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**The Merger and Acquisition of the Small to Medium Sized
Enterprise ("SME") on an International Stage, a Buyer and
Seller's Guide**

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Mihail-Andrei Lezau

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Mihail-Andrei Lezau

Abstract

Conducting a cross-border merger and acquisition (“M&A”) transaction that involves small to medium-sized enterprises (“SMEs”) from different jurisdictions, requires a understanding of the main steps involved. This is especially so, when one of the SMEs is located in a civil law jurisdiction from the European Union (“EU”) while the other SME is located in a common law jurisdiction, outside of the EU. The purpose of this dissertation is to acquaint the reader with the main steps needed, as well as the issues to avoid, in order to secure a successful sale or purchase of a privately held SME in a cross-border environment. To illustrate how the various factors work, a mock outbound cross-border M&A transaction will be used throughout this dissertation. This will involve a private SME purchaser located in the Federal Republic of Germany and a privately-held Target SME located in the United Kingdom of Great Britain and Northern Ireland. The various types of transactions, such as share purchase agreement (“SPA”), assets transfer and auction, will be described, together with the pros and cons to using them. The national and regional legislative provisions affecting the sale in each of the jurisdictions, will be discussed. The use of letters of intent and confidentiality agreements to kick-start the M&A transaction using a SPA, will be detailed. The process and types of due diligence, and data rooms usage will be explored, together with the condition precedent clauses needed to ensure the requisite third-party consents are received. Representations and warranties, the further disclosure provided by the seller and the specific (and general) indemnity provisions will be detailed. Discussion will also be had on the usage of covenants, specific clauses used to limit the liability of the seller and deficiencies in cross-border M&A transactions, especially in a post-Brexit world.

Keywords: merger, acquisition, share purchase agreement, letter of intent, confidentiality agreement, due diligence, conditions precedent, representations, warranties, specific indemnity, covenant, limitation of liability

Deutscher Abstract

Die Durchführung einer grenzüberschreitenden Fusions- und Übernahmetransaktion („M&A“), an der kleine und mittlere Unternehmen („KMU“) aus verschiedenen Rechtsordnungen beteiligt sind, erfordert ein Verständnis der wichtigsten Schritte. Dies gilt insbesondere dann, wenn eines der KMU in einer Zivilrechtsordnung der Europäischen Union („EU“) ansässig ist, während das andere KMU in einer Gerichtsbarkeit des Common Law außerhalb der EU ansässig ist. Der Zweck dieser Dissertation besteht darin, den Leser mit den wichtigsten erforderlichen Schritten sowie den zu vermeidenden Problemen vertraut zu machen, um einen erfolgreichen Verkauf oder Kauf eines KMU in Privatbesitz in einem grenzüberschreitenden Umfeld sicherzustellen. Um zu veranschaulichen, wie die verschiedenen Faktoren funktionieren, wird in dieser Dissertation eine simulierte grenzüberschreitende M&A-Transaktion verwendet. Dabei handelt es sich um einen privaten KMU-Käufer mit Sitz in der Bundesrepublik Deutschland und ein in Privatbesitz befindliches Ziel-KMU mit Sitz im Vereinigten Königreich Großbritannien und Nordirland. Die verschiedenen Arten von Transaktionen wie Aktienkaufvertrag („SPA“), Vermögensübertragung und Auktion werden zusammen mit den Vor- und Nachteilen ihrer Verwendung beschrieben. Die nationalen und regionalen gesetzlichen Bestimmungen, die den Verkauf in jedem der Gerichtsbarkeiten betreffen, werden erörtert. Die Verwendung von Absichtserklärungen und Vertraulichkeitsvereinbarungen zum Ankurbeln der M&A-Transaktion unter Verwendung einer SPA wird detailliert beschrieben. Der Prozess und die Arten der Due Diligence sowie die Nutzung von Datenräumen werden zusammen mit den aufschiebenden Klauseln untersucht, die erforderlich sind, um sicherzustellen, dass die erforderlichen Zustimmungen Dritter eingeholt werden. Zusicherungen und Garantien, die weitere Offenlegung durch den Verkäufer und die spezifischen (und allgemeinen) Entschädigungsbestimmungen werden detailliert beschrieben. Erörtert werden auch die Verwendung von Covenants, spezifische Klauseln zur Begrenzung der Haftung des Verkäufers und Mängel bei grenzüberschreitenden M&A-Transaktionen, insbesondere in einer Welt nach dem Brexit.

Schlagwörter: Fusion, Übernahme, Anteilskaufvertrag, Absichtserklärung, Vertraulichkeitsvereinbarung, Due Diligence, aufschiebende Bedingungen, Zusicherungen, Gewährleistungen, besondere Freistellung, Vereinbarung, Haftungsbeschränkung

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Abbreviations

BGB	the German Civil Code (Bürgerliches Gesetzbuch)
BKartA	the German Federal Cartel Office (the <i>Bundeskartellamt</i>)
BMWi	Germany's Federal Ministry of Economics
CA	Confidentiality Agreement
CP	Conditions Precedent
DD	Due Diligence
EC	the European Commission
EEA	European Economic Area
EU	the European Union
IPO	Initial Public Offering
LOI	Letter of Intent
M&A	Merger(s) and Acquisition(s)
MAC	Material Adverse Change clause
NDA	Non-disclosure Agreement
Parties	the Seller and Purchaser to a SME
SME	Small and Medium-Sized Enterprise
SPA	Share Purchase Agreement
SPAC	Special Purpose Acquisition Company
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	the United Kingdom
US	the United States of America

Introduction.

After years of researching, experimenting and developing, a young entrepreneur, based in one of the European Union (“EU”) countries (Germany) started a company called ONE that makes a great first-generation electronic product, called X. The company has 150 employees and an annual turnover of approx. €20 million, meaning that it meets the European Commission’s definition of a small and medium-sized enterprise (“SME”).¹ Referred to as “the backbone of the European economy” SMEs are defined as those companies that have less than 250 employees, no more than €43 million on their balance sheets total or no more than €50 million annual turnover.² For its second-generation electronic product called X2, ONE learned that it needs sub-component Y, which would greatly improve the second-generation electronic product X2 and likely make it more successful than its predecessor X. Sub-component Y is made by another SME, TWO, which is also based in Europe, in particular the United Kingdom, which is no longer in the EU and has been operating for decades. TWO has 100 employees, and an annual turnover of approx. €10 million, meaning it too can be defined as a SME. There is some indication that TWO wants to close up shop or sell itself to a potential buyer. To ensure that the sub-component Y continues to be available for its second-generation product X2, ONE makes the decision to purchase TWO.

The purpose of this Master’s Thesis (“Thesis”) is to provide an overview, guidance and understanding for parties interested in purchasing or selling of privately held companies that are SMEs in a cross-border international setting, related to continental European civil law and common law jurisdictions.³ For the purposes of this particular Thesis, the jurisdictional focus shall be on the United Kingdom (“UK) for European common law jurisdiction and on EU Member State Germany for civil law jurisdiction. The reason for selecting primarily these two jurisdictions, UK and Germany, is for practical considerations having regard to the abundance of literature available, that one is in the EU (Germany) and the other is not (the UK) and that both have distinctly different types of jurisdictions: one is civil law (Germany) and the other is common law (the UK). The

¹ Eurostat, ‘Structural Business Statistics: Small and Medium-Sized Enterprises (SMES) (European Commission, undated) <<https://ec.europa.eu/eurostat/web/structural-business-statistics/small-and-medium-sized-enterprises>> accessed 4 October 2022.

² *Ibid.*

³ Andrei Lezau, ‘The Merger and Acquisition of the Small to Medium Sized Company (“SMS”) on an International Stage, a Buyer and Seller’s Guide’ (Master’s Thesis Proposal, University of Vienna 2022).

interactions between ONE (located in Germany) and TWO (located in the UK) as they attempt to conclude the transaction is viewed through a number of legal requirements encapsulated within the following five chapters.

The first chapter of this Thesis will consider the laws and regulations which dictate mergers and acquisitions (“M&A”) in the UK and Germany, as well as the methods that can be employed to purchase an SME (the “Target SME”), such as share purchase agreement, assets transfer or as is the case in some jurisdictions, via auction. The second chapter will explore pre-transaction considerations such as letters of intent and confidentiality agreements sent between the purchasing SME (the “Purchaser”) and the seller (the “Seller”) of the Target SME. The third chapter looks towards due diligence and condition precedents clauses. The fourth chapter will analyze representations, warranties, specific indemnities and disclosure and provide an understanding on how to draft such clauses from the Seller or Purchaser’s perspective. The fifth and final chapter will be dedicated to covenants and other post-transaction considerations.

Chapters will also discuss, where available, case law related to the areas analyzed and how the courts have dealt with those specific issues. The subjects covered in each of these chapters are very large in scope and contain great in-depth sub-subjects, case law and commentaries. The emphasis of this Thesis is to provide the key steps when purchasing a Target SME in a cross-border international setting. It is important to understand that other issues may arise and do exist in the real world of private M&A transactions of Target SMEs, but due to their difficulty, complexity, bureaucratic components, as well as other factors, these go beyond the scope of this Thesis and will not be covered in depth. In addition, this Thesis will not consider the purchase or sale of publicly traded companies, instead limiting itself to privately held SMEs, including those privately SMEs that may have been public at some point but are no longer publicly traded.

1.0 Chapter 1: Selling or Buying an SME.

The focus of this chapter will be to introduce the pertinent laws, rules and regulations that allow private M&A transactions to occur in the UK, Germany and the EU. The purpose of these laws will be briefly discussed. The three types of M&A transactions that are possible will be

detailed, those being share purchase agreements, assets transfer and auction, together with an analysis of which should be utilized. As it will be further explained, the selection of the M&A transaction type will depend on a number of factors, such as the financial state of the Target SME, the location of the Purchaser, Seller, Target SME and foreign ownership restrictions. In addition, the transaction type selection will also depend on whether it is the Seller or the Purchaser's point of view. This chapter will then conclude with an analysis of how the Purchaser ONE and the Seller of Target SME TWO should proceed.

1.1 Mergers and Acquisitions Regulations.

1.1.1 The UK. Before proceeding to sell or purchase a Target SME, one has to be mindful of the legislation governing the private M&A process. In this common law jurisdiction, the purchase of a Target SME is regulated by the *UK Takeover Code* (the “Code”), which is enforced by the UK Takeover Panel (the “Panel”), with authority from the *Companies Act 2006*.⁴ The Code applies not only to publicly traded companies but also to private companies that are not listed on the London Stock Exchange (or any other stock exchange markets) anymore, if they were listed in the past 10 years prior to the transaction.⁵ The purpose of the Panel is “*to ensure fairness and equality of treatment for all shareholders of the target company on a takeover, within a framework that provides sufficient flexibility.*”⁶ Failure of the parties to abide by the Code in proceeding with the M&A, can lead to sanctions imposed not only by the Panel but also by the UK regulator of financial markets, that being the Financial Conduct Authority.⁷ In addition, depending on the industry, there are other laws and regulations that could be relevant such as:⁸

1. *The Market Abuse Regulation*, enacted following the UK's withdrawal from the EU that deals with insider dealing;

⁴ David Avery-Gee and Murray Cox, ‘Mergers & Acquisitions Law and Regulations UK 2022’ (ICLG, 2022) <<https://iclg.com/practice-areas/mergers-and-acquisitions-laws-and-regulations/united-kingdom>> accessed 11 October 2022.

⁵ *Ibid.*

⁶ *Ibid.*

⁷ *Ibid.*

⁸ *Ibid.*

2. *The Disclosure Guidance and Transparency Rules*, which mandates disclosure obligations of Sellers and Purchasers, and,
3. *The National Security and Investment Act 2021* (the “NSI Act”), which mandates obtaining permission for the transaction where the Target SME is part of specific industries, such as artificial intelligence, energy and so forth.

1.1.2 Germany and the EU. Unlike the UK, in this EU Member State, private M&A transactions are not regulated by any specific laws, rather German civil law general provisions related to purchase of goods will apply, as well as German corporate laws “*depending on the legal form of the target entity and [...] on the business the [Target SME] operates in.*”⁹ The legal form relates to the structure of the Target SME, which can be:¹⁰

1. A limited liability company, known as GmbH, regulated by the Limited Liability Companies Act (GmbHG);¹¹
2. An unlisted stock corporation, known as AG, regulated by the Stock Corporation Act,¹² or
3. A “*limited partnership with a limited liability company as sole general partner*” known as a GmbH & Co KG, and regulated by a partnership agreement.

In the EU, there is also a regulation entitled the Merger Regulation¹³ that came into effect in 2004 and replaced the original EU regulation on mergers, that being Council Regulation 4064/89, which had been in effect since 1989.¹⁴ The legislative change and replacement was due in part to the wishes of various business communities to have a “*clear and single system of merger*

⁹ Alexander Schwarz and Ralf Morshauser, ‘Private M&A in Germany’ (Lexology, 27 March 2019) <<https://www.lexology.com/library/detail.aspx?g=4f9a8946-c432-469e-bce1-9e16f40e85ce>> accessed 11 October 2022.

¹⁰ *Ibid.*

¹¹ Heiko Jander-McAlister, Roderich Fischer and Jorg Nickel, ‘Mergers & Acquisitions Laws and Regulations Germany 2022’ (ICLG, 2022) <<https://iclg.com/practice-areas/mergers-and-acquisitions-laws-and-regulations/germany>> accessed 11 October 2022.

¹² *Ibid.*

¹³ Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation) [2004] OJ L24/1.

¹⁴ Council Regulation (EEC) 4064/89 of 21 December 1989 on the control of concentrations between undertakings [1989] OJ L395/1; Riccardo Celli and Others, *Corporate acquisitions and mergers in the European Union* (Wolters Kluwer 2014) at pp. 1.

control at the EU level.”¹⁵ The Merger Regulation allowed a simpler way for uncomplicated M&A transactions to proceed, made various procedural changes on the approval (or refusal) of M&A transactions and updated certain definitions regarding joint venture agreements.¹⁶

The Merger Regulation can apply to M&A transactions where either the Seller or the Purchaser are not located in the EU.¹⁷ The EC’s jurisdiction was challenged in the *Gencor/Lonhro*¹⁸ decision. The EC rejected a M&A transaction between a UK-based company (back when the UK was still part of the EU) and a platinum and rhodium metal company based in South Africa on the basis that it would give the British company dominance over those metal markets.¹⁹ The British company appealed before the General Court.²⁰ It was decided that the EC was within its rights to prohibit such M&A transaction, as the mere sale of platinum and rhodium metals within the EU is sufficient for the EC to have jurisdiction, regardless of where the manufacturer’s plant or supply source existed.²¹

Pursuant to sub-Article 1(2) of the Merger Regulation, in order for this particular Regulation to apply to a M&A transaction or deemed to have a Community dimension, two factors must be satisfied.²² First, the total turnover of all Parties to the M&A transaction must be more than €5 billion and second, the turnover of each of the Parties to the M&A transaction must be at least €250 million.²³ If sub-Article 1(2) of the Merger Regulation does not apply, then nonetheless the Regulation will still apply if four other factors are met, which factors are encompassed in sub-Article 1(3) of the Merger Regulation.²⁴

According to sub-Article 1(3), if the total turnover of all Parties worldwide is at least €2.5 billion (first factor), the total turnover of all Parties spread over at least three Member States is more than €100 million (second factor), out of which (third), at least two of the Parties have

¹⁵ Riccardo Celli, *supra* note 14 at pp. 1.

¹⁶ *Ibid.*

¹⁷ *Ibid.* at pp. 13.

¹⁸ Case M.619 *Gecor/Lonhro*; *Ibid.* at pp. 13.

¹⁹ *Ibid.*

²⁰ Case T-102/96 *Gencor v. Commission*, [1999] ECR II-879; Riccardo Celli, *supra* note 14 at pp. 13.

²¹ *Ibid.*

²² Council Regulation (EC) No 139/2004, *supra* note 13 at sub-Article 1(2).

²³ *Ibid.*

²⁴ *Ibid.* at sub-Article 1(3).

turnovers of more than €25 million *each* and (fourth), at least two of the Parties have a *combined* turnover of at least €100 million, then the Merger Regulation will still apply.²⁵

The parameters of this Thesis involve the M&A transaction between one SME (ONE) of another SME (TWO), who have annual turnovers of €20 million and €10 million, respectively. By definition, a SME has an annual turnover of less than €50 million. Accordingly, an argument can be made that the Merger Regulation does not apply to the two SMEs discussed in this Thesis, on the basis that they do not meet or satisfy the aforementioned factors enumerated under sub-Articles 1(2) and (3) of the Merger Regulation.

1.2 Types of Transactions.

A related preliminary matter to consider prior to discussing types of M&A cross-border transactions, is the determination whether the pertinent cross-border M&A transaction will be *inbound* or *outbound*.²⁶ An inbound M&A cross-border transaction involves a foreign company purchasing a local company in its (the local company's) jurisdiction.²⁷ An outbound M&A cross-border transaction means that the local company is purchasing a foreign company in that foreign company's jurisdiction.²⁸

A Target SME can be sold or purchased generally in one of two main but different ways: either its shares can be exchanged in return for financial compensation, in a method called 'share purchase agreement' or SPA for short, or its assets, sometimes with certain liabilities attached to them, can be sold off in an assets transfer.²⁹ These types of transactions apply to both common law and civil law jurisdictions, such as the UK and Germany, respectively.³⁰ When a Purchaser uses an SPA to buy the Target SME, the structural components of the Target SME, such as the

²⁵ *Ibid.*

²⁶ Paul Luiki, 'Session 1 – M&A, Common Law and Civil Law, Confidentiality Agreement' (Drafting and Negotiating Cross-Border M & A and Joint Venture Contracts, Vienna, 25 February 2022) at pp. 8.

²⁷ Deepak Kumar and Others, 'Domestic, inbound and outbound M&A activity interdependence in Brazil' (2022) 48 Managerial Finance 1591.

