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M&A TRANSACTIONS IN THE SME SECTOR

INSURMOUNTABLE HURDLE OR MANAGEABLE CHALLENGE?

If you look into the relevant (trade) journals, M&A transactions are mainly reported in connection with mergers and acquisitions (M&A) by or between large companies.

Transactions of small or medium-sized enterprises (SMEs), however, hardly receive any public attention.

Nevertheless, they do take place and even form the majority. If you look at the figures, it becomes clear why: 99 percent of the companies based in Germany are small or medium-sized enterprises. They generate more than half of the value added, they provide almost 60 percent of all jobs and around 82 percent of all apprenticeships. Politicians also like to use these facts for promotional purposes. Who is not familiar with the frequently used slogan: "SMEs are the success factor of the German economy"?

TIGGES
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M&A has arrived in the everyday life of SMEs

Small and medium-sized enterprises are confronted with the same challenges as the large companies mentioned at the beginning. They have to ensure a solid equity base, steady growth and the maintenance of international competitiveness, to name just a few of the factors. In addition, there is strong pressure to digitalise. Small and medium-sized enterprises can (or sometimes are forced to) meet the increasing challenges through M&A measures.

In addition, these companies are often still owner/family-run and the company owners often face a lack of succession plans. For the strategic measures in the form of company transactions that are necessary in many cases, there is - unlike in large companies - there is usually no procedural and organisational infrastructure or internal roles defined. In addition, time and financial resources are limited.

However, at the same time the topic of M&A is becoming more and more a part of everyday life for SMEs due to the aforementioned reasons.

If you take all this together, an M&A transaction often means a major challenge for small and medium-sized enterprises, which is often almost impossible to master with the available resources. There is no such thing as a "typical" M&A transaction.

The personal and entrepreneurial (life) situations are too complex for that. Nevertheless, at the beginning of such a process there should always be careful planning and preparation. This includes the involvement of external (specialist) advisors, which ensures a structured approach and implementation and helps to optimise the success of the project, if not even make it possible in the first place.

It is advisable to draw up a checklist in cooperation with the shareholders, managing directors, specialist employees and external (specialist) consultants and to divide the process of an M&A transaction into the following phases:

- Preparation and contract initiation
- Due diligence
- Signing
- Closing
- Integration an post-closing measures

Although these measures are initially more complex, they help to reduce the complexity of the overall process and make procedures more manageable.

Due Diligence – What is it? What do I need it for? What do I need to pay attention to?

Structured and comprehensive preparation and planning of a transaction process is also essential for small and medium-sized enterprises ("SMEs") (see also the opening article of this series here). Once those responsible have made the strategic decision to sell or acquire the company or a specific part of it, i.e. once they have gone through the
(i) planning and preparation phase,
(ii) formed the team of advisors to be involved,
(iii) developed a transaction concept,
(iv) defined the responsibilities and
(v) established contact with interested parties, the next step is to master the upcoming due diligence phase.

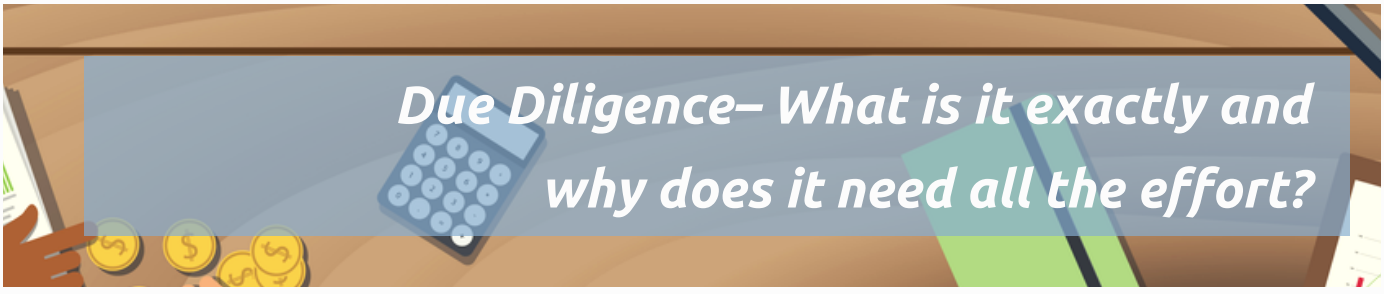
The term "due diligence" comes (how could it be otherwise?!) from Anglo-American law and means something like "due care". This is exactly what must be done when examining a company as a potential object of purchase.

