LENZ & STAEHELIN

M&A Disputes in Switzerland

Lenz & Staehelin explore recurring issues and considerations for the planning and drafting of dispute resolution clauses.

I. TRENDS IN M&A TRANSACTIONS

In recent years, the global M&A market has shown steady signs of recovery from the effects of the financial crisis. Transactions span a wide range of industry sectors, including healthcare, financial services, energy and technology.

However, difficult market conditions pose significant challenges for newly acquired businesses. The underlying factual bases upon which the purchase price is premised are crucial. In what has become an increasingly professionalized transaction process, buyers routinely take another close look after closing at what they were told about the acquired business and they are more inclined to initiate proceedings if they suspect breaches of warranties given by the seller.

II. COMMON DISPUTES IN M&A TRANSACTIONS

It has become standard to categorize M&A disputes according to the stage of the transaction in which they arise. One commonly distinguishes *pre-signing disputes* (arising prior to the signing of the transaction agreement), *pre-closing disputes* (arising between the signing and the closing), *closing disputes* (arising at the closing) and *post-closing disputes* (arising after the closing). While M&A disputes may occur across these phases, post-closing disputes are most frequent in practice. Most commonly, M&A disputes arise out of or in connection with representation and warranties as well as price adjustment agreements.

A. Pre-signing Disputes

Pre-signing disputes primarily arise out of, or in connection with, confidentiality and exclusivity agreements concluded by the parties at the outset of the negotiations. Pre-signing disputes also arise in the context of letters of intent or term sheets. These disputes turn in particular on whether a party is obliged to enter into, or to continue, negotiations towards the conclusion of an M&A transaction agreement, and on whether such obligation may be enforced through arbitration. Finally, pre-signing disputes may arise over the issue of whether a transaction agreement has been validly concluded despite the fact that it has not yet been signed by at least one of the parties.

B. Pre-closing Disputes

After the signing of the M&A transaction agreement the parties work towards the closing and take the necessary actions to fulfill the closing conditions (conditions precedent) set forth in the agreement. In the transaction agreement the parties typically agree to commit, or refrain from committing, certain actions during the period between the signing and closing (covenants). In this context, the question arises as to which remedies are available if the counterparty does not take the agreed actions (or if such actions do not comply with the agreement) or does not refrain from committing acts that are prohibited by the contract.

In our experience, the specific enforcement of such contractual obligations through litigation

or arbitration is rare. This is primarily owed to the fact that at this stage, the parties usually still have mutual interests in closing the transaction. In addition, the enforcement of pre-closing covenants is difficult from a practical point of view, in particular in terms of timing: If the time period between signing and closing lasts more than six months, the prospects of a successful takeover and integration of the target company are diminished as this leads to uncertainties for all parties involved (including stakeholders such as employees, clients and suppliers). This often has a negative impact on the expected economics of a transaction.

C. Closing Disputes

If following the signing a party refuses to close an M&A transaction, the other party is entitled to specific performance if the closing conditions are met or have been waived. In such action the claimant demands that the defendant be ordered to render his performance in exchange and simultaneously to the claimant's performance, for instance that the seller transfers the shares of the target company against payment of the purchase price by the buyer.

D. Post-Closing Disputes

In the post-closing phase, contractual representations and warranties represent a major cause of dispute. It has become standard practice to sell on the basis of a long list of representations, warranties and specific indemnities with the purpose of allocating the risks between the transacting parties taking into account the level of disclosure in the due diligence process. It has also become routine to analyze those risks in detail immediately after the closing and to evaluate potential claims on that basis.

Another important type of disputes arising after the closing concerns the adjustment of the purchase price (*post-closing*). Most common are adjustment mechanisms that seek to account for value changes of the target company between signing and closing. Sometimes, however, adjustments focus on future developments – for example, if the parties are not able to agree on the appropriate value of the target, they may provide for some form of earn-out mechanism. This would enable the seller to try and hold the new owner responsible for decisions potentially causing an earn-out shortfall. More frequent are arguments about the calculation of earn-out parameters (e.g., EBITDA or similar indicators of a company's performance). In these cases, disputes may revolve around the scope and meaning of the price adjustment provision, the application and interpretation of accounting principles and related quantum considerations.

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III. ARBITRATION AS A PREFERRED MEANS OF RESOLVING M&A DISPUTES

A. Key Differences of Arbitration as compared to Litigation

In the negotiations over an M&A transaction the parties have to decide whether they prefer to have disputes arising from the transaction resolved through arbitration or in litigation proceedings before state courts. Moreover, they need to address if their preferred general dispute resolution mechanism shall apply to all disputes or if a different mechanism shall be applicable to specific disputes.