²⁸ *Ibid.*

²⁹ Susan Singleton, *Beswick and Wine* (10th ed., Bloomsbury Publishing Plc 2018) at pp. 13.

³⁰ *Ibid.*; Baker McKenzie, 'Global Private M&A Guide – Limited External Content – Germany' (Baker McKenzie, 2022) <<https://resourcehub.bakermckenzie.com/en/resources/global-private-ma-guide-limited/emea/germany/topics/quick-reference-guide>> accessed 5 October 2022.

assets, liabilities, income, liabilities and employees, will continue to remain with the Target SME, which itself will also continue to maintain and reserve all of its rights and obligations, such as accounts receivables, accounts payable, loan/debt service and taxes.³¹ All the Purchaser obtains for valuable consideration are the shares of the Target SME, which are placed on the Purchaser's balance sheet and thus making the Purchaser the *de facto* new owner.

By contrast, if an assets transfer is used, be they tangible or intangible, movable or immovable (with some exceptions), will change legal title and will directly be incorporated into the purchasers' balance sheet.³² If some of the assets carry liabilities, such as a bank loan attached to them, then those will typically follow the assets, unless some negotiated arrangement is reached. It should also be pointed out that the types of liabilities that can follow assets sold via an assets transaction vary to an extent depending in which jurisdiction (i.e. common law or civil law) the sale is taking place.³³ This is discussed further in this chapter.

Both Germany and the UK, also allow a third form of selling companies, which is via auctions.³⁴ Considered a common method of selling companies in Germany, the auction process involves a *quasi*-SPA-type of transaction, divided into discreet sub-steps.³⁵ In chronological fashion, these include (1) the seller preparing the Target SME for sale, (2) reaching out to potential investors (or bidders), (3) entering into non-disclosure agreements ("NDA) with potential bidders, (4) having potential bidders submit non-binding bids, known as "indicative bids", (5) allowing the ability of due diligence to be performed by the potential bidders, that results in the (6) submission of the final bid, which is to be (7) selected by the seller of the Target SME.³⁶

In the UK, there are no rules or regulations that specifically deal with an auction transaction and the process is very similar as to the one in Germany: (1) the Seller provides a memorandum of interest and concurrently puts together a confidential collection of documents of

³¹ Susan Singleton, *supra* note 29.

³² *Ibid.*

³³ Mathias Bulow and Matthias Full, 'Private Mergers and Acquisitions in Germany: Overview' (Thomson Reuters Practical Law, 1 May 2020) <[https://uk.practicallaw.thomsonreuters.com/w-013-1932?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/w-013-1932?transitionType=Default&contextData=(sc.Default)&firstPage=true)> accessed 5 October 2022.

³⁴ *Ibid.*

³⁵ *Ibid.*

³⁶ *Ibid.*

the Target SME, (2) after receiving “outline bids” (which are similar to the German “indicative bids”) the Seller makes a buyers shortlist and provides these with the confidential information for the purposes of providing a final bid, (3) one Purchaser is selected who is given all the confidential information on the Target SME and (4) the final transaction is negotiated between the Seller and the Purchaser.³⁷

Returning to the example used in the Introduction section of this Thesis, since Purchaser ONE is wishing to acquisition Target SME TWO in the UK, this will be an *outbound* transaction for the Purchaser. The German company will go to the UK (outbound) to complete the purchase. To purchase Target SME TWO that makes the sub-component Y, the Purchaser ONE can either buy some or all of the assets of Target SME TWO that are responsible for producing sub-component Y. In the alternative, it can purchase all privately held shares belonging to Target SME TWO using an SPA transaction or if the Seller of Target SME TWO decides, it can proceed via an auction transaction. The question becomes which type of transaction should be used, a question whose answer will vary depending on who is being asked: the Seller or the Purchaser.

It should be mentioned that *if* the Purchaser ONE intended for the company to become publicly traded after the close of its merger with the Target SME TWO, it could have made use of a Special Purpose Acquisition Company (“SPAC”).³⁸ SPAC’s sole purpose would be to carry out the M&A transaction in the UK. A product originally from the US market in the 1980s-time period, these types of companies issue shares through an initial public offering (“IPO”).³⁹ Since the focus of this Thesis is on private M&A transactions, and SPACs often involve publicly traded stock, no further discussion will be made on this topic. The topic of SPAC was mentioned, in order to show the breadth of choices a privately-held company has in its pursuit of purchasing another company to facilitate, if it wished, to make the transaction public.

1.3 Selecting the Best Transaction Type.

³⁷ Phil Cheveley and Others, ‘Private Mergers and Acquisitions in the UK: Overview’ (Thomson Reuters Practical Law, undated) <[https://uk.practicallaw.thomsonreuters.com/3-552-5708?transitionType=Default&contextData=\(sc.Default\)](https://uk.practicallaw.thomsonreuters.com/3-552-5708?transitionType=Default&contextData=(sc.Default))> accessed 7 October 2022.

³⁸ Daniele D’Alvia, *Mergers, Acquisitions and International Financial Regulation Analysing Special Purpose Acquisition Companies* (Routledge Taylor & Francis Group 2021) at pp. 43.

³⁹ *Ibid.* at pp. 64.

The type of transaction to be employed will depend on a wide range of factors that include but are not limited to (1) the financial state of the Target SME (i.e. is it still operating or is it bankrupt, under receivership, etc.), (2) the location of the Purchaser and Target SME (i.e. is it in a common law or civil law jurisdiction)⁴⁰, and (3) foreign ownership restrictions.⁴¹ These are discussed separately, in turn.

1.3.1 The Financial State of the Target SME. If the Target SME is sold by an administrator or receiver because the Target SME is insolvent or has filed for bankruptcy protection, the Purchaser can only proceed with an assets transfer because (a) the administrator or receiver of the Target SME will want to obtain as much capital for the creditors of the Target SME, (b) it might not be possible to sell via an SPA anymore and (c) the Purchaser may want to avoid proceeding via an SPA for fear of finding unknown liabilities from which it may lack any protection.⁴² It is important to emphasize that assets transfer in insolvency situations are not carried out by the owner (or debtor) of the assets. Instead, such assets transfer will be carried out by an administrator. In Germany, pursuant to sections 80 and 81 of the German Insolvency Code, the administrator has the authority to sell assets or the entire Target SME.⁴³ In the UK, English law covers two types of receivership: (1) administrative with authority under the *Insolvency Act 1986* or (2) fixed charge, where only specific assets are sold off to pay back creditors.⁴⁴

1.3.2 The Location of the Purchaser and Target SME. This factor will also play a large role in the manner in which the transaction will proceed. For instance, if the Target SME is located in a EU country such as Germany, the main advantage of proceeding via an assets transfer from a Purchaser's perspective is that subject to exceptions such as employment, environmental, commercial or tax law, there is "*no automatic transfer of liabilities*" for the Purchaser.⁴⁵ In

⁴⁰ Susan Singleton, *supra* note 29.

⁴¹ Phil Cheveley, *supra* note 37.

⁴² Susan Singleton, *supra* note 29 at pp. 14.

⁴³ Georg Streit and Fabian Burk, 'Restructuring and Insolvency in Germany: Overview' (Thomson Reuters Practical Law, undated) <[https://uk.practicallaw.thomsonreuters.com/2-501-6976?transitionType=Default&contextData=\(sc.Default\)>](https://uk.practicallaw.thomsonreuters.com/2-501-6976?transitionType=Default&contextData=(sc.Default)>) accessed 6 October 2022.

⁴⁴ James Terry and Others, 'Restructuring and Insolvency in the UK (England & Wales): Overview' (Thomson Reuters Practical law, undated) <[https://uk.practicallaw.thomsonreuters.com/9-501-6812?transitionType=Default&contextData=\(sc.Default\)>](https://uk.practicallaw.thomsonreuters.com/9-501-6812?transitionType=Default&contextData=(sc.Default)>) accessed 7 October 2022.

⁴⁵ Mathias Bulow, *supra* note 33.

situations of distress, where only parts of the Target SME's assets are desired or where liability risks need to be avoided, an assets transfer transaction will be advantageous.⁴⁶ Having said that, the problem with proceeding via an assets transfer transaction in civil law jurisdictions such as Germany for a Purchaser is that by comparison to an SPA, it is relatively complex.⁴⁷ For instance, under various German laws and regulations, not only is each individual “*asset, claim, contractual relationship and so on*” required to be identified, but to transfer contractual relationships of the Target SME, the other contracting parties' consent is needed.⁴⁸

Third party consent could be required in UK common law jurisdiction for an assets transfer, depending on the terms of the liabilities associated with them.⁴⁹ Furthermore if some employees will be transferred to the Purchaser from the Target SME as part of the assets transfer, the employees will not have to reapply for their positions with their new employer, instead they will be automatically be given the same position, pursuant to the *Transfer of Undertakings (Protection of Employment) Regulations 2006*.⁵⁰ In the UK, there are even fewer exceptions to liabilities following an assets transfer than in Germany, meaning that even taxes must be agreed upon, and unless they are explicitly specified in the assets sale agreement, they will not be automatically added.⁵¹

The auction process is favored in both the UK and Germany more by Sellers than Purchasers. This is because it allows the Seller to limit the number of potential bidders, permits a higher purchase price in comparison to individual negotiations and allows more stringent quasi-SPA-type procedure during the auction process.⁵² The disadvantages from a Seller's perspective to using auction as a means to sell a Target SME is a much higher utilization of management resources in preparation, screening of potential bidders and other actions, as well as the real likelihood that the auction process will take a longer duration than necessary, depending on the pool of potential bidders that meet the requirements needed to complete the auction.⁵³

⁴⁶ *Ibid.*

⁴⁷ *Ibid.*

⁴⁸ *Ibid.*

⁴⁹ Phil Cheveley, *supra* note 37.

⁵⁰ *Ibid.*

⁵¹ *Ibid.*

⁵² Mathias Bulow, *supra* note 33.

⁵³ *Ibid.*

Finally, the most common form of purchasing a Target SME in both the UK and Germany is via an SPA, or a share deal. In the UK, all the tasks associated with an assets transfer, such as obtaining the consent of third parties, are not required in the case of an SPA.⁵⁴ In addition, very limited requirements or no notice is needed to give trade unions or employees representatives about the SPA.⁵⁵ Similarly, in Germany, SPA's simplicity make it very attractive, as no third party consent is required for the transaction to proceed as well, there is no concern of any assets remaining with the Seller post-transaction and all assets and liabilities get transferred from the Seller in one transaction.⁵⁶

1.3.3 Foreign Ownership Restrictions. The UK government has considerable powers under the *NSI Act* which came into effect in 2021.⁵⁷ Being applied equally to foreign and domestic Purchasers, the Department of Business, Energy and Industrial Strategy has an Investment Security Unit that is solely concerned with reviewing transactions that may have a national security angle.⁵⁸ Neither the UK government nor the *NSI Act* provide for a “national security” definition.⁵⁹ While the UK government does provide for some general guidelines, any types of M&A transactions can be reviewed the earlier of six months after the UK government became aware of the transaction or five years after the closing of the transaction.⁶⁰

The Purchaser and/or the Seller must give notification to the UK government (i.e. mandatory requirement) where transactions involve companies dealing with 17 “*prescribed sensitive sectors*” that include communications, defence, transport, artificial intelligence, and energy, to name a few.⁶¹ If the parties fail to give the UK government notice or give notice but do not receive approval from the UK government, then any transaction that was closed will be considered null and void.⁶² In addition, the UK government can impose serious civil and criminal

⁵⁴ Phil Cheveley, *supra* note 37.

⁵⁵ *Ibid.*

⁵⁶ Georg Streit, *supra* note 43.

⁵⁷ Phil Cheveley, *supra* note 37.

⁵⁸ *Ibid.*

⁵⁹ *Ibid.*

⁶⁰ *Ibid.*

⁶¹ *Ibid.*

⁶² *Ibid.*

sanctions for failure to comply with the *NSI Act*, which includes but is not limited to a fine up to 5% of the company's worldwide turnover and up to five years' imprisonment.⁶³

In Germany, the investment control rules related to private M&A transactions limits and restricts foreign ownership.⁶⁴ In addition, in recent years (2019) the EU introduced Regulation (EU) 2019/452,⁶⁵ aimed at “*harmonizing the screening of foreign direct investments into the EU*” as well as creating minimum standards and cooperation regime.⁶⁶ Germany's Federal Ministry of Economics (“BMWi”) using the Foreign Trade and Payments Ordinance, has the ability to stop or restrict the purchase (whether directly or indirectly) of no less than 10% of a German company's voting rights.⁶⁷ This can occur in two situations:⁶⁸

1. Sector-specific review: involving foreign investors, including those residing in other EU Member States, who directly or indirectly purchase German companies that make products listed in the German War Weapons List, such as armored vehicles, tanks and so forth.
2. Cross-sectoral review: applies in situations where a Purchaser outside the EU directly or indirectly buys a German company that has the potential to “*endanger public order or public security*” related *inter alia* to critical infrastructure or the operating software of such infrastructure.

1.4 Analysis and Discussion.

Based on the foregoing and turning to the hypothetical scenario given in the Introduction section of this Thesis, the German company ONE, as Purchaser, will need to make a decision. If it considers requiring the sub-component Y only as a one-time attempt to improve its second-generation electronic X2 product, then the best strategy would be to purchase the sub-component Y via an asset transfer from Target SME TWO. In this fashion, it can try out the sub-component

⁶³ *Ibid.*

⁶⁴ Mathias Bulow, *supra* note 33.

⁶⁵ Of the European Parliament and of the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union [2019] OJ L 79 I/1.

⁶⁶ Mathias Bulow, *supra* note 33.

⁶⁷ *Ibid.*

⁶⁸ *Ibid.*

Y and if it does not deliver, ONE can simply leave it in its assets inventory. On the other hand, if the sub-component Y can be improved and has other applications or uses in the UK market (in addition to the German market), ONE should consider proceeding with the sale via an SPA transaction. In contrast, the Target SME TWO should consider proceeding with the sale either via an SPA or auction transaction. Both of these will likely yield a higher return on the sale, especially if there are more than one interested Purchasers. It should avoid proceeding with an assets transfer, as that would potentially leave it less desirable to be purchased if it has fewer assets to offer potential Purchasers. In either way, they must be mindful of the *NSI Act* and provide the UK government the necessary notice of the pending transaction.

1.5 Conclusion.

Chapter 1 of this Thesis has explored the legislation governing private M&A transactions in the UK and Germany related to SMEs. The purchase of a Target SME in the UK was governed by the Code, and administered by the Panel, in conjunction with the *Companies Act 2006*. The purpose was to provide shareholders equal treatment and fairness in the sale of a company. If this requirement was breached, the Panel and UK regulators had the ability to impose sanctions. In Germany, civil law general provisions dictated how private M&A transactions would proceed together with German corporate laws, such as GmbHG, the Stock Corporation Act and partnership agreements. In addition, the EU enacted the Merger Regulation that supervised M&A transactions, in Europe. In order to fall within the scope or dimension of the Merger Regulation, the Parties involved must have had worldwide turnovers of at least €5 billion under sub-Article 1(2) or €2.5 billion under sub-Article 1(3) of the Merger Regulation. Since this Thesis dealt with two SMEs, an argument was made that the Merger Regulation was inapplicable to the transaction explored. There were predominantly three types of transactions when it came to the purchase of a Target SME: via an assets transfer, SPA or auction. In an assets transfer, the Purchaser would only buy specific assets from the Target SME and subject to certain legislative restrictions, there would be no automatic transfer of liabilities. In an SPA, the Purchaser would buy all the shares belonging to the Target SME and in an auction transaction, the Purchasers would engage in a bidding process for the company.

In selecting the best transaction type, one had to consider various factors, such as the financial state of the Target SME, the location of the parties and any foreign ownership restrictions. If the Target SME was insolvent, the receiver or administrator of the company would want to proceed via an assets transfer because it would want to obtain as much capital for the creditors, it might not be possible to sell the company any other way and the purchaser would not want to expose itself to unknown liabilities. Both Germany and the UK had laws regarding such situations, those being the German Insolvency Code and the *Insolvency Act 1986*, respectively. Furthermore, assets transfer, while possible in both jurisdictions, came with benefits and drawbacks: while the assets could be bought free of any liabilities (with certain mandatory exceptions), third party consent may be required, such as the creditors of the specific assets, in order for the transaction to occur. Proceeding via an auction transaction was more favourable to the Seller, but it required a much higher management resources utilization. The most common form of purchasing a Target SME was via an SPA, given its simplicity and non-requirement of things such as third-party consent and other formal events.

There were foreign ownership restrictions related to M&A transactions in both the UK and Germany. In the UK, pursuant to the *NSI Act*, the government reviewed transactions related to national security and the parties were required to give notice for certain prescribed sectors dealing with communication, defence, transport and so forth. Failure to provide such notice would void any M&A transaction, and the parties may be subjected to civil penalties in form of fines that are up to 5% of the company's worldwide turnover and/or up to five years' imprisonment.

In Germany, the BMWi could restrict or outright prevent the purchase of 10% or more of the voting rights of a German Target SME in two situations related to sector-specific or cross-sectoral review. In sector-specific review, the purchase of a Target SME could be stopped if the foreign investor was attempting to buy a German company making German War Weapons List items, such as tanks. In the cross-sectoral review, a foreign investor could be prevented from purchasing a German company if it could endanger public order or public security. Based on the above factors, a Purchaser may have wanted to use an assets transfer if it was not certain it would use the assets on a long-time basis. On the other hand, if the Purchaser wished to adapt or update the Target SME's products, it may have wanted to proceed via an SPA. From the Seller's

perspective, it could have engaged in an auction or SPA process, to maximize the amount of capital it will receive for the Target SME.