Or, in the words of an experienced colleague: "You wouldn't think of buying a used car without at least checking whether it has four wheels, a steering wheel and an engine!"

In the course of due diligence, the company or parts of a company to be acquired or sold are examined by the prospective buyer(s) with regard to the essential factors. As a rule, it is recommended that at least the triad of tax, financial and legal due diligence be followed and that an examination is carried out in these areas. However, this is not mandatory and always depends on the individual case. The same applies with regard to the scope and the level of detail of the due diligence. This ranges from a so-called "full scope" due diligence to a "red flag" due diligence limited to essential areas.

The legal framework of the due diligence as well as its significance for the seller and the buyer is closely linked to the pre-contractual and purchase-contractual obligations. Therefore an overall view of the different phases of the transaction process is required.

Not least because the risks identified in the course of the due diligence review do have an impact on the subsequent phase of contract drafting and negotiation or, in the worst case, can even lead to the termination of the transaction.



Due Diligence – What is it? What do I need it for? What do I need to pay attention to?

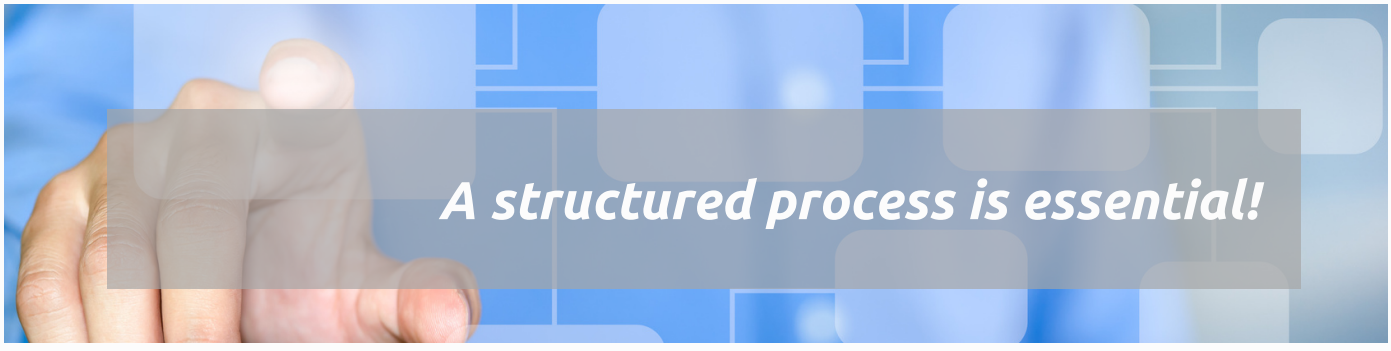
Leaving aside the worst-case scenario, the results of the due diligence serve to better classify risks and to regulate specific issues in the subsequent phase of contract preparation and negotiation, in particular:

- the breach of pre-contractual (information) duties and the related question of the definition of malice/intent on the part of the seller;
- the elaboration of the guarantees/exemptions agreed in the purchase contract;
- the elaboration and negotiation of the purchase price;
- the classification and definition of the parties' standard of liability/duties of care.

Due diligence is of central importance in the transaction process. In addition to the correct fiscal and legal structuring of the transaction, the valuation of the company in order to determine the purchase price and the correct drafting of the share purchase and transfer agreement (SPA), a professionally conducted due diligence is the fourth pillar of a successful transaction.

