ASA Conference

Quantifying Claims in Post-M&A Disputes

Assessment of damages for breach of representations and warranties and under specific indemnities – the law, the contracts, and the problems

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1. The Law (1): Statutory Remedies
Price Reduction

- Under Swiss law, a buyer's statutory primary remedies for breach of R&W are **rescission** and **price reduction** (not damages)
  - In M&A transactions, rescission is impracticable and typically excluded
  - Price reduction as remedy raises similar issues as damages
- Reduction of price in proportion to diminution in value caused by breach:
  - In theory, this requires the determination of an "objective value" of the acquired business …
  - … but in practice, courts tend to accept the price agreed between unrelated parties as fair value
  - Costs of cure = diminution in value?

1. The Law (2): Statutory Remedies
Damages

- Damages for breach of R&W are in principle **compensatory damages**:
  - Expectation interest ("benefit of the bargain")
  - Amount required to put buyer in a state as if there had been no breach
- Concept of "adeqaute causation":
  - Compensation only for loss of a kind which is "*in the ordinary course of events and following general experience likely to result*" from the breach
  - Not strictly a foreseeability test, but similar

1. The Law (3): Statutory Remedies
Avoidance for Fundamental Error

- Often an alternative to claims for breach of R&W
- Buyer may raise a claim to (fully or partially) set-aside the agreement for fundamental error
- "Partial rescission" (*Teilanfechtung*) leads to reduction of price to a level that the parties, "*acting reasonably and in good faith, would have agreed on had the matter been disclosed*" (so-called "hypothetical intent")
- In theory, this is different to the remedy of price reduction, but in practice, it leads to a similar result, yet with different procedural requirements
  - In particular, the applicable time limit (one year) only starts at the time of discovery of the fundamental error (not at closing)

2. The Contracts: Practice of M&A Agreements (1)
Damages as Sole Remedy for Breach of R&W

- In M&A agreements, damages is frequently the agreed **sole remedy** for breach of R&W
- The term "**indemnification for breach of R&W**" is in Swiss practice probably in most cases used to simply mean compensation for damage (without implying a broader concept of covered losses)
- "**Specific indemnities**" are conceptually different to R&W and tend to be tailor-made to identified risks (e.g. tax, environmental, certain litigation)
  - Often for third party claims, but not limited
  - Disclosure and knowledge are not relevant and certain exclusions or reduction reasons may be held not applicable
  - Proof for indemnified party may be easier, but this depends on terms of indemnity

2. The Contracts: Practice of M&A Agreements (2)
"Damage" Definitions and "Excluded Losses Provisions"

- Damage is difference (actual vs. hypothetical) in assets and liabilities; may consist in sustained loss and/or failed gain
- Parties attempt to define which losses must be compensated and/or how such losses (or the compensation therefor) must (or must not) be determined
- But remarkably often, SPAs contain no or only quite general rules
- Some exclusions are often in principle not controversial:
  - Alternative recovery, in particular from an insurer
  - Other compensation via an agreed price adjustment
  - Offset with benefits resulting from the breach, in particular reduced taxes
  - Provisions in the financial statements
  - Failure to mitigate and changes caused by Buyer after closing
- Essence of such exclusions and limitations is similar as under the law

2. The Contracts: Practice of M&A Agreements (3)
"Damage" Definitions and "Excluded Losses Provisions"

- The ubiquitous exclusion of "**consequential damage**"
  - The unfortunate article 208 paras. 2 and 3 CO
  - What does "consequential" really mean?
  - Does it mean to exclude:
    - only losses suffered by the buyer *in other respects than the acquired business* (e.g. a failure to realize synergies and the like) or also
    - certain losses occurred *within the acquired business* (or: target company)?
- Exclusion of **loss of profits**:
  - Are they always "consequential damage"?
  - What lost profits are excluded? – Only profits from new arrangements by the buyer or also profits of the acquired business that were thought to be part of the business going forward?
  - Note: The stakes for proving loss of profits are high in any event

2. The Contracts: Practice of M&A Agreements (4)
"Damage" Definitions and "Excluded Losses Provisions"

- Exclusion of "**diminution in value**"
  - Seeks to exclude the difference in value of the business as warranted versus its value as a result of a breach of R&W
  - Under the law, a reduced value of the object purchased would certainly fall under the definition of damage …
  - … but if the costs to remedy the breach are lower than a diminution in value (however determined), it seems appropriate to limit damages to such costs (and court practice seems to follow this approach)
- Exclusion of assessment by way of **multiples, DCF method** etc.
  - Sellers seek to limit exposure and protect against hefty surprises
  - Has become quite frequent (but courts have done nothing to stir up fear)
- What is the permissible limit of all this? Certainly fraud and intentional non-disclosure (CO 199)

3. Some of the Problems (1): *Estimation of Damage and Future Losses*

- Estimation of Damage:
  - In principle, damage (loss) must be proven by the plaintiff
  - Art. 42(2) CO: If the nature of the loss makes strict proof of the quantum impossible, the court has discretion to estimate the quantum
  - But stakes on proof remain high

- Future Losses:
  - To be subject to compensation, future loss must be **foreseeable** (and the difference to "hypothetical" is sometimes difficult)
  - Damages for future loss are assessed at the present value

3. Some of the Problems (2): *Substance and Earnings – The Substance Approach*

- Damages measured by **costs and shortfall of the target's net assets**
  - "Filling up the balance sheet" as compensation?
  - Some R&W (and some breaches) are more suitable to this approach than others, e.g. undiscovered liabilities, net equity warranties(?), overvalued inventory, missing assets and most breaches that are capable of cure
  - Tendency of court practice, in particular in case of undisclosed liabilities, see e.g. 4A_42/2009 (over-indebtedness), 4A_195/2008 (no damage in case of undisclosed liabilities backed by corresponding assets), BGE 107 II 419 (obsolete inventory), 81 II 213 (undiscovered mortgage debt)
  - Asset-based approach is perhaps the default rule if the buyer cannot show another valuation to be appropriate
  - Additional arguments: Customary contractual price adjustments (NWC, Net Debt, Net Equity) are asset-based and would lead to similar result; non-operative or easily replaceable assets

3. Some of the Problems (3): *Substance and Earnings – Earnings-Based Valuations*

- Courts are more reluctant, but do apply earnings-based valuations to assess damages
  - In particular for misrepresentations as to past earnings or earnings-related factors and factors relevant for or indicative of the ongoing earnings capacity, e.g. turnover or lease income (BGE 88 II 410)
- Earnings-based damages based on **presumed basis of the SPA**:
  - BGer, 4C.33/2004: Price of 660; seller warranted that accounts payable do not exceed 98 and that net equity is at least 281. After Closing, additional accounts payable of 62 are revealed. Buyer sued.
  - Court finds that price was agreed "based on net assets and earnings valuation"
  - Court holds: Reduction in the same proportion to the purchase price (660) as the additional payables (62) to the warranted net equity (281): 62/281=0.22 which leads to a reduction of 145 (0.22*660). Convinced?
  - Attempt to reach what the parties would, acting reasonably, have agreed

3. Some of the Problems (4): *Multiples and DCF*

- Courts seem to be sceptic, but perhaps no "right case" yet
- No higher state court case known in which assessment of damages was expressly based on a DCF valuation
- Arbitration practice may be somewhat more generous – but lack of visibility
- Frequent reservation: "speculative" nature of future cash flows (not only in damage claims from M&A), alleged tendency to "overcompensate"
- Valuation by multiples: In another context, courts have held a valuation solely based on multiples to be appropriate only for plausibility checks
- Combination of methods

Questions / Discussion

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