MASTER THESIS

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„The Applicability Of The Vendor Due Diligence Principle In Cross-Border Equity Joint Ventures"

verfasst von / submitted by

Mag.(FH) Albert Hansen

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Betreut von / Supervisor:	Mag. Dr. Paul Luiki, JD

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Declaration of Academic Integrity

I hereby confirm that I prepared this Master Thesis independently and on my own, by exclusive reliance on the tools and literature indicated therein. The sources of other people's work have been appropriately referenced. Quotation marks are used around materials written verbatim from other sources. The thesis has not been submitted to any other examination board.

Vienna, 29 July 2020

1. Introduction

At the beginning of a potential acquisition of another entity, or when a company considers partnering with another company, a closer look into the other entity has to be taken to assess its value and detect possible risks, as it is advised in a non-arranged marriage between two individuals. In business, that is usually called due diligence. Due diligence is an essential component in good business practice. To have a due diligence policy in place and not use it properly and consistently is a serious error that could be detrimental to the entire organization.[1] The Buyer Due Diligence is the traditional concept, in which a potential buyer assesses a target company and discovers shortcomings and risks, which he will then deal with by either opting out of the possible deal or by mitigating his risks contractually. Most prospective M&A deals tend to follow this well-worn path, which requires the parties' advisors to closely review documentation provided by the other party with a focus on legal, financial and business intelligence aspects. Additional inquiries may be performed through consultants hired by the buyer or the potential Joint venture partner.

Around the beginning of the 21st century, a new concept how to conduct proper due diligence in prospective M&A transactions has surfaced. It became particularly popular in European jurisdictions. It is commonly referred to as 'vendor due diligence' or 'sell-side due diligence' and implies that the vendor of a company performs a primary due diligence process on his own entity rather than having the potential buyer do it as would be standard in a regular due diligence. Vendor due diligence allows him to detect areas of shortcomings and risks within his company, which may have a direct influence on the value or general coming-into-existence of a possible deal.

This master thesis looks into whether the Vendor Due Diligence principle provides for a feasible assessment tool for companies in the formation process of a transnational equity joint venture and which legal aspects differ from those in an acquisition vendor due diligence. A special legal focus is put on the compliance

[1] Brendan Hewson, 'Fundamentals of due Diligence: A Critical Business Tool (Part One): The National Magazine of Business Fundamentals C&FM' [2006] 108(9) Business Credit 10-12, <https://search-proquest-com.uaccess.univie.ac.at/docview/230147985?accountid=14682> Accessed 12 May 2019

with antitrust regulations and the resulting restrictions related to information disclosure to the potential joint venture partner. Furthermore, the risk mitigation on the buyer and seller side through reps, warranties, covenants and indemnities with a focus on cross-border equity joint ventures is examined. Extensive publications exist on the traditional concept of Due Diligence while few publications look into the Vendor Due Diligence Principle, while it is becoming ever more popular especially in European jurisdictions.[2] The concept of applying a Vendor Due Diligence principle in Joint ventures has not been examined at all to the knowledge of the author of this thesis who herewith wants to provide the interested reader with considerations to that topic.

[2] Lee J. Potter Jr., 'Vendor due diligence: could it catch on here' [2011] (July 2011) Business Law Today <http://link.galegroup.com/apps/doc/A338120148/AONE?u=43wien&sid=AONE&xid=5ef9d3ee > Accessed 27 April 2019

2. The due diligence principle

Due Diligence is commonly referred to as the systemic internal process of thoroughly auditing a target or potential joint venture partner company and is usually performed by the potential acquirer or the other entity of the prospective joint venture. The definition may vary and the term has not received the attention it should deserve in both common and civil law, although it appears very frequently both in practice and in literature.[3] Due diligence can cover all areas important to understand the target or partner company, including its values and risks. There is no uniform procedure for a corresponding process, since the focus of each due diligence requires being set differently depending on the target. In addition, when designing a due diligence process it must be an essential exercise to keep in mind the nature of the transaction and whether it will be

- a share deal, in which a potential buyer acquires shares of the target company or

- an asset deal, in which the potential buyer acquires the total or just a part of the assets of the target company or

- the formation of a joint venture.

From practice, due diligence checklists are known and quite popular, as they provide for a standard guideline to follow. The due diligence process typically follows if a potential buyer or partner has screened a seller or joint venture partner and a term sheet as well as a non-disclosure agreement between the parties has been signed.

[3] Vicky Kapoor, *Due Diligence - Die Unternehmensprüfung Vor Der Unternehmensakquisition : Veranschaulicht Anhand Einer Legal Due Diligence Mit Praxisbeispielen* (Diplomica 2010) 5

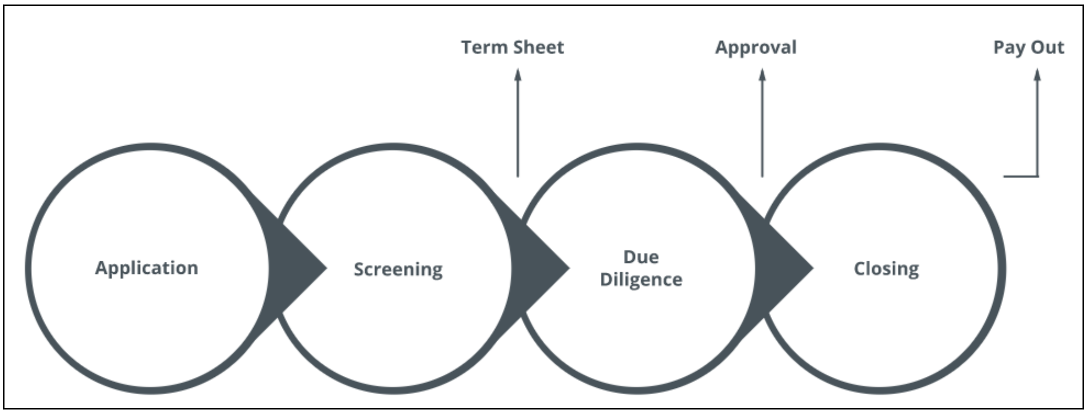

Table 1: Due diligence in a typical transaction process

2.1 The roots of due diligence

The roots of due diligence are to be found in the Anglo-American legal system, originally formed by common law and influenced mainly by US capital markets law.[4] US Common Law only marginally grants the buyer of a company warranty rights. Based on the principle "*caveat emptor*" ("let the buyer beware") according to which a potential buyer carries the risk that an object of purchase is free from material and legal defects provided that the buyer was able to recognize this, almost *forces* a potential buyer to run a sophisticated due diligence on the desired object. To enable a potential buyer to ascertain the nature of the object prior to the purchase, an opportunity to examine the entity and to optionally stipulate corresponding guarantees with regard to the defects identified, must be provided. This review is usually carried out using a due diligence process. It is of utmost importance to keep solid record of all processes and findings for the purpose of proofing should it be required at any stage.

In continental Europe and civil law jurisdictions, buyers enjoy a higher degree of warranty rights provided by the lawmaker. Nevertheless, due diligence processes have become an industry standard since those warranty rights have proven to be

[4] Clemens Hasenauer and Harald Stingl, *Due Diligence : Praxisleitfaden für Transaktionen* (Wien: Linde Verlag 2015) 2

unsuitable and often insufficient when applied on mergers or share deals.[5]

2.2 The objectives of a due diligence

In general, the assessment of value and risk within a target company are the pillars of every due diligence process. Detecting areas, where the buyer may later require having contractual warranties from the seller are equally important as well as the function, that it may allow to collect and store information about the target company which may later be useful.

Defining the objectives of a due diligence prior to its execution is vital for the success of it, as it allows prioritizing and focusing on areas of special interest. Depending on the specific requirements, individual areas, priorities and whether a share or an asset deal is sought, the audit can be determined based on the individual objectives expected from the due diligence. If the due diligence primarily fulfills the objective to detect the target company's value, greater emphasis may be employed on the financial due diligence process. The examiner, however, must always be aware, that the duty of care may not be compromised and a reasonable share of focus on the remaining pillars is essential.

The overall objective of a due diligence is to examine the target company, to structure and analyze the provided information and to finally provide the potential buyer with a due diligence report that allows him to understand and assess his options. Those can range from the pole of entirely buying the target object to the other pole of declining a purchase with multiple options in between. Both parties need to have a solid understanding of the other party to identify the object of purchase or partnership and thus be able to construct a purchase or joint venture agreement. Due diligence should be risk based-this means it should not only be tied to the risk assessment you're creating, but also be specific to the role or type of company you're reviewing.[6]

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[5] Clemens Hasenauer and Harald Stingl, *Due Diligence : Praxisleitfaden für Transaktionen* (Wien: Linde Verlag 2015) 33-35

[6] Brenan Cooper, 'The Importance and Best Practices of Vendor Due Diligence' (2017) 99(9) The RMA Journal 48

The due diligence process that relates to the assessment of the other party or parties in a joint venture transaction differentiates itself from the acquisition due diligence in a way, that it usually focuses only on the business divisions that are brought into the joint venture.[7] The due diligence itself prepares the basis for the joint venture agreement as well as the company agreement of the entity to be established. When it comes to assessing whether a joint venture is a reasonable option to expand one's business, it is essential to understand the legal, financial and commercial background – both one's own but also those of the partner-to-be.

Perhaps the most fundamental thing about due diligence is that it needs to be a fully informed approach to gathering information.[8]

2.2.1 Business valuation

Most reasonable companies that undertake to acquire shares or assets of a target company, base their decision on whether the target's value at the time of purchase/partnership or in the future meets or exceeds the indicated purchase or investment price. Thus, the due diligence fulfills the function to provide the buyer with a better understanding with regards to the object he desires to buy. Defining the value of a target company is based on the actual company valuation, which usually takes place after due diligence and by taking into consideration all aspects presented in the final report. The due diligence report also usually does not fix any price range to be paid for the target company.[9] The due diligence report nevertheless provides a very important set of figures about the target company that offers the prospective buyer some orientation. These figures are indispensable business metrics such as return on investment, return on equity and others as well as disclosures about risk-related discrepancies, such as liquidity issues, insufficient eq-

[7] Kai Haakon Liekefett, *Due Diligence bei M&A Transaktionen* (Berlin: Duncker & Humblot 2004) 35
[8] Brenan Cooper, 'The Importance and Best Practices of Vendor Due Diligence' (2017) 99(9) The RMA Journal 48
[9] Vicky Kapoor, *Due Diligence - Die Unternehmensprüfung Vor Der Unternehmensakquisition : Veranschaulicht Anhand Einer Legal Due Diligence Mit Praxisbeispielen* (Diplomica 2010) 7

uity ratio and others, which are reviewed and systematically structured.[10] Financial advisors are often hired externally for this pillar of a due diligence.

2.2.2 Risk assessment

Companies are reluctant to transparently share hidden weaknesses with a potential buyer. In an ever-more competitive global competition, companies want to present themselves strong and stable and withhold the dark side from the public. Consequently, it is unusual to gather data and information that is risky for the company from publicly available sources. The risk assessment is therefore an essential process within a due diligence to reveal the weaknesses, which are usually only known to the audited company. At the same time, the risk identification also plays an important role in determining value, as the weaknesses of a company - if correctly assessed and communicated - have a direct influence on the future purchase price.

Withstanding the above, disclosing openly the risks and weaknesses related to the target company may ensure a fair and transparent view on the status of the target and denies the buyer a further bargaining move when detecting default by himself.

2.2.3 Warranties

As mentioned above, the "*caveat emptor*" principle in the Anglo-American jurisdictions as well as the need in the civil law jurisdictions to increase a party's legal certainty requires the buyer to conduct a thorough due diligence on the target in order to convince himself that the object is free of defects. If defects or risks are detected, the buyer is advised to evaluate them with the objective to either accept a deal, decline a deal or have those defects clearly stated in the purchase or joint venture agreement to minimize his future risk.

[10] Ingo Schneider, *Haftung des Vorstands beim Unternehmenskauf* (Stingel 2008)

2.2.4 Preservation of evidence

Sometimes overlooked in literature, the preservation and documentation of evidence, that certain information had or had not been disclosed during a due diligence plays an important role. The issue of disclosure of information may have a material effect on the buyer's claims arising from the breach of warranty claims and terms and the corresponding liability of the seller.[11] In simplified terms, the buyer can rightfully raise claims for all defects which he had not been duly informed about by the seller in the course of the due diligence and which he could not have detected by himself applying reasonable efforts.

2.3 Types of due diligence

In literature there are several types of due diligence and the grouping can vary substantially. The major areas undergoing a due diligence process as grouped by the author of this thesis:

2.3.1 Legal due diligence

The legal due diligence should be a fundamental exercise in the framework of any due diligence process as it outlines the basis for the sale and purchase agreement. The major task within a legal due diligence is reporting on any litigation or disputes affecting the target company, irrespective of whether it takes an active or passive role. Legal due diligence covers a multitude of specialties as well as the more obvious legal areas such as title, consents and releases as well as regulatory issues. The legal due diligence adviser’s role is to identify areas of required action to ensure that consents and releases do not delay the transaction. In that respect, the briefing of advisers plays a vital role, which the management needs to take care of. Especially in a legal due diligence, it is essential to thoroughly prepare with a good briefing.

[11] Clemens Hasenauer and Harald Stingl, *Due Diligence : Praxisleitfaden für Transaktionen* (Wien: Linde Verlag 2015) 31

The legal portion of due diligence involves ensuring:

- that the company has been validly formed and exists
- the buyer or potential partner has an accurate understanding of the company's ownership and the rights of the different owners and the company's management;
- the buyer understands what litigation is pending or could arise in the future;
- the current insurance is adequate; and
- the company is in compliance with all applicable laws and regulations.[12]

In addition, there is a variety of further fields of investigation in the literature when conducting a legal due diligence. Numerous checklists are provided and they usually comprise of various chapters including organizational documents, capitalization and shareholders, financial conditions, tax matters, assets, personnel property, intellectual property, contracts, commitments and others.

The crucial question in the classification of the results of the legal due diligence is whether the outcome of the test results allows for an implementation into the representation and warranty provisions of the purchase contract or joint venture agreement. A continuation of the transaction process depends merely on that decision. Risks discovered during investigations may be so serious that the transaction should be terminated. This is particularly the case if ownership and/or power of disposition over the object of purchase cannot be determined reliably and are threatened with legal disputes with third parties or between several sellers. In addition, serious deficiencies in the legal position concerning property rights can justify the exit from negotiations at this stage. After all, a large number of legal disputes and compliance-relevant legal violations (eg in antitrust or corruption matters) are a strong indication that one should keep one's finger off a transaction.

[12] Jimerson Birr, 'What You See Is Not Always What It Seems: Due Diligence In The Mergers & Acquisitions Process Part I – Legal Due Diligence' (Jimerson Birr, 24 October 2017) <https://www.jimersonfirm.com/blog/2017/10/legal-due-diligence/> accessed 08 June 2019

The possibly imminent accumulation of fines, compensation payments and reputational damage can turn the transaction into a "million or even billions grave".[13]

The answer to these questions will only be found in close dialogue with the lawyers and consultants conducting the legal due diligence with the involvement of the in-house legal department if existent.

A typical list of documents provided in a data room includes:

- Organizational charts showing the corporate structure of the target entity (or seller in case of vendor due diligence), subsidiaries, and affiliates.
- Joint venture agreements, partnership agreements and other agreements in which profits and/or technology and/or other assets are shared
- Governing documents for the target (or seller in case of a VDD), subsidiaries, and affiliates. Include Articles of Incorporation, Articles of Organization, Bylaws, Operating Agreement, Articles of Association, and others
- Contracts relating to any material acquisitions, equity divestitures, assets.
- List of all jurisdictions in which the target owns a license to do business.
- Information on meetings involving the board, the shareholders and toher member meetings.
- Analysis showing the number of shares outstanding.
- Shares distribution of the target, its branches and affiliates.
- Documentation evidencing each issuance of private equity.
- A comprehensive overview of any warrants, convertible notes and any right entitling the holder to obtain equity.
- Others[14]

[13] Franz-Clemens Leisch and Andreas Lohner, ‘Compliance-Risiken im Transaktionsgeschäft‘ (2009) M&A Review 03/2009, < https://www.ma-review.de/hefte/ma-review-03-2009/> accessed 08 June 2019

[14] Kison Patel, ‘Complete M&A Due Diligence Checklist for 2020’ (13 February 2020) < https://dealroom.net/faq/due-diligence-checklist-template> accessed 05 May 2020

2.3.2 Financial due diligence

Over the years, financial due diligence has not only become an integral part of most M&A processes but it has developed to become a core metric. The financial due diligence pursues the goal of reducing the information asymmetry between the prospective buyer and the seller or between parties seeking to establish a joint venture. During the M&A process, financial due diligence identifies key value drivers as well as the strengths and weaknesses of the target company, identifies risks and opportunities in the business plan and quantifies them as far as possible.[15]

Financial due diligence involves detailed analyzes of a business supported by interviews with the key people in the company. Budgets are an essential planning and control tool in most businesses, so financial due diligence should show how the process works in the target company and, more importantly, how effective it is.

