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Corporate Finance/M&A - Switzerland

Acquiring Private Companies: Protection against Undisclosed Liabilities

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Introduction

The principal methods of buying a Swiss company are to buy its assets or shares, or to merge the target with the acquirer or with a newly formed subsidiary of the acquirer. Choosing the appropriate legal structure for the acquisition is the starting point of each transaction and will have a major impact on the risks of the acquirer to assume undisclosed liabilities.

Most commonly, acquisitions in Switzerland are effected through share deals. Therefore, this update focuses primarily on the protection of an acquirer against liabilities undisclosed by a seller in a share acquisition of a private target company, which is governed by Swiss law. In addition, it summarizes the different acquisition methods and the respective possibilities to protect an acquirer against undisclosed liabilities.

Acquisition of Shares

Background

Liabilities can reach into all areas of a company. Known liabilities can include bank debts, accrued and unpaid commissions or bonuses, lawsuits pending against the company or unprofitable contracts. Unknown liabilities generally relate to liability for sold products, rendered services or violated laws or regulations (eg, tax, social security, labour law, environmental law, anti-corruption laws, fair trade laws or antitrust laws), which can lead to claims and future lawsuits, or other damages that could result from the company's past activity, which are difficult to anticipate and quantify but may also include (matured and quantifiable) debts which are not reflected or inadequately reflected in the balance sheet, or which are otherwise undiscovered during the due diligence performed by the acquirer.

If the deal is structured as an acquisition of shares, all liabilities - both known and unknown - are effectively (indirectly) assumed by the acquirer, since the acquirer will become the owner of the target entity. As a consequence, the acquirer of the shares will request that the seller bear most of the risks associated with future claims or discoveries which directly or indirectly relate to the period prior to the acquirer's acquisition of the target company. The usual protection against such undisclosed liabilities is that the share purchase agreement provides for representations and warranties of the seller, including a representation that there are no liabilities besides those which have been disclosed in the closing accounts or in the disclosure schedule, if any.

Armed with this representation, in most cases the acquirer has a viable claim against the seller if the target company should be held liable for an undisclosed liability after completion of the transaction. However, the seller will argue that unknown contingencies are risks inherent in operating any business and should be borne by the individual or entity that owns the business at the time they arise. With the lines drawn in this matter, the negotiations begin.

Swiss contract law

Swiss contract law leaves relatively broad contractual flexibility to the parties of a share purchase agreement and contains few mandatory rules. However, the statutory provisions – which in principle favour the seller – are applicable to the extent they are not otherwise agreed or altered by the parties. In particular,

in case of a share purchase agreement, the statutory remedies under Swiss law provide only limited protection to the acquirer against misrepresentation, breach of warranty or non-performance. According to the practice of the Federal Supreme Court regarding share purchase agreements, statutory implied warranties relate to the title of shares in the target company and defects in its share certificates only, but not to the assets or liabilities, or the underlying business itself.

Therefore, when drafting and negotiating a share purchase agreement, the main focus from an acquirer's perspective – apart from determining the purchase price or purchase price formula – is to provide for precise and comprehensive representations and warranties relating to the assets, liabilities and business of the target company, which are essential in order to protect the acquirer against liabilities undisclosed by the seller. If the seller does not accept such representations and warranties, the acquirer will usually consider a (substantial) reduction of the purchase price.

The purchaser should insist on specific representations and warranties regarding the acquired business as well as its assets and liabilities (including contingent or other liabilities). However, the seller will try to limit its liability (as far as is permitted under Swiss law) either by limiting the scope of the representations or even by excluding certain representations and warranties. Further limitations typically derive from:

- references made in the purchase agreement to the due diligence conducted by the acquirer or those documents that were made available for review to the acquirer;
- any disclosure schedule(s) attached to the purchase agreement;
- deductibles, thresholds, *de minimis* clauses or caps provided for in the purchase agreement;
- the duration of the representations and warranties; and
- the procedures to resolve any alleged breach of representations and warranties.

To protect the acquirer, these points need to be carefully addressed and precisely defined.

From an acquirer's point of view and with a particular emphasis on undisclosed liabilities, negotiations should focus on the following issues.

Representations and warranties of seller

Under a typical 'no undisclosed liabilities' clause, the seller represents and warrants that the target company has no liabilities or obligations of any nature (whether known or unknown and whether absolute or contingent, accrued, disputed or undisputed, liquidated, secured or unsecured, joint or several, determined or determinable), except for liabilities or obligations reflected or provided for in the balance sheet or otherwise explicitly disclosed to the acquirer – to the extent the parties agree on a discloser concept – in the disclosure letter or in the due diligence. This warranty is supposed to assure the acquirer that it has been informed of all (potential) liabilities of the target company.

