

# Selling your business: a guide for founders



# Setting the scene

You're the founder of a business that you intend to sell. You might want to sell all or a part of it and it may be that you want to start the process now or that you're thinking about preparing your business for sale in the next few years. You would be right to think that the greatest challenges you face in selling are to find a potential buyer and to convince them that the business will deliver its business plan. Nevertheless, the sale process itself presents significant challenges from a legal and administrative perspective. This guide explores some of those key challenges to help you successfully prepare for, navigate, and complete your sale.

## WHAT WE COVER

We begin with the steps to take to prepare for the sale process – what's needed to "get your house in order". In particular, we discuss:

- Getting the right management team and professional advisors
- Ensuring key elements of the business are prepared for legal due diligence
- Getting ahead of potential external hurdles to completion from shareholders, lenders and regulators

Part 2 then considers the range of potential buyers and how this may affect the transaction, including private equity, trade and US-based buyers.

We then touch on tax matters in Part 3, so you can structure and negotiate the sale to keep the greatest amount of the proceeds possible.

We finish in Part 4 with an explanation of the sale process and how to navigate it successfully.

We do not cover exiting your business by listing on a stock market in this document, but our corporate finance team would be delighted to discuss this alternative option with you.

## HOW WE HELP

We work first to understand you and your business, so that we know what you need. We spot the most complex legal issues but raise them and deal with them in a way that maximises value and minimises risk. Pragmatism and commerciality are our key mantras in delivering our service.

Our market-leading private equity, venture capital, private wealth, and tax teams are highly experienced in advising founders across multiple sectors, stages in raising capital and in sales processes. We know the market and how to craft the best solutions for you and your business and our responsive team will be with you each step of the way.

## For more information please contact:

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**Dr. Philip Cavaillès**  
Partner

+49 89 21038-419  
[p.cavaillès@taylorwessing.com](mailto:p.cavaillès@taylorwessing.com)



**Dr. Christian Traichel**  
Partner

+49 89 21038-175  
[c.traichel@taylorwessing.com](mailto:c.traichel@taylorwessing.com)



**Inken Brandt, LL.M.**  
Associate

+49 89 21038-270  
[i.brandt@taylorwessing.com](mailto:i.brandt@taylorwessing.com)

# Part 1 – Preparing for a sale process

The key to moving forward efficiently to completion of a sale is having your house in order before you begin.

Here are some key issues to get ahead of:

## 1. Your management team and professional advisors

The quality of the management team is crucial and the buyer will, to a great extent, see the transaction as an investment in the team staying on, so you will need to choose your team carefully from the start. You'll need to ensure that, in addition to all-round strength, the individual members of the team have the different capabilities and attributes required in the key business areas and that each justifies their inclusion on merit.

Getting the right management team on board is crucial, but so is making sure they are rewarded, motivated and retained. Their remuneration and incentive structure, whether options, equity, bonuses, etc., should be carefully considered. Equally important is making sure the business is protected with appropriate service contracts for key management, including provisions to prevent management competing if they leave the business.

Choosing the right professional advisors (including accountants, corporate finance advisors, W&I brokers, etc.) is also key to the success of a transaction. Management might need their own advisors. We can help you in getting the right advisors in place.

## 2. Protecting the business

During the sales process, the buyer will want to learn as much as possible about you, your team, the company, its products, and your business plan (and perhaps the wider market). As part of this "due diligence", a buyer will require those "in the know", usually the management team, to disclose information so that they can make an informed assessment of the value and potential of the company. Legal due diligence will form only a part of

this exercise. The financial and tax due diligence will be also key and there will also typically (depending on the nature of your business) be commercial, IP, insurance, technology and ESG due diligence exercises undertaken at the same time. Problems, or even potential problems, could lead to a reduction in the value of your business or even the transaction going off the rails completely.

The disclosure process can be a difficult, stressful, and time-consuming exercise, but you can avoid a lot of headaches if you and your team are prepared for it and problems are dealt with in advance. One of the best ways to prepare is for your own lawyers to undertake due diligence before the buyer (a process called "vendor due diligence") so that issues can be identified and ironed out where possible and otherwise presented in the most favourable light to the buyer. Even if the sale does not proceed, this can be helpful to the business going forward.

At the same time, you also need to give sufficient time to running the business. It's important that performance continues to be in line with expectations during the sales process to ensure you receive the best possible valuation. Having the right advisors on board, who can help take things relating to the sale preparations off your plate, is important to ensure you can balance your time appropriately.

Areas to focus on to smooth the process of the transaction include:

- **Commercial relationships.** Formally documenting the terms of key commercial relationships, such as those with suppliers, customers, agents, and distributors, will give potential buyers clarity and confidence in what they are investing in and underpin the business plan. Having complete and signed copies of those terms is important and ideally these would be prepared or reviewed by the company's lawyers.
- **Key contracts.** You should review and appraise the contractual basis of strategically important financial commitments, supplier arrangements, and revenue generating relationships (e.g., property and equipment leases and customer contracts) so



as to understand the degree of flexibility available to change strategy or manage costs, the reliability of revenue streams, and the effect the transaction may have. In particular, you should check if these contracts can be terminated or amended, require notification, or permit your counterparty a right of first offer or refusal if a buyer takes control of the company (a "change of control" clause). If there is a change of control clause, this may require careful handling depending on the counterparty and importance of the contract. Understanding what's out there and considering how best to deal with it before the buyer unearths it can help to avoid delay and disruption.

- **Intellectual property ("IP"), know-how, trade secrets and brands.** Putting in place measures to manage and protect these assets from infringement or onward disclosure is essential. Buyers will want certainty that the company either owns or has the right to use any IP relevant to the business and will expect a company to be able to articulate clearly:
  - who was involved in the development of your IP and the contractual conditions under which it was developed. Defective IP ownership provisions almost always need fixing before closing a sale, so undertaking a review in advance will help smooth the process (and avoid a situation where the deal is being held up or jeopardised by one or two missing signatures from lost or intransigent former employees);
  - what open source software ("OSS") or copyleft components are contained in, distributed with, or used in the development of your IP and the terms governing their use. Certain OSS licences require, as a condition of use, that changes to the code are made available free of charge for use by others in a collaborative manner. Increasingly buyers are using "Black Duck scans" to identify OSS in software code, which often means a remediation process is needed. A comprehensive register of all OSS used by the business should be kept; and
  - how the company manages infringement risk. In particular, has the company properly registered all of its registrable IP (trademarks, patents, design rights) and does it have in place a process for monitoring, identifying and resolving possible infringements? Where possible IP infringement has been identified, this should be adequately resolved by the business ahead of any sale. For

unregistrable IP (e.g., trade secrets), can the company show appropriate procedures to prevent its dissemination?

