



ADVESTRA

Legal Due Diligence: How to Spot the Red Flags

M&A Academy

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What is Legal Due Diligence?

General

- Structured legal review of the target to identify risks and constraints in relation to a transaction
- Output is a decision tool for buyers and/or sellers, not a full legal audit

Red Flag

- High-level, risk-focused "exceptions only" review to identify major risks and value drivers
- Concise reports with "traffic-light" summaries and recommendations for actions

Full Fledged

- Broader and deeper review of legal topics, more descriptive and not just risk-based
- Provides more comfort and detail for documentation and pricing

Buy-side

- Focuses on buyer-specific risk assessment and deal strategy
- Forms the basis for risk allocation (pricing adjustments, CPs, indemnities etc.)

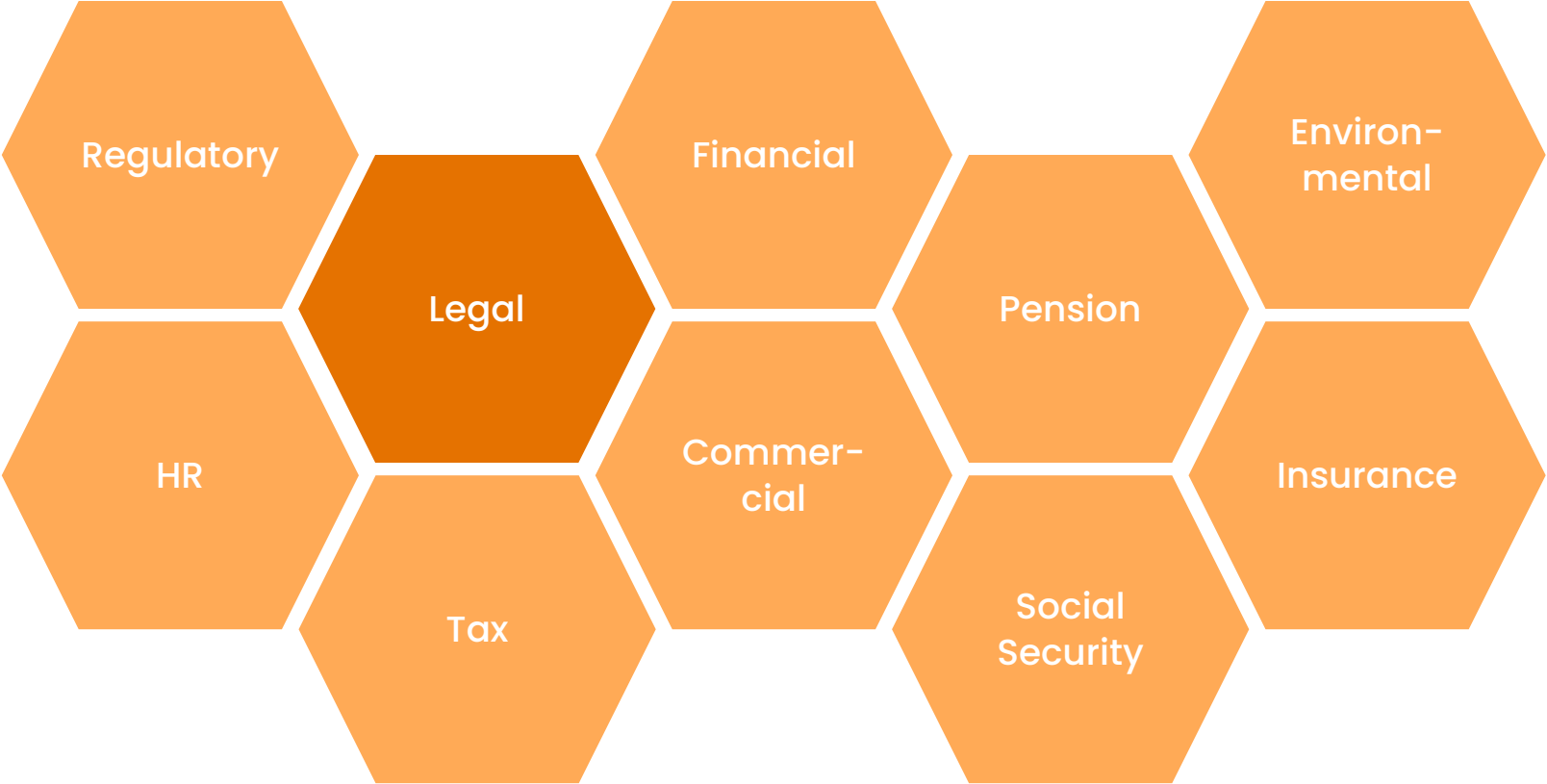
Sell-side

- Vendor due diligence report / fact book
- Aims to anticipate and manage issues upfront
- Supports process efficiency and bidder confidence

Purpose

Risks and opportunities	<ul style="list-style-type: none">• Go/no go
Structuring	<ul style="list-style-type: none">• Legal structuring (e.g, share deal vs. asset deal)• Carve-outs• Regulatory obstacles (e.g, governmental approvals)• Timing• Tax efficiency
Valuation / Purchase Price	<ul style="list-style-type: none">• Identification of risks impacting valuation• Cash-like and debt-like items
Documentation	<ul style="list-style-type: none">• Impact on share/asset purchase agreement, e.g. in relation to:<ul style="list-style-type: none">• Representations and warranties; disclosure concept• Specific indemnities• Limitations of liability• Conditions precedent and closing actions (e.g, regulatory approvals, third-party consent requirements)• W&I insurance• Transitional services (particularly in carve-out sales)
Integration	<ul style="list-style-type: none">• Synergies• Restructuring/financing needs• Relocation/resizing• Termination of obsolete agreements

