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Arbitration of disputes in international M&A transactions governed by Swiss law

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In practice, arbitration has become the preferred method for resolving disputes arising from international merger and acquisition (M&A) transactions that are governed by Swiss law. The reasons for this are, among other things, that international M&As have become increasingly complex and professionalised business transactions that typically involve numerous corporate entities and lengthy, multifaceted agreements.

Disputes in M&A transactions

Disputes in M&A transactions governed by Swiss law can arise out of the main agreements (eg, share purchase agreements) or the ancillary agreements (eg, exclusivity and confidentiality agreements, letters of intent, memoranda of understanding or shareholders' agreements). They generally fall into three disputes categories:

- pre-signing;
- pre-closing; or
- post-closing.

In practice, post-closing disputes are the most frequent. The typical grounds for M&A disputes are set out below.

Price adjustment (including earn-out)

Price adjustments and earn-out disputes arise frequently after transactions are closed. As most purchase price adjustment mechanisms are based on financial statement items (such as working capital, net worth, net financial debt or, in some cases, net assets), one of the parties – usually the purchaser – must prepare the initial closing accounts and the resulting post-closing purchase price adjustment calculation. Even though the agreement usually provides some guidance on how to determine the relevant figures and the balance sheet items included therein[(1)] by referring to generally accepted accounting principles (GAAP) in Switzerland or an international accounting standard accepted in Switzerland (such as International Financial Reporting Standards), in each case, as consistently applied by the target over a certain period in the past or in a particular business year, many questions often remain open for interpretation. Ultimately, this leads to disagreements and, later on, disputes.

In most cases, the purchase agreement provides that an independent expert determines the earn-out amount or adjustment and that such determination by the independent expert can, if one or both of the parties do not accept it, be challenged in front of an arbitral tribunal in Switzerland or abroad.

In the context of determining an earn-out payment, important sources of disputes are if:

- actual key performance indicators (KPIs) of the target ultimately deviate from projected numbers of KPIs;
- the purchaser changes the accounting policies or alters the operations of the business after the purchase, causing a significant impact on the potential earn-out amount; or
- contractual provisions are simply interpreted differently.

Misrepresentations and breach of warranty

In particular, due to vaguely, ambiguously or incompletely drafted representations and warranties, disputes regarding representations and warranties are very common. In most purchase agreements in Switzerland, the default remedies provided by statutory law are replaced (to the extent permitted by law) by contractual remedies (ie, in most cases, in connection with the amount of the damages directly resulting from the breach of warranties by the seller).

The purchaser will typically claim that the seller is in breach of the agreement, while the seller will most likely reject such claims arguing that:

- the claims of the purchaser are not covered by the contractual representations and warranties;
- the amount of the claims does not reach the de minimis threshold or that the aggregate amount of claims falls short of the agreed upon basket;
- there is alternative coverage of the damage (eg, by claims against a third party or an insurance); or
- the purchaser was made aware or gained knowledge of a specific fact during the due diligence process.

Fundamental error, pre-contractual failure to disclose or fraud

Closely interrelated to claims for misrepresentations and breach of warranties, the purchaser may also claim the rescission and unwinding of the purchase agreement or a reduction of the purchase price based on fundamental error, pre-contractual failure to disclose or fraud. In case of deliberate deception (including failure to disclose), the following is invalid and unenforceable according to Swiss law:

- contractual waivers;
- limitations on remedies; and
- limitations regarding the amounts of claims (eg, de minimis, basket or caps).

However, if the purchaser knew about the defects at the time of purchase or should have known based on an objective standard, the seller is not liable, pursuant to article 200 of the Code of Obligations. In such a case, the seller is liable only if they undertook to indemnify and hold the purchaser harmless for a particular matter or risk. In this context, it is useful to note that as a general rule in Switzerland, the parties provide in the purchase agreement that all information provided by the seller in the data room is considered to be disclosed to the extent that an experienced purchaser would be able to determine the relevant risk or matter based on a market standard due diligence review of the documents provided by the seller.

