB.

- **Engagement Fee and Reimbursement for Expenses:** The Sellers' Representative will be entitled to receive a one-time engagement fee, frequently ranging from EUR 25,000 to EUR 100,000.00 (exceptions apply). They shall be reimbursed for expenses, such as for work with lawyers or consultants. Such expenses will usually be borne by the Sellers' *pro rata* to their portion of the purchase price.
- **Decision Making; Advisory Committee:** A clear chain of command should be included. As with rules of procedure, the Sellers' Representative actions should be subject to clear instructions or broad directives by the Sellers. An advisory committee can be installed, consisting of a handful of Sellers.

- **Information:** Both Sellers and the Sellers' Representative should be subject to information obligations, so all parties involved have all the information necessary to make well-informed decisions.
 - **Limitation of Liability:** The liability of the Sellers' Representative will usually be limited to gross negligence (*grobe Fahrlässigkeit*) and willful misconduct (*Vorsatz*).
 - **Term, Resignation and Assignment:** The term will usually be roughly described as "until the deal is done." With a short notice period of often only a few weeks, the Sellers' Representative is entitled to resign (reducing their engagement fee). Assignments of the responsibilities of the Sellers' Representative will often need to be coordinated with the Sellers and might require the approval of a majority of the Sellers (based on their prior shareholdings in the Target Company or similar).
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B. Our International Platform for Technology Companies



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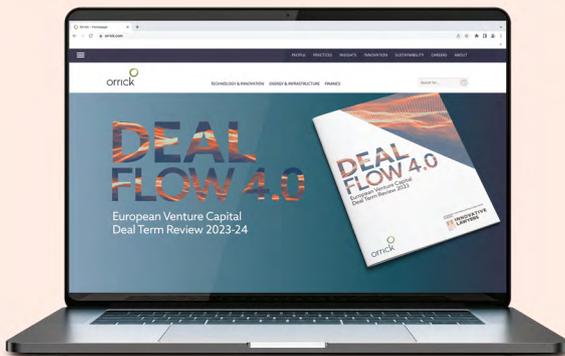
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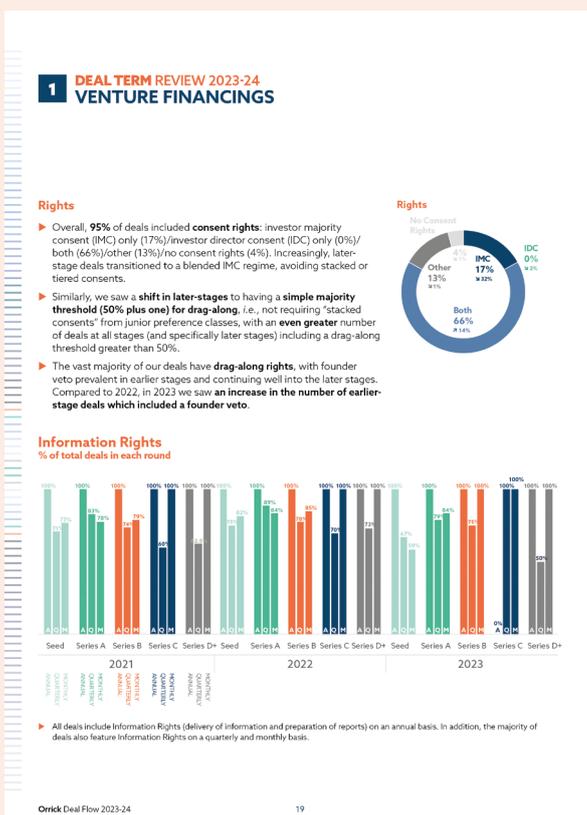
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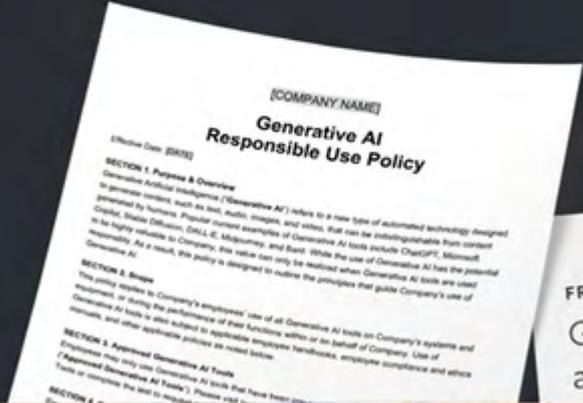


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OLNS #1 – Venture Debt for Tech Companies

May 2019

Venture Debt is a potentially attractive complement to equity financings for business start-ups that already have strong investors on board.

This is a highly flexible instrument with very little dilutive effect for founders and existing investors.



OLNS #5 – Venture Financings in the Wake of the Black Swan

April 2020

In the current environment, all market participants, and especially entrepreneurs, need to be prepared for a softening in venture financing and make plans to weather the storm. In this guide, we share some of our observations on the most recent developments and give practical guidance for fundraising in (historically) uncertain times. We will first provide a brief overview of the current fundraising environment, and then highlight likely changes in deal terms and structural elements of financings that both entrepreneurs and (existing) investors will have to get their heads around.



OLNS #2 – Convertible Loans for Tech Companies

August 2019

Due to their flexibility and reduced complexity compared to fully-fledged equity financings, convertible loans are an important part of a start-up's financing tool box. In a nutshell: a convertible loan is generally not meant to be repaid, but to be converted into an equity participation in the start-up at a later stage.