Focus Areas



Scope

Corporate

Title to shares, due incorporation/valid existence, corporate housekeeping, organization, corporate governance, overindebtedness

Material contracts

Conditions, term / termination, change of control, restrictive covenants (e.g. exclusivity)

Financing

Related-party loans, bank financing (often contain change of control provisions), security

Related party transactions

Potential issues if not at arm's length, continuation post-closing, necessity for transitional services

Regulatory

Permits, change of control, no violation of permits / regulation, correspondence with regulatory authorities

Intellectual property

Title to IP (including IP created by employees), in-licensing, out-licensing, registration, disputes

Information technology

IT assets, licenses, need for transitional services (e.g. IT support)

Employment

Compliance with laws, term/ termination, non-competition, severance, holiday and overtime balance; change of control; participation plans (ESOPs etc.)

Real estate

Title to properties, encumbrances (e.g., servitudes), contamination, lease agreements

Litigation

Pending or threatened disputes, amounts in dispute, assessment regarding outcome

Data protection

Compliance with laws, data processing agreements, location of customers and servers

Key Action Points

Preparation/kick-off phase

- Define deal context, transaction structure/perimeter and timeline
- Agree due diligence scope and approach (e.g., red flag vs. full-fledged)
- Identify key focus areas, value drivers and known sensitivities
- Set materiality thresholds
- Ensure communication flow
- Set and communicate deliverables and deadlines

Due diligence phase

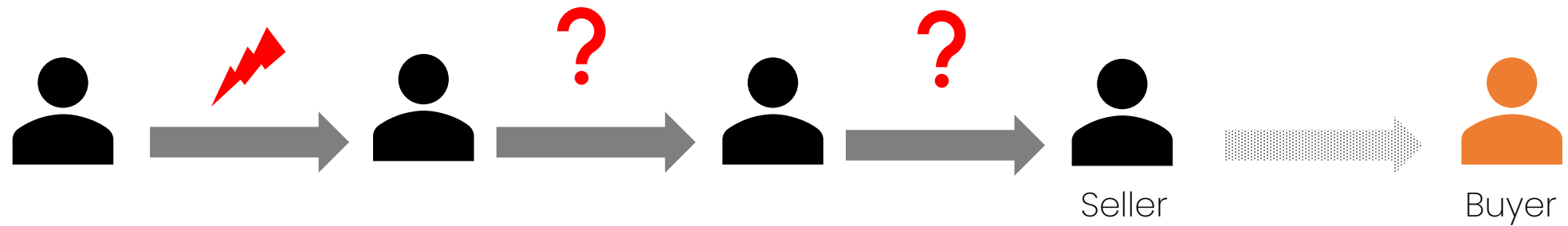
- Raise information gaps early
- Ensure timely reporting of material issues to relevant stakeholders
- Address proposed (sell-side) clean-up measures early
- Focus on deal-relevant risks
- Consider regular status updates