Apart from the parties' legal background and familiarity with dispute resolution, the decision between litigation and arbitration is mainly triggered by the various differences between these two dispute resolution mechanisms. In this regard, arbitration is widely perceived to have several advantages over state court

proceedings, in particular with respect to the extent of party autonomy, the flexibility of the proceedings, the better means to protect privacy and confidentiality, the selection of arbitrators and the time until a final resolution of the dispute (with limited possibilities of appeal). In our experience, in the context of M&A disputes the key differences between arbitration and litigation arise in particular from the flexibility of arbitration proceedings, the possibility to select experienced arbitrators, and the different approach of arbitral tribunals with respect to the substantiation and proof of claims (damages).

Obviously, what one party may view as an advantage of a particular form of dispute resolution, is in most cases perceived as disadvantage by the other side. Moreover, the advantages of one dispute resolution mechanism may not apply to all disputes arising at the different stages of an M&A transaction since different aspects are relevant, for instance, in pre-signing disputes as opposed to post-closing disputes. Therefore, it is generally not accurate to describe either arbitration or litigation as the more advantageous dispute resolution mechanism for M&A disputes. Rather, in the negotiations on the transaction agreement each party must assess which form of dispute resolution better suits its interests with respect to specific anticipated disputes arising out of this agreement.

1. Flexibility

One of the main differences, and advantages, of arbitration as compared to state court litigation is the flexibility of the proceedings. The parties may structure and tailor the proceedings to suit their specific needs for dispute resolution. This flexibility applies in particular with respect to the taking of evidence, specifically the presentation of witnesses and expert witnesses which is often limited in litigation proceedings.

The downside of the increased flexibility of arbitration proceedings is that it provides a reluctant party with additional opportunities to delay, obstruct or frustrate the proceedings. Different from a state court, an arbitral tribunal lacks the power to directly enforce its orders against the parties or third parties and may thus not effectively prevent such behavior.

2. Selection of Arbitrators with the Required Expertise

The possibility of the parties to select the members of the arbitral tribunal is undoubtedly one of the key distinguishing aspects of (international) arbitration as opposed to state court litigation. Parties may select arbitrators with a specific expertise, e.g., in a particular practice area (such as corporate and M&A or accounting), with a certain legal background, or to address any other sensitivity that the parties may deem relevant to their particular case.

3. Substantiation and Proof of Claims (Damages)

While the concepts, requirements and legal standards for the assessment of claims under Swiss law are in principle the same for arbitration and litigation proceedings, in practice there are significant differences as regards the admission of prayers for relief and the substantiation and proof of claims.

Swiss state courts apply strict standards with respect to the wording, definiteness and type of the prayers for relief submitted by the parties. This applies in particular with respect to prayers for declaratory relief (i.e., for a declaration of a specific right or legal relation).

Arbitration proceedings provide more flexibility also with respect to the substantiation and proof of claims, in particular damages. The interrogation of witnesses (or the review of witness statements filed by the parties together with their briefs) or of expert witnesses appointed by the parties is of significantly greater importance than in litigation proceedings. For a party to an M&A dispute for whom witness testimony may become indispensable to make its case (e.g., to prove an oral agreement), this can be a decisive aspect in favor of an arbitration agreement.

At least under Swiss law, there is no conceptual difference between litigation and arbitration as regards the burden of substantiation and proof (as these are regarded matters of substantive – not procedural – law). However, Swiss state courts often apply very strict, sometimes even exaggerated, standards in this regard. In addition, state courts are more inclined to dismiss claims for lack of substantiation or proof without reviewing the substance of the claims if the claimant does not

meet these standards. In contrast, arbitral tribunals are often more generous also in this regard. Once liability is established in principle, an arbitral tribunal is more likely to admit a claim for damages even if the damage can only be estimated, as long as it is supported by convincing (expert) evidence. For a claimant who asserts claims for breaches of contract, in particular of the representation and warranties, and claims damages resulting from such breaches (e.g., the diminished value of the target company), arbitration proceedings may thus be more favorable. In contrast, the defendant may have better chances for prevailing in litigation before a state court which is prepared to fully dismiss such damages claim already for lack of proper substantiation.