2.0 Chapter 2: Letters of Intent and Confidentiality Agreements.

After much consideration, Purchaser ONE and the Seller decide to proceed with the M&A transaction of the Target SME TWO via an SPA. The second chapter of this Thesis explores pre-transaction considerations that both the Seller and Purchaser (the “Parties”) must take into account, such as a Letter of Intent (“LOI”) and Confidentiality Agreement (“CA”). An LOI is in essence a written *agreement to agree*, whereby the Parties negotiate and agree on the terms of the sale for the Target SME.⁶⁹ A LOI is the equivalent to the *rules* of a football game, which set out how the game will be played by the Parties. The terms of a LOI can be binding, non-binding or hybrid, and range from what the final cost of the share price will be (non-binding term) to allowing the Purchaser access to the Seller’s confidential and sensitive data (binding term). LOIs are treated in Germany as non-binding agreements whereas in the UK and other jurisdictions they may in fact be enforced by the courts. CAs, also known as Non-Disclosure Agreements (“NDA”) are used to protect the Seller when sharing sensitive or confidential information with the Purchaser. CAs/NDAs attempt to prevent the Purchaser from disclosing confidential information to third parties. In proceeding with the M&A of the Target SME TWO, the Purchaser ONE should be mindful of differences between how common law and civil law jurisdictions treat LOIs and CAs.

2.1 Letter of Intent.

2.1.1 General Concepts of LOI. In a SPA transaction, a LOI is typically sent out by the Purchaser to the Seller of the Target SME and even if initially the terms of the LOI are not acceptable to the Seller (i.e. if it was sent before negotiations were entertained), it creates an opportunity for both Parties to determine whether to proceed (or not) with negotiations *before* any of the Parties have incurred substantial or considerable costs.⁷⁰ Succinctly, a LOI is akin to the

⁶⁹ Toni C Lichstein and Richard A. Spehr, ‘Agreements to Agree and Letters of Intent’ (1994) 3 Chicago Marketing Management 48 at pp. 48.

⁷⁰ Andrew J. Sherman, *Mergers & Acquisitions From A to Z* (Third Edition, AMACON 2011) at pp. 49-50.

game rules to a football match. The Parties are not agreeing on the outcome of the football match itself, rather on the rules of how the game will be played.

Originally, a term coined in the United States (“US”) and UK markets, a LOI is a written document which is the precursor to the final contract and can be said to serve primarily three functions or purposes.⁷¹ First, the LOI is a sort-of-tally that lists all the negotiation points (if any) that have been agreed by the Parties up to the point that the LOI has been created.⁷² Second, it establishes the procedural rules through which the Parties have agreed to for further negotiations of the transaction for the sale of the Target SME.⁷³ And third, the LOI, once signed by the Parties, signals their intent to use good faith in negotiating the remaining parts of the SPA transaction that will permit the sale of the Target SME to conclude in its entirety.⁷⁴

There are advantages and disadvantages to using a LOI. As further described in this chapter, the legal consequences of an executed LOI, that is, one signed by both Parties, will vary depending on which jurisdiction and in which manner it was drafted. Generally, an executed LOI sets out the Parties’ expectations and agreements in certain areas, and outlines any remaining issues, such as valuation gaps or closing challenges.⁷⁵ Perhaps the biggest advantage to an LOI is that it makes the prospect for a Seller to ‘shop around’ for another purchaser willing to pay a higher price for the Target SME, less likely, especially if the LOI includes penalties for such conduct.⁷⁶ By contrast, the most perilous disadvantage of utilizing a LOI is that depending on the jurisdiction where it is being used, it may be treated and enforced like a binding agreement, notwithstanding that it is an agreement in principle or agreement to agree or that the Parties had no intention to be bound by it.⁷⁷

2.1.2 Specifics of a LOI. Whether a LOI will be interpreted by a civil court as binding on the Parties, will depend on the *style* used to draft it: binding, non-binding or hybrid (i.e. a mixture

⁷¹ Heike Schweitzer, 'Private Legal Transplants in Negotiated Deals' (2007) 4 ECFR 79 at pp. 86.

⁷² *Ibid.*

⁷³ *Ibid.*

⁷⁴ *Ibid.*

⁷⁵ Andrew J. Sherman, *supra* note 70 at pp. 50.

⁷⁶ *Ibid.*

⁷⁷ *Ibid.*

of binding and non-binding).⁷⁸ In turn, the style utilized will be based on many factors that include but are not limited to:⁷⁹

- a) the timing and the purpose of any information to be made public on the transaction by the Parties, if any;
- b) whether the Parties have all information on the transaction or if further negotiations will be necessary;
- c) the costs incurred separately by the Parties before making commitments on bidding;
- d) the quickness with which a final sale agreement can be contemplated and signed by the Parties;
- e) any valuation ranges provided by the Purchaser to the Seller for consideration;
- f) whether the Purchaser can demand an exclusivity period (i.e. the time period when the Seller cannot seek out other purchasers) and whether the Seller is prepared to grant it; and,
- g) how confident the Parties are in each other that they are acting in good faith towards one another and the presence (or absence) of any other purchasers that are prepared to compete for the Target SME.

While there are exceptions, by and large the most common form of LOI used is a hybrid format type, which is considered the best option to ensure both Parties' interests and legal obligations are preserved.⁸⁰ A well-written LOI will distinguish and separate the binding and non-binding terms of this agreement to agree and spell it out accordingly in plain language. Binding terms are placed to provide assurances to the Parties and non-binding ones prepare the setup for any further negotiations. For instance, the Purchaser will want the Seller to be bound that it is the legal owner that has the legal right to proceed with the transaction (binding term) but will also provide an estimate (or ball-park figure) of the price it is prepared to pay for the shares (non-binding).⁸¹ Conversely, a Seller will want the Purchaser to protect any sensitive and/or confidential

⁷⁸ *Ibid.* at pp. 51.

⁷⁹ *Ibid.*

⁸⁰ *Ibid.*

⁸¹ *Ibid.* at pp. 52.

information on the Target SME (binding term) and that the key employees of the Target SME will remain with the company (not necessarily binding).⁸²

Other binding terms (emphasis added) examples and their reason for in a LOI include such terms as:⁸³

- a) Deposit – this can be refundable or not, and is to be paid by the Purchaser to the Seller. The deposit will be deducted from the final sale price and can be used by the Seller for its sale-preparation costs. In the event that the Purchaser backs out, the Seller will want to reimburse itself from the deposit for any expenses associated with the failed transaction and will want the term to be binding in the LOI.
- b) Due Diligence – the purpose of this binding term is to facilitate access by the Seller to the Purchaser of the Target SME's property, buildings, accounting and bank records, employee and litigation records together with any other sensitive and/or pertinent information related to the Target SME.
- c) No Material Changes – the Purchaser will want the Seller to be bound by an agreement where it will not take any actions that deviate from the Target SME's business and operations. The Purchaser will seek out this binding term to receive assurance the Seller will not do something drastic like take a very large loan out while the transaction takes place.

Non-binding terms (emphasis added) examples and the explanation for them in a LOI include but are not limited to:⁸⁴

- a) The purchase price for the shares (or stock price) – the reason for this is because there are many factors surrounding the final price of the shares, which may cause the price to go up (or down). For instance, if the Purchaser becomes aware of any

⁸² *Ibid.*

⁸³ *Ibid.* at pp. 55-6.

⁸⁴ *Ibid.* at pp. 53-4.

previously undisclosed liabilities, it may demand the stock price to be lowered, accordingly. As such this term should be non-binding on the Parties in the LOI.

- b) Target SME's employment agreements – the Purchaser may want that key employees of the Target SME remain post-closing of the transaction, or may want to fire or dismiss others. Depending on the jurisdiction and as described in the previous chapter, this process will be highly regulated, to protect the employees' rights. Again, such term should remain non-binding in the LOI.

There are many other terms, binding or non-binding that the Parties will want to consider and which are equally important. The above are typically some of the most common terms and were not meant to be reflective of an exhaustive list. For instance, other binding terms of a LOI include no-shop provisions (i.e. the Seller will not shop around for other purchasers), lock-up provisions (i.e. the Seller will not dilute or create new shares in the Target SME) and break-up fees (in situations where the Purchaser abandons or refuses to close the transaction).⁸⁵ The expectation is that before the final LOI is executed by both Parties, it will have gone through a series of negotiations, agreements and changes. Lastly, it should be noted that confidentiality or non-disclosure agreement is another important binding term in a LOI that even comes with its own separate form. The subject of CA will be discussed further below in this chapter.

2.1.3 Treatment and Characterization of LOI in Germany. Sub-section 154(1) of the German Civil Code (Bürgerliches Gesetzbuch, or BGB for short) stipulates that until such time as the Parties are in agreement on *all* aspects “*that at least one party wanted to reach agreement on*” is concluded, there is a rebuttable presumption, that there is no contract completed.⁸⁶ Sub-section 154(1) of the BGB applies with equal force even to minor or trivial aspects of a proposed contract.⁸⁷ Accordingly, it follows that a LOI, even one executed by the Parties, is *not*, under German law, a legally binding contract.⁸⁸ Instead, a LOI will likely be designated by German courts in a dispute as a “*legally non-binding fixation of a negotiation position*,” likely to be taken

⁸⁵ *Ibid.*

⁸⁶ Heike Schweitzer, *supra* note 71 at pp. 93.

⁸⁷ *Ibid.*

⁸⁸ *Ibid.*

into account during the court proceedings, but not definitive on itself as evidence of a legally binding contract.⁸⁹

Theoretically, in very narrow circumstances, it is possible for German courts to consider a LOI as a pre-contract, known as a Vorvertrag in Germany, and to use generally accepted principles to interpret whether the Parties intended to be bound by it.⁹⁰ Such theoretical instance would be one in which the LOI had no incomplete terms (i.e. all terms of the LOI are agreed upon and binding, meaning no hybrid or non-binding terms) and the Parties clearly intended to be bound by the LOI.⁹¹ Having said that, there is “*a strong presumption that complex transactions of high value will typically not be executed informally*” via a LOI.⁹² As a result, in Germany, when Parties do use LOI, that is typically an indication they do not wish to be bound by any terms at that juncture in the transaction.⁹³ The caveat in relation to the LOI use in Germany is that this is strictly in reference to M&A transactions. There are other industries in Germany, such as bond completion for financing of movie productions, where LOIs do have a stronger legal character.⁹⁴

2.1.4 Treatment and Characterization of LOI in the UK. In common law jurisdiction such as the UK, there is no statute or code to govern LOIs *per se*, however that does not mean contractual negotiations are a “no law” zone.⁹⁵ Unlike civil law jurisdictions such as Germany, where LOIs are seen as an indicia of non-binding obligation, common law jurisdictions such as US, Canada and UK can and will sometimes enforce agreements to agree such as LOIs.⁹⁶ UK-based LOIs will often make use of confidentiality (i.e. non-disclosure) and exclusivity (i.e. no-shop provisions) that will not only be binding but also enforceable in court.⁹⁷ To be clear, in general, “*bare agreements to agree*” are unenforceable under English law, however, through precedent case law, which is different than civil jurisdictions, there are at least two exceptions to the general rule: exclusive

⁸⁹ *Ibid.*

⁹⁰ *Ibid.* at pp. 93-4.

⁹¹ *Ibid.* at pp. 94.

⁹² *Ibid.*

⁹³ *Ibid.*

⁹⁴ *Ibid.*

⁹⁵ Ekaterina Pannebakker, *Letter of Intent in International Contracting* (Intersentia Ltd., Cambridge UK, 2016) at pp. 113.

⁹⁶ Heike Schweitzer, *supra* note 71 at pp. 88.

⁹⁷ Phil Cheveley, *supra* note 37.

negotiations of a temporary agreement and promises to use good faith in obtaining licenses and other governmental permissions.⁹⁸

2.1.5 Selected Cases on Disputes involving LOI. Notwithstanding the widespread use of LOIs in Germany, case law involving LOI dispute in this civil law jurisdiction is scarce bearing in mind the lack of will to be bound indicia.⁹⁹ On the other hand, in common law jurisdiction, perhaps the most infamous LOI case is the 1985 US case of *Pennzoil v. Texco*.¹⁰⁰ In the Pennzoil case, two American oil companies, Getty Oil and Pennzoil entered into an executed LOI titled “*agreement to agree*,” whereby Pennzoil was going to merge with Getty Oil.¹⁰¹ After finding out about the imminent transaction, another oil company, Texaco made a better offer to Getty Oil, which was accepted.¹⁰²

In 1985 Pennzoil successfully sued Texaco and was awarded US \$10.53 billion (approx. US \$29.05 billion or €29.50 billion in 2022)¹⁰³ in damages against Texaco.¹⁰⁴ The jury reasoned that since the LOI had the “*essential elements of the transaction*”, notwithstanding that the final contract was not executed and that this was a bare agreement to agree, it was nevertheless still found to be legally binding.¹⁰⁵ What is strange about this case is that Pennzoil did not sue Getty Oil, with which it had intended to merge with, rather it sued Texaco, a party that was not involved with the executed LOI. The *Pennzoil* decision was not unusual or a one-off rather, at least in common law jurisdictions, instead it represents a line of cases or the norm.¹⁰⁶ As explained in the UK case of *ERDC Group v Brunel University*,¹⁰⁷ “*letters of intent come in all sorts of forms ... there can therefore be no prior assumptions.*”¹⁰⁸

⁹⁸ Ekaterina Pannebakker, *supra* note 95 at pp. 113-4.

⁹⁹ Heike Schweitzer, *supra* note 71 at pp. 94-5.

¹⁰⁰ *Ibid.* at pp. 89; *Pennzoil Co. v. Texaco, Inc.*, No. 84-05905.

¹⁰¹ *Ibid.*

¹⁰² *Ibid.*

¹⁰³ Official Data, ‘Inflation Calculator’ (CPI Inflation Calculator, undated) <<https://www.officialdata.org/>> accessed 21 October 2022.

¹⁰⁴ Heike Schweitzer, *supra* note 71 at pp. 89.

¹⁰⁵ *Ibid.*

¹⁰⁶ *Ibid.*

¹⁰⁷ (2006) EWHC 687 (TCC); Robert Burns, ‘Letters of Intent: What do the Courts have to say?’ (Quigg Golden, undated) <<https://www.quigggolden.com/publications/letters-of-intent-what-do-the-courts-have-to-say/>> accessed 21 October 2022.

¹⁰⁸ *Ibid.*

2.2 Confidentiality Agreement.

2.2.1 German Version v. UK Version of CAs. Once the Parties have negotiated the LOI, one of the binding terms of the LOI will include the execution of a CA or NDA. The Seller will require the Purchaser to sign a CA/NDA for the purpose of protecting the sensitive information, rights and interests of the Target SME.¹⁰⁹ The Purchaser must agree to use any information obtained during the negotiations process on the Target SME, as well as that obtained during the due diligence process (further described in later chapters) *only* for facilitating the M&A transaction itself and to not share any knowledge learned with any third parties.¹¹⁰ German CAs/NDAs are typically much shorter compared to the ones in the UK jurisdiction.¹¹¹

The purpose of keeping German NDAs short is because it might give the ‘wrong signal’ to the other party to the transaction.¹¹² While presumptive, if the Purchaser is confronted with a long and complicated NDA, they might conclude there are significant problems or complications with the Target SME.¹¹³ In Germany, the ability to prove breaches of a CA/NDA is difficult, leading to non-effective legal sanctions.¹¹⁴ While some Sellers located in Germany attempt to enforce a breach of a CA/NDA via liquidated damages or contractual penalties, “*such clauses are rarely accepted in international and even in a German practice.*”¹¹⁵

By contrast, CAs in common law jurisdictions such as the UK, are more complicated. The governing law on confidential information protection comes from various sources, such as UK regulation *The Trade Secrets (Enforcement, etc.) Regulation 2018* and the equity principle of common law, which principle is used where the information is not protected by intellectual property rights.¹¹⁶ Claims for breach of CAs can be brought in the UK under the aforementioned

¹⁰⁹ Andreas Nelle, ‘Germany Negotiated M&A Guide, Corporate and M&A Law Committee’ (RAUE LLP, undated) <<https://www.ibanet.org/document?id=NMAGermany>> accessed 21 October 2022 at pp. 9.

¹¹⁰ *Ibid.*

¹¹¹ *Ibid.*

¹¹² *Ibid.*

¹¹³ *Ibid.*

¹¹⁴ *Ibid.*

¹¹⁵ *Ibid.*

¹¹⁶ Edward Kilner, ‘Non-disclosure agreements: how to protect confidential information’ (Harper James, 20 April 2022) <<https://harperjames.co.uk/article/non-disclosure-agreements-ndas-and-confidentiality-agreements-faqs/>> accessed 21 October 2022.

UK regulation provided the information given to an unauthorized third party (a) was in fact secret information (b) of commercial value that (c) was kept (reasonably) secret.¹¹⁷ Key to UK CAs provisions include the following:¹¹⁸

- (1) Defining the confidential information protected;
- (2) Setting out the boundaries for the permitted use of the confidential information (i.e. who can use, who can share it and when it should be returned);
- (3) The time length of the CA;
- (4) Restricting any attempts to circumvent the CA or solicit any of the Target SME's employees; and,
- (5) Remedies against the party who breached the CA and the jurisdiction that will take precedent for application towards any disputes.