Post due diligence

- Ensure key risks are clearly understood by decision-makers
- Focus on appropriate and viable remedies
- Feed findings into transaction documents drafting where required (CPs, covenants, warranties and indemnities)
- Coordinate post-closing implementation of necessary actions

Key Recurring Due Diligence Topics

Chain of Title (1/3)



Key Recurring Due Diligence Topics

Chain of Title (2/3)

- ⊗ Registered shares are transferred by:
 - Endorsement and delivery of share certificate or written assignment if uncertificated
 - Board approval if transfer is restricted under articles of association (*Vinkulierung*)
- ⊗ Formal requirements must be complied with for each historic transfer
- ⊗ Consequences if shares are not duly transferred
 - Rights to shares cannot be acquired by acquisitive prescription (*Ersitzung*)
 - Buyer may not acquire valid title to the shares → "broken" chain of title undermines transaction certainty
 - Defects cannot be "cured" by representations alone
 - Risk of competing ownership claims by previous shareholders
 - Shareholder resolutions may be void or subject to challenge
 - Shareholder rights (e.g., voting, dividends) may not be enforceable
- ⊗ In practice, missing or incomplete documentation of past share transfers is far more common than actual identified defects in the chain of title

Key Recurring Due Diligence Topics

Chain of Title (3/3)

Potential impact

- ⊗ Red flag in particular for financial investors who will seek to exit the target at a later stage
- ⊗ Buyer might step away from transaction or request alternative transaction structure if comfort on chain of title is insufficient

Typical early warning signs

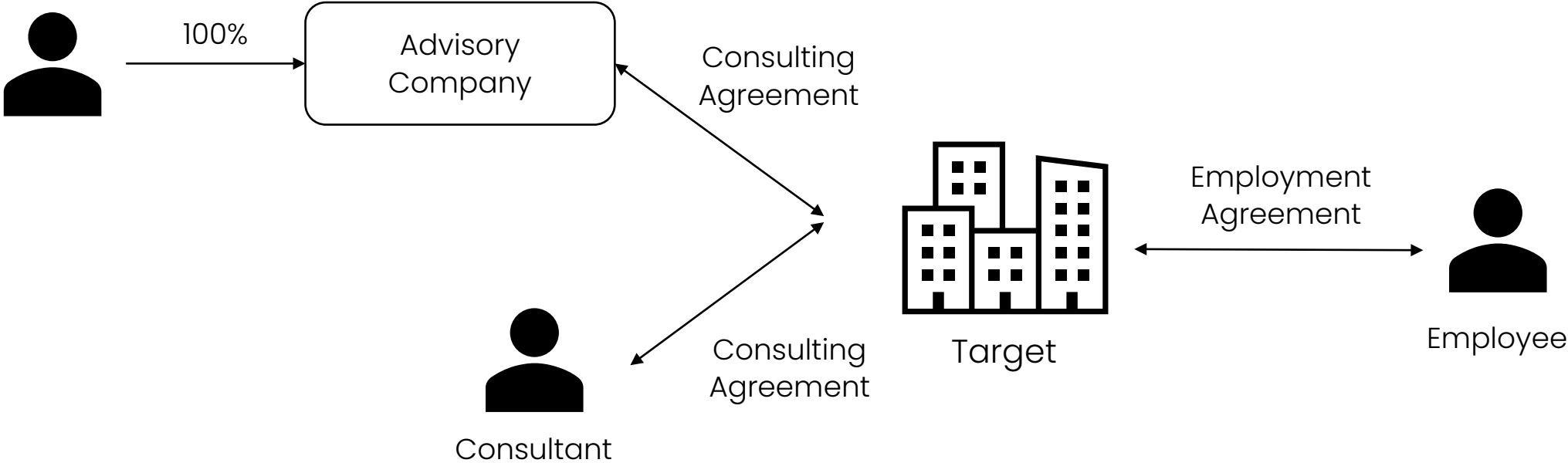
- ⊗ Incorporation of target dates back a long time
- ⊗ Significant number of past share transfers (including succession)
- ⊗ Target was not previously advised by legal counsel
- ⊗ Start-ups with early investment rounds by employees, family & friends