The following (rough) steps can be taken as an initial guide:

- Definition and coordination of the scope and areas of the upcoming due diligence, e.g. by means of a checklist;
- Setting up a project team consisting of contacts on the side of the companies involved in the transaction as well as corresponding (specialists) advisors and defining responsibilities during the due diligence process;
- Preparation of the documents to be made available as well as the (mostly virtual) data room for the due diligence;
- Planning and structuring of the Q&A process during due diligence. Scheduling of personnel resources of the aforementioned project teams to answer queries from interested parties within the framework of the Q&A process.



All that effort even for SMEs?!

Against the background of the reduction of risks described above as well as the increase of chances for a successful conclusion of the transaction (keyword: professional and structured handling of the transaction process vis-à-vis the interested parties), the performance of a due diligence should not be dispensed with – even in the case of company transactions involving SMEs.

The extent to which the aforementioned due diligence is then carried out depends on various factors, in particular the size of the company to be sold as well as the quality and content of any information provided in the preliminary talks and otherwise.

The concerns of many small and medium-sized entrepreneurs that their companies will be screened by "strangers", sometimes even direct competitors, are taken into account by setting up the due diligence process accordingly and by addressing the issues of "confidentiality" and "data protection and competition protection" during the planning.

If a medium-sized entrepreneur carries out a transaction without due diligence, contrary to all previous recommendations, this is not forbidden. However, in this case he must be aware that the buyer will secure himself to a much greater extent by means of corresponding guarantees (in particular "hard" balance sheet and equity guarantees as well as guarantees regarding a future cash flow) as well as extensive exemptions (e.g. taxes).

Whether this price justifies the supposedly saved effort due to the omitted due diligence? - In the vast majority of cases, probably not!

(Author: Christian Schon)

Data protection Due Diligence

A clean data protection structure has become a relevant value for buyers of companies with regard to the valuation of the company to be sold in the run-up to an M&A transaction. At the latest since the introduction of the DSGVO, no company can avoid the topic of data protection and the resulting requirements. Deficits in this area quickly lead to a legal risk for the buyer, who, in order to avoid the sword of Damocles of official fines (up to 4% of the previous year's turnover!), may have to invest considerable resources in order to remedy the weaknesses in the target company's data protection organisation.

Therefore, it is essential for a company buyer to identify and, if necessary, reduce the risks already in the course of the due diligence.

If data protection deficits are ignored, there is a risk that the buyer will be held responsible after the transaction.

This brief introduction provides an overview to raise awareness of the importance of data protection due diligence. In this respect, it should be noted that this does not deal with personal data processed in the course of the corporate transaction itself, e.g. the collection and processing of personal data for the buyer and the preparation of documents in the data room including the necessary contracts with the data room operator. The focus is on the due diligence of the data protection risks in relation to the target company and the question of which structural approach the buyer can use to identify and thus reduce these risks.

It is decisive to ask the right questions in the due diligence process in order to determine how the status quo and the level of data protection are to be assessed in the various areas of data protection law. For this purpose, the existing documentation should first be examined.

Data protection and due diligence belong together

- **Data protection and deletion concept** - In particular, the deletion of data (e.g. no CRM with "old data") must be implemented cleanly; the data protection concept is the starting point and, to a certain extent, the heart of how the topic of data protection is handled and organised in the company. Of course, the processes defined in the concept must actually be implemented, which in turn is part of the audit.

- **Processing directory (Art. 20 DSGVO)** - A frequent source of errors, as a directory does not exist or is incomplete, with the consequence that the company is not aware of all processing operations relevant under data protection law**.**

- **Data breach concept** - This is about the handling of data protection incidents and the documentation of any data protection incidents from the past; ultimately, the audit must also ensure that the company has appropriate processes and TOM in place so that data losses can be detected and to enable the company to react appropriately.

- **Documentation on IT and cyber security** - e.g. whether a data security concept (technical and organisational measures) is in place, including ISO certifications if applicable.

- **“Auftragsverarbeitungsverträge” (Art. 28 DSGVO)** - Almost every company uses IT service providers who process personal data on their behalf. Here it is important to check whether corresponding agreements exist with which the service providers guarantee compliance with certain minimum standards and thus safeguard the client.

