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ACQUISITIONS OF SWISS COMPANIES LEGAL AND TAX ASPECTS

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2011

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This brochure covers legal and tax aspects concerning the acquisition of companies and participations in companies not traded on the stock exchange. Tender offers and the notification obligation in connection with the purchase and sale of significant participations in listed companies are discussed in the brochure "**The Acquisition of Participations in Listed Companies – Rules on Tender Offers and Notification Obligation**". The sale of a company by an initial public offering is discussed in the brochure "**IPO's – Legal Aspects**".

III

Abbreviations:

BankA	Federal Act on Banks and Savings Banks
BankO	Ordinance on Banks and Savings Banks
CA	Federal Act on Cartels and Other Constraints on Competition
CO	Code of Obligations
CRO	Ordinance on the Commercial Register
DTA	Federal Act on Direct Taxes
LexF	Federal Act on the Acquisition of Real Estate by Persons Abroad
LR	Listing Rules of the Swiss Stock Exchange
MA	Federal Act on Merger, Demerger, Transformation, and Transfer of Assets
MCO	Ordinance on the Control of Mergers
OIA	Federal Act on the Occupational Old Age Survivors and Invalidity Insurance
OIO 2	Ordinance of the Federal Act on the Occupational Old Age Survivors and Invalidity Insurance
SESTA	Federal Act on Stock Exchanges and Securities Trading
STA	Federal Act on Stamp Tax
THA	Federal Act on the Harmonisation of Direct Cantonal and Communal Taxation
VA	Federal Act on Vesting
VAT	Federal Act on Value Added Tax
WTA	Federal Act on Withholding Tax

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A. TRANSACTION STRUCTURES AND PROCEDURES

- *The sale of a business can either be structured as an asset deal or as a share deal. In an asset deal, the assets and liabilities as well as all contractual obligations of a business are transferred to the buyer. In a share deal, the shares of a company, which owns the business, are transferred to the buyer so that the business is indirectly transferred to the buyer on the basis of the transfer of the shares in the company. Due to the unfavorable tax treatment of asset deals, most transactions in Switzerland are structured as share deals.*
- *The sale is either conducted as a privately negotiated transaction between the seller and the buyer or as an auction between the seller and several buyers. The auction procedure is generally used for the sale of large and attractive businesses.*

1. TRANSACTION STRUCTURES: ASSET OR SHARE DEAL

A sale of a business can be structured in either of the following two ways:

– **Asset Deal:**

In an asset deal, the buyer acquires the business directly by purchasing its assets and taking over its liabilities and contractual obligations. After the transaction, the buyer (or a company formed by the buyer for this purpose) becomes the direct owner of the business.

– **Share Deal:**

In a share deal, the buyer acquires the business indirectly by acquiring the shares of the company or the quotas of a limited liability company (*GmbH*) that owns the business. Therefore, the object of the purchase is not the business itself, with its assets and liabilities, but only the shares in the company or the quotas of the limited liability company which owns the business.

In Switzerland, the majority of business acquisitions are structured as share deals, as in an asset deal, the seller has considerable tax disadvantages which are not compensated by tax advantages to the buyer.¹ Therefore, asset deals are rare in Switzerland and lim-

¹ Cf. chapter F.1.2.

ited to cases where a legal entity sells a business unit or where a private individual sells a sole proprietorship or an interest in a partnership.²

Regardless of the tax issues, an asset deal is far more complex than a share deal. The complexity results not only from having to transfer a substantial number of assets and liabilities but also from having to transfer the contractual obligations which usually require the consent of the counterparty involved. This can prolong the transaction process and lead to higher costs especially in cases where the counterparties use their position to demand benefits in exchange for their consent.

2. TRANSACTION PROCEDURES: INDIVIDUAL NEGOTIATIONS OR AUCTION PROCEDURE

The following two transaction procedures are commonly used:

– **Individual Negotiations between Buyer and Seller**³

In an individually negotiated sale, a seller negotiates the sale of a business with one buyer only, without creating direct competition between several interested buyers. Using this procedure, the buyer and the seller conclude a contract based on their individual needs without one party unilaterally steering the process.

– **Auction Procedure**⁴

In an auction procedure, the seller invites potential buyers to submit bids and encourages competition between these bidders until a purchase agreement is concluded. The seller steers the auction process to ensure there is continuous competition among the potential buyers, while the buyers remain relatively passive with the result that the individual needs of the buyer are not taken into consideration.

The auction procedure is frequently more advantageous for the seller than the individually negotiated sale. The reason is that the competition among potential buyers often leads to a higher purchase price and also to a purchase agreement that is advantageous for the seller. An auction procedure, however, has the disadvantage of being relatively expensive because a separate due diligence and negotiation have to be conducted for each bidder. As a result, a full auction procedure is normally used only for businesses

² If a private individual intends to sell a non-incorporated business (*i.e.*, sole proprietorship or partnership), it is generally more advantageous, to first convert the business into a company (*AG* or *GmbH*) and to then sell the shares of the company. The conversion into a company is a tax-free transaction and the seller can realize a tax-free private capital gain if he waits at least five years after the conversion to sell the shares. In contrast, if a private individual realizes a gain on the sale of a sole proprietorship or a partnership, he is subject to income taxes and social security contributions. This generally results in the total transaction cost being prohibitively high (*cf.* chapter F.1.2 below).

³ The individually negotiated sale is discussed in detail in chapter B below.

⁴ The auction procedure is discussed in detail in chapter C below.

that will attain a high purchase price.⁵ For this reason, in small business acquisitions, a seller will initially contact several potential buyers and create competition amongst them in order to negotiate the highest possible purchase price. To avoid costs and achieve greater efficiency of the procedure, the seller will continue individual negotiations with one potential buyer only.

An auction procedure also has the disadvantage that the seller's intention to sell the business cannot be kept confidential between the buyer and the seller only. Knowledge of a potential change of the business ownership may have a negative effect on the relations with employees and customers.⁶ Further, should an auction procedure be unsuccessful because the potential buyers have shown less interest than the seller hoped for, this will negatively impact the seller since the potential buyers will have realized that the seller failed to achieve a sale of the business at satisfying conditions. The effect can be that a sale of the business may be impossible for several years unless the seller is willing to accept a very low offer.

Before deciding on the auction procedure, the seller has to carefully weigh its advantages and disadvantages. The procedure is often the best solution for a large business if there are many interested buyers and the business can conduct its daily operations uninterrupted by rumors on an imminent sale. On the other hand, an individually negotiated sale is often more appropriate for a small business with few interested buyers, or if rumors of a sale would disrupt relations with customers as well as business operations. In an individually negotiated sale, the seller should also try to introduce some elements of competition into the sales procedure by testing the interest of potential buyers before concentrating on only one buyer. In this way, the seller ensures that he negotiates with the buyer who offers the best price and that he has alternatives if the negotiations with this buyer fail.

⁵ Experience shows that auction procedures are used in approximately 80% of all businesses that are valued above CHF 100 million, 40% of all businesses that are valued between CHF 30 million and 100 million, and rarely for businesses that are valued below CHF 30 million.

⁶ For example, this is the case in project management, where it is essential to have a reliable owner of the business in view of the long-term duration of the contracts.

B. INDIVIDUALLY NEGOTIATED TRANSACTIONS

The majority of all business acquisitions are completed on the basis of individually negotiated transactions between the buyer and the seller.⁷

1. TYPICAL PROCEDURE IN INDIVIDUALLY NEGOTIATED TRANSACTIONS

Typically, an individually negotiated transaction proceeds as follows:

- *Confidentiality Agreement*
- *Preliminary Negotiations /Letter of Intent*
- *Due Diligence*
- *Contract Negotiations/Signing of Contract*
- *Closing*

Not all stages are necessary. The actual procedure depends on the circumstances of the individual case.

The negotiations between the buyer and seller usually begin with a first contact established by one of the parties or one of their advisors. At such early stage, the seller normally will not be willing to provide the prospective buyer with any non-public information. Such information is usually only transmitted if the buyer executes a confidentiality agreement that obliges him to keep the non-public information confidential.

After the first exchange of information, the parties usually negotiate the commercially important points,⁸ such as the price and the transaction structure. The preliminary verbal agreement of the parties can be incorporated in a letter of intent, if the parties consider it necessary to formalize their oral understanding.

A binding contract is normally negotiated and signed only after the completion of a due diligence, during which the buyer carefully analyzes the business. After successful completion of the contract negotiations and execution of a purchase agreement, the transac-

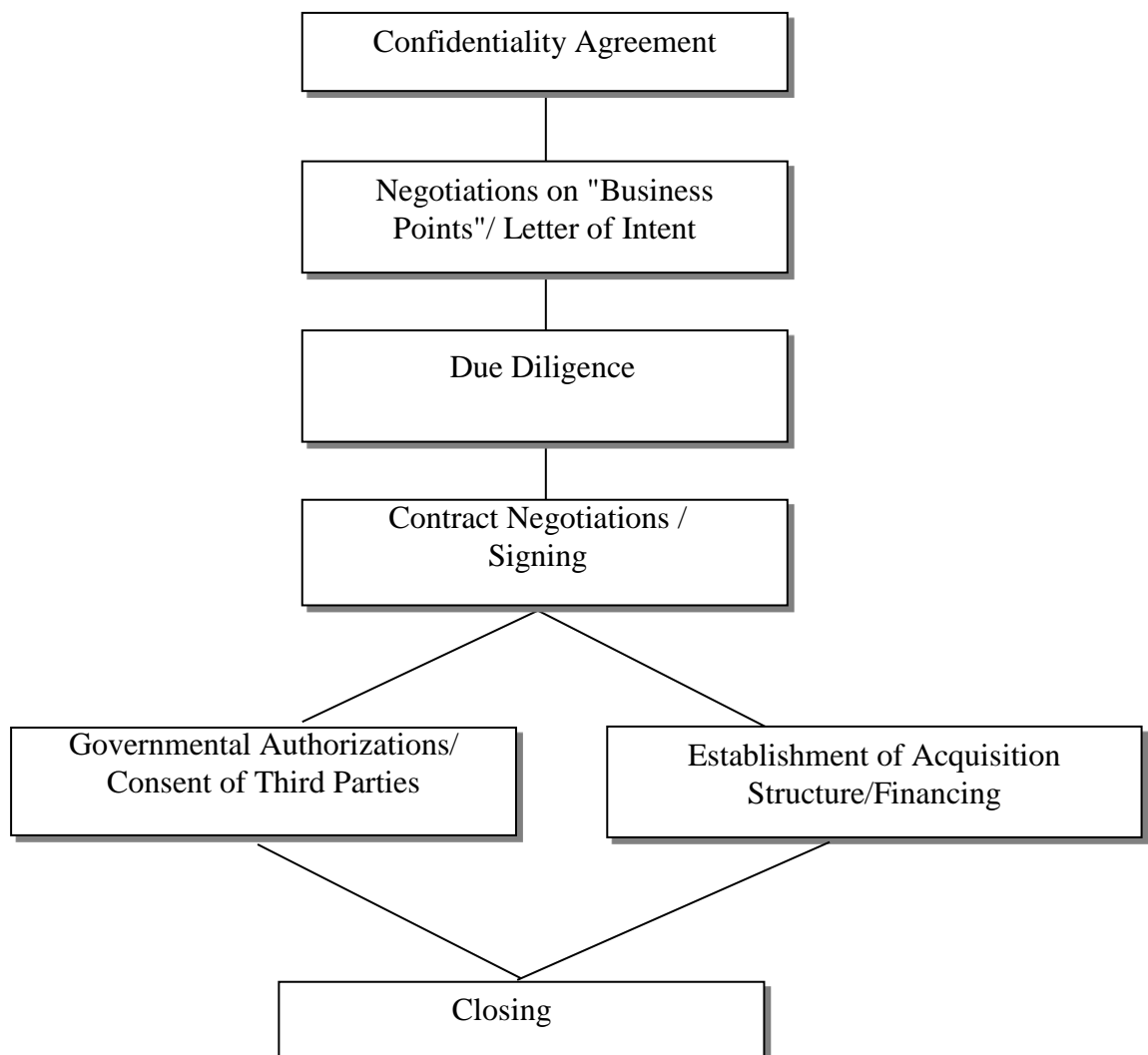
⁷ The auction method is discussed in chapter C below.

⁸ Hereafter also "business points".

tion can be closed (*i.e.*, the object of the sale is transferred to the buyer against payment of the purchase price). Often there is a long time period between the execution of the contract and its closing. In this interim period, the buyer obtains the necessary authorizations and third party consents, as well as arranging the financing of the transaction or the formation of an acquisition holding structure respectively.

Numerous transactions deviate from the typical procedure described above as the procedure depends on the individual circumstances of the case and on the needs of the parties. In many transactions, the parties do not find it necessary to conclude a letter of intent and in cases where the buyer is very familiar with the business, such as in a management buy-out-transaction (MBO-transaction), the due diligence can also be left out. Further, in simple transactions, there is often no interim period between the signing and the closing, and the transaction is completed directly after the signing of the contract.

The procedure of an individually negotiated transaction can be illustrated as follows:



2. CONFIDENTIALITY AGREEMENT

- *In the confidentiality agreement, the parties agree to keep their negotiations, as well as any non-public information they exchange during the negotiations, confidential.*
- *The confidentiality agreement normally prohibits the buyer not only from disclosing non-public information he received from the seller, but also from using the information for the buyer's own business advantage. In most cases, the confidentiality agreement also obliges the buyer to return all documents to the seller if the negotiations do not lead to the completion of the transaction.*
- *Confidentiality agreements often also prohibit the buyer from employing or enticing managers and key personnel away from the seller's business for a certain time.*

2.1 Purpose of the Confidentiality Agreement

The seller has a strong interest in keeping the fact that he is considering selling the business or that he is conducting negotiations confidential, as this can lead to the defection of employees and customers. Furthermore, the seller would also want to keep the information he provides to a prospective buyer to enhance the buyer's interest in the business or to justify the proposed price confidential, as such information often contains business secrets. For these reasons, the seller normally wishes to ensure at an early stage that his intent to sell the business, as well as the information concerning his business, does not become public knowledge. Often, the buyer also has an interest in ensuring that the negotiations do not become public knowledge since such information may give his competitors an indication about his strategic direction. To protect these interests, the parties conclude a confidentiality agreement at the beginning of their negotiations.

2.2 Content and Wording of the Confidentiality Agreement

A confidentiality agreement should first describe the information that has to be kept confidential. Normally, this includes the fact that negotiations are being conducted and the information and documents that the seller provides to the buyer. The following information and documents, however, are exempt from the confidentiality obligation since the seller has no legitimate interest to oblige the buyer to keep such information confidential:

– **Information in the Public Domain**

This encompasses information that stems from public registers or is contained in other publicly accessible documents such as press releases, annual reports or sales brochures.

– **Information Produced by Third Parties**

This category includes analysis reports prepared by the buyer's consultants and investment bankers on the basis of publicly available information, as well as product and market research conducted by the buyer or his consultants.

– **Information that Becomes Public Knowledge after Conclusion of the Confidentiality Agreement**

If confidential information becomes public knowledge, the seller cannot expect the buyer to keep such information confidential as the information has become accessible through the public domain. This exemption applies, for example, when the seller transmits to the buyer confidential information on new product developments or interim financial statements, and later discloses the information to the public when the new products come to the market or the annual report is published.

The confidentiality agreement should prohibit the buyer from disclosing confidential information to third parties, as well as using the information for the advantage of his own business. A clause to such effect prevents the buyer from using the information on the seller's prices and customers to submit competing offers to the same customers. It is difficult, however, to enforce this protection in practice, as it will be hard for the seller to provide conclusive evidence confirming that the buyer has used confidential information for his own purposes.

Most confidentiality agreements also provide that, if the parties fail to conclude a purchase agreement, the prospective buyer has to return all the documents he received from the seller and to confirm that he has destroyed all copies of these documents.

2.3 Prohibition against Enticing Employees away

In the negotiations and, in particular, in the due diligence procedure, the prospective buyer will receive information on the organization of the business, its key personnel and their terms of employment. For a business, which largely depends on its key employees for its success, there is a danger that the prospective buyer may try to entice these employees away should the purchase of the business fall through. To eliminate such a risk, the confidentiality agreement often also obliges the buyer not to employ or entice certain employees away from the business for a certain period of time. In practice, it is difficult to enforce a complete prohibition since, once the former employee has taken up employment

with the potential buyer, it will be difficult for the seller to prove that the former employee was enticed away and did not change jobs by free will. Therefore, a general clause which prohibits the potential buyer from employing certain key employees during the negotiation period, as well as for a fixed period after the closing of the agreement, is recommended as a better strategy.

Although it limits the possibilities of the employees to find new employment, such a clause is binding and enforceable under Swiss law. However, a prohibition to employ or to entice certain employees away would be illegal and non-binding, if the covenant between the buyer and seller would severely limit the employees' ability to find a new job. For example, in a specific industry, when the prospective buyer is the only alternative employer for the employees, such a prohibition would hinder the employees concerned from finding a new employer and, therefore, the clause will be considered void.

Such a prohibition clause can only be enforced against the prospective buyer and not against the employee. If the buyer violates the contractual prohibition by concluding an employment agreement with one of the employees of the seller's business, the employment agreement between the employee concerned and the potential buyer will be binding despite the fact that the buyer violated his contractual duties vis-à-vis the seller. The seller may, however, sue for damages and in a serious case, based on a court order, prohibit the buyer from using the services of the employee.

3. LETTER OF INTENT

- *After the initial negotiations, the parties often sign a letter of intent that contains a non-binding confirmation of their intent to conclude the transaction.*
- *The letter of intent normally also contains information on the completion of the due diligence and a time table on the further steps until the closing of the transaction; again, these steps are non-binding and merely show the intent of the parties.*
- *The letter of intent often contains binding provisions on confidentiality, the obligation not to entice employees away and exclusivity.*

3.1 Purpose of the Letter of Intent

Before the completion of the due diligence, the prospective buyer will most likely only have elementary information on the business; nevertheless, the parties may be able to decide, after the first round of negotiations, whether to proceed with the purchase of the business and to fix a purchase price. To confirm the mutual intent to carry out a transaction and to define the next stages of the procedure, the parties, at such stage, often decide to sign a letter of intent.

The purpose of the letter of intent is not to reach a binding agreement on the purchase of the business, but to describe the intention of the parties and to define the further procedure. The letter of intent is particularly useful in cases in which the seller has to obtain the consent of third parties and must provide them with a document detailing the results of the negotiations. The same also applies if the buyer has to obtain financing and, in its negotiations with banks or venture capital partners, must demonstrate that there is a high probability that the transaction will take place.

3.2 Content of the Letter of Intent

The content of the letter of intent should always be tailored to the limited purpose of the document. The parties should not try to elaborate on the details of the transaction in the letter of intent, because it would be better to directly negotiate these in the purchase agreement. The letter of intent should, however, describe the commercially essential points of the transaction, *i.e.*, the transaction structure, the price and any other additional obligations of the buyer and seller that they regard as crucial for the success of the transaction. It is in the parties' interests to recognize problems that may prevent the completion of the transaction at an early stage as this will allow them to terminate the negotiations before they have incurred expenses on the due diligence and preparation of the

transaction and before the transaction has become known to others. It is recommended, therefore, that the parties address all potentially problematic issues in their negotiations of the letter of intent rather than to avoid such issues. The negotiations allow them to either resolve these issues at an early stage or, if they present insurmountable obstacles, terminate negotiations while their expenses are still low.

Typically, a letter of intent has the following content:

3.2.1 Non-binding Provisions

In accordance with the purpose of the letter of intent, the majority of the provisions are non-binding in their nature:

3.2.1.1 *Intent to Complete the Purchase Transaction*

In the first non-binding provision of the letter of intent, the parties confirm their intent to carry out the planned transaction and define the essential business points of the transaction. The parties should describe the transaction structure, the object of the purchase and the purchase price. Other points that the parties regard as essential should also be described, *e.g.*, any particular payment schedule or the sellers' obligation to render services to or to work for the business after the sale. If the purchase depends on the results of the due diligence, the parties sometimes do not fix a purchase price, but rather provide for a price range or a valuation method whereby the purchase price will be calculated. The buyer agrees to these provisions on the basis of incomplete or sometimes one-sided information provided by the seller. For this reason, the document will usually state that the buyer's intent is based on the assumption that the information received from the seller will be verified as part of the due diligence and that unknown risks which emerge in the due diligence will lead to a re-evaluation of the business.

3.2.1.2 *Outline of the Next Steps*

In addition to defining the major business points, the letter of intent should lay down the next steps of the transaction:

3.2.1.3 *Description of the Due Diligence*

For the purpose of clarity, it is advisable that the parties define the extent and the duration of the due diligence. If the parties have different views on these points and have not addressed these issues in the letter of intent, problems may develop which may lead to a break-down of the due diligence process or prolong it unnecessarily. Further, a letter of intent should clearly describe the documents and information the buyer is to receive as part of the due diligence, whether the buyer is permitted to lead discussions with the management, whether a thorough environmental analysis will be conducted, and the period of time available to the buyer to analyze the documents and information received and to complete the due diligence.

3.2.1.4 *Timetable*

To avoid a misunderstanding between the parties on the stages or duration of the procedure, it is further advisable to include a timetable for the due diligence, the contract negotiations and the closing of the transaction. The timetable is not binding on the parties since they do not promise in the letter of intent to complete these stages. Further, the plans of the parties are often influenced by unforeseeable external factors, which is why experience shows that nearly all transactions take longer to complete than initially planned. Nevertheless, it is helpful for the parties to develop a common framework for the execution of the procedure.

3.2.1.5 *List of Documents to be Drafted*

The parties should agree on the necessary contracts and documents that have to be drafted and allocate a party to their drafting. The parties should, however, avoid discussing the provisions of these documents in detail. The attempt to regulate such details is not the purpose of the letter of intent; it will only prolong the conclusion of the document and will have the effect that the parties prematurely begin the contract negotiations.⁹

3.2.2 Binding Provisions

In order to drive the parties towards the conclusion of a binding purchase agreement, the letter of intent should also contain certain legally binding provisions:

3.2.2.1 *Confidentiality Clause*

This provision contains the confidentiality obligation described above in chapter B.2. If the parties have already signed a confidentiality agreement, the letter of intent may refer to such agreement and state that it remains in force after the conclusion of the letter of intent.

3.2.2.2 *Prohibition against Enticing Employees away*

A letter of intent will often contain an obligation on the buyer not to employ or entice certain employees away from the sellers' business. Since in the due diligence stage of the transaction, the prospective buyer receives detailed information on the organization and management of the business and usually also has direct contact with the top management, the seller risks that the prospective buyer will try to employ certain key personnel should the purchase negotiations break down. The content of this clause has been described above in chapter B.2.3. If the parties have inserted a clause containing this obligation in an already executed confidentiality agreement, they may refer in the letter of intent to this confidentiality agreement and confirm that the clause in the agreement remains in force after the execution of the letter of intent.

⁹ Should the parties wish to negotiate on any other points but the business points, it is better to do so in the purchase agreement.

3.2.2.3 *Exclusivity*

A prospective buyer will incur considerable expenses during the due diligence and the contract negotiation stages of the transaction. For this reason, the buyer will often demand that the seller grants him exclusivity rights *i.e.*, the seller agrees not to negotiate with other potential buyers on the sale of the business during a certain period. The reason for this provision is that the prospective buyer will want to avoid competitive pressure during the negotiations.

In practice, various types of exclusivity agreements have been developed. The potential buyer will have the strongest protection during the exclusivity period if the seller obliges himself to neither lead negotiations with any third parties nor to provide third parties with access to due diligence material, and in case of inquiries, to state that the business is not for sale. In contrast, the weakest exclusivity clause, is a clause which prohibits the seller during the exclusivity period, as long as the buyer does not deviate from the business points defined in the letter of intent, from entering into a purchase agreement with other potential buyers.

Whether the buyer can obtain an exclusivity clause, and, if so, the extent of the clause depends on the strength of the negotiation position of the seller and the buyer. If the target business is very attractive and therefore, the seller has a strong position, it will be extremely difficult for a buyer to obtain an exclusivity clause. On the other hand, if the buyer is the only party interested in the purchase and the seller, at the same time, has some economic pressure to sell the business, the buyer may be able to negotiate an advantageous exclusivity clause.

3.2.2.4 *Exclusion of Liability Resulting from "Culpa in Contrahendo"*

To avoid that a party, in the event of a break-down of the negotiations, raises claims under the Swiss theory of "*culpa in contrahendo*",¹⁰ it is advisable, to state in the letter of intent that each party has the right to terminate the negotiations at any time and that the termination does not give rise to any claims of the other party. This helps to avoid unnecessary and usually fruitless discussions on damage claims.

3.2.3 *Excluding a Legal Obligation*

To avoid any ambiguities, the letter of intent should clearly state which of its provisions are binding on the parties and which are non-binding. In particular, it should clarify that an obligation to carry out the transaction exists only once the parties have validly executed a written purchase agreement. A clear statement on the binding and non-binding provisions is the most crucial point of the document as, on the one hand, it prevents the parties from interpreting the document as an executed purchase agreement and, on the other

¹⁰ According to Swiss law, a party may raise claims for compensation of its expenses if the other party negotiated in bad faith, negotiated without the intent to conclude an agreement, or negotiated without having the authority to enter into an agreement.

hand, from claiming in their later negotiations that a binding oral agreement on the major points had been reached during their discussions.

In Switzerland, there is an actual risk that a party may allege the existence of a binding contract at an early stage of negotiations since, according to art. 11 of the Swiss Code of Obligations (CO), purchase agreements for businesses can be concluded orally.¹¹ According to art. 2 CO, for the conclusion of a binding oral agreement, it is necessary, that the parties agree on the objectively essential points of a purchase agreement, *i.e.*, on the purchase price and the object of the purchase.¹² It is, therefore, possible for a party to claim that, a binding oral agreement was concluded in a situation when the parties have orally reached an agreement on the business points of the transaction and none of the parties has explicitly stated that it will be bound only on the execution of a written agreement.

3.2.4 Waiving a Letter of Intent

In many transactions, the parties do not sign a letter of intent but, once they have reached a preliminary agreement on the major business points, immediately enter into contract negotiations. If the parties decide to proceed without signing a letter of intent, they should, however, at the very least, record in writing that they have no legally binding obligations until they have validly executed a written purchase agreement. Otherwise, one of the parties may claim that a binding oral agreement has been concluded, if agreement on the business points has been reached. The reservation of contract is only valid if one of the parties makes a statement to this effect. Although an oral statement is, in theory, sufficient, it is advisable to notify the other party in writing of such a reservation to prove that the statement was actually made.

¹¹ This applies to share deals and asset deals. In an asset deal that includes real estate, the parties must, however, pursuant to art. 216 CO, conclude a public deed on the sale of the real estate.

¹² An agreement on the subjectively essential points, *i.e.* on the points which are essential to one of the parties, other than the purchase price and object of the purchase, is only necessary if one party has made it clear to the other party that a binding contract can exist only if an agreement is reached on these issues.

4. DUE DILIGENCE

- *The buyer should analyze the business thoroughly during the due diligence in order to create a basis for the negotiations of the contract and to verify the assumptions and information on which the purchase price was negotiated.*
- *By conducting a due diligence examination the parties can avoid negative discoveries made only after the conclusion of the purchase agreement. To a large extent, a due diligence also avoids disputes on contractual warranties, because the parties can already govern the problems discovered by the due diligence when concluding the purchase contract.*
- *The due diligence should include operative, legal, financial, and tax issues, as well as questions regarding environmental protection.*

4.1 Information Deficit of the Buyer at the Commencement of the Due Diligence

One of the main problems of the buyer is that the seller has the advantage of knowledge and information about the business,¹³ as at the beginning of the negotiations the buyer usually only has access to publicly available information or information he received directly from the seller during the initial negotiations. In particular, the information from the seller often presents the business in a more favorable light with the goal of achieving the highest price possible. The buyer, however, usually has no information that would allow him to assess the risks connected with the business, and to critically challenge the assumptions on which the initially quoted purchase price was based.

Certain risks that the buyer cannot assess due to his lack of information can be limited by appropriate representations and warranties in the purchase agreement. However, the contractual representations and warranties cannot cover all possible uncertainties of the buyer. The representations and warranties are based on information obtained from the past (in particular on the reliability of the balance sheets and financial statements), the existence of assets, as well as the non-existence of liabilities or risks (such as litigations, liability claims, environmental protection issues, *etc.*).¹⁴ The representations and warranties do not, however, cover the future earnings or potential profitability of the business even though these factors are decisive for the valuation of the price. The realization of profits and the potential of the business lie entirely in the hands of the buyer, and therefore, a seller will rarely be willing to grant representations or warranties for these matters. With

¹³ The contrary, however, is true for management buy-outs, where the buyer usually has more information on the business than the seller.

¹⁴ For the representations and warranties, see in detail chapter B.5.4.2 below.

regard to these central aspects of the due diligence, the buyer must always form an independent opinion on the basis of a thorough examination of the business and the resources available to him.

If the buyer is not able to decrease his information deficit during the due diligence, he will be forced to take a reserved negotiation position because he will have to negotiate the contractual representations and warranties, as well as the price, knowing that there may be risks and uncertainties he is unaware of. As a consequence, if the buyer cannot conduct a thorough due diligence, the parties will not be able to develop trust that allows them to solve problems arising during the negotiations by finding constructive solutions. The seller, based on his knowledge of the business, assumes that the information he gives to the buyer is correct, while the buyer will remain doubtful.

4.2 Purpose of the Due Diligence

The objective of the due diligence is to enable the prospective buyer to cover his paucity of information by a thorough examination of the business in order to have sufficient information to properly value the business and to assess the risks which have to be covered in the purchase agreement. In particular, the prospective buyer must analyze, during the due diligence, whether the business is capable of achieving earnings that justify the purchase price and, in addition, if the business holds the necessary assets to achieve these earnings. Therefore, the buyer should analyze the existence of potential risks which may affect its future success of the business. After a successful due diligence the buyer should have gained knowledge enabling him to conduct further negotiations confidently.

A thorough due diligence will also facilitate the managerial responsibilities of the buyer after the purchase. On the basis of the information the buyer was able to obtain during the due diligence, he will be able to assess which management initiatives should be taken to achieve a better integration of the business upon completion of the acquisition. Thus, the effective use of the information obtained in the due diligence can shorten the integration phase. Without accurate information obtained from a thorough due diligence, the integration phase would be massively prolonged and the buyer could risk management mistakes due to his unawareness. This could lead to financial losses and, as a consequence, endanger the success of the acquisition.

The due diligence also has significance for the board of directors and the management of the buyer, as they have the obligation, in accordance with their duty of care, to examine the risks and the potential of the target business. Should they waive the due diligence and should problems arise after the acquisition, which could have been discovered by a due diligence, they are exposed to considerable criticism from their shareholders, and, in extreme cases, to a liability claim pursuant to art. 754 CO.

For the seller, a due diligence has the advantage that he will be able to limit his liability in connection to the representations and warranties, since problems discovered during the

due diligence will normally not be covered by such provisions. Instead, as mentioned in chapter A.4.7.2 below, the problems will be dealt with in the purchase agreement.