Only the party who provides the CA in the UK can terminate it and as such, if the Seller requires the Purchaser to execute a CA regarding sensitive Target SME information, only the Seller can terminate it.¹¹⁹ In the UK, CAs are legally binding, provided that they adhere to the contract formation requirements; they can also be enforceable provided they meet the criteria for CA breach – such criteria will vary from case to case.¹²⁰

2.3 Analysis and Discussion.

As the Purchaser ONE is located in the EU (Germany) and is attempting to purchase via SPA the Target SME TWO in the UK, it must be mindful of the slightly different treatment of LOIs and CAs between the two jurisdictions. Whereas LOIs are not enforceable and CAs are relatively short and not readily enforceable (but theoretically feasibly enforceable) in Germany, in the UK jurisdiction, the LOIs can be enforceable and the CAs are not only longer but can also be enforced, as well. To minimize its exposure, the Purchaser ONE, in proceeding with the transaction in the UK, should draft the LOI that has as few binding terms as it is possible and utilize a hybrid-

¹¹⁷ *Ibid.*

¹¹⁸ *Ibid.*

¹¹⁹ *Ibid.*

¹²⁰ *Ibid.*

terms LOI. It should also ensure that the persons who get accessed to the Target SME's sensitive and confidential information will be educated to understand that in the UK, there is remedy for CA breach. Any third party involvement in the transaction should be kept at a minimum and absolutely no information-sharing that can be construed as a CA breach, should be allowed. From the Seller's perspective, as the transaction will occur in the UK, it should try to take actions that are diametrically opposite to the Purchaser: include as many binding terms in the LOI and have a CA that is comprehensive and best suited for the Target SME TWO. This will allow the Seller to make the most of the UK's advantageous common law elements related to LOIs and CAs.

2.4 Conclusion.

The purpose of Chapter 2 of this Thesis has been to acquaint the reader with pre-transaction considerations such as the LOI and CA in both the UK and German jurisdictions. Generally, a LOI served three functions: it listed all negotiations done to the point of its execution, created the rules of procedure through which the Parties could continue with the negotiations and the signaled the intent of good faith use in negotiating the remaining steps of the SPA transaction. The biggest advantage of using a LOI was that it prevented prospective Sellers from 'shopping around' for other Purchasers, if there were binding penalties for such use. The biggest disadvantage of using LOIs was that depending on where it was being used, it could be treated and enforced like a binding agreement even if the Parties did not contemplate for it to be a binding.

A LOI could take a number of styles such as having all binding or non-binding terms or it could be a hybrid of binding and non-binding terms. The use of hybrid LOI was very common one and a LOI style would be based on many factors such as timing, whether the Parties had all the information, costs, valuation ranges, and exclusivity. A well-written LOI would include terms to equally protect both Parties and included binding terms such as the use of a deposit paid by the Purchaser (that could be used to offset the Seller's costs if the transaction did not go through), due diligence (that allowed full disclosure of all pertinent information, confidential, sensitive or otherwise on the Target SME), and no material change (such as preventing the Seller from taking on very large loans before the transaction completed). An LOI's non-binding terms would include the purchase price for the shares (in case the Purchaser found undisclosed information on the

Target SME), and employment agreements (in case the Purchaser wanted to keep certain key employees). Other equally important LOI terms included but were not limited to no-shop, lock-up and break-up fees provisions.

In Germany, LOIs were considered a negotiation position fixation that was legally non-binding but were not found to be legally binding, themselves. This was because under sub-section 154(1) of the BGB, there was no contract formed in Germany unless the Parties agreed on all aspects that at a minimum one party wanted to reach agreement. In practice, when Parties in Germany use a LOI, it was an indication they were not prepared to be bound, legally. By contrast, LOIs in the UK, while agreements to agree were generally not enforceable, there were exceptions to the rule where LOIs were found to be enforceable. UK Courts have held that LOIs come in different forms and there can be no presumptions. For instance, in the famous *Pennzoil* case Texaco paid US \$10.53 billion for merging with Getty Oil, because at the time of the merger, Getty Oil reached an agreement to agree to merge with Pennzoil.

CAs/NDAs' purpose was to protect the Seller from the Purchaser communicating sensitive or confidential information to third parties. Through CAs, a Purchaser would be required to agree to use any information obtained during the negotiation/due diligence process only for facilitating the M&A transaction itself. German CAs were much shorter than those from the UK jurisdiction because a Purchaser could conclude there were significant problems with the Target SME if it was required to execute a long CA. UK CAs were longer and were protected by different sources such as equity principles and UK regulation. Unlike in Germany, claims for CA breaches in the UK could be prosecuted. Accordingly, in proceeding with the SPA transaction to acquire the Target SME TWO which was located in the UK, the Purchaser ONE would need to be mindful regarding the LOI and CA. The LOI could be enforced as a binding contract and a CA could be prosecuted in the UK common law jurisdiction.

3.0 Chapter 3: Due Diligence and Conditions Precedent.

Up until this point, the fictional Parties described in this Thesis, those being Purchaser ONE and the Seller, have agreed to proceed with the M&A transaction for Target SME TWO via

a SPA and have signed (executed) a LOI and CA, in this regard. Next, and as further described in Chapter 3 of this Thesis, the focus will be on the next two critical parts of the M&A transaction: the due diligence (“DD”) period and conditions precedent (“CP”) clauses. DD occurs between the signing of the LOI/CA and signing of the SPA itself.¹²¹ Through DD, the Purchaser is able to uncover unknown issues or risks with the Target SME. In general, the Seller will provide access via data rooms that can take many forms and provide the Purchaser with the opportunity to ‘red flag’ any issues that come up during their searches.

There are different DD topics ranging from legal, financial, commercial, tax, intellectual property and environmental categories. There are also different types of DD ranging from Purchaser DD, Vendor DD, DD when the Target SME is in receivership and so forth. CP clauses constitute the part of the transaction that occurs after the signing of the SPA and closing of the transaction.¹²² CP clauses require that certain actions must be taken at a future date, in order for the transaction to be closed or else be terminated. CP clauses can range from regulatory approvals (i.e. required by governmental agencies), third parties consent such as banking financial approvals and those of a materially adverse change-type. These are described individually, below.

3.1 Due Diligence.

3.1.1 General Concepts. With the CA freshly signed by the Purchaser, the Parties are ready to begin the next phase of the M&A transaction: the due diligence phase. This phase takes place between the signing of the LOI/CA and the signing of the SPA. It is noteworthy to mention that *prima facie* no specific dictionary or standard legal definitions exist for DD.¹²³ One source defines the DD phase in plain language as the “*process of enquiry and investigation made by a prospective purchaser in order to confirm that it is buying what it thinks it is buying.*”¹²⁴ Central to the DD phase is the Latin phrase of *caveat emptor* meaning ‘buyer beware’, which signals the need for a Purchaser to verify the information on a Target SME.¹²⁵ DD is an instrument that

¹²¹ Paul Luiki Session 1, *supra* note 26 at pp. 11.

¹²² *Ibid.*

¹²³ Peter Howson, *Due diligence: The critical stage in mergers and acquisitions* (Taylor & Francis Group 2003) at pp. 4.

¹²⁴ *Ibid.*

¹²⁵ *Ibid.*

provides the Purchaser access to information of a sensitive nature on the Target SME (i.e. the preliminary disclosure), in order for the Purchaser to conduct what could be described as a “*comprehensive audit*.”¹²⁶ The DD phase assists the Parties, in a number of ways:¹²⁷

1. Achieving a realistic price for the Target SME, shaped by an SPA after the decision makers were informed of all unknown risks of the company;
2. Proving that the Purchaser’s management team has exercised its due care, absolving them from any regulatory or statutory duties associated with the DD phase;
3. Allowing the flow of information between the Parties at an early stage, in order to allow for a smooth transition.

3.1.2 Specific Topics and Types. There is no one type of DD or one DD discipline.¹²⁸ These vary by topic and situation, in order to ensure that all reasonable concerns of the Purchaser are met and that the Purchaser’s management have exercised their due care.¹²⁹ The main DD topics include (but are not limited) to the following sections:¹³⁰

1. Legal – focus is on any/all contracts entered by the Target SME with third parties. The search will help shape the warranties and indemnities to be required (discussed in chapter 4 of this Thesis). In addition, the Purchaser will want to know if the Target SME is involved in any lawsuit or legal matters and if, the degree of exposure to any potential judgment.
2. Financial – focus will be on the management, systems and accounting information on the Target SME. The search will assist in determining whether the Target SME is operating at a profit or at a loss, as well as help in identifying a valuation basis.

¹²⁶ Volker Endert and Andreas Mammen, ‘Improving the Acquisition Profit of Cross Border Transactions by Adjusting the Tax Due Diligence Process – a Theoretical Model Based on a German Target’ (2015) 23 Periodica Polytechnica Social and Management Sciences 41 at pp. 41.

¹²⁷ *Ibid.*

¹²⁸ Howson, *supra* note 123 at pp. 8-10.

¹²⁹ *Ibid.* at pp. 8.

¹³⁰ *Ibid.* at pp. 8-9.

3. Commercial – focus will be on the Target SME’s position in its industry and its competitiveness. This search will help identify the future prospects of the Target SME, indirectly its future profitability and further help establish the basis for valuation.
4. Human resources – focus will be on the Target SME’s employees, related to their experience, years with the company and any disciplinary conduct. This search will aid to uncover any exposure related to employees’ (mis)conduct, retaining any senior employees and so forth.
5. Intellectual property – focus will be on any intellectual property owned by the Target SME, whether they are still valid, and if so for how long of a duration. This search will impact the valuation basis. For instance, the valuation will vary significantly if the Target SME’s main invention’s (i.e. sub-component Y) patent only has 6 months left before losing it, as opposed to +10 years.
6. Taxation – the focus will be on the amounts of taxes owing, any liabilities associated with them and any possible arrangements with the government. The search will determine whether the Target SME’s taxation structure could be fine-tuned to lower its tax burden.
7. Environmental – the focus of this DD type will be to determine the Target SME’s compliance with the various processes, regulations and rules related to environmental protections. This search will uncover potential environmental liabilities, together with their extent and costs associated to rectify them.

Other DD topics include management, pension, IT, operational, insurance and antitrust, to name a few.¹³¹ The idea being that a Purchaser will need to carry out all relevant and important DD topics, in order to reach a primary conclusion on the state of the Target SME. In addition to different DD topics, there are also different *types* of DD that can take place, depending on the circumstances. The typical DD will be conducted by the Purchaser.¹³² The Seller may pre-emptively want to do its own DD (i.e. vendor DD), if the Seller wants to control the flow of information thereby maintaining an advantage in negotiations.¹³³ If the Target SME is in

¹³¹ *Ibid.*

¹³² *Ibid.*

¹³³ *Ibid.* at pp. 10.

receivership (i.e. bankrupt) then the information subject to DD will have to be made from the receiver, which may not always be complete or proper.¹³⁴ If the Purchaser does not want to spend too much money on a DD, it can proceed with a “*red flag legal*” DD, which uses a cursory form to determine and identify the most problematic risks associated with the Target SME, without engaging an in-depth review of the Target SME’s files.¹³⁵ Other types of DD include those in public bids or public offerings, if the Target SME is not private.¹³⁶

From a practical standpoint, giving access to data so that the Purchaser can conduct its DD, can be provided in multiple forms: physical, virtual or electronic.¹³⁷ As the name suggests, the physical access to data will come as a pre-arranged (physical) data room, where the Purchaser’s agents can physically go and review the pertinent documentation.¹³⁸ Virtual data rooms simply mean that access to the data will be done online.¹³⁹ Electronic access refers to different types of electronic access (i.e. CD, USB key, DVD, etc.) other than online access.

3.1.3 Due Diligence Differences between Germany and the UK. The general concepts and specific topics and types between German and UK DD are more or less the same.¹⁴⁰ For instance, in recent years, the “*red flag legal*” DD has become the most common type conducted in the UK.¹⁴¹ While seeking DD reports on all major aspects of the Target SME (i.e. legal, financial, tax, etc.) is important, the reason for conducting the red flag legal DD, is because Purchasers “*often set a materiality threshold under which any identified risks or liabilities are not subject to further analysis or investigation.*”¹⁴² Put differently, if the Target SME is facing too many lawsuits, is in breach of multiple environmental protection orders or is facing an impending raw materials shortage, those are enough red flags for a Purchaser to walk away and not close the transaction. Insofar as UK DD is concerned, no rules, regulations, case law or requirements were found

¹³⁴ *Ibid.* at pp. 12.

¹³⁵ Phillipp von Raven, ‘M&A/Legal Due Diligence Germany’ (Winheller Attorneys at Law & Tax Advisors, undated) <<https://www.winheller.com/en/business-law/company-law/ma-due-diligence.html>> accessed 31 October 2022.

¹³⁶ Howson, *supra* note 123 at pp. 11-2.

¹³⁷ Paul Luiki, ‘Session 3 – Due Diligence’ (Drafting and Negotiating Cross-Border M & A and Joint Venture Contracts, Vienna, 25 February 2022) at pp. 33.

¹³⁸ Andreas Nelle, *supra* note 109 at pp. 10.

¹³⁹ *Ibid.*

¹⁴⁰ Phil Cheveley, *supra* note 37; Andreas Nelle, *supra* note 109 at pp. 10.

¹⁴¹ Phil Cheveley, *supra* note 37.

¹⁴² *Ibid.*

mandating the Seller to disclose any information outside the four corners of the DD topics requested by the Purchaser.¹⁴³

By contrast, pursuant to German case law, for German DDs the Seller is required to disclose to the Purchaser “*such facts about the [Target SME] that may be reasonably expected to be decisive for the [P]urchaser’s decision to acquire the business.*”¹⁴⁴ In fact, even in situations where the Purchaser fails to conduct *any* DD, or only conducts a rudimentary (general) one or does not ask for specific facts on the Target SME, the Seller must nevertheless disclose specific information without delay.¹⁴⁵ Statutory German law can void an entire M&A transaction, where the Purchaser has shown that the Seller failed to knowingly disclose pertinent information on the Target SME.¹⁴⁶ Conversely, if the Purchaser is shown to have had positive knowledge about certain defects vis-à-vis the Target SME, under German law the Purchaser loses its rights to claim against the Seller.¹⁴⁷ In light of the foregoing, traditional German law “*does not impose such a broad duty to inspect the object to be purchased upon the [Purchaser] and therefore the rights of the [Purchaser] are not excluded if it does not carry out [DD].*”¹⁴⁸ Similar to recent trends in the UK, German Purchasers will only conduct red flag legal DD, in order to assess the most serious risks associated with the Target SME and to save costs and time.¹⁴⁹

3.2 Conditions Precedent clauses.

Two steps occurring at separate and different times in a M&A transaction for a Target SME, are the signing of the SPA and the closing of the M&A transaction itself.¹⁵⁰ The period of time between these two significant steps (i.e. between the signing of the SPA and closing of the M&A transaction), is when the Parties contract to complete certain steps at a future date in time

¹⁴³ *Ibid.*

¹⁴⁴ Andreas Nelle, *supra* note 109 at pp. 11.

¹⁴⁵ *Ibid.*

¹⁴⁶ *Ibid.*

¹⁴⁷ *Ibid.*

¹⁴⁸ *Ibid.*

¹⁴⁹ *Ibid.*

¹⁵⁰ Martin Chrometzka and Philip Ende, ‘M&A Vocabulary – Explained by the experts: Conditions Precedent’ (Rödl & Partner, 2020) <<https://www.roedl.com/insights/ma-dialog/2020-02/ma-vocabulary-explained-experts-conditions-precedent>> accessed on 26 October 2022.

and is called the *Conditions Precedent* or CP, for short.¹⁵¹ CP represents an important phase of a M&A transaction, which has the ability to halt the transaction altogether and *generally* include negotiated CP clauses related to subjects such as:¹⁵²

- 1) Regulatory and governmental approvals (i.e. antitrust approval, permits, etc.);
- 2) Commercially necessary approvals (i.e. banking financing approvals);
- 3) Internal decisions proof of acceptance (i.e. shareholders' resolution);
- 4) Non-removal of pertinent assets (i.e. ensuring that vital assets of the Target SME are not removed by the Seller post-SPA signing);
- 5) Purchase conditions fulfillment (i.e. settling with key employees to either depart or remain with the Target SME post-SPA signing).

3.2.1 UK CP clauses. In the UK, the rule of thumb is that there is no legal obligation to complete the M&A transaction until the CP clauses are either waived or met, as originally required.¹⁵³ Legal requirements such as those found under the *NSI* Act (discussed in chapter 1 of this Thesis) are of a mandatory nature and cannot be circumvented, as they are not within the Parties' control and must be included, typically as a CP clause.¹⁵⁴ In the UK, one of the more controversial types of CP clauses which are often abhorred by sellers is the "*material adverse change*" colloquially known as a MAC clause.¹⁵⁵ A MAC clause, typically relevant only in private M&A transactions, is a risk-allocation tool that permits the Purchaser to walk away from closing the transaction if an adverse event takes place, even in situations where the Seller is not at fault for any wrongdoing.¹⁵⁶

¹⁵¹ *Ibid.*

¹⁵² *Ibid.*

¹⁵³ Ian Ivory and Anton Rogoza, 'Conditions precedent: a Russian and English law comparison' (Thomson Reuters Practical Law, 19 January 2011) <[https://uk.practicallaw.thomsonreuters.com/4-504-1545?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/4-504-1545?transitionType=Default&contextData=(sc.Default)&firstPage=true)> accessed 26 October 2022.

¹⁵⁴ *Ibid.*

¹⁵⁵ Geraint Tilsley, 'US/UK M&A: Risk Allocation' (Lewis Silkin, 21 September 2021) <<https://www.lewissilkin.com/en/insights/usuk-ma-risk-allocation>> accessed 27 October 2022.

¹⁵⁶ Practical Law Corporate, 'Material adverse change (MAC) clauses: acquisitions' (Thomson Reuters Practical Law, undated) <[https://uk.practicallaw.thomsonreuters.com/w-034-8163?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/w-034-8163?transitionType=Default&contextData=(sc.Default)&firstPage=true)> accessed 27 October 2022.