Remediation / protection

- ⊗ Retrace and reconcile share history
- ⊗ Confirmations and assignments from previous shareholders (*Sprungzessionserklärung*) before signing or closing
- ⊗ Ratification by board of previous share transfers
- ⊗ Where share certificates are lost: court cancellation procedure with lengthy process (at least 6 months)
- ⊗ If issues cannot be fully remedied pre-closing:
 - Specific indemnities, potentially with escrow arrangements
 - Alternative deal structure (e.g., asset deal)

Key Recurring Due Diligence Topics

Employees vs. external contractors (1/3)



Key Recurring Due Diligence Topics

Employees vs. external contractors (2/3)

Control and supervision	<ul style="list-style-type: none">• Who decides how, when, and where tasks are performed?• Are they integrated into internal reporting and management structures?
Integration into organization	<ul style="list-style-type: none">• Company email address, business card, org chart inclusion• Participation in staff meetings, internal systems, benefits
Economic dependence	<ul style="list-style-type: none">• What percentage of their income comes from the target?• Multiple clients vs. de facto full-time for target
Risks and tools	<ul style="list-style-type: none">• Who provides tools, equipment, software, premises?• Right to subcontract or assign work?
Term	<ul style="list-style-type: none">• Long-term/unlimited, continuous, full-time• Project-based, limited to shorter periods

Key Recurring Due Diligence Topics

Employees vs. external contractors (3/3)

Potential impact

- ⊗ Contractor deemed to be an employee retroactively
- ⊗ Employer liable for unpaid social security contributions, penalties and interest
- ⊗ Exposure for employment law claims (holiday, overtime, dismissal protection, benefits and bonuses)

Typical early warning signs

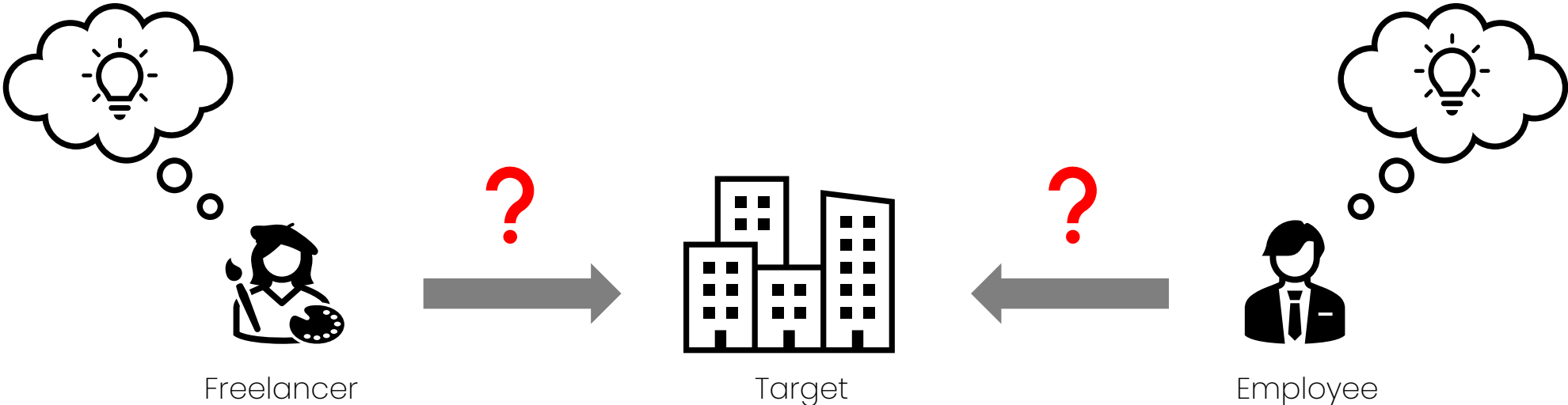
- ⊗ No formal management and no/limited workforce
- ⊗ Management contracts with legal entities
- ⊗ Long-term "contractors" working almost exclusively for the target
- ⊗ Use of company infrastructure (email, IT tools, premises) by "contractors"
- ⊗ Fixed monthly "salary-like" payments without clear deliverables
- ⊗ Exclusivity, non-compete or non-solicitation obligations towards the target