4.3 Confidentiality Interest of the Seller

While the prospective buyer has a legitimate interest in the full disclosure of all information necessary to assess the value of the business and the risks associated with it, the seller has a legitimate interest in confidentiality as the information the buyer receives during the due diligence contains business secrets. The due diligence analysis may also infringe on the rights of third parties, as in certain cases, legal confidentiality obligations towards third parties may forbid disclosure. For example, if a bank is sold the rules on banking secrecy do not allow the owner of the bank to disclose any client data to a prospective buyer. Other examples are license agreements or joint-venture agreements which prohibit the disclosure of these contracts to a third party.

In practice, the following methods provide an acceptable compromise between the interest of the buyer in a full disclosure and the interest of the seller in keeping certain information confidential:

– Confidentiality Obligation of the Buyer

Normally, the execution of a confidentiality agreement¹⁵ is a prerequisite for conducting the due diligence. Such a confidentiality agreement will, in general, not only prohibit the disclosure of information to third parties but also the use by the buyer of the information obtained during the due diligence for the buyer's own business advantage. However, if the prospective buyer is a competitor, the agreement only provides limited protection since the use of information can rarely be conclusively proven. A confidentiality agreement will also be limited, if the seller has a statutory or contractual obligation towards third parties to keep certain information confidential, as such an obligation prohibits the disclosure of information regardless of whether the third party has signed a confidentiality agreement.

¹⁵ For confidentiality agreements, see chapter B.2 above.

– Redaction of Sensitive Information

Sometimes the confidentiality interests of the seller can be safeguarded by redacting words and sentences in the documents which contain sensitive information, such as names of certain customers or the prices of goods and services. This method may also be used to comply with contractual or statutory confidentiality obligations,¹⁶ so long as after the redaction of the information the buyer is not able to draw any conclusions on the identity of the third parties involved.

– Due Diligence by a Third Party

In cases of particularly sensitive confidential issues or a statutory confidentiality requirement imposed on the business or seller, the seller may instruct a third party, such as an audit or a consultancy company, to conduct a due diligence on behalf of the buyer and to provide the buyer with a report (additionally the third party may provide a guarantee that no individual secret data will be released to the buyer). The report issued should contain sufficient information to allow the buyer to make decisions, while not disclosing data that has to be kept confidential. When acquiring a bank, this is usually the only method allowing for client related data (*e.g.*, credit risks, size of assets, *etc.*) to be examined without violating banking secrecy.

4.4 Areas and Extent of the Due Diligence

At the beginning of a due diligence, the parties should determine which documents and information should be reviewed in the exercise. It is reasonable to only analyze data that may have an influence on the decision to acquire the business concerned or on its valuation; an extremely detailed due diligence is not essential to these issues, only creates an unnecessary cost factor and threatens to prolong the transaction. However, a due diligence which does not discuss the valuation and risk factors involved will not provide the prospective buyer with the information he requires to make an informed decision.

As a first step, the parties should determine which areas are relevant to the buyer for the valuation of the business and, therefore, should be covered by the due diligence. While certain standard areas, such as, finances, tax, and fundamental legal issues, must be covered in practically every due diligence, other areas of review will depend on the type of business concerned. For example, in technology oriented-enterprises, intellectual property rights, license agreements, and the evaluation of the technology itself have to be emphasized, while in the chemical oriented-industries usually environmental issues and long-term supply and delivery agreements are the focus.

¹⁶

The redaction of the names of individual customers is normally sufficient to comply with the Federal Data Protection Act which does not allow disclosure of individual data on customers to a third party.

Therefore, at the outset, the parties need to determine the areas and the scope of the due diligence. Since the scope of the due diligence is determined by its purpose, namely to analyze data that is relevant for the valuation of the business and its risks, the scope will to a large extent depend on the size of the business. If the business has a turnover of several hundred million Swiss Francs, it is not appropriate to analyze the operations of the individual sales offices or to review the litigation proceedings with a litigious value of a few thousand Swiss Francs. The review of these details will cause considerable cost and lead to findings that have no material influence on the purchase price or the buyer's decision to acquire the business. Therefore, the parties should define threshold amounts that allow the seller to clearly evaluate which documents and information should be disclosed.

The parties' discussions on the areas and scope of the due diligence should lead to a due diligence checklist that defines the areas of the due diligence and describes the documents and information to be disclosed by the seller. However, this checklist should not limit the due diligence rigidly, since the initial analysis often leads to further legitimate information requests that may not have been included in the checklist.

4.5 Scope of the Due Diligence

The scope of the due diligence depends on the features of the target business and on the individual risks connected with the business. In general, the following areas will be analyzed with the emphasis and the scope of the due diligence adapted to the individual features of the business:

4.5.1 Operative Due Diligence

The purpose of the operative due diligence is to identify the operative risks and opportunities of the business. This enables the buyer to estimate the future profits and cash flows which are crucial for the valuation of the business. In the operative due diligence the following issues are analyzed in particular:

– Market Position

Potential of the markets in which the business is active, the competitive environment, the reputation of the business and relations to customers.

– Distribution

Distribution methods and access to distribution channels.

– **Core Competence / Technology**

Quality of core competences and technologies, potential to leverage core competencies and technologies with regard to new products and services, distance to competition.

– **Products**

Level of the development of products, comparison with competing products and pipeline of future products.

– **Cost Structure**

Potential cost savings and foreseeable cost increase.

– **Intangible Assets**

State of intangible assets, current state of the technology and the need for investment.

– **Current Assets**

Depreciation requirements of accounts receivable and inventory, and savings potential by reduction of current assets.

The operative due diligence should enable the buyer to critically review the business plan of the seller and the earning projections based on such business plan, and thereby to re-examine the valuation that has led to a preliminary agreement on the purchase price. Given that the results of the operative due diligence are decisive for the assessment of the future earnings and the valuation of the business, it is the most important area of the due diligence exercise; further, these issues cannot be covered by contractual representations and warranties. The results of the operative due diligence also enable the buyer to optimize the process of integration of the acquired company.

The operative due diligence is based on the analysis of documents (*e.g.*, market reports, management accounts, sales statistics, *etc.*), site visits, management presentations, and question and answer sessions with the responsible managers. These conversations with the management are essential since the due diligence also covers "soft factors" and the analysis of these "soft factors" cannot be derived from documents and figures. In particular, the potential or the further development of the business and the management's ability to take advantage of such potential can often be assessed only in a personal discussion with the management of the business.

4.5.2 Human Resources Due Diligence

An essential factor for the success of a business, but at the same time, one of the biggest cost factors, is its personnel. During the due diligence, it must be determined which employees play an important role for the success of the business, whether these employees

are willing to continue to work for the business after its sale or whether they, if necessary, can be replaced. Apart from this analysis, which in particular concerns the top management, and in some cases the research and development department, the buyer also has to analyze whether the employees of the business have the necessary know-how and capacity to carry out the planned business strategy or if investments will be necessary in this area.

Furthermore, the buyer should also analyze whether the business employs too many employees, and if so, the financial consequences of a restructuring. In particular in countries other than Switzerland, the lay-off of personnel can lead to extremely high and sometimes prohibitive costs which can prevent the necessary restructuring or even impose costs in an amount which would have a negative effect on the value of the company.

As a part of the human resources due diligence, the pension fund of the target company has to be analyzed since deficits in this area can lead to high financial burdens for the buyer. The essential question is whether the assets of a pension fund, or provisions for pensions in the financial statements, are sufficient to cover the accrued pension claims of the employees, since, in the case of any coverage gaps, the employer according to our experience has to pay at least 50% of such gaps.¹⁷ It is just as important to analyze the general level of pension benefits provided by the business to its employees. If a considerable difference exists between the benefits received by the employees of the target company, and the benefits received by the employees of the acquiring company, this difference usually leads to high costs upon integration since the lower level of benefits will usually be increased to the higher level. While a deficit in the coverage of pension claims is normally borne by the seller through a reduction of the purchase price or a grant of a special indemnity, the seller cannot usually be held responsible for differences in the general level of benefits between the target company and the acquiring company as this difference is not caused by the target company but by the acquiring company, *i.e.*, the buyer.

4.5.3 Financial Due Diligence

In this part of the due diligence, the financial position of the business is examined. The balance sheets and financial statements, as well as the accounting and consolidation principles, which form the basis of the financial statements, and their application in practice, have to be analyzed. Only a critical review of the accounting, valuation and consolidation principles allows the buyer to assess the quality of the earnings. Otherwise, a danger exists that the buyer, *e.g.*, due to hidden extraordinary earnings or the disclosure of hidden reserves, may base his valuation on too high sustained earnings and consequently on a too high value of the business. The financial due diligence should aim at determining the value of the sustainable earnings in the years before the purchase. The results of the financial due diligence, together with the results from the operative due diligence, provide the basis for the estimates on future sustainable earnings which is central to the valuation of the target company and the assessment of the purchase price.

¹⁷ For the pension plan issues see chapter E.3 below.

Further, during the financial due diligence, the financial consequences of the integration and consolidation of the acquired company on the buyer's financial statement will be analyzed. If the target company applies accounting and valuation principles that deviate from those used by the buyer, the restatement that is necessary in the financial integration may have consequences that may strongly influence the buyer's decision to buy the business.

4.5.4 Legal Due Diligence

The purpose of the legal due diligence is to analyze the legal relations of the target company. In particular, the legal due diligence covers the following areas:

– Corporate Law

In this area, the buyer has to examine whether the target company has been established and administrated in conformance with the applicable law and if all the necessary corporate documents are available. If the company has minority shareholders, the legal position of these shareholders has to be carefully analyzed since obligations contained in shareholders agreements may considerably limit the entrepreneurial freedom of the buyer.

– Contracts

When planning the due diligence, the buyer has to examine those contracts that are essential for the business and have an influence on its strategy and earnings. The contracts which are essential for the business will depend on the type of the business and its individual features.

For contracts which deal with the main activities of the business, it is important to pay attention to their duration and promised consideration. In this respect, it has to be analyzed, whether such contracts are favorable for the business or contain pricing mechanisms that, in the future, lead to higher payments and reduce the expected earnings. Contracts that expire or cannot be renewed at equally favorable terms will have the same effect. The buyer must also analyze whether the agreements that are important for the business contain change of ownership clauses that may lead to the termination of these agreements if the business is sold. Such termination may lead to lower earnings and consequently to a lower valuation of the business.

Apart from the important individual contracts, it is also necessary to review the standard agreements that are used for suppliers and customers as the terms of these standard agreements, even if only in their total number, considerably influence the risk situation of a business.

– Pending and Threatening Procedures

The success of a business can be strongly influenced by threatening or pending litigation or other procedures. On the one hand, it is necessary to analyze any procedures

that may alter the way in which the business is conducted, *e.g.*, administrative procedures that may result in the prohibition of the sale of certain products, in important design changes or force the business to change its practices. On the other hand, it is also necessary to analyze the procedures that may potentially lead to high damage payments. In these cases, the buyer has to examine whether the risks associated with these procedures have been recorded properly in the financial statements, *i.e.*, whether the provisions established for these procedures are sufficient to cover the risks associated with them and whether the outcome of the procedures have an impact on the business activity.

– **Authorization and Licenses**

In the legal due diligence, the buyer has to analyze which authorizations and licenses are necessary for the business, whether the business has actually obtained these authorizations and licenses and whether they remain valid after the sale of the business. It is also necessary to critically analyze any requirements and conditions tied to these authorizations and licenses, as these may, as often found in the industrial sector, lead to additional investments or to increased costs.

– **Legal Framework of the Business Activity**

Typically the business activity has to comply with many legal provisions. Non-compliance with existing laws may have a materially negative effect on the valuation of a business. The buyer may have to change certain business practices, in order to comply with laws and regulations, which may lead to higher costs. The buyer must also determine whether the business is exposed to claims for damages and fines due to the violation of laws and regulations. In particular, the violation of antitrust laws and environmental regulations may lead to heavy fines and damage claims which may considerably reduce future earnings.

The legal framework of the business activity is not only relevant in relation to possible violations but also important in relation to the scope for the development of new business activities. If the valuation of the business is based on an increase of the profit as a result of planning drastic rationalization measures and outsourcing of certain functions, the buyer has to analyze whether the applicable provisions leave sufficient flexibility for these measures, *e.g.*, whether security provisions impede certain rationalization and outsourcing measures. In the due diligence, it is therefore not only necessary to analyze the legal provisions and restrictions that the business is subject to at the time the business is sold, but also, as far as possible, to analyze pending legal developments and new provisions that may in the future restrict business activities or lead to a higher cost and reduce future earnings.

– Labor Law

Collective employment agreements and "promises to employ" may complicate future restructurings and even make them impossible. The wording of standard employment agreements can have a similar effect, therefore, these standard agreements have to be analyzed as well. Apart from these issues which are relevant for the entirety of the employment conditions, the individual employment agreements of top managers and other key personnel have to be analyzed, as the terms of these agreements may have a considerable influence on the business. In particular, the question whether the top management and key personnel may leave the business and whether they are subject to non-competition clauses can be critical for the success of the business, especially in the transitional phase of the acquisition. With regard to technology oriented companies, it will be relevant whether non-competition provisions on research and development employees can be implemented and whether all inventions and developments, to the extent legally possible, pass over or can be transferred to the business.

The buyer should also analyze the number and size of any labor law disputes. Normally, individual disputes in this area do not materially influence the financial position of the business. A high number of these cases may, however, point to problems that may have a negative influence on the operational area of the business.

– Intellectual Property Rights

The intellectual property rights of a business are often important assets and success factors. In some businesses, particularly in consumer goods and services, trademarks that are well recognized in the market are some of the most important assets, whereas for technology oriented companies, patents and certain software copyrights can be major value drivers. The first step for the buyer is to analyze whether the intellectual property rights used by the business are actually owned by the business and validly registered in the countries where the business is active. If these rights are owned by third parties, the buyer must analyze whether the business has concluded sufficient license agreements to ensure the continued use of such rights. If certain patents or trademarks must be considered as decisive success factors, the buyer should, in a second step, analyze through a patent or trademark research whether such patents and trademarks endure materially and do not violate the rights of third parties.

– Property and Rights to Use Immovable Property Respectively

The property owned by a company can be a material factor for its success and value. In such cases, the buyer not only has to analyze whether the real estate concerned is actually owned by the business, but also determine whether regulations under public law or rights of third parties restrict the use of the property and negatively influence its value. In the case of rented objects, the rental contract must be evaluated since increases in rent payments or the expiration of the rental contract may lead to expenses or the

loss of an attractive business location that may negatively influence the value of the business.

– Insurance

The insurance of a business is important to cover risks connected with the business activity. In particular, liability policies have to be analyzed which cover risks in the area of product and environmental liability as these risks may considerably influence the value of the business. The existence of sufficient insurance coverage in the area of product liability often facilitates the negotiation of the purchase agreement as the buyer, in such cases, does not need to insist on extensive warranties for the coverage of risks concerned but can rely on the insurance coverage.

– Software

Software is often a decisive factor for the success of the business and practically always a significant cost factor. In this area, the buyer has to analyze whether the business has the rights to software developed by the business itself and whether the business has sufficient licenses for any used software developed by a third party. In license agreements, change of ownership clauses that allow the software owner to request a higher fee, if the business is sold and the owner changes, can be problematic. Usually this is the case when acquiring a business of a group of companies which conducts business on the basis of a group license agreement. This will lead to higher costs for the buyer and as a result include a corresponding reduction of the purchase price.

The above description highlights the areas which have to be covered in the legal due diligence and demonstrates that there is a close connection between the legal due diligence and other areas of the due diligence. In particular, the review of contracts and intellectual property rights has to be closely coordinated with the operative due diligence. If the operative due diligence shows that certain patents, trademarks or contracts are important factors for the success of the business, these intellectual property rights and contracts have to be analyzed in the legal due diligence to verify whether these rights are sufficiently protected in the long term. A direct connection also exists between the legal and the financial due diligence as the buyer has to ensure that the problems and risks detected in the legal due diligence are adequately accounted for in the financial statements. Particularly, the financial statements must contain adequate provisions to cover risks of ongoing litigation or the costs of compliance with new conditions for licenses and authorizations.

4.5.5 Tax Due Diligence

In this part of the due diligence, the tax status of the business and its compliance with tax laws and regulations have to be analyzed. It is also important to analyze if any risks exist due to the structure of the business and its previous tax planning. These risks may stem, in particular, from transactions between the business and its previous owner or from inter-company pricing between various foreign subsidiaries of the business. If transactions or contracts were concluded at terms which deviated from customary market conditions,

such as the payment of excessive salaries, management fees to the seller or excessive prices for goods and services delivered to subsidiaries in high tax jurisdictions, this may lead to adjustments in the taxable income and additional tax charges. Risks may also be caused by aggressive tax structures, such as the use of holding or finance companies located in offshore jurisdictions, or the use of commission and contract manufacturing structures which are used to channel income away from high tax jurisdictions.

During the examination of the tax relations of the business, it must be evaluated whether the planned acquisition itself will lead to a negative tax consequence *e.g.* whether, due to the applicable tax regulations, the tax loss carryforward cannot be used¹⁸ or certain tax favorable structures and practices cannot be continued by the future owner.

4.5.6 Environmental Due Diligence

Due to the high costs associated with the removal and restoration of soil and water contamination and other environmental concerns, it is advisable to thoroughly analyze such problems in the due diligence. Soil and water contamination can lead to high expenses in the future which often cannot be covered entirely by contractual warranties as such contractual remedies are subject to statute of limitations, whereas the liability for removal and restoration have a long latency period until discovery.

The environmental due diligence normally begins with a general risk assessment conducted by a specialist. If risk factors are identified (*e.g.*, environmentally damaging businesses, false waste disposal, old deposits, *etc.*), the buyer has to conduct a more detailed analysis, which may include a soil and water analysis, in order to achieve a correct assessment of the environmental risk. This detailed analysis is often quite expensive and time-consuming, and, therefore, this analysis often becomes the "critical path" in the whole acquisition procedure.

4.6 Due Diligence Procedure

The due diligence is normally based on a checklist ("Information Request") predefined by the buyer which lists all the documents and information he intends to review. The seller will provide that information to the buyer either on the premises of the business or, to avoid any disruption of the business, outside of the business in a data room. In addition to the review of documents,¹⁹ the buyer will normally also conduct site visits and meet with management and auditors.

¹⁸ In Switzerland, the control change in a company will not lead to loss of tax loss carryforward: In other countries, the change of control in the company could have such an effect.

¹⁹ Today, with the technical possibilities available, it is possible to create a virtual data room; the documents will be saved to a server and the interest buyer receives a passport to access the data room. The advantages of a virtual data room are that several interested buyers can access it at the same time, without any disruption on the seller. Further, it is known, which interested buyer reviewed which documents.

It is advisable for both parties to keep detailed records on the documents reviewed. These records prevent a later conflict between the parties concerning the information transmitted in the due diligence procedure. This is particularly important in later disputes on warranties, as problems that have been disclosed in the due diligence normally cannot lead to further warranty claims.

To properly structure the due diligence procedure, it is advisable to clearly define a clear line of communication between the parties during this procedure. It is in the interest of the seller that all questions of the buyer are channeled through one person that has been identified for this purpose, and that the management of the business is only involved in clearly defined management interviews. In this manner, disruptions of the business and uncertainties that may arise if information is compiled from various sources can be avoided.

4.7 Solutions to Problems Emerging in the Due Diligence

If problems emerge in the due diligence, they can be dealt with in various ways in the contracts, *i.e.*, if risks arise that were unknown to the buyer or if it becomes clear that the business cannot attain the earnings on which the purchase price was based:

4.7.1 Conditions Precedent to the Closing of the Transaction

If during the due diligence problems emerge which are crucial to the success of the acquisition and which can be resolved, the appropriate solution is to subject the closing of the transaction to the condition precedent that such problems must be solved first. If, for example, the buyer in the due diligence detects that certain contracts that are essential for the conduct of the business can be terminated by the counter party or are cancelled automatically, the best solution is to subject the purchase agreement to the condition precedent that the counter party consents to the acquisition of the business. A condition precedent is also the appropriate resolution when the buyer in the due diligence detects that certain assets that belong to the business *e.g.*, intellectual property rights, are owned by the seller. In this case, the closing should be subject to the condition precedent that the seller first transfers these assets to the business. The preconditions should not only be implemented but the seller must be obligated to fulfill the corresponding conditions, *e.g.*, to confer intellectual property rights or to conclude a service agreement respectively.

4.7.2 Reduction of the Purchase Price

The reduction of the purchase price is the appropriate solution if during the due diligence facts are detected that directly influence the valuation of the business. In particular, the buyer will seek a reduction of the purchase price if he detects that future earnings will be lower than expected because, for example, they are mainly driven by extraordinary gains. Another reason for a price reduction is if the buyer finds out that the company does not have the patents for the inventions that are crucial for its business and therefore, the buyer is exposed to increased competition and lower earnings in the future. A reduction is even

appropriate when the due diligence shows that additional costs will arise in the future, for example, if the business faces important one-time charges, such as the remediation of environmental contamination or the replacement of expensive equipment. Provided that the costs can be estimated, a purchase price reduction is the right solution.

For the seller, it is important that the reasons that lead to a reduction of the purchase price are clearly recorded. This prevents the buyer from later asserting an additional warranty claim for the same reasons. If the purchase price, for example, is reduced because the risks associated with certain projects have not been properly assessed and provisioned in the financial statements, the seller should reference the reason for this reduction in contractual provisions. This prevents the buyer from claiming that the provisions for the risks recorded on the balance sheet are insufficient and to request a payment on the basis of the balance sheet warranty.

4.7.3 Adjustment of the Purchase Price / Indemnities

If in the due diligence, the buyer detects problems which lead to uncertain financial consequences (*e.g.*, pending litigation, risks in the credit portfolio of a bank or risks in connection with big projects), it is normally not appropriate to solve these problems through warranties or representation. On the one hand, the problem is known to the buyer and on the other hand the seller cannot reasonably be expected to confirm in a representation that the problem does not exist. Furthermore, the duration of representations and warranties is normally not sufficient to cover these problems, since it often takes longer to properly assess their financial consequences. In these cases, it is better to provide for a later adjustment of the purchase price in accordance with the actual costs incurred, or for the seller to provide an indemnity that he will bear the costs of the negative financial consequences of the relevant problem.²⁰

4.7.4 Representations and Warranties

If in the due diligence, the buyer detects risks and it is not possible to assess the actual cost and provide for a price reduction at the time of the conclusion of the purchase agreement, the best solution is to deal with such risks with representations and warranties in the purchase agreement that are tailored to protect from these risks. Further, the contract should exclude the application of art. 200 CO, as pursuant to this provision a seller will only be liable for warranties made when the buyer was not aware of the relevant risk.

²⁰ For adjustment and indemnities, see chapter B.5.2.2 and chapter B.5.4.5 below.

5. PURCHASE AGREEMENT

- *Since the Swiss law dealing with the acquisitions of companies does not contain any adequate provisions which deal with the rights and obligations of the parties to an acquisition, the purchase agreement has to define their rights and duties, and in particular, also the representations and warranties provided by the seller in detail.*
- *In an asset deal, the object of a sale (i.e., the individual assets and liabilities) and the transfer mechanism for each class of assets and liabilities have to be precisely defined. In a share deal, the shares of a corporation are the object of the sale and the assets and liabilities will pass over to the buyer indirectly with the transfer of the shares.*
- *The purchase price is normally a fixed amount unless the buyer and seller cannot agree on it because they have different expectations of the future earnings of the business. In such cases, a formula can be devised that ties the price to the earnings. This purchase price calculation is often adjusted if the valuation is based on a debt / cash free basis to reflect any changes in the level of net debt that has occurred between the closing and the date of the financial statement. If the contract provides for an adjustment clause or for an earn-out component, the contract not only has to define a clear formula for the calculation but also a procedure that leads to a binding result for both parties.*
- *If the closing is subject to a condition precedent (e.g., authorization under merger control regulations, or other governmental authorizations, consent of third parties, etc.), there will be an interim period between signing and closing. The contract should not only clearly define the conditions precedent, but also the rights and duties of the parties with regard to the fulfillment of these conditions and the management of the company during this interim period.*
- *The contract should contain a detailed record of the representations and warranties provided by the seller. The content of the representations and warranties depends on the individual risk situation of the company. Essential are the warranties as to balance sheets and financial statements, tax, environmental risks, labor law and pension issues, intellectual property rights, insurance, and product liability. Apart from these representations and warranties, purchase agreements usually also contain indemnities by the buyer for problems that were already known to the parties at the time the purchase agreement was concluded.*

- *The purchase agreement will often contain further provisions with additional obligations of the seller, such as the provision of services in the transitional phase or a non-competition clause.*

As part of the acquisition of a company, the parties usually negotiate extensive contracts which regulate all the details of the planned transaction. A high level of detail is necessary, as the acquisition of the company is normally a complex transaction in which the parties agree to various obligations that often considerably exceed the simple transfer of ownership in the assets against payment of the purchase price. A purchase agreement contains, in most cases, conditions precedents which can only be fulfilled if the parties cooperate with one another. Further, the agreement provides for extensive representations and warranties, and often also contains additional covenants that regulate the seller's behavior after the closing of the transaction (*e.g.*, prohibition on competition or further participation in the business).

If a purchase agreement fails to address all the relevant issues, art. 184 *et seqq.* CO will apply, which contain provisions for cases in which the parties have not incorporated specific clauses in the purchase agreement. These provisions, however, are not tailored to the acquisition of companies. Therefore, the parties cannot rely on the legal provision of the CO to fill the contractual gaps appropriately. In order to avoid ambiguity, the parties should seek to prevent contractual gaps in the purchase agreement by carefully analyzing the effects of the transactions and by comprehensively defining mutual rights and duties.

The wording of the purchase agreement should reflect the result of the negotiations and the intentions of the parties in such way that if a dispute between the parties arises at a later point, the content and the construction of the agreement cannot be challenged. A precisely worded purchase agreement should clearly define the rights and duties of the parties, prevent a legal procedure between the parties, or at a minimum make the result of such procedure foreseeable. In contrast, if a purchase agreement is unclear or does not regulate crucial points, questions on the construction of the agreement may lead to uncertainty and disputes between the parties; legal procedures are detrimental to both parties, as they usually lead to costs that are not offset by benefits.

The content of a purchase agreement depends on the particularities of the target company and on the individual needs of the parties. A purchase agreement, therefore, contain specific provisions tailored to the particular facts of the case. In general, the agreement will regulate the following issues:

5.1 Object of the Sale

5.1.1 Share Deal

In a share deal, the object of the sale is the shares of the corporation²¹ only. The assets and liabilities, as well as the legal contracts and obligations, will be transferred to the buyer indirectly with the transfer of the shares which grant the buyer the control over the company. For this reason, it is sufficient if the purchase agreement defines the shares subject to the transfer and does not mention the individual assets, liabilities or contracts and other legal obligations since the assets, liabilities, and contract do not form part of the object of the acquisition.

5.1.2 Asset Deal

If a business is sold in an asset deal, all assets and liabilities constitute the object of the sale and, therefore, together with all contracts and other legal obligations to be transferred consequently, have to be defined in the purchase agreement. Although Swiss law allows the use of general descriptions, as for example, "all the assets, liabilities and contracts of the business", to avoid problems, it is advisable to describe in detail the assets, liabilities and contracts to be transferred (ideally, in a list attached to the agreement). In a large transaction, such an annex list would be excessively long. Therefore, instead of using an annex list, reference can be made to the balance sheet details and other accounting documents, as well as the general catch all clause.²²

If the purchase of the business is accomplished with an asset transfer, in the sense of art. 69 *et seq.* MA, which provides for one uniform act of transfer, the transferred assets, liabilities, and contracts must be listed individually; art. 71 para. 1b MA, further requires that the transferred objects are defined by an inventory with the correct description of the assets and liabilities to be transferred, whereby, property, securities, and intellectual property are to be listed individually.

5.2 Purchase Price

5.2.1 Fixed Purchase Price

Normally, the purchase price is defined as a fixed amount that represents a compromise negotiated between the parties based on the valuations conducted. The purchase price is also influenced by the legal structure of a transaction: a purchase agreement which transfers all the risks of the transaction to the buyer, normally, will lead to a lower purchase price than a purchase agreement which incorporates broad representations, warranties and

²¹ Or in the case of a *GmbH* the quotas.

²² To protect the buyer from an incomplete transfer of assets, purchase agreements in asset deals usually contain a representation that the seller has transferred all assets that he has used for the conduct of the business immediately prior to a closing (*cf.* chapter B.5.4.2.4.)

indemnities as the buyer will take the risks into account when assessing the purchase price.

5.2.2 Adjustment of Purchase Price

5.2.2.1 *Adjustment of the Purchase Price to Changes of the Current Assets and Financial Liabilities*

Even if the purchase price is defined as a fixed amount, the parties often provide for its adjustment to any changes in the inventory of assets and liabilities that have occurred between the closing date and the date of production of the balance sheet.²³ In particular in an asset deal, this adjustment is necessary because the cash flow that is generated by earnings or divestitures of the business, during this time frame, flows directly to the owner of the business, with the consequence that the equity capital and the working capital are diminished. Without a proper adjustment mechanism, the buyer runs the risk of not receiving the net working capital that is reflected in the last balance sheet but a much smaller net working capital.²⁴

In a share deal, changes in the inventory of assets and liabilities between the closing date and the date of the balance, will only lead to a change in the equity capital, if the company makes a profit or a loss, since the sale of a company can be represented as a financially closed system (so long as there are no distributions out of the company) in which the generated cash flow will remain. However, an adjustment mechanism may also be necessary in share deals, if the purchase price is based on a debt-free / cash-free enterprise value. In these cases, the purchase price is a gross amount that has to be corrected if the amount of debt or cash has changed since the date of the balance sheet that was the basis of the business' valuation.²⁵

5.2.2.2 *Formulation of the Adjustment Mechanism*

If the parties include an adjustment mechanism in the purchase agreement, it is important to clearly define the benchmark values and the procedure by which the purchase price will be adjusted. Without a clear understanding of these essential points, long disputes will evolve with negative consequences for the parties.

First, the individual balance sheet positions, which provide the basis for the adjustment, will need to be defined. It is advisable to attach the individual balance sheets in an annex and to mark the relevant balance positions individually, as well as to define the accounting standard and practices that were used to determine the relevant positions. Also the amount in the price variation needs to be evidenced in a way that makes a mathematical calculation, with reference to the relevant positions, possible.

²³ The balance sheet is of importance to the parties, as the valuation of the buyer will be based on this document.

²⁴ The net working capital can be reduced by forced sales of stock, fast collection of receivables and the extension of the payment periods for payables.

²⁵ To avoid last minute manipulations, it is advisable to rely on financial debt and net working capital. If the parties rely only on the cash, the seller may attempt to decrease receivables and increase payables to maximize the cash position.

5.2.2.3 Procedure

The purchase agreement should provide for a procedure that enables the simple and effective calculation of the adjustment in a manner that makes the final result binding on both parties. For this purpose, the purchase agreement should provide that one of the parties ascertains the relevant positions on the basis of the adjustment formula and procedure provided for in the purchase agreement. These positions are then audited by the auditors of the business. As soon as the positions are calculated, they can be transmitted to the other party together with the adjusted sum. The other party has the right to review the calculation on the basis of the accounting standards of the business and contradict them if necessary. If the differences between the parties cannot be resolved in negotiations, the contract should provide that a neutral accounting firm will calculate the exact amount of the adjustment. Under Swiss law, it is possible to make the finding of the neutral accounting firm binding on the parties as an expert determination (*Schiedsgutachten*).