3.2.2 UK MAC Clauses Explained. The overarching difference between a typical CP clause and an atypical MAC CP clause is control: MAC clauses cover events over which a Seller has no control over and potentially cannot (even if willing and able) meet. MAC clauses include situations such as:¹⁵⁷

- (a) *force majeure* (i.e. wars, natural disasters, pandemics etc.);
- (b) changing of the laws in the cross-border country where the Target SME is located that either negatively impacts Purchaser's ability to operate it or outright makes it unlawful;
- (c) financial markets changes that negatively affect the Target SME from an economical perspective (i.e. currency exchange rate changes, employment levels, etc.); and,
- (d) a new competitor's products that just came on the market or raw material, labour and/or other costs that dramatically decreases the value of the Target SME.

Not surprisingly, in the UK, a Seller will not be or unlikely to be willing to accept a MAC CP clause in the SPA, as opposed to other common law jurisdictions, such as the US.¹⁵⁸ A Purchaser may be able to *persuade* a MAC clause on a Seller in such situations as (a) the Parties' negotiation positions' strength, (b) the anticipated length of time between the signing of the SPA and the closing of the M&A transaction, (c) the Target SME's nature of business and the (d) market, economic and social stability conditions, to name a few.¹⁵⁹

3.2.3. UK Case-law on CP clauses. Given the hesitation of a Seller to accept a MAC CP clause in the SPA, it is not surprising that such CP clause has been subject to considerable litigation in the UK jurisdiction. Following the *Grupo Hotelero Urvasco v. Carey Value Added SL and Another*¹⁶⁰ decision, which is a leading English Court decision, UK courts “*will require a long-term adverse impact on*” the Target SME's position, when assessing if a MAC CP clause has been

¹⁵⁷ *Ibid.*

¹⁵⁸ Geraint Tilsley, *supra* note 155.

¹⁵⁹ Practical Law Corporate, *supra* note 156.

¹⁶⁰ [2013] EWHC (Comm) 1039; Practical Law Corporate, *supra* note 156.

satisfied.¹⁶¹ As such, unless explicitly worded to define a specific period of time, MAC clauses will only be applied to transactions in situations where the outside factors are of a long-term duration on the company. The *Grupo Hotelero* decision also speaks to the knowledge of the Parties before using a MAC clause to terminate the transaction: if one of the Parties was aware of pre-existing issues that could negatively impact the Target SME, then that particular party (usually the Purchaser) will be unable to rely on the MAC clause to get out of the transaction.¹⁶²

In the *Cukurova Finance International Limited and another v. Alfa Telecom Turkey Ltd.*¹⁶³ a Privy Council decision, the decision to be made was on the interpretation of a MAC clause that was subjective in nature (i.e. the MAC clause could be invoked not by objective standards but rather by one party's literal opinion).¹⁶⁴ The Parties accepted that one of the Parties, Alfa Telecom Turkey Ltd., could invoke a MAC clause and terminate the entire transaction, if it "*formed an opinion, which was honest and rational, that there had been an adverse effect.*"¹⁶⁵ The Privy Council held that there was no evidence that such opinion exercised by Alfa Telecom Turkey Ltd. was not honest nor rational and ruled in favour of Alfa Telecom Turkey Ltd.¹⁶⁶ While Privy Council decisions are not binding, they are persuasive and likely to be considered by British courts.¹⁶⁷

3.2.4 Germany CP clauses. In private German M&A transactions, two of the most common CP clauses are (1) the European Commission ("EC") or the German Federal Cartel Office, the *Bundeskartellamt* ("BKartA") merger control clearance and (2) the Ministry of Economics and Technology's (i.e. the BMWi defined in chapter 1 of this Thesis) foreign investment control clearance.¹⁶⁸ Since the EC merger control clearance deals with transactions above SMEs turnover profits (an objective standard), it will not be discussed. Focus will only be on the BKartA merger control clearance. The legislative provisions giving the BKartA authority comes from the Act against Restraints of Competition ("GWB"). Pursuant to sub-paragraph 1,

¹⁶¹ *Ibid.*

¹⁶² *Ibid.*

¹⁶³ [2013] UKPC 2; Practical Law Corporate, *supra* note 156.

¹⁶⁴ *Ibid.*

¹⁶⁵ *Ibid.*

¹⁶⁶ *Ibid.*

¹⁶⁷ *Ibid.*

¹⁶⁸ Mathias Bulow, *supra* note 33.

section 37, clause 3 of the GWB, a merger is defined as the purchase of 25% and 50% of the Target SME's shares.¹⁶⁹ Unlike in the UK jurisdiction, in Germany MAC CP clauses are rarely, if ever, accepted by Sellers on the market.¹⁷⁰ This is because in Germany, M&A practice holds the general presumption that after the Parties have signed a SPA, the closing of the transaction should be an eventuality reached and permitting any of the Parties to walk away should be discouraged, *even* if in the meantime the circumstances have changed.¹⁷¹ As such, in a similar vein to LOIs treatment in Germany, no case law was found in the research of this Thesis on the topic of MAC CP clauses by German courts.

Insofar as the CP clause related to receiving merger clearance from the BKartA is concerned, such clearance will only be provided if the merger does not result in negatively affecting the competition (i.e. does not impede competition) on the German domestic market.¹⁷² This is codified in the GWB at sub-para. 1, section 36.¹⁷³ The German government does allow an exemption to this rule, also found in the same sub-para. 1, section 36 of the GWB, which allows the merger between two companies even if it distorts competition, provided that such merger creates competitive condition improvements which outweigh the disadvantages associated with market domination.¹⁷⁴

From a practical standpoint, after the SPA has been signed and the BKartA given notice, if the BKartA has not informed the Parties that it is starting an "*in-depth review*" within one month of giving the notice, the transaction will be treated as if it was approved and hence the CP clause was met.¹⁷⁵ If the BKartA notifies the Parties of the in-depth review but fails to issue a prohibition order within four months, and no extension has been agreed upon by the Parties of the Principal Examination, then the merger is considered approved, pursuant to section 40 of the GWB.¹⁷⁶ In the event that a merger does become subject to a prohibition order issued by the BKartA and the transaction was nevertheless completed, it will be voided and the Parties will be subjected to steep

¹⁶⁹ Andreas Nelle, *supra* note 109 at pp. 16.

¹⁷⁰ *Ibid.*; Mathias Bulow, *supra* note 33.

¹⁷¹ Andreas Nelle, *supra* note 109 at pp. 16.

¹⁷² *Ibid.* at pp. 17.

¹⁷³ *Ibid.*

¹⁷⁴ *Ibid.*

¹⁷⁵ *Ibid.*

¹⁷⁶ *Ibid.*

and substantial fines.¹⁷⁷ To avoid such situation, should the BKartA prohibit the transaction, the Parties can apply to the Federal Minister of Economic Affairs and Energy for relief, if the transaction, pursuant to section 42 of the GWB is “*in the interest of the public good, taking into account considerations beyond the competition rules.*”¹⁷⁸ On the topic of BMWi’s foreign control clearance, this subject was already covered in Chapter 1, section 1.3.3 of this Thesis.

3.3. Analysis and Discussion.

Given the Target SME TWO’s location in the UK, the Purchaser ONE should consider commissioning a red flag legal DD at the outset of the DD phase. If the Target SME TWO presents no serious “deal breakers” such as an overwhelming number of lawsuits, it should then proceed with conducting DDs in the areas it finds most importantly. In addition to conducting DDs in the legal, financial, commercial, human resources, environmental and taxation areas, an in-depth DD should be conducted for the intellectual property part of the company. After all, since Purchaser ONE needs sub-component Y for its second-generation electronic device X2, it must ensure that all pertinent intellectual property assets, such as patents, are in good standing, are not about to expire or are challenged.

On the topic of CP clauses, in addition to the general ones (i.e. regulatory, commercial, etc.) two important CP clauses to keep in mind for the Purchaser will be (1) that the intellectual property assets related to sub-component Y are not removed by the Seller and (2) that an appropriate MAC clause is inserted to account for the possibility that between the signing of the SPA and the closing of the transaction, the sub-component Y *does* become outdated. The Seller on the other hand, should proceed with disclosing the pertinent information requested under the DD (but nothing outside the scope of the DD), but when it comes to CP clauses, it should resist or limit the effect of a MAC clause. This is because the Seller must protect its interest in selling the Target SME and prevent the real possibility for the Purchaser to walk away for reasons outside the Seller’s purview.

¹⁷⁷ *Ibid.*

¹⁷⁸ *Ibid.*

3.4 Conclusion.

Chapter 3 of this Thesis explored two important parts of a M&A transaction: due diligence and conditions precedent phases. DD occurred between the signing of the LOI/CA and that of the SPA, while the CP phase took place between the signing of the SPA and the actual closing of the M&A transaction. DD provided the ability for a Purchaser to seek out sensitive information on the Target SME. DD was described as a comprehensive audit. DD assisted the parties to achieve a realistic price for the company, gave proof that the Purchaser's management team carried out its regulatory due care on the transaction and allowed the information to flow between the Parties early in the process. There were different focuses of DD, such as legal, financial, commercial, human resources, intellectual property, taxation and environmental areas. These were the general focuses that a Purchaser would be interested to know particulars, however there could have been many other focuses as well, such as management, pension, IT, operational and insurance areas. DD could also have taken different forms besides one driven by the Purchaser: it could have been a vendor DD, the DD obtained from a receiver or a red flag legal DD, which only looked at the most problematic aspects of the Target SME. DD was carried out using physical, virtual or electronic rooms, where data on the Target SME was obtained in different forms. Recent trends in DD for both the UK and German jurisdictions saw a common usage of red flag legal DDs. The difference between UK and German DDs was that in Germany, a Seller were required to disclose specific pertinent information on the Target SME even in instances where the Purchaser did not conduct any DD or did a rudimentary one. If the Seller did not disclose the pertinent information and the Purchaser showed that the Seller knowingly failed to act, then the entire M&A transaction could be voided.

Conditions Precedent or CP clauses related to subjects such as regulatory/governmental approvals, commercial approvals, internal decisions proof of acceptance and non-removal of pertinent assets, to name a few. In the UK, CP clauses related to governmental approvals (i.e. such as those found under the *NSI* Act) were mandatory and had to be included. Some CP clauses such as MAC clauses were found to be relevant primarily in private M&A transactions. A MAC clause allowed a Purchaser to walk away from closing the transaction (even if the SPA was signed) and covered events over which the Seller did not have any control over, such as *force majeure*, law

changes in the country where the Target SME was located, financial markets and raw material, labour and/or other costs changes. In the UK, a Seller would not want a MAC clause in the SPA but could be persuaded depending on the Parties' negotiation positions' strength, anticipated length of time between the signing of the SPA and closing of the M&A transaction, and the nature of the business of the Target SME. The leading British MAC CP clauses case was the *Grupo Hotelero* decision that stood for the proposition that: (a) MAC clauses only applied to M&A transactions in situations where the outside factors were of a long-term duration and that (b) if any of the Parties were aware of pre-existing issues that could create problems for closing the transaction of the Target SME, then those Parties could not rely on the MAC clause to get out. Further persuasive but not binding case law suggested if the Parties agreed that a MAC clause could be invoked by only one party's subjective opinion, then that would be allowable in common law jurisdictions.

Common German CP clauses were BKartA merger control clearance and BMWi foreign investment control clearance. The latter CP clause related to BMWi, was discussed in chapter 1 of this Thesis. BKartA authority came from the GWB. The German authorities could provide approval for the merger if it did not result in negatively affecting competition on German domestic market, pursuant to section 36 of the GWB. An exception was allowed to merge two companies even if doing so distorted competition provided the merger improved competitive conditions that outweighed the disadvantages associated with market domination. After the SPA was signed by the Parties, pursuant to a CP clause, they had to notify the BKartA of the potential merger. If the BKartA did not inform the Parties it intended to do an in-depth review within 30 days of the notice, then the Parties could assume the M&A transaction was approved. If the BKartA did inform the Parties of an in-depth review, and did not issue out a prohibition order within 4 months of the review notice, then the Parties could presume the transaction was approved. If a prohibition order was issued, the Parties could apply to the Federal Minister of Economic Affairs and Energy for an exemption from the prohibition order pursuant to section 42 of the GWB if the Parties could show that the merger was in the public good's interest, with a view towards rules on competition.

In regards to the hypothetical scenario of this Thesis, since the Seller was located in the UK, then the Purchaser ONE should proceed with a red flag legal DD at the outset to see if the Target SME TWO had any serious issues that would dissuade the Purchaser from concluding the

transaction. If there are no such serious issues, then the Purchaser should consider doing DDs in the most important areas it deems fit such as legal, financial, commercial, environmental, taxation and most importantly in the intellectual property field. This was because as Target SME TWO had a vital intellectual property that Purchaser ONE sought (i.e. sub-component Y), then it needed to know that all intellectual property assets were in order. With regards to CP clauses, Purchaser ONE should have inserted CP clauses ensuring that the intellectual property of Target SME TWO would not be removed and a MAC clause to account for any unforeseen possibility that Target SME TWO's intellectual property became outdated. The Seller on the other hand, in addition to complying with its DD obligations, should have refused any MAC CP clause or limit its ability that allowed the Purchaser to walk away for motives outside the control of the Seller.

4.0 Chapter 4: Representations, Warranties, Disclosure and Specific Indemnities.

Part of the previous chapter outlined forms of disclosure such as the various data rooms (i.e. physical, virtual or electronic) that allowed the Purchaser to complete its DD. While the Parties have or are continuing to agree upon all relevant CP clauses (also discussed in the previous chapter), the Purchaser will contemporaneously ask the Seller to provide representations and warranties (individually, "Representation", "Warranty" and collectively "Reps and Warranties") on different subjects or areas regarding the Target SME. The Reps and Warranties sought are the result of the DD phase. The Seller can outright agree to all of the requested Reps and Warranties, or consent in part to them with the caveat of providing *further* disclosure ("Specific Disclosure"). The Specific Disclosure will explain the parts of the Reps and Warranties that the Seller is unable to fulfill. In addition (and in alternative) to Reps and Warranties, a Purchaser can request specific indemnities ("Specific Indemnities"), to which the Seller will have to respond. Chapter 4 of this Thesis defines and explores the dynamics between Reps and Warranties, Specific Disclosure, and Specific Indemnities.

4.1 Representations and Warranties.

4.1.1 General Concepts. In the context of M&A, the terms Representation and Warranty have similar definitions. A Representation can be defined as a statement made by one party, such

as the Seller, in relation to an *existing* fact in order to induce another (i.e. the Purchaser) to commit to an agreement (i.e. the SPA).¹⁷⁹ A Warranty on the other hand is either a promise or a statement that the existing fact *will continue to remain true in the future* regarding a subject matter.¹⁸⁰ One difference between a Representation and Warranty relates to the consequences if they are breached. If the Warranty turns out to be false, the remedy against the party who made it will be a damages claim calculated or claimed on a *contractual* basis, in the form of general indemnity.¹⁸¹ A Representation breach on the other hand, that is, a misrepresentation that was made to induce a party to enter into a contract, will give rise to a damages claim based on torts law and even allow for the rescission of the entire contract.¹⁸² The general indemnity is provided to the Purchaser following the breach by the Seller, although typically litigation will be required prior to the Seller moves to provide the general indemnity. In some jurisdictions, such as the US or Germany, Reps and Warranties are used interchangeably whereas in other jurisdictions, such as the UK, they are treated separately.¹⁸³ Of importance to Reps and Warranties is that if they turn out to be falsely given by the Seller (i.e. breach of warranty), a Purchaser's remedy against the breach is a general indemnity against the Seller.¹⁸⁴

Reps and Warranties not coincidentally cover the same subject/aspects of a SPA that were the same subjects covered during the DD phase, such as: (1) the share capital of the Target SPA, (2) the Seller's legal right to enter in the SPA, (3) financial books, records and accounts, (4) the legal status of the Target SME's assets and whether they are sold free and clear from any encumbrances, (5) litigation status of the Target SME as both claimant and defendant, (6) intellectual property rights, (7) taxation status, (8) contract status with customers, suppliers and

¹⁷⁹ Vincent Costa, 'Representations and Warranties in M&A Transactions' (Campolo, Middleton & McCormick, LLP, 9 November 2018) <<https://cmmlp.com/representations-and-warranties-in-ma-transactions/>> accessed 7 November 2022; Simon Spooner and Charlie Wedin, 'Representations and Warranties in Private M&A' (Osborne Clarke, 14 October 2014) <<https://www.osborneclarke.com/insights/representations-and-warranties-in-private-ma>> accessed 7 November 2022; Ross McNaughton and Matthew Poxon, 'Company Acquisitions: Representations Warranties and Disclosure' (Paul Hastings (Europe) LLP, 23 January 2014) <[https://webstorage.paulhastings.com/Documents/PDFs/wldoc-14-1-28-12_4-\(pm\).pdf](https://webstorage.paulhastings.com/Documents/PDFs/wldoc-14-1-28-12_4-(pm).pdf)> accessed 7 November 2022.

¹⁸⁰ *Ibid.*

¹⁸¹ *Ibid.*

¹⁸² *Ibid.*

¹⁸³ Eva Davis and Others, 'UK M&A Deals: What a US Buyer Should Expect' (Winston & Strawn LLP, 2014) <<https://www.winston.com/images/content/1/0/v2/105605/UK-MA-Deals-What-a-US-Buyer-Should-Expect-Davis-in-Transaction.pdf>> accessed 7 November 2022.

¹⁸⁴ Paul Luiki, 'Session 4 – Share Deal Asset Deal, Reps & Warranties' (Drafting and Negotiating Cross-Border M & A and Joint Venture Contracts, Vienna, 25 February 2022) at pp. 42.

other vendors, (9) various statutory and lawful compliance measures (i.e. anti-bribery, by-laws, etc.) and (10) insolvency.¹⁸⁵ The aforementioned aspects/subjects do not constitute an all-encompassing list and other subjects may exist, depending on the industry in which the Target SME operates.