- **Disputes.** Actual and potential disputes and investigations (whether litigation, arbitration, or regulatory investigation/intervention) should be monitored, assessed, and managed to minimise their impact on the value of the business. Whilst you might not be able to avoid or resolve a dispute, it's important to conduct a proper assessment of relevant risks, and to maintain clear records of decision-making processes. Showing the risks have been properly considered and addressed and being able to explain and evidence the current position, and that advice has been sought where appropriate, will be important to getting a buyer comfortable. You should also consider key compliance related risks in relation to the "failure to prevent" offences (i.e., in relation to bribery, tax evasion and economic crime) and that adequate/reasonable procedures are in place.
- **Employment.** You should maintain good employee records, such as formally documenting employment and service contracts and regularly updating the company's policies and employee handbook.
- **Options.** As a crucial starting point when it comes to the German tax implication of equity incentive programs for employees, a fundamental differentiation has to be made between genuine shares and stock options.
  - While a beneficiary receiving shares may benefit from preferential capital gains taxation schemes under German tax law (flat tax, partial income method or capital gains exemption), the recipient of options that are not exchange traded (which can only be the case for listed companies) are subject to full income taxation (subject to certain limited relief rules) upon exercise of the option. In other words, neither the granting nor the vesting of such options qualifies as a taxable event for German tax purposes.
  - As a consequence, the income taxation of options cannot be accelerated but should only materialize when exercising the option. If the exercise of the option occurs concurrently with (or close to) an exit, the capital gains realized as a result of the exit do not benefit from any preferential taxation scheme.
  - A transfer of genuine shares (rather than options) is often not intended under an existing incentive program.

In the following we would like to briefly highlight some of the wage tax implications arising from an option program at the level of a target limited liability company (GmbH) in its capacity as employer of the German tax resident beneficiaries:

- Assuming that a strike price per share falls short of the prevailing fair market value of a share upon exercise of the option, the target GmbH as employer of the beneficiary will have to comply with certain requirements under German tax law.
- The delta between the fair market value of a share and the strike price qualifies as part of the total compensation received by the beneficiary and is subject to German wage tax.
- In the first place, the target GmbH will have to deduct the amount of wage tax on the delta (and social security contributions, if any) from any cash salary payable to the relevant beneficiary and remit the wage tax amount to the tax office in charge.
- Should the cash salary of the beneficiary not be sufficient to cover for the wage tax amount, the target GmbH will have to claim the required wage tax amount in cash from the beneficiary.
- If the wage tax amount cannot be fully recovered from the beneficiary, the target GmbH will have to notify the exercise of the option and transfer of the shares to its tax office in order to be released from any secondary liabilities for wage tax.
- If the target GmbH fails to give notification to the tax office, it will be exposed to a secondary liability for any wage tax to be imposed on the beneficiary.
- The aforementioned procedure applies irrespective of whether, prior to maturity, the options will be held by the beneficiary as an individual or through a vehicle controlled by the beneficiary.
- However, in terms of claiming the wage tax amount from the beneficiary to avoid any secondary liability, it is typically the more prudent approach to grant the options to the beneficiary (rather than to a vehicle) to ensure that the beneficiary as direct owner of the shares and, hence, recipient of exit proceeds will be able to cover for the wage tax amount in cash to be claimed by the target GmbH.

Please note that the afore-mentioned treatment does not apply to a holder of shares or stock options who

has received such shares/options as consideration under an M&A transaction instead of a full purchase price payment in cash. In such scenario, the holder will be taxed on the capital gain realized under the M&A transaction and any income or capital gains generated from the shares/options going forward should not be subject anymore to wage tax but qualify as investment income to which certain tax benefits can apply.

### 3. Horizon Scanning

As well as identifying issues in the business it's also important to identify any potential hurdles or blockers to closing a deal, for example from shareholders, lenders, and regulators, at an early stage to avoid losing momentum or running into issues at a late stage that can be difficult to resolve. A few key areas to give some thought to include:

- **Understanding expected returns and required consents.** If you've raised equity financing over the course of the company's life, it will be critical to understand how your return waterfall works, including any liquidation preference, and to have modelled expected returns for different classes of shares at different exit valuations. Once you've done that, map those returns against the consent regime (director, shareholder, or other) applicable to a sale – are there any investors whose consent is required to do a deal but whose returns are looking lacklustre? Tensions can arise where founding teams and early-stage investors wish to pursue an exit, but more recent investors want the company to build towards the next valuation inflection point and beyond before selling out. Strategic investors that are less returns-orientated can also be difficult to manage as part of any sale process, although the worst of this can be avoided if proper protections have been negotiated at the time of their investment.
- **Larger cap tables.** In addition to understanding how your key investors will view a potential deal, if you have a larger cap table and/or a long tail of smaller shareholders, consider the content and timing of communications with that wider audience. It will be key to find the right balance of maintaining confidentiality around the sale process and keeping shareholders in the loop to avoid bottlenecks later in the process. In particular:
  - check that the contact information you're holding for shareholders is up to date (including e-mail addresses for any documents to be sent for signature via DocuSign);

- consider how smaller shareholders will be engaged in the sales process (e.g., are powers of attorney appropriate so that you or members of the management team can sign documents on their behalf?); and
- consider how best to deal with any potentially hostile shareholders (e.g., disgruntled former employees). Is there the ability to drag any dissenting or non-responsive shareholder, and, if so, is your drag along mechanism fit for purpose for the type of deal you're anticipating?

