Practice Guides

SWISS M&A

Third Edition

Contributing Editors
Ueli Studer, Kelsang Tsün and Joanna Long

LEXOLOGY
Getting the Deal Through

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Practice Guide

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Warranties, Indemnities and Insurance in Private M&A

Christoph Vonlanthen and Oliver Triebold[1]

In private M&A, buyers commonly have available post-closing or indemnification recourse against sellers. This recourse typically rests on a general and specific indemnities. These provisions operate as an adjustment to the equity value or the purchase price. They are intended to ensure that within agreed-upon parameters, the buyer receives the benefit of its bargain. Increasingly as well, M&A deals are insured. In this chapter, we discuss key considerations applicable to the buyer's post-closing recourse.

Default regime

Sophisticated parties typically agree to disapply the statutory default regime governing contracts of sale (ie, articles 197 et seq of the Swiss Code of Obligations (CO)) and instead delineate the buyer's post-closing recourse in the sale and purchase agreement (SPA) subject only to any mandatory fraud-related remedy. The reason for this is that the default regime is ill-suited to the acquisition or disposition of a business. For example:

- the Swiss Supreme Court takes the view that the default regime applies to defects affecting the shares (in a share deal) or the individual assets and liabilities (in an asset deal), but not the business;
- the default regime imposes a duty to inspect and give prompt notice (CO 201) that is ill-fitted to the purchase of a whole business comprising a collection of assets, liabilities, and contracts where breaches may only emerge over time; and
- the warranty periods under the default regime (CO 210) can simply be too short for certain breaches (eg, for liabilities arising in connection with a tax audit covering pre-closing tax periods).

Accordingly, the SPA will typically contain an extensive catalogue of warranties on the key attributes of the business, lay out the terms of the buyer's indemnification and include detailed procedural provisions, such as on the conduct of third-party claims.

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Contractual warranties

There is no distinction under Swiss law and practice between representations and warranties. In this chapter, we will therefore refer to them as warranties only. Warranties are statements of fact given as of a particular date (usually as of signing, closing or a certain reporting date). They are made about the contracting parties, the shares in a share deal, the assets in an asset deal and the business.

The warranty package serves four essential purposes:

- it is the basis for indemnification or insurance;
- it is a key component of the buy-side due diligence;
- its accuracy (to a material adverse change standard) can sometimes be elevated to a condition to closing; and
- it is the basis for a fraud claim to rescind the SPA or collect damages.

Scope

The scope of the warranties in the Swiss market broadly aligns with international practice. Warranties will consist of fundamental warranties (eg, title to the shares or assets, capacity, and the absence of regulatory or third-party consent requirements) and business or general warranties (chiefly on the financial statements, undisclosed liabilities, no material adverse changes, taxes, social security and pensions, permits, compliance, material agreements, employees, intellectual property, real and personal property, insurance, litigation, environment and finder's fees, as well as industry-specific matters).

Depending on whether the SPA is structured to shift the business risks to the buyer at signing (eg, in a locked-box deal) or at closing (eg, in a closing adjustment deal), warranties will tend to be given either at signing only or both at signing and closing. Leverage and negotiations among the parties can, however, result in many permutations of these basic models.

A fairly recent trend is for sellers to seek to ring-fence the scope of warranties. For example, the seller may seek to provide that the environmental warranty addresses environmental risks comprehensively, precluding the buyer from having a second bite at the apple by relying on other warranties.

In a cash deal, the buyer will typically solely give fundamental warranties coupled with, in leveraged acquisitions, warranties on its debt financing. In a share-for-share deal, the buyer will give co-extensive warranties.

Qualifications and limitations

The warranties are qualified by disclosure made by the seller (rather than the target). In practice, the entire data room is commonly disclosed against the warranties. This arguably seller-friendly arrangement borrows from the UK tradition, which is tempered by the concept of fair disclosure grounded in case law. The Swiss practice has co-opted that concept, and typically defines fair disclosure in the SPA. Fair disclosure generally means the disclosure of a fact, matter or circumstance in a manner that allows, or would reasonably be expected to allow, the buyer and its advisors to reasonably identify and assess the relevant fact, matter or circumstance. In other words, the relevant facts cannot be buried in the data room.