OLNS #6 – Leading Tech Companies Through a Downturn

May 2020

Steering a young technology company through a downturn market is a challenging task but if done effectively, the start-up can be well positioned to benefit once the markets come back. While OLNS#5 focused on raising venture financing during a downturn, in this guide, we want to give a comprehensive overview of the legal aspects of some of the most relevant operational matters that founders may now need to deal with, including monitoring obligations and corresponding liabilities of both managing directors and the advisory board, workforce cost reduction measures, IP/IT and data privacy challenges in a remote working environment, effective contract management and loan restructuring.



OLNS #3 – Employment Law for Tech Companies

January 2023 - updated and expanded edition replacing the 2019 edition

Young technology companies are focused on developing their products and bringing VC investors on board. Every euro in the budget counts, personnel is often limited, and legal advice can be expensive. For these reasons, legal issues are not always top of mind. But trial and error with employment law can quickly become expensive for founders and young companies.



OLNS #7 – Flip it Right: Two-Tier U.S. Holding Structures for German Start-ups

July 2024 - updated and expanded edition replacing the 2021 edition

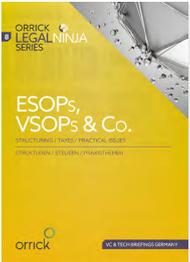
Operating a German technology company in a two-tier structure with a U.S. holding company can have great advantages, most notably with respect to fundraising in early rounds and increased exit options and valuations. However, getting into a two-tier structure (be it through a "flip" or a set-up from scratch) requires careful planning and execution. This guide shows you what to consider and how to navigate legal and tax pitfalls.



OLNS #4 – Corporate Venture Capital

March 2020

Corporates are under massive pressure to innovate to compete with new disruptive technologies and a successful CVC program offers more than capital - access to company resources and commercial opportunities are key features that justify CVC's prominence. This guide serves to share best practices for corporates and start-ups participating in the CVC ecosystem and also to ask important questions that will shape future direction.



OLNS #8 – ESOPs, VSOPs & Co.: Structuring / Taxes / Practical Issues
June 2021

OLNS#8 provides a comprehensive overview of equity-based and Employee-ownership programs (or in short "ESOPs") play a critical role in attracting and retaining top talent to fledgling young companies. Stock options reward employees for taking the risk of joining a young, unproven business. This risk is offset by the opportunity to participate in the future success of the company. Stock options are one of the main levers that start-ups use to recruit the talent they need; these companies simply can't afford to pay the higher wages of more established businesses. With OLNS#8, we want to help start-ups and investors alike to better understand what employee ownership is, structure them in a way that is congruent with incentives, and implement them cleanly.



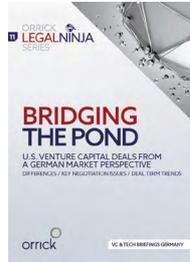
OLNS #9 – Venture Capital Deals in Germany: Pitfalls, Key Terms and Success Factors Founders Need to Know
October 2021

Founding and scaling a tech company is a daunting challenge. OLNS#9 summarizes our learnings from working with countless start-ups and scale-ups around the world. We will give hands-on practical advice on how to set up a company, how (not) to compose your cap table, founder team dynamics and equity splits, available financing options, funding process, most important deal terms and much more.



OLNS #10 – University Entrepreneurship & Spin-offs in Germany - Set-up / IP / Financing and Much More
November 2022

German universities are increasingly becoming entrepreneurial hotbeds, but university spin-offs face some unique challenges. OLNS#10 helps founders by providing them with an overview of how to get a university-based start-up off the ground. We will discuss founder team composition and equity-splits, the cap table composition, important considerations for the initial legal set-up (founder HoldCos and U.S. holding structures) as well as financing considerations. We will also return again and again to the specifics of IP-based spin-offs, especially when it comes to how a start-up can access the university's IP in an efficient manner.



OLNS#11 – Bridging the Pond: U.S. Venture Capital Deals from a German Market Perspective
August 2023

Venture financings and deal terms in the U.S. and in Germany have many similarities but there are also some differences. To help navigate these challenges, we have put together OLNS#11. The guide offers founders and investors with a "German market" background an introduction to U.S. VC deals and helps them understand where U.S. deals differ from a typical German financing. OLNS#11 also augments and builds on OLNS#7 that explains how German founder teams can get into a U.S./German holding structure.



OLNS#12 – Advisory Boards in German Start-ups: Role / Duties and Liability / Best Practices
November 2024

Advisory boards are a standard corporate governance feature and its start-up specific tasks develop over time when the company matures. OLNS#12 summarizes the role of the advisory board, duties and liability risks, practical guidance regarding its appropriate size and composition and gives best practices for a functioning advisory board. Throughout the guide, experienced investors and founders share their lessons learned when it comes to board competencies and how best to deliver value. In addition, this guide presents the first results of the OLNS Board Study 2024/2025, an empirical study on the size and composition of advisory boards in the various financing stages of more than 2,900 German start-ups.

In addition to the in-depth publications of the Orrick Legal Ninja Series, in our **Orrick Legal Ninja Snapshots**, we pick up on the latest developments and provide you with quick, digestible insights into current legal issues that are highly relevant to the German venture/tech ecosystem. Click [here](#) to find out more and follow our *Orrick Germany* LinkedIn page to keep up to date with future issues.

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