■ **Guarantor and warranty and indemnity (W&I)**

**insurance.** The buyer will require some or all of the shareholders to give warranties (factual statements about the company and its business) in the transaction agreements. If these are untrue or inaccurate the buyer may be able to claim damages from the persons giving the warranties. Typically, warranties are given by management and other shareholders with intimate knowledge of how the business is run (or at least certain aspects of it). One way of removing or limiting risk for the warrantors for any claim for a breach of warranty is to arrange W&I insurance. If it's available, then a claim can be made under the policy rather than against the warrantors. If W&I insurance is not available or if there are categories of excluded claim (e.g., known issues identified during due diligence) that the buyer still requires cover for, will it just be management left on the hook financially for any claim for a breach of warranty or will all shareholders contribute proportionately? It's worth you having that conversation with shareholders early on to establish what level of support you can expect and how that might be achieved (e.g., an escrow or retained amount as between the shareholders for a period of time so that claims can be paid out of the transaction proceeds).

- **Debt repayment and release of security.** If you have external debt in place, buyers will typically look for this to be paid off, with any related security released, prior to completion. Engage with your lenders and their legal counsel early to understand the process, timings, and likely costs, including any break costs/early repayment penalties.

- **Warrant holders.** Warrants relating to current or historic venture debt financings are common in venture capital-backed companies, with warrants being typically exercised immediately before completion and the resultant shares sold. Bring warrant holders into the process sooner rather than later – they will instruct their own legal counsel and will want to review and negotiate the documents they need to sign. Consider a short-form minority sale agreement to help smooth that process. Factor the time for all of this into your process and budget. For German income tax implications as regards the granting and exercise of warrants as well as the determination of the tax base, please refer to the above section 2. Protecting the business—Options on page 3 et seq.

- **Regulatory approvals.** Regulators in the US, Europe and UK are increasingly hawkish when it comes to scrutinising, and intervening in, transactions, whether that's under existing merger control laws or newer foreign direct investment ("FDI") rules, the German Foreign Trade and Payments Act ("AWG") or UK national security ("NS") legislation. Jurisdictional assessments are rarely straightforward and/or clear cut. The AWG regulates in Germany international trade and payments to protect national security and align with foreign policy goals. It ensures free trade while allowing controls on exports (for sensitive goods, technologies or dual-use items), foreign investments, and sanctions compliance for critical security and policy reasons. Many of these regimes are suspensory and can involve lengthy approval processes, so it will be important to establish at an early stage whether any filings and/or approvals are required.

# Part 2 – Understanding your buyers

Your universe of potential buyers can have a significant impact on the shape, structure, and speed of a deal. This section explores some of the unique features, and potential challenges, of some of the different types of buyers – private equity, strategic, and US.

## 1. Private equity

### Jargon busting, documents and drivers

For many founders, private equity („PE“) jargon can be bewildering. The good news is that none of this is rocket science.

- **‘private equity investor’, ‘fund’, ‘sponsor’ and ‘institutional investor’** – while these are all different types of investors, these terms are pretty much interchangeable.
- **‘leveraged buy-out’** – short-hand for any transaction where existing management and/or new management together with a PE investor acquire a company using third party debt.
- **‘senior debt’ vs ‘junior debt’** – senior debt is usually advanced by commercial banks and so called because they normally take first-ranking security over the assets of the business. ‘Junior debt’ or ‘mezzanine debt’ ranks behind senior debt but ahead of equity. These can include high street lenders or other boutique debt providers who specialise in this type of transaction.

The terms of the documents on a PE deal may also seem somewhat „over-the-top“, perhaps even suffocating. It may be tempting to think that the buyer is looking to control the business. It is almost never the case that institutional investors want to take control, they would prefer to leave the management team to run the business day-to-day. However, they approach investments with heavy duty documentation to ensure

that a sufficient level of protection for their investment is maintained.

The jargon and documents of the private equity world may be unfamiliar at first but understanding what drives an institutional investor on a leveraged deal is simple. Essentially it is getting the right mix of equity and debt to leverage the equity returns. This will be determined by confidence in the strength of the business plan and the amount of debt and interest it is believed the business can support through its free cash flow.

The function of PE houses is to make acquisitions, help build and grow the business, and sell them. This means that PE buyers can often move faster than their trade counterparts due to their streamlined internal systems and external approach (including their familiarity with doing transactions).

In addition, perhaps unlike trade buyers, from the outset a PE investor will be considering their exit (which will typically occur within five years of their initial investment). This mindset is a defining feature of a PE buyout and will influence the structure of the deal and what protections you should expect.

### How will you invest?

A PE buyer will most likely want you re-invest or roll-over in the newco structure (the percentage of your proceeds from the sale that they want you to invest will be a matter for negotiation). What does this involve?

- **Rollover and Reinvestment** – PE investors will ask you to „rollover“ or reinvest some of your sale proceeds in the company. Managers are often asked to reinvest a certain amount of their proceeds after tax, but this may vary depending on the nature of your sale process and the commercial negotiations. In a rollover, the seller retains a portion of their shares in the company being sold and transfers these into the new ownership structure. This means that the seller continues to hold a minority stake in the company and shares in its future profits. A rollover often serves as a sign of the seller's confidence in the company's future performance. Reinvestment, on the other hand, means that the



seller takes the proceeds from selling their shares and invests that amount back into either the same company or another project. This could involve buying back shares in the same company (after having sold all their shares) or investing in another business or project. In summary: With a rollover, the seller retains part of their shares from the outset within the new ownership structure, whereas with reinvestment, the seller first sells their shares and then reinvests the proceeds. A rollover of shares in a German target company into an EU/EEA tax resident company can often be implemented in a tax-neutral way depending on the acquisition and holding structure on the buy-side. However, no tax-neutral rollover is available when transferring shares into a non-EU/EEA resident company. As regards the reinvestment, there are no tax benefits because any capital gains can only be reinvested on an after-tax basis.