In practice, once the Purchaser has concluded its DD and has not found any information to the contrary, it will seek Reps and Warranties from the Seller for, *inter alia*, the subjects covered above in points (1) through (10). For example, the Purchaser will want Reps and Warranties in the SPA, affirming that there are no lawsuits where the Target SME is either a claimant or defendant, that the Target SME has paid all taxes in its jurisdiction for the previous years and that all assets belonging to the Target SME are free and not encumbered by any deeds against them. The Seller can agree to these Reps and Warranties outright without any caveats. Reps and Warranties only cover *unknown/undisclosed* issues to the Purchaser about the Target SME at the time the SPA was signed.¹⁸⁶ Put differently, in order for the Purchaser to claim a remedy under general indemnity provisions for a breach of Reps and Warranties, it must not have had any prior knowledge of the issues claimed under a general indemnity clause.

If the Seller is unable to provide the aforementioned requested Reps and Warranties due to legal reasons, the Seller can agree *in part* to the requested Reps and Warranties. In doing so, it can respond that the Target SME is not involved in any *other* lawsuits, has paid *most* taxes in its jurisdiction and its assets are not *all* encumbered by any deeds against them *other than* the information provided in a disclosure annexed to the SPA.¹⁸⁷ The annexed disclosure would then reveal all lawsuits, taxes payable and still outstanding for X, Y and Z years as well as any assets which are still encumbered.¹⁸⁸ If/once this information is disclosed by the Seller and becomes known to the Purchaser, a claim for misrepresentation or breach of Warranty, is no longer possible and a remedy under a general indemnity cannot proceed. However, due to this Specific Disclosure, the Purchaser can negotiate a lower price for the Target SME.

¹⁸⁵ Phil Cheveley, *supra* note 37.

¹⁸⁶ Paul Luiki Session 4, *supra* note 184 at pp. 42.

¹⁸⁷ Andrew Mills, 'Full disclosure: Is this warranted?' (MJ Hudson, January 2019) <<https://mjhudson.com/preparing-for-disclosure/>> accessed 10 November 2022.

¹⁸⁸ *Ibid.*

4.1.2 Reps and Warranties in the UK. In the UK, private M&A sellers will delete the Representation portion as legal counsel will refuse to provide *both* Reps and Warranties in a SPA for a Target SME.¹⁸⁹ Typically, only Warranties are provided in this jurisdiction.¹⁹⁰ Under the pertinent provisions of the UK *Misrepresentation Act 1967*, should a misrepresentation be found in the SPA, a Purchaser may well be allowed to rescind the *entire* contract.¹⁹¹ By contrast, a Warranty will not be susceptible to the *Misrepresentation Act 1967*.¹⁹² To shield the Seller from potential exposure, the practice in the UK jurisdiction is to delete the Representations portion of the SPA. This distinction is elucidated in the 2012 UK case of *Sycamore Bidco Ltd. v. Breslin*.¹⁹³

In the UK case of *Sycamore Bidco Ltd.*, the Purchaser found errors post-closing in the audited accounting books that were provided to the Purchaser pre-transaction of the Target SME.¹⁹⁴ The Purchaser was not aware of this error and hence sought the remedy of general indemnity from the Seller.¹⁹⁵ The audited accounting books were subject to a Warranty only, however the Purchaser sued for both breaches of Reps and Warranties.¹⁹⁶ As discussed in the General Concepts of this chapter, a Warranty proven not to be true will attract a remedy based on a contractual basis whereas a misrepresentation will attract a tortious claim against the Seller (and even possibly the ability to rescind the entire agreement).¹⁹⁷ In the *Sycamore Bidco Ltd.* case, the difference between the lower Warranty-breach remedy and the higher Representation-breach remedy was calculated at well over £10 million (pound sterling).¹⁹⁸ In refusing to interpret the Warranty as a Representation, the Court stated that Reps and Warranties are in fact very different in the UK jurisdiction because they were in fact treated as different legal terms throughout the SPA.¹⁹⁹

¹⁸⁹ Eva Davis *supra* note 183.

¹⁹⁰ *Ibid.*

¹⁹¹ *Ibid.*

¹⁹² *Ibid.*

¹⁹³ [2012] EWHC 3443 (Ch); Emma Dolphin, 'Warranties and Representations – Why it Matters' (2013) 15 Legal Week London 21.

¹⁹⁴ *Ibid.*

¹⁹⁵ *Ibid.*

¹⁹⁶ *Ibid.*

¹⁹⁷ *Ibid.*

¹⁹⁸ *Ibid.*

¹⁹⁹ *Ibid.*

4.1.3 Reps and Warranties in Germany. In contrast to the UK, the German jurisdiction allows the grouping of Reps and Warranties together.²⁰⁰ In keeping with other documents, such as CAs/NDAs, Reps and Warranties are significantly shorter than their UK counterparts.²⁰¹ Under German law and in particular under section 442 of the BGB, in a situation where due to gross negligence of the Seller, no information is known about specific problems with the Target SME and a Rep and Warranty was given, the Seller's liability will be limited when it was found to have willfully misrepresented the information or if a Warranty of a specific nature was given.²⁰² Under sub-paragraph 1, section 437 and section 439 of the BGB, if there is a breach of the SPA, for example due to a false Warranty, the Purchaser is entitled to rely on the Seller attempting to cure the defect.²⁰³ If the Seller refuses to cure the defects or unable to do so, BGB sections 323, 326 and 346 give the Purchaser the right to rescind the entire SPA.²⁰⁴

From a practical standpoint, once the M&A transaction has been completed, the Seller will no longer have access to the Target SME to cure any issues and the prospect of returning the Target SME back to the Seller for a refund is not desired by either of the Parties.²⁰⁵ Instead, the practice is to contract out of these provisions in a defined and limited scope and exchange them with the Purchaser's entitlement to seek compensation for damages.²⁰⁶ To this end German law, sub-paragraph 1, clause 2 of section 280 of the BGB, places a fault presumption upon a Seller when negligence is claimed against them in a damages claim or in a claim for a specific Reps and Warranty breach.²⁰⁷

Associated with Reps and Warranties, Sellers in the German jurisdiction also provide “*specific warranties*” which are technically considered guarantees, because they cover issues that are not necessarily due to the Seller's fault.²⁰⁸ These specific warranties or guarantees are limited

²⁰⁰ Alexander Schwarz, *supra* note 9; Mirko Bengel and Others, ‘Legal Guide to Mergers & Acquisitions in Germany’ (Germany Trade & Invest, 2016) <<https://www.gtai.de/resource/blob/63706/a4052d9574df2c0aaffc6ec1788c9eac/mergers-and-acquisitions-germany-data.pdf>> accessed 7 November 2022.

²⁰¹ Alexander Schwarz, *supra* note 9.

²⁰² Andreas Nelle, *supra* note 109 at pp. 11.

²⁰³ *Ibid.*

²⁰⁴ *Ibid.*

²⁰⁵ *Ibid.* at pp. 12.

²⁰⁶ *Ibid.*

²⁰⁷ *Ibid.*

²⁰⁸ *Ibid.*; Mirko Bengel, *supra* note 200 at pp. 95.

in scope by the findings of the DD process.²⁰⁹ They include technical guarantees that (a) the information provided in the data room (whether physical, virtual or electronic) was correct, accurate and complete, (b) that the Target SME was incorporated properly, (c) the existence of the assets, liabilities, financial statements and intellectual property rights of the Target SME, and (d) whether any threats or disputes regarding the Target SME is pending and may occur in the future.²¹⁰ The limitation period for any disputes arising out of Reps and Warranties or guarantees is two years pursuant to sub-paragraph 1, clause 3, section 238 of the BGB, or depending on the circumstances, three years pursuant to section 195 of the BGB.²¹¹ This period of time can be extended or shortened contractually.²¹²

4.2 Disclosure and Specific Indemnity.

In order for the process of DD discussed in chapter 3 of this Thesis to function, implicitly it was necessary for the Seller to disclose the information sought by the Purchaser on the Target SME. That information was delivered via the data rooms in its various forms (i.e. physical, virtual, etc.). Some practitioners believe that the most critical type of disclosure or the “heart” of disclosure in a M&A transaction lies in the substantive replies of the Seller to Purchaser’s Reps and Warranties sought in the SPA, colloquially known as Specific Disclosure.²¹³

4.2.1 Disclosure in the UK. In this jurisdiction, in addition to the disclosure made by the Seller during the DD phase, two other distinct types of disclosure exist: general disclosure and Specific Disclosure.²¹⁴ General disclosure consists of publicly available information that can be obtain by anyone.²¹⁵ For example, the UK Companies House will provide basic corporate filings

²⁰⁹ Andreas Nelle, *supra* note 109 at pp. 12.

²¹⁰ *Ibid.*

²¹¹ *Ibid.*

²¹² *Ibid.*

²¹³ Andrew Mills, *supra* note 187.

²¹⁴ Carol Osborne and Jeremy L. Saiderman, ‘Disclosure in M&A Transactions: UK & US Perspectives’ (Lexology, 18 June 2013) <<https://www.lexology.com/library/detail.aspx?g=f3dd3609-4fac-4bc1-8335-91bad5381246>> accessed 10 November 2022; David Gent, ‘Disclosure against Warranties in UK Corporate Transactions’ (Bird & Bird, 9 November 2021) <<https://www.twobirds.com/en/insights/2021/uk/disclosure-against-warranties-in-uk-corporate-transactions>> accessed 10 November 2022; Brigitta Naunton, ‘Buyer beware! Disclosure in acquisitions – What it’s for, and who it benefits?’ (Harper James, 25 January 2022) <<https://harperjames.co.uk/article/disclosure-in-acquisitions-who-benefits/#section-7>> accessed 10 November 2022.

²¹⁵ Carol Osborne, *supra* note 214.

on the Target SME.²¹⁶ In the UK jurisdiction, publicly available information is deemed to have been disclosed to the Purchaser, regardless of whether the Purchaser has actually sought the information out or not.²¹⁷ Specific Disclosure relates to the Seller providing specific information that will *negate* the Representation or separately, the Warranty, sought out by the Purchaser.²¹⁸ For instance, a Specific Disclosure made in a disclosure letter by the Seller will specify the lawsuits the Target SME is involved with *against* (and therefore negating) a Warranty seeking out that the Target SME is not involved in any litigation disputes.

In the UK jurisdiction, when providing Specific Disclosure (typically confined in a ‘disclosure letter’), the Seller must do so in a *fair* or sufficiently precise manner.²¹⁹ This is because the disclosure letter will “*qualify all of the representations and warranties (but not specific indemnities)*” in a SPA.²²⁰ Put differently, in order for the Seller to rely upon Specific Disclosure against any breaches of Representations or Warranty claims, the Seller must disclose the information in a fair manner. The concept of what constitutes fair disclosure within Specific Disclosure, has been considered by UK courts in a number of cases, such as:²²¹

- *Levison and Others v. Farin and Others*, [1978] 2 All ER 1149. The Seller warranted no MAC of the Target SME’s assets, but then disclosed that the owner’s declining health created losses. When the M&A transaction closed a loss of £8,600 was discovered by the Purchaser. The High Court ruled against the Seller and rejected the Seller’s disclosure to qualify the warranty, as the disclosure revealed a *possible* loss cause (the owner’s illness) but failed to specify an *actual* asset value decrease.
- *Daniel Reeds v. EM ESS Chemists Ltd.*, [1995] CLC 1405. The Seller warranted that the Target SME had all requisite licenses to sell paracetamol tablets, disclosed all licenses it had but failed to list the most important license, the manufacturer’s license, which had expired. The Court of Appeal rejected the Seller’s argument that the Purchaser should have done a better DD job. The Court held that “*fair disclosure*

²¹⁶ *Ibid.*

²¹⁷ *Ibid.*

²¹⁸ *Ibid.*

²¹⁹ *Ibid.*

²²⁰ *Ibid.*

²²¹ David Gent, *supra* note 214.

requires some positive statement of the true position and not just a fortuitous omission from which the [Purchaser] may be expected to infer matters of significance.”

Through the above two mentioned cases together with other common law cases, the UK jurisdiction has developed a running definition of what “fair disclosure” entails. It requires a Seller to provide enough particulars that will allow a Purchaser with sufficient ease to identify the scope and nature of the information disclosed against a specific Warranty or Representation.²²² Fair disclosure must also be balanced against the information obtained by the Purchaser prior to the completion of the SPA, through the inclusion of an “*anti-sandbagging clause*.”²²³ Through such clause, a Seller will attempt to minimize the success of a Purchaser’s indemnification claim against a Warranty or Representation breach, on the grounds that the Purchaser had prior knowledge when it completed its DD process or through other sources.²²⁴

4.2.2 Disclosure in Germany. In this jurisdiction, disclosure is not broken down into sub-categories such as general or Specific Disclosure or disclosure obtained during the DD phase, as is the situation in the UK.²²⁵ In fact, common German practice calls for a Purchaser to accept the disclosure provided as part of the DD process as also the disclosure used against Reps and Warranties.²²⁶ Whereas in the UK jurisdiction a Seller has to negotiate for an anti-sandbagging clause, under German law, if a Purchaser had any knowledge on issues with the Target SME, then the Purchaser loses any indemnity rights against the Seller.²²⁷ This practice is balanced against the requirement (obtained through German case law) that obligates a Seller to disclose all pertinent information on the Target SME even in situations where the Purchaser fails to conduct *any* DD.²²⁸ Furthermore, as in the UK, there is *some* information that is publicly available, such as the commercial register and separately, the land register.²²⁹ The commercial register will provide

²²² *Ibid.*

²²³ Glossary, ‘Anti-Sandbagging Provision’ (Thomson Reuters Practical Law, undated) <[https://uk.practicallaw.thomsonreuters.com/8-382-3232?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/8-382-3232?transitionType=Default&contextData=(sc.Default)&firstPage=true)> accessed 10 November 2022.

²²⁴ *Ibid.*

²²⁵ Andreas Nelle, *supra* note 109 at pp. 10.

²²⁶ *Ibid.*

²²⁷ *Ibid.* at pp. 11.

²²⁸ *Ibid.*

²²⁹ Alexander Schwarz, *supra* note 9.

general information on the corporate profile while the land register will provide some details on the real estate owned by the Target SME (if any).²³⁰

In situations where the disclosure was not proper leading to a breach of a Rep and Warranty, the *modus operandi* in Germany is for the Purchaser to notify the Seller of this fact and give it the opportunity to cure the defect.²³¹ If the Seller fails to do so, then the Purchaser can claim damages as of right against the Seller.²³² The burden of proof is on the Purchaser to show that an “adequate causal link” exists between the damages suffered by the Purchaser and the Reps and Warranty breach of the Seller.²³³ To this end, Sellers will attempt to minimize their liability by claiming they should be liable only for their constructive or actual knowledge related to the false Reps and Warranties given.²³⁴ In litigation, the details (both from a grammatical and descriptive perspective) provided are crucial for successfully claiming or defending in a breach of Reps and Warranties lawsuit, as pre-trial discovery does not exist in the civil procedure of the German legal system.²³⁵ In common law jurisdiction, pre-trial discovery allows the Parties to a lawsuit to show the evidentiary foundations for their claims or defences.²³⁶

4.2.3 Specific Indemnity. This type of indemnity gives Purchasers of a Target SME comfort for problems disclosed either in the DD process or through disclosure letters.²³⁷ To protect against an anti-sandbagging clause (i.e. Purchaser’s prior knowledge of issue with the Target SME), a Specific Indemnity clause will spell out the defect found and the amount to compensate if the Seller is unable to resolve the problem. Specific Indemnity is found in both UK and German jurisdictions.²³⁸ Two important areas for Specific Indemnity areas in the German market (in addition to the ones found through the DD phase) relate to taxation and environmental matters.²³⁹

²³⁰ *Ibid.*

²³¹ Andreas Nelle, *supra* note 109 at pp. 13.

²³² *Ibid.*

²³³ *Ibid.*

²³⁴ *Ibid.*

²³⁵ *Ibid.*

²³⁶ Black AJ, “Pretrial Discovery in Scotland, England and Canada” (1992) 39 Netherlands International Law Review 267; Glossary, ‘Discovery’ (Thomson Reuters Practical Law, undated) <[https://uk.practicallaw.thomsonreuters.com/8-107-6127?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/8-107-6127?transitionType=Default&contextData=(sc.Default)&firstPage=true)> accessed 11 November 2022.

²³⁷ Paul Luiki Session 4, *supra* note 184 at pp. 42.

²³⁸ Phil Cheveley, *supra* note 37; Mathias Bulow, *supra* note 33.

²³⁹ Mathias Bulow, *supra* note 33.

Similarly, in the UK market, Specific Indemnity is also used vis-à-vis tax obligations of the Target SME.²⁴⁰

4.3 Analysis and Discussion.

A dialogue will ensue between Purchaser ONE and the Seller of the Target SME TWO in relation to the Reps and Warranties that are to be negotiated in the SPA. The Reps and Warranties agreed upon or those requiring Specific Disclosure, will dictate the final price for the company. If the Seller requests that the SPA be governed by UK common law jurisdiction, given the location of the Target SME TWO, then the SPA will reflect only Warranties (as opposed to Reps and Warranties). After conducting its DD, Purchaser ONE will have to take notice of any issues found with the sub-component Y, intellectual property assets or any other critical issue deemed fit. Any specific issue found by Purchaser ONE will need to be addressed *not* by a Warranty but by a Special Indemnity clause, given the Purchaser ONE's awareness. If Purchaser ONE has not found any further issues in its DD process, then it should seek out very broad Warranty clauses in order to maximize its general indemnity coverage for any unknown issues that will be discovered once it has taken possession of the Target SME TWO.

