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German M&A/PE Update – The Dangers of Knowledge Attribution via the Management Team

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I. Executive Summary

According to a judgment of the German Court of Appeal (*Oberlandesgericht*) of Düsseldorf[1] ("Court"), the knowledge of the management team of a target company in an M&A/PE transaction may—under certain circumstances—not only be attributable to the seller, but also to the purchaser. In a worst-case scenario for the purchaser, this may result in the full exclusion of (damage) claims in connection with an M&A/PE transaction.

II. Underlying Facts of the Judgment

The major facts of the case can be briefly summarized in a simplified manner as follows:

In a share deal M&A/PE transaction, the management team of the target company was actively involved in the negotiations, the due diligence process, and the signing and closing of the deal (after unsuccessfully pursuing an MBO). The management willfully deceived the purchaser by, among other things, providing rigged financial statements/balance sheets, which stipulated non-existing annual profits. The transaction was signed by entering into a share purchase agreement with customary provisions, including a balance sheet guarantee, a knowledge attribution clause, and an exclusion of seller's liability in case of purchaser's knowledge. On the signing day, a member of the management team was appointed as managing director of the purchasing entity. Subsequently, members of the management team acquired a substantial minority stake in the purchasing entity (as already contemplated in the letter of intent).

After becoming aware of the willful deceit, the purchaser demanded the unraveling of the purchase agreement and damages from the seller. In the first instance, the regional court dismissed the case because of the positive knowledge of the managers, which was attributable to the purchaser and which excluded damage claims.

III. Major Grounds of the Judgment

The Court held that (A) the knowledge of the management team was principally attributable to the purchaser, while (B) such attribution was effectively excluded by the provisions of the share purchase agreement.

A. *Attribution of Management's Knowledge to Purchaser Due to Statutory Provisions*

According to the Court, the management's knowledge was attributable to the purchaser via section 166 para. 1 German Civil Code. According to this provision, vitiated consent or (deemed) knowledge is attributable to the principal via its agents and representatives.

1. Direct Application of Section 166 Para. 1 German Civil Code

The Court concluded that the appointment as managing director in the acquiring entity was sufficient for the (direct) applicability of section 166 para. 1 German Civil Code, even if the equity participation of the management team member became effective after signing.

2. Analogous Application of Section 166 Para. 1 German Civil Code

Moreover, the Court concluded that the knowledge of the members of the management team was attributable to the purchaser by analogous application of section 166 para. 1 German Civil Code due (i) to "*anticipated shifted allegiance*" (*vorzeitig übergegangene Loyalität*) of the management by teaming up with the purchaser/sponsor and (ii) to the instigation of the sale negotiations by the management.

According to the Court, the fact alone that the management team stayed in office in the target company was not sufficient for an attribution of knowledge to the purchaser.

B. *Exclusion of Attribution by Way of Construction of the Share Purchase Agreement*

In a second step, the Court concluded that the attribution of knowledge was validly excluded in the individual case at hand by the provisions of the share purchase agreement (after a respective taking of evidence and a respective construction of the SPA).

IV. Conclusion

The potential issue of knowledge attribution via the management team stipulated by the Court could become applicable in different scenarios, such as MBOs, management incentive schemes or in case of a continuing interest (*Rückbeteiligung*). Given the current absence of a clarifying judgment by the Federal Court of Justice (*Bundesgerichtshof*), this new case law should be taken into consideration in M&A/PE transactions when acting on the buy side.

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[1] *OLG Düsseldorf (I-6 U 20/15), NZG 2017, 152 et seq.*