- **Sweet equity** – Managers of a company are typically allocated „sweet equity“ to incentivise future performance which will need to be carefully structured from a tax law perspective in order to avoid dry income taxation. You may be allocated some

as a founder if you are staying on in the business. This gives managers a financial stake in the business and incentivises them to grow the company because they will then receive significant returns on an exit for a low investment cost (i.e., it „sweetens“ their deal with the company). PE investors will set aside a „pot“ or „pool“ (a certain number of reserved shares) of sweet equity on completion of a transaction so that any existing and future managers can be allocated shares. Sweet equity shares generally have limited rights and protections. For example, you may not have any voting rights nor any rights to receive distributions, and you will likely be required to sell your sweet equity if you leave the company prior to an exit (and will get different amounts for it depending on how you leave, for example as a „good“, „bad“ or „intermediate“ leaver – for more on these terms see the table below). For tax purposes, sweet equity is typically structured in such way that it qualifies for the preferential capital gains taxation schemes under German tax law (flat tax, partial income method or capital gains exemption).



## Protecting your investment

As an investor after the sale, you will want to consider how best to protect yourself and your investment. Set out below are a list of the key equity terms and how you might want to position yourself against a PE investor. These are designed to be indicative of a typical situation and not to provide legal advice. You should always obtain legal advice and personal tax advice to understand exactly how the proposed structure will impact you.

Key terms	Institutional investor position	Manager / Founder position
<b>Additional consent matters</b>	Institutional investors will require additional consent rights in certain default situations, such as a material failure to perform against budget. These rights are intended to allow the PE investor to control management and/or shareholder matters (if they do not already have control) and if necessary to initiate rescue financing or to remove or appoint directors.	You should ensure that the trigger situations to implement such additional consent rights are sufficiently material (e.g., financial default events) and if a rescue financing is made, you are able to subscribe for additional shares to maintain your pro rata shareholding (a "catch up right").
<b>Permitted transfers</b>	Institutional investors will likely want a veto over certain share transfers to prevent them taking place without their consent.	You should ensure the equity documents allow certain transfers to be "permitted transfers" that do not require investor consent. Such transfers may include transfers to a family member or trust for tax planning purposes or transfers to a warehousing entity to be held for new members of the management team.
<b>Drag along right</b>	Institutionelle Investoren verlangen zusätzliche Zustimmungsrechte in bestimmten Ausfallsituationen, z. B. bei einer wesentlichen Nichterfüllung des Budgets. Diese Rechte sollen es dem PE-Investor ermöglichen, das Management und/oder die Angelegenheiten der Anteilseigner zu kontrollieren (sofern er nicht bereits die Kontrolle innehat) und erforderlichenfalls eine Rettungsfinanzierung einzuleiten oder Geschäftsführer abzurufen oder zu ernennen.	Sie sollten sicherstellen, dass die Auslösesituationen für die Umsetzung solcher zusätzlichen Zustimmungsrechte hinreichend wesentlich sind (z. B. finanzielle Ausfälle) und dass Sie im Falle einer Rettungsfinanzierung in der Lage sind, zusätzliche Anteile zu zeichnen, um Ihre anteilige Beteiligung aufrechtzuerhalten (ein „Nachholrecht“).
<b>Drag along right</b>	If an institutional investor wants to sell all of their shares to a third party, it will want the ability to require minority shareholders to also sell their shares (known as a "drag" right) so that the new third party buyer can acquire 100% of the business.	You should aim to agree a threshold to exercise the drag (e.g., 50% or more of the ordinary share capital) and/or the drag rights could be suspended for a period of time or until certain returns are achieved to give the managers the opportunity to follow through on the business plan. Consider if there are circumstances where you would like to force a sale.
<b>Tag along right</b>	PE investors will usually want this right only to apply if the sale would result in a new investor taking control of the company.	You should ensure that if a material level of shareholders receive an acceptable offer from a third party, they are obliged to provide that the third party makes an offer to purchase at least the same proportion of the other shareholders' shares on the same terms (a "tag" right).

Key terms	Institutional investor position	Manager / Founder position
<b>Leaver provisions</b>	<p>If you leave the business before an exit, a PE investor will typically want you to sell some or all of your sweet equity back to the company. This allows it to reallocate your sweet equity to any new managers to encourage them to grow the business.</p> <p>The amount of money you will get for your sweet equity will depend on the circumstances in which you leave. Typically, there are "good", "intermediate" and "bad" leavers.</p> <p>It is possible that a PE investor may also look to reduce the interest/coupon on your loan notes/ preference shares.</p>	<p>The investment documents should clearly define what constitutes a "good", "intermediate" or "bad" leaver as this will determine what price you will receive for your shares. Good leavers typically leave employment due to death, disability or illness, intermediate leavers have often been terminated with notice, whereas bad leavers have voluntarily resigned, been dismissed for cause or breached their restrictive covenants.</p> <p>Good leavers usually receive "market value" for their shares, bad leavers the lower of the price they paid and market value and intermediate leavers receive market value for an increasing percentage of their shares the longer it is until they become a leaver (this is called "vesting").</p>
<b>Restrictive covenants</b>	<p>A PE investor will seek to limit your ability to damage the business of the company if you leave and will require managers to agree to certain restrictions ("restrictive covenants") including agreements not to compete with the business and not to solicit customers or staff.</p>	<p>Restrictive covenants in the investment documents may cut across any restrictive covenants you already have in your employment agreement. You should always make sure the restrictions are reasonable and do not prevent you from earning a living after you leave the business.</p> <p>Non-compete provisions in the service agreement are only allowed with at least 50% of compensation whereby such restrictions in the equity documentation do not trigger a compensation requirement.</p>
<b>Representation and Warranties</b>	<p>The founders and existing shareholders will be asked to give representations and warranties, such as to the accuracy of your financials and management to confirm certain factual information contained in the various vendor due diligence reports and/or those reports commissioned by the institutional investor. If you fail to disclose anything which makes a warranty untrue, you will be in breach of warranty and may be liable to pay the institution's damages.</p>	<p>You should expect to be able to cap your liability under the representations and warranties by negotiating a financial limit on your liability and ensuring the warranties expire after a certain period of time. Proper preparation and disclosure mitigate against the risks of any claim arising.</p>
<b>Information rights</b>	<p>You and the management team will be asked to provide various information to the PE investor, including accounts, capital tables, an annual business plan and budget (that the investor will likely want to approve) and a management pack (often measuring performance against KPIs).</p>	<p>You should ensure that the information obligations are achievable for you and your team and will not unduly distract management from running the business. You should also want to consider what information you would want as a shareholder if you were no longer a director or employee of the business.</p>

## 2. Strategic buyers

Also commonly referred to as „trade buyers“ in an international context, this is a type of acquiror operating in the same or an adjacent space as your company, which is often making the acquisition for strategic rather than purely financial reasons. Strategic goals can vary, but typically include a desire to integrate assets and operations with a view to realising cost or other synergies, gain new customers, talent or intellectual property, expand product lines and offerings, and/or accelerate growth in new markets.