The seller usually seeks to add a knowledge qualification to this representation, arguing that it cannot be expected to identify every conceivable contingent liability to which the target company may be subject. As in most cases the seller is familiar with the past and current operations of the target company, the acquirer will typically resist such qualification, arguing that the risk is more appropriately borne by the seller. However, if the acquirer agrees to a knowledge qualification, the next issue will be whose knowledge is relevant. From an acquirer's point of view, the relevant group of people should be as broad as possible and ensure that the people who are the most knowledgeable about any specific part of the business to be acquired are included, and thus the representation has a significant reach.

Often the seller insists on narrowing the scope of this representation by limiting the types of liability which must be disclosed. For this purpose the seller usually requests that the representation extends only to liabilities of the type required to be reflected as liabilities on a balance sheet prepared in accordance with applicable accounting standards (eg, International Financial Reporting Standards (IFRS) or Swiss generally accepted accounting principles (GAAP)). From an acquirer's point of view it can be argued that the standard for disclosing liabilities on a balance sheet under IFRS or Swiss GAAP is relatively strict and the acquirer needs to assess the potential impact of all types of liability, regardless of whether such liabilities are sufficiently definite to merit disclosure in the financial statement of the target company according to the rules of a specific reporting standard.

If the acquirer seeks even broader protection against undisclosed contingencies, the acquirer should consider proposing a definition of the term 'liability' that not only expressly includes contingent liabilities, but also unmatured, unaccrued, unliquidated, unasserted, conditional or potential liabilities.

With regard to other representations or indemnifications, unlike under US law, no clear case law exists under Swiss law to define whether a Swiss court would consider, for example, a company's defective product as a contingent liability of the company, unless the defective product has actually caused damage

or a claim or lawsuit is at least threatened. Therefore, the acquirer should include further provisions in the share purchase agreement relating to specific categories of contingent liability in order to protect the acquirer against various contingencies which technically may not constitute contingent liabilities as of the date of signing or completion of the transaction.

In particular, the acquirer should insist that the purchase agreement contain representations and warranties that:

- the target company is in compliance with the applicable law;
- the financial statements reflect the financial conditions and the results of operations, shareholder equity and cash flow of the target company, and all accounts and books are properly kept, accurate and complete in all respects; and
- no representation or warranty made in the share purchase agreement contains untrue statements of material facts or fails to state a material fact necessary to make such representation or warranty not misleading.

Where a risk is already identified before signing the share purchase agreement, the acquirer has different options to protect its interests, including:

- expanding the scope of the seller's obligations by asking for specific indemnification against future liabilities which may arise after the closing date from such (identified) circumstances already existing before the closing date. Often a well-advised acquirer will insist on an indemnity from the seller against any tax claims, social security claims, product liability claims or environmental claims relating directly or indirectly to the period before closing;
- reducing the purchase price or deferring the payment of a portion of the purchase price; and
- requesting security, such as payment of a portion of the purchase price to an escrow agent or a bank guarantee.

Procedures for resolving breaches of representation and warranties

The remedies under Swiss law for a breach of representations and warranties are derived from general principles of contract law and the law relating to the sale of tangible goods. These principles do not usually provide an adequate solution in the context of a share purchase agreement and, as a consequence, the acquirer – as well as the seller – will seek to vary the statutory provisions by negotiating specific contractual terms regarding the procedures to be used for the settlement of alleged breaches of representations and warranties.

If a breach of warranty is discovered the acquirer, after having complied with the notice procedure provided in the share purchase agreement, may seek a reduction of the purchase price. Swiss courts apply the relative method to determine the appropriate reduction. This method allows for a reduction of the purchase price in proportion to the ratio of the fair value of the goods or shares without the defect to the actual agreed purchase price, and the fair value of the goods or shares considering the defect. In practice, it is difficult to determine the fair value. Therefore, the acquirer will instead seek to include indemnities (ie, stating in the share purchase agreement that the seller will have to hold the acquirer harmless against a specific loss or damage in relation to certain matters, or requesting that the target company be put in the position as it would have been if there had been no defect). In both cases it is not necessary to determine the fair value of the shares as the seller will simply have to discharge its payment obligation and may not argue that the acquirer would have purchased the shares for the same consideration even it had known of the breach when signing the agreement.