A clear definition of the calculation mechanism and procedure of the purchase price adjustment in the purchase agreement, will avoid long-winded disputes which would evolve in the case of uncertain adjustment clauses or poorly-defined procedures.

5.2.3 Earn-Out Clauses

5.2.3.1 Agreement on an Earnings-Linked Purchase Price

In cases, in which the parties cannot agree on the purchase price because their expectations of the future earnings of the business substantially differ, the purchase price can be linked to the future earnings to be realized by the business ("earn-out" clause). The entire purchase amount can depend on the future earnings or, more commonly seen in practice, in addition to a fixed purchase amount, a part of the purchase price is made dependent on the future earnings. If the future earnings develop as predicted by the seller, he will receive a high purchase price. If the view of the buyer prevails, the final purchase price will be nearer to the fixed portion of the purchase price, which reflects a valuation that is based on the buyer's estimate of the business' earnings. The earn-out clause leads to a fair reconciliation of parties' interests since the purchase price is determined by the actual development of the business success.

The main problem with earn-out clauses is that after the sale, the buyer is responsible for the management of the business and the business strategy, which he may perform in a different way than expected by the seller, meaning that the seller's expectations of the future profits of the acquired business may not realize. This may be the case when the buyer decides after the sale to integrate the acquired business in his already existing business structure and thereby to optimize the profit of the entire structure rather than the profit of only the acquired business itself. Experience shows that earn-out clauses are best accepted by sellers if the seller, after the closing of the purchase agreement, continues to manage the business for the period that is relevant for the calculation of the earn-out, which is in particular true in the acquisition by financial investors who do not aim for such integration.

Earn-out clauses are also problematic since the buyer, by obtaining control over the business, has the possibility to manipulate the earnings of the business. The buyer may accomplish this by an aggressive investment and depreciation policy, by adding to the business activities, by transferring profitable activities to other companies he controls, or simply by charging excessive prices for goods and services the buyer himself, or a company controlled by the buyer, delivers to the business. Swiss accounting rules are particularly favorable to these practices as they allow a company to understate earnings to a large extent by inflating depreciation charges and provisions.

5.2.3.2 *Formulation of Earn-Out Clauses*

If the parties, in spite of the problems connected with earn-out clauses, decide to include such a clause in their agreement, it is advisable that the contract not only contains a mathematical formula for the calculation of the earn-out amount, but also describes in detail the earnings on which the calculation is to be based on. Normally, it is better to base the calculation on EBITDA, than on the after tax profit, as EBITDA cannot be influenced by a change in depreciation and investment policy. The calculation of the earnings should be based on strict accounting standards such as IFRS or US GAAP. To avoid ambiguities, it is furthermore advisable to specify the positions, which are taken into account in the calculation of the relevant earnings, in a model calculation that is attached to the purchase agreement.

To avoid manipulations of the earnings, the purchase agreement should also prohibit the buyer from entering into any transactions with the business that are not based on market prices, or to transfer any activities from or to the business during the period relevant for the calculation of the earn-out amount. Even though uncertainties can be reduced by such a provision, practice shows that it is, nevertheless, not always possible to prevent manipulations and disputes over the amount of relevant earnings.

5.2.3.3 *Procedure*

To avoid difficulties in the determination of the earnings and in the calculation of the earn-out amount, it is advisable that the parties in the agreement use the same mechanism as described in chapter B.5.2.2.3 for purchase price adjustments, *i.e.*, appoint a neutral accounting firm, which as an arbitrator, determines the earnings in a manner that is binding for both parties should the parties themselves not be able to agree on the amount.

5.3 Provisions relating to the Closing of the Transaction

In most transactions, the sale of the business cannot be performed immediately after the signing of the purchase agreement. Often there is a considerable period between the signing and the closing because authorizations have to be obtained before the closing or other conditions precedent have to be fulfilled. Sometimes the buyer needs time to arrange the financing or to establish an acquisition structure by founding an acquisition company.

Most purchase agreements therefore, will contain provisions defining the date of the closing,²⁶ the conditions to be complied with before closing, as well as the actions to be performed by the parties between signing and closing.

5.3.1 Date of the Closing

If the parties need a time period between signing and closing to prepare themselves for the closing, the date of the closing can be fixed directly in the purchase agreement. If the closing of the transaction is, however, subject to the fulfillment of certain conditions precedent,²⁷ it is normally difficult to set a specific date for the closing. Instead the date should be defined with reference to the completion of these conditions.²⁸ If the closing of the transaction depends on the fulfillment of certain conditions, the transaction will remain suspended for a certain time due to the uncertainty on the fulfillment of the conditions precedent. In order to avoid that such period is too long, the purchase agreement should also specify a date, after the expiry of which, the agreement is automatically terminated or allows either party to terminate it, due to non-fulfillment of the conditions precedent to closing.²⁹

5.3.2 Default and Delayed Performance

If the contract is not fulfilled by the time of the closing date, the following consequences will occur:

5.3.2.1 *Refusal of Performance by the Performing Party*

If one of the parties has not fulfilled its obligations in accordance with the purchase agreement by the closing date, the other party may hold back on performance as well, pursuant to art. 184 para. 2 CO with regard to art. 82 CO. Performance refers, in this context, only to the principal performance of the purchase agreement, *i.e.*, the payment of the purchase price and the transfer of the purchase object. If a party does not fulfill their secondary obligations, the other party may only hold back performance if a step-by-step principle was explicitly provided to be applicable to secondary obligations.

5.3.2.2 *Default and Consequences of Default*

If a party, at the closing, does not perform its contractual obligations, the general rules on default as defined in art. 102 *et seq.* CO, as well as the rules in art. 190 *et seq.* and art. 214 *et seq.* CO (specialized rules of default in contracts of sale) are applied, in addition to the above mentioned right to withhold performance.

²⁶ If the purchase agreement does not provide for a date of closing, the provision of art. 75 CO will govern, with the effect that the closing will be immediately after the signing of the agreement.

²⁷ Cf. chapter B.5.3.3 below.

²⁸ For example, "ten days after the conditions precedent defined in art. XX of this agreement have been fulfilled."

²⁹ This provision is, in particular, relevant to obtaining the authorization of the Competition Commission, a procedure which can take a long time if a determination of the planned transaction on the competition in the relevant markets has to be made.

a) Event of Default

The party not performing will cause an event of default, when the following requirements are met:

- The other contracting party must be willing to perform on the date due.
- The party ready to perform its obligations under the contract has to provide notice of default to the party which has failed to comply with his obligations, according to art. 102 para. 1 CO. A notice is not required if the due date was determined in the contract or can be determined. This requirement is fulfilled if the contract states a specific due date of the contractual performance, as well as if the contract stipulates that the due date is dependent on the satisfaction of certain preconditions and the date of satisfaction of such conditions is determinable. In this case, the closing will be on the due date.

b) Consequences of Default by the Seller

If the seller is in default the buyer has the following legal remedies:

- Upon default, the buyer can still demand performance by the defaulting seller, *i.e.*, he can demand the handover of the purchase object and the performance of the contractually agreed obligations. The buyer may, pursuant to art. 184 para. 2 CO with regard to art. 82 CO, withhold his own performance until performance by the seller, so long as the buyer is willing to fulfill his obligations. In addition to demanding the performance of the seller, the buyer may claim indemnities, pursuant to art. 103 CO, for damage due to the delay if fault is with the seller. The defaulted seller is also liable for risk of loss, pursuant to art. 103 CO, *i.e.*, for a destruction or deterioration of the purchase object without any relation to his own actions (*e.g.*, a fire).
- Alternatively, the buyer may, in accordance with art. 107 *et seqq.* CO, demand damages. First, however, pursuant to art. 107 para. 1 CO, the buyer has to set an appropriate grace period for subsequent performance.³⁰ If this period expires without the defaulting seller fulfilling his obligations, the buyer, pursuant to art. 107 para. 2 CO, has the choice to either rescind the agreement and to demand damages in the amount of the "negative interest in the transaction",³¹ pursuant to art. 109 CO, or to renounce the per-

³⁰ An appropriate time limit is considered one equal to the time needed by an average seller with common care and with normal technical equipment; an extension may be granted of seven to 10 working days; no extension will be granted in a case where it is clear from the facts that the debtor is refusing to perform his performance or if a fix date was set in the purchase agreement, which is rarely the case in share deals.

³¹ The "negative interest in the transaction" is equal to the difference between the actual financial state of the Performing Party and the hypothetical financial state which would prevail if the parties never had concluded an agreement.

formance of the seller without rescinding the contract and demand damages in the amount of the "positive interest in the transaction".³²

c) Consequences of Default by the Buyer

Generally the same rules apply to the default by the buyer as described above, *i.e.*, the seller can demand performance by the buyer, the payment of the purchase price, file a suit for performance and at the same time withhold his own performance until the purchase price has been paid. In addition, pursuant to art. 104 CO, the seller may demand default interest, independently of the fault of the buyer. If the damage due to the delay of the payment is higher than the default interest, the seller can demand compensation for the additional damage, in accordance with art. 106 CO.

Alternatively, the buyer may proceed in accordance with art. 107 *et seqq.* CO and demand damages, as described in section b above. According to art. 214 para. 1 CO, if the buyer is in default, the seller has the right to exercise the right of choice in art. 107 CO without granting a grace period. This allows him to immediately step back from the contract and demand the "negative interest in the transaction" or to renounce the performance by the seller without rescinding the contract and demand damages in the amount of the "positive interest in the transaction". If the seller does not instantly make use of this right, he can still set an appropriate grace period for the subsequent performance of the buyer and exercise his right of choice if the buyer does not perform within this granted period.

5.3.2.3 Contractual Regulation of the Consequences of Default

The statutory consequences of a default are sometimes relatively complex and in individual cases subject to interpretation. This can lead to uncertainties for the parties involved in the transaction. Furthermore, the calculation of damages is often quite difficult as neither the "negative interest" nor the "positive interest" can be easily calculated. It is therefore advisable to specifically regulate the following issues in the purchase agreement:

– No Notice of Default

The purchase agreement should provide no notice of default is needed for the event of default, so long as performance has not been completed by the closing date.

– Definition of the Grace Period

It is advisable that the parties define the grace period during which the defaulting party may still perform its obligations. This avoids any uncertainty created by the requirement in art. 107 para. 1 CO that a grace period must be "appropriate". In practice, a period of five to ten working days is the norm.

³²

The "positive interest in the transaction" is equal to the difference between the actual financial state of the Performing Party and the hypothetical financial state that would prevail if the Defaulting Party had fully complied with its contractual obligations.

– *Regulation of Consequences of Default / Compounded Damages*

The practical application of the statutory rights in art. 107 *et seqq.* CO is usually complicated since the difference between the rescission of the contract and the adherence to the contract with the renouncement of performance by the other party is a legal fineness not often understood in practice, but with remarkable financial consequences for the involved parties. It is advisable, therefore, to provide a clear right of choice with the result that the performing party, after expiry of the grace period, may either demand the performance by the defaulting party as well as demand damages for the delay of the performance or, as an alternative, rescind the agreement and demand the restitution of its "positive interest in the transaction". To avoid uncertainty on the exact amount of such damages, it is further advisable to define a compounded amount of damages, in terms of a penalty in the event of a rescission of the contract. These damages are normally at least equal to the costs and expenses the performing party has incurred in connection with the intended transaction. It is, however, important that the contract stipulates that the performing party may demand payment of any damages that exceed the compounded damages amount; this amount becomes the "exit price" to terminate the contract.

5.3.3 Conditions Precedent for Closing

Often the closing of a purchase agreement is subject to certain conditions precedent, the fulfillment of which, for legal or economic considerations, is necessary before the parties can close the transaction. Normally, purchase agreements for companies are subject to the following conditions:

5.3.3.1 *Official Licenses*

As described in chapter D below, the purchase of a business in Switzerland is normally possible without any official licenses. If, however, an individual transaction is subject to an authorization requirement as described in chapter D.2 below, or if the transaction is subject to merger control approval, as described in chapter D.1 below, the contract must be subject to the condition that the parties have received the necessary authorizations.

5.3.3.2 *Consent of Third Parties*

Sometimes the economic success of an acquisition depends on the consent of a third party. This is particularly the case when the consent of a third party is necessary for the transfer of certain contracts that are essential for the economic success of the business. The consent of the contractual counter parties is always necessary if a business is sold in an asset deal as in such a transaction, the individual contracts have to be transferred from the seller to the buyer and this transfer is normally only possible with the consent of the counter party. The consent of the contractual counter parties can also be necessary in share deals, if the contracts concerned contain a change of control clause that is triggered by the planned transaction. In these cases it is advisable to subject the closing of the purchase agreement to the condition precedent that the parties have obtained this consent.

The consent requirement should, however, be limited to the contracts that are essential for the economic success and the value of the business. For contracts of minor importance, it is sufficient to obtain the consent for the transfer after the closing date.³³

5.3.3.3 *Authorizations by Authorities*

The authorization by certain governmental authorities or administrative bodies is a necessary condition for the closing, in cases when the transfer of the business itself is not subject to governmental approval, but the activities of the business are subject to licenses or concessions which can only be transferred with the authorization of the competent authorities. The licenses and concessions are granted to the owner of the business, and since in an asset deal the owner changes, it will be necessary to obtain such authorizations. Although the owner of the business does not change in a share deal, the authorization of governmental authorities, which have granted licenses, may also be necessary if these licenses or concessions contain a change of control clause which allow the competent authorities to withdraw the license or concession in the case of a change in the company's ownership or if the licenses and concessions are cancelled automatically on the change of ownership. If these licenses and concessions are essential for the success of the business, the consent of the competent authorities should be provided as a condition precedent to the closing of the contract or else an essential value of the business could be destroyed.

5.3.3.4 *Right of Pre-Emption*

Sometimes the shares to be sold in a share deal or the assets to be sold in an asset deal are subject to pre-emption rights. If such rights of pre-emption are triggered by the conclusion of the purchase agreement, the agreement must be subject to the condition that the third parties concerned waive their pre-emption rights or that the procedure described for these rights has been fully complied with and the entitled persons did not exercise their rights.

5.3.3.5 *Consent of Corporate Bodies*

Sometimes a buyer or seller can only finalize a transaction if their board of directors or another corporate body consents to the transaction. The consent of these corporate bodies is a condition precedent to the closing. As such condition precedent, in effect, subjects the closing to the unilateral decision of one party, the counter-party usually does not accept such condition precedent but demands that the relevant internal consent is obtained before the agreement is signed so that the closing does not have to be subject to this condition precedent.

5.3.3.6 *Contract Subject to Financing*

If the buyer was able to secure the financing of the transaction before the signing of the purchase agreement, he would want to subject the purchase agreement to a condition precedent that a bank makes an irrevocable commitment to finance the transaction. This

³³

Cf. chapter B.5.3.4.2.c for solutions if the counter-parties do not consent.

condition precedent, however, subjects the closing of the transaction to the power of the buyer, since the buyer can easily cause the bank to refuse to commit to finance the transaction. Therefore, the seller normally does not agree to this condition precedent, but demands that the buyer secures the financing of the transaction prior to the signing of the purchase agreement.³⁴

5.3.3.7 *Material Adverse Change Clause*

In some cases the buyer will request a general material adverse change clause, *i.e.*, that the contract will only be concluded, if the acquired business has no developments in economically relevant areas that lead to a considerable deterioration of the business. Often, the seller will try to be responsible for deciding if the clause has been triggered. Material adverse change clauses that are formulated in overly broad terms, or which let the seller decide if the clause has been triggered, subjects the closing of the purchase to the free discretion of the buyer; therefore, the seller usually will not agree to such a clause. If due to certain reasons, *e.g.* because the financing of the buyer is also subject to a material adverse change clause, such a condition has to be incorporated, it should be formulated in an objective manner. This means, that the decision if the material adverse change clause has been triggered, should not be left to the free discretion of the seller but instead be decided by a judge in cases when the parties fail to come to an agreement. The clause should be formulated in a manner that the condition can only be triggered by events that occur in the business itself and cause essential negative consequences, whereby the termination of an essential negative consequence should be specified.³⁵

5.3.3.8 *Prohibition of the Transaction by Authorities or by Court Order*

Often the closing is subject to the condition that the transaction is not prohibited by authorities or by a court order. This condition is also valid without a corresponding clause in the contract, since a party cannot be forced to complete the closing, if the transaction has been prohibited by the competent authority or by court.

5.3.4 Performance Obligations of the Parties at Closing

To avoid any uncertainties with regard to the performance obligations of the parties at closing, it is advisable to list these in the purchase. The most important performance obligations are to transfer the ownership of the object of the sale to the buyer and to pay the purchase price. Depending on the type of transaction further obligations may need to be undertaken, such as for the additional transfer of assets outside of the business or the execution of employee or services contracts.

Clear definitions must be provided, whether a party must perform in advance of the closing or, as usual in the case of acquisitions, whether the obligations are to be fulfilled step-

³⁴ In practice, exceptions are made in the case of MBO-transactions and rescue companies, so long as there are no other buyers who request the incorporation of the condition.

³⁵ *E.g.*, 5% or 10% of the value of the business.

by-step. This is particularly true for secondary obligations since the principle stipulated in art. 184 CO is only applicable to principal obligations, *i.e.*, the payment of the purchase price and the transfer of the purchase object. Therefore, the buyer cannot withhold payment of the purchase price if the seller has transferred the object but not complied with secondary obligations as provided for in the contract.

5.3.4.1 *Performance Obligations at Closing in a Share Deal*

In a share deal, the contract must provide that the seller undertakes all necessary actions for the valid transfer of the concerned shares. The formally required steps for the transfer of ownership have to be defined on the basis of the corporate and securities laws applicable to the target business.³⁶ If Swiss registered shares (*vinkulierte Namenaktien*) that are subject to transfer restrictions are sold, a valid transfer is only possible if the board of directors of the transferring company consents to the transfer; therefore, a resolution of the board of directors has to be provided to the buyer at the closing to ensure the valid transfer of ownership.³⁷

In addition to the actions necessary for the valid transfer of ownership, the seller will usually provide the buyer with a letter of resignation of the board of directors of the seller. After the closing, the buyer will hold a shareholders' meeting in which the new board of directors of the buyer is elected.

5.3.4.2 *Performance Obligations at Closing in an Asset Deal*

In an asset deal, the assets, liabilities, contracts, and employees must be transferred to the buyer. This transfer can either be accomplished in one single act within an asset transfer pursuant to art. 69 *et seqq.* of the Federal Act on Merger, Demerger, Transformation, and Transfer of Assets ("MA") or by the transfer of the individual assets, liabilities, and contracts:

a) Asset Transfer According to MA

Pursuant to art. 69 *et seqq.* MA, a registered company or sole proprietorship can transfer, wholly or partially, assets and liabilities to another legal entity within one single act. Precondition to such a transfer is a validly executed transfer agreement approved by the management or administrative body of the legal entities participating in the asset transfer.

Generally, it is possible to structure the purchase agreement in a way that it complies with the requirements of the MA for transfer agreements of asset transfers. If the purchase agreement itself constitutes the basis of the asset transfer, it must be submitted to the

³⁶ If no securities have been issued for the shares of a Swiss company, these shares are transferred by assignment. If securities have been issued, these securities must be handed over. For registered shares (*Namenaktien*), an endorsement or assignment and the registration of the new shareholder in the company's shareholders ledger is, apart from the physical transfer of the securities, necessary for the valid transfer of these shares.

³⁷ If the seller does not control the corporate body, the consent of this corporate body should be made a condition precedent to the closing.

commercial register, including all its enclosures and the application for the asset transfer. Consequently, these documents become accessible to the public. If this result is to be avoided, it is advisable to prepare the purchase agreement and the transfer agreement separate from each other, whereby the transfer agreement would contain the necessary information for the asset transfer and serve as evidence for the commercial register.

A further requirement, found in art. 71 MA, is the precise definition of the assets and liabilities to be transferred in the contract. Real estate, securities, and intellectual property rights are to be listed individually; the contract must also contain a list of employee relationships to be transferred with the asset transfer. Art. 77 MA requires that the employees, respectively their representatives, are consulted, as explained in chapter E.1; if this consultation is neglected, the employees may by order of court request that the registration of the asset transfer is prohibited.

To effectuate the asset transfer, the legal entity transferring its assets must apply to the responsible commercial register at the place of the registered office of the entity. The transfer is effective at the time of the registration at the commercial register. In one single act, all assets and liabilities listed in the contract are transferred to the buyer. In particular the transfer is structured as follows:

– ***Transfer of Assets***

The assets listed in the contract, *i.e.*, account receivables, movables, real estate, intellectual property rights, and further rights are automatically transferred to the buyer at the time of the registration at the commercial register without any further action required. The later registration of the individual assets, which is usually necessary, *e.g.*, in the land register, has a solely declaratory purpose.

– ***Transfer of Liabilities***

With registration in the commercial register, the buyer automatically becomes the debtor of the liabilities; no notice is required to the concerned creditors. Pursuant to art. 75 MA, the legal entity transferring the liabilities does not become exempted from the liabilities, but instead is jointly liable with the new debtor for three years following the registration.

Pursuant to art. 75 para. 3 MA, the transferred claim must be secured if the joint liability terminates before expiry of the period of three years, *e.g.*, because one of the entities is liquidated or the concerned creditors can reasonably prove that the joint liability does not provide sufficient security. The joint liability will only terminate, if the concerned creditor agrees to the change of debtor and waives the liability of the transferring entity. To obtain such a notice of disclaim is in practice difficult since the creditor will seldom have a reason to release the previous debtor from his liability as the statutorily joint liability provides more security for him.

– *Transfer of Contracts*

Unfortunately, the MA does not provide for regulations concerning the automatic transfer of contracts. Pursuant to the general interpretation of the MA, contracts should not pass to the buyer in the transfer of assets automatically, since the Federal Council specifically declined such a supplement to the law on the basis that contractual relationships cannot be transferred without the consent of all involved parties. Therefore, contracts must be transferred as described in b) below.

Nevertheless, the transfer of assets and liabilities will have the effect that the rights and duties found in these contracts will pass on to the buyer, whereby the transferring entity will remain jointly liable, as described above. If the concerned counterparty does not agree to transfer the contract, this can lead to a division of the contractual relationship: the transferring entity will remain the formal contract party and will have to exercise the duties formally associated with the contract, but the claims resulting from the contract and the duty to fulfill the counter performance are passed on to the buyer.

– *Employment Relationships*

The transfer of the employment contracts is subject to employment laws, as described in chapter E.2.2. In essence, all employment contracts are transferred to the buyer, irrespective of whether the concerned employees were identified in the transfer agreement. Thereby, the transferring entity becomes jointly liable with the buyer for the claims of the employees which originated before the transfer.

b) Separate Transfer of Assets, Liabilities, and Contracts

As an alternative to the asset transfer, the acquisition of a business can also be completed by transferring the assets and liabilities individually. This alternative can be employed in cases when the joint liability should be avoided. In particular, the following procedure should be pursued:

– *Transfer of Assets*

With regard to the transfer of the ownership of assets, the purchase agreement should provide for all the necessary actions of the seller to transfer the individual assets of the business. Depending on the type of assets, the seller accomplishes this by transferring physical possession,³⁸ assignment,³⁹ filing an application with the land register,⁴⁰ or filing applications to other registries.⁴¹

³⁸ For movables and securities.

³⁹ For any rights and claims against third parties, and for shares where no securities have been issued.

⁴⁰ For real estate.

⁴¹ For the transfer of patents and certain other intellectual properties.

– *Transfer of Liabilities*

With regard to the transfer of liabilities, it is important to distinguish between internal and external assumption of liability:

- With the internal assumption of a liability (art. 175 CO), the buyer assumes the obligation to satisfy the liability concerned and to hold the seller harmless from claims of the third party creditor. This internal assumption of liability has no effect on the third party creditor, *i.e.*, the seller still remains the debtor and the third party creditor may consequently raise claims against the seller, yet the creditor has no rights against the buyer.
- With the external assumption of liability (art. 176 CO), the seller ceases to be liable to the third party creditor and is replaced in his function as debtor by the buyer. Such an external assumption of liability is only valid with the consent of the third party creditor.
- It is usually impossible or at least highly impractical to obtain the consent to an external assumption of liability from all third party creditors of a business, therefore it is advisable for the parties to pursue a pragmatic solution for the transfer of liabilities: the parties should agree in the purchase agreement that the buyer internally assumes all liabilities which are part of the business and keeps the seller harmless from such claims. As of the closing date, the parties can try to obtain the consent of the creditors to the external assumption of liability for certain material long-term liabilities.
- For short-term liabilities, *e.g.*, liabilities that have to be satisfied within 60 to 90 days after the closing date, it is normally not practical to obtain consent to the external assumption of the seller's liabilities. In this case, the contractual obligation of the buyer to satisfy the liabilities by due date is normally sufficient as the liability of the seller is automatically extinguished with the payment by the buyer.
- For long-term liabilities the parties will try to obtain consent of the creditors for the external assumption of liability between the signing of the contract and the closing date. In case the third party creditor refuses to consent, the seller will usually demand from the buyer security for his obligations under the internal assumption of liability.

The problems associated with the transfer of long-term liabilities are normally alleviated by the fact that financial debt is usually not transferred in asset deals, but instead the transaction is structured on a debt-free / cash-free basis. Thereby, most of the liabilities to be transferred will be short-term liabilities (of accounts payable) which can be paid off in a relatively short period of time. If the release of the buyer from long-term obligations is the basis of the transaction, it can be necessary to im-

pose the consent to the change of debtors as a condition precedent to the closing of the contract.

– *Transfer of Contracts*

In the case of an asset deal, when contracts have to be transferred to the buyer, the transfer of the position as the contracting party from the seller to the buyer is normally only possible with the consent of the counter party to the contract.⁴² If certain agreements are essential for the economic success of the business, it is advisable to subject the closing of the purchase agreement to the condition precedent that the counter parties consent to the transfer of these contracts to ensure that the buyer after the closing can continue to conduct the business as.⁴³

For contracts not essential to the business, it is usually sufficient that the consent of the counter parties is obtained after the closing of the transaction. In practice, the parties will usually not try to obtain the consent of the counter parties for these contracts, analogously to short-term liabilities, but will provide in the contract that the buyer has to fulfill these contracts so that the seller's liability under these contracts is automatically terminated and that the buyer has to hold harmless the seller from all claims of counter-parties concerned.⁴⁴ With regard to long-term contracts, the parties will try to obtain the counter parties' consent to the transfer of the contract. The buyer and seller, however, also have to define a mechanism that applies if a counterparty refuses to consent to the transfer. Normally, the parties will provide that the seller will remain the contract party vis-à-vis third parties. Internally, the seller will transfer all his rights under the contract to the buyer, whereas the buyer will undertake to fulfill the contract and to hold the seller harmless from all claims of the counter party. With this "internal" transfer of the contract, the parties can in an economic sense achieve the same result as with a full transfer of the contract.

– *Employees*

Employee contracts are transferred pursuant to the employment laws asset forth in chapter E.2.2 below.

c) **Asset Transfer or Individual Transfers of Assets and Liabilities?**

Asset transfer on the one hand and the individual transfer of assets and liabilities on the other hand, have various advantages and disadvantages to be considered when structuring the transaction:

⁴² Employment agreements, however, are automatically transferred pursuant to art. 333 CO; cf. chapter E.2.2.

⁴³ Cf. for such condition precedent chapter B.5.3.3.2 above.

⁴⁴ This procedure is, in particular, applied for short-term contracts with customers.

– ***Transfer in One Act***

The advantage of an asset transfer is that the transfer can be completed in one single act and the ownership is passed on at the date of the registration in the commercial register, without the requirement for any further formalities. Contrary hereto, with the individual transfer of assets and liabilities, each position must be transferred separately. As a result, the asset deal can be structured more rationally when choosing an asset transfer.

– ***Joint Liability***

The disadvantage of the asset transfer is that the seller is jointly liable with the buyer for the transferred liabilities of the business. As the joint liability is provided for by statutory law, it is difficult to convince the creditors to waive the liability of the seller. This is easier with the single transfer of assets and liabilities. If the buyer has better credit ratings than the seller, it will be to the advantage of the creditor to provide a more suitable debtor. The joint liability can, however, be avoided by not listing any liabilities in the transfer agreement and limiting the transfer to assets. The liabilities can then be transferred in a single succession.

– ***Rights of Employees***

Whereas the transfer of employee contracts and contingencies is governed similarly in asset and share deals (since it is within the domain of employment law), the intervention rights of the employees are regulated differently. According to art. 77 para. 2 MA, in cases when the employees have not been consulted properly, they can prevent the registration of the asset transfer in the commercial register and therewith the closing of the purchase agreement. The single succession does not give the option to the employees to prevent the closing of the transaction.

– ***Disclosure***

In the case of the asset transfer a detailed inventory with the individual assets, the value of the transferred assets, the consideration paid for the assets, as well as a list of all employee contracts transferred over, must be presented to the commercial register (art. 71 para. 1 MA with regard to art. 108 letter a of the Ordinance of the Commercial Register). This comprehensive publicity can be contrary to the confidentiality requirements of the parties.

Due to these advantages and disadvantages, consideration in each individual case should be given, whether the purchase of the business shall be conducted with an asset transfer or a single act. Often it will be useful to limit the asset transfer to the position of the assets and transfer the liabilities individually.

5.3.5 Closing Minutes

To document the closing of the purchase agreement, it is advisable to write closing minutes in which the parties confirm that the conditions precedent to closing have been fulfilled and that each party has undertaken the closing actions as described in the contract.

5.3.6 Actions of the Parties between Signing and Closing

If the closing does not take place immediately after signing the contract, *e.g.* because various conditions precedent needed to be fulfilled, the actions of the parties between signing and closing must be regularized as follows:

5.3.6.1 *Conduct of Business*

To ensure that the substance of the business is not changed between signing and closing, the seller normally agrees to continue the ordinary course of business and to obtain the consent of the buyer for all actions and decisions that are outside the ordinary course of business. In particular, the purchase and sale of equipment and other material assets, changes in the management structure, as well as the conclusion, termination and alteration of material contracts should all be subject to the consent of the buyer. It lies within the freedom of the parties to define which actions are subject to such consent. Yet, too strong an influence of the buyer can be problematic in this transitional period if the closing is subject to merger control clearance or other governmental authorizations, since control over the business may not be transferred before the pertinent authorization has been obtained. Therefore, in these cases the influence of the buyer must be limited to actions and decisions that would materially change the business, whereas the ordinary management of the business must remain under the control of the seller.

5.3.6.2 *Distributions*

If a company is sold, it is in the interest of the buyer that equity and liquidity between signing and closing are not reduced by distributions. Therefore, the purchase agreement in share deals usually prohibits any distributions during this period. In asset deals, such a prohibition is not possible since the business is directly owned by the seller and the generated cash flow accrues directly to him. To avoid the reduction of the net working capital between signing and closing of the asset deal, it is advisable to adjust the purchase price in accordance with the development of the net working capital between the date of the financial statement that was the basis for the purchase agreement and the closing date.⁴⁵ If the purchase agreement contains this adjustment clause, the purchase price can be reduced when the net working capital is lower than the agreed amount and accordingly the price must be increased if this marginal value is exceeded at the time of the closing of the contract.

⁴⁵

Cf. chapter B.5.2.2.