The core analyzes of the financial due diligence include in particular the following reviews:[16]

• the historical and the planned earnings situation, including analyzes of an expectable sustainable result

• the historical and planned financial position including analyzes of financial debt and

• historical and planned financial position including analyzes of working capital and investments

The results of the financial due diligence, together with the other areas of due diligence are used to determine the purchase price, the share purchase agreement, the

[15] Thomas Pomp, *Praxishandbuch Financial Due Diligence* (Wiesbaden: Springer Fachmedien 2015) 1

[16] Thomas Pomp, *Praxishandbuch Financial Due Diligence* (Wiesbaden: Springer Fachmedien 2015) 25

general negotiation strategy and act as the basis for integration plans in a joint venture.

The fundamental building blocks of financial due diligence are very similar to those in the other due diligence disciplines. In the majority of cases, firms of accountants carry out the financial due diligence. The team carrying the responsibility within an organization for this part of the due diligence consults with auditors and reviews the audit files for the past years (usually up to 3 years) and, if they are also looking at tax, the tax files for up to as long as available, typically in Austria that is seven years.

An exemplary list of documents provided in data rooms includes[17]:

- Financial statements for the target and its branches.
- Schedules of all prepaid expenses and deposits.
- Statements that explain liabilities and other financial obligations.
- Copies of letters stating the target entities' accounting controls
- Key accounting policies
- Material changes to accounting policies adopted in the past (and planned).
- Budgets and operating plans, and financial projections prepared.
- Unaudited financial statements.
- Overview about (or better: analysis of) cash management controls and practices used within the target's organization.
- Investment policies.
- Financial policies including copies of related contracts.
- Any agreement or arrangement that may potentially result in a loss on the target company's side.

[17] Kison Patel, 'Complete M&A Due Diligence Checklist for 2020' (13 February 2020) < https://dealroom.net/faq/due-diligence-checklist-template> accessed 05 May 2020

- Current listing of standby letters of credit, performance bonds, performance guarantees.
- Copies of bank statements and settlements with banks, if any.
- Summary of all material capital expenditure projects in the recent past.
- A report on the nature of the target company's inventory system, its policies describing how it is executed plus cost allocation policies related to inventory.
- A comprehensive summary of planned and/or expected capital expenditures in the upcoming years. (Usually 1-2 years)
- A complete inventory list of the target company's assets and equipment, regardless of whether it will become part of the deal or not.
- An overview about the status of current insurance coverages accompanied by copies of policy documents related to them. It should also include a summary of claims, which were made against any insurance policy.
- Others

2.3.3 Commercial due diligence

Commercial due diligence often refers to market and strategic due diligence. Its primary objective relating to the market is to analyze the customer and competitive situation of the target company. A typical commercial due diligence on the market comprises of external and internal analysis areas.

Table 2: Traditional commercial due diligence[18]

The external commercial analysis allows having a general look into the overall attractiveness of the market in which the target company does business. Additionally, framework conditions that cannot be influenced by the target company must be closely looked at. As part of this process, a thorough examination of the general environment including (macro-)economic circumstances, must be conducted. The analysis of this area should focus on technological developments, the competitive environment as such as well as other specifics influencing future business there.

The internal analysis areas evaluate the implementation expertise and critical success factors of the target company. As part of this process, strategy & focus (customer structure, geographical footprint, value contribution and others) and internal competences (value chain, technologies, research & development, management, etc.) are all assessed thoroughly.[19]

Besides the market evaluation, the strategic aspect relating to the sustainability of the business model as such is examined in order to evaluate the plausibility of sales and margin development according to the business plan. As a result, com-

[18] Fostec&Company, 'Commercial due diligence (CDD)' (Fostec&Company) <https://www.fostec.com/en/competences/market-intelligence/commercial-due-diligence-cdd/> accessed 04 June 2019

[19] Fostec&Company, 'Commercial due diligence (CDD)' (Fostec&Company) <https://www.fostec.com/en/competences/market-intelligence/commercial-due-diligence-cdd/> accessed 04 June 2019

mercial due diligence deals not only with the market, but also with the strategic orientation of the target or partner company.

The commercial due diligence is typically provided by specialized service providers such as special departments of accounting firms, strategy consulting firms or smaller consulting companies with specialized knowledge of niche markets. These service providers obtain information from (published) public sources and, more importantly, by exchanging themselves with knowledgeable people doing business in the same market as the target company. The major objective of a commercial due diligence is to give comfort that the deal actually works and a return on investment according to the business plan can be reached.[20]

A close interconnection between the commercial due diligence and the financial due diligence team can be fruitful in a way that results from commercial can be plugged right into the forecasts and scenarios of the financial team resulting in a more accurate evaluation of the possible deal.

A typical list of documents provided in data rooms includes[21]:

- A list of the target's top suppliers for the past years.
- Material supplier and subcontractor contracts.
- Summary of the policies and procedures when evaluating and onboarding any new supplier or contractor.
- A list of marketing and strategic plans that were prepared by the target, if accessible.
- Projected new products and/or improvements and/or line extensions of products already existing.
- A comprehensive overview about the target company's marketing brochures, sales sheets, presentations. Generally speaking all available advertising/marketing materials assist in understanding the target's business better.

[20] Peter Howson, *Due Diligence – The critical stage in mergers and acquisitions* (1st edition, Routledge 2003) 83

[21] Kison Patel, 'Complete M&A Due Diligence Checklist for 2020' (13 February 2020) < https://dealroom.net/faq/due-diligence-checklist-template> accessed 05 May 2020

- Descriptions of existing products including product lines
- Summary of all ongoing R&D projects, including an estimated timeline for completion thereof.
- Summary of all marketing risks and opportunities.
- A list of policies and procedures that are related to commercial issues including but not limited to pricing, discounts, returns, credits, claims of warranty and others.
- List of the top customers for each of the past 3 years, including revenue that is directly attributable to them. Depending on the market size and whether the target company is moving within an oligopoly or a monopolistic market, the number of top customers can vary significantly.
- It may also be wise to look at customers that have stopped doing business with the company and obtain an explanation for the reason behind.
- A list of all material sales channel partners including revenue of a defined past period.
- A breakdown of gross and net profits sorted by product and/or geography and/or sales channel.
- Copies of all material customer contracts from the past and present with a focus on long-term partnerships.
- Copies of all material partners in the downstream sales channel
- If existing, a list of contracts with government customers.
- And others

2.3.4 Human resources due diligence

With human resources and cultural factors playing a key role in the long-term success of any M&A deal, it is essential to identify challenges and opportunities relating to a target company’s workforce during due diligence. The objective is to avoid large financial costs, ensure positive workforce transition, and support the long-term success of a transaction. Typical fields of review include (selection)[22]:

- General human resource policies in the target company
- Specific and applied human resource policies
- Agreements and Contracts involving employees
- Benefits
- Compliance

Additional focus, and in no case regarded as irrelevant, should be put on reviewing the target company's culture and other similar (softer) HR issues. It is rather unlikely that the shape of the deal is strongly determined by company culture itself but any management is well-advised when taking these circumstances into consideration prior to any deal-making. Additionally, with many M&A deals leading to a review of workforce requirements, the identification of all material issues relating to the retention of key employees is of high importance, especially in industries involving high brainware input.

The human resource due diligence process typically commences with an information request followed by management interviews and employee representatives. Compared to other areas of due diligence, this segment commonly devours a comparably smaller investment of time and capital.

A special legal focus within the jurisdictions of the European Union has to be laid on the implications of the Council Directive 2001/23/EC on the approximation of the laws of the Member States [of the European Union] relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses. *"The transfer of an undertaking, business or part of the undertaking or business shall not in itself constitute grounds for dismissal by the transferor or the transferee. This provision shall not stand in the way of dismissals that may take place for economic, technical or organizational*

[22] FMP Global, 'HR Due Diligence Checklist for Mergers & Acquisitions' <https://fmpglobal.com/services/international-hr/global-mergers-acquisitions/mergers-acquisitions-hr-checklist/> accessed 14 June 2020

reasons entailing changes in the workforce."[23] Little freedom is given to new owners of companies as the European Court of Justice has predominantly ruled in favor of dismissed employees furnishing them with the right to remain or be substantially compensated for their dismissal.

A typical list of documents provided in data rooms consists of[24]:

- List of all the employees of the target company sorted by executive level and including basic metrics such as title, position, age, location and others allowing a comprehensive overview about the target company
- Performance reviews
- General outline of the recruiting and onboarding process for employees including interview guidelines, new-hire orientation practices and others
- An overview (and optimally an analysis) of payroll documents for all employees
- Copies of employee contracts, arrangements with labor unions, collective bargaining agreements and the like.
- Confidentiality Agreements for key employees
- Policies related to disciplinary actions such as code of ethics, absenteeism, sick leave policy and others
- Employee benefits
- Compliance policies
- Human resource consulting agreements if existing
- A list of incentive stock option plans if applicable.
- List and summary of all pension plans if applicable.
- If applicable, an overview about possible litigation (and court judgments) brought forward by any current or former employee.
- Copies of all employee manuals and policies.
- An overview of loans and sums owed.
- And others

[23] Council Directive (EU) 2001/23/EC on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses

[24] Kison Patel, 'Complete M&A Due Diligence Checklist for 2020' (13 February 2020) <https://dealroom.net/faq/due-diligence-checklist-template> accessed 05 May 2020

2.3.5 Management due diligence

Management due diligence looks at the state of fitness of the triangle that is formed by:

- The target company's management team and
- the investment thesis they follow and
- the strategic goals they have set.

Any company investing in another company – be it in the course of an acquisition or a joint venture - not only invests in the company as an entity but also realizes an investment in people and a management team's leadership capabilities. These acquired capabilities are critical to the profitability and strategic impact of the venture. Management can add more value to an acquisition than almost anything or anyone else. The evaluation of management seeks to give an objective assessment of the senior managers' capability both individually and collectively. The level of deep knowledge about a management team's leadership strengths and weaknesses before and during the deal process as well as post-transaction is a success factor on the way to ensuring the goals of the deal are accomplished.

Management due diligence provides a neutral external perspective on the management of the target company. It looks at both individuals as well as the team. Management assessment reports may reinforce opinions already held or expose specific risks. The argument for a meticulous process of evaluation is that it gives new insights into the managers' capacity to deliver what is expected from them, thereby reducing some of the uncertainty, and hence risk, in a deal. Reports should give an insight into individual managers and into the capabilities of the senior management team as a team.

The scope of HR due diligence depends on the focus of the potential investor and the buyer type. For the financial investor, it is usually of the highest priority that the top management is retained to the company in a leading role. The financial investor therefore tends to seek to involve the top management in the target company.[25]

In a possible joint venture deal, the assessment of the partner company's management team becomes even more critical as material decisions are usually made on a consensus basis. More information is provided below in chapter 8.3

A typical list of documents provided in data rooms may consist of the following (selective) [26]:

- contracts (both written and orally) regulating the roles within the management team including party transactions and relevant approval procedures,
- written contracts or agreements between the target company and its shareholders and/or directors, both former and existing,
- CVs or biographies of each member of the management team and other key employees,
- a comprehensive list of shareholders, officers or employees of the target company who had or have an interest in any of the assets of the company
- and others.

2.3.6 Environmental due diligence

The process of environmental due diligence includes the assessment of environmental conditions of a property of the target company in connection with a merger, acquisition or joint venture formation. It intends to allow the potential buyer or partner-to-be a deeper look into potential risks associated with environmental liabilities. Those can include[27]:

[25] Thomas Pomp, *Praxishandbuch Financial Due Diligence* (Wiesbaden: Springer Fachmedien 2015) 39
[26] Olivia Gorajewski, 'What documents should be in a virtual data room' (Uslawfornordics, 07 January 2018) < http://www.uslawfornordics.com/virtual-data-room/> accessed 03 May 2020
[27] Peggy Otum, 'Practical considerations for environmental due diligence in a competitive M&A market' (2019) Business Law Today <https://www.americanbar.org/groups/business_law/publications/blt/2016/02/05_otum/> accessed 28 June 2019

- potential redemption costs associated with contamination issues, both known and potential,
- required investment to achieve regulatory compliance,
- financial assurance obligations for the target company's environmental obligations that the prospective buyer will need to assume post-closing,
- Environment, health & safety (EHS) litigation that may be caused by toxic tort, worker exposure claims and others. They may again present pending or potential litigation,
- Fines to be expected from competent authorities for non-compliance with environmental laws and regulations,
- Moreover, health issues as a direct consequence may also play an important role when assessing environmental due diligence and its consequences.

From the perspective of the potential joint venture partner, environmental issues that come up during a proper due diligence may essentially influence the assessment of the deal. Making sure that the due diligence process reflects an appropriate business sensibility is truly essential. When it comes to designing the environmental due diligence process, the scope may vary based on the value of the joint venture both in financial figures but also judged by the value to one's portfolio, the readiness to take risks and the circumstances in the market, for example how rigidly authorities apply the execution of laws and regulations. The environmental due diligence review must take into account as many factors as possible. Understanding the types of liabilities that the prospective buyer may consider to be non-surmountable obstacles for a deal, will help inform the approach to due diligence. In some cases, environmental costs with a low value related to the total deal amount may still be material to the deal. In other cases, materiality may be set substantially higher. Regardless of the threshold that is determined, experienced environmental transaction counsels will know to flag environmental concerns that individually may fall below the threshold, but taken together may present a material issue. [28]

[28] Peggy Otum, 'Practical considerations for environmental due diligence in a competitive M&A market' (2019) Business Law Today <https://www.americanbar.org/groups/business_law/publications/blt/2016/02/05_otum/> accessed 28 June 2019

Environmental due diligence has become an ever-increasing field of importance in the last years when designing a due diligence process. For many joint venture partners, educated by and suffered under their own rigorous domestic regulations, environmental due diligence can have the longest lead-time in the entire setup creation process. Environmental due diligence may highlight matters which require a seller, a buyer or a joint venture partner to notify insurers of liabilities to which policies are required. Excluding certain assets from a deal could be the most effective way of excluding potential material liabilities from the acquisition. In a merger or acquisition deal, acquiring certain assets of a company with residing environmental responsibilities instead of shares easily puts an end to those historical liabilities. However, a decision with regards to the nature of the deal and whether shares or assets are acquired, must surely be made taking into consideration more than just a single aspect from one due diligence chapter. In a joint venture deal, the risks related to environmental circumstances must be viewed from different perspectives, especially whether the risks are "brought into" the future joint venture.

A typical list of environmental due diligence documents provided in data rooms consists of (selective) [29]:

- A detailed list of all investigations by authorities related to environmental violations,
- Possible litigation connected to environmental matters involving the target company,
- If the target company's business involves any kind of hazardous material, information related to its generation, storage or disposition must be provided,
- If applicable, a list of environmental studies and assessments related to property and/or possible contamination,
- Allowances and/or reserves built – if any - for the management of environmental liabilities,
- The complete significant communication with any competent authority,

[29] Kison Patel, 'Complete M&A Due Diligence Checklist for 2020' (13 February 2020) < https://dealroom.net/faq/due-diligence-checklist-template> accessed 05 May 2020

- Environmental audit results
- Copies of approvals from governmental authorities related to environmental matters.
- All investigations, citations, notices of violation, litigation and others, related to employee health,
- All emergency response policies and procedures.
- Summary of all current or past litigation brought against the target by any current or former employee.
- (Health): Accidents within the past years.
- Material safety data sheets if available,
- And others

2.3.7 Tax due diligence

Within the meaning of the deal economy, an M&A transaction is considered to be advantageous if the anticipated subjective idea of the acquirer in terms of the value of the target object over the entire M&A process exceeds the price that has been paid for the target object.[30] From a tax perspective, the economic advantage of an M&A transaction depends on[31]:

• the potential tax risks and opportunities of the targeted transaction that are identified during the transaction stage,
• the costs that are incurred on account of conducting the due diligence itself, as well as
• the tax savings that may be realized when consuming the target transaction, minus the requisite restructuring costs that are incurred during the integration stage.