According to statutory Swiss law, the acquirer is entitled to rescind the agreement under certain circumstances, in particular if representations and warranties prove to be false in a material way and if such right has not previously been waived or excluded. Often the parties will exclude this right since rescission does not normally provide an acceptable solution for warranty problems for either the acquirer or the seller. However, from an acquirer's point of view, and particularly with respect to undisclosed liabilities, it may be an advantage to insist on the right to rescind the agreement if a material breach of warranties is discovered. Even if the acquirer later decides not to rescind, the fact that it has the right to do so might provide additional bargaining power when settling the warranty claims.

Swiss statutory law provides only for damages under certain circumstances - for example, if the acquirer suffers damages as a result of a breach of warranty which is not covered by either an indemnity or a reduction of the purchase price. Therefore, in most cases this statutory regime is replaced by a tailor-made remedy system agreed upon by the parties, which usually provides for damages as the exclusive remedy, and thus excludes rescission of the agreement and reduction of the purchase price as alternative remedies.

It is standard practice in Switzerland that the seller will seek to limit its liabilities by asking for a maximum

liability amount to be stated in the purchase agreement and that the parties agree on certain minimum thresholds which need to be reached or exceeded before a claim can be brought against the seller. Usually the parties agree (i) a *de minimis* threshold which provides that a claim may not be pursued or considered unless it exceeds a certain threshold amount, and (ii) a general or cumulative threshold which provides that no claims may be made unless the aggregate of all claims exceeds a certain threshold amount. While the seller will try to negotiate a deductible (ie, that its liability shall arise only to the extent that the general threshold is exceeded), the acquirer will want to ensure that the full amount can be recovered (ie, the general threshold is a mere threshold and not a deductible).

In this context, the acquirer must take into consideration that according to Article 200 of the Code of Obligations, the seller is not liable for any defects of the purchased goods or business of which the purchaser had knowledge at the date of signing. Further, the second sub-paragraph of this article provides that for defects of which the acquirer, using normal diligence, should have known, the seller is liable only if it has assured the acquirer of their non-existence. This is particularly relevant if a due diligence review has been carried out prior to signing the agreement or completing the transaction. From an acquirer's point of view, it is essential that Article 200 is explicitly waived in the share purchase agreement.

Statutory Swiss law sets forth that every acquirer has a duty to examine the purchased object as soon as reasonably possible and to notify the seller immediately of any defects. Should the acquirer fail to comply with this notification requirement, the sold item is deemed to have been accepted, except where there are defects which could not have been discovered in the course of a diligent examination. To the extent that hidden defects are uncovered later, immediate notice must be given; otherwise the hidden defects are deemed to have been accepted.

From an acquirer's point of view it is important to waive such duty to examine the business and to notify the seller immediately. The acquirer should try to negotiate that it is allowed to notify the seller of any breach discovered at any time up to the lapse of the contractual limitation period.

Since the Swiss statute of limitations for warranty claims is very short (one year from the date of completion), the acquirer would be well advised to insist on extending such time limit. Usually the parties extend this limitation period to 18, 24 or even 36 months and - importantly from an acquirer's point of view - often agree to longer warranty periods for claims involving tax, social security and environmental matters.

From an acquirer's point of view, the purchase agreement should also contain language to the effect that any claim made prior to the expiration of the applicable survival period shall continue to survive until it has been finally decided, settled or adjudicated. This is designed to ensure that incipient claims or claims which have not been fully liquidated prior to the end of the survival period are nonetheless preserved pending their ultimate disposition.

Pricing

The share purchase agreement usually provides for the acquirer's obligation to pay the purchase price on completion to the seller, or possibly in part into an escrow account which, with respect to the potential risk of undisclosed liabilities, would favour the acquirer, securing its right to request a reduction of the purchase price.

An alternative to providing additional protection for the acquirer against undisclosed liabilities and to setting the purchase price in relation to the actual performance and development of the acquired business is to determine the consideration by reference to the results of the target for a certain period after completion (earn-out formula). From the acquirer's point of view, an earn-out formula can work to its advantage as it ties the consideration to be paid to the performance of the business and, with respect to undisclosed liabilities, offers the possibility to offset any losses or damages against future earn-out payments to the seller. Apart from securing the mere payment of a warranty claim once such claim has been successfully asserted, an earn-out scheme can give additional protection against undisclosed liabilities if it is 'bottom-line oriented' as opposed to 'top-line oriented' (ie, turnover related). To the extent that the acquirer cannot successfully argue that a certain liability that came into play after completion of the transaction should have been included in the accounts of the target company prior to completion or should otherwise have been disclosed in the purchase agreement or its schedules, such newly arisen liability will probably be accounted for in a 'bottom-line oriented' earn-out scheme, since such liability will most likely have a negative effect on the profits of the target company in the relevant period.

