*"Initial Negotiations and Documentation – Letter of Intent, Non-Disclosure Agreement – Germany"*

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**1. At what stage of the M&A process does a client usually get you involved (i.e. do you usually get involved when the client needs an NDA or only when LOI negotiations start or pre-NDA during the structuring phase)?**

We recommend our clients involve us as early as possible. The earlier we are involved, the more we can help to structure the deal and identify potential issues early on.[1] Generally, clients involve us once internal discussions on their M&A-related business idea have commenced. Also, it is our perception that the deeper the client relationship the more likely it is that we are involved early on.

The execution of an NDA, once a potential purchaser has been identified, is market-standard in Germany. German statute law provides comparably strong protection of personal data and industrial secrets (e.g. see Sec. 17 of the German Act Against Unfair Competition (*UWG*)[2]).
Despite such protection, concluding an NDA is recommended, in particular, because:

- the information to be protected can be defined precisely in the NDA;
- shifting the burden of proof to the detriment of the partner receiving confidential information is possible; and
- contractual penalties can be provided for, which allows the disclosing party to receive a fixed compensation without having to prove a specific damage.

[1] This is particularly important when advising the seller.

[2] Sec. 17 (Disclosure of trade and industrial secrets) of the German Act Against Unfair Competition reads as follows (excerpt):

*(1) Whoever as the employee of a business communicates, without authorization, a trade or industrial secret with which he was entrusted, or to which he had access, (…) to another person for the purposes of competition, for personal gain, for the benefit of a third party, or with the intent of causing damage to the owner of the business, shall be liable to imprisonment not exceeding three years or a fine.*

*(2) Whoever for the purposes of competition, for personal gain, for the benefit of a third party, or with the intent of causing damage to the owner of the business, acquires or secures, without authorization,*

*1. a trade or industrial secret a) by using technical means; b) by creating an embodied communication of the secret; or c) by removing an item in which the secret is embodied; or*

*2. without authorization, uses or communicates to anyone a trade secret which he acquired through one of the communications referred to in subsection (1), or through an act of his own or of a third party pursuant to number 1, or which he has otherwise acquired or secured without authorization shall incur the same liability. (…)*

*(4) In particularly serious cases the sentence shall consist in imprisonment not exceeding five years or a fine. A particularly serious case shall usually exist in circumstances where the perpetrator:*

*1. acts on a commercial basis;*

*2. knows at the time of the communication that the secret is to be used abroad; or*

*3. himself effects a use pursuant to subsection (2), number 2, abroad. (…)*

**2. What is the earliest that you have been involved in an M&A transaction and what were your tasks? Why should a client involve lawyers in initial negotiations or project assessment stage?**

When advising the sellers and/or the target company in M&A transactions, we were involved by the client at the very beginning of the client's internal discussions of the project. In the case of buy-side engagements, lawyers tend to be involved later.

Being involved at the start of internal discussions is a beneficial situation for both the client, who will receive advice on all aspects of the initial phase of the transaction, and the law firm involved. In a sell-side engagement, the law firm can then take its role as a true project leader, in particular by:

- structuring the process from the start, from both a legal and tax point of view as well as from an organizational angle;
- checking all legal issues in early project documentation (teasers, information memoranda on the target company, process letters, NDAs, LOIs, MoUs, Heads of Terms, data room rules, etc.); and
- co-ordinating the involvement of other advisers.

Clients tend to underestimate legal issues related to the initial phase of an M&A transaction. For example, under certain circumstances information contained in teasers or information memoranda can have the quality of a public statement on specific characteristics of the target company.[3] Even statements of the seller's advisers may be a basis for the seller's liability due to a rather extensive attribution of knowledge under Sec. 166 (1) of the German Civil Code (*BGB*).[4] Therefore, it is important to not only scrutinize sellers' statements thoroughly beforehand, but to include appropriate disclaimers in relevant materials. Such disclaimers can help to avoid sellers' liability[5] by excluding:

- the capacity of the statements made to influence the decision to purchase; and
- the purchaser's reliance on the relevant statements.

Further, under German statutory law, certain obligations arise from the mere "(i) commencement of contract negotiations, (ii) the initiation of a contract, where one party, with regard to a potential contractual relationship, gives the other party the possibility of affecting his rights, legal interests and other interests or (iii) similar business contacts".[6] Each party must take account of the rights, legal interests and other interests of the other party.[7]

[3] Under Sec. 434 (1) 3 of the German Civil Code, the target company has a "material defect" if characteristics are missing "which the purchaser can expect from the public statements on specific characteristics … made by the seller … or his assistant, including without limitation in advertising …, unless the seller was not aware of the statement and also had no duty to be aware of it, or at the time when the contract was entered into it had been corrected in a manner of equal value, or it did not influence the decision to purchase ...".