Sometimes, because they are buying for their own strategic reasons, such buyers are prepared to make higher offers for businesses than PE houses who are looking for a purely financial return from the existing business. This is particularly the case now with many strategic buyers able and willing to fund acquisitions exclusively from existing cash resources rather than having to rely on debt finance, which has become materially more expensive in the sustained higher interest rate environment.

Being part of a larger group may also offer new and enhanced opportunities to scale your business, with ready access to new markets, sectors, and/or sales and distribution channels, all of which will be particularly relevant if there's an earn-out or you're taking equity in the buyer group.

Against that backdrop, we consider some of the key features of an acquisition by a strategic buyer.

### Deal structure

Strategic buyers tend to want to acquire 100% control when they undertake an acquisition and then integrate the business into their wider group. This may mean that ongoing management is given less autonomy than in a private equity deal, find themselves operating in a different business culture, or are no longer required for the ongoing business. Management teams that do stay on are likely to need to make a transition from being „decision makers“ to „decision takers“, but the flipside of this structure and approach is that you tend to get more of an opportunity for a „clean break“ than on a PE deal.

If you're going to stay on in management at the business, as with a PE investor, you should give careful thought to the cultural fit and your ongoing employment rights. It's understandable for your main focus to be on getting the deal over the line but asking the right questions about what „integration“ means for you and your team and what support and investment the

business will be given following completion of the sale is important. Doing this before you hand over the keys to your business and relinquish negotiating power is key.

In terms of process and documentation, compared to private equity buyers strategic buyers sometimes have less flexibility on terms, sometimes having an internal „playbook“ they need to follow, and can be slower and more cautious, particularly if it's a first time or transformational deal for them. They also commonly want to receive a great deal of information about the strategic and technical elements of the business (beware the business and legal hazards in doing that!), but there may be less of a focus on short-term financials than a PE investor would have and the diligence process may otherwise be simpler given the buyer's greater existing knowledge of the market.

You may also find yourself dealing with a „hybrid“ of PE and strategic buyers if a company already owned by a PE house (known as a „portfolio company“) is making the acquisition (a „bolt-on“ or „add-on“ acquisition). The terms you receive as a seller may, in that case, be a combination of those provided by PE buyers on a typical buy-out (e.g. rollover or reinvestment on a higher level) and those of strategic buyers or more slanted to one type of buyer or the other, depending on the process of the negotiations.

### Consideration structure

Unlike private equity buyers, strategic buyers do not tend to ask management to „rollover“ or reinvest a portion of their sale proceeds into the company. They often instead offer more money up front, use „earn-out“ consideration structures, and might, less commonly, offer shares in the ultimate, perhaps listed, controlling company of their group.

### Earn-outs

An earn-out usually provides that the sellers will be paid further consideration if the business achieves certain targets in the years after the sale (commonly the one- to three-year period after the sale). The targets may be financially driven, such as revenue, EBITDA or ARR, targets, or strategically driven, such as product development milestones, or a mixture of the two.

Earn-outs are used both to bridge valuation gaps between buyers and sellers and to incentivise the selling management team to stay on in the business, help with integration, and drive future performance. Unlike the equity issued to management on a PE deal, the upside of an earn-out is commonly capped, but it may be easier to achieve the target than performing above the third party and shareholder debt hurdles set in a



private equity structure (but, of course, this will depend on where the targets are set).

Having less control over the business could also mean that achieving the target is not entirely in the hands of management (e.g., does the business require investment from its owners, could business be diverted away from it, or could employee numbers be cut?). This means you should pay close attention to the contractual restrictions on the buyer and its obligations to assist you in achieving the earn-out targets. Remember that the people you're dealing with at the buyer and/or their priorities may change over the course of an earn-out period, so you could be caught out if you haven't built the appropriate guardrails into your documents.

It's worth you considering the culture of the buyer in helping previous sellers achieve their own targets, and you should also consider what happens if you leave the business before the earn-out is paid out. In some circumstances, if you are a „good leaver“, for example, if you are unwell, retire or die, you or your estate may be permitted to keep a greater share of the proceeds than if you are a „bad leaver“, for example if you are dismissed or resign.

It is also particularly important to structure earn-outs correctly for tax reasons, see Part 3 for further details.

### Share consideration

Selling your shares in return for shares in the buyer adds a new dimension to a deal, particularly where it's a pure share for share deal or where the share component of a mixed cash/share deal is significant. In those circumstances, sellers will need to grapple with many of the same issues as a buyer. These include:

- **Valuation of consideration shares.** If consideration shares are being offered, you'll need to agree a value for them. This can be a thorny issue when it comes to unlisted companies, particularly if a buyer is seeking to rely on a previous valuation. It will also be important to understand what class of share you're being offered and where it sits in the return waterfall, noting that the consideration shares are being acquired for value and should be treated accordingly.
- **Reverse due diligence.** Most sellers aren't expecting to have to carry out due diligence when they launch a sale process, but where a significant portion of the overall consideration is in the form of shares, it would be worth carrying out some level of reverse/confirmatory due diligence on the buyer to ensure there are no material flags that impact your

willingness to do the deal. If the buyer has completed a funding round recently or has itself been acquired (e.g., by a PE house), it might be possible to get access to the investors' due diligence reports on a non-reliance basis to short-circuit some or all of that exercise and bridge the gap between the date of those reports and your deal with appropriate warranty cover.