5.3.6.3 *Actions Regarding Conditions Precedent*

To ensure the requirements of the closing are complied with, it is advisable to state in the purchase agreement which party is responsible for the fulfillment of the conditions precedent and to clearly define the steps the party has to take. If the contract is subject to the condition precedent that the merger control authorities grant approval, normally the buyer is obligated to submit the corresponding requests, with the support of the seller in providing the necessary information and documents. In connection with these procedures, the question arises as to whether the buyer has a contractual obligation to comply with conditions the merger control authorities may impose as a prerequisite for granting an approval. As these conditions can have far reaching consequences, and may encompass the sale of certain subsidiaries or businesses, most buyers will not agree to a clause that forces them to comply with all the conditions imposed by the merger control authorities. In competitive situations between various potential buyers, a buyer sometimes has to agree to these obligations if the other potential buyers are not subject to any merger control restrictions and would be at an advantage.

5.4 Warranties and Representations

Warranties and representations are an important part of any purchase agreement. From an economical perspective these provisions have the function of ensuring that the buyer actually receives the object of the sale in the state that corresponds to the one presented in the due diligence and to allocate risks identified in the contract negotiations between the parties. Since the risk allocation has an economic value, there is a close connection between the determination of the purchase price and the warranties and representations; the higher the risk assumed by the seller in warranties and representations, the higher the purchase price since the valuation has a more certain basis. In contrast, the price will be lower if the buyer assumes more risks than usual; this will be the case if the business is in bankruptcy.

5.4.1 Statutory Representations and Warranties

If a purchase agreement does not contain any express representations and warranties by the seller, the seller, according to art. 197 CO, represents that the object of the sale is free of defects and can be used for the purpose envisaged by the parties. Depending on whether a sale of a business is structured as an asset deal or a share deal, this statutory provision has different applications:

5.4.1.1 *Statutory Warranty as to the Quality in Asset Deals*

The Federal Supreme Court views the asset deal to be a contract "*sui generis*" and not a purchase agreement, pursuant to art. 184 *et seqq.* CO, since the parties commit themselves to several obligations in an asset deal that cannot be compared to the duties pro-

vided in a regular purchase agreement.⁴⁶ As a consequence, the Federal Supreme Court does not apply the statutory warranties in respect of quality to the contract of such a transaction but instead applies suitable provisions for each specific obligation corresponding to the type of asset deal. In general, all statutory warranties in respect of quality can apply to the obligations of the seller when acquiring a business, if these obligations could also form part of a regular purchase agreement.⁴⁷

When applying the provisions on warranty in respect of quality in an asset deal, the question arises, when a defect would be considered to eliminate or substantially reduce the value of the object or its fitness for the designated purpose, in the sense of art. 197 CO. Since the purpose of an asset deal is to transfer the entire business, the question has to be assessed on the basis of the entire transferred business and not on the basis of the individually transferred assets.

According to art. 197 CO, the fact that the purchase price is higher than the objective value of the business cannot alone be regarded as a defect, because the value of the business is not a prerequisite characteristic of the purchase object.⁴⁸ Only if the difference in value can be attributed to the fact that the business deviated from certain expectations that lead to an impairment, will there be a legally relevant defect. Compared to regular purchase objects, *e.g.*, cars or specified chemicals, no valid quality standards exist for businesses defining the target state of a business. Therefore, the target state must be assessed by what a reasonable buyer would have expected when taking all relevant circumstances into account. The target state is dependent of the activity of the business, the age of fixed assets, and on other statements provided by the seller before and after contract negotiations. Within the scope of this standard, typically the following problems can present deficiencies:

– *Incorrect Balance Sheets*

If the last balance sheet prepared before the sale is not correct because the business in the period relevant for the balance sheet possessed more liabilities than accounted for, or the individual balance positions were undervalued or overvalued, a legally relevant defect exists. On the basis of art. 957 *et seqq.* CO, the buyer may assume that the balance sheets are materially correct and accordingly can define the relevant target state of the business for the purchase.

– *Required Assets or Absent Rights*

When purchasing a company, the buyer can reasonably assume that the company is in possession of the assets and rights necessary to conduct business or at least has the re-

⁴⁶ BGE 129 III 17 *et seqq.*; *cf.* Federal Supreme Court decision of 10.12.1986, in: SJ 1987, p. 179 *et seq.*

⁴⁷ *Cf.* Federal Supreme Court decision of 10.12.1986, in: SJ 1987, p. 180; BGE 88 II 410.

⁴⁸ BGE 91 II 353.

quired contractual rights of use⁴⁹ to use the assets rightfully. Additionally, the buyer can expect the assets to be in a suitable condition, although he may not expect them to be new since the condition is subject to required investments or the age of the specific assets respectively.

– *Compliance with Essential Legal Provisions*

The buyer can expect that the seller complied with all applicable legal provisions when conducting the business and that the buyer after the transfer of the business does not take over any liabilities not accounted for in the balance sheet which result from legal violations of the seller before the purchase.

A defect, pursuant to art. 197 CO, will only lead to claims if it would materially or legally eliminate or substantially reduce the value of the object or its fitness for the designated purpose. Since according to the will of the parties the business as an economic entity is the object of the purchase in an asset deal, the materiality must be measured with regard to the whole business, *i.e.*, a defect can only be considerable if it leads to a decrease in value of the business as an entity or if the operational activity is considerably disabled. As a result, claims are excluded if only small assets are missing or are unsuitable or a small part of the storage is overvalued. It is irrelevant that these specific problems would be considered as defects pursuant to art. 197 CO. While the buyer can claim for an asset transferred individually, this is not possible when the same deficient asset is part of an entire transaction in which the defect only plays a subordinated role. If the parties would have agreed to lower the price or to renounce the transaction if they had been aware of the defect, a significant defect exists, pursuant to art. 197 CO. In practice, the line is drawn at about 1% to 2% of a value decrease. Smaller deviations will rarely have an importance in negotiations because they are within the range of rounding differences.

5.4.1.2 *Statutory Warranties as to the Quality in a Share Deal*

In share deals, the Federal Supreme Court supports the opinion that, pursuant to art. 184 *et seqq.* CO, there is a sale of a chattel,⁵⁰ but that only defects of the formal object of purchase are relevant (*e.g.*, lack of coupons *etc.*) unless the seller has provided special warranties.⁵¹ The buyer may raise claims only if the shares themselves have a defect, which will seldom be the case, but may not raise claims if the business itself or assets owned by the company are defective.

This practice is not appropriate, since the parties will focus on the business and not the shares as the object of the purchase. In every case in which shares are acquired granting more than 50% voting rights, it has to be assumed that the parties had the intent to transfer the business. Pursuant to Art. 18 CO, the business entity must be the object of pur-

⁴⁹ When accountable assets are not listed in the balance sheet the buyer must assume that specific rights of use exist.

⁵⁰ BGE 107 II 418.

⁵¹ BGE 79 II 158; 107 II 422.

chase with regard to statutory warranties of quality. Therefore, the same criteria as mentioned in chapter B.5.4.1.1 in connection with asset deals apply with respect to share deals. Uncertainty remains if the Federal Supreme Court will adapt its practice to the criticized legal theory. On the one hand, legal prerequisites for the enforcement of warranties of quality are so strict that in most cases claims already fail on this point so that the Federal Supreme Court did not yet have to define if a material defect of the business may be the subject in a share deal. On the other hand, by promoting the option that buyers may also refer to errors in substance or deception, an appropriate result can be achieved. Consequently, the probability of a change in practice is unlikely even if from a legal point of view the theory has strong arguments.

5.4.1.3 *Prerequisites to Assert Warranty Claims*

An action for breach of warranty in respect of quality can only be enforced if the buyer fulfills the following prerequisites:

– *Examination of the Purchase Object*

According to art. 201 CO, the buyer must inspect the condition of the acquired object as soon as feasible within the normal course of business. If the buyer does not do so, or does so too late, all defects which could have been detected are considered accepted. Even though a business is a quite complex purchase object, the regular period of 10 to 20 days to examine the object after handover applies according to practice of the Federal Supreme Court.⁵² The Federal Supreme Court has not yet decided on the extent of such examination in the purchase of a business. It can be assumed that the buyer should inspect essential business transactions as well as essential assets, since these are a condition to further conduct business after the transfer. A post-acquisition due diligence or even an audit, in which all value relevant factors are examined in detail, is not recommended. It would not be considered an examination in the normal course of business. Normally, the buyer will only thoroughly examine the business on the basis of the following annual financial statement; up till then, he may rely on the correctness of existing financial statements.

According to the legal consequences provided in art. 201 CO, the acquired object is deemed accepted, except in the case of defects that would not be revealed by the customary inspection, if the buyer did not make an inspection or the inspection did not reveal the defects, even though these defects would have been noticeable in a proper inspection.

– *Notification Duty as to Defects*

Pursuant to art. 201 CO, when such defects come to light subsequently, the seller must be notified immediately, failing which the object will be deemed accepted even in re-

⁵² Cf. BGE 107 II 418: about 20 days never minding Christmas and New Years.

spect of such defects. The duty to immediately notify of a defect requires the buyer to notify the seller of the business within two to three days after he becomes aware of the defect, whereby the defect must be specified in order for the seller to be able to determine the consequences of the defect.

– *Unknown or Unnoticed Defect at Signing*

Pursuant to art. 200 CO, the seller is not liable for defects known to the buyer at the time of signing of the contract or defects that any attentive buyer should have discovered.⁵³ This regulation is reasonable since defects the buyer knows at the time of the purchase signing can be accounted for in the price evaluation or the seller may at least assume the buyer to have made corresponding reductions.⁵⁴

In a purchase of a business the question whether claims pursuant to art. 200 CO should be excluded, arises especially in cases in which the buyer performed a due diligence prior to the purchase. If the buyer detects defects on the basis of the documents provided by the seller, or should the defects have been detected in a careful review, he cannot raise any claims with regard to these defects. Consequently, the due diligence will always have negative consequences for the buyer when it is not performed carefully so that all defects are detected. The due diligence will also have negative consequences, if the knowledge of defects is not properly dealt with, *i.e.*, if the buyer does not request a price reduction or contractual guarantees in which art. 200 CO is explicitly excluded.

If no due diligence was performed prior to signing the purchase agreement, the buyer should not be accused of not having pertained normal attention, pursuant to art. 200 CO, with the result that he would accept all defects he could have taken notice of in the due diligence. In BGE 66 II 137, the Federal Supreme Court held that the buyer has no examination duty in the sense of art. 201 CO prior to the conclusion of the contract and must not involve experts for the visitation of a house. This standard can also be applied with respect to the purchase of a business: even if a due diligence is customary in acquisitions of businesses, it is not the duty of the buyer to perform one.

– *Assertion of the Claim within a Year*

According to art. 210 CO, an action for breach of warranty of quality becomes time-barred one year after delivery of the object to the buyer, even if he does not discover the hidden defects until a later time. This short period is problematic in the acquisition of businesses, since hidden defects usually are only detected in the next annual financial statement. Defects resulting in violation of environmental or tax requirements will

⁵³ Decisive is the time of purchase: BGE 117 II 262 *et seq.*

⁵⁴ This regulation does not make sense, in cases warranties were included in the purchase agreement to cover known risks in order for them not to be accounted for in the price evaluation. In these cases, it is logical to exclude the application of art. 200 CO in the contract.

usually only be noticed once the competent authorities intervene. As a consequence, several defects have a latency period going beyond the short period of one year.

The previously mentioned hurdles complicate the enforcement of statutory warranty claims especially when purchasing a business; the short period of inspection and notification usually cannot be complied with due to the complexity of the object of purchase. Besides, often disputes arise as to whether the buyer should have detected defects due to the information he had prior to the purchase. The short limitation period leads to cases in which massive defects cannot be claimed for, because they only appear after this period. Consequently, the buyer must regularize these issues in the purchase agreement in a way that these materially legitimate claims can be enforced.

5.4.1.4 *Failure of Intent*

Pursuant to the standard practice of the Federal Supreme Court, a buyer may refer to a failure of intent with respect to the purchase of species if the failure of intent can be attributed to a material defect of the purchase object.⁵⁵ This does not mean that every material defect will automatically lead to a legally relevant failure of intent. Yet, the buyer can claim a failure of intent, if the requirements of an error or a deception are fulfilled, even if he could claim a breach of warranty of quality.

The Federal Supreme Court assumes that in cases of failure of intent the buyer must not comply with the prerequisites of the statutory warranty rules described in chapter B.5.4.1.3 since in contradiction to claims pursuant to art. 97 CO, it is not the compliance of the contract in question but the conclusion of the contract itself. Therefore, if there is a failure of intent, the provisions on examination and the obligation to give notice of defects, as well as the short application period, are not applicable. In the event of claims of failure of intent the rules described in the following paragraphs apply.⁵⁶

The relation between failure of intent and warranty of quality can be problematic for the buyer as the Federal Supreme Court assumes that, a buyer claiming a breach of warranty of quality accepted the contract since by referring to the legal remedies found in the purchase agreement, the buyer declares to adhere to the contract.⁵⁷ Therefore, if the buyer wants to enforce a failure of intent, he should first only refer to failure of intent: if the prerequisites are not fulfilled, he may then enforce a breach of warranty of quality.⁵⁸

When statutory warranty claims are excluded or restricted in the contract, this restriction also applies to the enforcement of failure of intent, when it refers to material defects (pro-

⁵⁵ Cf. BGE 79 II 160; 81 II 213; 83 II 21; 84 II 517; 88 II 412; 107 II 419; 108 II 104; 114 II 134 *et seq.*; 127 III 83.

⁵⁶ BGE 107 II 421; 108 II 105.

⁵⁷ BGE 88 II 412.

⁵⁸ BGE 108 II 104.

vided the restriction refers to that defect and the restriction is valid pursuant to art. 199 CO).⁵⁹

– *Fundamental Error*

According to art. 24 para. 1 letter 4 CO, a party may invoke the rescission of a contract with regard to an error, when he erred on the conclusion of the contract, conclusion or performance, which in good faith business transactions presents the basis of the contract. Based on this, the buyer in species purchases may refer to a fundamental error when the purchase object has a defect of an impact that a reasonable contracting party in the same situation would not buy the respective object or only for a cheaper price.⁶⁰ The fundamental error must concern present or past facts. Future facts may only be the issue if both parties at the time of signing the contract assumed that the future fact would realize.⁶¹

The Federal Supreme Court also applies these principles to the purchase of a business and allows the use of the fundamental error when the defect has a strongly negative impact on the value of the business. Up to now the Court has not decided how extensive the value reduction must be. In light of recent cases, it has to be assumed that the deviation must be more than "material", as provided in art. 197 CO, since in these cases higher deviations were discussed.⁶² Therefore, fundamental error may only be invoked when the value of the company is materially below the expected value, due to unknown problems, and the deviation is so substantive that, according to the principle of good faith, the purchase agreement has lost its economic value. Consequently, a reference to fundamental error will only be possible when the value decreases about 15% to 25%. It also depends on the agreement of the parties; if certain facts were agreed to be essential for the valuation, a small deviation will suffice. Since future projections may be the basis of an error in substance, if the parties were certain of those projections, it may be referred to future value risks. It will not suffice that earnings are lower than estimated; it must be a fact agreed on to be certain, as with certain authorizations to be obtained to conduct the business, which the parties were sure to receive after closing the contract. In connection with errors it is irrelevant if the seller knew the defect; as long as the previously described prerequisites are fulfilled, the buyer may invoke a fundamental error even if the seller was not aware of the problem.⁶³

A reference to fundamental error is also possible if it was caused by negligence of the buyer, *i.e.*, if the buyer could have avoided it by carefully examining the purchase object. Yet, pursuant to art. 26 CO, the buyer is liable for the negative interest in such

⁵⁹ BGE 126 III 59 *et seqq.*

⁶⁰ BGE 97 II 46.

⁶¹ BGE 109 II 110.

⁶² BGE 97 II 43.

⁶³ BGE 97 II 47.

cases, provided the seller was not aware of the error. The standard of diligence is not too high for the buyer. As already described, the buyer is not obliged to perform a due diligence; only if the buyer, when being normally careful, could have noticed the error in the documents provided by the seller, can a negligent error exist.

– *Deception*

If the buyer is deceived by the seller, the buyer can also invoke art. 28 CO that allows the rescission of the contract. The deception must lead to an error in motive, which is causal for the conclusion of the contract or at least for the performance of the contract.⁶⁴ It is sufficient, in the case of a deception, if causality exists; contrary to the fundamental error, it must not be proven that the error concerned an important ground of the contract.

The deception must be intentional, *i.e.*, the person deceiving has to know that his action will lead to an error by the other party. Indirect intent is sufficient, *i.e.*, if the person deceiving believes that a certain result is possible and takes such possibility into account. Deception exists when the seller, without knowing the facts, makes positive statements about the business and takes into account that these could be wrong.⁶⁵ If the seller neither intentionally nor indirectly intentionally deceived the buyer, he may only refer to fundamental error, provided it reaches the required intensity.

The deception may exist when the seller actively simulates false facts or if he keeps essential information secret. Practice shows that, especially in the following situations, deception can exist:

– *Active Deception*

Active deception usually occurs before the contractual negotiations in a situation when false information about the target business is provided by the seller.⁶⁶ It can be verbal or in writing, *e.g.*, in an information memorandum given to the interested buyers. The deception may lie in falsely promised earnings or turnover figures or in incorrect information regarding the right to use intellectual property rights or fixed assets. The fact that this information is often provided under the terms of "no liability assumed" does not change that it will be considered as deception, if the seller intentionally provided incorrect information.

However, distinction must be made between facts and value judgments or forecasts, which the buyer should realize are subjective. Statements that the business has a high value and has great future prospects cannot encompass a legally relevant deception, even if the business does not develop as predicted. If these prospects are

⁶⁴ BGE 81 II 219.

⁶⁵ BGE 53 II 150.

⁶⁶ *Cf.* BGE 81 II 213, deception about debt of a real estate company.

based on false information with the knowledge of the seller, a deception can be assumed; if the seller predicts high earnings in connection to a pharmaceutical product, but he knows the product is not permitted due to an adverse reaction, a legally relevant deception can be assumed.

– *Concealed Deception*

A concealed deception exists, if the seller had a duty of disclosure with regard to the facts kept which he conceals. This duty of disclosure can arise from the requirement to conduct business in good faith.⁶⁷ Consequently in the following case a disclosure duty of the seller can come into existence:

• *Questions of the Buyer*

If the buyer asks questions in the negotiations regarding the purchase object, the seller has the duty to answer these questions truthfully and in case of problems, corresponding to the asked questions, disclose these.⁶⁸ This is particularly important in due diligence procedures when far-reaching questions regarding the business are asked.⁶⁹ If the seller refuses the disclosure of certain facts due to business confidentiality, it is legitimate, as long as he clearly states the reasons.

• *Noticeable Error*

If the seller realizes that the buyer has fallen into the error of assuming "false facts", the seller is obliged to correct the buyer's error. Keeping quiet is considered active deception.⁷⁰ If the buyer assumes that the business is the owner of a trademark and states in negotiations that the trademark is an important factor of the evaluation, the seller must notify him if the business were to be only a license holder. However, the seller must not actively search for the buyer's errors and evaluate if the price calculation is completely based on correct information.⁷¹

• *Disclosure of Essential Defects*

If the seller is aware of important defects of the business *e.g.*, contamination, incorrect accounting, or the loss of an important patent due to an action for annulment, the seller is obliged, with respect to the contractual relationship, to disclose these problems since they may strongly influence the decision of the buy-

⁶⁷ BGE 116 II 430, 105 II 79 *et seq.*

⁶⁸ Giger, BK, OR 199, n. 39.

⁶⁹ M. Vischer, Due Diligence bei Unternehmenskäufen, SJZ 96 (2000), S. 232 f.

⁷⁰ Merz, BK, ZGB 2 n. 271; BGE 92 II 334; BGE 90 II 449 *et seqq.*

⁷¹ BGE 102 II 84.

er;⁷² to present the business as free of defects would constitute an active deception.⁷³ The extent of the duty of disclosure is dependent on the actions of the seller. If, in an information memorandum detailed positive aspects of the business are listed, the buyer will expect the seller to also name negative aspects of a similar impact.

Deception exists, pursuant to art. 28 CO, in cases when an auxiliary person of the seller is acting as the deceiving person, since the actions of auxiliary persons are accounted to the seller in accordance with art. 101 CO.⁷⁴ A deception also occurs if the auxiliary persons acted in good faith, because the seller did not inform them about the problems of the business. Also the corporate bodies of the business can be viewed to be auxiliary persons, when they are acting in the interest of seller, *e.g.*, providing documents for a due diligence.

If the buyer is in error because he was deceived by a third party, not being an auxiliary person, *e.g.*, the analysis of a journalist, no deception pursuant to art. 28 CO exists, provided the seller was not aware of this fact. The error of the buyer, in this case, is only legally relevant if a fundamental error according to art. 24 CO exists.

– *Assertion of Claims due to Error and Deception*

Pursuant to art. 31 CO, a party subject to error and deception may rescind the contract within one year after the discovery of the error or deception by notifying the counterparty (declaration of rescission).⁷⁵ According to the practice of the Federal Supreme Court, this period is not subject to an absolute limitation, which means the buyer may also invoke a rescission after 10 years.⁷⁶ If the buyer waits for the last possible moment of the one year period, this can lead to the violation of the requirement to act in good faith and at least may have the consequence that the rescission is insignificant pursuant to art. 25 para. 1 CO.⁷⁷

A party may not refer to a failure of intent and rescind the contract, when in the meantime, the party expressly or impliedly approved of the contract.⁷⁸ If the buyer first notifies a rescission but agrees to continue the contract, this would be seen as an approval of the contract.⁷⁹ An implied approval is given in cases when the buyer refers to statutory contractual remedies, a breach of warranty of quality, after detection of the defect,

⁷² BGE 66 II 139; BGE 81 II 138; Decision of the Federal Supreme Court dated 10.12.1986 in SJ 1987, p. 180 *et seq.*

⁷³ BGE 116 II 430.

⁷⁴ BGE 63 II 77; 81 II 213; 108 II 421.

⁷⁵ BGE 108 II 105, the consent of the seller is assumed when he does not oppose.

⁷⁶ BGE 114 II 140.

⁷⁷ *Cf.* BGE 107 II 421.

⁷⁸ *Cf.* BGE 97 II 47 *et seq.*

⁷⁹ BGE 108 II 105.

because thereby he stipulates to want to adhere to the contract.⁸⁰ If the buyer interferes in the business activities also after detecting the defect, *e.g.*, by financing or managing the business, this can also be viewed as an implied acceptance of the contract.⁸¹ If the buyer only invokes a partial nullity the interference is not relevant since the buyer in such cases is willing to maintain the business. When the interference has the purpose to secure the existence of the business and is absolutely necessary, it cannot be regarded as an implied approval of the contract.⁸²

– ***Consequence: Invalidity or Partial Invalidity of the Contract***

Generally the contract will be rescind with effect "*ex tunc*", when a party invokes fundamental error or deception. This has the consequence that services rendered and services received must be returned in an equal degree. In analogy with art. 20 para. 2 CO, the Federal Supreme Court has developed the practice that in purchase agreements of businesses a buyer may refer to the partial invalidity of the contract in cases of fundamental error. Therefore, the buyer may maintain the business but the price will be reduced in a manner that the renders services at equilibrium.⁸³ According to this practice, the price will be reduced to the amount the parties would have reasonably agreed to if they had knowledge of the actual circumstances.⁸⁴ Consequently, the effect of the defect on the price must be calculated, which leads to the same result and problems as with respect to cases of price reduction as described in chapter B.5.4.1.1 and 5.4.3.1.1b.

Pursuant to art. 20 para. 2 CO, such partial invalidity can only be invoked if the parties would have also agreed to the contract with the changed circumstances. The Federal Supreme Court does not rely on the actual will of the seller but examines from an objective point of view if a reasonable seller in knowledge of the defects would sell the business at the reduced price.⁸⁵ Since the price must be reduced to the amount the parties would have reasonably agreed to, the objective prerequisites of the partial invalidity are usually complied with, provided the price is not set at such a low level that a sale is not sensible for the seller.

This partial invalidity leads to similar results as in the case of enforcing price reduction in a share deal. Yet, in this case the modalities of statutory warranty claims must not be complied with but the deviation of the value must be higher than in warranty claims.

⁸⁰ BGE 88 II 412.

⁸¹ Cf. BGE 108 II 105 *et seq.*

⁸² Cf. BGE 97 II 43.

⁸³ BGE 107 II 423; BGE 99 II 307.

⁸⁴ BGE 107 II 424; BGE 81 II 220 *et seq.*

⁸⁵ BGE 107 II 424 *et seq.*

5.4.2 Contractual Representations and Warranties

The statutory provisions described above do not adequately protect the legitimate interests of the buyer since the risk allocation between the buyer and the seller is unpredictable. Especially in cases when the agreement is rescinded by the buyer due to an error in substance or willful deception, the statutory provisions can lead to unacceptable results for the seller. It is therefore recommended that both parties clearly define in the contract the representations and warranties the seller grants, and also the consequences of a breach of these representations and warranties. The extent of the representations and warranties in a given purchase agreement depends on the individual circumstances of the case, the specific risks of the business sold and the purchase price, because the allocation of risks between buyer and seller is reflected in the purchase price as described above.

The frequently used representations and warranties in Switzerland generally correspond with the standard developed in international merger and acquisition practices. Even though significant differences can arise in individual cases due to the business and its individual requirements, the contractual representations and warranties of the seller usually cover the following areas:⁸⁶

5.4.2.1 *Valid Existence of the Company and any Subsidiaries in a Share Deal*

In virtually every share deal, the seller will warrant that the company, whose shares are sold, and any subsidiaries of the company, have been validly founded and operate in accordance with the applicable law at the closing. This representation can be particularly relevant for foreign companies, since in certain countries deficiencies in the founding process or the fulfillment of formal obligations (such as an obligation to regularly file certain documents) can entail the consequence that the company is invalid. In the case of Swiss companies this representation is hardly ever relevant since the valid existence of the company can be proven with an excerpt from the commercial register and later detected deficiencies of the founding process will not lead to the invalidity of the company. In certain cases this warranty may also be relevant in Switzerland. A company that has been formed for illegal purposes, *e.g.*, a company that has been formed to circumvent the Swiss rules on the acquisition of real estate by foreigners, may be null and void, even after having been registered in the commercial register.

5.4.2.2 *Valid Existence and Transfer of the Shares Sold in a Share Deal*

In a share deal, it is essential that the seller warrants that the shares transferred were validly issued and that full ownership in these shares, free of any rights of third parties, has been transferred to the buyer at the closing.

⁸⁶

The extent of the representations and warranties and any limitations on the remedies in case of breach, in the end, depend primarily on the negotiation position of the buyer and seller. Where the seller is in a strong position because the target business is very attractive, he usually can limit his exposure. Alternatively, the seller who is in a weak position is often constrained to grant the buyer extensive warranties without being able to limit the remedies.

In this connection, the seller also has to warrant that, apart from the share capital presented to the buyer in the due diligence, no further shares were issued, and that the company has no obligation to subscription rights or options of shareholders that would dilute the participation sold to the buyer.

5.4.2.3 *Ownership of Subsidiaries*

If in a share deal the acquired company owns subsidiaries, the seller will have to warrant that at the closing date the acquired company will own a certain number of shares in the subsidiaries. Since the dilution of the participation in the subsidiary also diminishes the value of the acquired company, the seller will usually warrant that apart from the subsidiary's share capital presented to the buyer in the due diligence, no other shares or equity securities were issued in the subsidiary, and that the subsidiary has no obligation to subscription rights or options of shareholder that would dilute the participation of the acquired company.

5.4.2.4 *Existence and Completeness of the Transferred Assets in an Asset Deal*

In an asset deal, the assets and liabilities of the business are the object of the sale. Therefore, the seller's representations have to refer directly to these assets and liabilities. The seller in an asset deal usually grants the following warranties, instead of those described in chapters B.5.4.2.1, B.5.4.2.2 and B.5.4.2.3:

– *Transfer of Ownership in Assets*

The seller warrants that on the closing of the purchase agreement all assets that are the object of the sale have been validly transferred to the buyer. Since the object of the sale is defined at the time the purchase agreement is signed, the normal business activities will lead to differences between the status of the assets and liabilities as of signing and closing. If these changes are caused by the normal activities of the business, the buyer has to accept these changes in assets and liabilities as a normal consequence of the conduction of business. To avoid negative changes in the assets and liabilities, it is advisable that the seller warrants to not sell any assets as of the date of the financial statement that forms the basis of the purchase agreement. Furthermore, the purchase agreement should provide for an adjustment of the purchase price for any changes in the net working capital as described in chapter B.5.2.2.

– *Completeness of Assets*

Since the buyer intends to conduct the activity of the business and requires all the assets the business has used so far, the seller, in an asset deal, will have to warrant that the assets transferred at the closing date, together with the assets leased by the business from third parties, constitute all the assets necessary to conduct the business to the same extent as before.

5.4.2.5 *Warranties as to the Financial Statements*

In a share deal, the buyer normally will demand that the seller warrants that the balance sheets and financial statements on which the buyer has based his valuation of the company are correct and that the balance sheet neither overstates the value of the assets nor understates the amount of the liabilities. In the formulation of the warranty, it is essential to define the accounting standard to which the warranty refers since only this standard allows the buyer to judge whether the financial statement is correct.

If the financial statements and the corresponding warranties, without any further specification, refer to Swiss accounting standard, the buyer must be aware that these standards are only broadly defined in the CO, which allows the board of directors and management a scope of discretion in the presentation of a company's results and can even lead to impreciseness. According to today's minimal accounting standards, it is, for example, possible to improve a company's results to a certain extent by the dissolution of hidden reserves (unrealized depreciation or excessive provisions), and thereby present a better result than the operations of the company would allow. Swiss accounting standards also allow management much discretion in the valuation of fixed and financial assets, in the depreciation policy, and in the valuation of inventory;⁸⁷ they even may compensate an excessive valuation of certain assets by undervaluation of other assets if these assets are recorded on the same line in the balance sheet.

Due to the lack of conceptual clarity of the Swiss accounting standards, it is advisable to adopt stricter accounting standards, as for example IAS, US GAAP or FER. A reference in the warranty to these standards, however, is only possible if the seller has actually applied one of these standards. If the seller has not used such a strict bookkeeping standard, but has based his financial statement only on the minimal standard of the CO, the accounting practices actually applied within the framework of this minimal standard should be described in an annex to the purchase agreement in order to have a better definition of the standard used.⁸⁸ If the warranty covers a consolidated financial statement prepared under Swiss standards, this description of the actual accounting method is particularly important as, according to art. 663g para. 1 CO, a Swiss company is completely free in the choice of its consolidation standards, and may use either a national or international standard or develop its own standard for the consolidation.

The financial statement, in any event, depicts the financial status of a company or a business on the determined date of balance. The business will, however, continue to change after this date due to its normal business activities. The financial status described in the financial statement will not be identical to the actual financial status of the business at the signing of the agreement or the closing of the transaction. To solve this problem the seller

⁸⁷ The methods may, in particular, choose any of the available inventory accounting, such as FIFO, HIFO, LOFO, LIFO, or even methods which are based on average costs.

