Mergers and Acquisitions: Share Deal vs. Asset Deal – Risks and Impediments

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1 Acquisitions

1.1 Share Deal

A share deal contains the purchase of all company shares or the purchase of a certain rate of shares which empowers the buyer to exercise control over the company. Thereby all rights and obligations and with that, all assets and liabilities were transmitted to the buyer.[1] Based on that fact, the corporate investment represents the legal object of purchase and meets the criteria of a legal purchase in accordance with § 433 (1) sentence 2 BGB (Bürgerliches Gesetz-Buch, German Civil Law Code)[2] read in conjunction with article § 453 (1) BGB.[3] The advantage of such an acquisition is that the assets don't have to be transferred one by one, but rather in one transaction.

In case of buying just a rate of shares without the ability of exercising control, the transaction fulfils the definition of an acquisition of assets. The term share embodies all kind of shares of legal entities, despite their legal structure and contains especially shares of limited partnerships, joint-stock companies, limited companies or corporations.[4]

The following figure shows the general idea of an acquisition on a share deal basis.

1 See Engelhardt, 2017, p. 5
2 See Jansen, 2016, p. 291
3 See Picot, 2012, p. 301
4 See Picot, 2012, p. 301

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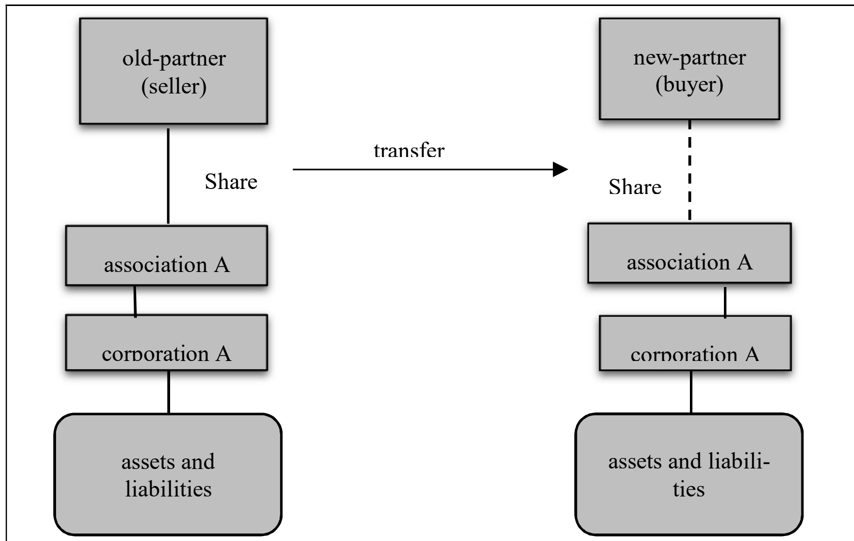

Figure 1: Share Deal, own representation based on Engelhardt, 2017, p. 6

1.2 Asset Deal

As in chapter 1 explained a share deal contains the purchase of all company shares or the purchase of a certain rate of shares which empowers the buyer to exercise control over the company. An asset deal recognises the purchase of all[5], or individual assets, held by an individual or company and not the purchase of company shares in any case. In some cases, it is possible to obtain also liabilities or portions of liabilities, when discussed with the creditors in advance.[6] Each asset and liability is transferred accordingly to the singular succession from the seller to the buyer. Hence it meets the criteria for being a purchase in accordance with § 433 (1) sentence 1 BGB.[7]

The following figure shows the general idea of an acquisition on a asset deal basis.

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5 See Picot, 2012, p. 301
6 See Engelhardt, 2017, p. 6
7 See Jansen, 2016, p. 291