By contrast, the Seller should attempt to resist overly broad Warranties sought out by Purchaser ONE and provide as narrow Warranties, as possible. A narrow Warranty agreed upon equates with a higher possibility that any issues found later on with the Target SME TWO will not fit into any of the Warranties given. If Purchaser ONE will not agree to narrow Warranties, then the Seller will need to consider two approaches:

1. Whether to make further disclosure on any outstanding issues with Target SME TWO, through the use of Specific Disclosure. The advantage of using it means that in the event a serious issue with the company materializes, Purchaser ONE will not be able to successfully sue the Seller for breach of Warranty, if said Warranty will be deemed qualified by the Specific Disclosure. The disadvantage to Specific Disclosure is that if the Seller uses it too much, it will signal to

²⁴⁰ Phil Cheveley, *supra* note 37.

Purchaser ONE that there may be other hidden problems with Target SME TWO, which will lead to a lower selling price for the company.

2. In the alternative, the Seller could insist on 'anti-sandbagging clauses' to take into account any/all prior knowledge that Purchaser ONE has on Target SME TWO. This is a delicate approach because the Seller would need to have sufficient evidence to show in a court of law that the Purchaser was aware of existing defects with the company. At the same time, if Purchaser ONE requests Specific Indemnity clauses then that would diminish the use of the 'anti-sandbagging clause.'

As it will be discussed in further detail in the last chapter of this Thesis, chapter 5, both the Seller and Purchaser ONE will have other tools available to them. Such tools include the use of covenants, caps, baskets, and floors. These tools, in addition to the concepts discussed in this chapter, will allow the Parties to protect their legal rights, as they proceed to conclude this M&A transaction. That said, the most important tool for both Parties will be their negotiation ability.

4.4 Conclusion.

This chapter defined and explored the dynamics between Reps and Warranties, Disclosure and Specific Indemnities. A Representation was the statement related to an existing fact made to induce one party into entering a SPA. A Warranty was a promise that the existing fact would remain true in the future. If a Warranty was breached, then the remedy would be general indemnity calculated on a contractual basis. If a Representation was breached then the remedy would be on a tortious basis, even allowing the possibility for the Purchaser to rescind the agreement. Reps and Warranties were given out for potential issues for which the Purchaser had no knowledge. Reps and Warranties typically reflected the DD process and were requested by the Purchaser for various areas such as: the financial records, litigation status, tax status and intellectual property status of the Target SME. Depending on the jurisdiction, the Seller could refuse to provide both Reps and Warranties and instead give out only Warranties. Such was the case with the UK jurisdiction where typically only Warranties were given out. In other jurisdictions such as Germany, Reps and Warranties were given out together. Reps and Warranties in Germany

were found to be shorter than the UK counterparts. If the Seller was grossly negligent, was unaware of specific issues with the Target SME, and provided a Rep and Warranty that later was determined to be false, then pursuant to section 442 of the BGB, the Seller's liability was limited. The Purchaser was entitled to have the Seller try to resolve the issue (sections 437 and 439 of the BGB), and if the Seller was unable to fix the problems, then the Purchaser had the possibility to rescind the entire SPA, pursuant to sections 323, 326 and 346 of the BGB.

If the Seller was unable to consent to the Reps and Warranties sought out by the Purchaser, it could still consent to them in part and give the Purchaser further disclosure, known as Specific Disclosure. In the UK, Specific Disclosure meant that the Seller had to give fair or with sufficiently precise manner particulars in its Specific Disclosure that the Purchaser could understand. As stated in the UK *Daniel Reeds* case, the Court of Appeal explained that the Seller was required to reveal the true position of the Target SME through some positive statement and not merely omit information from which the Purchaser could infer a significant issue. Specific Disclosure was an important factor for the Seller, as a properly used one allowed a Seller to rely upon them for any alleged Warranty breaches. Disclosure in Germany was obtained through the DD process and the Purchaser is usually expected to accept as the entirety of disclosure even used against Reps and Warranties. However, in Germany there was equally an expectation that the Seller would disclose all important information on the Target SME, even in situations where the Purchaser conducted no DD.

In the UK jurisdiction, a Seller would ask for the inclusion of an "anti-sandbagging clause" that attempted to insulate the Seller from a potential damage claim against a Warranty breach. In particular, if the Purchaser became aware of issues with the Target SME during the DD phase or via different means prior to the signing of the SPA, then the Purchaser would be barred from claiming against the Seller for a Warranty breach on the grounds that it had prior knowledge. Under German law, no "anti-sandbagging clause" was needed as a Purchaser would be precluded from taking action against a Seller for a Rep and Warranty breach if it had prior knowledge of the issue. For situations where the Purchaser did have knowledge of pre-existing issues with the Target SME, the Purchaser would require Specific Indemnity clauses against the known issues. This was because Reps and Warranties only covered unknown defects with the Target SME. In situations

where the Purchaser did have a legitimate claim for a Rep and Warranty breach, the onus was on the Purchaser to show an adequate causal link between the damages and the breach.

As the transaction will be cross-border, the Seller wanted the SPA to be governed by UK common law jurisdiction. Purchaser ONE had to draft the Warranties to reflect its DD process and consider only subjects for which it knew of no existing issues. In so doing, the Purchaser should have drafted the Warranties to be as broad as possible in order to maximize coverage under the general indemnity provisions. If Purchaser ONE was aware of any issues with Target SME TWO, then it should have requested Specific Indemnity clauses. By contrast, the Seller of Target SME TWO should have attempted to provide narrow Warranties for the company. If the Seller was unable to negotiate such narrow Warranties, it should have revealed Specific Disclosure in order to qualify the Warranties and insulate itself against a lawsuit from the Purchaser. In so doing, the Seller risked that it would receive a lower price for Target SME TWO. Alternatively, the Seller could have used an ‘anti-sandbagging clause’ to minimize any Warranties breaches through the prior knowledge of the Purchaser, however, such clause would be diminished in power if the Purchaser already sought out Specific Indemnity clauses. Suffice to say that the importance of negotiations skills could not be emphasized enough during the M&A transaction process.

5.0 Chapter 5: Covenants and Other Considerations.

As the M&A transaction nears completion, the Parties will need to consider subjects related to the Target SME post-closing situation. To this end, the last and final chapter of this Thesis, chapter 5, will analyze covenants, both in pre- and post-closing forms, together with their implications and how the Parties will attempt to protect their respective rights through their usage. On the topic of covenants, this chapter will also consider related issues, in both the UK and German jurisdictions, such as the reasonableness of post-closing covenants and employees’ rights after the closing of the M&A transaction. Limitations of liability of the Seller will also be discussed, with regards to such concepts as liability caps, *de minimis* claims and baskets, including ‘tipping’ and deductible types of baskets. This chapter will conclude by considering other related matters, such as deficiencies in legislation related to cross-border M&A transactions after the UK has left the

EU (i.e. Brexit). As it will be shown, the lack of a legal framework for cross-border M&A transactions, is not fatal nor cumbersome for new UK-based mergers and acquisitions.

5.1 Covenants.

Covenants are the promises made by the Seller and Purchaser towards one another with regards to the Target SME, during the course of the M&A transaction but also as it draws closer to the end.²⁴¹ These promises are included in the SPA, are enforceable and come as a permutation of the following descriptors: pre-closing, post-closing, positive and negative.²⁴² For instance, a covenant can be pre-closing positive or post-closing negative and vice versa. As the name suggests, covenants that are pre- or post-closing refer to the status of the M&A transaction (i.e. before or after of the closing date).²⁴³ Positive covenants require the Parties to take certain actions while negative (also known as restrictive) covenants forbid certain practices.²⁴⁴ Covenants exist in both the UK and German jurisdictions.²⁴⁵

5.1.1 Pre-closing Covenants. Covenants agreed to prior to the closing of the M&A transaction include but are not limited to:²⁴⁶

- 1) The Seller giving access to the Target SME's premises so that the Purchaser can review the company assets and/or meet with company personnel (i.e. employees) to inform them of the impending M&A transaction. This is an example of a positive covenant;
- 2) Operating the Target SME in the ordinary course of business by the Seller until the Purchaser is in a position to take over at the closing of the transaction – a positive covenant example;

²⁴¹ Robert Connolly, 'Purchase Agreement Essentials – Positive Covenants and Restrictive Covenants in M&A Transactions' (Financial Poise, 4 February 2020) <<https://www.financialpoise.com/purchase-agreements-positive-restrictive-covenants/>> accessed 14 November 2022.

²⁴² *Ibid.*

²⁴³ *Ibid.*

²⁴⁴ *Ibid.*

²⁴⁵ Alexander Schwarz, *supra* note 9; Ian Ivory, *supra* note 153; Phil Cheveley, *supra* note 37; Martin O'Donoghue and Steven J. Foristal, 'Comparing Private M&A Transactions in the U.K. and U.S.' (Armstrong Teasdale, 24 February 2022) <<https://www.armstrongteasdale.com/thought-leadership/comparing-private-ma-transactions-in-the-u-k-and-u-s/>> accessed 14 November 2022.

²⁴⁶ Robert Connolly, *supra* note 241.

- 3) The Seller abstaining from firing or hiring new employees, liquidating the Target SME's assets or taking other drastic courses of business action before the closing of the M&A transaction – a negative (restrictive) covenant example;
- 4) The Parties abstaining from giving public notice of the successful M&A transaction until after the closing date – a negative (restrictive) covenant example.

5.1.2 Post-closing Covenant. These covenants go into effect immediately after the closing of the transaction and can last anywhere between 12 months to 36 months thereafter.²⁴⁷ These types of covenants include (but are not limited to):²⁴⁸

- 1) Non-compete covenant, whereby the Seller promises to not compete with the Purchaser, post-closing of the M&A transaction and abstain from running another company doing exactly or very similarly what the Target SME was doing – a restrictive covenant example;
- 2) Non-solicitation of employees, consumers or suppliers, whereby the Seller promises not to 'poach' employees, consumers or suppliers from the Target SME after the closing of the transaction – a negative covenant example;
- 3) Access rights to documentation,²⁴⁹ whereby the Purchaser promises to give access to the Seller post-closing to certain documentation in order to allow the Seller to meet its obligations with regards to any Reps and Warranties or indemnity provisions – a positive covenant example;
- 4) Allocation of tax payments,²⁵⁰ whereby the Parties agree who will bear the burden of paying any taxes associated with the closing of the transaction – a positive covenant example.

5.1.3 Covenants-related Issues. In the UK, restrictive (negative) covenants must be reasonable vis-à-vis not only the Parties' *legitimate* interests but also towards the public interest.²⁵¹

²⁴⁷ Martin O'Donoghue, *supra* note 245.

²⁴⁸ *Ibid.*

²⁴⁹ Alexander Schwarz, *supra* note 9.

²⁵⁰ Robert Connolly, *supra* note 241.

²⁵¹ Richard Burrows and Dominic Sedghi, 'Corporate Law Update' (MacFarlanes, 23 September 2022) <<https://www.macfarlanes.com/what-we-think/in-depth/2022/corporate-law-update-3-23-september-2022/#Restricti>

If they are not reasonable, they are unenforceable.²⁵² In making the reasonableness determination, UK courts will consider the purpose of the negative covenant, its time duration, the Parties' respective bargaining power and the public impact on its restrictive nature.²⁵³ This issue was explored in the recent UK Court of Appeal decision of *Credico Marketing Ltd. v. Lambert*.²⁵⁴ In *Credico*, the claimant entered into a contract with Mr. Lambert's company, S5 Marketing for marketing campaign services.²⁵⁵ Both Mr. Lambert and S5 Marketing signed two restrictive covenants in favour of Credico: one for the duration of the contract and another one for six-months post-closing of the contract and in return Credico granted them access to its customer data base.²⁵⁶ Ten years later, after the completion of the contract, Credico discovered that Mr. Lambert and S5 Marketing had engaged Credico's customer base on behalf of a rival of Credico, during the time period of the contract with Credico and after the termination of the contract.²⁵⁷

Credico sued and the UK High Court agreed that Mr. Lambert and S5 Marketing breached both of the restrictive covenants.²⁵⁸ On appeal, the UK Court of Appeal agreed with the High Court that the first restrictive covenant for the duration of the contract was breached because Credico had invested resources in Mr. Lambert/S5 Marketing and legitimately expected them not work for an adversary.²⁵⁹ With regards to the second restrictive covenant, for the six months duration post-closing of the contract, the Court of Appeal decided it was *not* valid.²⁶⁰ This appellate Court ruled that Credico acted as an intermediary between its customers and marketing campaign services providers, such as Mr. Lambert/S5 Marketing.²⁶¹ In so ruling, the Court of Appeal inferred there was no proprietary information that traditionally may have justified a post-closing negative covenant.²⁶² It would be against public interest and not reasonable for a contractor to be unable to work on behalf of other companies regarding customers found on a competitor's list after it

ve> accessed 14 November 2022.

²⁵² *Ibid.*

²⁵³ *Ibid.*

²⁵⁴ *Ibid.*; [2022] EWCA Civ 864.

²⁵⁵ *Ibid.*

²⁵⁶ *Ibid.*

²⁵⁷ *Ibid.*

²⁵⁸ *Ibid.*

²⁵⁹ *Ibid.*

²⁶⁰ *Ibid.*

²⁶¹ *Ibid.*

²⁶² *Ibid.*

finished working for that particular competitor and no contract existed any longer.²⁶³ Ergo in the UK jurisdiction, any negative covenants must have a reasonable factor in them, failing which courts of that jurisdiction will not enforce them.

In the German jurisdiction, one of the most important issues that can be dealt via covenants, relate to the treatment of employees, post-transaction.²⁶⁴ There is a ‘three pillar-system’ related to retirement benefits of employees borne out of three sources: the pension insurance provided statutorily by German law, the pension related to the occupation and pension provisions of a private nature.²⁶⁵ The first two pillars are financed in part by the employer.²⁶⁶ If an employee of the Target SME has been with the company for a minimum of five years and has an age of 30 years or more, the occupational pension is expected to be non-forfeitable, by German law.²⁶⁷ One important covenant that a Purchaser should make (in addition to the associated Reps and Warranties) is to require of the Seller to continue making the obligatory pension contributions (positive covenant) and refrain from taking any money out of that pension fund, once the transaction closes (negative covenant) in order to avoid any unpleasant surprises.²⁶⁸

In a relation subject to employees, section 613(a) of the BGB insulates employees from detrimental consequences as a result of the M&A transaction.²⁶⁹ Under German law, the Purchaser takes ownership of all employment contracts, upon closing of the transaction, but before that can happen, employees must be given notice of the impending M&A of the Target SME and must do so *before* the transaction is completed.²⁷⁰ Employees of a German company that is being bought, have the right to object to their employment contract transfer 30 days after being given notice.²⁷¹ If employees object, their contract must be settled, likely through compensation to either get them to consent to the transfer to the Purchaser or compensation to terminate their employment

²⁶³ *Ibid.*

²⁶⁴ Michael Whalley and Ralf Kurney, *International Business Acquisitions: Major Legal Issues and Due Diligence* (4th Edition, Wolters Kluwer 2014) at pp. 253.

²⁶⁵ *Ibid.*

²⁶⁶ *Ibid.*

²⁶⁷ *Ibid.*

²⁶⁸ *Ibid.* at pp. 254.

²⁶⁹ *Ibid.*

²⁷⁰ *Ibid.* at pp. 255.

²⁷¹ *Ibid.*

contract.²⁷² In the UK, a similar structure scheme exists for current employees of the Target SME, in respects to both pension and employment contracts.²⁷³ Accordingly, it is crucial that the necessary covenants are placed as to when employees are to be given notice of the impending transaction and which of the Parties will be responsible for dealing with any issues arising from employees refusal to accept the transfer.

5.2 Other Considerations.

5.2.1 Limitations on Liability. Both German and the UK jurisdictions offer ways for the Seller to limit its liability vis-à-vis the indemnity that must be paid in the event of a Reps and Warranty breach.²⁷⁴ Entered as an additional section in the SPA, limitation of liability clauses are broken down into several topics, ranging from maximum liability caps, the *de minimis* claims, baskets and its alternative, the ‘tipping’ baskets.²⁷⁵ In the German jurisdiction, the customary limitation of a Seller’s liability is *capped* at 10%-50% of the total purchase price under the SPA for the Target SME.²⁷⁶ This means that the most a Seller in the German jurisdiction will be required to indemnify a Purchaser for any breaches of Reps and Warranties (or other related issues) is capped at 50% of the price it received from the sale of the company. By contrast, in the UK jurisdiction, the Seller’s liability can be as low as 10% but as high as 100% of the total purchase price.²⁷⁷

De minimis clauses, sometimes called ‘floors’ refer to the threshold or absolute minimum amount of damages needed to be incurred by a Purchaser due to a Warranty breach before such damages amount can be taken into account in respect of an indemnity claim from the Seller.²⁷⁸ Put differently, if the damages sum incurred is below the *de minimis* or ‘floor’ amount, it will not be

²⁷² *Ibid.*

²⁷³ *Ibid.* at pp. 184-7.

²⁷⁴ Alexander Schwarz, *supra* note 9; Phil Cheveley, *supra* note 37; Martin O’Donoghue, *supra* note 245.

²⁷⁵ *Ibid.*

²⁷⁶ Alexander Schwarz, *supra* note 9.

²⁷⁷ Martin O’Donoghue, *supra* note 245.