[30] Marianne Schramm and Ekkehard Hansmeyer, '*Transaktionen erfolgreich managen. Ein M&A-Handbuch für die Praxis*' (1st edition, C.H. Beck Vahlen Munich)
[31] Volker Endert and Andreas Mammen, 'Improving the Aquisition Profit of Cross Border Transactions by Adjusting the Tax Due Diligence Process – a Theoretical Model Based on a German Target' (2015) 23 (1) Periodica Polytechnica Social and Management Sciences < https://search-proquest-com.uaccess.univie.ac.at/docview/1668442237?OpenUrlRefId=info:xri/sid:primo&accountid=14682> accessed 29 June 2019

Tax due diligence can be defined best as the process by which the tax affairs of a company are independently reviewed in connection with a transaction or joint venture formation to identify possible risks related to taxation as well as benefits inherent in the company. The objective is to establish particular facts and circumstances with regards to its tax position. It is thus a very important topic in deal and post-deal structuring. Tax due diligence is fairly straightforward and obvious and does depend less on the degree of transparency by the seller.

Tax indemnities and warranties, which are properly incorporated into any transaction or joint venture agreement, allocate the tax risk accordingly. One solution to minimize risk is to grant tax deeds. A tax deed gives pound for pound recovery, subject to exclusions, for unexpected tax liabilities without the need to prove loss, whereas warranty damages depend upon the loss suffered by the buyer, who is in most jurisdictions coerced to take steps to mitigate its loss. The most important indemnity in the tax deed is a broad provision covering tax liabilities arising as a result of pre-completion profits or events occurring prior to completion. Tax indemnities are generally limited by specific exclusions, financial limits and time limits.[32] A profound tax due diligence should always review tax deeds and warranties and their scope of influence on the deal.

A typical list of documents provided in data rooms may consist of (selective)[33]:

- An overview of the results of all tax audits conducted in the past years,
- Tax liabilities and allowances as well as deferred tax assets,
- A comprehensive summary of company policies related to taxation, including transfer pricing and audit policies,
- If existing, tax assets and their reflection on relevant statutory accounts,
- A list of of sale and leaseback transactions, if any,
- Overseas activities related to taxation issues,

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32 Eloise Walker and Peter Morley, 'M&A: the role of the tax deed and tax warranties and usual indemnities and exclusions' (*Out-Law Legal Update*, 12 October 2018) < https://www.pinsentmasons.com/out-law/legal-updates/ma-tax-deed-tax-warranties> accessed 27 June 2019

33 Kison Patel, 'Complete M&A Due Diligence Checklist for 2020' (13 February 2020) < https://dealroom.net/faq/due-diligence-checklist-template> accessed 05 May 2020

- Ongoing investigations initiated by any competent tax authority, independent of whether the target company is directly affected and also independent of whether the investigations are ongoing or took place in the past,
- Any plans on the side of the target company to change taxation schemes,
- A list of possible audits or investigations in the past related to employment taxes,
- Copies of all documents submitted to tax authorities
- Copies of all communications and agreements between the company and any taxing authority.

2.3.8 IT and technology due diligence

Understanding the target company, protecting one's potential investment in it, negotiating the deal, understanding how to derive value from it and processing a draft agreement are all going to demand some type of information technology due diligence.

Originating from the growing importance of IT for businesses, the success of implementing the transaction depends very much on whether the IT system has been integrated early enough and in an appropriate way. Therefore, not only in technology-oriented companies or before planned integrations, a neutral IT due diligence is required. This is the only way to provide for a professional assessment of whether core applications and IT infrastructure can be scaled and integrated into the buyer's systems, or which plans have to be set up so that a functional IT can be guaranteed. In addition, operational and monetary risks need to be assessed as well as potential for cost reduction calculated and necessary investments quantified.

A typical list of documents provided in data rooms may consist of (selective)[34]:

- A comprehensive list setting out current and planned IT projects
- Analysis of key IT resources available within the target. This may include software, hardware and programming skills (people).
- A list of existing software on the target's side including licenses
- How is existing software maintained and new software purchased?
- How is existing hardware maintained and new hardware purchased?
- A plan clearly outlining the IT architecture including servers, devices, OS, databases and other material infrastructure. This must include network systems, specifications and other technical information,
- Access to external IT support including scope, validity and value,
- Overview of costs per year related to maintenance, upgrade and replacement of critical IT infrastructure,
- Copies of most important software and service contracts,
- Detailed summary of the key security protocols.
- Further information on disaster recovery policies and procedures.
- Outline of of data privacy policies and procedures.
- Overview of all personal and/or sensitive information.
- Data encryption policies
- Summary of any logged security issues.
- Summary of any anti-virus and anti-malware protections.
- Mobile device security of customers and employees if applicable
- Outline of past or ongoing cyber attacks and/or intrusions.
- And others

[34] Kison Patel, 'Complete M&A Due Diligence Checklist for 2020' (13 February 2020) < https://dealroom.net/faq/due-diligence-checklist-template> accessed 05 May 2020

2.3.9 Intellectual property due diligence

Intellectual property due diligence should be a key component in any merger and acquisition deal as well as in joint venture formations. In order to make sure, that IP rights actually exist and are owned by the potential target or partner and can as such be used as presumed, one must engage in IP due diligence. IP rights may have to be assigned or licensed as part of the deal if the target company is being sold out of a group in order to avoid IP rights not being transferred. In all cases, in which the target company is merely a licensee of intellectual property rights, the scope of items that require examination is decidedly broader.

As part of the IP due diligence process, the target company generally must provide detailed documentation on the nature and scope of patent rights and the validity, enforceability, and transferability of such rights.[35] As a rule, it is expected that all registrations protecting the target company's proprietary technology have been adequately documented are made accessible during the due diligence process.

Finally, the risks related to IP have to be correctly assessed. The question must focus around whether there is any ongoing litigation or risk of future litigation that can be identified and quantified related to the use of technology by the target company. In order to do so, the inquiring experts undertake a litigation review to assess any potential claims, infringement, or insurance issues.

In addition to addressing the general IP risk issues described above, IP diligence also requires the review of several key areas, including ownership issues, freedom-to-operate considerations, scope, validity and enforceability concerns and the transfer of rights to third parties.

Modern literature provides a wide range of checklists dealing with several areas of due diligence on IP rights. The author of this thesis has summarized the following areas of main interest when conducting an IP due diligence:

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[35] Sergio Garcia, 'IP due Diligence: Key to Success in M&A Transactions.' (2007) 20 (3) Biopharm International <https://search-proquest-com.uaccess.univie.ac.at/docview/195734805?accountid =14682> accessed 29 June 2019

- Patents
- Trademarks
- Copyrights
- Trade Secrets
- Regulatory Compliance
- Reporting Issues under State Laws, i.e. the Sarbanes-Oxley Act in the United States
- Others, i.e. access to source code

A typical list of documents provided in data rooms may consist of (selective) [36]:

- Trademark and patent overview,
- Owned websites and domains,
- Agreements allowing the target company the use of IP rights owned by a third party,
- Agreements under which a third party is granted the right to use IP owned by the target.
- How are IP rights developed, acquired, recognized and protected by the target company?
- Are there any shared IP rights with any third party?
- Past, ongoing or potential infringement proceedings by a third party against the target company,
- Past, ongoing or potential infringement proceedings initiated by the target company against any third party,
- And others

[36] Kison Patel, 'Complete M&A Due Diligence Checklist for 2020' (13 February 2020) < https://dealroom.net/faq/due-diligence-checklist-template> accessed 05 May 2020

2.3.10 Antitrust due diligence

Antitrust audits are increasingly essential as well as due diligence in the context of transactions as a result of rules regarding parental liability and succession at a European level.[37] Antitrust audits must be conducted in a wide range of circumstances and by staying up to date with ever-changing jurisprudence. European law as well as national regulations and provisions, including but not limited to data protection regulations, influence the antitrust positioning of the target, both in M&A as well as in a joint venture formation. The antitrust audit is there to detect non-compliance with those laws and regulations. If the envisaged deal is not covered by a block exemption, which the European lawmaker has provided, parties can seek an individual exemption from the European Commission. Needless to say, obtaining an individual exemption decision is time-consuming – it may take several years.[38]

Fines for antitrust violations can be extensive, up to 10 percent of global turnover in the European Union. In most jurisdictions, agreements with dealers to maintain their transfer prices and/or retail prices is a serious antitrust infringement.

Antitrust due diligence should therefore be concerned with the possibility of buying into anti-competitive behavior. The due diligence investigators must hence look first at existing agreements with the other party's dealers. Within the European single market, terminations, or threats to terminate dealers based on their pricing policies or parallel importing, or exporting practices may give rise to significant antitrust exposure. The due diligence exercise should therefore also focus on the look out for the kinds of agreements and should analyze whether they meet all the conditions for coverage by block exemption regulations. The due diligence process should also aim at identifying contracts that may be unenforceable because of antitrust law.

[37] Christina Hummer and Lukas Leitner, '*Antitrust Audit in the Context of Transactions: Motives and Key Practical Aspects'* (2012) 3 Journal of European Competition Law & Practice
[38] Peter Howson, '*Due Diligence – The essentials of M&A due diligence'* (1st edition, Routledge 2018) 117

A substantial and well-processed antitrust assessment focuses on whether an actual violation of substantive antitrust laws has occurred, is likely to have occurred or will likely occur. It is intended to:

- Prevent authority investigations related to potential antitrust violations initiated *ex officio* or by third parties,
- Detect the nature and extent of suspected or alleged antitrust violations and provide a plan how to overcome,
- Analyze whether any practices applied by the target company present a significant risk of antitrust-violating behavior,
- Assess the effectiveness of a target company's antitrust compliance program and antitrust training in avoiding antitrust violations.

Given the fact that a substantive antitrust compliance assessment may uncover actual violations of antitrust law, it will be very important to conduct the legal assessment appropriately and consistently with the target company's own investigations rules and principles. It will also be important to consider whether the assessment shall be conducted with the assistance of external legal counsel to secure the benefit of Legal Professional Privilege.[39]

A list of questions related to the preparation of an anti-trust due diligence could involve the following:

- how about prior violations with regards to anti-trust? Have protocols been put in place as a result of (any) prior antitrust violations? The uncovering of possible prior or ongoing antitrust violations on the side of the target company is especially important to take place at an early stage already. This allows sufficient time to assess the possible consequences on the deal and elaborate on a process as to how this can be cured or prevented.

- has the target company already installed an antitrust compliance program and is it state-of-the-art and updated with current regulatory requirements

[39] International Chamber of Commerce, Practical antitrust compliance tools for SMEs and larger companies, ch 8 Antitrust due diligence (The ICC Anti-Trust Compliance Toolkit, 2013) 51

and the laws within its jurisdiction? Does the program have the backing of the target business executives and can any documents related to it be reviewed?

- how does the target company enforce its compliance policies? Is compliance taken seriously in the context of company culture? Are there any communication means in place that allow employees to report non-compliant behavior? Has the target company for example installed a whistle blower hotline and has it received any calls so far? The review of calls made to whistle blower hotlines or of emails sent anonymously is generally possible but must respect the confidential nature of such information.

- does the target company partner with companies or other entities with compliance issues? Who does the target company do business with and are they the subject of any past or ongoing antitrust investigation? Are there any trends within the industry that may impact the likelihood and speed of antitrust or regulatory approval?

- Where does the company do business? If the transaction involves national security or foreign investment issues, obstacles getting the transaction approved may come up. To give an example, the *Exon-Florio* provision gives the President of the United States the power to suspend or block a transaction for reasons of national security.[40]

- The purchasing or partnering company should also be certain to ask about any and all compliance investigations, internal or external, that are currently taking place. This may not be a deal-breaker for the transaction, but knowing about any ongoing, pending or anticipated investigations helps the purchaser estimate potential consequences in dealing with them, or possibly ceasing operations in an area that has a compliance issue.

[40] Marc Greidinger,'The Exon-Florio Amendment: A Solution in Search of a Problem.' American University International Law Review 6, no. 2 (1991) pages 111-177

- Other areas that could be investigated include whether any antitrust sanctions, penalties or damages have been imposed on the target company, whether there are any informal agreements or sales arrangements in place, a review of the board of directors and any shares they may hold in competing companies, and a review of any existing merger control clearances. Along with this last item, it would be wise to insure that the target company has not engaged in gun jumping, which is when a transaction is implemented prior to receiving all necessary clearances.[41]

Furthermore, insurance, pension and other areas can be important and form an own chapter in a company’s due diligence.

[41] AKD Benelux Lawyers, ‘Antitrust Due Diligence in M&A‘ (24 August 2016) < https://akd.eu/insights/antitrust-due-diligence-in-m-and-a> accessed 05 May 2020

3. The vendor due diligence principle

3.1 The definition of vendor due diligence

In a standard Vendor Due Diligence, it is the seller, rather than the buyer, who appoints advisors, entrusted to look into legal, financial, operational, commercial, tax and other areas to audit the relevant documentation of his own entity. These experts are then obliged to draft written reports on the findings of the due diligence performed on the sellers entity often including a statement of plausibility on the statements made with reference to risks and opportunities.[42] After clearance by the seller, such reports are provided to potential buyers subject to signing confidentiality and non-reliance agreements, acknowledging that the reports may contain errors or omissions for which the seller and/or its entrusted advisors must not be held responsible. After submission of these reports to the potential buyer and a potential clearance by the seller to additionally allow him to review underlying documentation or interview management, the buyer has access to a digital data room and can extract most relevant knowledge about the target company to assess whether a deal makes sense for him or not.

Vendor due diligence can therefore be described as the investigation and analysis of the seller's company by the seller himself. Vendor due diligence is typically provided to potential buyers on a non-reliance basis, although with a duty of care being provided to the potential buyers. It is constructed to provide a balanced analysis of the company; anticipating questions and issues, which buyers may raise and thus can assist to alleviate such concerns where appropriate.

Vendor due diligence is equivalent to sell-side due diligence. In Europe, the process where a seller starts due diligence is normally called vendor due diligence (vendor DD), whereas in the US it is often called sell-side due diligence (sell side DD).

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[42] Frank Höhne, *Praxishandbuch Operational Due Diligence : Bewertung der operativen Leistungsfähigkeit produzierender Unternehmen* (Springer Fachmedien Wiesbaden 2013) 3

3.2 Advantages of the vendor due diligence

The vendor due diligence principle offers a variety of advantages over the traditional buyer due diligence principle.

- When multiple parties bid for the acquisition of a target company, the seller can decrease the degree of invasiveness and redundancy caused by numerous consultants from numerous potential buyers requiring on-site due diligence within the seller's entity by providing copies of a single set of documentation to all potential buyers.

- From a timing aspect, it allows for a simultaneous process by several parties. Especially with a number of interested potential buyers, having consistent reporting and documentation can reduce the time required for the sales process. Hence, vendor due diligence brings the advantage of decreased response time and a diminished amount of (obvious) questions. Vendor due diligence can therefore increase the quality of received offers while at the same time maximizing the value of the deal. It can therefore be said that vendor due diligence under normal circumstances offsets the costs involved.[43]

- Strategically, when a potential buyer is provided with a vendor due diligence report containing all known material risks, liabilites and shortcomings disclosed by the vendor, the strategy option to bid high initially to get exclusivity and then diminish the price during the negotiations based on findings, is eradicated.

- The potential buyers are provided with all relevant documentation on the target company resulting in more efficiency and requiring less time and costs. The intensity of competition among the bidders may be increased as all are supplied with the same level of information through the issuance of a vendor due diligence report. Depending on the degree of detail

[43] Corporate Finance In Europe, 'Vendor Due Diligence' <https://www.corporatefinanceineurope.eu/due-diligence/vendor-due-diligence.htm> accessed 24 May 2020

provided, it therefore reduces the amount of time, which the potential buyers require to obtain a reasonable degree of familiarity with the target company's businesses, finances, operational and legal issues, when they otherwise need to invest substantially in legal and advisory expenses to attain a baseline understanding of the target entity. On the vendor's side, these cost savings could result in more prospective buyers remaining in the hunt and might result in a higher purchase price or better sale terms for the seller.[44]

- Data rooms may be limited to digital nature only and no physical facility at the seller's entity needs to be established. That not only allows reducing costs, but also enables the seller to track meticulously which information was retrieved by which potential buyer giving him a leap advantage when designing his contract negotiation strategy individualized to a party. Virtual Data Room (VDR) technology meets all the expectations of vendor due diligence, therefore using it is highly recommended as a best practice for conducting it[45]. Even in the early stage of preparations, it is an important tool to organize the transaction and keep control over it. All documentation that is classified as 'sensitive' can easily be stored in a central location, is accessible 24/7 and can be restricted to authorized individuals or entities as selected by the provider of the data. All decisions as to who is granted access to which documents, are made solely by the owner of the documents. Advisors responsible for vendor due diligence usually have a tool that allows them to analyze documents online in a structured and comfortable way. Confidential documentation, which is already available outside the company, is protected by strict security standards.