Failure to complete a transaction

In a few cases, the transaction is not completed because, for example, the purchaser claims that a material adverse change has occurred or that another condition precedent to closing has not been fulfilled. If the seller defaults in preforming its contractual obligations, such as taking the required actions to fulfil the condition precedents to closing, they – as a rule pursuant to article 103 of the Code of Obligations – become liable for the damage resulting from the delay. To the extent not otherwise set out in the purchase agreement, the seller then has two options pursuant to articles 107-109 of the Code of Obligations. It can either adhere to the purchase agreement and demand specific performance or damages (positive interest) or rescind the purchase agreement and demand damages (negative interest).

Advantages of arbitration

Compared to litigation, arbitration has major advantages for resolving international M&A disputes:

- confidentiality – arbitration proceedings are, in contrast to most court proceedings in Switzerland, confidential. This is a majorly desired trait when resolving M&A transaction disputes;
- expertise – the parties can choose their own arbitrator(s) with the required expertise and thereby ensure that the necessary knowledge to resolve international M&A disputes exists. This is an important advantage, as judges of lower courts in Switzerland often do not have the expertise and practical experience to fully understand the peculiarities of complex M&A agreements and processes;
- neutrality – in international disputes, as such international M&A disputes, arbitral tribunals are regarded as more neutral than domestic courts;
- flexibility – the parties can independently organise the proceedings, allowing the setting of shorter time frames, the language of the proceedings and the applicable law. In particular, the possibility to choose English as the language of the proceedings is an advantage for foreign parties to international M&A transaction disputes, compared to litigation in Switzerland; and
- enforcement – based on the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, arbitral awards can not only be easily enforced in Switzerland, but also in 167 other states. This is an advantage when parties from multiple countries are involved, as is often the case in international M&A transactions.

As time is an important factor in many international M&A disputes, particularly if completion of the transaction hinges on resolving the disagreement, the existence of fast-track or expedited arbitrations that offer shorter time limits for each procedural step are a further significant advantage of arbitration, compared to standard Swiss litigation.

Arbitration clauses in M&A agreements

In international M&A and ancillary agreements governed by Swiss law, the parties must consider the below options to stipulate their arbitration clauses.

Mediation or conciliation

The parties may decide for mediation or conciliation prior to arbitration. However, if they do so, it is important that the arbitration clause clearly states whether the mediation or conciliation is mandatory, and that it defines the related time limits and procedure.

Consolidation

If an M&A transaction involves several agreements, the parties should make sure that the included arbitration clauses are identical and refer to arbitration rules, such as the Swiss Rules of International Arbitration, which allow the consolidation of connected arbitrations in order to avoid multiple arbitrations before different arbitral tribunals.

Arbitration institution

Instead of conducting an ad hoc arbitration, the choice of a renowned arbitration institution, such as the Swiss Arbitration Centre, has proven to work well. One of the advantages of institutional arbitration are the pre-established rules and procedures, which ensure that the arbitration proceedings begin in a timely manner.

Fast-track and emergency arbitration

If the parties to the M&A opt for an arbitration institution, they may further decide for an accelerated proceeding by simplifying the procedure and shortening the deadlines for submissions. A fast-track arbitration is particularly advantageous if a fast decision (eg, whether a material adverse change has occurred that gives the purchaser the right to walk away from the transaction) has to be made. Further, many arbitration institutions, including the Swiss Arbitration Centre, have implemented emergency arbitration mechanisms in their arbitration rules on an opt-out basis. If parties must deal with provisional measures because they cannot wait until the final award, these mechanisms allow the appointment of an emergency arbitrator.

Comment

Due to the high probability of disputes in connection with M&A agreements and the obvious advantages of arbitration in solving such disputes, tailor-made arbitration clauses that ensure an efficient dispute resolution are crucial elements of every international M&A agreement that is governed by Swiss law.

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Endnotes

(1) For example, if the amount of working capital is the key figure, the target's current assets cash, inventory and accounts receivable and its current liabilities such as ordinary course payables and other short-term obligations payable within one year.