Remediation / protection

- ⊗ Full remediation for the past typically not possible (except back payments for social security)
- ⊗ Specific indemnities and escrow arrangement to protect against liabilities
- ⊗ Exceptionally, price adjustment reflecting quantified exposure
- ⊗ Clean-up arrangements, e.g. formal employment of consultants/contractors

Key Recurring Due Diligence Topics

IP Ownership (1/3)



Key Recurring Due Diligence Topics

IP Ownership (2/3)

IP created by employees

- IP created in the course of employment and within contractual duties (*Diensterfindungen*): belongs to the employer
- IP created outside contractual duties (*Gelegenheitserfindungen*): employer may acquire IP within six months if agreed to in writing; employee is entitled to an adequate remuneration; not typically a concern
- Computer programs: exclusive right of use automatically vests in the employer

IP created by external contractors

- No automatic transfer of IP under Swiss law
- IP remains with the external contributor unless explicitly assigned in writing

Key Recurring Due Diligence Topics

IP Ownership (3/3)

Potential impact

- ⊗ Red flag in particular where IP is a core asset of the target (tech, software, life sciences)
- ⊗ Buyer may not acquire full control of key assets if IP is not owned by the target
- ⊗ Insufficient comfort on IP ownership may lead to price adjustments, additional protections or deal restructuring

Typical early warning signs

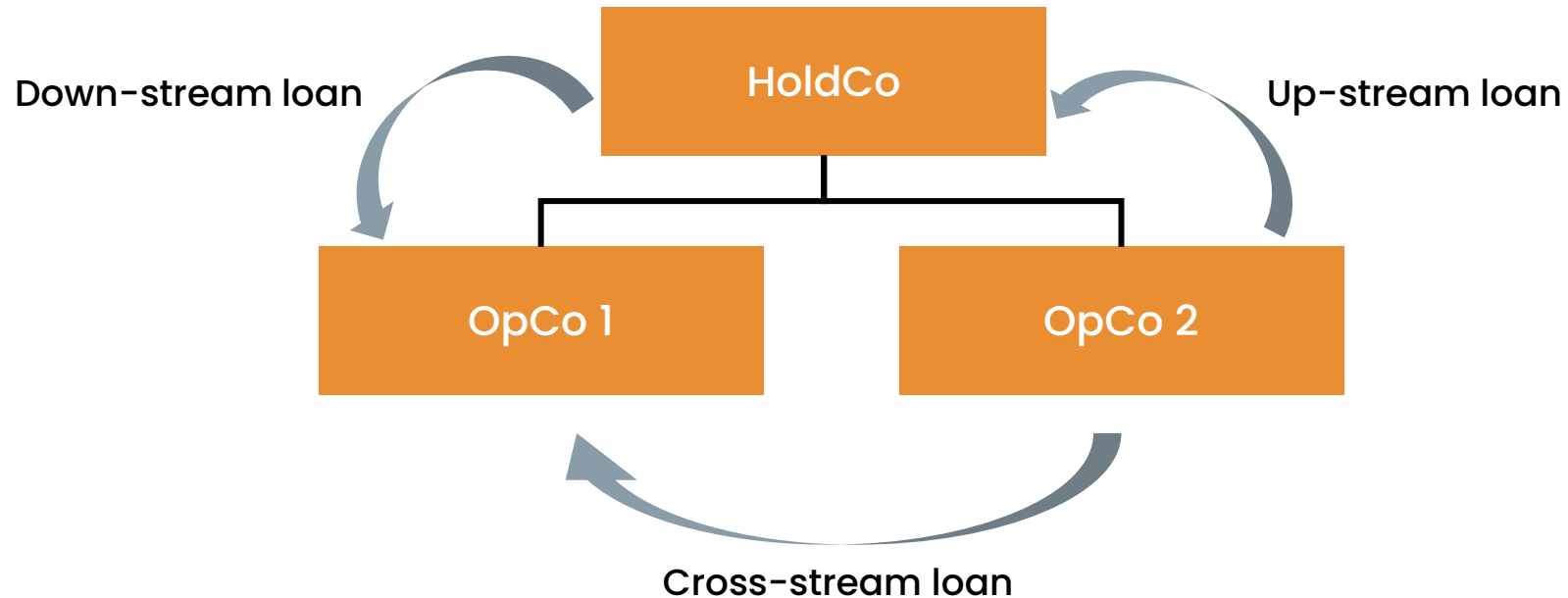
- ⊗ Start-up or scale-up background of the target
- ⊗ Use of freelancers, consultants or external developers
- ⊗ Founder-driven R&D without formal documentation
- ⊗ Outsourced development or software build-up without IP transfer clauses