- The seller keeps control over confidential information as in a vendor due diligence typically only results and no underlying documentation is pro-

[44] Lee J. Potter Jr., 'Vendor due diligence: could it catch on here' [2011] (July 2011) Business Law Today, <http://link.galegroup.com/apps/doc/A338120148/AONE?u=43wien&sid= AONE&xid=5ef9d3ee > Accessed 11 May 2019

[45] Aleksandra Prusator, 'Vendor Due Diligence – the Value of Negotiation Preparation' <https://fordatagroup.com/vendor-due-diligence-the-value-of-negotiation-preparation/> accessed 14 May 2020

vided.[46] Especially in technology-driven industries, this aspect contains an important strategic dimension.

- The seller detects areas of shortcomings within his company early on and can make an active decision whether to invest into remedying or proactively disclosing them in the letter of intent. This limits discussions about the value of the transaction and potentially raises the trust between the parties.

- Up to the point in time when the prospective buyer collects his own information, the prospective buyer bears no risk from eventually futile due diligence costs. For this reason, objects of purchase, which may initially be assessed as less attractive, can be selected by potential buyers anyway, as the investment is decidedly lower than if they went for a buyer-side due diligence.[47]

3.3 Disadvantages of the vendor due diligence

The vendor due diligence principle underlies some disadvantages too.

- Whereas in a buyer side due diligence the costs of hiring legal and other advisors are typically much heavier on the potential buyer's side, in a vendor due diligence it is the vendor who has to invest significantly into consultation services, depending on the intended scope and detail of the vendor due diligence report.

- The probable reluctance of the potential buyer to rely solely on the vendor due diligence documentation provided by the seller, may result I sunk costs, if the buyer insists on a full-scope buyer-side due diligence and the

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46 Clemens Hasenauer and Harald Stingl, *Due Diligence : Praxisleitfaden für Transaktionen* (Wien: Linde Verlag 2015) 83

47 Roedl & Partner, 'Due Diligence durch den Verkäufer (Sell-side due diligence) < https://www.roedl.de/themen/unternehmenskauf-in-deutschland/sell-side-due-diligence> accessed 22 March 2020

seller agrees for the motive of keeping the potential buyer interested.

- Furthermore, as the vendor due diligence report will be prepared on instructions from the seller only, it may not necessarily deal with each potential buyer's or partner's primary concerns in the first place. If the target company does in fact express any concerns, further detailing or even an extended due diligence may be necessary to fulfill the request of additional information by the other side.

- Another important consideration from a legal point of view is that of the solicitor-client privilege. The distribution of a vendor due diligence report to potential buyers that contains any legal advice will almost certainly constitute a waiver by the seller of its solicitor-client privilege in respect of that advice.[48] That issues needs to be addressed clearly between the seller and its legal advisors prior to the assignment.

- The contractual relationship between the seller and the vendor due diligence auditor could give rise to doubts as to its independence. When an auditor is commissioned, the independence enshrined in the professional principles already alleviates this conflict. In addition, the confidence in the independence of the DD auditor should be increased by offering a direct presentation of the results to the prospective buyer, combined with the possibility of questions.

- Security issues related to virtual data rooms (see below chapter 3.5)

3.4 Virtual data rooms in vendor due diligence

A virtual data room is – in most cases - a cloud-based solution for securing and sharing confidential information between a seller and potential buyers. It can substantially ease the due diligence process within the framework of an M&A deal by

[48] David Kruse and , 'Legal Vendor Due Diligence: Staging a Successful Sale' (*Blakes Business Class*, 16 June 2016) <https://www.blakesbusinessclass.com/wp-content/uploads/2016/06/Legal_Vendor_Due_Diligence.pdf> accessed 12 May 2019

allowing potentially interested parties to access relevant data through a secure internet connection. Over the past years, data rooms have quite rapidly evolved from physical data rooms to virtual editions, as the latter are most cost-efficient, easier to access, and security-wise optimally adjusted to a digitalized world. In an effort to streamline the vendor due diligence process, virtual data room applications have been developed and improved over the past years. They allow for an organized research of electronic forms by providing access to electronic versions of documents from anywhere on the planet, at any time of day or night.[49] This digital solution allows:

- The enhancement of providing relevant documentation to interested parties. At the very same moment, in which a document is stored, it can be made accessible to numerous parties without the need to physically reproduce the document,
- To provide for an increased level of data safety as the access to documents is granted to authorized users only making use of an encrypted connection,
- To track and trace each interested party's movements, time with documents and other activities that may be analyzed,
- In addition, a variety of advantages over physical data rooms exist and are depicted in the graph below.

[49] Aleksandra Prusator, 'VDR in due diligence process' (*Fordata*, 2020) <https://fordatagroup.com/vdr-in-due-diligence-process/> accessed 03 May 2020

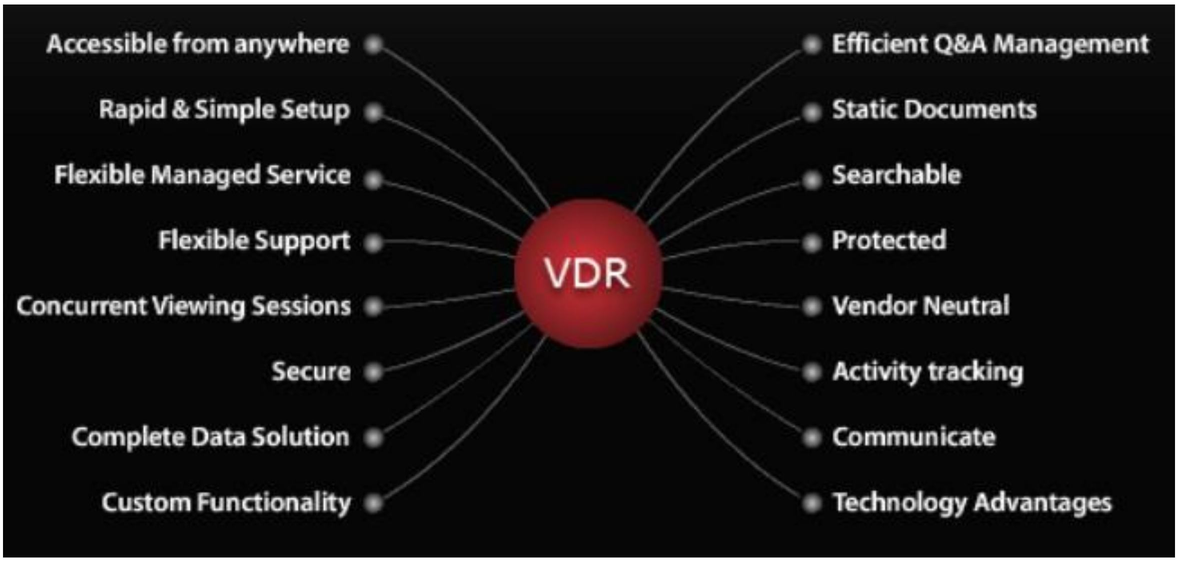

Table 3: Virtual Data Room[50]

3.5 Security practices in virtual data rooms

A virtual data room (VDR) offers – as the name already indicates – access to information by digital means. What control is there on a printed confidential document lying on a manager's desk in an office that is frequented by co-workers, administrative staff, and even cleaning staff in the after work hours? How can one be sure, that his or her CD / DVD / USB stick is not shared or misused by unauthorized individuals?

These rhetorical questions indicate that a VDR may provide for a higher standard of security compared to sharing data the traditional way. However, even a VDR that disables the "print and save" function makes retaining a secure document more difficult. If a document can be viewed on a computer screen, it can be captured, saved, and redistributed. There are numerous ways this can be done, even if a digital camera is not available, including: cell phone cameras, screen captures, manual remake and third party screen monitoring services.[51]

Options to raise security levels may include

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[50] Landmark vSpace, 'Virtual Data Rooms' (Virtual Project Spaces) <http://www.landmarkvspace.com/services/virtual_datarooms.aspx> accessed 03 May 2020

[51] IDR Share, 'Online Data Rooms: Documents Rights Management' < https://www.idrshare.com/online-data-rooms-document-rights-management/> accessed 26 April 2020

- the screening of all individuals granted access to confidential information

- tracking of documents visited by each individual to secure proof when needed later

- signing of Confidentiality and/or Non-disclosure Agreements prior to granting access

- keeping highly confidential documents out of any data room, be it physical or virtual and grant access only in person and without electronic means. This however is not practicable in a typical M&A due diligence

3.6 Liability in relation to vendor due diligence

Once the seller has organized all necessary information about his company, which he wants to share, a vendor due diligence report is typically established and made available to all bidding parties as a supplement to an Information Memorandum containing the seller's own risk analysis of his company, the target company. That vendor due diligence report thus forms the major basis for the assessment of important circumstances of the target and the transaction, including the typical areas as described above in the chapter above.

To fulfill its purpose, a vendor due diligence report must be a reliable source of information and, hence, give the potential buyers a fair and adequate view of what has been reported in it. Indemnities for damages in relation to a defect of the vendor due diligence report, i.e. any substantial deficiency of the advice presented by the vendor or its counsel, must be able to be claimed by the buyer as would be the case if the purchaser's own advisor had performed the due diligence.[52]

[52] Axel Calissendorff, 'Liability and Reliance in Relation to Vendor Due Diligence' (*Mondaq*, 05 March 2007) <https://www.mondaq.com/Strategy/46654/Liability-and-Reliance-in-Relation-to-Vendor-Due-Diligence> accessed 22 March 2020

What is worth looking at in this context is also how lawyers have to position themselves in the context of vendor due diligence procedures. While a lawyer is typically contracted to serve the interests of his client as a service provider, liabilities towards potential buyers may arise out of incomplete or wrong information in the vendor due diligence reports.

Legal advisors over the years have developed a certain practice as to the disclosure of a vendor due diligence report to the vendors' counterparts. There are two types of main instruments that may help avoid – or at least minimize – liability or potential conflicts of interest for lawyers. These are on the one hand side "release letters" and on the other hand "reliance letters".

Prior to a vendor due diligence report is consigned to a potential buyer, he is requested to sign a so-called release letter in which he commits to keep all contained information in that vendor due diligence report to himself and not share any content with any third party. The sole purpose of the vendor due diligence report is to assess the possible transaction, it must not serve any other purpose. Moreover, a clear statement needs to be issued in which the bidder confirms that he is in no contractual relationship with the seller's legal counsel, who has issued the vendor due diligence report on behalf of his client, the seller.

If all things go well and the parties approach a deal in the form of an acquisition agreement – or in this case a joint venture agreement – the buyer is supplied with a reliance letter issued by the seller's law firm. In such letter, the potential buyer or joint venture partner is given sort of a guarantee, that he can rely on the facts presented in the vendor due diligence report. Statements by the law firm on the seller's side that no relationship as a client or out of a contract have been established, are not essential anymore. The vendors law firm may also consider including statements in those reliance letters clearly referring to:

- a general limitation of liability on the law firm's side that they only accept liability that arises out of own (gross) negligence,
- a limitation of liability related to the fact, that they have acted for the sole purpose of serving the seller's purpose,

- that the scope of the vendor due diligence report has intentionally been limited to certain areas due to an agreement with the seller, resulting in a non-review of certain other areas.

In the end, reliance letters materially influence the judgment of a vendor due diligence report by potential buyers as the degree of “reliability” may vary.

Reliance letters appear to be quite widespread in England, both in the conventional constellation of buyer due diligence and, particularly at auctions, for vendor due diligence processes. In the past few years, several large transactions have been carried out in the United Kingdom in the context of auctions, in which extensive vendor due diligence reports have been prepared and reliance letters have been issued to buyers (mostly acquisition companies from private equity funds) and to the financing banks. Limitation of liability is standard. In contrast, practice in the United States appears to be considerably more cautious, which may have to do with the fact that the risk of being involved in litigation is rated higher in the United States.[53] In Central Europe the situation seems to be different vendor due diligence situations with Reliance Letters for buyers tend to be the exception still.

[53] Matthias Wolf, ‘Reliance Letters‘ (fdokument, 08 May 2018) <https://fdokument.com/document/reliance-letters-lenz-staehelin-reliance-letters-matthias-wolf-inhalt-i-reliance.html> accessed 21 May 2020

4. Vendor due diligence in joint venture transactions[54]

4.1 The joint venture as a strategic option

Joint ventures are partnerships between two or more independent companies and can be construed in different ways. The parties enter into this form of partnership for commercial, strategic, or financial reasons amongst others. A joint venture can be established to develop a narrowly defined project or technology, or to own and operate a whole business. A variety of joint ventures are established through contractual relationships between two or more joint venture parties, while others involve the creation of a separate entity to carry out the joint venture.[55] This thesis will focus on equity joint ventures, in which the parties establish a separate entity.

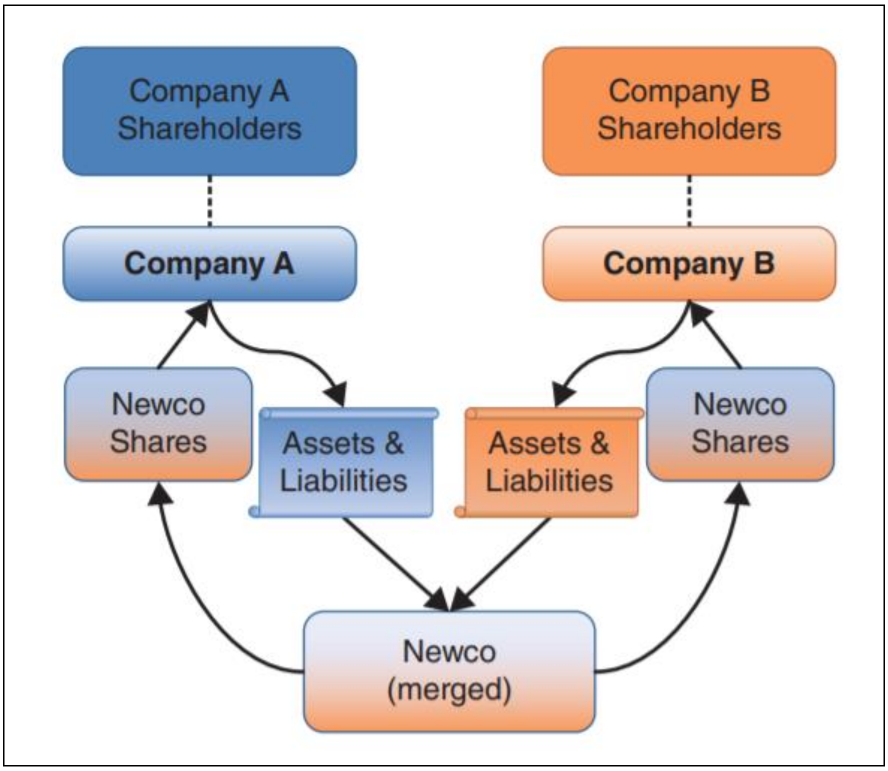

Table 4: Schematic picture of an asset deal paid for by cash or paid for by stock[56]

[54] In a typical M&A transaction, there is always a seller and a buyer. Since strategic partnerships and joint ventures do not provide these roles but rather define the parties involved as *partners*, the terminology may require being adapted. As there is no such term like *partner-induced due diligence*, the author of this thesis refers to the vendor due diligence principle in the sense as if a *partner* were a *vendor*.

[55] Angela Y. Madathil, 'Due diligence for joint ventures' (Goosmann, 28 May 2019) <https://blog.goosmannlaw.com/deal-maker-on-your-side/due-diligence-for-joint-ventures> accessed 17 May 2020

[56] Thomas Kessler, 'Joint ventures' in Scott C. Whitaker (ed), *Cross-Border Mergers and Acquisitions*, (John Wiley & Sons 2016) 415

The main purpose of any joint venture can be described as the combination of both partner's strengths, while pooling their resources with the intention to create competitive advantage in a market and minimize risk. Prior to entering into joint venture partnership, it is essential that both parties specify in detail which goals, aspiration but also which limitations must be applied. Subsequently, the nature of the joint venture can be chosen. Usual forms include corporations, limited liability companies, partnerships and other forms of entity that may be possible under certain jurisdictions. It may also be construed as a partnership between companies of different size, depending on the scope of the projects, the component of time or for other reasons.