- **Documents relevant to data protection law in connection with HR** - This is also a very sensitive area, ranging from dealing with applicants and the practice of on-boarding new employees to the contractual regulations with them. When it comes to employee data protection, it is always important to ensure that the reference requirements resulting from Article 13 of the DSGVO are fulfilled and that all processes are “clean” (Do data protection notices for the processing of employee data exist? Is there a concept for handling special personal data according to Art. 9 DSGVO? Do the employees have declarations of confidentiality? Consent regarding Images in place, e.g. for publication of photos on website)?

- **Website check** - In particular, check whether the data protection declaration was issued in compliance with the law and actually covers all processings in connection with the visit to the site; check for cookie banner/cookie policy.

A data protection review of the target company is indispensable for the purchaser in order to avoid incalculable risks which usually only materialise to its disadvantage after closing, e.g. if products and solutions of the target company are integrated which cannot be marketed under the application of the DSGVO or only after modification.

(Author: Sebastian Keilholz, LL.M.)

IP Due Diligence

Due diligence is still mainly associated with the examination of tangible assets, business relationships or the number of employees of the company to be sold. With globalisation and digitalisation, this focus has shifted when determining the value of the company: today, IP rights in particular determine the purchase price of the company to be acquired and often influence the purchase decision.

This is particularly true when foreign buyers set their sights on German companies. Especially of interest are the patents and know-how to develop or take over innovative technologies or also brands that (still) stand for "Made in Germany". The technology and healthcare sectors are particularly interesting for foreign investors, i.e. the areas that have once again come into sharper focus as a result of COVID-19; this applies especially to software products and IT systems. According to a PWC study from 2020, private equity investors are most frequently involved in small and medium-sized transactions.

It is a matter of taking stock of and making a well-founded analysis of all property rights - these are patents, utility models, trademarks, designs, any licences granted on them, but also the copyrights which, at least in Germany, cannot be registered, in this regard any rights to a company's know-how.

As temporary monopoly rights, the aforementioned IP rights convey absolute exploitation rights to the company - absolute because a monopoly right reserves to its holder the right to exploit the protected IP right and the underlying innovation alone and to the exclusion of third parties. This also highlights the importance of such intangible legal assets when assessing the value of a company in the context of an acquisition.

IP Due Diligenceis used to determine

- whether and to what extent the company to be acquired owns property rights,
- whether licences have been granted to it or whether it is dependent on licences,
- whether legal disputes exists, and,
- the extent to which know-how is embedded in the company and what measures are in place to protect the know-how.

The devil is in the details...

IP Due Diligence

Obviously, in the case of a young company or start-up, the focus will be on determining the know-how, since there may not yet be any patented technology, or perhaps none that is ready for patenting. If it is an established company that already has technologies and brands introduced to the market and, in parallel, an IP portfolio that is at least partially registered, a search in the respective IP databases can provide a quick and reliable overview.

A high-tech or biotech company or a provider of complex technical solutions requires a more intensive IP due diligence than a company that is mainly interesting for the buyer because of its distribution channels.

By checking the data in the registers of the competent authorities, the registered owner, the status of the IP right (is the patent or trademark still valid or has the term of protection expired?), the term and the scope of protection of the respective IP right can be determined quite quickly. However, register entries do not always reflect the actual legal situation. It is not uncommon for IP rights to be registered not in the name of the target company, but - for tax reasons - in the name of an "IP holding company" within a group of companies or in the name of a third party close to the company, e.g. the original founder of the company or a shareholder.

In addition, the register does not show whether the IP rights are covered by licences.However, this is relevant for the availability and value of the IP right, which is why it is imperative to have a look at the licence agreements. If the acquirer takes over the target company and enters into existing licence agreements as licensor, he will usually be interested in a quick termination of the agreement, whereas on the licensee side he will obviously be more interested in a continuation of the licence agreement.