[4] Sec. 166 (1) of the German Civil Code reads as follows: "Insofar as the legal consequences of a declaration of intent are influenced by an absence of intent or by knowledge or by constructive notice of certain circumstances, it is not the person of the principal, but that of the agent, that is taken into account."

[5] In the case of public target companies, a specific disclaimer should be included with regard to the prohibition of insider dealing (Art. 14 of Regulation (EU) No. 596/2014 (*Market Abuse Regulation*); formerly Sec. 14 of the German Securities Trading Act (*WpHG*)).

[6] Sec. 311 (2) of the German Civil Code; quasi-contractual liability for so-called *culpa in contrahendo*.

[7] Sec. 241 (2) of the German Civil Code.

Also, there is a general duty to perform in good faith.[8] Based on these principles, German courts have developed comprehensive case law on the liability of a seller, e.g., in case of:

- non-disclosure of or incorrect information on facts that are relevant for the target company's value (such as profit and revenues, debt, tax liabilities, etc.)[9];
- break-up of contractual negotiations after having generated the other party's legitimate expectation that the agreement in question will be concluded[10]; and
- delaying contractual negotiations and thereby preventing the contracting party to execute a possible agreement with a third party.[11]

Therefore, involving lawyers from the start of an M&A transaction is key.[12]

## 3. Letter of Intent: binding vs. non-binding.

Historically a legal concept coming from Anglo-American legal practice, the execution of an LOI has become standard market practice in Germany. The LOI is generally accepted as a useful paper to document the results of initial negotiations, clarify which issues still need to be negotiated, structure and plan the further steps to be taken and strengthen the parties' trust in each other and in the M&A project itself.

Usually, an LOI is not intended to be legally binding. In fact, parties tend to avoid any obligation to continue negotiations or even execute final agreements on the transaction. In view of possible liability in case of a break-up of contractual negotiations after having generated legitimate expectation that the agreement in question will be concluded (see above), the consequences of a break-up should be specifically addressed in the LOI. Usually, the LOI provides for the parties' right to discontinue the negotiations at any time and for an exclusion of liability in such case.[13]

The title "Letter of Intent" does not exclude it being binding, and parties should not rely on the LOI being binding or non-binding. Instead, it is recommended to explicitly clarify whether each clause of the LOI is binding or non binding. This is usually done in a specific LOI clause (often

[8] Sec. 242 of the German Civil Code.
[9] German Federal Court (*BGH*), NJW 1977, 1538; NJW-RR 1989, 307; NJW 2002, 1042; DB 2002, 942.
[10] German Federal Court (*BGH*), NJW 1996, 1884; NJW-RR 01, 381.
[11] German Federal Court (*BGH*), NJW 1984, 867.
[12] Further to the aforementioned liability-related issues, aspects of legal drafting are sometimes underestimated. We have seen cases where draft NDAs or LOIs have been circulated by the client. We have seen drafts with structural errors (such as wrong parties, i.e. the target company itself as a party in the case of a share deal/the shareholders as parties in the case of an asset deal or affiliated companies not being included into the scope of the agreement). Correcting such drafts can be burdensome, in particular if they have already been sent to the contracting party.
[13] Under German law, the liability in case of break-up of contractual negotiations can generally be excluded (subject to Sec. 134 of the German Civil Code on transactions violating a statutory prohibition and Sec. 138 of the German Civil Code on immoral transactions (*sittenwidrige Rechtsgeschäfte*); further, pursuant to Sec. 276 (3) of the German Civil Code a party may not be released in advance from its liability for intentional acts). Specific requirements apply, if the exclusion of liability is made by way of general terms and conditions. In such cases, the liability for damages arising from a grossly negligent breach of duty cannot be excluded or limited (Sec. 309 number 7 of the German Civil Code which tends to be applied by courts even in case of agreements between two companies).

under “miscellaneous” at the end of the LOI) or by way of splitting the LOI into binding and non-binding sections.

Usually, the provisions on the following are intended to be (and should be explicitly stated as being) binding upon the parties:

- confidentiality;
- exclusivity and non-solicitation;
- failure of negotiations (right to discontinue the negotiations);
- costs;
- break-up fee;
- term; and
- governing law and jurisdiction (including for arbitration).

Irrespective of the legally binding or non-binding character of the LOI provisions, the LOI usually has a factual binding effect which should not be underestimated. This is generally advantageous for further negotiations. However, the lawyer, in its role as a project leader, should avoid defining too detailed negotiating positions in the LOI. The LOI is not and should not be confused with Heads of Terms or a first draft of the SPA.[14] As a legal advisor, you need to strike the balance between capturing the main (!) legal and commercial aspects and leaving sufficient room for further negotiations on the actual contracts.