Joint ventures can be a beneficial way for a company to enter a new market or line of business. From a strategic viewpoint, there are quite a few items to consider. Often the best partner for a Joint venture is a competitor. In this respect, it must be of utmost importance to define several factors such as: what will be shared and to which extent, who will run the operations, who will own any intellectual property created, what are the goals of the venture and others.

Separating it clearly from a strategic partnership, in which the parties remain independent, the following graphic shows a typical setting, in which companies decide to enter a joint venture rather than divest, outsource, sell or acquire:

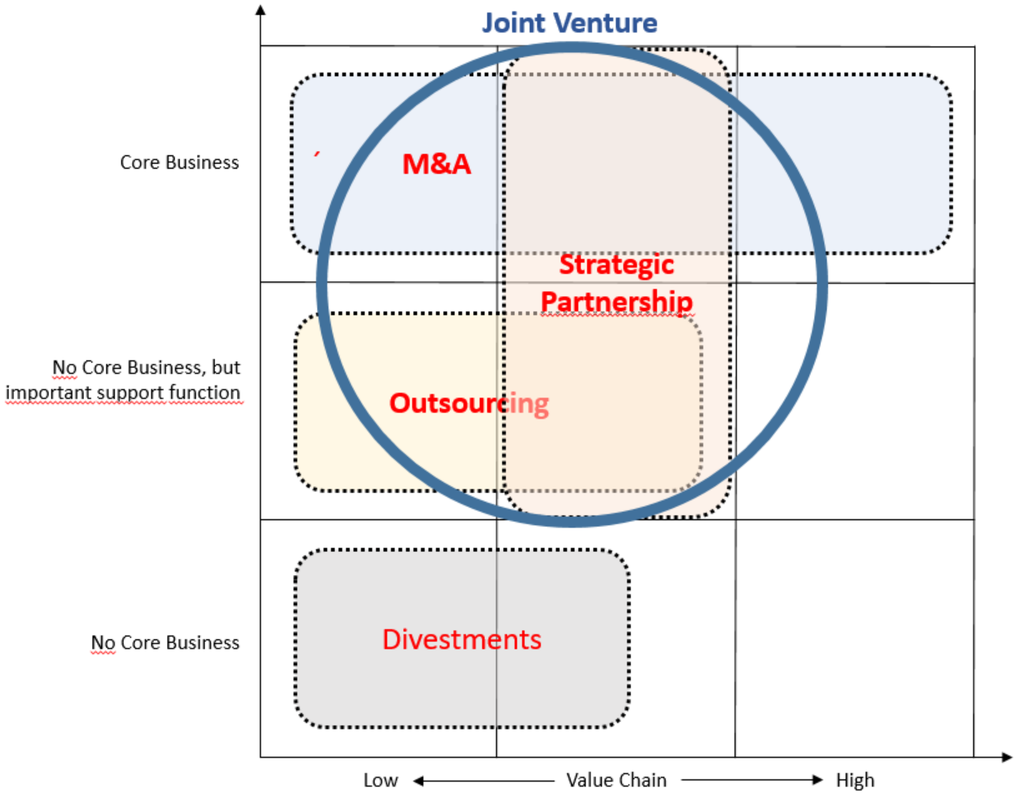

Table 5: The joint venture as a strategic option (own graphic)

The key strategic considerations behind deciding for a joint venture and an M&A transaction differ in various aspects:

- Strategy: whereas transaction decisions in an M&A transaction are unilaterally made by the parties, in a joint venture strategic considerations must always be made under a collaborative aspect. Strategic alignment must be a continuous process throughout the lifetime of a joint venture.[57]

- Agreement negotiations: Rigidity in traditional mergers and acquisitions versus flexibility in joint ventures,

- Duration: Infinite in traditional mergers & acquisitions versus (mostly) finite in joint ventures,

[57] Lucas Dow et al., 'The science of alliances – Success factors in Joint ventures and Strategic Alliances' (PWC, 2014) < https://www.pwc.com.au/pdf/science-of-alliances-2014.pdf> accessed 23 May 2020

- Benefit and risk allocation: In a typical merger & acquisition transaction, the risk and the benefits in the future remain entirely with the buyer after closing. In a joint venture both risks and benefits are shared equally in a 50:50 setup or by the share of ownership or as contractually agreed between the parties. This provides a high degree of flexibility.

- Governance and compliance: one management team in a typical merger & acquisition transaction versus numerous management teams in a joint venture setting. “The best from both sides”.

- Company culture: one prevailing culture in a typical merger & acquisition transaction versus “alliance culture” in a joint venture that is usually influenced by both companies and possible by the “forming and performing” phase of the new entity in an equity joint venture.

It is essential for businesses to understand the key considerations in determining the best path for inorganic growth and to decide whether a joint venture brings more benefits than a strategic alliance, a merger or an acquisition.[58]

4.2 Differing aspects to M&A due diligence

Now how does the Due Diligence Process in joint ventures differ from those in a standard M&A transaction? Both follow the same basic process that is initiated when a decision to buy/partner has been made, potential counterparts have been identified and confidentiality agreements have been signed. Both use similar advisors in the form of law firms and consultants, to investigate similar topics found in a standard due diligence like financial, legal, compliance, etc. In addition, both serve the same core purposes: to verify that the company is getting what it expects from the other party and to understand in more detail the assets, capabilities and

[58] PWC, ‘Buy vs. Partner – Deciding when M&A or an alliance is the right path for growth’ (2018) < https://www.pwc.com/us/en/services/deals/pdf/pwc-buy-vs-partner.pdf> accessed 08 April 2020

risks associated with the other party. The final decision as to whether one should acquire a target company or rather seek a partnership with it or its mother company, can be based on this analysis.

However, the due diligence process differs in a way, that the strategic component is so much more essential to be focused on. The nature of a Joint venture provides a share of power, meaning there is no ultimate control and that clearly impacts all aspects of a due diligence process. Strategic partner due diligence becomes much more important in a joint venture deal adding depth and texture to the initial picture of the counterparty's strategy and strategic drivers, its appetite for risk and future investments, its history in other joint ventures and with other partners, and its corporate culture and decision-making style.[59]

When comparing M&A and joint venture due diligence, I often think of them as the difference between selling your home and moving away ... [versus] selling half your home to another family, who will move in with you. With the latter, you are going to pay attention to a lot of different things.[60]

The following areas of due diligence conducted in a joint venture transaction have been identified as differing from the classic M&A transaction:

4.2.1 Strategic partner due diligence

Joint venture formations require a more extensive strategic partner due diligence overall. It is critical to closely examine the other party's current and future strategy in order to test the strategic fit and alignment while creating a mutual governance and organizational design. Moreover, it is essential to check trust, cultural compatibility, compliance with laws and other fields of importance.

[59] James Bamford, 'How Due Diligence Differs For M&A And Joint venture Deals' (Water Street Insights, 18 July 2019) < https://www.waterstreetpartners.net/blog/how-due-diligence-differs-for-m-and-a-and-joint-venture-deals> accessed 21 May 2020
[60] James Bamford, 'How Due Diligence Differs For M&A And Joint venture Deals' (Water Street Insights, 18 July 2019) < https://www.waterstreetpartners.net/blog/how-due-diligence-differs-for-m-and-a-and-joint-venture-deals> accessed 22 May 2020

In addition to contributing to the joint venture with their own assets such as machinery/technology, facilities, financial assets, key customers, and others, a wise allocation of the most important responsibilities around management within the joint venture are truly essential. The recent past has seen a number of failed joint ventures that were analyzed post termination and found to have failed due to missing strategy, bad management design or conflicts of people. The basic issue of authority is not something that can be “worked out later on.” But must be given the right priority already when designing the joint venture. With regards to significant issues that affect a company, after research and internal discussion, someone must be responsible to make a decision or resolve disagreements. Organizations should have a conflict resolution procedure where, if necessary, a mediator can help them constructively resolve conflicts.[61]

4.2.2 Commercial due diligence

In a joint venture, access to the potential partner’s corporate financials may be more difficult to get, despite a significant need to know their financial health and ability to fund future investments in the joint venture. Parties with serious doubts about the other party’s ability to finance often ask for guarantees, or ask for a third-party letter of credit, usually provided through financial institutions.

In a vendor due diligence setting, it may be reasonable to raise the issue of one’s own corporate financial situation as if it was during a standard M&A due diligence. This will also allow to openly request the same from the counterparty and thereby ensure a higher level of understanding of the joint ventures real future commercial abilities.

[61] Bryan L. Berson, ‘Strategic Alliances And Joint ventures‘ (2013) 52(8) Quality < https://search-proquest-com.uaccess.univie.ac.at/docview/1448721445?rfr_id=info%3Axri%2Fsid%3Aprimo> accessed 22 May 2020

4.2.3 Legal and compliance due diligence

The legal and compliance joint venture due diligence must focus on an expanded range of assets and activities that may potentially affect the new venture's performance and may create risks. Whereas in a typical M&A due diligence, the assets and activities that are not part of the deal – those that remain the property of the seller or are excluded for other reasons – do not require to be given too much attention, in a joint venture due diligence they must also remain in the focus. Since they can potentially impact the future venture's performance and/or reputation, they remain a critical factor during the due diligence process. If – for example – a potential partner has a record of corruption, crime, regulatory violation or else, it clearly impacts the future venture more than in an M&A deal, where the assets are sold and usually transferred to the new owner without an old trace of reputation.

In any joint venture vendor due diligence setting, it may be beneficial to provide the potential future partner with statements from senior management declaring that it has in the past and presence been in compliance with laws, rules and regulations as well as third party auditor reports. The same can and should be requested from the potential partner to maximize trust.

4.2.4 Technical due diligence

Joint venture due diligence also requires evaluating the technical and operational capabilities of the other party. But unlike M&A due diligence, it must translate how these capabilities will map to and complement those of the company to optimize a joint venture.[62]

In a joint venture due diligence it is therefore essential to compare the potential partner's technical capabilities in relation to one's own capabilities. The complementation of each side's contributions with regards to technical capabilities direct-

[62] James Bamford, 'How Due Diligence Differs For M&A And Joint venture Deals' (Water Street Insights, 18 July 2019) < https://www.waterstreetpartners.net/blog/how-due-diligence-differs-for-m-and-a-and-joint-venture-deals> accessed 22 May 2020

ly affects the joint venture’s capabilities with regards governance, organization, service agreements, etc.

Whereas in a typical M&A due diligence there is no substantial need to extend the due diligence beyond assets and activities that can be directly regarded as being part of the deal, it is essential in a joint venture due diligence to examine all critical assets and activities that will remain solely in the scope of the other party and that may be provided “to” the joint venture.

4.3 Legal aspects

A planned joint venture deal may be subject to failure during due diligence in case high risks surface, that are connected to the possible deal and if they are considered to be incurable. Sometimes such risks cannot be overcome by the agreement and incorporated clauses regarding warranty, indemnification or other legal safeguard. The policy must always be to ensure that there is a closing condition and an exit mechanism due to hidden flaws or risks discovered during the process or thereafter especially in case of unethical methods applied in the past and/or present such as corruption or bribery which has not been discovered earlier in the process.[63]

4.3.1 Anticompetitive concerns

Already in the very early stages of planning a joint venture partnership, it is essential to begin considering possible antitrust issues that may affect the joint venture or its future operations. In fact, it is critical to ensure compliance with all applicable antitrust laws during due diligence already, including guidance on avoiding inappropriate information sharing, creating documents related to the transaction and the potential impact of those documents in a government investigation.

[63] Patria Group, ‘Guideline on compliance due diligence - Joint ventures, mergers and Acquisitions’ < https://www.patriagroup.com/responsibility/stakeholder-collaboration/guideline-on-compliance-due-diligence-joint-ventures-mergers-and-acquisitions > accessed 23 May 2020

Any company that considers becoming a partner in a joint venture is entitled to learn about the other partner's business in order to assess, negotiate and optimally close the deal. However, certain information that may be considered interesting may at the same time be competitively sensitive. Such information typically includes:

- price information, both of the past, the present and planned
- costs and cost drivers
- strategic plans, especially when the companies move within the same industry, which is typically the case in joint ventures

The risk of non-compliant antitrust behavior during due diligence is influenced by the degree of overlap of markets in which the potential partners move. It is essential to minimize antitrust risks throughout premerger negotiation and due diligence process, as well as during the integration planning process.[64] In order to assess that overlap with the future partner's company, it may be helpful addressing questions as to which products and/or services are offered, what are the customer target groups and others.

A non-comprehensive list of activities to avoid during an anti-trust due diligence can look as follows (selective):

- The exchange of competitively sensitive information that may be considered as such when both joint venture partners move within the same industry, which is most often the case in this form of cooperation. Sensitive information usually includes pricing, discounts, commercial agreements and others. In a vendor due diligence setting, selecting and providing appropriate information requires utmost attention by the vendor, since the reported data originates within his business sphere and is provided in the absence of the buyer actively asking for it.

- Information that may change or influence the competitive positioning of the "not yet founded" joint venture through adjusting strategy in pricing,

[64] Holly Vedova, Keitha Clopper, Clarke Edwards, 'Avoiding antitrust pitfalls during pre-merger negotiations and due diligence' (Federal Trade Commission, 20 March 2018) <https://www.ftc.gov/news-events/blogs/competition-matters/2018/03/avoiding-antitrust-pitfalls-during-pre-merger> accessed 23 May 2020

commercial agreements, discounts, sales organization and others

- Prior to closing, the placement or integration of staff from either side in existing and/or new positions in the respective other company may also lead to anti-trust concerns since know-how and insights are transferred between the partners-to-be.

- All kinds of integration activities including but not limited to the integration of (central) infrastructure, IT systems, supply chain, marketing initiatives, corporate identity, intellectual property and so on should be carefully considered and avoided if possible.

A non-comprehensive list of activities, that are generally permitted across jurisdictions and which would unlikely lead to anti-trust investigations between two companies forging a future joint venture, may include as follows (selective):

- Principally, all agreements that are construed strictly at arm's length between the two entities and do not constitute sensitive information that0would not be shareable with other parties.

- The exchange of accumulated (principally competitive-sensitive) data during the due diligence process which supports valuation purposes only.

- Providing basic information on the future integration planning for (shared) infrastructure, IT systems, supply chain integration, potential staff redundancies, compensation schemes, human resource policies and others as long as this is based on a one-sided information flow only, while no discussions and(or strategic alignment takes place.

- Redacted information including documents on competitors if they shield customer identities and other information that could potentially be misused in an anti-competitive manner by bidders or possible joint venture partners. It is especially critical to redact this information in a way that makes it impossible to be traced down and inadvertently reveal confidential customer information and identity. This is especially important if the future joint venture partners are in direct competition in the relevant markets. The degree of protection requirement rises with the sensitivity of competitive information to be shared.

The information shared in a vendor due diligence should be narrowly tailored and reasonably related to the needs of the partners while keeping in mind, the antitrust issues that can arise at any stage during pre-closing. Modifying the scope of information that is provided may prove to be helpful if the vendor due diligence is to be made accessible to a larger number of potential partners. At earlier stages in the joint venture process, a larger number of companies may review the information in order to assess the business opportunity. A lesser amount of information is typically needed to be shared at those earlier stages. At later stages in the vendor due diligence process, the number of companies still remaining in the bid and reviewing the information usually decreases. In contrary, the degree of detail requested by the remaining parties is increased significantly as they assess the business opportunity with or depth. This on the vendor's side will require stronger safeguards such as clean teams.

Clean team agreements limit access to competitively sensitive information in data rooms to select individuals (clean team members) who require access to evaluate the assets. Clean team members should be scrutinized to confirm they do not occupy business roles that could enable them to misuse the information for anticompetitive purposes.[65]

Concerning the reduction of risk, the dissemination of confidential information must be strictly restricted to individuals having access to the data room and by additionally prohibiting those individuals from downloading or e-mailing confidential information stored in the data room. Even if information needs to be taken out physically or in the form of data, a clear document destruction process must be in place and be binding for all individuals having access to data. Consequences

[65] Holly Vedova, Keitha Clopper, Clarke Edwards, 'Avoiding antitrust pitfalls during pre-merger negotiations and due diligence' (Bureau Of Competition, Federal Trade Commission of the United States) <https://www.ftc.gov/news-events/blogs/competition-matters/2018/03/avoiding-antitrust-pitfalls-during-pre-merger?utm_source=govdelivery> accessed 12 July 2020

in case of breach can include penalties as well.

4.3.1.1 European Union

In the European Union, the intended creation of a joint venture may fall under national merger-control regulations[66], as well as the Union-wide merger-control regulation[67] and thus become subject to required permission by the European Commission as set forth under the regulation 139/2004[68], respectively by national competition authorities[69].