⁸⁸ The description of accounting practices is also advisable if IAS, US GAAP or FER are used. The annex in this case should describe how the seller has made use of the option rights he has under these standards.

will usually warrant that the business has been conducted in the ordinary course since the date of balance, and that no transactions have been entered into that would deviate from the ordinary course of business. The more time passes since the last annual financial statement, the less significance the balance sheet and financial statement will have since they do not depict the actual state of the business. In these cases, the financial statement warranty will often refer to an interim financial statement. Such warranties, however, should be restricted due to the fact that an interim statement does not have the same quality as a year-end statement, as such interim statements are often not based on a physical counting of the assets, and accruals are usually not as precise as in an annual financial statement.

5.4.2.6 *Warranties as to Tax Issues*

Normally, the seller is requested to warrant that the target company has timely filed all the required tax returns, that these tax returns are complete and correct, and that the company paid all tax and other public levies that were due before the signing of the agreement.⁸⁹ With this warranty, the seller assumes the liability for all tax burdens accrued before the closing of the transaction, including any penalties resulting from these taxes.

In an asset deal, the seller is not expected to grant a tax warranty. The reason is that according to Swiss law, claims for tax accrued before the closing date can only be directed against the seller as the owner of the legal entity at the relevant time. The seller in an asset deal, however, will normally warrant that none of the assets sold is subject to any liens or encumbrances for tax having accrued before the closing date or due to the closing of the transaction and thereby exempts the buyer from any liability in this regard.⁹⁰

5.4.2.7 *Warranties as to Authorizations and Licenses*

The buyer of a business will normally require the seller to warrant that the business has obtained all authorizations and licenses that are necessary for the conduct of its activities. Otherwise, it would be impossible for the buyer to continue the activities of the acquired business. It is important that the seller also warrants that the competent authorities have not threatened to withdraw certain authorizations or to subject any existing authorizations to new conditions, as this could lead to considerable expenses or to an interruption of the business activity which would negatively affect the value of the business.

Authorizations that are subject to a change of control clause can be problematic for the buyer since they are automatically terminated or can be cancelled by the competent authority in the case of a sale because the authorizations refer to the seller. These problems, however, cannot be solved with a warranty of the seller since the actions of the competent authorities cannot be influenced by the seller: whether the competent authorities will actually cancel a license or authorization due to the change of control clause depends to a

⁸⁹ The word "taxes" is usually defined to include all kinds of direct and indirect taxes, duties, and often also social security contributions.

⁹⁰ For the appropriate indemnity, see *cf.* chapter B.5.4.4 below.

large extent on the buyer and his abilities to fulfill the conditions for the issuance of the license or authorization concerned. If the license or authorization is essential for the success of the business, it is in such cases advisable to subject the purchase agreement to the condition precedent that the competent authorities confirm that they will not invoke the change of control clause or will issue a new identical authorization to the buyer.⁹¹ In any case the buyer should achieve a warranty that all authorizations subject to a change of control clause were presented to him. This provides the buyer with the assurance that the condition precedent regarding the receipt of authorization covers all relevant authorizations.

5.4.2.8 *Warranties as to Contracts with Third Parties*

Normally the seller will warrant that the contracts with third parties which are material for the conduct of the business actually exist in the form as presented in the due diligence, that the business is not in default of these agreements, and that these agreements cannot be terminated due to the closing of the transaction. If the parties are aware that certain contracts with third parties contain change of control clauses, the seller cannot be expected to warrant that these contracts will not be terminated due to the closing of the transaction as the seller cannot control the actions of the counter parties to these contracts. If contracts subject to change of ownership clauses are essential for the conduct of the business, it is recommended to subject the closing of the contract to the condition precedent that the counter party confirms that he will not invoke the change of ownership clause despite the change of control⁹². In these cases, the seller should, as described in connection with authorizations, warrant that he has disclosed all material contracts containing change of ownership clauses so the buyer is assured to have covered all relevant contracts.

5.4.2.9 *Warranties as to Pending Procedures*

In share deals, the seller will normally warrant that there are no procedures pending or threatening against the company, exceeding an agreed legal threshold, except for those disclosed in the due diligence.

If the seller warrants that the financial statement of the sold business is correct⁹³ as described in chapter B.5.4.2.5, the seller also warrants that the balance sheet contains provisions that adequately reflect the risk of pending procedures as assessable at the date of the balance sheet preparation. Since the question whether a provision for certain risks is accurate is always answered on the basis of the facts and information available at the time the balance sheet was prepared, the seller providing the financial statement warranty only warrants that the provision is sufficient in view of the risk assessed at that time, but not large enough to actually cover a negative result of future procedures. Consequentially, the

⁹¹ Cf. chapter B.5.3.3.3 above.

⁹² Cf. chapter B 5.3.3.2 above.

⁹³ For such warranties see chapter B.5.4.2.5 above.

buyer will sometimes require the seller to warrant that the existing provision is sufficient to cover a future negative result of the procedure. If a seller grants such a warranty that exceeds the normal warranty on the financial statement, he will in most cases demand to receive the positive difference if the actual result of the procedure is more favorable than expected and the provisions were not exhausted completely for the coverage of the procedure.

5.4.2.10 Warranties as to Intellectual Property Rights

As intellectual property rights are essential to the value of the business, the seller can be expected to warrant that the business owns all intellectual property rights rightfully or has adequate licenses to them. The fact that the seller often cannot exclude that an unknown reason for invalidity of registered rights exists, will often prevent the seller from granting an unrestricted warranty as to the validity of such intellectual property rights.⁹⁴ Therefore, the seller will often try to limit this warranty, by representing that such intellectual property rights have been validly registered and that to the best of his knowledge no reasons for nullity or for a challenge exist. This restriction on a warranty is, however, not acceptable for a buyer if the success of the business and the price paid for it directly depend on the valid existence of certain intellectual property rights.

5.4.2.11 Warranties as to Environmental Risks

Although Swiss environmental legislation and its enforcement have not reached the standard of the United States or Germany, environmental regulations have become more and more important in Switzerland within the last few years. Especially since the revision of art. 116 of the Federal Environmental Act, which allows the competent authorities to order the remediation of any environmental contamination, can preexisting soil contamination cause high costs for the company. Buyers, therefore, often demand far-reaching warranties in the environmental area. They usually try to obtain a warranty that the activities of the business were always in compliance with applicable environmental regulations, that the assets of the business, particularly real estate, comply with these regulations, and that no contamination exists that would oblige the business to take remedial action. If the due diligence led to the awareness that some remediation is necessary and the cost of such remediation can be assessed, it is, in most cases, not appropriate to solve these issues by a warranty of the seller. Instead, it is advisable to deduct these costs directly from the purchase price or to provide an indemnity by the seller whereby he assumes the costs of this remediation as far as they exceed any provisions explicitly set aside for this remediation.⁹⁵

⁹⁴ The reasons for nullity may exist due to conflicts with third party rights. For the nullity of patents, it is also sufficient that any third party has published a report or a notice on a similar invention or development before the pattern has been filed.

⁹⁵ For these indemnities, see chapter B.5.4.4 below.

5.4.2.12 Warranties as to Compliance with Safety Regulations

As in other countries, a considerable number of safety regulations designed to protect employees from accidents and illnesses caused by their work exist in Switzerland. The rules applicable strongly depend on the business' features. The regulations vary from prevention measures (dust and ear protection) to the prohibition of certain actions harmful to health. The seller usually warrants that the business complies with applicable safety regulations and that no governmental requirements were enacted that have not yet been complied with. However, if the parties after the due diligence become aware that the business does not comply with certain safety regulations, it is not appropriate to solve the problem with a warranty. If certain additional investments are necessary to comply with these regulations, the amount of this investment should be directly deducted from the purchase price or, if the amount cannot be precisely assessed, the contract should provide guarantee according to which the seller takes over this cost.

5.4.2.13 Warranties as to Pension Funds

As described in chapter E.3.3.2, if pension funds do not have sufficient assets to cover the accrued pension claims of the employees, it can lead to significant expenses for the business. According to Swiss accounting rules, such future obligations are not required to be shown as a liability in the balance sheet of the business, and the business is not required to establish a special provision for any future expenses that may be necessary to cover such deficit. Therefore, the fact that a deficit in the pension plan is not shown in the balance sheet does not constitute a violation of a balance sheet warranty as described above.⁹⁶ The buyer consequently will demand that the accrued pension claims of the employees are fully covered by insurance agreements, the means of a pension fund, or specific provisions in the financial statement.

5.4.2.14 Warranties as to Product and Service Liability

Depending on the activities of the target business, client liabilities can be a serious problem. A certain number of customer complaints and guarantee cases is an ongoing burden of any active business, with the cost of the appropriate remedial action being accounted for in the ordinary expenses and in the valuation of the business. If these costs exceed the normal level, the buyer will expect them to be covered in a warranty, since these excessive expenses are not taken into account in the valuation of the business. Therefore, most purchase agreements contain warranties that the seller has to bear the liability for claims for goods delivered and services provided before the closing of the contract; provided the expenses exceed the provisions established for these claims, or the expenses exceed the

⁹⁶ According to IAS and FER, deficits in the pension plans have to be recorded in the balance sheet of the business. A balance sheet warranty that is tied to one of these standards would be violated if the deficit was not properly recorded in the balance sheet.

normal level of expenditure taken into consideration by the business the expenses are not covered by liability insurance.⁹⁷

5.4.2.15 Warranties regarding Insurance Policies

The insurance coverage of the business is material for its risk profile, and also strongly influences the relationship between the seller and buyer since risks that are covered by insurance do not have to be covered by special warranties or indemnities by the seller. As the buyer in this sense often relies on insurance coverage disclosed to him in the due diligence, the seller, in most purchase agreements, has to warrant that such insurance policies actually exist at the closing date, and that the business has complied with its obligations towards the insurance companies and the insurance coverage is secured. If the insurance coverage of the business is automatically terminated at the closing because the target business is part of a group of companies and is covered by group insurance, the parties have to find other solutions to secure the continued insurance coverage of the business. The seller or buyer can for example conclude a subsequent insurance to maintain the previous insurance coverage.

5.4.3 Breaches of Warranties

5.4.3.1 Claims of the Buyer

5.4.3.1.1 Statutory Claims

If a warranty is breached, the buyer, according to Swiss law, has the right either to rescind the agreement and reverse it (conversion) or to demand a reduction of the purchase price (reduction). In order to assert these rights, it is required that the buyer performed the duty of examination and notification as described in chapter B.5.4.1.3 and that the limitation period of a year has not expired yet.

a) Conversion

A rescission of the purchase agreement of a business is normally very impracticable since the buyer, after the closing, usually integrates the acquired business into his own organization, and thereby changes the business to such an extent that it cannot be returned to the seller after repayment of the purchase price. Additionally, problems arise because the buyer must keep on conducting business during the time of proceedings in order to avoid economic damages to the business and resulting changes. Except for cases in which the business loses its value due to the defect completely, the court will usually not enforce a conversion pursuant to art. 205 para. 2 CO but instead a reduction.

⁹⁷ This expense level is normally defined as a percentage of sales.

b) Reduction

The case of a reduction of the purchase price, *i.e.*, the subsequent reduction of the purchase price due to a defect, is normally the solution when a warranty has been breached. In practice, the amount by which the purchase price will be reduced is essential.

According to prevailing theory and the practice of the courts, the purchase price must be reduced pursuant to the "relative method" in the case of a material defect, *i.e.*, the purchase price is reduced by a percentage which amounts to the difference between the actual value of the business sold and its value if no warranty had been breached.⁹⁸ This method respects the relation between value and price of the business at the time the contract was agreed upon; however, it is based on an ascertainable objective value which does not exist in relation to businesses. Even though economic theory and practice are searching for a precise objective evaluation method of a company, no method exists allowing a precise evaluation which is necessary to pursue the relative method.⁹⁹

Since this difficulty also arises when determining the value of other purchase objects, the Federal Supreme Court, in its practice, assumes the objective value to correspond to the purchase price and the reduction in value to correspond to the costs necessary to rectify the defect, unless the parties can prove a basis to apply the relative calculation method.¹⁰⁰ This method is in particular reasonable when the business has additional liabilities, if certain assets are missing, or compliance costs arise. In these cases the defect can be repaired by the seller paying the additionally necessary costs and the buyer receiving a business without defects due to this payment. This calculation method will lead to the same result as the relative method, in which the business must be evaluated, in the following described cases:

- If assets not needed for operational purposes are missing they will be viewed as 100% price relevant in the regular business evaluation pursuant to the Discounted Cash Flow Method. These assets could be sold by the buyer after the purchase allowing him to generate earnings which are relevant in the Discounted Cash Flow Method.
- If assets needed for operational purposes are missing they must be replaced to enable the ongoing business. This will lead to an outflow of funds which is also directly relevant to the Discounted Cash Flow Method.
- Unexpected liabilities must be paid sooner or later which will lead to an outflow of funds also directly relevant to the Discounted Cash Flow Method.

The previously described calculation method fails when the defect does not lie in the substance itself but reduces the earnings of the business. Such a situation occurs when the

⁹⁸ BGE 111 II 162; Decision of the Federal Court dated 10.12.1986, SJ 1987, 181.

⁹⁹ Also the Discounted Cash Flow Method is based on future figures which cannot be projected with security.

¹⁰⁰ BGE 111 II 162; Decision of the Federal Court dated 10.12.1986, SJ 1987, 181.

business is lacking a concession that cannot be procured later, which is necessary for a certain business sector, or when it becomes obvious that a part of the profit accounted for in the annual financial statement is fictitious and cannot be achieved in future. In these cases the effect of the loss of earnings on the evaluation of the purchase price must be estimated. If the parties cannot prove that they have used a specific evaluation method, the judge will use a "regular" calculation method and deduct the loss of earnings proportionally from the purchase price. In cases when there will be only a loss of earnings for a certain period of time, a proportional reduction would not be accurate, and instead the discounted amount of the loss of earnings can be reduced from the purchase price. The liquidation value of the business presents the lowest level of these result-oriented deductions since the buyer, even if not able to generate earnings, still could liquidate the business.

c) Claims for Damages

If the buyer suffers, other than from the decrease of value caused by the material defect, from additional damages, he may further claim these damages consequential to a defect. As far as the purchase agreement is rescinded by a conversion, the buyer may, pursuant to art. 208 para. 2 CO, claim indemnity for damages caused directly by the defect without having to prove the culpability of the seller.¹⁰¹ For the further damages caused by the conversion as well as damages consequential to a defect in the case of a reduction, the buyer may only claim damages if the seller is culpable. The seller can however reject the claim by proving he is not at fault.¹⁰²

As part of further damages and damages consequential to a defect respectively, the buyer may claim the positive interest of the contract. In the case of a purchase agreement of a business the following claims for damages may arise:

– Short-term Loss of Earnings Caused by Absent Assets or Compliance Problems

Defects not having a negative influence on sustainable earnings also can lead to short-term loss of earnings. *e.g.*, production failures may occur while new fixed assets are being procured or a temporary closing of the business may be required if a pharmaceutical company, not complying with legal prerequisites, must first adopt them.

If the defect causes a reduction of sustainable earnings, this damage can be directly compensated by a reduction of the purchase price. Thereby, the loss of earnings is satisfied and cannot be claimed a second time as damages consequential to a defect.

¹⁰¹ According to BGE 79 II 376 the directly caused damage corresponds to the negative interest and the consequential damage corresponds to the positive interest.

¹⁰² BGE 96 II 115.

– *Synergy Effects*

If the acquired company is integrated into the business of the buyer and certain defects disable or delay this integration, the loss of these synergy profits encompasses consequential damages. Practice shows that synergy effects can hardly ever be proven convincingly; this corresponds to the fact that the occurrence of synergy effects are rarely proven in accomplished mergers.

– *Loss of Future Profit in Conversions*

If the buyer decides to rescind the agreement and perform a conversion, he will usually try and claim the future profit or increase in value of the business as a consequential damage. These claims not only suffer from difficulties of evidence, as future profit cannot be proven convincingly, but also from conceptual problems. On a conversion, the buyer will receive the purchase price back and be enabled to pursue further projects in which he can gain profit. This newly-generated income then must be deducted from the loss of profit.

The previously described problems of proving further damage or consequential damages show that these claims can rarely be enforced in practice; in practice, only the short-term loss of earnings can be enforced with a high probability of success.

5.4.3.1.2 *Contractual Regulation of Warranties*

These previously described statutorily provided for warranty claims are not appropriate for the purchase of a business. Usually the following modification will be provided for in the purchase agreement:

– *Exclusion of the Conversion*

As described in chapter B.5.4.3.1.1.a, a conversion in the case of a purchase of a business is not possible. Consequentially, the conversion is normally excluded in the business purchase contract or it is only provided for cases in which the right of reduction exceeds a certain threshold.

– *Right of Improvement*

Sometimes the business can be afflicted with defects the seller could rectify; if the acquired business is lacking assets accounted for in the balance sheet because they were never transferred from the private ownership of the seller to the business in a legally binding manner, the defect can be rectified by correctly transferring the assets. In this sense the contract will often provide that the seller will be granted a certain period after notification of the defect to cure the defect. Only if the seller is not able to improve the defect in a given time can a reduction be claimed.

– ***Calculation of the Reduction***

As discussed in chapter. B.5.4.3.1.1.b, the calculation of the amount of reduction is controversially discussed in theory and in practice of the courts. A contractual risk allocation is only then economically reasonable if the financial performance is foreseeable. In this sense it is advisable to provide in the contract the calculation of claims in the case of a breach of warranties. In the case of problems with respect to assets and liabilities it is advisable to provide that the costs must be replaced which are necessary to restore the condition of the business as it was assured.¹⁰³ If the problems however result in reduced sustainable earnings the claim will be calculated with EBIT-Multiples or similar evaluation formulas.¹⁰⁴ This formula will rarely be included in contracts since the buyer usually does not want to disclose how he calculated the purchase price exactly.

– ***Exclusion of Indemnities***

As described in chapter B.5.4.3.1.1.c, claims for damages consequential to a defect allow a broad scope for argumentation and evidence, although they usually do not lead to satisfying results. These indemnities, difficult to predict in their scope, are normally excluded by contract. As a result, the financial claims of the buyer are reduced to the right of price reduction.

– ***Exclusion of the Examination and Notification Duty***

The strict examination and notification duty of the buyer described in chapter B.5.4.1.3 in connection with complex purchase objects, as for businesses, often leads to the fact that materially legitimate claims are excluded, since in practice, the short period for examination and the substantiated notification duty can hardly be complied with. As a consequence, these periods are usually waived by contract. To some extent, it is provided that the buyer has a duty to notify, *i.e.*, the buyer must report the defect within given period.¹⁰⁵ Yet, in the case of a breach of this contractual notification duty, the buyer only loses his claims to the extent the delay leads to higher damage.

– ***Extension of the Limitation Period***

The short limitation period of one year is also problematic since many hidden defects in the purchase of a business have a longer latency period. As a result, this period is usually extended to 1½ to 2 years. For environmental issues even longer periods can be provided since their latency period is extremely long. With respect to warranties as to taxes, the contract often provides that the warranty is valid until the limitation of the

¹⁰³ If the substance is essentially higher than the purchase price it must be reduced correspondingly.

¹⁰⁴ In practice these problems do not arise that often, since future earnings are usually determined by the buyer.

¹⁰⁵ Normally 30 to 60 days.

tax consequences. Otherwise, the buyer would be forced to request the tax authorities to revise the taxes within the limitation period in order to claim any defects.

5.4.3.2 *Mitigation of Loss by the Buyer*

According to art. 99 para. 3 CO and art. 44 CO, the buyer has to mitigate the damage caused by a breach of warranty. If a problem emerges in the business that may be considered as a breach of warranty, the buyer has to take the necessary measures to keep the financial damage caused by this problem as small as possible. If a claim of a third party is the cause of the breach of warranty,¹⁰⁶ the buyer has to take the necessary steps to defend these claims. The buyer may not simply rely on the seller's warranty and acknowledge the existence of the claim.

The same rule applies to warranties on procedures, product liability, and environmental issues. The buyer first has to try to defend the business against the claims concerned and / or solve the problems with as little expense as possible before he can raise claims against the seller.

To avoid problems with the buyer's mitigation obligation, it is advisable that the buyer involves the seller in the solution of these problems by notifying the seller as early as possible. It is also advisable to transfer the responsibility for procedures and the defense against third party claims that may lead to warranty claims directly to the seller. If the seller is directly involved in the defense against third party claims and in procedures the seller later cannot claim that the buyer insufficiently defended such claims of third parties and try to refuse warranty claims of the buyer.

5.4.3.3 *Limitation of Claims*

Often purchase agreements provide that the buyer's warranty claims are limited by a minimum and a maximum amount. A minimum amount clause, which provides that the buyer may raise claims only if the damages stemming from a breach of warranties exceed a certain threshold amount, is reasonable since disputes on small amounts usually cause expenses that bear no reasonable relation to the amount in dispute. Purchase agreements often contain a maximum amount to ensure that the seller, even in case of warranty claims, receives a certain minimum purchase price. Whether the maximum amount is agreed upon and how high it will be depends on the negotiation position of the parties. However, the buyer can only be expected to accept this limitation of potential warranty claims if he has been able to conduct a thorough due diligence that places him in a position to assess the potential risks associated with the business.

According to art. 199 CO, any contractual limitations of warranty claims are not valid if the seller has willfully deceived the buyer on deficiencies of the business.

¹⁰⁶

This case occurs for example where a third party raises a claim that has not been taken into account in the balance sheet that is covered by the seller's warranty, but according to the applicable accounting standard should have been recorded in the balance sheet. Then the seller's warranty is breached if the claim raised by the third party actually exists.

5.4.4 Independent Indemnities by the Seller

A contractual warranty or representation is only appropriate if the buyer actually can assume that the business correlates to what has been promised to him. If a buyer uncovers a deficiency in the due diligence this problem cannot be solved by a representation by the seller that the deficiency does not exist.

This situation occurs, for example, if the buyer learns during the negotiations or the due diligence review, and before the signing, that environmental authorities have ordered the company to undertake certain remedial action with regard to preexisting soil contamination, if the tax authorities have raised claims that are disputed by the business, or at the time the agreement is signed litigation is pending that may lead to a material cost to the business. If the extent of these problems cannot be clearly quantified and the cost cannot be directly deducted from the purchase price, these problems are best solved by an indemnity by the seller.¹⁰⁷ With this indemnity, the seller assumes the expenses caused by the remediation of soil contamination or the consequences of the tax and litigation procedures identified in the due diligence review as far as these expenses exceed the provisions established for this purpose. The purpose of such indemnities in a purchase agreement is to create a security for the evaluation of the business since the risks assumed by the seller do not have to be taken into account in the price valuation. With an indemnity of the seller the problem is solved since he assumes an essential risk. Yet, he may expect to achieve a correspondingly higher purchase price because the buyer does not have to deduct a risk premium of the purchase price.

The wording of indemnities is strongly dependent on the detected problems being covered by these indemnities, and therefore, varies from agreement to agreement. In the composition of these indemnities the parties can also use flexible solutions that take into account that certain covered risks are normal enterprise risks that the buyer assumes on the purchase of the business. For example, when an indemnity covers environmental remediation costs the parties can provide that the buyer and seller each bear a part of the remediation cost with the percentage to be borne by the buyer increasing over time. With the increase of the buyer's participation the parties take into account that the remediation costs, to some extent, are part of the normal business expenses, and that after a certain period of time it becomes difficult to assess whether the soil contamination has been caused by the business activities before the closing or after the closing.

If the seller assumes specific risks in an indemnity, he will usually demand a certain degree of control over the solution of the problems concerned. Otherwise, the seller incurs the risk that the buyer will not use his best efforts to solve the problems but instead relies on the payment from the seller under the indemnity. In the case of indemnities covering pending tax or civil litigation, the responsibility of these procedures is normally transferred to the seller. Such solution is also advantageous for the buyer: if the seller assumes

¹⁰⁷ In accordance with art. 111 CO.

the responsibility of these procedures he can not later raise the defense that the buyer has mismanaged these procedures.

Indemnities are independent contractual obligations neither subject to limitation periods nor to examination or notification duties corresponding to warranties and representations. Instead they have a regular limitation period of 10 years. A buyer who wants to take advantage of these contractual indemnities should explicitly state that these are independent indemnities of the seller not subject to the modalities of statutory warranties and representations. This will prevent the seller from claiming in a possible later procedure that the formulations are warranties that have reached their limitation period. Since the content is often the same in representations and warranties, the precise distinction is necessary to the advantage of the buyer.

5.4.5 Securing Warranty and Indemnity Claims

Depending on the financial situation of the seller, it may be necessary to secure the payment of claims of the buyer under warranties and indemnities since it can be problematic to enforce a positive judgment. This issue is relevant if the buyer is an individual person who can change his residence after the sale or if the seller is a company that will be liquidated after the sale or is not solvent. In practice, the parties use the following methods to secure the payment of the buyer's claims:

5.4.5.1 *Deferred Payment of the Purchase Price*

The claims of the buyer can be secured by deferring a part of the payment of the purchase price until a date after the expiry of the warranty period. The buyer then has the right to settle claims he may have under warranties or indemnities with the remaining part of the purchase price. The partial deferral of the payment of the purchase price is the most advantageous method for the buyer to secure the payment of obligations of the seller, since a part of the transaction can be financed at a later stage. Furthermore, the roles are shifted since the seller in a dispute must raise a claim for the payment of the remaining purchase price. This fact markedly improves the negotiation position of the buyer in any settlement of negotiations.

Since the partial deferral of the payment of the purchase price not only significantly strengthens the buyer's negotiation position, but also exposes the seller to the risk that the buyer may become insolvent and not able to pay the remaining portion of the purchase price, sellers are seldom prepared to accept a partial deferral of the payment of the purchase price as a means to secure the buyer's claim against them.

5.4.5.2 *Bank Guarantee in Favor of Buyer*

The seller can secure the claims of the buyer under warranties and indemnities by transmitting an abstract bank guarantee to the buyer on the closing date. This bank guarantee allows the buyer to draw, up to the amount of the guarantee, the amount necessary to cover any of his claims against the seller. Since the buyer, at the time he draws an amount under the bank guarantee, does not have to prove this claim, the bank guarantee has the

same effect on the positions of the parties as in a dispute on claims under warranties and guarantees as a partial deferral of the payment of the purchase price. In a dispute, the seller has the position of the plaintiff since he is trying to recover the amounts drawn by the buyer under the bank guarantee. The buyer in this procedure can allege as a defense that he has claims under warranties and guarantees that he can settle with the buyer's claim. Consequently, the seller also bears the risk that the buyer may become insolvent after drawing the bank guarantee. Due to this fact and the strong position of the buyer in the settlement of negotiations, the sellers usually are not willing to secure warranty claims with abstract bank guarantees.

5.4.5.3 *Bank Surety*

The claims of the buyer can also be secured by a surety¹⁰⁸ that the seller transmits to the buyer at the closing. Under the surety, the buyer can demand payment from the issuing bank if the seller has acknowledged the existence of certain claims under warranties or indemnities, or if the buyer has obtained a favorable judgment. A bank surety, contrary to a partial deferral of the purchase price payment or a bank guarantee, does not lead to a shift of the plaintiff role between the buyer and seller. Since a bank surety in addition does not expose the seller to any risk if the buyer becomes insolvent, the bank surety usually is the appropriate means to secure the buyer's claims under warranties and indemnities.

5.4.5.4 *Escrow Account*

The claims of the buyer can also be secured by an escrow account. If the parties agree on this mechanism to secure the buyer's claims, the buyer will pay a part of the purchase price at the closing to an escrow account, which is established in the name of a third party who acts as escrow agent. The escrow agent is instructed to pay the funds deposited in the escrow account to the seller on a certain date in the future, unless the buyer, until that date, has notified the escrow agent that he has claims against the seller. In such cases the escrow agent may only dispose of the funds in accordance with the common written instruction of the seller and buyer, or pursuant to an enforceable judgment. An escrow account has practically the same effect as a bank surety with regard to securing the buyer's claims, *i.e.*, the seller is protected against the risk that the buyer may become insolvent, while the roles of plaintiff and defendant, in the case of a dispute do not shift. Escrow accounts, like bank sureties, normally are acceptable to adequately protect the legitimate interests of the seller and buyer.

5.5 Further Obligations of the Seller

To ensure the economic success of the purchase of a business, it is often not sufficient that the object of the sale is merely transferred. In many cases it is necessary that the sell-

¹⁰⁸ In accordance with art. 492 CO.

er assumes certain additional duties in the purchase agreement. These duties naturally depend on the individual needs of the parties and the target business. Often contracts contain the following obligations of the seller:

5.5.1 Transfer of Additional Assets

A company that is sold in a share deal sometimes does not own all the assets that are necessary for its business. In groups of companies, certain assets, such as real estate or expensive machinery, are sometimes held by another company of the group and only rented by the business concerned

In such cases it must be assured that the buyer can continue to rent these assets. It is advisable to clearly define in the purchase agreement the terms of the lease agreement and to attach such lease agreement to the purchase agreement. At the closing date of the transaction the lease agreement can then be signed.

An alternative to the further rent is to transfer or sell the assets between the signing of the purchase agreement and the closing to the transaction. To avoid the value of the target company being negatively affected by this transaction, the terms of the transfer have to be clearly defined in the purchase agreement. It is advisable to attach the contract on the transfer of these assets to the purchase agreement to avoid any ambiguities between the parties connected to such a transaction.

5.5.2 License Agreements / Transfer of Intellectual Property Rights

If a single company that was part of a group of companies is acquired, the buyer needs to first determine whether the company concerned actually owns the intellectual property rights it uses. In many cases, these rights are owned by an exploitation company that centralizes the exploitation of intellectual property rights in the group concerned, since such structure presents sizeable tax advantages. If the intellectual property rights are exclusively used by the target business, it is usually appropriate to provide in the purchase agreement that these intellectual property rights are sold to the buyer in a separate transaction. The situation is more complex if the intellectual property rights are not exclusively used by the business that is sold but also for other business activities. This situation occurs, for example, if a holding company sells one of its subsidiaries that uses patents for its business and these patents are also used by other subsidiaries. If the intellectual property right concerned is primarily used by the business that is sold and represents an important portion of the value of the business, in most cases it is appropriate to transfer this intellectual property right to the buyer, and to provide a license agreement for the seller that he can continue to use the intellectual property right for other activities. If the intellectual property right concerned, however, is primarily used by the seller this intellectual property right is usually not transferred to the buyer, but the seller only grants the buyer a license that allows him to use such intellectual property right for the business.

In these license agreements concluded between the buyer and seller for the common use of intellectual property rights, the fields where the seller and buyer may use these rights

must be clearly defined since the parties want to avoid a competitive situation; the buyer does not want the seller to be able to use these intellectual property rights to directly compete against the sold business and vice versa.

5.5.3 Occupation of the Seller in the Acquired Business

If the success of a business depends on the personal commitments of the seller, it is often necessary that he continues to work for the acquired business for an interim period on the basis of an employment or consulting agreement. In this case, the terms of employment or consultancy should be defined in the purchase agreement, and the appropriate employment or consultancy agreement should be attached as an annex to the purchase agreement.