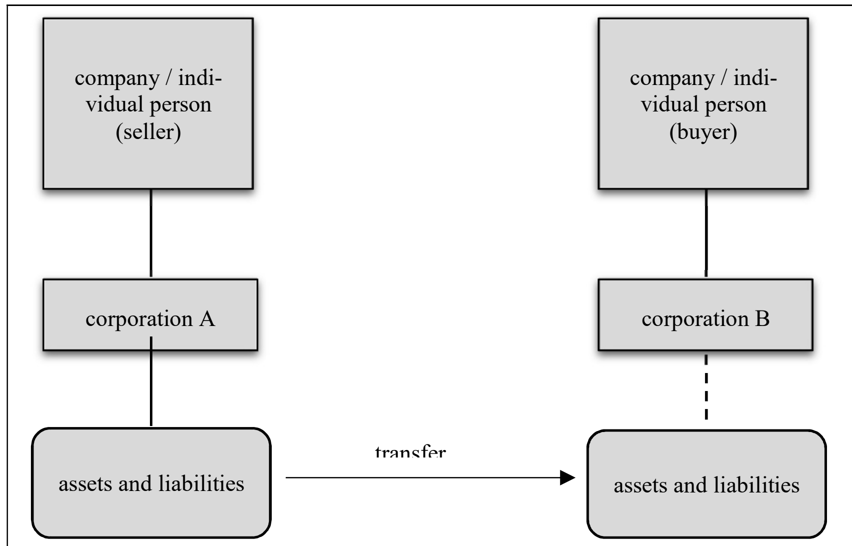

Figure 2: Asset Deal, own representation based on Engelhardt, 2017, p. 7

2 Contractual Item

2.1 Share Deal

As in the previous sequence described a share deal generally contains the purchase of shares and not individual assets. For that reason, it is mandatory that the purchase object complies to the transactional structure and the contractual item must be defined precisely.[8] As in figure 2 already mentioned, the buyer obtains a direct participation in the assets of the company or rather the legal entity. Hence the identity of a company stays untouched, legal entities are legal persons, partnerships or even individual companies. However, the important part is that the company assets are strictly separated from the private assets of the company member if the companies legal form is a corporation or partnership. Based on that fact, the share deal meets the criteria of a legal purchase in accordance with § 453 BGB. So, the seller of the ownership rights is not only liable for the legal validity of the sold rights, but also for their economic value, considering specific risk,[9] as the purchase of rights got extended by the provisions for the purchase of goods which shall apply accordingly. Therefore, the seller is obliged to transfer the

[8] See Engelhardt, 2017, p. 30
[9] See Brauweiler, 2018

rights free of material defects and defects of title to the buyer, pursuant to §§ 434, 435 BGB.[10]

Unlike with the asset deal, there is no need of transaction works for every single company asset as it is just a change in the owner. It is for this reason that all concluded contracts with third parties do not need to be transferred as the company remains as the contractual partner. This is also the case for all changes due to the changes of undertaking as pursuant in § 613a BGB.

As it is not unusual for companies to have contracts with licensors, banks, subcontractors and suppliers, they may have some change of control clauses in which these third parties are terminating the contract in case of an owner change. To avoid this, a proviso clause regarding the transfer of shares (closing-conditions) should be implemented within the sale purchase agreement.[11]

It is also necessary to take account of the fact that the company purchase may cause an impact on the purchased group company's demands for deliveries and services of energy and raw materials from other group entities. Therefore, it is important to implement delivery contracts (term-sheets) with the concerned group entities through the transition period to ensure proper supply within the present framework.[12]

2.2 Asset Deal

The acquisition of a company within an asset deal can be even more than just buying all assets a company offers in its books. Furthermore, it can contain a total of goods, knowledge, customer relations and legal or tangible rights. It is generally a legal purchase in accordance with §§ 433 et seq. BGB. In addition, the buyer has a claim for performance as pursuant in § 433 (1) BGB in which the seller on the one hand transfers the ownership to the buyer and on the other hand does it free of material defects and defects of title. Regarding § 23 HGB, a company cannot be sold without its trade transaction for which it has been constituted.

Notwithstanding from selling goods, if the purchasable objects are intellectual property rights, patent rights or copyright treaties the company purchase meets the criteria of being a purchase of rights in accordance to § 453 BGB, the buyer must ensure that the enterprise / shareholder value equals the total of wanted tangible and intangible assets. Furthermore, the seller is obliged to

- transfer all related company know-how to the seller within a competition agreement,

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[10] See Picot, 2012, p. 303 f.
[11] See Picot, 2012, p. 304
[12] See Picot, 2012, p. 303 f.

- give the acquirer any instruction and information about the company's fields of activity.