The EU competition law treatment of joint ventures (joint ventures) depends on whether the joint venture is a concentration:

- If it qualifies as such, it falls within the scope of Regulation (EC) 139/2004 on the control of concentrations between undertakings (Merger Regulation) and may require to be notified to the European Commission before it is set up.

- If not, the parties must assess whether it falls under the prohibition of restrictive agreements as set forth in Article 101 of the Treaty on the Functioning of the European Union.

From an antitrust perspective, the question must therefore be asked to what extent the joint venture will potentially restrict, distort or even prevent competition. It is therefore of utmost importance, to know which options regarding contract drafting exist under the consideration of existing European Union antitrust laws. The nature of the intended joint venture (R&D joint venture, production joint venture, retail joint venture, and others) also has an influence on its legality under anti-

[66] In Austria: § 7 Abs 2, §§ 9 ff KartG
[67] Council Regulation (EC) 139/2004 on the control of concentrations between undertakings (EC Merger Regulation) [2004] Articles 2,3,5
[68] Council Regulation (EC) 139/2004 on the control of concentrations between undertakings (EC Merger Regulation) [2004] Article 4
[69] In Austria: § 9 Abs 1, § 17 Abs 1 KartG

competitive considerations. The European legislation exempts certain joint ventures even if they principally go directly against anti-competitive laws.[70]

However, antitrust-relevant behavior can already occur before the actual establishment of a joint venture, through negotiations and information disclosure. This can be the case when negotiations and/or information disclosure between the future partners - which are competitors in their relevant market – leads to no competition between them.

Vendor due diligence in a European-Union-based joint venture must therefore include the assessment of the future joint venture under anti-competition considerations.

4.3.1.2 United States

As soon as possible, the partners-to-be who wish to engage in a future joint venture, should clearly discern the competitive relationship between their entities. This is a key point that directly influences the level of antitrust scrutiny in the contemplated deal under Section 7A of the Clayton Act, 15 U.S.C. § 18, which prohibits transactions in the United States that may "substantially" lessen competition. In general, transactions among competitors will be viewed more critically by antitrust authorities than other transactions.[71]

In the jurisdiction of the United States of America, Section 7 of the Clayton Act prohibits mergers and acquisitions where the effect "*may be substantially to lessen competition or to tend to create a monopoly"*.[72] Section 7 is also applicable

[70] Treaty of the functioning of the European Union [2016] 2016/C 202/01, art 101 (3) and the relevant block exemption regulation
[71] Creighton J. Macy, 'M&A Antitrust Compliance – Issues before signing and pre-closing' (American Bar Association, 19 April 2018) <https://businesslawtoday.org/2018/04/ma-antitrust-compliance-issues-signing-pre-closing/> accessed 18 June 2020
[72] Anonymus, 'Acquisitions and Mergers under Section 7 of the Clayton Act' (Business and the legal environment, 2012) < https://courses.lumenlearning.com/buslegalenv/chapter/26-7-acquisitions-and-mergers-under-section-7-of-the-clayton-act/> accessed 23 May 2020

for joint ventures, based on a ruling from 1964.[73]

What companies doing business in the United States always have to keep in mind when assessing anticompetitive concerns is being proactive and keeping a solid record of all protocols. Legal advice should be sought in case there are any concerns on either side.

At all times companies should take into consideration the sensitivity of the information offered to or requested by a counter-party and how the exchange of the information could affect competition, both in the short term and if the deal doesn't happen. Once the process is set up, both parties should police the rules to ensure they are followed.[74]

A second important component in that respect is the Sherman Act, which deals with competitively sensitive information and how it must be treated in the course of any due diligence proceeding. Section 1 of the Sherman Act, 15 U.S.C. § 1 et seq., prohibits "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce." The basic elements of a Section 1 violation are[75]:

1. The existence of a contract, combination, or conspiracy between or among at least two separate entities

2. That unreasonably restrains trade

3. That affects interstate or foreign commerce

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[73] United States vs. Penn-Olin Chem. Co. [1961] Civil No. 2282 D. Delaware
Two companies, Hooker and American Potash, dominated sales of sodium chlorate in the Southeast, with 90 percent of the market. Pennsalt Chemicals Corporation produced the rest in the West and sold it in the Southeast through Olin Mathieson Chemical Corporation. The latter two decided to team up, the better to compete with the giants, and so they formed Penn-Olin, which they jointly owned. The district court dismissed the government's suit, but the Supreme Court reinstated it, saying that a joint venture can serve to blunt competition, or at least potential competition, between the parent companies. The Court said that the lower court must look to a number of factors to determine whether the joint venture was likely to lessen competition substantially.

[74] Holly Vedova, Keitha Clopper, Clarke Edwards, 'Avoiding antitrust pitfalls during pre-merger negotiations and due diligence' (Federal Trade Commission, 20 March 2018) < https://www.ftc.gov/news-events/blogs/competition-matters/2018/03/avoiding-antitrust-pitfalls-during-pre-merger> accessed 23 May 2020

75 Sherman Anti-Trust Act (1890) Enrolled Acts and Resolutions of Congress, 1789-1992; General Records of the United States Government; Record Group 11; National Archives

Government in the course of an antitrust review may challenge or even interdict joint ventures, if they consider any information to have been improperly shared. If worse comes to worst, a private plaintiff may also attempt to use such improper information sharing as evidence in alleging a conspiracy.[76]

In relation to vendor due diligence in a joint venture evaluation, considerations relating to the Clayton and the Sherman Act (besides Exon-Florio, Hart-Scott-Rodino filing, FTC Act §5 and others) must be made. Counsel support can be crucial to ensure compliance with all applicable laws, acts and regulations.

4.3.2 Compliance

The increasing number of compliance rules to be followed, exposes management to greater risk of non-compliant behavior. This also increases the liability risk for management and their companies. In addition to the sanctions, compliance violations may result in violations of the law and can lead to high fines or personal prosecution and often threatens a company's reputation when it reaches the media.

Compliance is almost always the top management's duty, however it is often the case, that compliance officers are installed and design a compliance management system, which is required to be reviewed frequently taking into consideration altered circumstances over time. This also applies without restriction to the design of joint venture projects, both at the company as well as at the shareholder level. While the compliance framework, in which the joint venture is established needs to be assessed, the same applies to all future stakeholders in the joint venture. The compliance requirements of the future partner, i.e. the shareholders of the joint venture company, are taken into account and need to be in full compliance with the applicable rules.[77]

Depending on the type of compliance violation (and whether its nature was willful or negligent), civil or corporate claims for damages, as well as fines or penalties

[76] Michael B. Bernstein, Matthew A. Tabas, Matthew H. Fine, 'Due Diligence Anti-trust Issues", (22 June 2018) The Lexis Practice Advisor Journal < https://www.lexisnexis.com/lexis-practice-advisor/the-journal/b/lpa/posts/due-diligence-antitrust-issues > accessed 23 May 2020

[77] Torsten Fett, Christoph Spiering, *Handbuch Joint venture*, (2nd Edition, C.F.Müller 2015) 563

are possible. In extreme cases like bribery and corruption, management may even be exposed to criminal accountability as set forth

- in national anti-bribery and anti-corruption laws based on the Council Act of 27 September 1996 drawing up a Protocol to the Convention on the protection of the European Communities' financial interests.

- exterritorial regulations like the *US Foreign Corrupt Practices Act*, the *UK Bribery Act* and others which apply to entities and people entirely regardless of their nationality.

In a joint venture vendor due diligence, it may be worth considering submitting an affidavit or other kind of written declaration upfront, in which the management confirms compliance with all applicable compliance rules, regulations and laws. In addition, providing a compliance management system as an asset to the newly established equity joint venture may raise trust and ensures "compliance with compliance".

4.4 Best practice ideas in joint venture vendor due diligence

A myriad of best practice recommendations for due diligence in general can be found online and in literature. Best practice in vendor due diligence has already been far less examined and best practice in joint vendor due diligence is a scarcely studied subject. The author of this thesis suggest the following areas as being applicable in the context of conducting a vendor due diligence in the scope of forming an equity joint venture:

- Gathering and sharing the right information

One of the most fundamental things about vendor due diligence in general is that it needs to be a fully informed approach to gathering and sharing the right information. Different joint venture (or transaction) strategies require different sets of information to be shared in a vendor due diligence. The scope of the future activity needs to stay in the focus while gathering and sharing information to the potential partner. Losing the focus may dilute the success of the future joint venture. It is crucial to provide additional information to the other party in an effort to maximize interest and perceived value when it is time to do so.

- Transparency versus retention

As the nature of a joint venture provides that all partners share some common interest, a party to such an agreement must carefully assess the degree of transparency concerning information sharing. While in a typical M&A vendor due diligence, the scope should be set in a way that the buyer focuses on certain (and limited) key areas, in a joint venture vendor due diligence, it may be advisable to share information beyond that scope, even when it is not legally necessary but advisable for the future success of the joint venture.

- Fourth Parties

As a partner to a future joint venture, a company needs to always carefully consider parties beyond third parties - fourth parties – which can be understood as the other party's third parties. Whereas in a typical M&A due diligence, fourth parties may not play an important role after closing - unless they are part of the business process which would rather make them a third party – in a joint venture vendor due diligence, they may plan a more influential part along the way of the future venture's activities. It may be worth including them in a stakeholder's analysis, however the access to that information may be limited. As a vendor, providing that information on fourth parties, which potentially contribute in the one or other way to the future success of the venture, may be beneficial.

- Inclusion of the management team

Allowing middle management teams to be introduced to the potential partner's management team at an early stage already will ensure

  - a higher degree of acceptance from the start and a positive contribution to the internal acceptance of the future venture with another party

- increase the level of information to be gathered during the vendor due diligence process by different teams that are involved.

- ultimately allows a company to select management staff to be employed directly in the future joint venture while ensuring their commitment from an early stage onwards.

- Attitude of the local staff

The attitude of the labor force that will be working for the future joint venture is a quite important factor. There is no more unfortunate beginning to a joint venture then a hostile labor force. In a vendor due diligence setup, the potential future partner could proactively provide a qualitative staff report on motivation, experience and other factors that contribute to the future success. Some effort should be made to allow informal meetings with key personnel so as to have the future partner obtain a realistic view of their current attitudes, grievances, if any, expectations as to the future course of the joint venture company.

4.5 Cross-Border Implications on Joint ventures

Mergers and acquisitions in general as well as decisions to get on board a joint venture deal are connected to a variety of internal and external factors, which have been intensively analyzed over the past decades. A 2015 comprehensive literature review on determinants of cross-border mergers and acquisitions lists about 240 articles. Most publications have also focused on U.S. and Anglo-Saxon transactions: There is less research on the different European countries, and almost none on the transactions being done in emerging countries - inbound or outbound. This should progressively change both with the increasing internationalization of the M&A market, and the development of national education and research programs on finance and management.[78]

[78] Gilles Ourvoie, 'Cross-Border Deal Evolution and Rationale' in Scott C. Whitaker (ed), *Cross-Border Mergers and Acquisitions,* (John Wiley & Sons 2016) 17

The specific analysis of cross-border acquisitions and deals is more recent and therefore not as widely studied yet. Any decision maker involved in a possible joint venture deal should take into consideration the main economic forces and legal implications, which might influence the deal evaluation, the due diligence connected to it and the outcome of the deal. A decision-making process that is founded on the basis of this knowledge provides for a better understanding of the deal design. It also contributes positively to getting a holistic understanding of the relevant determinants that influence a cross-border deal.

Every jurisdiction is different. Each deal in each jurisdiction must be planned on its own merits and the findings checked against local legislation. In addition, it is also important for the overall deal evaluation, that risk is assessed in a consistent manner. What is needed is local investigation and local interpretation, but a central risk assessment methodology.

To date, there is no explicit "law on joint ventures" in any jurisdiction. In European law, the term "joint venture" is merely a legal concept. Useful guidance is more often found in company law. The legal practice of joint ventures is substantially dependent on the use of customary documents, some contractual, others no more than a manifestation of intent, drafted and utilized by lawyers throughout nations establishing accepted standards of business conduct and finding expression in legal forms developed through decades of professional use by lawyers, auditors, commercial bankers, risk capital investors and organizations of the most varied kind.[79]

The establishment of a joint venture can underlie governmental regulations allowing only for limited direct investment of foreign partners into joint ventures. Through their legislation, these countries are forcing investors to set up companies in their country only with the participation of a regional partner company. Some countries – Qatar for instance - do force foreign investors to go for a shared approach with a local player, in most cases requiring a minimum foreign share while applying also upper limits related to certain industries in which the majority owner must be a local player. Even in those cases, joint ventures should not be viewed

[79] Ronald C. Wolf, *The Practitioners' Treatise on International Joint ventures*' (Wolters Kluwer Law & Business 2015) 30

as purely defensive tools: they are indeed a true alternative to acquisitions, in any domestic or international corporate strategy. Cross-border joint ventures are well known for a number of advantages as compared to acquisitions[80]:

- The co-owner may bring its local knowledge and assets to accelerate growth in a foreign market.

- Joint ventures may be the first step in developing a long-term market-entry strategy by allowing one to continue being on the market well prepared once the joint venture is dissolved.

- The scope of what is shared between the partners may be very selective either from a product range perspective or from a functional or operational standpoint. The scoping can be customized.

- It is usually possible to negotiate the buy-back of the shares of the co-owner, once the joint venture is dissolved for whatever reason.

In addition, some sectors may be closed for foreign direct investment and thus remain inaccessible in the usual way. Foreign companies that engage in international business may be required to run their operations from within "free trade zones". Moreover, they may also be restricted from operating within "critical industries," such as defense, education or banking for example. To give an example, in the United States of America, there is a range of laws forbidding the export of certain products or technologies related to military or aerospace use.[81] Foreign currencies may have convertibility restrictions. Taxation may be subject to national preference regulations. Local laws may require joint ventures to hire a certain number of local employees. Trade unions in connection with employee-friendly labor laws may impact the future success of the joint venture. Joint ventures may have to invest in a "development parfait." For example, for many years, the business may have to invest in expensive infrastructure projects and communi-

[80] Gilles Ourvoie, 'Cross-Border Deal Evolution and Rationale' in Scott C. Whitaker (ed), *Cross-Border Mergers and Acquisitions,* (John Wiley & Sons 2016) 28
[81] University of Kansas, 'Overview of US export laws' <https://export-compliance.ku.edu/ overview-us-export-laws> accessed 27 July 2020

ty programs. Executives and entrepreneurs must decide whether the potential benefits of entering an alliance or joint venture is worth the risk.[82]

Host governments may also seek to promote joint ventures with a focus on vertically-integrated operations enabling a better conversion of know-how transfer. For the development of specialized operations, they might prefer to engage consultant services rather than form a special partnership. The foreign company, however, may not want to agree on the establishment of local facilities, which compete for supplies with facilities it already owns elsewhere or because it feels that local handling and processing would cancel out economic advantages it expects from participation in the venture.[83]

4.5.1 Cross-border vendor due diligence

The concept of vendor due diligence in cross-border equity joint ventures has not been studied so far. It can be understood as a due diligence process between potential future partners in an equity joint venture who decide to provide their respective company's due diligence report to the other partner.

A potentially partnering company that decides to participate in a cross-border due diligence process needs to understand upfront the intended procedure and the expectations of all involved parties, and carefully assess its own risk exposure. Due diligence procedures within its own jurisdiction already includes a wide range of information, which can be truly staggering depending on the entities involved, the complexity of the joint venture, what has been negotiated, etc.[84] In addition, the cross-border nature of an envisaged deal includes the required knowledge about the laws of the foreign jurisdiction in question, the cultural expectations of the parties, such as prone to dispute or negotiations and others. The documents, which

[82] Bryan L. Berson, 'Strategic Alliances And Joint ventures' (2013) 52(8) Quality <https://search-proquest-com.uaccess.univie.ac.at/docview/1448721445?rfr_id=info%3Axri%2Fsid%3Aprimo> accessed 31 May 2020
[83] R. Hamlisch / G.K.F Moore, 'Joint ventures in Fishery Development in the CECAF region' (1975) Food and Agricultural organization of the United Nations < http://www.fao.org/3/h0222e/h0222e05.htm> accessed 05 July 2020
[84] Ronald C. Wolf, *The Practitioners' Treatise on International Joint ventures*' (Wolters Kluwer Law & Business 2015) 17

normally accompany an international joint venture, are merely standard. What is not standard are the various forms of creating an international joint venture and the due diligence process related to it.