The situation with regard to non-registered property rights, such as copyrighted works, in particular software rights and know-how, is even less clear. These rights are often the most important asset of the target and information about them can only be obtained by presenting agreements with third parties, such as R&D, cooperation and IT/software development contracts. Complete and accurate documentation is crucial here. This also applies to employee inventions, encumbrances on IP rights in the form of liens or delimitation agreements as well as any pending or concluded legal disputes in connection with the IP rights

Potential buyers or investors would therefore do well to focus not only on the tangible assets when examining the "target", but also on the industrial property rights.

(Author: Micaela Schork, LL.M.)

Der Teufel steckt im Detail...

Contract negotiation and signing

Once the due diligence process has been completed by the potential buyer (or his advisor), the actual contract negotiations begin, culminating (at best) in the conclusion of the contract.

In this phase, the focus is in particular on the draft share purchase and transfer agreement (SPA) and, if necessary, on supplementary draft agreements (e.g. consultancy agreement, lease agreement, service agreement). As already mentioned, the results of the due diligence serve to better classify risks and to regulate specific issues in the context of contract drafting and negotiation.

The focus of contract drafting and negotiation is usually on the concrete formulation of the purchase price, the cataloque of reps and warranties, the classification and definition of the standard of liability / duties of care of the parties as well as regulations on the dissolution of legal relationships between the seller and the target company (e.g. repayment of shareholder loans, rental agreements, etc.).

However, questions of execution are also specified in this phase of the transaction: for example, whether the acquisition is to be made directly by the acquirer or indirectly via a company yet to be founded (NewCo) as an acquisition vehicle. The way in which the shares are to be transferred also plays a decisive role.

The transfer of a limited liability company (GmbH) share and thus also the corresponding SPA require notarial form. Furthermore, any existing consent requirements must be clarified. Common consent requirements here are those from the articles of association of the target companies (vin-culations, consent of spouses, etc.).

Even if there is no "right" or "wrong" way to structure the SPA, a common structure has become established in practice:

- Regulation of the essential terms of the contract: Parties, subject matter of the contract, purchase price and payment terms, effective date, rescission and termination; entitlement to the profit of the current business year.
- Closing: Generally at a later date than signing; buyer obtains economic power of disposal over the target company.
- Liability: Various assurances / guarantees by the sellers regarding the shares and the company
- Non-competition clause
- Taxes: Delimitation of liability is generally based on the effective date principle (before the effective date = seller; after the effective date = buyer).
- Costs: Cost regulations with regard to the conclusion and execution of the contract as well as with regard to the external advisors involved.

Various arrangements regarding the purchase price are possible!!

The purchase price arrangements are varied and range from a fixed purchase price to a variable arrangement including an earn-out. Which one makes sense depends on the specific individual case and should be coordinated in particular with advisors from the finance and tax departments. From a legal point of view, it is advisable to provide collateral in this context in order to ensure that (i) the shares are actually received with payment of the purchase price or (ii) any guarantee claims are secured, e.g. by retaining part of the purchase price.

With regard to liability, statutory liability and warranty are usually excluded under the SPA and replaced by a separate warranty and liability regime. The background to this is that it is often difficult to prove when incorrect closing information leads to warranty claims as a material defect in an individual case. In addition, the seller could often exculpate himself from the accusation of fault.

Against this background, independent guarantees are usually agreed. The issuance of such guarantees ensures that the seller is liable for missing or incorrect information regardless of fault. These guarantees can cover all the areas of questioning or areas of the company that were made the subject of the due diligence (if carried out).

This means both the legal circumstances of the company as well as the economic circumstances, such as, for example,

- the company's financial situation.
- accuracy and completeness of the company information
- legal guarantees regarding ownership and right to dispose of the shares
- accuracy and completeness of the financial statements (balance sheet guarantee)
- existence of a certain amount of equity (equity guarantee)
- secured existence of the protection rights
- existence of all permits required for the business operations of the company
- contract portfolio (e.g. rental and employment contracts including any claims from employee participation models)
- employees

Contract negotiation and signing

The legal consequences of a breach of a guarantee are also regulated differently and to the exclusion of the statutory provisions. In principle, liability is limited to compensation for damages. The amount of the warranty claims can be limited (cap or agreement on a de minimis limit). In the same way, regulations on the statute of limitations that deviate from the law are often agreed.