Same as with the share deal, the asset deal requires an individual transfer of all third-party contracts (suppliers, customers, lessors or leasing companies). If the acquirer wishes to release himself from the obligation, a tripartite agreement with all contractual partners is inevitable. This can be even more critical in cases of continuing obligations as a third-party member denies the transfer of the contract to the transferee. In such a case, it is only possible to solve that issue via internal relationship between the contractual partners.[13] In some cases it can be hard to identify all transferrable assets, due to missing machines or parts, or incomplete lists of transferrable assets. Due to this fact catch-all-clauses were implemented within the sale purchase agreement.[14]

However, defining the object of purchase has a direct effect on the transfer of employment relationships. Since the purchaser buys the company and gains the total ownership, he also acquires the rights and obligations within the employment relationships in accordance to § 613a BGB.

Aggravating this situation, the company cannot be part of the transfer process regarding the company purchase, but rather the company's items and rights in the sense of the singular succession according to general civil law. So, within the principle of legal certainty it is precisely defined which individual parts of the company are being transferred within the property transaction process. There is a considerable difference between acquiring a manufacturing or a service company, as various levels of know-how, staff, machinery, customer lists are involved and are forming the basis for the supply of goods or services.[15]

3 Due Diligence

In everyday life, it happens that customers are buying goods from manufacturers "as seen" and under a systematic asymmetry of information. Germany tried to solve the problem by using special warranty clauses implemented in their selling contracts until the 1990s, in which the Anglo-Saxon concept of the due diligence has prevailed.[16]

As every acquisition comes with risk, whether a reliable evaluation is possible or not, it is always reasonable to execute a due diligence, due to getting a true and fair view of the financial position, financial performance and cash flow in ad-

[13] See Picot, 2012, p. 302
[14] See Engelhardt, 2017, p. 30
[15] See Picot, 2012, p. 303
[16] See Jansen, 2016, p. 314

vance. It is advisable to execute this activity in an early stage of the negotiation process and right before making an official offer. Although there is a distinction between the Buyer Initiated Due Diligence and the Vendor Initiated Due Diligence, in most of the cases the due diligence is requested by prospective buyers.[17] Hence the BIDD is only executable after signing a confidentiality agreement, due to the fact of classified business information, the VIDD is reasonable when trying to meet a larger number of buyer needs. To be as trustworthy as possible and to evade unjustified security demands from perspective buyers, the VIDD is mostly done by third party companies, as their core competency is company valuation. In terms where a due diligence is not done or not done correctly, the manager of the acquiring company is guilty of delinquency[18] in accordance with §§ 76, 93 (1) AktG (Aktiengesellschaften-Gesetz, German Stock Corporation Act) and must pay an indemnity as in conjunction with article § 93 (2) AktG.[19]

Before acquiring a company or even starting to bid, the buying party must determine if there are any synergy effects when purchasing a company. Furthermore, every company purchase means that risks are also part of the transaction which must be taken. Therefore, a correct evaluation of the purchase price recognizing these points is vital for the buyer. To do so, the buyer needs certain information, which the seller can contribute. The due diligence can an approach of willingness of the seller to deliver the information needed, and to adjust the asymmetrical distribution of information between the two parties.[20] However a bigger amount of information given to the buyer, leads to more detailed demands regarding the contractual warranty obligation from the seller, and vice versa.

So, in the first place the due diligence gets all relevant information needed for determining a correct purchase price for a company as for the company valuation. The procedure adjusts the asymmetrical distribution of information between both contractual parties and gives the buyer a better a chance of allocating risks and weaknesses of the transaction target. It assesses all needed warranties arising from recognised risk positions and lack of information.[21] In the end, it consolidates all discussed points and records them for evidentiary purposes and implementation into the purchase agreement.[22]

The following figure shows the initiator of a due diligence, the main target, the individual forms of a due diligence and the general effect.