The seller also will often negotiate to provide that business warranties are not breached unless the breach is material or would cause a material adverse effect (MAE). By contrast, fundamental warranties typically will be given 'clean' or to a lower level of materiality than MAE

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(or the definition of MAE will be modified to refer to a seller MAE based on the ability of the seller to consummate the transaction).

The seller will also typically seek to qualify the scope of specified warranties, especially those having a forward-looking nature, by reference to its own knowledge. The SPA typically lists the persons whose knowledge will be deemed to constitute knowledge of the seller for such purposes and what types of inquiries they must conduct.

Indemnification

Recoverable damage

There is often a fair amount of negotiation among the parties to tailor the concept of damage to the specifics of the transaction. That concept is key as it underpins the buyer's indemnification claims. Leverage, parties involved and deal atmospherics often play a significant role.

As a general matter, under Swiss law recoverable damage includes an increase in liabilities, a decrease of assets, and the loss of profit that naturally result from the breach in accordance with the usual course of things. The key inquiry is around causality. Similarly, in an M&A transaction, negotiations often boil down to the desire of the parties to exclude indirect damage that is not foreseeable by the parties.

Many SPAs use the terms of 'consequential damages' and 'indirect damages' interchangeably. Consequential damages are a common law concept referring to the damage resulting from special circumstances of the buyer that were communicated to or known by the seller (eg, a buy-side strategic plan modelling the integration of the target company). That concept has no readily available equivalent under Swiss law.

Loss of profits often is the subject of negotiation. As a general proposition, loss of profit can be the direct and foreseeable consequence of a warranty breach and sometimes the only loss that the buyer may incur in connection with such a breach.

Sometimes the parties attempt to define what is indirect, excludable damage by reference to CO 208, paragraph 3. It is worth noting that case law under that provision does not apply directly to M&A transactions, lends itself to significant judicial discretion and has been controversial among legal commentators. An alternative can be to craft a contractual definition of direct, indemnifiable damage including all damage that is the reasonably foreseeable result of a breach.

Punitive damages are often excluded. It is noteworthy that if the target business is sued by a third party in jurisdictions where punitive damages are recognised, and that fact pattern also constitutes a breach of a warranty under the SPA (for example, the absence of litigation), the exclusion of the punitive component of the damages payable to the third party can leave the buyer short in its recovery from the seller.

Standard exclusions include loss of investment opportunities, loss of goodwill or reputation, and internal administrative and overhead costs, although that list is by no means exhaustive.

Once the parties have agreed on the scope of indemnifiable damage, the indemnification clause has a significant advantage over simply relying upon the default regime: the effect of that clause (assuming that no other exclusions under the SPA apply) is to make whole the buyer on a Swiss franc-for-franc basis, and typically allows for the recovery of (reasonable) legal expenses. In the absence of such clause, the buyer would be required to prove a reduction in the value of the business (where the courts normally assume that the purchase price reflects the value of the business 'defect free').

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Credit-enhancement of an indemnification claim can be a key consideration for the buyer. Where that is warranted, the parties typically negotiate an escrow, holdback or insurance. We address insurance in more detail below.

Quantitative limitations

Given that the indemnification clause creates a significant Swiss franc-for-franc monetary exposure for the seller, quantitative limitations are customary. The most frequent quantitative limitations are:

- De minimis amount: only a claim or related claims having a minimum value will be recoverable on the basis that it would be unreasonable to have both parties and their lawyers expend more time and resources on a claim than what the claim is worth.
- Threshold or deductible (or a combination of both): the buyer's eligible claims must, on an aggregate basis, reach a minimum amount before the buyer can recover them. This amount is either structured as a deductible (then the buyer can only claim the amount in excess) or a threshold or tipping basket (then the buyer can claim the whole amount from the first Swiss franc) or a combination of both of these constructs (when the threshold is met, the buyer can claim the whole cumulative amount net of the deductible).
- Cap: the seller's aggregate liability for any business warranty claims will be limited to a percentage of the purchase price (rather than the enterprise value), usually between 5 and 30 per cent.