The buyer, however, should not rely on the continued work of the seller for the success of the business. Normally, a person who sells a business does not want to continue to work for the business for an indefinite period of time. The buyer must take into account that the seller will, sooner or later, leave the business, or that at least his motivation will decrease. This situation cannot be cured by legal provisions since it is impossible to enforce motivation or creativity. Only a strong incentive that is tied to the future performance of the business can, at least to a certain extent, ensure the motivation of the seller. If the buyer intends to ensure that the seller continues to work with full commitment, he can provide that the payment of the purchase price is dependent on the performance of the business under the lead of the seller.¹⁰⁹ To give the seller a strong incentive for his further work in the business, he can also be included in an option program of the buyer enabling him to profit corresponding to his good performance.

The seller who continues to work for the business he has sold must be aware that he cannot continue to work in the same manner he worked before the sale. The management style and reporting usually have to be adapted to the new owner and the seller after the closing of the transaction is subject to the instructions of the buyer. This fact often creates problems for the seller who, as the owner of the business, has enjoyed much freedom before the sale. In view of these potential problems, it is advisable for the buyer to retain the services of the seller only for a clearly defined interim period with a primary focus of introducing new management to the business.

5.5.4 Interim Solutions for the Provision of Services

If the buyer acquires a company that was part of an affiliated group, he will often realize that the acquired business has relied for certain functions on services provided by the parent company or affiliated companies. In groups of companies, EDP, accounting, and human resources services are often provided by a central service company that is not sold together with the business. If the buyer does not have the resources to immediately provide these services himself, the parties must devise a transitory solution until the buyer

¹⁰⁹ For the earn-out, see chapter B.5.2.3 above. An earn-out is often acceptable to the seller if he continues to manage the business, and thus can influence the future performance of the business.

has built up his own resources. In these cases, the purchase agreement has to provide that the parties conclude a service agreement for these services according to which the corresponding services can be continued in the transitional period.

An alternative to a service agreement is to transfer a number of the central service employees to the buyer. This solution is often quite interesting for the seller and it can also reduce his own overheads.

5.5.5 Prohibition on Competition

After the completion of the sale, the seller will still have all the know-how and the relations to customers and suppliers that are necessary to successfully conduct the business sold. Therefore, the seller could damage the buyer considerably if he would start a business that competes with the business he has sold. In certain cases, these competing activities could endanger the whole economic success of the acquisition of the business. Consequently, most purchase agreements contain a covenant that prohibits the seller from competing with the business he has sold. For the seller, it is important that this prohibition of competition not only provides that the buyer can demand actual performance in case of a breach, but that he can also demand payment of liquidated damages since it is often very difficult to prove the actual accrued damage.¹¹⁰

According to the decisions of the Federal Supreme Court, such prohibition of competition covenants contained in a purchase agreement are only subject to the limitations set in art. 27 CC. On this basis, an extensive formulation of the covenant to not compete is possible under Swiss law as the Federal Supreme Court is not likely to assume that a business party who agrees to a covenant not to compete limits his economic freedom to an unacceptable extent, but rather assumes that this party knowingly has entered into this agreement and was adequately compensated for doing so.

According to the practice of the Federal Supreme Court, a prohibition of competition contained in a purchase agreement is not subject to MA, *i.e.*, is not regarded as an agreement to limit competition as defined in art. 5 MA. Therefore, MA does also not limit the extent of a covenant of non competition the parties want to agree upon. The Swiss legal situation differs considerably from the legal situation in the EU. According to EU law, a prohibition of competition contained in purchase agreements is regarded as an agreement restricting competition. Therefore, such prohibition of competition can only be agreed upon as far as it is necessary to ensure the economically successful transfer of the business from the seller to the buyer. In the EU, a prohibition of competition is only possible within a limited scope since three to five years is the maximum period that is allowed for these covenants.

¹¹⁰

If the covenant not to compete provides for the payment of liquidated damages in case of a breach, the purchase agreement must explicitly state that the payment of these liquidated damages do not lead to the abolition of the covenant not to compete. Otherwise, the one time payment of liquidated damages, according to art. 160 para. 1 CO, leads to the abolition of the covenant not to compete.

C. SALE IN AN AUCTION PROCEDURE

- *Large and attractive companies are often sold in an auction procedure. The auction procedure is not a public auction, but rather a series of parallel negotiations. The advantages of an auction procedure for the seller are that he has control over the procedure and that potential buyers, due to the competitive situation, usually make better offers than in individual negotiations.*
- *The auction procedure begins with an invitation letter that is sent to potential buyers. If a potential buyer confirms his interest in purchasing the target company and signs a confidentiality agreement, he will receive a procedure letter describing the auction procedure and an information memorandum describing the target company.*
- *On the basis of the information memorandum, the prospective buyers submit non-binding offers to purchase the company. The seller then invites those bidders who have submitted the best offers to a second round in which the prospective buyers are given the opportunity to conduct the due diligence and they are provided with a draft purchase agreement.*
- *After the due diligence, the bidders must submit a binding offer and a mark-up of the purchase agreement.*
- *On the basis of the binding bids, the seller chooses one of the prospective buyers with whom final negotiations are conducted and the contract is concluded.*
- *In an auction procedure, problems may emerge if there is insufficient interest in the company from the prospective buyers and the seller is forced to abandon the procedure. This will usually make it difficult to sell the company in the near future. Furthermore, it is possible that competitors make "spy-offers", i.e., try to be admitted to the due diligence by making a high non-binding offer in order to obtain information on the company without any actual intent to purchase the company. Sometimes a buyer also tries to disrupt the procedure by an "ultimate offer" which is subject to the condition that the auction procedure is terminated and an exclusivity agreement is executed with this particular bidder.*

Over the last few years, a trend developed to sell large and attractive companies in an auction procedure. In the beginning of an auction procedure, the seller invites a number of potential buyers to submit bids for the company. The seller then conducts parallel ne-

gotiations with those potential buyers who submit attractive offers and decides only at the end of the procedure on a specific buyer. This creates a competitive situation between the potential buyers during the whole procedure. The auction procedure not only has the advantage for the seller that a higher purchase price can be achieved, but also, allows for more advantageous contractual conditions in his favor.

An auction procedure is only feasible if a certain number of potential buyers exists who are actually interested in purchasing the company and are willing to participate in such a procedure. An auction procedure, therefore, can only be conducted successfully if a company is interesting enough to attract a number of bidders who are willing to submit attractive offers and are able to incur the expenses connected with this procedure.

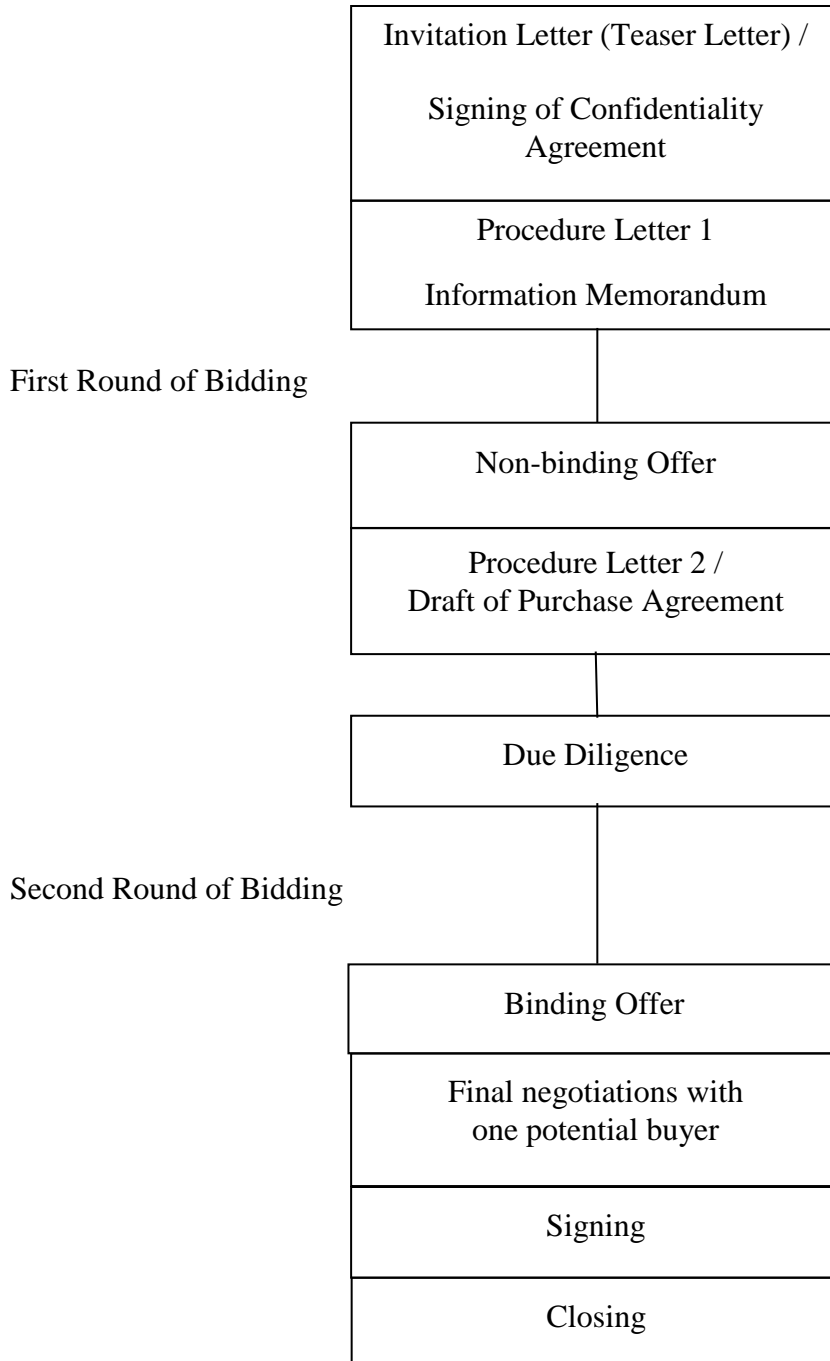
Problems can arise in cases in which the competition discontinues and only one interested buyer remains. Naturally, if the one bidder is aware of his position, he will try to use the situation to obtain the lowest possible price. The seller in this situation can either accept the low bid or terminate the auction. Because the public is informed of the auction procedure, the termination of the auction procedure will prevent the seller from being able to sell the company at favorable conditions for a long time, since all the potential buyers are aware of the failed attempt to sell the company. Therefore, the seller should, before deciding on an auction procedure, realistically assess whether a sufficient number of potential buyers exists and, in particular, whether the company is attractive for the financial buyers. Only if sufficient interest among the industrial and financial buyers exists, should an auction procedure be conducted.

An auction procedure, despite all confidentiality agreements, publicizes the seller's intent to sell the company,¹¹¹ a fact that can negatively influence relations with the customers and employees of the company. In particular, if the sale of the company cannot be realized quickly, the uncertainty of customers and employees can have a negative influence on the value of the company.

¹¹¹ On the one hand, the large number of parties involved leads to this publicity, on the other hand, the invitation letter (see chapter C.3.1) which is sent to a large number of parties has no confidentiality obligation to it, so that the information contained therein can be freely used.

1. AUCTION PROCEDURE

Although an auction procedure is adapted to the individual situation of the company and the potential buyers, and therefore, differs in each case, generally, the procedure is conducted as follows:



During this procedure, the number of participating bidders is progressively reduced. The invitation letter is usually sent to a large number of potential buyers. Only those potential buyers are invited to the first round of bidding who have confirmed their interest to purchase the company and have signed the confidentiality agreement provided with the invitation letter. Normally only those bidders who have submitted the highest non-binding offers are admitted to the second round of bidding to conduct a due diligence. The final negotiations are conducted with the potential buyer who submitted the highest binding offer.

Unlike the individually negotiated sale, described in chapter B above, in which the buyer and seller together control the procedure, the auction procedure is controlled exclusively by the seller who manages the whole procedure. The seller, in particular, establishes the procedure timeline by setting deadlines. The control of the timeline is one of the biggest advantages of the auction procedures for the seller; with strict time management, the seller may avoid a decrease in the value of the company created by the insecurity among customers and employees in light of the possible sale. The auction procedure, like the individually negotiated sale, must always be part of a divestment procedure preparing the company for the sale and separating it from a group of companies or a business unit, if applicable. The preparation of the sale is normally more intensive than in the individually negotiated sale since the company must be presented in a form, usually an information memorandum, which is comprehensible and attractive for a financial buyer who has little or no industry specific knowledge.

For this purpose, a business plan has to be prepared that is realistic and supports the financial projections contained in the information memorandum. The company must also provide a management structure which allows it to continue working with the existing management since a financial buyer normally does not have a management body to continue this task, and therefore, must rely entirely on the existing management. In the case of a sale to an industrial buyer, these factors are less important since, not the business plan itself is decisive, but the synergies created by the integration and since the acquired company is immediately integrated at the management level. In particular, for the financial buyers, whose participation is often crucial for the success of an auction procedure, a detailed information memorandum that explains the company and its perspectives, a convincing business plan, and a stable management organization are very important.

2. LEGAL NATURE OF THE AUCTION PROCEDURE

An auction procedure is not a voluntary auction pursuant to art. 229 para. 2 CO, since the object of the sale is not sold in a public procedure of offerings but the competition is created solely among the interested buyers. From a legal viewpoint, the auction procedure is a series of clearly structured parallel negotiations with several interested parties.

The seller will usually inform the buyers that he is free to determine the criteria on the basis of which he will choose the buyer, and that he may also terminate the auction procedure at any time without having the duty to sell the company. Therefore, the seller has neither a legal obligation to actually sell the company, nor an obligation to sell it to the potential buyer who offers the highest price. As the auction procedure encompasses a series of parallel negotiations, the seller also has no legal obligation to treat the bidders equally or to give them the same information.

Although the law imposes few obligations on the seller, it will usually lead to negative commercial consequences should the seller deviate from the legitimate expectations of the potential buyers. The legitimate expectations of the buyers are that the company is actually sold, that it is sold to the bidder who has submitted the highest offer, and that all bidders are treated equally. Deviation from these unwritten rules of auction procedures often has the effect that bidders will abandon the procedure since they will doubt that they have a fair chance in the procedure. If several bidders abandon the procedure because they are disappointed by the behavior of the seller, this may force the seller to terminate the whole procedure, or to accept a relatively low bid from one of the remaining bidders.

3. INDIVIDUAL STEPS OF THE AUCTION PROCEDURE

3.1 Invitation Letter (Teaser Letter)

In the beginning of the auction procedure, the seller, or the consultants organizing the auction procedure, will try to identify potential buyers. For this purpose, a "long list" of potential buyers is drafted. The list ideally contains a number of industrial buyers, as well as a number of financial buyers. The seller then sends these potential buyers a first letter that briefly presents the company and promises that an information memorandum will follow. The function of this letter is to incite the interest of potential buyers and to attract a high number of seriously interested prospective buyers to the auction procedure. For this purpose, the identity of the target company has to be disclosed. This has the effect that the seller's intent to sell the company will become public knowledge.¹¹² Therefore, the seller, at the time the teaser letter is sent out to potential buyers, must have a clear

¹¹² This effect normally cannot be avoided, even if the seller tries to present the target business in an anonymous form, he has to disclose so much detailed information that industry insiders can normally identify the business.

communication concept that takes into account the needs of the company employees and customers.

Besides presenting the relevant company, this first letter will also briefly describe the intended sales procedure. At this early stage, the seller normally only expresses that he intends to conduct an auction procedure within a certain period of time but will not yet set any specific dates.

The invitation letter will usually contain a confidentiality agreement that must be signed before a potential buyer will receive the detailed information memorandum. The content of the confidentiality agreement has been described in chapter B.2 above. The confidentiality agreement will prohibit the potential buyer from disclosing to third parties the information contained in the information memorandum or in any other documents he receives during the auction procedure, or to use this information for any purpose other than the evaluation of the company. The confidentiality agreement, however, will not include, at this stage, a prohibition to employ or entice away employees of the company since no potential buyer would accept such a far-reaching obligation to obtain the information memorandum.

3.2 Procedure Letter 1 and Information Memorandum

The potential buyers who confirm their intent to purchase the company will subsequently receive a procedure letter 1 and an information memorandum:

3.2.1 Procedure Letter 1

The procedure letter that is sent, together with the information memorandum, to potential buyers describes the planned auction procedure and usually has the following content:

3.2.1.1 *Description of the Sales Procedure*

The procedure letter explains each step of the auction procedure and provides a tentative timetable without, however, setting the definitive dates and deadlines for the individual steps since the seller usually will want, at this early stage, to retain a certain amount of flexibility allowing him the possibility to adopt the schedule to the specific interested parties.

3.2.1.2 *Invitation to Submit a Non-binding Offer*

An essential part of the procedure letter is the invitation of the potential buyers to submit, on the basis of the information memorandum, a non-binding offer by a certain date. Normally, the seller also invites the buyer to list any authorization requirements that he may have to comply with, to briefly describe his concept for the financing of the transaction, and to outline his plans for the further development of the company.

3.2.1.3 *Reservations of the Seller*

The procedure letter also includes the reservations of the seller with respect to his position in the sales procedure:

– ***Information Memorandum Disclaimer***

The seller usually excludes any liability for the content of the information memorandum and states that the buyer may raise claims only on the basis of representations and warranties contained in a validly signed purchase agreement but that the information memorandum may not be construed as a representation of the seller of the relevant company.

– ***Termination of Auction Procedure***

The seller normally reserves the right to terminate the auction procedure at any time without incurring any liability towards the bidders. This clause letter avoids the bidders from raising any claims under the theory of "*culpa in contrahendo*" if the auction procedure is terminated.¹¹³ Normally, however, the seller will have the goal to actually sell the company in the auction procedure, even more so, in light of the substantial expenses he occurs. In certain extraordinary situations, particularly if the bids are insufficient or if the position of the target company unexpectedly deteriorates during the procedure, it may be reasonable to terminate the sales procedure and keep the company, or prepare it in the course of the next few years for a future sale. A termination of the procedure also makes sense if a potential buyer submits an extremely attractive offer that is tied to the condition that the auction procedure is terminated and the potential buyer is granted exclusivity for a certain period of time.¹¹⁴

¹¹³ The theory of *culpa in contrahendo* allows a potential buyer to claim damages in the amount of the expenses he had in negotiations, if he can prove that the seller had no intention to sell the business when entering into negotiations.

¹¹⁴ For these exclusive offers, see chapter C 4.3 below.

– ***Choice of the Seller***

To avoid ambiguity, it is advisable to state in the procedure letter that the seller is free to choose the buyer, and that he is also free to determine the criteria according to which he makes his decision. This statement, in particular, avoids that the interested buyer, who submits the offer with the highest purchase price, raises a claim under the theory of *culpa in contrahendo* if the seller decides to sell the company to another bidder. Although, the seller normally will sell to the bidder offering the highest price, good reasons to sell the company to the bidder who offers a lower price exist *e.g.*, unfavorable contractual terms demanded by the highest bidder, or complications in connection with a merger control procedure may make the bid with the highest price less attractive than the lower bid that does not present these problems. A lower bid may offer advantages, such as positive solutions for the employees, or further cooperation with the seller.

3.2.2 Information Memorandum

The purpose of the information memorandum is to describe the company in sufficient detail for the potential buyer to make a preliminary valuation and, on such basis, submit a non-binding bid. For this purpose, a typical information memorandum contains the following information:

– **Markets in which the Company is Active**

In this part of the information memorandum the markets in which the company is active are described. This description normally contains statistical data on the growth of these markets, information on the market position of the company and its development opportunities in these markets.

– **Description of the Business Activity**

This part of the information memorandum usually contains a detailed description of the products of the company, its fixed assets, and the processes used for the production. To evaluate the company, it is necessary to describe all the production factors. A description of the marketing and distribution strategies, as well as the internal organization and management structure of the company are also required.

In addition to the description of the present business activities, the buyer is advised to include a business plan for the next few years and describe the major goals of the company's strategy. This description is necessary to calculate future profits which are essential for the valuation of the company.

– Financial Data

An important part of the information memorandum is the financial data *i.e.*, the balance sheet, the financial statement, and the cash flow statement of the company as this financial data forms the basis of the buyer's valuation and bid.¹¹⁵ Often, the historical financial data is adjusted for any management fees or similar charges charged to the company by the seller, and for extraordinary or periodic expenses that are operationally not justified. Usually, the buyer will carefully and very critically analyze the adjustments in a later due diligence since experience shows that the seller often will try to use the adjustment to optimize the results of the company in order to attain a higher valuation.¹¹⁶

– Future Projections

An information memorandum contains financial projections for the future years demonstrating the development of the company based on the business plan. Further, a budget and estimated financial statement can be prepared which will be used to justify a high valuation of the company. As future earnings are the most important element in the valuation of a company, it is advisable to work with particular care on this part of the information memorandum. The seller should not present imaginatively high profits as such maneuvers are usually immediately uncovered by bidders and only lead to a loss of confidence. His goal should be to show plausible figures that are based on a realistic business plan, which can be defended in the due diligence and in the management presentations.

– Notification of Risks

A well-prepared information memorandum should also contain a risk section. In view of the knowledge of the buyers, it is not necessary that such a risk section contains the same level of detail as a prospectus in a public placement. Normally, it is sufficient to note that the environment in which the company is operating may change in the future and that, although all protections have been made on the basis of reasonable assumptions, these assumptions are always subject to a considerable degree of uncertainty.

¹¹⁵ The valuation of the company is generally based on the presumed future earnings. Nevertheless, the earnings achieved to this day form the basis for this valuation.

¹¹⁶ "Extraordinary" or "periodic" expenses are often repeated every year; sometimes management fees or similar charges cover extra services that the seller has to buy from third parties at considerable expense.

– **Disclaimer**

The information memorandum must always contain a disclaimer in which the seller and his consultants decline all liability for the content of the information memorandum. Furthermore, the seller should state that the information memorandum cannot be regarded as a contractual warranty, but that only those representations and warranties explicitly contained in a validly signed purchase agreement may entitle the buyer to raise claims.

– **Transaction Structure / Term Sheet**

Since the seller asks the bidders to submit a non-binding offer, the information memorandum should always define, in the form of a short term sheet, the transaction structure and its principle terms. In particular, the structure of the transaction (asset or share deal), any adjustment of the purchase price (net debt / net current asset adjustment),¹¹⁷ and the most important representations, warranties and indemnities, the seller is willing to grant, should be defined. Further, the term sheet should present the major terms of the transaction to allow for a comparison of the offers submitted by various bidders; otherwise, bidders may maintain, at a later time, that they have based their bid on a completely different transaction structure and risk allocation.

3.3 Non-binding Offer

After receipt of the information memorandum the bidders who are still interested in a purchase will submit a non-binding offer in which they quote a price, or a price range, for the purchase of the company. Normally, a bidder clearly states in his bid the basis on which the offer is substantiated; the bidder will refer to the information memorandum and also disclose any other assumptions which he has made. In this way, the bidder clearly signals that he will lower the offered price if the due diligence does not confirm the information contained in the information memorandum or the assumptions made by the bidder, or if, in the due diligence process, the buyer uncovers risks that were unknown to him when he made the bid.

On the basis of these non-binding offers, the seller will decide which bidders he will invite for the second phase of the auction procedure and to the due diligence. Before this decision is made, the seller and his consultants will often hold discussions with the bidders to clarify questions or to motivate them to increase their offers. These conversations will take place, in particular, if all offers received are low, there are considerable differences between the individual offers, or if bidders who were presumed to be very interested in the company have made low bids.

¹¹⁷ Cf. to such adjustments chapter B.5.2.2.

The non-binding offer does not oblige the bidder to actually purchase the company or to continue to participate in the auction procedure. He may decide not to participate in the due diligence after having received an invitation, or he may decide not to submit a final offer after the due diligence.

3.4 Procedure Letter 2 and Draft Purchase Agreement

The seller usually sends a procedure letter 2 to those bidders who have qualified for the second phase of the auction procedure. This procedure letter 2, in which the next steps of the procedure are described, usually contains the following:

3.4.1 Description of the Further Procedure

In the first part of the procedure letter, the further procedure and precise deadlines for the completion of the actions by the bidder are provided.

3.4.2 Due Diligence Invitation

The interested buyers are invited to perform a due diligence. The seller normally sets the date for the due diligence and informs the bidders on the details of the due diligence.

3.4.3 Draft Purchase Agreement

With the procedure letter, the seller provides the interested buyers with a draft of the purchase agreement. The bidders can then mark-up this draft to reflect their interest in the document and enclose it as part of their binding offer.

The wording of this draft, in particular with regard to representations and warranties, is usually seller-friendly; it is then the task of the bidders to make amendments to the agreement necessary to safeguard their interests.¹¹⁸ When drafting the purchase agreement, the seller should, however, not succumb to draft a completely one-sided agreement; experience shows that these agreements provoke many changes by the bidders that make a comparison of the different offers difficult and result in prolonged negotiations necessary to find a reasonable compromise.

3.4.4 Invitation to Submit a Binding Offer

The bidders in the procedure letter are invited to submit to the seller, within a certain deadline, a binding offer. This offer consists of the purchase price the bidder is willing to pay and a mark-up of the draft purchase agreement supplied by the seller. Normally, the seller requests that the offers are structured in such a manner that they can be accepted by the seller within a certain deadline without any further negotiations. Apart from the purchase price and the mark-up purchase agreement, the offer must also contain information on the following points:

¹¹⁸ For the content of the purchase agreement, see chapter B.5 above.

– **Financing of the Transaction**

In his binding offer, the interested buyer must describe the financing of the transaction in detail. Smaller bidders are usually required to submit a financing commitment from a bank.

– **Buyer's Plans with the Company**

Usually, the seller demands that the bidder describes his plans for the further development of the company including the possible continuation of employment of current management and personnel.

– **Authorizations**

One of the criteria for the buyer's decision to accept an offer is whether the transaction with a certain buyer will be subject to any governmental authorizations. Sellers usually demand that the interested buyers list in their binding offer the governmental authorizations that need to be obtained and also describes their view on the probability of success of the pertinent procedure and the potential duration of this procedure.

3.4.5 Reservations of the Seller

The seller usually makes the same reservations as in the procedure letter.¹¹⁹

3.5 Due Diligence

3.5.1 Organization of Parallel Due Diligence Procedures

The interested buyers who are invited to the second round are provided with the possibility to conduct a due diligence. In a typical auction procedure, a due diligence will be performed by two to five interested buyers.

The performance of such parallel due diligence reviews encompasses one of the most difficult organizational challenges in auction procedure, since several identical data rooms must be prepared, as well as management presentations and on site visits must be coordinated. The procedure can be facilitated by providing an electronic data room allowing the interested buyers to review data through a specially provided server over internet. The advantage of such data rooms is that the documents required by the different bidders can be easily allocated to their data room and it is possible to follow which bidder reviews which document. The disadvantage is that the interested buyers cannot be prevented from downloading data and making copies.¹²⁰

¹¹⁹ Cf. chapter C. 3.2.1.3.

¹²⁰ Using the print screen function or, if necessary, using the electronic camera.

3.5.2 Documents and Information

Contrary to individually negotiated transactions, the extent and depth of the due diligence are not individually agreed upon by the parties, as the seller does not have time to negotiate these issues with several bidders. The seller, therefore, will collect the information and documents that are relevant for the buyer and allow access using a data room. When collecting the pertinent documents, the seller has to anticipate which documents are required by the interested buyers to verify the information memorandum and their own assumptions which led to their offer. Although, particularly in bigger transactions, it is necessary to limit the information displayed in the data room to essential points, it is advisable for the seller not to restrict the documents and information made available to the interested buyers too extensively, as incomplete information only leads to further questions. A failure to disclose the relevant information during the due diligence also has the effect that the interested buyers may submit lower offers, as they would assume that the information that was not available in the data room must be negative for the company. In extreme cases, insufficient due diligence documentation may even cause certain bidders to abandon the auction procedure, as they have no sufficient basis to assess the risks associated with the company or to critically review their valuation of the company.

In the presentation of the due diligence material, the seller explains the criteria he has applied for collecting the information and documents. For the bidders, it is of particular interest that the seller describes how he distinguished between relevant and irrelevant information and documents (*e.g.*, all contracts which cover a business volume of more than CHF 100,000). Within the categories defined by these criteria, the seller may not suppress information that is negative for the company. If the seller, for example, states that he has disclosed all procedures with a litigious value of more than CHF 50,000 he may not hide that a class action has been filed in the United States with a higher litigious value because he fears that this class action may negatively influence his negotiations with the bidders. Given that, the contractual warranties are based on the results of the due diligence,¹²¹ this behavior would in most cases lead to a claim of the buyer under the warranties. If the seller willfully deceives the buyer in the due diligence, any limitations of seller's liabilities under the warranties would, according to art. 199 CO, not apply to the buyer's claims under this warranty. Furthermore, the buyer may, in a case in which the seller willfully deceives him by suppressing certain information, demand the rescission of the agreement, pursuant to art. 28 CO, or a reduction of the purchase price, pursuant to the theory on partial invalidity.¹²²

¹²¹ In this case, the contract would probably contain a warranty whereby the seller represents that no other procedures, with a litigious value in excess of CHF 50,000 apart from those disclosed in the annex to the purchase agreement exist.

¹²² The seller has, under Swiss law, no general duty of disclosure vis-à-vis the bidders which would force him to disclose all information that might be of interest for the bidders (for the disclosure obligation *cf.* chapter B.5.4.1.1). If the seller in a due diligence discloses, specific information in accordance with certain criteria set by the seller, the buyer legitimately may assume that all the information that is covered by such criteria was provided. Therefore, the suppression of certain information known to the seller, within the criteria defined by the seller, would be regarded as an act of willful deception pursuant to art. 28 CO.

3.5.3 Management Presentation

Further to the review of documents in the data room, the due diligence normally includes management presentations whereby the management presents relevant information on the company, such as, the markets in which the company is active, strategies, human resources, *etc.* The bidder in these presentations can also ask questions to get a better feeling on certain "soft factors" as, in particular, the abilities of the management.

3.5.4 Environmental Issues

In an auction procedure, the environmental due diligence usually presents problems since, as described in chapter B.4.7, it is time consuming. If three to five buyers are invited to the due diligence, each the individual bidder cannot conduct an environmental due diligence because the succession of environmental due diligences by each bidder would disrupt the company. Furthermore, it would be difficult to coordinate all the due diligences. Given that environmental risks are extremely important for the evaluation of certain companies, the seller is advised to hire a renowned environmental consultant who would conduct the due diligence, before the auction starts, the results of which the seller would present to the bidders.

3.5.5 Confirmatory Due Diligence

Certain information and documents which may be essential to the decision of the interested buyers, and therefore should be made available for the due diligence, may, however, contain business secrets, the disclosure of which would lead to existential problems for the seller. The disclosure of these business secrets is, in an auction procedure, even more problematic, than in an individually negotiated transaction, as such disclosure is also made to bidders which in the end are not the buyer and the disclosure to all bidders may harm the interest of the actual buyer. To avoid these problems, the due diligence can be structured in such a way, that certain information is only disclosed, after receipt of the binding offer, to the buyer with whom the final negotiations will be conducted in the form of a "confirmatory due diligence". This procedure has the disadvantage that the bidder's binding offers are always subject to the condition that the confirmatory due diligence does not deviate from the information disclosed so far and does not show any unexpected negative results, such as new risks. Therefore, such a procedure has the consequence that the "binding offers" are, in the end, not effectively binding.