- **Contractual protections.** As a future shareholder in the buyer, you should expect some level of contractual protection in relation to your „investment“, both in terms of representation and warranties cover in the SPA (i.e., beyond the typical fundamental buy-side title/capacity warranties) and appropriate minority shareholder protections in the shareholders' agreement and/or articles of association. The extent of those protections will depend on relative bargaining positions and the size of your stake in the buyer – the stronger your hand and the larger your stake, the more you can expect here.

## 3. US buyers in Germany

It is increasingly common to find German growth companies the subject of interest from US acquirors, particularly given the relative strength of the US dollar and the perceived discount at which German targets trade relative to their US peers.

US buyers, especially those less familiar with the German market, tend to have a different approach to deal terms and may look to implement these even where the target is based in Germany and German law is chosen as the law governing the transaction documents, so it's important to understand these differences in approach to help bridge the expectation gap on transatlantic deals.

We set out below some of the key differences between German and US buyers in their approach to the legal terms.

### Pricing mechanisms

US strategic buyers most commonly use a „completion accounts“ price adjustment mechanism. This means that the company is valued on a „cash free, debt free“ basis using estimates of financial benchmarks (such as net assets and/or working capital), with the price paid at completion then „trued up“ after completion when actual performance as at completion has been determined. Some of the purchase price is often retained by the buyer (in „escrow“ or as a „holdback“) in case it

needs to be applied to the true up process.

By contrast, German law deals, especially in an auction scenario, tend to use a „locked box“ mechanism and US strategic buyers that have not done German M&A before are unlikely to be familiar with the approach. In this case, the „cash free, debt free“ price is agreed using historic accounts, with the purchase price hard-wired into the acquisition documents. That price is then only adjusted downwards if there's „leakage“ (i.e., the transfer of value from the target to the sellers in the period between the date of those historic accounts and completion). Leakage includes things like dividends, gifts, the payment of transaction costs/bonuses, and the waiver of debts owed by the sellers to the target. If there is leakage, the sellers receiving that value are required to compensate the buyer for it on a Euro for Euro basis.

Economically, locked box mechanics work to transfer the risk and reward of the target business from the date of the locked box accounts. As a result, where targets are profitable, you will often see buyers being asked to pay interest (a „ticking fee“) on the purchase price between the date of the locked box accounts and completion to compensate sellers for forfeiting those profits. This can be a significant amount where the gap between signing and completion is longer, which is increasingly the case given the tougher and more complicated regulatory regimes.

The locked box approach requires less negotiation and, assuming there's no leakage, means the purchase price does not need to be adjusted after completion, which gives sellers greater price certainty and ease in comparing bids. It's therefore seen as more favourable to sellers. Sellers can improve the chances of persuading a US buyer to accept this approach by having a set of high quality (ideally audited) accounts ready to go and by ensuring there's enough time in the process for the buyer to get comfortable with them.

US PE houses tend to be more comfortable with locked box mechanisms than their strategic counterparts, partly because of the volume of cross-border deals they do, but also because the fixed price nature of a locked box mechanism gives them certainty as to the amount required to be drawn down from their limited partners.

### **Conditions to the deal**

Perhaps the starkest difference between US and German style deals is the approach to completion conditions where a split between signing and completion is required. In Germany, conditions are typically limited

to mandatory/suspensory regulatory or anti-trust approvals, which has the effect of transferring business risk to the buyer at signing on the basis that, once signed, the deal is more likely to complete.

In contrast, US buyers will expect (and receive) a wider array of conditions, including a no material adverse change (MAC) condition, a condition that the full suite of representations/warranties is materially true and accurate when repeated at completion, and a requirement for the target to have complied with its conduct of business undertakings between signing and completion. The consequence is that business risk does not typically transfer until completion (in line with the US approach taken on pricing mechanisms) because buyers are given more „outs“ if something goes wrong after signing.

### **Liability and recourse**

In the US, the liability regime typically has more „teeth“ from a buyer's perspective, with representations and warranties often given on an indemnity basis and backed by significant sums held in escrow or otherwise retained by the buyer (a so-called „holdback“), making it easier for buyers to establish and recover losses on a dollar-for-dollar basis if issues arise.

By contrast, in Germany, a successful representation and warranty claim will require a buyer to prove that the breach resulted in a damage for buyer or target and will be subject to limitations, including a requirement for a buyer to seek to mitigate its loss.

Warranty and indemnity insurance („W&I“) has become an effective bridge when it comes to these differing approaches in recent years, with its prevalence giving sellers more of an opportunity for a „clean break“ by allowing them to give representations and warranties subject to nominal (e.g., EUR 1.00) liability caps, with the buyer's principal mode of recovery now being against the insurance policy. This set-up also often appeals to buyers if the management team are staying on in the business as it offers them a means of recovery without having to „offside“ that team by bringing a claim against them, although many US strategic buyers still favour a more traditional approach to liability.

That said, insurance doesn't cut through all potential points of difference – buyers may require sellers to cover the cost of a policy and stand behind both the deductible/excess (i.e., the initial portion of loss that an insurer won't cover) and any areas excluded from cover (for instance, a known issue identified during due diligence).

In terms of the disclosure process, German law acquisition agreements permit sellers to disclose matters generally to the buyer (as well as making specific disclosures), such as all the contents of a data room fairly disclosed to the buyer, to qualify the representation and warranties and limit the potential liability of sellers. By contrast, US buyers will expect sellers to specifically disclose all relevant matters against each of the warranties, which can be a much more laborious approach. A common compromise in this situation would be to generally disclose a more limited bundle of documents.

### **Restrictive covenants**

Non-compete provisions under current US law and practice (noting that the Federal Trade Commission has proposed a ban in non-compete clauses in most employment agreements) tend to be given by sellers for longer periods, commonly three to five years, than in German deals where the period is usually one to two years, because longer than two years is generally viewed by the courts as overly restrictive and not enforceable.

### **Employees**

US buyers may not be used to German employment law. For example, „employment at will“ arrangements are common in the US but are not standard in Germany. Union/works council engagement is also important in Germany and in Europe. The buyer's advisors should guide them through these issues, but it is useful to make a buyer aware early on of any collective bargaining arrangements (e.g., in respect of pay or redundancy), if the transaction may trigger consultation or information rights, or if any industrial action is threatened. Any required engagement should be built into the timetable.