Now, when looking at how a vendor due diligence principle can be applied successfully in a cross-border joint venture evaluation, it may be helpful to review the chapters of a standard vendor due diligence in a cross-border context. Which sections need to be looked at in particular and how do they differ from a vendor due diligence within one's own jurisdiction. Which viewpoints need to be added to ensure one gets a clear picture of the envisaged joint venture? Hereunder is a listing of areas, which the author deems necessary to be looked at in this context adding to those already described in chapter 4.2.

4.5.2. Foreign investment policy

In a cross-border due diligence, the attitude of the local government towards foreign investment plays a crucial role for the success of a possible joint venture. It does so at every stage, during negotiations by applying rules that may be unknown before, during the joint venture and in the event of dissolution, by possibly applying rules on buy-back, equity split and the like. In a vendor due diligence setting of such a joint venture establishment, the local partner would provide detailed insight not only on the legal framework in which the future joint venture operates, but also the unwritten rules and the climate within the foreign investment is viewed by the local authorities.

If the joint venture shall operate in a country with detailed foreign investment regulation, the legislative pronouncements in the foreign investment laws can mostly be ignored for purposes of understanding the operating circumstances. No matter that the National Parliament declares foreign investment to be welcome, if the functionaries of the authorities have a different view, the joint venture shall incur many obstacles. The proper understanding requires visits to the appropriate ministries and talks with the responsible officials. The impressions gathered shall probably be accurate and crucial to an appraisal of the joint venture's commercial possibilities, which are particularly dependent on the public functionaries of the local jurisdiction.[85]

4.5.3 Strategic foreign partner due diligence

To assess the commercial history of the future partner company in his country provides for a difficult investigation when conducted in the course of a buyer due diligence. In a vendor due diligence setting of a joint venture, providing such records and assessments, eases the process for the potential partner. The same applies to the assessment of the partner's reputation in the local market. Does it have a good public image? Is it associated with any particular family or group and if so, what are the implications of this? Does the joint venture company have access to local financing and to which extent? Are the partners financially strong with interests in other companies? What is the relevance of other companies in which the future partners have interests? Whereas in a buyer due diligence, limited access to such informaio can be gathered through credit agencies and local banks, it increases the level of trust and shortens the time-to-deal when provided within the context of a vendor due diligence.

4.5.4 Legal and compliance vendor due diligence

Providing a future potential partner with a report on one's own legal and compliance records surely is one of the most sensitive issues in the scope of a vendor due diligence setting. As a potential partner to a joint venture in a foreign jurisdiction, it may be advisable to deviate slightly from the vendor due diligence principle and not rely on bona fide.

[85] Ronald C. Wolf, *The Practitioners' Treatise on International Joint ventures*' (Wolters Kluwer Law & Business 2015) 67

4.5.5 Counsel considerations

In any vendor due diligence, the liability aspect related to the vendor's due diligence report provided to the potential buyer or partner in our case, requires to be looked at.[86] Those who conduct vendor due diligence procedures but fail to do it well, may find themselves, once the joint venture has been established, subject for breach of professional responsibility to their clients.

However, for the moment, the practice is not uniform between clients and those whom they have hired. Of course, the matter can easily be resolved in the initial terms of retainer. The client can simply stipulate that the results of due diligence procedures shall be delivered in the form the client wishes for its permanent use or held for consultation by the attorneys. Good practice obligates the advisors to have their conclusions summarized and kept in a manual; any serious due diligence procedures should culminate in a specification handbook, which, if needed, can be consulted as one would any manual.[87]

Whereas in most European jurisdictions, the revelation of due diligence results to potential partners is less problematic, in the United States and other common law jurisdictions, the client-attorney privilege provides for a very different aspect. This kind of privilege concept, which applies to any United States law firm, is quite contradictory to the concept of allowing a non-client to rely on a vendor due diligence report prepared by it. Most U.S. law firms will not permit a non-client even to see its due diligence report unless the non-client first signs a letter agreeing that it may not rely on its contents. This practice presumably results from liability concerns - malpractice claims against law firms are more commonplace in the United States than anywhere else.[88]

Therefore, it is essential for any United States-based law firm prior to engaging in a vendor due diligence process, to understand the implications of this type of due

[86] Tobias Frank, *Compliance Risiken bei M&A Transaktionen* (Tectum, 2012) 75
[87] Ronald C. Wolf, *The Practitioners' Treatise on International Joint ventures*' (Wolters Kluwer Law & Business 2015) 318
[88] Lee J. Potter Jr., 'Vendor due diligence: could it catch on here' [2011] (July 2011) Business Law Today, <http://link.galegroup.com/apps/doc/A338120148/AONE?u=43wien&sid= AONE&xid=5ef9d3ee > Accessed 18 July 2020

diligence, especially in a cross-border setting, One solution, that was already dealt with in chapter 3.6, is the issuance of reliance letters by the seller's law firm to the potential buyer or partner to a joint venture.

Because of the differences in the U.S. legal system versus those of European countries, vendor due diligence, at least in its most fulsome form that permits buyer or partner reliance on the final due diligence reports will remain interesting only on a limited level. [89]

[89] Lee J. Potter Jr., 'Vendor due diligence: could it catch on here' [2011] (July 2011) Business Law Today, <http://link.galegroup.com/apps/doc/A338120148/AONE?u=43wien&sid= AONE&xid=5ef9d3ee > Accessed 31 May 2020

5. Contract drafting aspects in cross-border joint ventures

The future parties to a joint venture need to document in all details, how they will share future profits and losses accomplished by the joint venture. Moreover, whatever kind of tangible or intangible asset is brought in by each party needs to be well documented. Finally, it must be clear to both sides in the joint venture, how those assets plus assets generated over the lifetime of the joint venture are distributed at termination of the joint venture.

Since all joint ventures are built around a mutual project between the parties, there may be more or less overlap of strategic goals, operations and – generally speaking – capabilities. It is very advisable that both partners in the joint venture have a clear and mutually accepted understanding of the overall business relationship within the scope of agreements and beyond.

In most joint venture cases, the parties involved in the deal invest their funds in what becomes their third, jointly-owned entity and share in the resulting profits and losses. It is the presence of this third, independent and mutually owned entity that especially, but not solely, differentiates a joint venture company from a strategic alliance. The nature of strategic alliances is a clear separation of two or more companies. Whatever is desired to be part of their alliance can be set forth in agreements, but the entities stay independent. An equity joint venture in contrary requires a separate entity to be established in which both companies have shares and control.

There is no doubt that the separate entity that is created in most joint venture operations, as well as the joint venture agreement that dictates its operation, raises the stakes over a strategic alliance. As such, these stakes should lend a level of seriousness to negotiations as the two (or more) business owners progress through the discussion and discovery stages of a potential joint venture.[90]

Therefore, once the vendor due diligence reports have been issued to the other party, the contract negotiation phase can be initiated. This usually takes several

[90]Mary T. Wroblewski, ‘What is a joint venture agreement between two companies?'
< https://smallbusiness.chron.com/joint-venture-agreement-between-two-companies-23727.html>
accessed 05 July 2020

weeks and involves legal advice on how to design relevant agreements, culminating in the joint venture agreement. What needs to be established by the parties in parallel is a strategy on how to communicate in these times, who will lead the negotiations, where they take place, setting milestones and other important factors.[91]

Once the phase of closing is already in sight, the parties to the joint venture need to start the carve-out preparation phase. An abundance of factors has to be taken into consideration including the carve-out of assets that are brought into the joint venture, designing integration plans, synergy development, alignment on company culture, defining standard operating procedures, obtaining anti-trust approval from the competent authorities if applicable, and others.

Moreover, finance needs to start considering the closure of accounts and the purchase price allocation. Post-closing transition teams need to launch the integration of both sides, and the business plan is implemented. Ultimately it is then all about executing the business, marketing, and integration plans.[92]

5.1 Structuring cross-border joint venture deals

Cross-border joint ventures involve different countries with different legal systems that may operate very differently from each other. This is particularly true when comparing civil law systems, the legal system prevalent in most of Europe, and common law systems, which prevail in the US, UK and former dependent territories. In addition, cultural differences in how the legal systems is set up and law is executed may cause problems or difficulties not always readily apparent at the time when a potential joint venture is assessed.

The Anglo-American experience is based largely on the principles of contract law. If two parties agree to do something, it will be described and defined in detail with an attempt being made to document the rights and duties of the parties in most

[91] Thomas Kessler, 'Joint ventures' in Scott C. Whitaker (ed), *Cross-Border Mergers and Acquisitions,* (John Wiley & Sons 2016) 413
[92] Thomas Kessler, 'Joint ventures' in Scott C. Whitaker (ed), *Cross-Border Mergers and Acquisitions,* (John Wiley & Sons 2016) 413

conceivable situations. The parties will expect their provisions to be fully enforceable and remedies clear. Under civil law, the approach and expectation is different. Parties entering into joint ventures under civil law systems should be aware that their rights and duties may be affected by the general legal background.[93]

Areas that require in-depth assessment prior to establishing a cross-border joint venture are varied but should include at least[94]:

- A proper examination of feasible forms of legal corporations that exist in the target jurisdiction and which of them are applicable for the joint venture,
- Which potential or existing restrictions on foreign investment, control or ownership *per se*, exist,
- "Overriding" concepts of local law rendering the provisions of an agreement void or unenforceable.
- Ensuring that fiscal transparency and neutrality are maintained across borders.
- The overseas employment of employees from the joint venture's participating companies.
- Material legal circumstances that may potentially limit the joint venture in its operation or existence *per se*,

A web of legal implications resulting from various parameters can look as follows:

[93] Neal Todd, 'Cross-border joint ventures' < https://content.next.westlaw.com/Document/I8abc8eab1c9a11e38578f7ccc38dcbee/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1> accessed 22 June 2020
[94] Neal Todd, 'Cross-border joint ventures' < https://content.next.westlaw.com/Document/I8abc8eab1c9a11e38578f7ccc38dcbee/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1> accessed 05 July 2020

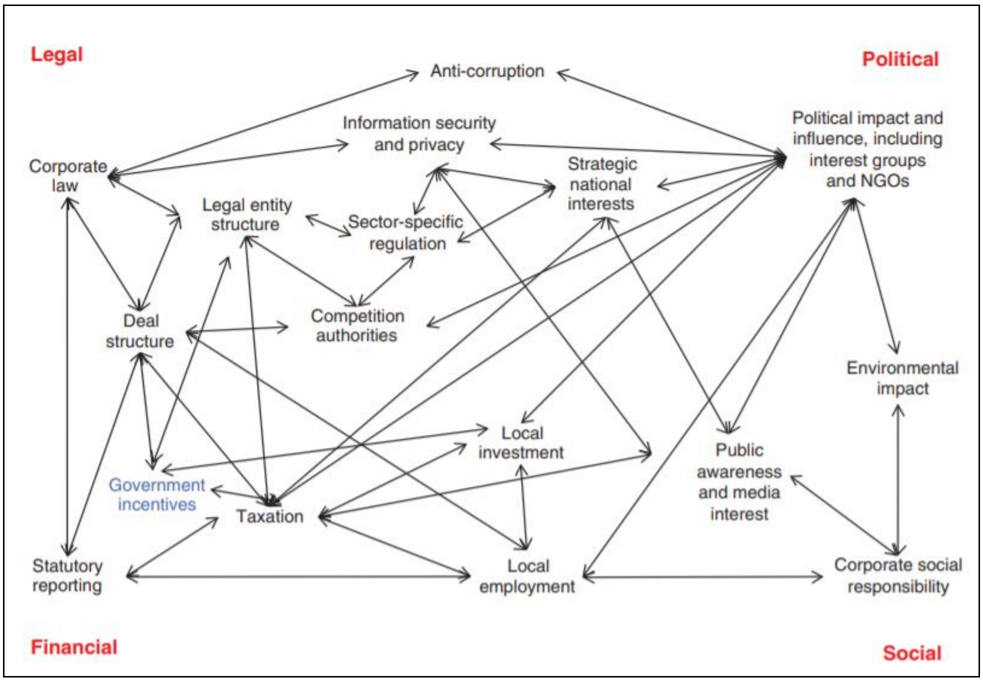

Table 6: Web of key legal, financial, political, and social interdependencies related to cross-border integration[95]

5.2 The letter of intent

Once the stage of sourcing possible partners is been finalized or has reached an acceptable level, most companies seeking to engage in an international joint ventures begin by exchanging correspondence with two or more companies. Ideas are expressed from one party to another about a possible collaboration. The thought of an international joint venture begins to take shape. Once the partners-to-be have reached a level of basic understanding of how the future venture could be shaped, the informal letter of intent comes into play. Its true purpose and also its best function, is to create an open agenda of the principal points on how the parties shall collaborate. The letter of intent can best be described as a "working agenda" or "points to be discussed" so as to convey its true purpose.[96] A letter of intent is hence used to set objectives and define the major issues between the future partners prior to the signing of the joint venture agreement. It may also reveal the real interest of the involved parties to reach an agreement. While it is common, that the party who initiated the joint venture idea and started the search pro-

[95] Andrew Scola, 'Legal, financial, social and political interdependencies with cross-border integration' in Scott C. Whitaker (ed), *Cross-Border Mergers and Acquisitions*, (John Wiley & Sons 2016) 68

[96] Ronald C. Wolf, *The Practitioners' Treatise on International Joint ventures*' (Wolters Kluwer Law & Business 2015) 99-100

cess provides the draft of the letter of intent, this option is generally open to both. A letter of intent, if correctly worded, is a non-binding document, except with regards to confidentiality during negotiations.

5.3 The joint venture agreement

Once the parties have successfully agreed on taking the project to the next stage, they prepare, negotiate and sign a joint venture agreement that then needs to be executed by both parties. This is a usually a highly technical document which incorporates a variety of areas necessary to ensure a mutually beneficial start into the venture. It states what the terms of the joint venture are and it contains cornerstones of the commitments, which both parties agree to bring into the future business. In addition, it must indicate what needs to take place prior to the establishment of the joint venture company. It requires containing numerous clauses concerning all the conditions, which must be fulfilled prior to closing; the warranties and representations of the parties as well as the necessary approvals. The joint venture agreement can be regarded as a primary source for ownership and managerial rights.[97] Contained in the joint venture agreement must also be the right to conduct due diligence procedures. In the context of following a vendor due diligence principle, it should especially outline which documents are prepared by each partner and in which form they are brought forward, assessed and commented on.

A typical joint venture agreement shall encompass the following items:

- Definition of the business

  In the definition of the business section, the company describes what the joint venture will do as a business, what kind of products and/or services it will provide and sell. It usually also describes where in terms of geography the joint venture will operate. Clarity on the concluded points is especially advisable in cross-border joint ventures where language interpretation may

[97] Ronald C. Wolf, *The Practitioners' Treatise on International Joint ventures*' (Wolters Kluwer Law & Business 2015) 100

reveal differentiated understanding post-closing. Moreover, it is also important to include a "good faith" clause. This states that all joint venture parties will commit to implement the strategic vision designed to move the venture forward.[98]

• Management

Literature and experience has shown, that the success of a joint venture also depends on senior management. The earlier it is chosen and established, the more it is independent from the mother companies and the clearer their agenda, authority and reporting lines are, the higher the success rate usually is. Deciding on who brings in which staff or which side is responsible for the recruitment is therefore essential to be clearly set out. The future structure of the board of directors of the joint venture entity is crucial. Members must be carefully assessed, discussed and chosen by the partners. Fairly obviously, the board should be comprised of an odd number of directors unless impasse is contemplated and dealt with elsewhere in the agreement. It is common for the two joint venture partners' representatives to agree upon the odd numbered director.[99]

• Contributions of each partner

The joint venture agreement must outline meticulously which tangible and intangible assets have been contributed to the joint venture by which partner. It may be appropriate to specify values for the respective contributions of the parties based on tax considerations.[100] Vendor due diligence reports can help steer in the direction of a preferred (tax) jurisdiction.

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[98] Thomas Kessler, 'Joint ventures' in Scott C. Whitaker (ed), *Cross-Border Mergers and Acquisitions,* (John Wiley & Sons 2016) 417
[99] Milton R. Stewart and Ryan D. Maughn, 'International Joint ventures, a practical approach' <https://www.dwt.com/files/uploads/Documents/Publications/International%20Joint%20Ventures%20Article_Stewart.pdf> accessed 05 July 2020
[100] Milton R. Stewart and Ryan D. Maughn, 'International Joint ventures, a practical approach' <https://www.dwt.com/files/uploads/Documents/Publications/International%20Joint%20Ventures%20Article_Stewart.pdf> accessed 05 July 2020

• Funding and financing

One of the most essential sections in a joint venture agreement is the funding and financing part. The parties to the agreement must thoroughly think through the financial requirements as well as the terms and conditions that are required to fund the joint venture company properly. This commences with the initial funding and establishing clear rules about who will be funding the operations and what the funding party will receive in return for such funds. It further sets the baseline for subsequent funding.[101] The parties should delineate in as much details as possible and necessary who gets what, where, when, why and how. Dividend distributions, capital calls and allocations of losses must be covered.

