INFORMATION FOR DIRECTORS AND SUPERVISORY BOARDS

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MANAGEMENTLTR

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DUE DILIGENCE

Our comprehensive review of the economic, legal, tax and financial situation

FOR BUYERS

Meticulous and reliable audits by our experts in advance of planned corporate acquisitions

FOR SELLERS

Effective preparation for the sale process by our experts

DUE DILIGENCE

Identification of risks in transaction processes and the appropriate response.

BUYER DUE DILIGENCE

A buyer due diligence audit is a careful evaluation of an acquisition target by the buyer or their advisers. Potential buyers generally already have a pretty good idea of the target company's situation before they express an interest, but there will always be information that isn't publicly disclosed and presumed known facts may not actually be accurate.

A due diligence audit always aims to establish whether the target company is a 'good fit'. It particularly focuses on identifying any risks associated with the target company which the buyer might want to use as a bargaining point for a lower purchase price. In the worst-case scenario they can also be deal breakers. The scope of the audit can vary depending on the buyer's requirements, which should always be discussed in detail by the buyer or seller and their advisers beforehand to ensure that the audit delivers the desired results.

In practice, the most relevant due diligence audits are the financial, commercial, tax and legal audits. More specific audits, such as technical, IT, environmental and insurance due diligence audits, can also be performed if the company's size and business model makes them necessary.

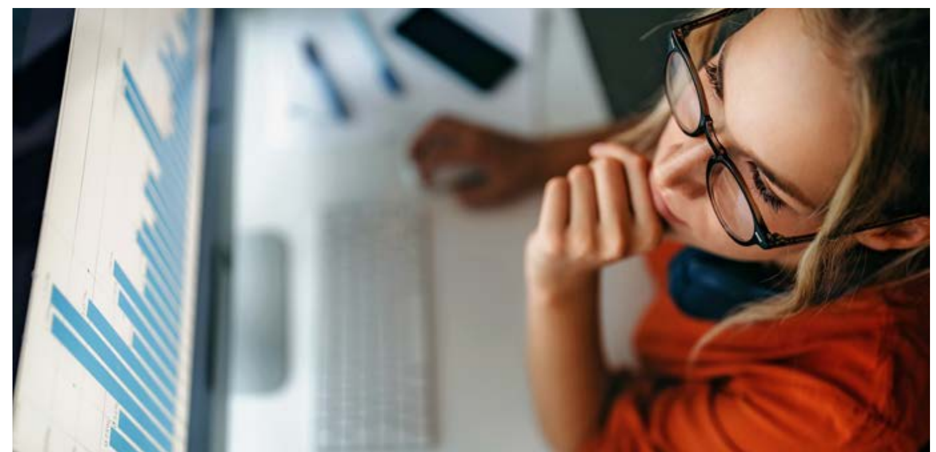
Legal significance: Is there a (de facto) obligation for a buyer to implement a due diligence audit?

It's up to the buyer whether to perform a due diligence audit or not, especially if that buyer is a company owner or sole shareholder. The situation is somewhat different for the managing director of a limited liability company (German GmbH), who is bound by statutory requirements and rules of procedure in their decision processes.

In certain circumstances the buyer due diligence audit is a customary business practice in M&A processes. This factor should be taken into consideration in the interpretation of legal standards if no due diligence audit is performed. In actual fact, however, due diligence audits are commonplace today, although it is debatable whether they should be considered a customary business practice for this reason.

Section 43, paragraph 1 of the German Limited Liability Companies Act ***(Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG)*** stipulates that the director of a German GmbH must manage the company's affairs with the due diligence of a prudent businessman. This section also states that 'directors who breach the duties incumbent upon them shall be jointly and severally liable to the company for any damage arising' (section 43, paragraph 2). Although section 93, paragraph 1, sentence 2 of the German Stock Corporation Act ***(Aktiengesetz, AktG)*** primarily applies to stock corporations, it does have a 'ripple effect' for limited liability companies. The so-called 'business judgement rule' states that 'no dereliction of duties exists in those instances in which the member of the management board, in taking an entrepreneurial decision, was within their rights to reasonably assume that they were acting on the basis of adequate information and in the best interests of the company'. In other words, the director of a German GmbH has to ensure that they have adequate information upon which to base their purchase decision. That information is generally achieved by way of a due diligence audit, even though such an audit is not mandatory. The warranty implications in section 442 of the German Civil Code ***(Bürgerliches Gesetzbuch, BGB)*** also apply to corporate acquisitions. According to section 442 the rights of the buyer due to a defect are excluded if they have knowledge of the defect at the time when the contract is entered into or have no knowledge of the defect due to gross negligence.