3.6 Binding Offer

The bidders wishing to continue the transaction must submit a binding offer to the seller within a certain deadline. If the auction procedure does not provide a confirmatory due diligence, these binding offers should not contain any reservations, and in particular must provide the purchase price, a mark-up of the draft purchase agreement supplied by the seller, and further information required in the procedure letter 2. Often the offers will dif-

fer from these requirements and add reservations which make further negotiations necessary.

3.7 Final Negotiations and Signing of the Agreement

Upon a review of the binding offers, the seller will decide to sell the company to one of the bidders. If the offers are very close, the seller will usually negotiate once more with the bidders to try to obtain a higher price from one of them. Often, the buyer and seller will in the end conduct final negotiations to find compromises on open issues which needed to be finalized in the purchase agreement. These final negotiations, which should lead to a fixed purchase price and a purchase agreement, must be conducted within a very short period of time, since the seller must keep the possibility open to choose another interested buyer if the negotiations with the chosen bidder do not lead to a satisfactory result. Therefore, the other bidders are usually not informed when the seller has chosen one bidder for the final negotiations, but are notified only when the seller has actually concluded a purchase agreement with one of the bidders.

4. SPECIFIC PROBLEMS WITH AUCTIONS PROCEDURES

4.1 Insufficient Interest from Potential Buyers

Auctions become problematic if the seller receives only a very small number of responses to his invitation letter, or if he receives non-binding offers that are far below his expectations. In these cases, the seller can only try to convince the interested buyers by directly contacting them and requesting them to increase their bids to a level that is acceptable. Yet, often the seller has no other choice than to terminate the auction procedure. The termination of an auction procedure will have the consequence that the company cannot be sold for several years as all potential buyers will realize that there was insufficient demand for the company and therefore will only offer a low price.

The failure of an auction procedure is often the consequence of the seller over estimating the company, for instance, the seller over estimates the attractiveness of the company for potential buyers, or is not aware of weaknesses that later lead to insufficient offers. Most problems can be avoided if the divestiture procedure is properly prepared:

– Market Tests

The interest of potential buyers should be tested by conducting individual discussions with certain industrial and financial buyers. Only if a considerable number of these potential buyers show an interest, should the seller begin an auction procedure. Naturally, the seller does not have to talk to all potential buyers that are on the long list for the invitation letter; it is sufficient, if he meets with a representative cross-section of industrial and financial buyers in the industry.

– Vendor's Due Diligence

In the preparation for the sales procedure, the seller should not only draft a reasonable business plan, but he should also critically analyze the company for any weaknesses and correct these weaknesses if possible. Therefore, it is advisable that the seller conducts a small "vendor's due diligence" to critically analyze the company in anticipation of the buyers' questions. This procedure not only helps to avoid disappointments in the auction procedure but also allows the buyer to take corrective measures if he detects any problems.

4.2 "Spy Offers"

In an auction procedure, parties who have no realistic interest in a purchase, often ask for an information memorandum only to obtain information that they can use in their own company. This problem can be avoided, to a certain extent, if the invitation letter is only sent to parties who have the means to finance the transaction and actually can be assumed to have an interest in the company. It is therefore not advisable to have an extremely "long list" of potential buyers. The seller should critically analyze whether the parties on the "long list" actually can realize the transaction.

Competitors are often considered as the bidders with the potentially highest interest in a purchase. Although the danger exists, that competitors ask for the information memorandum only to obtain information that they can use in their company, they will nevertheless, receive an invitation letter. The potential damage can be controlled by avoiding the disclosure of any sensitive business secrets in the information memorandum. Just as problematic, if not more so, are "fake potential bidders", who sometimes try to be admitted to the due diligence review by submitting a high non-binding offer. These competitors abuse the due diligence for a legal form of industrial espionage. It is difficult to avoid such abuse of the auction procedure; a non-binding offer that is submitted by a "fake potential buyer" in order to access the due diligence can hardly be distinguished from a serious offer. As a counter measure, the seller can try to ask competitors to sign a stronger confidentiality agreement before admitting them to the due diligence and, in particular, demand that the competitor signs a clause prohibiting him from employing any managers or key employees of the company if he does not buy the company in the auction procedure. Another possibility is to withhold certain information from the due diligence conducted by the competitors and only provide it in a confirmatory due diligence, in which a competitor is admitted only if he is chosen for final negotiations. This procedure, however, has the disadvantage that the buyer will subject his binding offer to the condition that the confirmatory due diligence shows a satisfactory result.

4.3 Exclusivity Offers

In auction procedures, it sometimes occurs that a bidder with a strong interest in the company demands the auction to be terminated and that he be granted exclusivity for further negotiations. This offer is usually coupled with the threat that the bidder will withdraw from the auction procedure if the seller does not agree to this action. Consequently, this offer forces the seller to choose between exclusive negotiations with one strongly interested party, or a competitive bidding between various parties. If the seller decides to terminate the auction procedure and negotiate exclusively with one bidder, he risks that the potential buyer, after obtaining the exclusivity agreement, may slowly decrease his bid, as he will no longer have any competitive pressure from other bidders. Due to this risk, it is usually not advisable to yield to the pressure of a bidder who wants to agree on an exclusive negotiation.

If the offer of the bidder demanding exclusivity is so attractive that the seller is willing to assume the risks associated with a termination of the auction procedure, a purchase agreement should be promptly negotiated with this bidder. Time is of the essence as it allows the seller to resume the auction if the exclusive negotiations fail. If the seller decides to enter into exclusive negotiations with one buyer, he will inform the other interested buyers that the auction has temporarily been suspended without informing them of the actual reason for the suspension.

D. MERGER CONTROL, AUTHORIZATION REQUIREMENTS AND DISCLOSURE OBLIGATIONS

1. MERGER CONTROL UNDER ANTITRUST LAW

- *According to the Federal Act on Cartels and Other Constraints on Competition ("CA"), mergers and acquisitions of large enterprises have to be notified to the Competition Commission and may only be completed with approval by the Commission. This notification requirement applies to sales and purchases of businesses with a combined total worldwide turnover of over CHF 2 billion, or to businesses with a turnover of over CHF 500 million which is realized in Switzerland and if at least two of the involved businesses each attain a turnover of at least CHF 100 million in Switzerland. Independent of the size of the participating businesses, the transaction has to be notified to the Competition Commission if one of the businesses, according to an earlier decision of the Competition Commission, has a dominant market position.*
- *The Competition Commission can prohibit acquisitions if the merger of the concerned businesses creates a market dominance that eliminates effective competition. The Competition Commission may decide to approve a merger subject to certain conditions (e.g., the sale of business sections), if effective competition can be secured by these conditions.*
- *If a transaction, that has to be notified to the Competition Commission, is completed without proper authorization of the Commission, the transaction is null and void, and the participants are subject to criminal penalties (fines).*
- *If an acquisition produces effects on foreign markets (due to export to such markets, subsidiaries or regional offices in the country concerned), it is possible that the transaction is also subject to the merger control laws of these countries. Therefore, the effects of a transaction in foreign countries, as well as foreign merger control rules and their application have to be analyzed in every transaction that extends beyond Switzerland.*

The purchase of a business always leads to a change in the market position of the participating enterprises, and in cases in which a competitor takes over a business, to an addition of market shares. As this change in the market position and the market share influence competition, the antitrust laws of most industrial countries contain merger control rules that subject large transactions to an authorization requirement.

1.1 Swiss Antitrust Law

According to art. 9 CA, mergers of large businesses, and businesses that have a controlling market position, have to be notified to the Competition Commission prior to their completion. The transaction may be completed only after the Competition Commission has given its approval.

Contracts between the parties should provide for the condition that the closing of the transaction will be postponed until such time as the approval from the Competition Commission is obtained or the time period for a prohibition has elapsed unused.¹²³ Alternatively, a provision can be included that, in case the condition is not met, the agreement will cease to be valid.

1.1.1 Application of the Swiss Merger Control Rules

According to art. 9 CA, transactions are subject to notification and authorization requirements if the turnover of the businesses exceeds certain thresholds or if one of these businesses, according to an earlier decision of the Competition Commission, has a controlling share in a market that is relevant for the transaction. The only way a transaction will be subject to Swiss merger control is if the transaction attains these turnover thresholds; the country of incorporation of the company is irrelevant for this purpose, with the effect that a transaction taking place abroad, with the buyer, the purchase object and seller having their residence abroad, can be subject to Swiss merger control if the transaction reaches the relevant thresholds.

1.1.1.1 *Thresholds*

a) General Thresholds

A transaction has to be notified to the Competition Commission, in accordance with art. 9 CA, if the enterprises that are involved in the transaction jointly achieve a worldwide total turnover of at least CHF 2 billion or jointly achieve a total turnover of at least CHF 500 million in Switzerland and two of the enterprises involved in the transaction achieve a turnover of at least CHF 100 million in Switzerland. According to art. 4 of the Ordinance on the Control of Merger (MCO),¹²⁴ the turnover the businesses have achieved, by the sale of goods and services in the normal course of their business in the last business year, is to be considered as the relevant turnover. Extraordinary income, such as income from the sale of participations or of fixed assets, is not considered relevant turnover for the purpose of calculating the relevant thresholds. Further, "Swiss turnover" is only turnover achieved by the sale of goods and services to customers located in Switzerland. Sales achieved by the export of goods and services, therefore, are not considered as Swiss turnover.

¹²³ Cf. Chapter B.3.3.1 above.

¹²⁴ Ordinance on the Control of Merger dated June 17, 1996 (SR 251.4).

b) Thresholds for Banks and Insurance Companies and Financial Intermediaries

As the turnover of the insurance companies is not a reasonable factor to assess its economic performance (*cf.* art. 3 sec. 3 CA),¹²⁵ the gross premium on insurance policies concluded is used for calculating the thresholds. The "Swiss turnover" of an insurance company is the gross premium on insurance policies that have been concluded with customers resident in Switzerland.

For banks and other financial intermediaries, the gross revenue is relevant according to art. 9 sec. 4 CA. The gross revenue consist of the revenue generated in regular business activity during the last fiscal year, including interest, commissions, revenue from proprietary trading and revenue from participations. Swiss revenue only consists of revenue generated with customers domiciled or resident in Switzerland.

c) Enterprises Relevant for Calculating the Threshold Amounts

For the calculation of the threshold amounts, all enterprises are taken into account which either (i) in a transaction take over control of another enterprise, or (ii) are taken over by another enterprise in the transaction. Therefore, the buyer and the object of purchase are included in the calculation of thresholds. The seller is normally not considered to be a "participating company" according to art. 3 MCO, as he gives up control over the target company.¹²⁶ The seller's turnover is taken into account only if the seller does not give up control, but after the transaction exercises joint control over the company together with the buyer. This situation occurs where the seller only sells a part of his participation and, after the transaction, the buyer and seller jointly control the company based on a shareholders agreement. This joint control only exists if the seller due to his participation actually retains material influence on the company after the transaction. If the parties have chosen a transaction structure where the seller sells the company in several steps, but since the beginning already gave up control over the company, or if the seller only retains a minimum participation that does not give him any influence over the company, the participation of the seller does not lead to joint control and the seller consequently will not be taken into account in the calculation of the threshold amounts.

¹²⁵ Art. 6 MCO including a detailed definition of the term "gross premium".

¹²⁶ Hence, the seller is not taken in to account as parent company of the sold enterprise for the purpose of calculating the turnover.

d) Involvement of Parent Companies, Subsidiaries and Associated Companies

For the calculation of the relevant turnovers, the turnover of the companies directly involved in the transaction is not the only one taken into account. According to art. 5 MCO, the turnover of the following companies is also taken into account:

- Subsidiaries of the directly involved companies, *i.e.*, all companies where one of the involved companies owns directly or indirectly more than half of the capital or the voting rights, or which one of the companies otherwise controls.¹²⁷ If one of the companies has joint control over a company together with a third party, this joint venture company is also considered a subsidiary;
- Parent companies, *i.e.*, any companies that directly or indirectly own more than half of the capital, the voting rights in one of the companies that is directly involved in the transaction or otherwise control such a company.¹²⁸ If several parties exercise joint control over a company which is directly involved in the transaction, all the parties exercising the joint control are considered parent companies;
- Associated companies, *i.e.*, companies that are subsidiaries of a parent company as defined above.¹²⁹

1.1.1.2 Companies Exercising Market Control

Independent of the turnover of the parties involved, pursuant to art. 9 CA, a transaction must be notified if the Competition Commission came to the decision in a prior procedure involving one of the participating companies that the relevant company exercised a dominant control over the relevant market or an up- or downstream market, as defined in art. 4 para 2 CA.

1.1.2 Time of the Notification to the Competition Commission

For transactions for which the notification requirement applies pursuant to art. 9 CA, an approval from the Competition Commission must be obtained prior to their completion. Swiss law, however, does not set any specific deadlines for the notification of a transaction to the Competition Commission. The parties, therefore, do not have to notify the Competition Commission immediately after they have executed the purchase agreement. The disadvantage of prolonging the notification is that the closing will also be deferred until the Commission has provided its approval, since the transaction may not be closed without such approval.

In practice most notifications occur immediately upon the signing of the purchase agreement, as on the one hand it is clear that the parties intend to complete the transaction, and

¹²⁷ Art. 5 sec. 1 let. a MCO.

¹²⁸ Art. 5 sec. 1 let. b MCO.

¹²⁹ Art. 5 sec. 1 let. c MCO.

on the other, all information necessary for the notification form part of the agreement.¹³⁰ Following the practice of the Competition Commission, a transaction can also be notified to the Commission if it can be proven to the Secretary of the Commission that all parties to the transaction are willing to undertake the completion of the transaction. Therefore, a notification may be made on the basis of the letter of intent or a memorandum of understanding; such an early notification should, nevertheless, be complete and should allow for an examination by the Competition Commission. An early notification only makes sense in cases in which the parties are certain that the information relevant for the notification in the letter of intent or in the memorandum of understanding will not be different from the information found in the purchase agreement. Should the information relevant for the notification change considerably by the time the purchase agreement is executed, the parties would need to notify the Commission and, where the information substantially differs, may need to re-apply.

The parties can expedite the notification process by informally discussing, based on a submitted draft of the notification, the planned transaction with the Competition Commission to obtain an indication of the Secretary's view of the transaction, in particular with regard to shortcomings on formal aspects and content. This allows the parties to file only the formal application once the purchase agreement has been executed. This allows the parties to discuss shortcomings of their application with the Commission and incorporate the advice of the Commission in their formal application.

1.1.3 Content of the Notification

Pursuant to art. 11 MCO, the notification must contain the following information:

– Description of the Parties

The notification must contain a short description of the business activities of the parties and include information on all the parent companies, subsidiaries and associated companies that taken into account for the purpose of calculating the turnover relevant for the threshold amounts.

¹³⁰ For details, *cf.* chapter E. 1.1.3.

– **Description of the Planned Transaction**

The planned transaction has to be described and the buyer has to disclose the goals he pursues in the transaction, including any plans for restructuring or expansion. It is advisable to describe in detail the extent to which the buyer's intentions may lead to an increase in competition.

– **Calculation of the Relevant Turnover**

The turnovers that are relevant for the threshold amounts have to be documented with the latest annual reports of the involved companies. If in the annual reports the relevant "Swiss turnover" is not shown separately, the parties have to prove this turnover with a written confirmation by the company's management or auditors.

– **Information on the Markets Influenced by the Transaction**

The notification must describe all markets that are affected by the transaction. All markets where the individual market share of at least two of the companies involved in the transaction reaches at least 20% or where the market share of one of the companies involved in the transaction reaches at least 30% are considered to be "affected" by the transaction. In all these markets, the market share of the companies involved, and, as far as known, of the three most important competitors, has to be described for the preceding three years. Furthermore, all competitors that have entered these markets in the last five years or could enter these markets in the next three years, have to be listed.

Art. 11 MCO defines the market sectors and geographic market that must be shown from the point of view of the other market side. As the Competition Commission bases its decision on whether actual competition exists in a market affected by the transaction, or, whether there at least exists potential competition due to the fact that new competitors could enter the market, the description of the markets influenced by the transaction and the description of the entry barriers is an essential part of the notification. As shown in chapter E.1.1.4.3, the definition provides a certain amount of discretion to the notifying parties in order to define the market in a way taking in to account their interests. The market share of the buyer and of the acquired business will be smallest if the relevant market is defined as large as possible; therefore, the buyer should try to define the markets relevant for the transaction as broadly as possible concerning the market sector and geographic market. With regard to the market sector the parties should try to include in the market definition as many substitute products as possible and to not limit the market to single products or services. The parties should emphasize international competition in the geographic description of the market, or at least try to portray entire Switzerland as the geographical area. The result should be that parties are able to reduce the market share or the impact of the transaction on competition. In difficult cases, an expert opinion showing that the relevant products and services are replaceable within the different regions of Switzerland or the entire Switzerland may be useful. The parties should also try to show that the entry barriers

to the market are low to present a positive view on potential competition. In the description of the entry barriers, innovative business models and distribution channels (in particular through the internet) should be taken into account, as these innovative methods sometimes allow a newcomer to enter an otherwise closed market.

In some cases, it may be better to define the market as narrowly as possible so that the market share of the affected business does not overlap (which would lead to an increase of the market share). This is true particularly when a broad definition of the relevant market would lead to a trigger of the relevant thresholds.¹³¹

– **Enclosures to the Notification: Annual Reports, Contracts, Internal Analyses and Reports**

According to art. 11 para. 2 lit. d MCO, the parties must submit to the Competition Commission, as an enclosure to the notification, not only the purchase agreement¹³² and annual reports of the involved businesses, but also all internal reports and analyses that have been conducted in view of the transaction and which contain information on the markets that are influenced by the transaction. Therefore, the buyer has to also present to the Competition Commission purely internal documents that have been prepared to evaluate the transaction or present the integration of the acquired business and its future development according to a business plan by the management, by project teams or by investment bankers for the presentation of the business case, if these documents refer to the markets where the buyer, or the target company, are active. Experience shows that these documents, unfortunately, often contain strong language on market control, the advantages of such control, and on potential price increases that justify a premium to be paid for the target company. As these documents are harmful to the parties when used during the merger control procedure, the parties should avoid creating such documents in the first place. Once a document exists that falls under art. 11 para. 2 lit. d MCO, it has to be submitted to the Competition Commission. Failure to submit this document may entitle the Competition Commission to revoke a decision on the basis of willful deception and prohibit the merger retroactively. In addition, a fine in the amount of CHF 100,000 may be imposed.¹³³

¹³¹ Cf. chapter E.1.1.4.3.

¹³² In addition to the actual purchase agreement, all contracts relevant to the transaction must be submitted, *i.e.*, side-agreements such as agreements on co-operations between the buyer and seller, service agreements, non-competition agreements, the shareholders agreement concluded after closing if the seller continues holding shares in the purchase object.

¹³³ Art. 52 CA.

– **Registration Form**

As provided in art. 13 MCO, the Competition Commission has developed a form to facilitate the filing of the notifications.¹³⁴ Every notification must be filed on this form. The information provided on the form may, and in most cases should, exceed the minimum required by the form, and any further explanations accompanying the form must be structured in accordance with the commentary provided by the Competition Commission.

– **Informal Discussion of the Draft Application with the Secretary of the Competition Commission**

Prior to filing a formal notification, it is advisable to contact the Competition Commission for a first informal discussion of the transaction. This way the parties will get a feeling as to which information the Competition Commission regards as essential. This usually helps the parties to avoid delays in the procedure because the competition commission requests additional information.

According to art. 12 MCO, it is also possible to agree with the Secretary of the Competition Commission on a simplified notification, if the Secretary is of the opinion that certain information listed in art. 11 MCO is not necessary in the case at hand or if the parties will not be able to obtain the information concerned. It is sometimes possible to obtain a waiver for market data if no statistical data exists for a specific market as the parties usually cannot be expected to conduct such market research after the transaction has been executed. The Secretary also allow a simplified notification if the case does not present any problems, *i.e.*, the parties involved reach the threshold turnover, but have no significant market shares in the markets relevant for the transactions.

1.1.4 Procedure of the Competition Commission

1.1.4.1 *Formal Examination of the Notification*

If a transaction is notified, the Secretary of the Competition Commission first examines whether the notification is complete regarding content and formal aspects. If the notification is incomplete or the parties have failed to attach certain enclosures that are necessary, the Secretary will ask the filing business to supplement the notification, according to art. 14 MCO. If the notification is complete, the Secretary will confirm the receipt of the complete notification within ten days.

1.1.4.2 *Preliminary Review*

Upon receipt of the complete notification, the Competition Commission will examine, pursuant to art. 32 CA, whether there is any basis that the transaction will create or enhance a controlling position in a market. The Competition Commission examines in this

¹³⁴ This form can be downloaded from the website of the Competition Commission.

preliminary review whether there are any markets that are affected by the transaction, *i.e.*, whether the individual market shares of at least two of the enterprises involved in the transaction is above 20%, or, if only one of the involved entities is active in the market, whether the enterprise involved has a market share exceeding 30%. If these limits are not exceeded, the Competition Commission will assume that the transaction will not create or enhance any controlling position in a market. Even if these limits are exceeded, the Competition Commission will come to the same conclusion if the transaction does not result in an addition of market shares and has also no vertical effect,¹³⁵ or, if despite of the addition of market shares, another enterprise still has a higher market share.

The preliminary review must be completed within one month after the notification has been submitted to the Competition Commission. If the Competition Commission comes to the conclusion that the intended transaction neither creates nor enhances the market control, the Competition Commission will issue an order authorizing the transaction. If the Competition Commission does not issue any order within this deadline, the expiry of the deadline has the same effect as if an order authorizing the transaction has been issued.

1.1.4.3 Examination by the Competition Commission

If in the preliminary review the Competition Commission comes to the conclusion that there is some basis that the transaction creates or enhances a position that allows an enterprise to control a market, the Competition Commission will initiate a formal procedure according to art. 33 CA, and will notify the parties by issuing an order to this effect. The issuance of this order has the consequence that the planned transaction may not be completed before the Competition Commission has rendered a formal decision on the case.

At the same time, that the Competition Commission notifies the parties of the formal procedure. Pursuant to art. 33 para. 1 CA and art. 18 MCO, it will publish an announcement in the Swiss official Commercial Gazette. In this publication, the parties and the intended transaction are disclosed in order to give third parties, within a certain time period, the possibility to express their views on the planned transaction and its effects on competition. For the purpose of examining the merger, the Secretary of the Competition Commission may require the parties involved in the transaction and third parties (*e.g.*, competitors, counter-parties, or consumer organizations, *etc.*) to submit further information and documents.

According to art. 10 CA, the Competition Commission may prohibit an acquisition if the transaction creates a controlling market position, and if such controlling position eliminates effective competition in the market concerned. The examination of the Competition Commission generally is structured as follows:

¹³⁵ For the addition of market shares and vertical effects, see chapter D.1.1.4.3.c below.

a) Definition of the Relevant Market

First, the competition Commission defines the markets that are influenced by the planned transaction. According to art. 11 para. 3 MCO, a "relevant market" consists of goods and services that can be substituted from the perspective of the counter parties, *i.e.*, consumers due to fulfilling the same needs in the same manner can be substituted. The Competition Commission usually defines the market quite narrowly with regard to the substitution of goods and services. This has the effect that the affected business triggers the thresholds.

According to art. 11 para. 3 MCO, the geographically relevant market is limited to the area where the consumers actually purchase the goods and services that constitute the substantive relevant market. The geographic scope for the relevant market, therefore, always depends on the demand and supply, legal or factual limitations on trade, and the transportation costs. If goods are not subject to any governmental restrictions on trade, do not cause high transportation costs, and are mainly acquired by industrial users, the Competition Commission will assume the existence of global markets or at least a European market. If the goods that constitute the market are acquired by private customers or small enterprises which show little geographic flexibility, the market is limited to a canton or to a region of Switzerland.

Based on the Competition Commission's definition of the relevant geographical market and market sector, the products and services offered by the involved enterprises will be divided into a number of sub-markets in the form of a matrix structure. These are the basis of the market share analysis.

b) Analysis of the Market Shares of the Enterprises

Second, the market shares of the enterprises that are involved in the transaction are analyzed in relation to the relevant markets. The Competition Commission assumes that the planned transaction has no competitive effects on a relevant market if either (i) the combined market share of the involved enterprises in a relevant market is below 20%; or, (ii) one of the enterprises involved in the transaction has a market share below 30% in a market in which it is active. In this case, the Competition Commission assumes the transaction does not present a problem.

c) Specific Effects of the Planned Transaction on Competition

If the market shares in the relevant markets exceed the limits of 20% or 30% respectively, the Competition Commission will analyze the specific effects of the transaction on competition in the relevant market:

– ***Horizontal Effects of the Transaction: Addition of Market Shares***

The Competition Commission analyzes whether the planned transaction results in a material addition of market shares in the relevant market. This is only possible if the involved enterprises conduct business in the same relevant market. If this is not the case, the planned transaction, has no effect on competition. Therefore, the Competition Commission also allows mergers of enterprises if the involved enterprises have market shares above 30% in the relevant markets but the markets do not overlap. This shows that in cases of high market shares of the involved enterprises in Switzerland, a narrow definition of the market can avoid the accumulation of market shares. The involved parties may not succeed at reducing their market shares to a non-critical threshold by a broad definition of the market. In this case, it is recommended to define the market sector and geographical market in a narrow way. In this way, the markets of the involved parties will not overlap and the market shares will not be cumulated.

– ***Vertical Effects of the Transaction: Vertical Integration***

If a buyer acquires an enterprise that is not active in its market, but in a market that is vertically connected with its market, the transaction does not lead to an addition of market shares but to a vertical integration that may have an effect on both markets. This effect occurs where a manufacturer of herbicides purchases an enterprise that produces the raw material for herbicides or a food retailer purchases a meat processor whose products it sells. The Competition Commission regards a vertical integration as a problem because it may force competition out of the business. For example, the acquisition of the meat processor by the retailer has the effect that the retailer will, in the future, purchase all its meat from this processor and that third party processors will be excluded. If the vertical integration closes an important part of the market for third party competitors, the Competition Commission may, in spite of the fact that the transaction does not lead to an addition of market shares, come to the conclusion that the transaction hinders competition.

– ***Actual and Potential Competition***

If the Competition Commission comes to the conclusion, that a transaction has horizontal and vertical effects which negatively influence competition, it will proceed to analyzing the actual competitive situation in the relevant market.

The first step in this analysis is the examination of actual competition created by competitors that already operate in the relevant market. If a competitor exists in the market,

who has a higher market share than the combined market share of the enterprises involved in the transaction, the Competition Commission will assume that effective competition is not hindered but enhanced. The Competition Commission would deviate from this assumption only where the enterprises with a high market share would collude to jointly control a market by systematically avoiding competitive situations.¹³⁶ The Competition Commission also assumes that a transaction has no anti-competitive effect where there are several smaller competitors in the relevant market that have the resources to successfully compete.

Even when, after the acquisition transaction, no strong actual competition exists due to the addition of the market shares, potential competition may be sufficient for the further existence of effective competition. Potential competition exists where a relevant market has very low market entry barriers and a new competitor may easily enter this market. In this case, the Competition Commission assumes that excessive prices will immediately attract new competitors who will erode any advantages of a strong market position. Where the potential competition exists, the Competition Commission believes that the possibility of new competitors' entry will already hinder an enterprise with high market share from exploiting its position.

In the analysis of potential competition, the Competition Commission particularly examines the barriers to a market entry (special know-how, patents, capital requirements, starting differences and costs) and the actual entries in the preceding years. It is clear that the acquirer in particular in critical cases, *i.e.*, where the enterprises involved in the transaction have high market shares, must show to the Competition Commission in its notification that the barriers to enter the relevant market are low, and to plausibly claim potential competition.

In the end, the Competition Commission will prohibit a planned acquisition only if the market share of the parties in the relevant markets exceeds the thresholds of 20% and 30% respectively, the transaction leads to an addition of market shares or to anti-competitive vertical effects, and neither actual nor potential competition exists that would hinder the combined enterprise from exploiting its strong market position by increasing its prices. Even where competition is threatened by the planned transaction on the basis of such criteria, an acquisition is possible if the buyer can prove that the target business is in such bad economic and financial shape that it would not be able to compete in the market.¹³⁷ In this case, the acquisition is the preferable option for competition and has certain social benefits compared to insolvency.

Pursuant to art. 33 para. 3 CA, the Competition Commission, has to terminate the formal procedure within four months after having notified the parties of the beginning of the formal procedure by issuing an approving or dismissing order. If the Competition Com-

¹³⁶ Indication of collusion would be similar prices and conditions of the enterprises active in the relevant market.

¹³⁷ "Failing company defense".

mission does not issue an order within such a deadline, the Competition Commission is deemed to have authorized the transaction. The Competition Commission may in such case, however, issue an order extending the procedure if the procedure has been prolonged by circumstances for which the parties involved are responsible.¹³⁸

In the order that terminates the procedure, the Competition Commission can either authorize or prohibit the planned transaction. If the Competition Commission finds, pursuant to art. 10 CA, that the planned transaction does not prevent effective competition in all relevant markets, but only in certain markets, the Commission may authorize the transaction under conditions that prevent the negative effects of the transaction. In particular, the Commission may require that the enterprises involved in the transaction sell certain businesses or subsidiaries or order them to grant licenses or supply certain products to competitors. In this case, the Competition Commission may provide in its order that the transaction may only be completed if these conditions have been fulfilled or alternatively demand that the parties fulfill the conditions during a certain period after the completion of the transaction. In view of the negative experience of the Competition Commission in the UBS merger case with regard to the conditions that had to be fulfilled after the closing of the transaction, the Commission will request in future that any conditions imposed, must be fulfilled before the transaction is completed. This imposes on enterprises a condition which can have, on certain subsidiaries or businesses, an unreasonable time pressure.¹³⁹

1.1.5 Competence of the Banking Commission (FINMA)

For mergers or acquisitions of banks, competition issues alone are not decisive. If the Swiss Federal Banking Commission ("FINMA") regards a takeover, of a weak bank by a stronger one, as necessary to protect the creditors of the weaker bank,¹⁴⁰ the protection of the creditors takes precedence over competition issues. In such cases, according to art. 10 para. 3 CA, it is not the Competition Commission but the FINMA that decides on the admissibility of the transaction. Therefore, FINMA decides on and allows the takeover of a troubled bank even if it results in the acquirer controlling a regional market.

If an acquirer intends to justify the takeover of a bank with the interest of the bank's creditors, he has to notify the Competition Commission of the transaction in accordance with art. 9 CA. At the same time, he must file an application with FINMA for the authorization of the transaction on the basis of the creditors' interest. According to art. 17 MCO, the

¹³⁸ This includes cases in which the involved enterprise willfully delays the proceedings or does not comply with its cooperation obligation. Furthermore, this may include cases with a particularly complex market situation that requires longer investigations. Such circumstances are attributable to the involved parties.

¹³⁹ The Competition Commission, in analogy to the solutions found by foreign merger control authorities could agree to solutions that ensure compliance with the conditions imposed by the Competition Commission without subjecting the enterprise to an unreasonable time pressure. For example, it could be possible to transfer a subsidiary that has to be sold to a trustee who then conducts an auction procedure.

¹⁴⁰ A possibility to save or stabilize a bank may be the takeover by a stronger bank. The FINMA actively supports this option in times of crisis.

Banking Commission can then take over the procedure and render a decision. FINMA can also act *ex officio* without any application to it, and in urgent cases, even render a decision before the notification has been made if this is necessary to save a bank.