The same applies to taxes. Here, it is advisable to provide for comprehensive tax guarantees and a tax exemption clause in the SPA in order to protect against any risks in this area.

Here, the accrual and deferral is generally based on the effecive date principle. This means that the seller is responsible for all tax matters (commenced and completed) and the associated tax risks before the effective date. All tax risks after the effective date are the responsibility of the buyer.

In summary, it is evident here as well that comprehensive planning and a structured process are essential. This requires some effort, but it is worth it anyway. Especially if it contributes to the successful completion of the planned transaction.

(Author: Christian Schon)

Closing & integration

Once the SPA has been notarized and the previous phases of the process have been successfully completed, a significant part of the transaction process has been completed, but the overall process is not yet finished. After the signing of the purchase agreement, the "closing" and the "integration" of the target company into the existing structures of the acquirer now begin.

In many transactions, the signing and closing deviate. Such a divergence is usually not desirable from the seller's point of view, because the occurrence of the execution conditions usually falls within the risk sphere of the acquirer and can therefore be influenced by him.

Typical closing conditions:

- antitrust clearance
- Restructuring measures to make the target company "saleable"
- Waiver of pre-emptive rights and declarations on any statutory co-sale rights and obligations
- Issuance of consents under company law and advance approvals by corporate bodies
- Issuance of attestations to the annual financial statements of the target company
- Conclusion of certain contracts
- Approval of banks, funding bodies, guarantee associations, etc.
- Registration of liability limitations according to Sec. 176 para. 2 HGB or Sec 25 para. 2 HGB in the commercial register or entry of the purchaser in the list of shareholders (Sec. 16 para. 1, 40 GmbHG).

The more complex the contractual structure is and the more extensive the conditions and approval requirements for an effective transfer of shares and execution of the SPA are, the more advisable is the separation between signing and closing mentioned at the beginning. In this case, the closing conditions (i.e. what must happen for the closing to take place) and the closing actions (i.e. what actions must be taken during the closing itself) should be defined as precisely as possible in the SPA. Common areas of regulation in the context of closing actions:

- Conclusion of necessary contracts (e.g. lease agreement for business property, service agreements, license agreements, etc.)
- Fulfillment of conditions (e.g. proof of financing; approval of committees, etc.)
- Determination of balance sheets or interim financial statements
- Dismissal/appointment of managing directors
- Proof of payment of purchase price

For documentation purposes, a closing protocol is then usually drawn up and signed by the contracting parties. Upon successful completion of the closing, the transaction is completed, i.e. ownership of the shares in the target company is transferred to the acquirer. Or, in short, the acquirer becomes the legal owner from this point in time

The merging and integration of previously independent companies into a functioning entity leads to the actual completion of the transaction process. In order for this to succeed satisfactorily, special attention must be paid to structured planning and implementation.

At the beginning, there is the development and constant review of the integration strategy, taking into account the knowledge previously gained during the transaction process. This includes, among other things:

- Determining the ideal takeover and integration structure (e.g. conversion, asset deal, share deal).

- The adaptation of structures at the acquirer (national and international mergers and other conversion measures).

- Dealing with (tax) legal issues, such as existing control and profit transfer agreements.

- The consolidation of compliance organizations and IT infrastructure standardization of the corporate governance structure (e.g. with regard to group-wide uniform approval requirements or the implementation of management structures of the acquiring organization).

- The consolidation of compliance organizations and IT infrastructure.

The next step is to implement the previously developed integration strategy as quickly and efficiently as possible in order to restore normal business operations as quickly as possible. The challenge here is to integrate upcoming integration tasks into the business processes during ongoing day-to-day operations.

As mentioned above, structured planning and implementation are essential to ensure that the acquisition and integration of the target company is a success and that the people involved in the implementation are not unduly burdened, so that they can then devote themselves to new tasks and projects with renewed motivation.

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