**4. a) What provisions are market standard for NDAs in your jurisdiction (e.g. do you usually have contractual penalties in your NDAs)?**

It is market standard in Germany to:

- define confidential information to be protected under the NDA;
- define the specific obligations of confidentiality (e.g. restricted use for the purpose of the transaction only and prohibiting exploitation of the information provided; extension of confidentiality on representatives, employees, agents, advisers etc. assigned by the party receiving confidential information);
- provide for exceptions to confidentiality (in particular in case of public information or in case of mandatory disclosure); and
- extend the scope of the NDA to information provided by shareholders and affiliates (or agree on the performance of the NDA for the benefit of the shareholders and affiliates[15]).

In an LOI governed by German law it is not required to explicitly provide for a claim for damages in the event of the violation of confidentiality. Such claims follow from statute law (Sec. 280 of the German Civil Code). However, such claims require the claimant to prove the damage it suffered and the amount of such damage. This is generally difficult. Therefore, it is advisable to include contractual penalties[16] in the NDA that provide for a fixed compensation:

- for any breach of the confidentiality; and

[14] In some cases we have seen long negotiations on draft LOIs, in particular when the parties have already agreed upon a certain deal structure and/or purchase price structure. The downside is that the transaction process is then slowed down (in particular if the start of the due diligence review is being delayed). On the other hand, we have seen cases where breakthroughs in the LOI negotiations on important structural issues were advantageous when it came to negotiating the SPA.

[15] So-called *contract for the benefit of third parties* (Sec. 328 of the German Civil Code).

[16] As specifically addressed in Sec. 340 of the German Civil Code.

- for any time period (usually expressed in working days or weeks) where such breach is being continued.[17]

Nevertheless, the Parties find it usually very hard to agree on contractual penalties, especially in two-sided NDAs. In one-sided NDAs you should expect push back on contractual penalties, as well.

**b) Are there any NDA provisions which are particular to your jurisdiction?**

Against the background of possible liability under German statute law, from the beginning of negotiations and/or for the breach of disclosure obligations (see above), it is common for the sellers to exclude, by a specific clause in the NDA, any responsibility for the accuracy and completeness of the information provided.

**c) Is eliminating all confidential information and destruction of all confidential materials feasible in practice after the termination of a transaction? Should a party keep certain documents for internal records and to defend itself in case of dispute resolution?**

NDA templates generally provide for the return, deletion or destruction of confidential information upon the request of the other party. It is reasonable, however, to:

- exclude confidential information contained in any electronic file created pursuant to any routine backup or archiving procedure from such obligation, to the extent the deletion of such information is only possible at disproportionate expense; and
- provide for an exception to the obligation to delete or destruct all confidential information if keeping records is mandatory under applicable law, including the rules of a professional body. Lawyers are generally obliged to keep their records for at least 5 years.[18] This of course may be helpful in case of disputes.

**5. When would you rather start an M&A process with an LOI and when with an SPA? How often do you see an LOI being used as opposed to starting the negotiations directly on the basis of an SPA?**

Generally, in private M&A auction sale processes, you will not see an LOI but an indicative and binding offer before entering into SPA negotiations. Some of the main terms that you would usually also find in an LOI, such as the purchase price and the main representations and warranties, are often part of the binding bids in an auction process. This is also in the interest of the seller. Sellers will be interested in controlling and, to the extent possible, dictating the terms of the SPA. The more competition they can achieve through an auction sale the more likely it is that the terms of the SPA are beneficial to the seller.

Aside from auction sales, the majority of our transactions start with LOIs. It helps parties to structure the deal on the basis of a much simpler document than an SPA. It also helps to

[17] The same applies with regard to any breach of exclusivity and non-solicitation clauses (if any such clause is included into the NDA, which often is not the case when the NDA is executed at the very beginning of negotiations).

[18] See Sec. 50 (2) of the German Federal Lawyer's Act (*BRAO*): a *Rechtsanwalt* must keep the files for five years after bringing a case to conclusion.

identify material issues. Identifying potential deal breakers upfront saves time and money for all parties involved. In the exceptional cases where we start directly with an SPA, the parties have usually progressed their negotiations quite far without involving external counsel or have agreed on a very straight forward transaction which does not justify the extra effort of agreeing an LOI.

**6. What are the usual contents of a standard LOI in your jurisdiction?**

Further to the above-mentioned provisions generally intended to be binding upon the parties (see above under section 3), the following are usually addressed in a German-law LOI:

- statement of the intent to purchase and sell;
- structure of the transaction as a share or asset deal;
- key points of the transaction (e.g. basis for the negotiations of the purchase price or factors for the determination of the purchase price; provisions on a variable purchase price and the purchase price adjustment; representations and warranties to be included in the final transaction documents; payment terms; etc.);
- requirements of the parties and open issues (e.g. due diligence review to the satisfaction of the purchaser; approval of the transaction by the parties' board(s)/shareholders; merger control clearance and/or other conditions precedent);
- due diligence review, further steps to be taken and timeframe;
- confidentiality (often a reference to or restatement of the NDA);
- exclusivity (and contractual penalties in case of breach of exclusivity);
- non-solicitation (and contractual penalties in case of breach of non-solicitation); and
- non- binding/binding character.