²⁷⁸ Paul Luiki Session 4, *supra* note 184 at pp. 54; Monika Behrens and Jaroslaw Kaminski, ‘M&A Vocabulary – Explained by the experts: Limitation of liability (de minimis, basket, cap)’ (Rödl & Partner, May 2020) <<https://www.roedl.com/insights/ma-dialog/2020-05/ma-vocabulary-limitation-of-liability-de-minimis-basket-cap>> accessed 15 November 2022.

counted towards an indemnity claim.²⁷⁹ It is important to highlight that a damages claim on its own that passes the *de minimis* threshold is insufficient to seek an indemnity claim.²⁸⁰ Instead, Sellers will require (via a SPA limitation of liability clause) that a certain number of *de minimis* damages amounts be added up into a *basket*, before an indemnity claim can be made.²⁸¹

The basket can be a tipping one or a deductible type.²⁸² In a deductible basket scenario, a Seller will only be liable for the aggregate damages *over and above* the basket total.²⁸³ For example, if the deductible basket total is €25,000 and the Purchaser's Warranty breach damages are €40,000, then the Seller is only liable for €15,000. In a tipping basket scenario, once the basket is 'full', the Seller will become liable for its entire sum.²⁸⁴ Using the aforementioned example again, once the tipping basket reached the €25,000 and the Purchaser's Warranty breach damages are €40,000, the Seller will be liable for the full amount of €40,000 (i.e. no deductible). In the German jurisdiction, the common practice is for the *de minimis* amount to be 0.1%-0.2% of the total purchase price, while the basket to be between 1%-2% of the total purchase price.²⁸⁵ These figures are roughly the same when it comes to the UK jurisdiction.²⁸⁶

Other methods of limiting the Seller's liability vis-à-vis Reps and Warranty breaches include: time limitation on when an indemnity claim can be made,²⁸⁷ exclusions of liability where the Purchaser caused it²⁸⁸ and anti-sandbagging clauses, already discussed in the previous chapter of this Thesis.

5.2.2 Deficiencies in Cross-Border M&A Transactions Post Brexit. Britain's decision to leave the EU has had an impact on private M&A transactions involving cross-border mergers

²⁷⁹ Paul Luiki Session 4, *supra* note 184 at pp. 54.

²⁸⁰ Monika Behrens, *supra* note 278.

²⁸¹ *Ibid.*

²⁸² *Ibid.*

²⁸³ *Ibid.*

²⁸⁴ *Ibid.*

²⁸⁵ Alexander Schwarz, *supra* note 9.

²⁸⁶ Martin O'Donoghue, *supra* note 245.

²⁸⁷ Phil Cheveley, *supra* note 37.

²⁸⁸ Alexander Schwarz, *supra* note 9.

between companies from EU Member States and those from the UK.²⁸⁹ In particular, Directive (EU) 2017/1132²⁹⁰ and its UK enactment counterpart, *The Companies (Cross-Border Mergers) Regulations 2007*,²⁹¹ which facilitated cross-border mergers between limited liability companies in the UK and those from European Economic Area (“EEA”) ceased to apply after Brexit took place on 31 January 2020.²⁹² Under the old regime, a cross-border merger between a UK company and another company located in the EU Member State, could be achieved in three ways.²⁹³ These were via absorption (i.e. when one company absorbs another as part of the merger), absorption of a wholly-owned subsidiary (i.e. same as absorption but involving a subsidiary) or through the formation of a new company (i.e. two or more companies that come together to form a new one through their merger).²⁹⁴

Post-Brexit, the only remaining available option is the third one, that is, the formation of a new company, which is done *without* the assistance of either Directive (EU) 2017/1132 or the UK Regulation counterpart.²⁹⁵ Through the formation of a new company in the EU (using existing EU legislation), the transfer of a business (and its assets) located in the UK to the new company formed in the EU, is still a viable option.²⁹⁶ One change that will need to be effected is the transfer of the registered office, which will likely necessitate the dissolution of the Target SME in the UK, before it can be registered in Germany.²⁹⁷ This is because, post-Brexit, UK legislation no longer permits a company to have its registered office transferred outside of the UK.²⁹⁸ Alternatively, the Purchaser can leave the Target SME as is and continue to operate it in the UK. Should it proceed with the first option, in the process of transferring the company from the UK to the EU, the same considerations would have to be taken into account, as previously discussed in this Thesis:

²⁸⁹ Robin Johnson and Ros Kelleway, ‘Navigating Brexit Our EU cross-border reorganizations guide’ (Eversheds Sutherland, February 2020) <<https://www.eversheds-sutherland.com/documents/services/corporate/EU-cross-border%20reorganisations-guide-FEB-2020.pdf>> accessed 16 November 2022;

²⁹⁰ Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law [2017] OJ L169/46.

²⁹¹ (2007 No. 2974).

²⁹² Anthony Turner, ‘Cross-border mergers – Use it or lose it!’ (Farrer & Co LLP, January 2020) <<https://www.farrer.co.uk/globalassets/briefings/cross-border-mergers---use-it-or-lose-it---january-2020.pdf>> accessed 16 November 2022; Robin Johnson, *supra* note 289.

²⁹³ *Ibid.*

²⁹⁴ *Ibid.*

²⁹⁵ Robin Johnson, *supra* note 289.

²⁹⁶ *Ibid.*

²⁹⁷ *Ibid.*

²⁹⁸ *Ibid.*

employees, real estate, licenses, permits and contract transfers, business assets transfers and tax assessment.²⁹⁹ As it has been stated and can be observed, private cross-border M&A transactions “are largely governed by private contractual arrangements; this remains the case.”³⁰⁰ In proceeding with a M&A transaction post-Brexit, decisions need to be made whether to leave some of the business operations/employees in the UK or transfer everything to the EU.³⁰¹ This will have an impact as to whether the Target SME is still be considered as having its principal location in the UK anymore.³⁰²

While *not* attempting to minimize the consequences post-Brexit related to mergers, it must be pointed out that the legislative framework in the EU vis-à-vis M&A transactions, is still not perfect. For instance, in addition to the Merger Regulation (discussed in chapter 1 of this Thesis) and Directive (EU) 2017/1132 (discussed earlier in this chapter), cross-border M&A transactions dealing with EU entities are governed by the Cross-border Mergers Directive,³⁰³ in the case of limited liability companies and by Directive 2009/65/EC,³⁰⁴ in the case of undertakings for collective investment in transferable securities (“UCITS”).³⁰⁵ EU-based partnerships, cooperatives, foundations, limited partnerships or other legal entities have no legal framework specifically for them, to allow for cross-border M&A.³⁰⁶

While such legal entities do meet the criteria under Article 54 of the Treaty on the Functioning of the European Union (“TFEU”),³⁰⁷ such that they have the “*freedom to merge*”, there is no obvious legal framework in the EU for how they can proceed with a M&A

²⁹⁹ *Ibid.*

³⁰⁰ Paul Rajput, ‘BREXIT has happened – what does it mean for company law and M&A transactions?’ (Lewis Silkin, 11 February 2021) <<https://www.lewissilkin.com/en/insights/brexit-has-happened-what-does-it-mean-for-company-law-and-m-and-a-transactions>> accessed 16 November 2022.

³⁰¹ Robin Johnson, *supra* note 289.

³⁰² *Ibid.*

³⁰³ Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies [2005] OJ L310/1.

³⁰⁴ Of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) [2009] OJ L 302/32.

³⁰⁵ Jessica Schmidt, ‘Cross-border mergers and divisions, transfer of seat: Is there a need to legislate Study’ (European Parliament, Directorate-General for Internal Policies, 2 June 2016) <<https://www.europarl.europa.eu/cmsdata/105632/schmidt.pdf>> accessed 16 November 2022.

³⁰⁶ *Ibid.*

³⁰⁷ Consolidated Version of the Treaty on the Functioning of the European Union [2016] OJ C202/164 at Article 54.

transaction.³⁰⁸ This has the net effect of creating legal uncertainty, high risks and associated consequences (i.e. retaining legal counsel to deal with unforeseen situations).³⁰⁹ This serves as a reminder that while the UK was still in the EU, cross-border M&A transactions had some legal framework, post-Brexit, the situation regarding cross-border M&A transactions is not necessarily worse or better, in either the EU or the UK.

5.3 Analysis and Discussion.

Purchaser ONE will need to consider pre-closing covenants requiring that the Seller and the Target SME TWO continue to operate normally the business, do not take any drastic actions, such as firing or hiring new employees, taking loans out, etc. The Seller will want post-closing covenants granting it access to documentation, in the event that a Reps and Warranty breach is claimed. The Seller will want to limit its liability and will likely agree to a 50% liability cap of the SPA purchase price whereas the Purchaser will want the cap to be as high as possible. The Seller will want the *de minimis* claims to be more than 0.2% and the basket to have a deductible, while the Purchaser will want the exact diametric opposite: a very low *de minimis* claim (i.e. 0.1%) and a tipping basket.

The Purchaser will have to decide, after the closing of the M&A transaction, how it wants to proceed. Does it want Target SME TWO to remain and operate in the UK? Would it be better to dismantle the company and transfer the shares of Target SME TWO to a newly formed company in the EU (i.e. Germany)? Such questions will depend, in part on the market demand for the anticipated second-generation product X2 as well as whether there is demand for the sub-component Y in the UK jurisdiction for other uses. Post-Brexit, Purchaser ONE will no longer have the ‘single market’ it enjoyed pre-Brexit, meaning that it will look at paying higher taxes and other associated fees with transferring/operating Target SME TWO’s business and/or assets from one jurisdiction to another. These issues must be kept in mind, as Purchaser ONE takes the proverbial reign of Target SME TWO.

³⁰⁸ Jessica Schmidt, ‘Cross-border Mergers, Divisions and Conversions: Accomplishments and Deficits of the Company Law Package’ (2019) 16 ECFR 222 at pp. 223-4.

³⁰⁹ *Ibid.* at pp. 224.

5.4 Conclusion.

The final chapter of this Thesis looked at factors to consider as the M&A transaction came to an end. It considered covenants, which were described as promises of an enforceable nature requiring the Parties to take an action. In the case of a positive covenant, a positive action or abstain from taking an action, if the covenant is negative or restrictive. Covenants could be for pre-closing or post-closing of the M&A transaction and dealt with a myriad of issues such as non-compete, non-solicit, right to access documents, allocation of taxes, and so forth. In the UK, restrictive covenants should be given even more importance as UK courts would not enforce them, if they were found to be unreasonable. In order for a post-closing restrictive covenant to have been found to be reasonable, a determination would need to be made regarding its purpose, time duration, bargaining power of the Parties and the public impact. In the German jurisdiction, the Parties needed to take into account the employees' pension rights and give them notice vis-à-vis the impending M&A transaction *before* the transaction was closed. Under the pertinent German laws, employees had the right to refuse going to work for the newly merged company. Similar issues related to employees existed in the UK. The Parties needed to decide and include the covenant clauses related to who will provide notice of the merger, who will continue to contribute to the employees' pensions and so forth.

The Parties needed to also focus on limitations on liability, especially for issues arising post-closing. In addition to the anti-sandbagging clause (described in the previous chapter), liability for the transaction could be limited by making use of liability caps, *de minimis* claims and baskets. Liability caps were described as clauses that limited the Seller's exposure for general indemnity in the event of a Reps and Warranties breach. The exposure could have been as low as 10% to as high as 50% in the German market, to even 100% in the UK market, of the purchase price value of the SPA. *De minimis* claims meant that before a Purchaser could seek damages, the claim must have had a certain monetary figure, which could be between 0.1% to 0.2% of the SPA purchase price. Once accrued *de minimis* claims reached a certain threshold, they would be considered a 'basket.' The basket sum could be claimed against the Seller's general indemnity for the various breaches of Reps and Warranties. If the Parties agreed the basket to be of a deductible type, then the Seller would be exposed for costs that were *above* the sum of the basket. In a tipping

basket scenario, the Seller was exposed to the entire sum of the basket and not just the sum *above* the basket.

After the UK exited the EU, colloquially known as ‘Brexit,’ a number of legislative provisions stopped being applicable with regards to M&A transactions. Directive (EU) 2017/1132 and the UK enactment, *The Companies (Cross-Border Mergers) Regulations 2007* would no longer apply. M&A transactions of the absorption, absorption of a wholly-owned subsidiary or the formation of a new company, would no longer be possible using the old legislative provisions. Having said that, post-Brexit, it was still possible to proceed with a M&A transaction involving a UK company, through the formation of a new company in the EU, which would then take over the business assets of the aforementioned UK company without the need of the old regime’s legislative framework. This was because private cross-border M&A transactions continued to be governed by contracts law, a fact that continued to remain true. It was shown that even in the EU, the legislative framework for M&A transactions was not complete, as other legal entities such as partnerships or limited partnerships, had no explicit legal provisions allowing them to engage in cross-border M&A transactions. The Parties, and specifically, Purchaser ONE, had to have taken all these issues in consideration before deciding whether to wind down the company in the UK or allow it to continue operating.

Final Comments.

Completing a private M&A transaction of a SME in a cross-border setting that encompassed both civil and common law jurisdictions, required skill, knowledge and understanding of the legal system in both jurisdictions, in order to bring the transaction to its conclusion. The mock situation considered in this Thesis involved a German SME, named ONE, doing an outbound cross-border private M&A transaction of another SME in the UK jurisdiction, called TWO. Before doing such cross-border M&A transaction, it was important for the Purchaser ONE to consider all pertinent legislative provisions of the UK, which could have prevented the closing of the transaction. For instance, in the UK, under the *NSI Act*, the Parties required permission for the transaction to proceed from the UK government, especially one involved in specific industries such as artificial intelligence and energy. The Parties should also have been

prepared to understand the consequences of the UK leaving the EU (i.e. Brexit). Particular EU legislation such as Directive (EU) 2017/1132 and the UK enactment, *The Companies (Cross-Border Mergers) Regulation 2007* were no longer available, to be used as the legislative framework for the cross-border M&A transaction. While the cross-border M&A transaction would still be possible to proceed, it would require a newly formed company in the EU and then having to transfer the business and assets of the UK company, to it.

The three ways in which the Target SME could have been purchased included proceeding via a SPA, an assets sale or by auction. The most common method of proceeding was via a SPA, because once the Purchaser was in possession of the Target SME's privately-held shares, it controlled the company. In order to start the process, the Purchaser would have sent the Seller a LOI, which was defined as an agreement to agree whereby it declared the price it was prepared to pay for the Target SME. After some back-and-forth negotiations, the Parties would have agreed to the terms of the LOI, which terms included both binding and non-binding terms. Binding terms included stipulations such as requiring a deposit or allowing for DD process to be completed. To prevent the disclosure of the sensitive information to unauthorized third parties, it was common for the Seller to require the execution of a CA/NDA, as part of the LOI agreement. LOIs signaled that the Parties intended to use good faith to complete the cross-border M&A transaction, tallied all the negotiations points and established the procedural rules needed to complete the sale. While under German law a LOI was not considered a legally binding contract, in the common law jurisdictions such as the UK and US, LOI could and have been considered binding, such as in the 1985 infamous US *Pennzoil* case.

Once the LOI and the CA have been executed, it was time for the Purchaser to commence its DD process. The Purchaser may have wanted to begin with a red flag legal DD, to cursorily determine whether the Target SME had any serious financial or legal risks (to name a few) that would have ended the possibility of concluding the transaction. Provided no such red flags existed, then the Purchaser would have invested in a more in-depth DD process that closely looked at the various topics related to the Target SME, such as its commercial, human resources, intellectual property and taxation status, to name a few. The Purchaser would have conducted the DD process through physical, virtual and electronic means of data rooms. The Parties would also have

negotiated any pertinent CP clauses, requiring the Parties to take certain future steps towards the completion of the M&A transaction. Such CP clauses included obtaining the obligatory regulatory/governmental, commercial and any other necessary approvals.

Provided no issues were discovered in the DD process, the Parties' next step was to agree upon the Reps and Warranties. Since the mock transaction in the Thesis took place in the UK jurisdiction, typically Warranties were given by the Sellers and not both Reps and Warranties. Through Warranties, the Seller warranted that existing facts vis-à-vis the Target SME would continue to remain true after the closing of the transaction. If the Purchaser was not aware of any issues with the Target SME and the Seller agreed to the Warranties, should those Warranties turn out to be false, the Seller would have had to indemnify on a general basis the Purchaser for the Warranties breaches. If the Seller agreed in part to the Warranties and gave further Disclosure on specific issues related to the Target SME, then the Purchaser would have had to seek out Specific Indemnity, because Warranties breaches for issues known to the Purchaser were not covered.

Once the Parties agreed to all requisite Reps and Warranties, purchase price for the Target SME, all general and specific Indemnity provisions, they would have agreed to the most part of the SPA with a closing date, in the future. While simultaneously ensuring that the CP clauses were adhered to, the Parties would have also agreed upon covenants and limitation of liability, as part of the SPA, agreed to before the signing of the SPA document. Covenants could have required the Parties to take some actions (positive covenants) or refrain from doing something (negative or restrictive covenants) either before the completion of the transaction or afterwards. Examples of post-closing covenants included non-compete, non-solicitation and access rights to documentation. In the UK jurisdiction, it was important that any restrictive post-closing covenants were reasonable, otherwise they were not enforced by British courts. The Seller would have tried to limit its liability for selling the Target SME in the event of Warranties breaches so that it limited the indemnity amount required to provide to the Purchaser. This was done through limiting the Seller's liability cap to between 10% up to 100% of the Target SME purchase price (in the UK jurisdiction), using a threshold for damages before a claim was counted, which was something called *de minimis* claims, and making the use of baskets (either tipping or with a deductible) which

required a certain number of *de minimis* claims to exist, before the Purchaser could have sought indemnification from the Seller.

There were a number of EU legislative provisions that were not available to the UK anymore, after Brexit. Nevertheless, a cross-border M&A transaction involving privately-held SME still could still occur. This meant that overall, much consideration, research and attentiveness had to be given to ensure a smooth transaction. Especially bearing in mind the state of cross-border M&A transactions in the EU alone still required work. For example, certain legal entities such as partnerships, still did not have any of their own legislative framework to allow for their completion. The important aspect that had to be taken from this Thesis was that the subject of private cross-border M&A transactions involving SMEs in different jurisdictions was a broad one, covering many areas and issues. The purpose of this Thesis was to acquaint the reader with the main important elements of such transactions while acknowledging that other matters did exist that were specific to each individual transaction. As such it was of great significance that any lawyer working on behalf of the Seller or the Purchaser to have done his due diligence to ensure he has covered all pertinent aspects of the private cross-border M&A transaction of the SMEs, especially since these entities were located in different jurisdictions which had different legal systems, of their own.

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