• Ownership transfer of the joint venture

One issue that is sometimes overlooked but must be inherent in any joint venture agreement is the regulation on what happens if one of the parties to the joint venture desires to sell part of all of its share. The parties may agree to a variety of possible transfer arrangements, including rights of first offer, rights of first refusal, drag-along rights and tag-along rights.[102]

• Governing law and alternative dispute resolution mechanisms

Even though the jurisdiction at the location of the joint venture usually defines the chosen law, it is quite common to provide for a choice of law from a neutral jurisdiction. The same applies to the venue if that is mutually convenient for the involved parties. Nevertheless, it is often a reality that the parties prefer their home jurisdiction or request a neutral jurisdiction to be

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[101] Thomas Kessler, 'Joint ventures' in Scott C. Whitaker (ed), *Cross-Border Mergers and Acquisitions,* (John Wiley & Sons 2016) 417

[102] Milton R. Stewart and Ryan D. Maughn, 'International Joint ventures, a practical approach' <https://www.dwt.com/files/uploads/Documents/Publications/International%20Joint%20Ventures%20Article_Stewart.pdf> accessed 12 July 2020

incorporated into the agreement. [103] Legal consultation is advised, especially since there are jurisdiction, predominantly in the Middle East, that do implicitly not allow foreign governing law to be included into agreements or which regard their laws as superseding any foreign law if the joint venture is doing business within their territory.

• Provisions of termination

Even though the inclusion of termination and post-termination clauses may be widely regarded as a sign of mistrust when presented in joint venture deal-making, it is more than ever necessary these days to address and include them into a joint venture agreement. Detailed provisions regulating termination and who is entitled to terminate and at which point during the life cycle of the joint venture, should be inserted clearly stating how and when the joint venture agreement can be terminated.

Reasons for termination of a joint venture can be numerous; however the following are commonly referred to in literature:

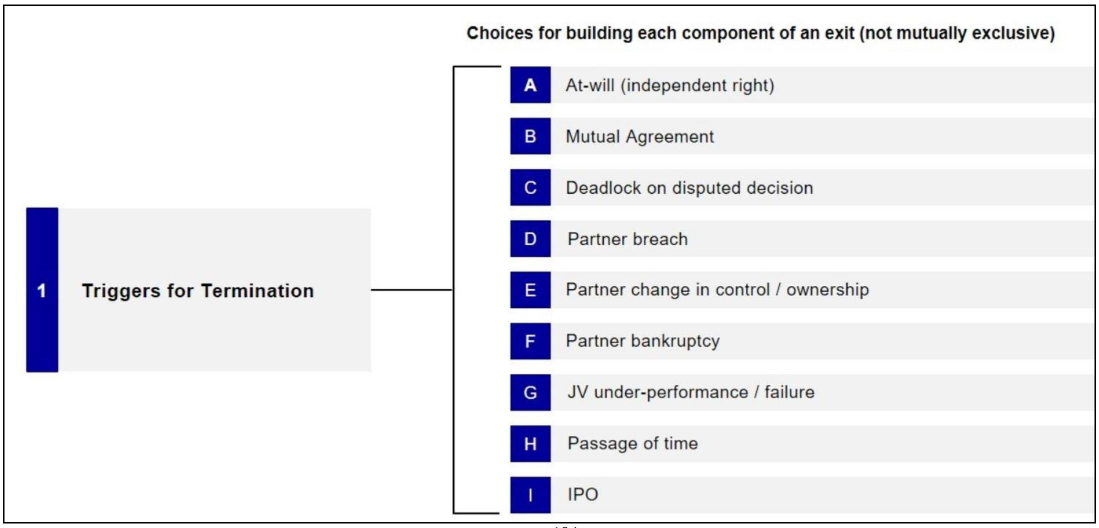

Table 7: Triggers for termination of a joint venture[104]

[103] Neal Todd, ‘Cross-border joint ventures‘ < https://content.next.westlaw.com/Document/I8abc8eab1c9a11e38578f7ccc38dcbee/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1> accessed 12 July 2020

[104] Joshua Kwicinski, ‘Contemplating your joint venture exit strategy: Structuring exit terms in joint ventures‘ (Water Street Partners, 10 April 2018) <https://www.waterstreetpartners.net/blog/contemplating-the-inevitable-how-to-structure-exit-terms-in-joint-ventures> accessed 12 July 2020

Non-Disclosure, Non-Competition, Non-Disparagement and Non-solicitation Provisions

In any legitimate joint venture agreement there should be restrictions applied to the joint venture partners in relation to confidential information. Such information must not be passed onto third parties without the prior written consent of the joint venture partner. Additionally, in practice, it is quite usual that joint venture agreements contain clauses which establish certain restrictions on the parties. Such restrictions may be construed in the form of obligations not to compete with the other partner in the joint venture and/or with the joint venture itself. Such clauses are known as “non-compete clauses”. Attention needs to be paid to whether these restrictions may be viewed as anti-competitive, hence subject to antitrust regulations and violation of the freedom of entrepreneurial activity (as often found in Central Asian jurisdictions for example). Furthermore, joint venture agreements may sometimes include non-disparagement clauses, which aim at preventing the other partner in the joint venture from disseminating (essentially negative) information about the other partner and/or the joint venture itself. Finally yet importantly, the applicability of non-solicit / no-poach clauses, disallowing each partner to hire the other partner’s employees, is controversially discussed and could potentially violate antitrust regulations.[105]

• Intellectual Property

In a successful joint venture, development efforts may expedite research and development. The question often surfaces who will be holder of the IP rights, especially when the joint venture is dissolved or terminated. If the joint venture agreement is not structured correctly, the resulting IP can be significantly devalued or become subject to ownership claims by the individual joint venture partners. Therefore, incorporating clauses into the joint venture agreement, which clearly regulate existing and future IP rights, is

[105] Pallavi Guniganti, ‘No-poach provisions justified in joint ventures, lawyer says’ (GCR USA, 29 May 2018) < https://globalcompetitionreview.com/article/usa/1170006/no-poach-provisions-justified-in-joint-ventures-lawyer-says> accessed 12 July 2020

crucial to understand and mitigate potential risks related to IP.

- Other clauses

Sample joint venture agreements are widely available and non is essentially identical to any other. Especially in cross-border joint ventures, a variety of factors can influence the requirements and the degree of detail, which must be applied when drawing up the joint venture agreement. Local counsel support is always advised to avoid the pitfalls of a weak joint venture agreement in a more or less unknown jurisdiction.

Recent research on alliance governance has shown again, that joint ventures are particularly complex forms of collaboration. Companies that form a joint venture are often confronted with difficulties in anticipating next steps and patterns of behavior during the agreement negotiation stage. This is especially true for companies engaging in such a business model for the first time. When initial joint venture contracts are incomplete, renegotiation represents a key strategic challenge and opportunity at the same time, for enhancing contractual safeguards or coordination guidelines over the course of the joint venture. [106] Partners to a joint venture may however underestimate the costs and risks of such renegotiation. Legal advice may substantially decrease the risk of gaps in the joint venture agreement at an early stage already.

[106] Valérie Duplat et al., '*Renegotiation of joint venture contracts: the influence of alternative governance mechanisms*' [2018] 53(2) Long Range Planning

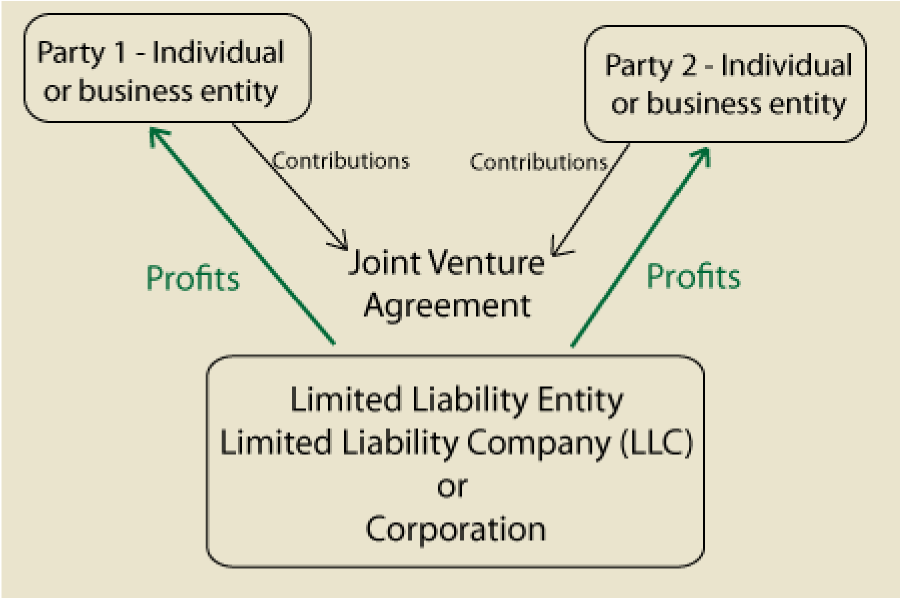

Table 8: The setting of a joint venture agreement[107]

5.4 The Shareholders Agreement

The joint venture agreement often contains clauses conferring special rights on one partner. For example, a minority partner may be ensured a certain number of seats on the board of directors. Or, there may be provisions that no change of capital in the joint venture shall be possible without the unanimous approval of all partners, regardless of their capital participation. In what document a particular clause should appear is a legal decision and one that is not entirely free from doubt. In the end, most lawyers repeat the same clause in various documents.

Consequently, concerning rights between shareholders, it is quite common to construct a shareholders' agreement, which deals exclusively with these issues. In reality, the same topics could be inserted in the joint venture agreement. However, literature and experience vaguely point out the advantages of excluding these topics and putting them into a separate shareholders' agreement. Such a technique permits a more analytic view: what did the shareholders intend to be regulated between them? Instead of searching through a lengthy joint venture agreement, it should be all contained in the Shareholders' agreement. Additionally, as new

[107] Bryan Springmeyer, 'Structuring joint venture agreements in California' (Springmeyer Law) <http://www.calstartuplawfirm.com/business-lawyer-blog/california-joint-venture-agreement.php> accessed 19 July 2020

shareholders become member of the joint venture agreement their signature may be secured to the new agreement. If amendments are needed, they can be annexed to the Shareholders' agreement, facilitating understanding.[108] The Shareholders' agreement has a significant role in enhancing and protecting minority interests so as to warrant an individual treatment in a separate chapter

5.5 Common ancillary agreements

Besides the essential documents required across most jurisdictions and described above, there may be ancillary documents requested by either or both parties to the future joint venture.

- a formation agreement

  is commonly referred to as an agreement, which the parties sign once they have agreed on the terms of the joint venture but require additional time to satisfy closing conditions set out in the agreement, such as obtaining governmental and/or regulatory approvals or third-party consents, securing third-party financing, or hiring key employees and others. This ancillary document has integrated drafting notes with essential clauses and comments.

- a confidentiality agreement

  is a very basic document that should be signed prior to any detailed negotiations going on and definitely prior to providing a vendor due diligence report. The purpose of confidentiality agreements does not need much explanation as the name stands for itself: Ensuring that confidential information remains between the signatories to the confidentiality agreement and is not passed on to any third party without the prior written consent by the other party.

[108] Ronald C. Wolf, *The Practitioners' Treatise on International Joint ventures*' (Wolters Kluwer Law & Business 2015) 219

- a board of directors agreement

  which usually includes offer letters and service agreements between the joint venture and its board members and regulates the board member's functions. As an independent and separate document, its use is highly endorsed, especially in the case of a significant capital joint venture. Its purpose is mainly to establish how voting shall be done on a variety of issues. The possibilities are simple majority, super-majority and unanimous. In the formation of a joint venture, this is a highly useful document because by creating a super-majority requirement, for example 75% of the votes, a minority partner only having one-third of the seats on a board can block any affirmative action.[109]

- the agreed due diligence procedures

  may be contractually agreed on prior to a joint venture agreement. In the case of vendor due diligence as the chosen means, such agreement may not be necessary unless either party wishes to secure rights to additional due diligence proceedings during the lifetime of the joint venture.

- agreed financial budgeting

  Quite a substantial amount of time is used up by management to prepare budgets and operating plans for the newly formed joint venture. These are precious working documents that may have a legal relevancy. They indicate what the parties planned, the limitations of the joint venture; its expansion possibilities; how money would be spent and on what. Having these documents annexed to the joint venture agreement thus provides an

[109] Ronald C. Wolf, *The Practitioners' Treatise on International Joint ventures*' (Wolters Kluwer Law & Business 2015) 104

invaluable reference and even a check on the actions of the majority.[110]

- other ancillary agreements

various additional ancillary agreements such as technology licenses or distribution contracts can be forged and naturally each venture produces its own specific tailored ancillary contracts.

[110] Ronald C. Wolf, *The Practitioners' Treatise on International Joint ventures*' (Wolters Kluwer Law & Business 2015) 105

6. Appendices

6.1 Executive summary in English

Cross-border equity joint ventures are on the rise globally and offer a great opportunity for entities of all sizes and across most industries to move their businesses across borders. No business should seek any kind of cooperation without conducting a proper due diligence. Once a decision is made to collaborate with another company, it truly pays off to get the right information from the right people at the right time. Any offer made to form a joint venture must be "subject to due diligence". It goes without saying, that the cost of a due diligence exercise pays for itself many times over. The scope of investigation for a due diligence report, can vary substantially, but the more one knows, the better.

This thesis looked into whether a vendor due diligence process - in which the partner to a joint venture prepares a due diligence report by his own initiative and covering all relevant aspects about its entity - can and should also be applied in the formation of a joint venture. No literature has so far been published on this approach and the author of this thesis has extracted areas, that need to be paid special attention to when moving cross-border and working on the basis of a self-induced due diligence report. Aspects to consider are of political, cultural and of course legal nature, the latter especially also involving antitrust regulations that vary among jurisdictions.

This thesis is a first look into the application of vendor due diligence in cross-border equity joint ventures. Further investigations are necessary to better understand the implications for a concept that has so far not been applied in joint ventures but rather in large-scale bidding processes.

6.2 Executive summary in German

Grenzüberschreitende Joint Ventures sind weltweit auf dem Vormarsch und bieten Unternehmen jeder Größe und in den meisten Branchen gute Chance, Ihre Internationalisierung voranzutreiben. Kein Unternehmen sollte irgendeine Art von Zusammenarbeit anstreben, ohne eine ordnungsgemäße Due Diligence durchzuführen. Sobald eine Entscheidung getroffen wurde, mit einem anderen Unternehmen zusammenzuarbeiten, lohnt es sich wirklich, die richtigen Informationen zur richtigen Zeit von den richtigen Personen zu erhalten. Jedes Angebot zur Gründung eines Joint Ventures muss „der gebotenen Sorgfalt (Due Diligence) unterliegen". Es versteht sich von selbst, dass sich die Kosten einer Due-Diligence-Prüfung um ein Vielfaches amortisieren. Der Untersuchungsumfang für einen Due-Diligence-Bericht kann erheblich variieren, aber das Wissen über das Gegenüber sollte natürlich so groß wie möglich sein.

In dieser Arbeit wurde untersucht, ob ein Vendor Due Diligence-Prozess, bei dem der Partner eines Joint Ventures von sich aus einen Due Diligence-Bericht erstellt und alle relevanten Aspekte seines Unternehmens abdeckt, auch bei der Gründung eines Joint Ventures angewendet werden kann und sollte. Bisher wurde keine Literatur zu diesem Ansatz veröffentlicht, und der Autor dieser Arbeit hat Bereiche herausgearbeitet, die bei grenzüberschreitenden Projekten auf der Grundlage eines selbstinduzierten Due-Diligence-Berichts besonders berücksichtigt werden müssen. Zu berücksichtigende Aspekte sind politischer, kultureller und natürlich rechtlicher Natur, wobei letztere insbesondere auch kartellrechtliche Vorschriften betreffen, die von Land zu Land unterschiedlich sind.

Diese Arbeit ist ein erster Blick auf die Anwendbarkeit der Vendor Due Diligence in grenzüberschreitenden Joint Ventures. Weitere Untersuchungen sind erforderlich, um die Auswirkungen auf ein Konzept besser zu verstehen, das bislang nicht bei Joint Ventures eingesetzt wurde, sondern in groß angelegten Ausschreibungsverfahren Anwendung fand.

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