Survival periods

Swiss SPAs usually provide for the following warranty periods:

- for legal title normally, five or even 10 years;
- for tax, pension and social security warranties, three to 12 months following the expiration of the applicable statute of limitations; and
- for all other warranties, between six and 36 months; it is very rare not to allow the buyer at least a full audit circle to examine the target business and make claims.

The parties sometimes discuss whether the lapse of the survival periods results in a time bar or forfeiture of the relevant claims. Unlike with forfeited claims, buyer can still assert time-barred claims under certain circumstances (eg, by offsetting them against seller claims).

Specific indemnities

Specific indemnities are commitments by a party to pay another party on a Swiss franc-for-franc basis for specified liabilities or claims. Usually, specific indemnity claims:

- exist irrespective of the buyer's and seller's knowledge;
- are subject neither to disclosure nor to the quantitative limitations applicable to warranties; and
- survive for five to 10 years following closing.

If negotiation leverage allows, buyers often request a specific indemnity for all taxes (often including pension and social security contributions) arising up and until the relevant cut-off time (ie, closing or locked-box date) under an 'our-watch-your-watch' principle.

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Specific indemnities can further be negotiated for known contingent liabilities, such as current litigation, where the seller is not willing to deduct the amount of the contingent claims from the purchase price but the buyer insists on being indemnified if the contingent liability materialises (eg, the litigation is lost).

In locked-box deals, where the purchase price is based on the amounts of cash, financial debt and working capital as at the date of the target's last financial statements (the 'locked-box date') and subsequent profits are literally 'locked in the box' until closing, the buyer will insist in the SPA on the seller's undertaking to indemnify the buyer on a Swiss franc-for-franc basis for any leakage of value out of the box.

Generally, sellers (or the beneficial owners of pass-through entities) who are individuals residing in Switzerland holding their shares 'in their private wealth' insist that the buyer undertakes (1) not to trigger an 'indirect partial liquidation', and (2) to indemnify the sellers for all taxes incurred as a consequence of a breach of that undertaking. The reason for this is that this class of sellers can usually realise a tax-free capital gain. However, under certain circumstances, especially if the buyer accesses cash accumulated in the target before closing within five years of closing (eg, by way of dividend or merger), the tax authorities can requalify the seller's tax-free capital gains into taxable income under the concept of indirect partial liquidation.

Insurance

The insurance market is dynamic and growing. It offers an ever-expanding range of products to address potential transactional challenges, such as post-closing recourse for warranty breaches, protection against tax risks (tax covenant), ongoing litigation claims, and environmental risks. In this chapter, we concentrate on buy-side warranty insurance.

Uses of insurance in M&A transactions

Insurance can be bought to enhance the post-closing recourse available to the buyer. Alternatively, insurance can be the sole recourse available to the buyer, especially when the seller is looking for a clean break. Technically, this is achieved by including a usual warranty package and indemnification clause in the SPA but reducing the cap to 1 Swiss franc.

Insurance can offset a credit deficit of the seller without using an escrow, which may attract negative interest in the current environment, or a holdback (both an escrow and holdback will be viewed negatively by financial sellers as they impact their internal rate of return); it can be used to enhance the attractiveness of a bid in an auction (it is now common for the seller in a competitive process to run a soft stapling process); it can also be used to retain a good relationship with the seller when it rolls over part of its equity. The premium is often borne equally by the parties or by the party who benefits the most from obtaining the warranty insurance.

Key terms

Key terms include quantitative limits, coverage and policy period.