Other Transaction Structures

Traditional asset acquisition

In an acquisition of assets the acquirer purchases all or substantially all of the assets of a company or of a division or segment of a company, and generally assumes only those liabilities which it specifically agrees

to assume. In principle, this is the most effective way for an acquirer to be protected against liabilities, as all liabilities that are not specifically assumed (including undisclosed liabilities) remain with the selling entity.

However, traditional asset deals are complicated under Swiss law. Asset deals governed by the Code of Obligations require that the title to each asset be transferred individually, pursuant to the specific requirements applicable to each type of asset, as follows:

- a written deed of assignment for claims and patent rights;
- delivery for tangible property; and
- a notarized deed for real property.

Contracts and governmental authorizations may be transferred only with the consent of the contractual counterparty – whether they have an explicit change of control clause or not – or the competent governmental authority, with the exception of: (i) employment contracts, which in case of transfer of an entire business or part thereof are transferred by operation of law (unless such transfer is declined by the employee); and (ii) under certain circumstances, insurance and lease contracts.

Where an operating business is sold through a simple partnership or sole proprietorship which is not registered in the Commercial Register, the assets will still need to be transferred separately; however, all the liabilities connected to such business may be transferred automatically without the need for creditor consent. Further, the seller remains liable to creditors for a period of three years from the closing date of the transaction. As this mechanism is in the interest of neither the acquirer nor the seller, the parties will usually try to exclude these statutory provisions of the Code of Obligations in the purchase agreement. However, there is no clear court precedent as to whether such exclusion would be considered valid.

Asset transfer under the Merger Act

Compared to the traditional asset acquisition described above, the Merger Act simplifies the transfer of assets and liabilities insofar as the transfer is effected by operation of law – that is, without the need to comply with the specific transfer requirements for individual types of asset and claim.

The assets and liabilities to be transferred must be listed in a reasonably detailed inventory and the transfer needs to be filed with the Commercial Register in order to become effective. Assets and liabilities which are not listed in the inventory remain with the seller. Thus, in principle, the acquirer obtains full protection against undisclosed liabilities.

Even though this new transfer method seems advantageous from the acquirer's point of view, asset transfers are rare as:

- the transaction, the acquisition agreement and therefore the purchase price and other sensitive data will be publicly available;
- creditors are protected by rules providing for joint liability of the seller and the acquirer (ie, the seller remains liable to creditors for a period of three years after the asset transfer becomes effective for liabilities that originate before the date of the transfer) and the right to request security under certain circumstances; and
- there is no case law on whether agreements and governmental authorizations may be transferred without the consent of the contractual counterparty or the competent governmental authority.

A feasible and possibly attractive alternative to an asset transfer under the Merger Act would be a combination of an asset transfer and a subsequent share sale. First the seller would transfer the assets at book value (or at such other value as the parties agree) to a newly established entity and then the shares of the newly established company would be sold to the acquirer.

Merger/consolidation

The surviving entity (in case of absorption) or the new entity (in case of consolidation) acquires all rights, properties and liabilities of the constituent (non-surviving) entity. In particular, all (even undisclosed) liabilities will transfer by operation of law to the surviving or combined new entity – no exclusions are possible or enforceable. Once a merger or consolidation takes effect, the non-surviving entity ceases to exist legally and the former shareholders receive shares in the new or surviving entity based on the exchange ratio determined in the merger agreement.

Undisclosed liabilities may have an impact on the underlying valuation of the involved companies and the exchange ratio. Although it is unusual under Swiss law, it is possible to include in the merger agreement representations and warranties to protect the acquirer against such undisclosed liabilities, which in case of breach entitles the acquirer or its shareholders to receive additional shares or damages from the shareholders of the other company.

Comment

The protection of an acquirer in case of an acquisition of a private target company mainly depends on the form and structure of the acquisition. Traditional asset deals and asset transfers under the Merger Act are the most effective ways to protect an acquirer against liabilities, as all liabilities which are not specifically assumed by the acquirer remain with the seller. However, a merger structure affords the acquirer only to obtain limited protection against liabilities undisclosed by a seller or target company.

In case of a share deal, the protection of the acquirer against undisclosed liabilities depends on:

- the precise and comprehensive drafting of the representations, warranties and indemnities;
- the limitations and the settlement procedure agreed on by the parties;
- the pricing and payment mechanism; and
- the bargaining power of the parties involved.

From the acquirer's perspective, the combination of an asset transfer under the Merger Act and a share sale should be considered, since the advantages of both structures can be combined.

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