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[17] See Picot, 2012, p. 256
[18] See Engelhardt, 2017, p. 12
[19] See Picot, 2012, p. 256
[20] See Picot, 2012, p. 257
[21] See Pomp, 2015, p. 9
[22] See Engelhardt, 2017, p. 12

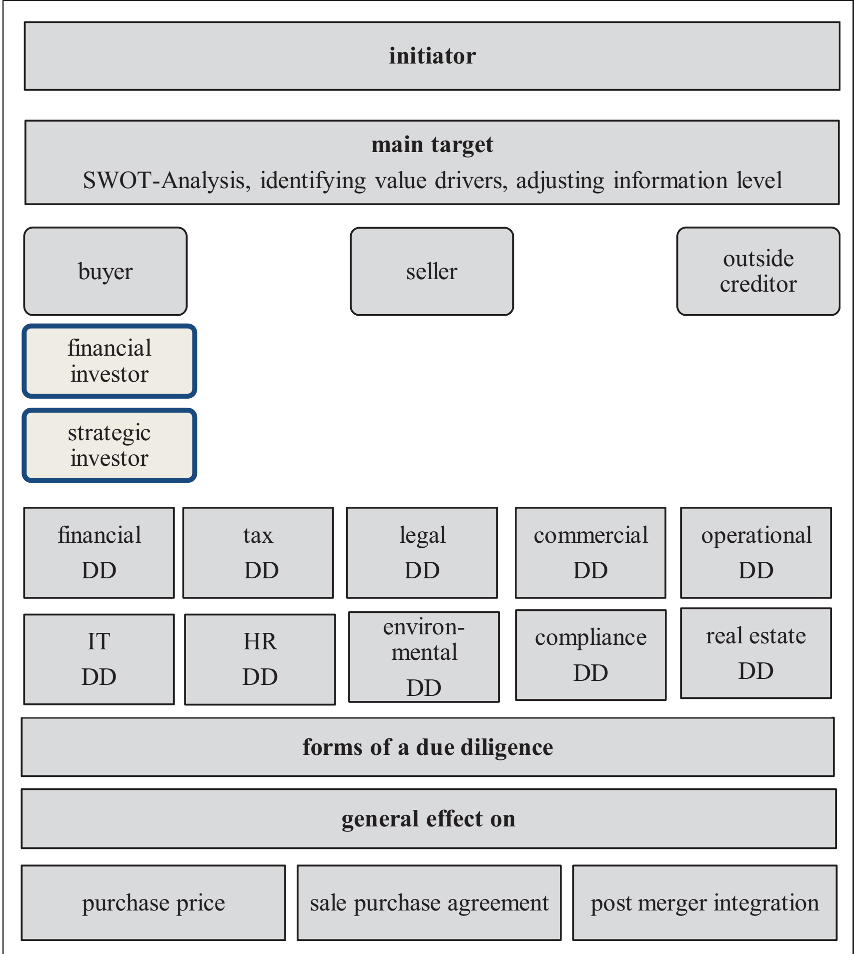

Figure 3: Due Diligence: target, initiator, forms and effect, own representation based on Pomp, 2015, p. 10

4 Purchase Price

As already in the previous section discussed the due diligence has a general effect on the purchase price determination. So, in this segment the major topic is the proper differentiation between value and price and the determination of a purchase price.

However, the purchase price is defined as the actual price the buyer is willing to pay for an object and the seller is willing to transfer the object of purchase. Based on this fact, the differentiation between shareholder or enterprise value and price of the company is vital, as the value is defined by the monetary evaluated company-relevant information, while the price is defined by the value expressed equivalent in monetary units which is rendered to get an economic asset.[23] Hence the price of a company is the marginal price between the minimum price achievable by the seller without gaining economical disadvantages and the maximum available price which is paid by the buyer.[24]

Another approach of determining the purchase price, aside from the asymmetry between supply and demand within a heterogenous market regarding the relation between value and price, lies by the stakeholders (seller, buyer, loan and equity providers, advisors) involved in the transaction of an enterprise itself. One of the most important stakeholder is the seller, as he is interested in getting a high compensation for the company (shareholder value) due to the fact of the going concern principle and the future associated discounted cash flows earned. The second important stakeholder is the buyer, as he is interested in buying a company earning a certain amount of minimal return defined before doing an investment. Certainly, an investment is economically viable in case that the capital investment is more profitable than any comparable investment on the market.[25] The following question will be how to determine the shareholder value as the Federal Constitutional Court does not define a certain method within its legal regulation. Therefore, it is common practice to use the discounted cash flow (DCF) method within company valuation.[26] Nevertheless the DCF method is not the panacea as companies differs from each other. As for service companies, the DCF method is viable, the net asset value method is more likely usable for companies with higher figures in property assets[27] as the hidden reserves are revealing a much precise view of the assets value.