Retention (or excess or attachment point) is the deductible; in other words, the portion of risk that remains with the buyer. Over the years, retention has come down significantly: it is now usually between 0.5 per cent and 1 per cent of the enterprise value (EV), but it can be as low as 25 basis points of EV or even nil in specific industries, such as real estate. Creativity has no bounds: retention can be turned into a basket (a tipping retention: once the retention is exceeded, the policy responds from the first Swiss franc) or it may step down after a set period of

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time (a dropping retention). Most insurers also include a de minimis amount per claim, generally not lower than the due diligence materiality threshold (this must be factored in when configuring the due diligence review).

The policy limit operates as a cap. It is typically between 10 and 20 per cent of EV. The premium is expressed as a percentage of the policy limit (that percentage is also called the 'rate online'). It currently hovers at between 1 and 2 per cent of the policy limit and will become cheaper for excess capacity in an insurance programme (layering first in line and excess insurance).

Coverage relates to the scope of the warranties insured. Traditionally, insurance covers the business warranties (subject to exclusions further discussed below). A new trend is the ability to insure fundamental warranties. The underwriters will review the warranty package and overlay qualifiers or exclusions when the warranty package is perceived as too buyer-friendly.

The policy period can be negotiated. It often tends to be around two years for warranties and up to seven years for tax and fundamental warranties.

Exclusions

For all its merits, warranty insurance is not iron-clad. Sophisticated parties will pay a keen eye to exclusions. These include, among other things:

- matters known (even if the SPA contains a 'pro-sandbagging' provision);
- specific areas that are typically difficult to due diligence and can cause considerable losses, such as cyber-events, data breach, bribery and corruption ('ABC exclusions'), sanctions, condition of assets, pollution, contamination, clean-up, the impact of the pandemic, transfer pricing and availability of tax attributes (some of these exclusions can typically be removed if there is a specific and targeted due diligence or if the target has a policy covering the particular risk);
- activities and operations in jurisdictions viewed as higher risk; and
- specific deal features, such as leakage, price adjustment mechanism, breach of covenants, and pre- and post-completion reorganisation.

The definition of insurable loss is generally based on reasonably foreseeable damage but will typically exclude lost opportunities, reputational damages, internal administrative and overhead costs, frustrated expenses and damages applying multipliers. Underwriters may also seek to exclude consequential and punitive damages.

Process

Insuring a deal first involves appointing a broker. Brokers sound out the market, identify potential underwriters and obtain quotes, which they summarise in a non-binding indication report.

An expense agreement is then signed with the selected underwriters, which kickstarts the underwriting and due diligence process.

During that process, the underwriters will be most concerned about disclosure, the scope of due diligence and the vigour of the negotiations between the seller and the buyer. The selected underwriter will have identified exposure areas of heightened focus in the underwriting process (such as, most recently, the impact of covid-19).

Usually, it takes about two weeks from the non-binding indication report to get to a position where the policy is 'bound', which means that the underwriters will have provided a firm binding quotation.

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The insured will generally be requested to sign a declaration warranting to the underwriters that it is not aware of any matter that might give rise to a claim under the insurance policy. Upon receipt, the insurer will confirm that the cover is in place subject to completion of the transaction. For historical reasons, insurance is still less prevalent in Switzerland than in other jurisdictions. However, underwriters are keen to insure Swiss deals, and we have little doubt about market participants' increasing adoption of insurance.

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Appendix 1

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Christoph Vonlanthen is a specialist in mergers and acquisitions, growth equity, corporate governance and capital markets.

Christoph is a partner based in both the Geneva and Zurich offices, and has vast experience accumulated in Switzerland, New York and London in market-leading transactions, including buyouts, divestitures, spin-merge transactions, exchange offers, divestitures, carve-outs, rights offerings and IPOs in a range of industries. He regularly advises strategics, financial sponsors and investment banks on complex cross-border assignments. Christoph also assists fund managers and institutional investors on structured investments, co-investments and secondary sale transactions.

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