If the buyer due diligence audit is a customary business practice in M&A processes, failing to perform one would constitute gross negligence in accordance with section 442 BGB and result in the exclusion of warranty.



However, this point has not been conclusively resolved in literature. Also, after a due diligence audit, the buyer could under some circumstances be deemed to have an awareness of all data that are available in the data room, including the data on defects that are contained in such information. In this case the buyer's rights due to a defect in accordance with section 442 BGB are also excluded. It is relatively easy to gather evidence on the documents provided in the data room, especially when a virtual data room is used, because there is a log of all files uploaded to the data room, as well as who read the files and when. This is why, in practice, many buyers attempt to insert a clause excluding section 442 BGB in the purchase and sale agreement.

VENDOR DUE DILIGENCE

As the name implies, a vendor due diligence audit is implemented by the seller or their adviser. When owner-managed small and medium-sized enterprises are sold there are often only a few interested parties – and in some cases only one potential buyer. Even so, the seller should still take the appropriate steps to prepare for the sale process, especially if they are planning to sell their company to a potential buyer that is larger and has more experience in transaction processes.

The seller can prevent any unpleasant surprises by involving advisers at an early stage of the process.

They can then remedy any deficiencies before any documents are issued to people outside the company. A consistent multi-year plan consisting of projected income statements, balance sheets and cash flow statements should either already exist or be prepared. An expert adviser can also estimate the sale price at an early stage of the process as the basis for a negotiation strategy. The due diligence audit also helps the seller to identify critical factors and effectively prepare for potential attempts by the buyer to secure price concessions or guarantees.

Another important part of the due diligence audit is to establish when to make which documents available to a potential buyer.

The seller should never simply tick off the items on a list of requirements provided by the buyer. In fact, it's important for the seller to retain decision control over what information to disclose.
The seller should also be aware that some potential buyers are likely to be competitors who might well use the information obtained to their advantage – especially if the deal isn't closed. So the seller should always consider what information they would definitely not want a competitor to see. Sometimes it's helpful to break down the due diligence process into several phases in order to ensure that business critical information is not shared until the number of interested parties has been reduced to one potential buyer who has provided a letter of intent with an indicative offer that is acceptable to the seller. However, even in this 'exclusivity phase' it is important not to fully disclose all information. For example, customer contracts should only ever be included in a due diligence audit after anonymisation. This also applies if the potential buyer has signed a non-disclosure agreement and made an undertaking not to misuse the information. Even if the potential buyer would be liable to pay damages, the seller would face a protracted legal battle because a causal relationship between the due diligence audit and the migration of customers to the potential buyer's company is difficult to prove.

Limited liability company directors have a statutory non-disclosure obligation if sharing the information could cause harm to the company.

There are also legal requirements to meet when disclosing information about employees, such as anonymising it first (data privacy laws).

SUMMARY

It is standard practice these days to implement a due diligence audit before a corporate acquisition. However, these audits differ considerably in terms of scope and format.

A potential buyer should always give careful consideration to the information that is relevant for their purchase decision to ensure an efficient due diligence process.
The seller is also advised to make timely preparations for the sale to achieve a better negotiating position – and maximise the sale proceeds.

This is the first issue of our regular information bulletins for clients covering various aspects of the work of company directors, supervisory boards and advisory boards.

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You're very welcome to contact us if you have any questions and we'll be happy to help you find the right solution.

When we perform a due diligence audit you can expect more than the usual standard reports. We always discuss expectations and information requirements with the client in advance so that we can develop a targeted and efficient audit strategy.

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