Based on the going concern principle in some cases the purchase price of a company cannot be determined although the sale purchase agreement has already been signed as the company is still running operations. Due to that fact the sale purchase agreement is enlarged by price adjustment clauses. These clauses are recognising future adjustments regarding the company's value within the contract

[23] See Jansen, 2016, p. 320
[24] See Sinewe, 2015, p. 50
[25] See Jansen, 2016, p. 321
[26] See Picot, 2012, p. 306
[27] See Engelhardt, 2017, p. 31

and allowing the seller a participation in future company earnings. Common price adjustment clauses are[28]:

- trust accounts, which are distributing the contractual price after a contractual period
- earn-out clauses are giving a reimbursement to the buyer in case of missing contracted income goals
- purchase price clauses which are adjusting a decrease in the customer base due to the transaction
- locked-box concepts which are determining the purchase price based on a contracted effective date balance sheet or a future transition date

5 Post Merger Integration (PMI)

One of the last procedures which is crucial for the success of an acquisition is the integration procedure. This process is vital for the company, and if done correctly the determined synergy effects will occur during the integration phase.[29] Therefore a proper preparation and discussing essential integration topics before the signing or transaction process is necessary and contributes in strengthening the organizational structure as well as ensuring business operations, preventing initial difficulties which are narrowing revenue.

Possible integration models can be bolt-on, in which the current company remains its structure and is an affiliate company. Another possibility is the takeover, where the acquiree is totally incorporated into the company. Best-of-both describes that the qualities of both companies are merged and implemented, whether the transformation process combines the two companies into one new company.

Any of these methods are divided into two phases. In the design phase, which is critical for the success of any model, the management is defining the company's strategy and determines a structural plan for the integrational process.

This phase includes the following tasks, all contributing to an easier integration process:

- determining the aspirational level of the company and defining business goals
- identifying all short, middle, and long-term value-creation potentials
- planning any further integrational procedure
- ensuring the company's future effectivity[30]

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[28] See Engelhardt, 2017, p. 31; See Picot, 2012, p. 308 f.
[29] See Jansen, 2016, p. 362
[30] See Picot, 2012, p. 535

In the implementation stage the structural plan is being executed and deviations are controlled. An appropriate IT infrastructure and staff training is essential in this stage for the integrational success.[31]

6 Conclusion

In summary, it can be said that it is not possible to say if a share or asset deal is the ultimate decision for a company. More likely it is the company's strategy which can determine which kind of acquisition method it uses. In this seminar paper the general idea of the share and asset deal was given pointing in the second section out, that there are risks about the change of control clauses in which creditors like e.g. banks can terminate a contract in case of an owner change. This can lead to a termination of loan contracts and may have an impact on the company's financial structure or even the current cash situation. Another point is that the acquisition may have an impact on the purchased group company's demands for deliveries and services of energy and raw materials from other group entities for ensuring its operations. So, it is important to implement term-sheets with the concerned group entities through the transition period to ensure proper supply within the present framework

It was shown that a due diligence is vital for the acquisition process as it helps determining the purchase price, and leads to a much smoother integrational procedure. Neglecting a due diligence or executing it incorrectly, the manager of the buying company is guilty of delinquency and may face legal action in terms of the business judgment rule. Furthermore, the planned synergy effects won't occur, as a proper strategy was not developed by the management in prior stages before the transaction process.

Risks and impediments regarding the purchase price can arise in the correct valuation of the shareholder value. As there are plenty of methods, like the DCF method or the net asset value method, every stakeholder can determine which approach he prefers and what is maximum or minimum price he is willing to pay. Another big point is the fact that price adjustment clauses can damage the contract or even cause a reverse transaction of the contract, as the price is adjusted due to the higher risks of the seller, who is revealing vast amounts of information to the prospective buyer.

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