Remediation / protection

- ⊗ Pre-closing IP clean-up (assignments, confirmations)
- ⊗ Specific representations & warranties
- ⊗ Targeted indemnities or exclusions
- ⊗ Purchase price impact or deal restructuring
- ⊗ (Mere licenses are often insufficient for an M&A exit scenario)

Key Recurring Due Diligence Topics

Up-stream / down-stream / cross-stream loans (1/2)



Key Recurring Due Diligence Topics

Up-stream / down-stream / cross-stream loans (2/2)

Potential impact

- ⊗ Risk of unlawful repayments or distributions (seller risk)
- ⊗ Hidden tax exposure (withholding tax, profit recharacterization)
- ⊗ Impact on cash-free / debt-free mechanics and purchase price

Typical early warning signs

- ⊗ Particular risk in group structures with recurring up-, down- or cross-stream loans or guarantees
- ⊗ Financing structures not revisited for several years
- ⊗ Interest rates below or above tax safe harbors
- ⊗ Securities granted without compensation
- ⊗ Absence of tax rulings in complex intragroup financing structure
- ⊗ Shareholder loans/current accounts from/to shareholders/managers

Remediation / protection

- ⊗ Full remediation for the past typically not possible
- ⊗ Specific indemnities, potentially with escrow arrangements, to protect against liabilities
- ⊗ Adjustment of interest rates to tax safe harbor rates/arm's-length level
- ⊗ Refinancing, waiver or conversion of shareholder loans (e.g. into equity)
- ⊗ Termination of impermissible securities or guarantees

Key Takeaways



Legal due diligence is a decision tool, not an audit

Focus on deal-relevant risks and value drivers rather than technical completeness or theoretical exposure.

Not all issues are deal breakers

Distinguish between no-go risks, price adjustments and issues otherwise manageable that can be addressed contractually or post-closing.

Risk allocation happens outside the data room

Due diligence findings drive deal structure, conditions precedent, covenants, indemnities, liability limitations and W&I insurance.

Ensuring information flow is key

Coordination between due diligence workstreams and key stakeholders and continuous feedback loop into negotiations are critical to reflect findings adequately.

Early red-flag spotting protects deal momentum

Identifying relevant issues early avoids last-minute fixes, stalled negotiations, inadequate risk allocation as well as competitive disadvantages in auction processes.

Questions / Discussion