### **Transfer tax**

When the shares in a German company are directly or indirectly transferred, no transfer tax (stamp duty) of the consideration is payable in relation to the transfer of shares in such German company.

### **Private equity-related differences**

US private equity buyers who are not used to the German market may come with a slightly distinct perspective on management equity:

- **Leavers – “rollover” equity.** In the US, private equity investors usually have a call on any termination of employment on „rollover“ equity (the equity participation purchased with the proceeds of sale). It may be possible to negotiate for “good leavers” (often death, disability or termination without cause) not to have their rollover equity subject to a call option or otherwise a call at fair value is common. A “bad leaver”, such as a voluntary resignation, would usually receive either fair market value or the lower of fair market value and the amount paid, depending on the private equity house concerned. Sometimes, good leavers in the US are given the right to require the company to purchase their rollover equity.
- **Options or profits interests (US) vs. equity (Germany).** US transactions favour management incentive equity participation usually through share options or profits interests, which can often be on standard form, as opposed to the “sweet” equity usually granted in German sales. You should carefully consider tax advice on any proposed equity structure. German shareholders may also be more likely to have minority protections and be protected from certain forms of dilution.
- **Vesting.** In Germany, vesting tends to be time based (often four years with one-year cliff) and applies to the leaver situations, so everything is 100% vested on the private equity investor's exit (accelerated vesting). While, in the US, it is often a mixture of time and performance (usually company performance rather than individual performance).
- **Leavers – management incentive schemes.** In the US, unvested incentive equity and vested incentive equity in a “bad leaver” situation (voluntary termination, cause or a violation of restrictive covenants) is usually forfeited. An executive who resigns voluntarily may sometimes be permitted to receive fair value for their vested equity. Good leavers (often death, disability or termination without cause) will often forfeit unvested awards but will be permitted to exercise their vested awards at fair value.

# Part 3 – Tax considerations

The tax treatment of any sale proceeds (whether received on completion or in the future) and of any holdings in the new structure will directly impact how much value you will end up with as the result of the transaction. You will most likely want to have any transaction to attract the minimum rate of tax available. It is important to note that tax structuring may not be possible shortly before the transaction and generally not be implemented with retroactive effect.

## Consideration structures

Your individual tax position will depend on the type of consideration you receive, the method of calculating it and the timing of any payment. You may receive any combination of the following types of consideration: cash, shares, or loan notes, and your tax position may be complicated by any entitlements to receive consideration post-sale, possibly by way of an „earn out“.

Where you receive cash for the disposal of shares in the target company your proceeds are, as a general rule, subject to capital gains tax for the fiscal year in which the closing occurs.

Where a founder has held the shares in the target company indirectly through a holding vehicle in the form of a corporate entity as from the incorporation of the target company, any capital gains realized by the holding vehicle are 95% tax exempt under German tax law (effectively resulting in a tax charge of approx. 1.5% of the capital gains). However, any profit distributions made by the holding vehicle to the founder as shareholder (whether or not sourced from the capital gains previously realized) are subject to German flat tax at a rate of 26.375% to be withheld by the holding vehicle. In

such a case, the overall tax burden eventually suffered by the founder may even exceed the tax burden imposed on capital gains directly realized by the founder (i.e. without the interposition of a holding vehicle). In the latter case, capital gains are (subject to a 1% participation threshold) subject to the partial income method (Teileinkünfteverfahren) which provides for a 40% tax exemption for capital gains with a full income taxation for the remaining 60% of capital gains (effectively giving rise to a maximum overall tax burden of 28.5% or less depending on the founder's individual tax position).

Particular care should be taken by individuals in transactions where „rollover“ or „earn-out“ mechanisms are included in the drafting. Although they are useful commercial tools to incentivise founders and senior management staying on in the business (particularly in a private equity context) and bridge valuation gaps between buyers and sellers, they can result in unexpected tax consequences.

You should seek tax advice as early as possible on the appropriate way to structure such entitlements.

- **Earn-outs** – An „earn-out“ can be structured as a future entitlement to shares or loan notes or as payments of deferred and/or contingent cash consideration. Future entitlement to shares may include allocations of „sweet equity“ as discussed in Part 2. Often an earn out is contingent on certain future events or performance metrics. The way an earn out is structured will affect how and when it will be taxed in your hands. Some points to be aware of are set out below.
  - Large values of deferred or contingent consideration can trigger significant tax charges on completion of the sale (regardless of when, or if, such amounts are eventually paid). Accordingly, careful consideration should go into the drafting of these provisions and the mechanisms for calculating any future amounts as described in the transaction documents.
  - A seller's entitlement to earn out consideration should ideally be linked only to the performance of the company (and not any individual) and



should not be conditional on any individual's ongoing employment (among other things) to maximise the likelihood that it is taxed under the preferential capital gains rules. However, in the case of sellers still assuming, after the closing, senior management functions in the target company or any of the buy-side companies controlling the target company, face a high risk that the earn-out amount is fully taxed as ordinary income under the wage tax rules rather than the capital gains rules. By contrast, an earn-out should not be an issue for tax purposes if the seller no longer contributes to the performance of the target company after the closing.

- **Rollover** – As discussed in Part 2, a founder seller may be requested to „rollover“ part of their shareholding in the target company to shares and/or loan notes of equivalent value in the new structure.
- Where you receive shares (or certain types of loan notes) in the new structure for the disposal of shares in the target company it may be possible for German tax resident founders / senior managers to „rollover“ any existing shares in the target company in a tax neutral manner (for more details, please refer to Part 2, Section 1 Private Equity--Rollover and Reinvestment).



# Part 4 – Running a process

Now that you have successfully organised your business, have attracted potential buyers, understand their drivers, and planned the deal structure to be tax efficient, all that's left to do is get the deal over the line!

Running a process can be intense and time consuming, however, this is where we can help. Our corporate team at Taylor Wessing has vast experience in representing selling shareholders, founders and management teams and navigating them through the deal process to a successful completion.