B. Planning and Drafting Arbitration Clauses

The proper planning and drafting of dispute resolution clauses is an important aspect in any transaction. Planning for dispute resolution – and considering arbitration in that context – typically involves the pursuit of a number of strategic goals. These include the parties' desire to ensure a neutral decision-making, consolidate all disputes in a single forum, ensure enforceability of the arbitration agreement, avoid unnecessary delays in resolving disputes, take advantage of procedural flexibility, ensure confidentiality and control cost. Proper planning and drafting of dispute resolution clauses help to save time and costs when it comes to a dispute, but also to make the resolution process more predictable.

Whether a party can obtain its preferred dispute resolution method for a particular transaction depends on that party's negotiation power and the interests of the opposing side. Moreover, drafting of dispute resolution clauses is typically not the center focus of parties negotiating M&A contracts. Often, they are not able or willing to devote sufficient time to that aspect. And sometimes, dispute resolution clauses are the result of a compromise that does not serve either party's interest and instead may lead to uncertainties, procedural complications or inefficiencies.

In our experience, the vast majority of international M&A contracts provide for institutional arbitration (such as the Swiss Rules, the ICC Rules or the SIAC Rules), while one sees ad hoc-arbitration clauses occasionally and mainly in purely domestic settings. Where the parties opt for institutional arbitration, this largely simplifies their task of drafting the arbitration agreement. In this case, the starting point should be the standard arbitration clause of that particular institution (which can be found in the applicable arbitration rules or on the institution's website).

The parties may then consider supplementing the clause, taking into account the specific circumstances of a particular transaction. The more obvious points the parties may want to consider addressing include the number of arbitrators, the place of the arbitration, the language of the arbitration, and the substantive law applicable to the merits of the dispute. Depending on the parties' needs in a particular transaction, they may want to address additional aspects such as specific confidentiality arrangements, a provision for fast track arbitration and related timing aspects or a carve-out for certain disputes that should be subject to a separate and distinct dispute resolution mechanism (e.g., expert determination proceedings). Also, multi-party and multi-contract situations (including issues of joinder and consolidation) may require specific arrangements that need to be addressed in the arbitration clause.

If the parties agree on ad hoc (non-administered) arbitration, additional points may need to be included in the arbitration agreement, particularly relating to the initiation of proceedings and the appointing of the arbitrators.

While most M&A transactions provide for arbitration as a general dispute resolution mechanism, some agreements carve out selected aspects of the transaction and provide for separate means to resolve disputes relating to these aspects – such as expert determination proceedings for price adjustment disputes or fast track arbitration for certain pre-closing disputes.

Expert determination is in particular of great practical importance for price adjustment disputes. These disputes often turn on complex valuation or accounting questions and the parties want to ensure that the person deciding these questions has the required knowledge and expertise. The distinctive feature of expert determination is that it is binding upon the parties (and in case of subsequent

proceedings also for a court or arbitral tribunal).

Fast track arbitration (or expedited procedure), with shortened time-limits for the various steps of the proceedings, can be a viable option at least for certain types of M&A disputes when time is of the essence – in particular with respect to *pre-closing* and *closing* disputes.

These alternative dispute resolution mechanisms can readily be combined with a general arbitration clause, but particular attention is required to the drafting of such separate and distinct dispute resolution clauses to avoid jurisdictional objections or parallel proceedings. The same applies when the dispute resolution mechanism should address multi-party and multi-contract situations or be relied on with respect to non-signatories.

IV. SUMMARY

In recent years, we have experienced in our practice an increase in the number of M&A disputes. While controversies may occur across all phases of an M&A transaction, post-closing disputes are most frequent in practice. This applies in particular to disputes concerning representation, warranties and covenants as well as price adjustment agreements (which in practice often involve expert determination and sometimes raise complex procedural issues and interrelations with arbitration proceedings – before, after or even in parallel to expert determination).

In today's globalized economy, arbitration has become the method of choice for dispute resolution in international M&A transactions. It is generally perceived as a commercially effective means to resolve M&A disputes and given preference over state court proceedings. This applies in particular if the available options are the home courts of the opposing side or the courts of a third country. Among other advantages often quoted in favor of arbitration, it allows the parties to select a neutral forum and to appoint arbitrators who are not only experienced in dispute resolution, but would also understand the relevant aspects of an M&A transaction. But perhaps most importantly, arbitration provides the required flexibility in the handling of proceedings that allows tailor-made practical solutions to particular issues as they may arise in M&A disputes.

Naturally, what one party may view as an advantage of a particular form of dispute resolution, is often perceived as disadvantage by the other side and each transacting party will have to assess which form of dispute resolution best suits its interests (in anticipation of the possible disputes that may arise under the relevant transaction agreement). ■

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