While you're doing the deal, you also need to be sure not to lose sight of your fiduciary duties as a managing director of a target company or, as mentioned above, the task of running the business. You need to keep running the business in the interests of its current shareholders and keep ensuring the business is running successfully. An unforeseen dip in turnover or profits at this stage could lead to less favourable terms or, possibly, to buyers walking away from the deal altogether.

## Auction process

Target businesses are often sold in auction processes as sellers are able to maintain control by dictating the timeline and non-negotiable items, and creating competitive tension that will drive the price and deal terms upwards.

Following the signing of confidentiality agreements, an auction will begin with bidders being provided with a process letter setting out when bids are due and what they must include. Bidders are often asked to provide a non-binding / indicative first round bid on the basis of an "information memorandum", which is usually prepared by corporate finance advisors and sets out key information about the business, its prospects, and why it's attractive. The number of bidders may then be reduced to a smaller number taken through to the

second round, perhaps four or five but this depends on the deal process.

Bidders will then be invited to access an online data room, review any vendor due diligence reports, and attend management presentations to further conduct their due diligence. These documents will have been produced by the sell-side in advance. Bidders may also engage with potential lenders and W&I insurers (for more on this see below), if required.

Typically, bidders will also be provided with a draft share purchase agreement (the „SPA“) that sell-side lawyers will have drafted. Bidders will be asked to submit a mark-up of the SPA to the seller as part of their bid in a form that they are prepared to sign. If you or the management team will be shareholders after completion of the sale, bidders will also be asked to mark-up or submit a proposed „equity term sheet“, which will set out the key equity terms so that they can be agreed in principle between the parties. While a term sheet is not usually legally binding, it is helpful in ensuring the parties are all on the same page before proceeding to the longer form documents and for comparing different bids in the round.

If the auction process is a multi-stage process, successful bidders may be taken to stage three where they will be provided with more information on the target business (the whole data room may not be made available to them at stage two to help maintain greater confidentiality, particularly if strategic buyers are involved) and invited to improve their bids.

At the end of the auction process, your aim will be to have several offers from bidders who have completed due diligence and provided a draft SPA that they would be prepared to sign. At this stage, it's usual to provide one of the bidders with "exclusivity", whereby they will be invited to sign an exclusivity agreement giving them the right to be the only bidder with whom you have negotiations for a certain period (often four to six weeks) to provide time to agree the final documents and proceed to exchange and completion.

During the exclusivity period, the preferred bidder, the sellers, and their teams of advisors will work to agree

the final deal documentation, which will include the legal agreements, schedules, ancillary agreements, business plans, funds flow, warranties and indemnity insurance policies, etc. The legal agreements will include:

- The SPA – sets out the main terms of the acquisition and the documents to be delivered and actions to be taken at completion.
- The investment agreement – an agreement between all of the shareholders that details the principal equity terms and records rights and obligations of shareholders in the future. It is also referred to as a subscription and shareholders' or just shareholders' agreement.
- The articles of association – contains internal rules covering the governance and shareholder rights in the company. This document is publicly available in the commercial register of the respective local court for companies incorporated in Germany.

We will make sure the documents include what is required to protect your investment.

It's fairly common for the exclusivity period to be extended to provide more time, so there is usually no need to be concerned if this is required. During this period, it is useful to be able to devote as much time and attention as possible to the sales process. We can relieve the burden of much of the project management but setting aside time for update calls and the disclosure process, in particular, will be helpful.

Once the documentation is all in place and the bidder has their funds ready to transfer, it will be time to proceed to completion of the transaction (Closing).

## Warranty and indemnity insurance

Warranty and indemnity insurance is generally taken out by the buyer. Nevertheless, sellers can ease the process by seeking indications of terms and pricing from potential insurers early on. We can help put you in touch with warranty and indemnity insurance brokers who can test the market. Brokers then produce a non-binding indication of terms document, providing a recommendation of terms for a buyer to take out. This gives the bidders a head start in the process of putting the insurance policy in place and is known as a "soft-stapled" policy. The successful bidder would then negotiate with the preferred warranty and indemnity insurance provider to finalise the terms of the policy and pricing.

An alternative is for the seller and its advisors to agree a warranty and indemnity insurance policy and pricing with the insurer during the auction process (on behalf of the successful bidder) and ask the successful bidder to enter into the policy (known as "hard stapling"). This has the advantage of streamlining the process, giving the parties certainty, and enabling the commercial warranties to be aligned with the policy. However, it reduces the buyer's flexibility. Many buyers have their own broker relationships and prefer to put their own arrangements in place. Hard-stapled policies also tend to be expensive in terms of both cost and time investment because the sellers cannot guarantee that the buyer will enter into the policy.

## Closing

As a founder, you will be most concerned with ensuring that once the SPA is signed, it is binding on all parties, and that the buyer has access to the money it needs to complete the sale at closing (known as the buyer's „certainty of funds“). Your corporate finance advisors should undertake the required due diligence to ensure the buyer has certainty of funds and we may put in place appropriate legal arrangements where required. We will also guide you through the signing process. This may involve some of the parties giving "power of attorney" so that the authorised persons have the power to sign on their behalf. This is often the case if there are a large number of sellers. The signing process for the acquisition of a German GmbH need to be notarised in front of a German notary. So, there are certain formal requirements with which you will need to comply. We can help guide you through that process.

Signing and closing of the transaction may occur simultaneously or be split over time. A split signing and closing will be necessary if the sale is conditional upon the parties obtaining any approvals and/or consents (e.g., from regulators). You may need to comply with certain requirements in the period between signing and closing and we can advise you on agreeing and understanding your obligations. There will also be a lot to organise at closing, whether this occurs at the same time as closing or later, but we will help to ensure that the process of finalising your deal and receiving your money is as straightforward as possible.

## **Your Team:**

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**Dr. Philip Cavaillès**  
Partner

+49 89 21038-419  
[p.cavaillès@taylorwessing.com](mailto:p.cavaillès@taylorwessing.com)



**Dr. Christian Traichel**  
Partner

+49 89 21038-175  
[c.traichel@taylorwessing.com](mailto:c.traichel@taylorwessing.com)



**Inken Brandt, LL.M.**  
Associate

+49 89 21038-270  
[i.brandt@taylorwessing.com](mailto:i.brandt@taylorwessing.com)



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