1.1.6 Exceptional Authorizations from the Federal Government

Even if the Competition Commission has prohibited a transaction because it eliminates effective competition, the Swiss Federal Council¹⁴¹ may, according to art. 11 CA, issue a special authorization if this is necessary to safeguard public interest.¹⁴² So far the Federal Council has never issued such an authorization. It is, however, possible that in a restructuring case, the Federal Council would issue such authorization if it is necessary to save a substantial number of jobs and is justified by public interest.

1.1.7 Appeal Procedures

If FINMA prohibits a transaction or subjects an authorization to certain conditions, according to art. 44 CA, the relevant parties may file an appeal against such a decision with the Federal Administrative Court within 30 days. Against the decision of the Federal Administrative Court, the parties may, again within 30 days, file an appeal with the Federal Supreme Court. Such appeal procedures, however, seem to be theoretic since a transaction can hardly remain suspended during the whole appeal procedure. In practice, most purchase agreements provide that the parties may rescind the agreement if the Competition Commission does not issue an authorization within a certain period of time.

1.1.8 Sanctions for Violations of the Merger Control Rules

If a transaction is not notified to the Competition Commission, the responsible persons can be punished with fines of up to CHF 20,000 according to art. 55 CA. The enterprises which have consummated a transaction before having received an authorization from the Competition Commission can be punished with a fine in an amount up to CHF 1 million pursuant to art. 51 CA. The same fines may also be applied if an enterprise does not comply with conditions the Competition Commission has imposed in connection with an authorization. According to art. 51 para. 2 CA, such fines may be increased up to 10% of the "Swiss turnover" in case of repeated non-compliance, *i.e.*, if an enterprise still does not comply with a condition imposed by the Competition Commission in spite of having been served notice.

If a transaction which has to be notified to the Competition Commission pursuant to art. 9 CA, has been completed without an authorization, such a transaction is null and void, according to art. 34 CA, unless the Competition Commission or, as in the cases mentioned above, FINMA or the Federal Council retrospectively issue an authorization. If the retrospective authorization is not issued, the parties involved in the transaction have to take the necessary steps according to art. 37 CA, to re-establish effective competition. If the

¹⁴¹ Bundesrat.

¹⁴² For the procedure, *cf.* art. 36 CA.

parties and the Competition Commission cannot agree upon such steps, the Competition Commission can request the sale of the business that had been acquired or the obligation to grant licenses to competitors. If no other measures are possible, the separation of the merged enterprises may be ordered.

1.2 Foreign Merger Control Regulations

Most industrialized countries today have merger control rules that are designed to prevent transactions that eliminate or materially hinder effective competition in certain markets. Such merger control rules particularly exist in the United States, the European Union, certain countries of the EU, Japan and Canada.

Foreign merger control regulations are always applied if a transaction has an influence on the market in the country concerned. For example, the acquisition of an American enterprise by a Swiss company is subject to US merger control regulations. The acquisition of a Swiss enterprise or an enterprise domiciled in a third country may also be subject to US merger control regulations if the transaction has effects on the US market because the enterprise or the acquirer have subsidiaries or branches in the United States or export their goods and services to the United States. Due to the broad application of foreign merger control regulations, it must be examined in each case whether a given transaction has effects on foreign markets and whether the countries concerned therefore subject the transaction to merger control regulations. Such analysis is extremely important as the non-compliance with foreign merger control regulations may lead to fines that are much higher than those provided by the Swiss Antitrust Act. Experience shows that foreign proceedings (in particular in the EU and the USA) may be more elaborate and time consuming for transactions than the Swiss merger control.

2. AUTHORIZATION REQUIREMENTS FOR ACQUISITIONS

In principle, the acquisition of Swiss businesses is not subject to any governmental authorizations. There are however certain exceptions to this rule:

- *Authorizations for the acquisitions of banks: For the acquisitions of banks, there is no notification requirement. As the FINMA can object to the acquisition of an interest of 10% or more in a bank if the buyer is unsuitable, it is recommendable, that the acquisition of a participation in a bank is first discussed with FINMA. Foreigners, however, need to obtain an approval to acquire a substantial participation in a bank, which, in return, depends on the question whether a Swiss entity can acquire a participation in a bank in the home country of the foreign.*
- *Authorization requirements for foreign acquirers of real estate companies: Foreign acquirers need a special authorization if they purchase real estate that is not used for business purposes or real estates companies which own such real estate.*

In principle, the acquisition of Swiss enterprises is not subject to any authorization requirement. This principle applies also to foreigners. There are, however, certain exceptions to this general rule:

2.1 Acquisition of Banks and Participations in Banks

2.1.1 Assurance of Proper Business Conduct

For the acquisition of a bank or a participation in a bank, the acquirer, in principle, does not need a prior authorization from the FINMA.¹⁴³ According to art. 3 para. 2 lit. c^{bis} of the Federal Act on Banks and Savings Banks (BankA), a person or entity owning, directly or indirectly, 10% of the capital or the voting rights in a bank or having considerable influence on the management in another way must assure that it does not exercise a negative influence on the management of the bank. If this requirement is not fulfilled, the relevant bank may lose its operating license. Even though art. 3 para. 5 BankA requires notification only when a participation of over 10% is acquired, there is no authorization requirement as such, it is recommendable that a declaratory ruling is obtained from FINMA in accordance with art. 3 sec. 2 let. c^{bis} Bank A.

Unlike the managers of the bank, the owner of a participation in a bank does not need to have the education and professional experience necessary to manage a bank. The owner

¹⁴³ See, chapter C.2.3.2 below for the acquisition of a bank by a foreigner.

may, however, not exercise a negative influence on the bank that would prevent the professional management from managing the bank prudently and diligently. Therefore, persons or entities may be prevented from holding a participation in a bank if, in the past, they have used banks or other enterprises for illegal purposes, or have endangered or stripped enterprises of their assets or there are considerable indications that they will act in this way.

If the FINMA is of the opinion that the acquirer of a material participation in a bank does not meet the described requirements FINMA may impose sanctions. According to the principle of proportionality, it seems, however, to be inappropriate to revoke the bank's license in case of a minority participation of an unsuitable owner. The FINMA can in such cases take other steps, as for example, issue an order that prohibits the shareholder from exercising the voting rights of his shares or to set a deadline for the sale of the shares.

2.1.2 Special Requirements for Foreign Acquirers

Pursuant to art. 3^{bis} BankA, a foreign acquirer, who purchases a controlling participation in a Swiss bank, has to obtain a special license from FINMA. This rule also applies to the acquisition of a Swiss company which is controlled by foreigners. A controlling participation, as defined in art. 3^{bis} BankA, exists where one or more foreign shareholders have the majority of the voting rights in the bank or if they are able to control on the basis of a strong minority position.¹⁴⁴

FINMA can make the grant of the license dependent on whether persons or entities resident or incorporated in Switzerland are able to acquire or found banks in the country of the buyer. If the buyer itself is a bank or a financial institution, subject to supervision, FINMA can make the grant of the license dependent on the decision of the respective foreign authority.¹⁴⁵

2.2 Acquisition of Real Estate and Real Estate Companies

Persons resident in Switzerland, as well as Swiss citizens and entities controlled by such persons, may acquire Swiss real estate and real estate companies without authorization. Foreign individuals as well as companies controlled by these individuals are subject to an authorization requirement if they acquire real estate not used for business purposes. This regulation is included in the Federal Act on the Acquisition of Real Estate by Persons Abroad and is a relict from times with dominant fears of foreign infiltration.

The authorization requirement may affect the acquisition of companies:

¹⁴⁴ E.g., in the case of a highly fragmented shareholder structure.

¹⁴⁵ Art. 3^{bis} sec. 1^{bis} BankA.

2.2.1.1 *Authorization Requirements for Asset Deals*

According to the Federal Act on the Acquisition of Real Estate by Persons Abroad ("*Lex Koller*" or "*LexF*"), an authorization is necessary if a foreign citizen or a foreign company purchases Swiss real estate. According to art. 2 para. 2 *LexF*, no authorization is required if the real estate is permanently used for the conduct of a business, *e.g.*, trade, fabrication or other commercial industry, handicraft business or service provider. Therefore, a foreign buyer may purchase real estate used for business purposes, without being subject to an authorization requirement, regardless of whether the real estate is used for such purpose by the foreign buyer himself, by an enterprise owned by the foreign buyer, or by a third party on the basis of a lease agreement. In case, the real estate is not exclusively used for business purposes but also for residential purposes because applicable zoning regulations require a partial residential use, the foreign buyer does not need an authorization as long as the residential use complies with the applicable regulations. No authorization is required if reserves not used for business purposes are available and can be used for such purposes in due time.

If a foreigner purchases a business in an asset deal, he may acquire any real estate that is used for business purposes as part of the assets without being subject to authorization requirements. However, the respective foreigner will not obtain an authorization for real estate not used for business purposes, such as *e.g.*, residential premises, that are part of the sold assets. If a foreigner purchases an asset, the real estate not used for business purposes should be excluded from the purchase object at the beginning. Such real estate should be sold to a Swiss buyer independent of the asset deal.

2.2.1.2 *Authorization Requirement in a Share Deal*

No authorization is necessary if a foreigner purchases a Swiss company that owns Swiss real estate. This principle also applies if the company owns Swiss real estate that is not used for business purposes and serves the company as capital investment as long the business activities of the company prevail over the capital investment. Only the purchase of a real estate company, *i.e.*, a company whose actual purpose is to own, manage or trade in real estate not used for business purposes, is subject to authorization. Therefore, *LexF* does not hinder foreigners from purchasing Swiss companies other than pure real estate companies that mainly investment in residential real estate.

2.2.1.3 *Procedure*

If it is unclear whether a particular asset or share deal is subject to authorization, the buyer may request a declaratory ruling on the authorization requirement from the competent authorities.¹⁴⁶

It is advisable to ask for such a ruling if the foreign buyer intends to conclude an asset deal with real estate with combined use or considerable reserve areas. The same applies if

¹⁴⁶ Art. 15 *LexF*.

a foreign buyer purchases the shares of a company that has invested a high percentage of its assets in residential real estate and it is uncertain whether the company qualifies as real estate company. If the transaction is subject to authorization, the buyer has to file an application for an authorization with the competent authorities based on cantonal law and prior to closing. The signed agreement must be submitted as well. The closing of the transaction has to be deferred until such authorization is granted.

3. DISCLOSURE OBLIGATIONS

In principle, neither the public nor the authorities have to be informed of the purchase of a business. There are, however, a number of important exceptions to this rule:

- If a person acquires a participation in a listed company and its total participation thereby exceeds the thresholds of 3%, 5%, 10%, 15%, 20%, 25%, 33 1/3%, 50% or 66 2/3%, such fact has to be notified to the stock exchange and the company. The company will disclose the participation to the public. The same notification obligation also applies to a sale if due to such sale the participation drops below one of these limits.*
- If a business is transferred according to art. 69 MA, the transfer has to be recorded in the commercial register, and is therefore available information to third parties.*
- In an asset deal, the transferred employees have to be informed about the transaction. Due to such information the transaction will usually become known to the public.*
- If a person purchases a participation in a bank and its total participation will subsequently exceed the thresholds of 10%, 20% 33% or 50%, such transaction has to be notified to FINMA. Yet, the FINMA is obligated to secrecy. The new ownership structure has to be disclosed in the following annual report of the respective bank.*
- If a transaction is subject to Swiss merger control, it must be notified to the Competition Commission. Even though the Commission is bound to secrecy, it will disclose details about the transaction upon initiating the formal procedure and will offer third parties the opportunity to present their views to the transaction.*
- Listed companies which purchase or sell a business have to inform the public about this transaction pursuant to the rules on ad-hoc publicity if the transaction has a size which materially influences earnings, turnover or the business activities of the listed company.*

According to Swiss law, neither the seller nor the buyer has to disclose his intent to sell or purchase a business to the authorities or any third persons. There are, however, several important exceptions to this general rule:

3.1 Acquisition of Material Participations in Listed Companies

According to art. 20 of the Federal Act on Stock Exchanges and Securities Trading (SESTA), a person who directly, indirectly or jointly together with any third parties acquires listed shares in a Swiss company and whose participation in the company, subsequently, exceeds the thresholds of 3%, 5%, 10%, 15%, 20%, 25%, 33 1/3%, 50% or 66 2/3% of the voting rights of such company, has to notify the company and the stock exchange where the relevant shares are listed. This notification is also necessary where the participation after the sale of shares falls below such thresholds. The reason for such notification is to ensure that the control over a listed company cannot change without informing the public shareholders.

According to art. 22 SESTA, the notification must be sent to the stock exchange and the company concerned within four trading days after a relevant transaction has been concluded; the company has to notify the public within two trading days after the receipt of the notification.¹⁴⁷

3.2 Asset Transfer in a Merger

If a business is transferred in an asset deal pursuant to art. 69 *et seqq.* MA, the transfer has to be recorded in the commercial register. The asset transfer agreement must be filed along with the application to the commercial register. Third parties are thereby made aware of the transfer and have the opportunity to review the transfer contract, which discloses the commercial reasoning for the transfer and each of the transferred assets or liabilities.

3.3 Disclosure Obligations under Labor Law

As described in detail in chapter F.1 below, the employees whose employment agreement are transferred in a asset deal have to be informed about such transaction and about the social, legal and economic consequences such transaction may have for them. Further details on the transaction, like the purchase price, do not have to be disclosed. Since the employees do not have to be informed before the signing of an agreement but only before the completion of the transaction, the purchase agreement may be negotiated between the parties confidentially.

If a company is sold in a share deal, neither the company itself nor the buyer have to inform the company's employees about the transaction.

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For details on the notification obligation see *cf.* the Walder Wyss brochure "The Acquisition of Participations in Listed Companies – Rules on Tender Offers and Notification Obligations".

3.4 Notification Obligations under the Banking Act

According to art. 3 para. 5 BankA, an individual or entity has to notify the FINMA if he acquires a participation of 10% or more in a Swiss bank or increases his participation by purchases to more than 20%, 33% or 50% of the voting rights or capital. Such notification obligation also applies if due to a sale the participation falls below one of these thresholds. FINMA will not disclose such information to the public, so that the changes in participations in non-listed banks will not become public knowledge until the annual report of the relevant bank is published. According to art. 25c para. 1 No. 3.10.2 of the Ordinance of Banks and Savings Banks (BankO), changes to the ownership structure have to be included in an annex to the annual report. Due to the disclosure obligation in the annex of the annual financial statements, the sale of a bank cannot be kept secret permanently.

According to art. 3 para. 5 BankA, not only the buyer of shares is subject to the disclosure obligation. The bank is also obliged to notify the FINMA upon becoming aware of circumstances subject to disclosure.

3.5 Notification Obligations under the Antitrust Act

As described in chapter E.1 above, the Competition Commission must be notified of acquisitions of companies subject to merger control according to art. 9 CA. The Competition Commission may not disclose the details of the transaction to the public or third parties. However, if the Competition Commission initiates formal proceeding after the preliminary examination pursuant to art. 32 CA, the Secretary publishes the main content of the notification in the Swiss official gazette of Commerce according to art. 33 CA. In this way, the intended transaction is disclosed to the public.

3.6 Purchase and Sale of Businesses by Listed Companies / *Ad-hoc* Publicity

3.6.1 Obligation of *Ad-hoc* Publicity

Companies whose shares are listed on the Swiss Stock Exchange (SIX) are obliged, according to art. 53 of the Listing Rules of the Swiss Stock Exchange (LR), to disclose to the public and the SIX, any facts which are unknown to the public if such facts can result in a material change in the stock market price.¹⁴⁸ According to the practice of the SIX, listed companies have to disclose sales and purchases of businesses if such transactions have a material influence on the assets and liabilities of the companies or their business activities and therefore, it must be assumed that such transaction will also have a material

¹⁴⁸ Cf. for details: Walder Wyss "Listing at the SIX".

influence on the stock market prices. Therefore, listed companies have to disclose major purchases and sales of businesses.

In accordance with art. 53 LR, *ad-hoc* publicity is triggered only by "facts", not by plans or intentions of a listed company. Therefore, the intention of a listed company to purchase a business or dilute a subsidiary does not trigger the disclosure obligation. A listed company may voluntarily disclose the intention of making certain divestments or acquisition in the context of its information policy. If such plans and intents are disclosed, it must be pointed out that the carrying out of such transaction is uncertain. Otherwise, the company might be faced with the obligation of deceiving investors. A disclosure is necessary if negotiations are conducted and the parties conclude a letter of intent which contains the main terms of the transaction. The same applies if a purchase agreement is signed even if the purchase agreement is still subject to certain conditions precedent, such as for example an authorization under merger control rules.

3.6.2 Confidentiality Option

According to art. 54 LR, listed companies may keep information that is subject to *ad-hoc* publicity confidential if the information is related to a business strategy of the company and the disclosure could harm the interest of the company. Therefore, a listed company may keep the beginning of negotiations, the conclusion of a letter of intent or of a purchase agreement confidential, if the company has a legitimate interest in doing so. For example, this is the case during negotiations or upon signing the letter of intent if the negotiations were endangered otherwise and if it became known to third parties.¹⁴⁹ Even after the conclusion of a purchase agreement, non-disclosure is possible, if the closing is to be prepared without disruption by third parties and if such disclosure could hamper the closing.

If a listed company decides to keep a transaction confidential, it must ensure that neither rumors circulate nor any insider tips become public, since, if rumors emerge, the company has to immediately comply with its disclosure duty under art. 55 para. 2 LR.

A fact that has been kept confidential due to confidentiality interests of the listed company must be notified once the confidentiality interest has ceased to exist, *i.e.*, a disclosure of such information would not be harmful to the company. Therefore, a company would have to disclose that it has concluded an agreement, if the closing has been prepared to such an extent that it cannot be affected by a disclosure to third parties.

3.6.3 Circulation of Notification

The company has to disclose a fact subject to *ad-hoc* publicity in at least two electronic media systems, common with professional market participants, such as Telekurs or Reu-

¹⁴⁹ This condition is usually fulfilled if third parties disturb the negotiations by submitting competing offers upon disclosure. For this reason, the commencement of negotiations and the conclusion of letters of intent or similar documents as heads of terms, memoranda of understanding *etc.* are usually not disclosed.

ters. The information must be published in a manner that ensures equal treatment of all investors. According to the practice of the SIX admission board, the publication should always take place after trading hours so that the investors can digest the new information prior to beginning of trading the next day. If the disclosure has to be made during trading hours, SIX may suspend trading in the shares concerned until the information has been digested. In any event, the information concerned has to be communicated to the admission board at the SIX not later than one hour prior to the beginning of stock market trading.

E. EMPLOYMENT ISSUES

- *If a Swiss company is sold in a share deal, its employees have no right to decide on such transaction and need not even be informed about it. In contrast, if a business is sold in an asset deal, its employees have to be informed before the transaction is completed and have to be consulted by the seller if the transaction has negative social consequences for them.*
- *If a company is sold in a share deal, the employment agreements remain unchanged as the employer (i.e., the company) does not change from the point of view of the employees. If a business is sold in an asset deal, the employment agreements of all the employees of the business are transferred to the buyer. The employees may, however, object to the transfer. The buyer of the business becomes jointly liable with the seller for all the claims of the employees against their former employer (e.g., unpaid loans, bonuses, payment of damages etc.), whereas the seller of the business remains liable with the buyer for the obligations the buyer under the employment agreement until the time the relevant employment agreement could have been terminated.*
- *The pension fund foundation, respectively the pension fund, cannot be the object of a sale as it is an independent legal entity which is neither owned by the business nor its owner. The pension fund, however, "follows" the employees as it remains responsible for their pension claims even after the business has been sold to a new owner. If the pension fund covers the employees of the transferred business and also continues to cover other employees of the seller, it will be partially liquidated with a part of its assets being transferred to a new pension fund established for the employees of the transferred business.*
- *If a pension fund has a deficit, the buyer of the business must take into account that he will have to cover at least 50% of any deficit in the coverage of the pension fund through higher future contributions. He has, however, no rights in any surplus but may only marginally benefit from such surplus through lower future contributions. Only employers' contribution reserves which can directly be applied to the contributions of the employer can in economical terms be regarded as assets of the business sold.*

1. EMPLOYEE INFORMATION AND CONSULTATION

1.1 Share Deal

If a company is sold in a share deal, its employees have no right to decide on the transaction. From a legal point of view, they do not even have to be informed about the transaction as neither the parties to the transaction nor the employer have a legal obligation to inform the employees of the transaction.

1.2 Asset Deal

If a business is sold in an asset deal, the seller, according to art. 333a CO, must inform the employees of the business, or their representatives (if they have elected representatives),¹⁵⁰ about the planned transaction and of its legal, economic and social consequences for the employees. Should the sale of the business lead to restructurings or other measures that have ramifications for the employees, the employees, or their representatives, have to be consulted, *i.e.*, they must have an opportunity to comment on the plans and to make their own alternative proposals.

Even if the seller has an obligation to consult with the employees, the employees cannot prevent the transaction, as their consent is not necessary for the transaction or restructuring. The obligation to consult with the employees is in fact an obligation to listen to their comments and proposals.

The information provided to, and, if necessary, the consultation with the employees or their representatives, according to art. 333a CO, has to take place before the closing of the transaction. The employer, therefore, does not have to inform the employees before the purchase agreement is concluded but can comply with his obligations in the period between the signing of the purchase agreement and the closing. This makes it possible for the seller to negotiate the purchase agreement in confidentiality, in spite of information and consultation obligations.

1.3 Foreign Branches and Subsidiaries

In a sale of foreign subsidiaries or foreign branches of a business, the rights of the employees and the duties of the seller and the buyer towards them are regulated by the employment laws of the country where the employees work. It is important to note that the rights of such employees may be more protected under foreign labor law than under Swiss law.

¹⁵⁰ The election of employee's representatives is regulated by the Federal Act on the Co-determination Rights of Employees (*Mitwirkungsgesetz*). According to such act, the employees of businesses who employ more than 50 persons have to elect representatives if at least one fifth of the employees request the election of employees' representatives.

Foreign labor law is to be complied with when a Swiss company directly sells a foreign subsidiary or branch, and also, if a foreign business is sold indirectly, *i.e.*, if a Swiss company with foreign subsidiaries or branches is sold. Therefore, it is important to understand the labor laws of the jurisdictions where the employees work before such transaction is undertaken, and in particular, to examine the duties the seller under such foreign laws.

2. TRANSFER OF EMPLOYMENT AGREEMENTS IN THE SALE OF A BUSINESS

2.1 Share Deal

2.1.1 No Change of the Employer

The transfer of the ownership in a company in a share deal does not change the company's legal relations or contracts with third parties.¹⁵¹ This principle also applies to employment agreements. These agreements continue to exist unchanged after the completion of the share transaction.

2.1.2 Continuation of the Employment Agreements

The principle, that concluded employment agreements of a company are not changed if the company is sold in a share deal, has the consequence that neither the employer nor the employee may terminate the employment agreement with immediate effect due to such transaction. The employment agreement may be terminated only within the legal and the statutory termination periods or if existing, within any longer contractual notice periods. The company may after the share deal also not unilaterally change employment agreements to the detriment of the employees in order to adopt the employment agreements to the format normally used by the buyer.¹⁵² Such changes can only be made if the employer and employee agree on them. If such an agreement is not possible, the company can terminate the current purchase agreement within the applicable notice periods and at the same time offer an employment agreement with the new terms. The buyer should, however, take into account the legal restrictions court practice has developed for notices served in order to achieve a change of employment terms. The service of notice is regarded as abusive if the terms of the new employment agreement are below industry standards. In case of an abusive termination, the employer, according to art. 336 *seqq.* CO, has to pay the employees special compensation in the amount of up to six months salary.

¹⁵¹ An exception is contracts with a change of ownership clause, which allows the company's counter party to unilaterally terminate the contract concerned in case the ownership in the company is transferred.

¹⁵² A change in favor of the employees is possible at any time, as for example, salary increases, the promise of special stay on bonuses, shorter working hours or the inclusion of the employees into option programs the buyer offers his employees.

2.2 Asset Deal

2.2.1 Transfer of the Employment Agreements

If a business is sold in an asset deal, all employment agreements of employees who have worked in such business are, in accordance with art. 333 CO, automatically transferred to the buyer of the business. According to a decision of the Federal Supreme Court, this encompasses all the employees that objectively and independent of internal divisions of the business, have worked for the benefit of the business concerned. Art. 333 CO is mandatory provision and, therefore, the seller and buyer cannot restrict in the purchase agreement the number of employees that are transferred. To limit the economic consequences of the automatic transfer of employees, the seller and buyer can use the following methods:

– Termination of Employment Agreements by the Seller

The seller can terminate the employment agreements of employees who work for the target company before it is transferred. This has the consequence that the joint liability of buyer and seller discussed in chapter E.2.2.3 below does not apply to such agreements.

– Internal Agreement on the Transfer of Employees

The buyer and seller in the purchase agreement can provide that the buyer takes over only specific employees and that the seller keeps him harmless from any claims of other employees who, due to the fact that they have worked for the business, claim that they have been transferred to the buyer. Such an agreement cannot hinder an employee who worked for the acquired business to raise claims against the buyer, it only has the effect of obliging the seller to make the necessary payments to the buyer.

The employees who work for the transferred business, however, can prevent the transfer of their employment agreement to the buyer by objecting, pursuant to art. 333 para. 1 CO, to the transfer of the employment agreement. Upon objection, the employment agreement, regardless of any contractual notice periods, is terminated on the next date on which it can be terminated pursuant to the statutory notice periods. The salary for the period until the employment agreement is terminated has to be paid by the buyer who can also demand that the employee works for him during the notice period.¹⁵³

2.2.2 Continuation of the Employment Agreement

The employment agreements are transferred to the buyer as they are. As far as any rights of the employees depend on the length of their service, the time of the commencement of the employment with the seller, or any predecessor of the seller, is relevant for such rights and not the time of commencement with the buyer. With regard to the termination and changes of the employment agreements, the same principles apply as to a share transac-

¹⁵³ The seller is jointly liable for such salary payments *cf.* chapter 2.2.3 below.

tion. The fact that the business has been transferred does not entitle the buyer to terminate the employment agreements with immediate effect or to unilaterally change such agreements to the detriments of the employees. The buyer may however terminate the agreements with the normal statutory or contractual notice periods and either agree with the employees on new employment agreements or offer them new employment agreements after having terminated the old ones in compliance with the applicable notice periods.

The transfer of the business does not have the effect that the buyer becomes party to the collective bargaining agreements previously entered in by the transferred business. Nevertheless, such collective bargaining agreements continue to be in force for at least one year, regardless of any longer contractual term. After the expiry of the year, the buyer can negotiate a new collective bargaining agreement with the trade unions or conduct its business without such an agreement.

2.2.3 Joint Liability of Buyer and Seller for the Employees' Claims

If employment agreements are transferred in an asset deal, the buyer becomes jointly liable with the seller for all claims under the transferred employment agreements against the seller by the employees working for the transferred business. Therefore, the buyer assumes joint liability for any outstanding salary payments, bonus payments, payments under profit sharing plans or option plans and also for any claims the employees may raise due to a violation of their employment agreements. The seller assumes joint liability with the buyer for all the claims employees may have during the period between the transfer of the business and the date when the employment agreement could have been terminated (or is terminated, in cases when an employee objects to the transfer).

Due to this joint liability, the seller, as well as the buyer, assumes a relative high risk if one of the parties does not fulfill its obligations towards the employees. Purchase agreements in asset deals, therefore, usually contain mutual indemnities whereby seller and buyer agree to indemnify each other with regard to the claims of the employees for time periods before the closing (indemnity by the seller) and with regard to the period after the closing (indemnity by the buyer). Such an agreement, however, has only an internal effect between the buyer and seller but does not serve as a defense against claims of the employees. If there is an actual danger that one of the parties becomes insolvent, it is therefore advisable that the other party demands security for its claims under the indemnity.¹⁵⁴ If in such a situation the party concerned cannot furnish any security in spite of an acute insolvency risk, the problem of joint liability often makes it impossible to purchase a business from a financially troubled company.

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It is in particular advisable to demand such a security if the buyer is a "rescue company" (*Auffanggesellschaft*) which takes over a business of a company which is in financial trouble.

3. PENSION ISSUES

3.1 Administration of Pension Plans by Independent Foundations

The pension claims of Swiss employees are not covered directly by their employers but by legally independent pension foundations (*Personalvorsorge-stiftungen*¹⁵⁵). The employer transfers a certain percentage of the employee's salary¹⁵⁶ to such foundation to fund the future pension benefits. At least 50% of such contributions are borne by the employer (employer's contribution), whereas the remainder is borne by the employees and deducted from their salary (employees' contribution). The pension foundations invest the contributions they receive in the capital market and with these funds cover the accrued pension claims of the employees in accordance with actuarial principles.

The pension foundations are legally separated from the business and the employers so that neither the business nor its owner have any possibility to use the funds of the pension foundation for their own purposes. Consequently, the assets and liabilities of the pension foundation, according to Swiss accounting standards, are not recorded in the financial statement of the business concerned. This applies also to a surplus of the pension foundation, *i.e.*, if its assets exceed the amount necessary to cover the accrued pension claims of the employees calculated pursuant to actuarial principles, as the employer has no rights to such surplus. In contrast, a deficit of the pension fund need not be recorded in the balance sheet as the obligation of the employer is normally limited to the payment of the contributions to the pension foundation so that he has no direct liability for the pensions to be paid to the employees.

The enterprise whose employees have a pension foundation has no ownership rights in such pension foundation. A pension foundation has neither members nor an owner, it is an independent legal entity which exists only to fulfill its purpose, *i.e.*, to cover the employees' pension claims defined in its pension regulations. The pension foundation is managed by the foundation board with 50% of the members being appointed by the employer and 50% by the employees.¹⁵⁷ The investments that the pension foundation may make are strictly regulated in a Swiss pension fund by regulations which, in particular, severely limit loans a pension fund may grant to the employer. The management of the pension fund is also regularly supervised by the cantonal supervisory authorities.

¹⁵⁵ In principle, it is also possible to organize a pension fund in the form of a cooperative society (*Genossenschaft*); but these are very rare.

¹⁵⁶ The exact percentage depends on the size of the pensions provided by the pension plan and the age of the employees.

¹⁵⁷ The representatives of the employer may not use their position in the foundation board to further the financial interests of the employer as they become personally liable if they do not comply with the statutory rules and regulations on the investment of the foundation's assets.

3.2 Pension Foundations in a Sale of a Business

3.2.1 No Change in the Purpose of Pension Foundations

Due to its legal and financial independence, a pension foundation which exists for the employees of a business cannot be the object of the purchase of a business. Regardless of the sale of a business, the pension foundation has to continue to serve its purpose, *i.e.*, to cover the pension claims of the employees as defined in its pension regulations.

3.2.2 Automatic Transfer of the Pension Foundation

If a pension foundation covers only the employees of the business sold, the sale of the business does not cause any changes in the coverage of the employees' pension. The employees remain covered by such pension foundation and the pension foundation in this way "follows" the business sold. The buyer of the business due to his control over such business can also appoint the employer's representatives in the foundation board and thereby exercise a certain influence over the pension foundation.

3.2.3 Contracts of Adhesion and Partial Liquidation of the Pension Fund

If a pension foundation not only covers the employees of the business sold but also other employees which continue to work for the seller; the pension foundation will not "follow" the business that has been sold. In such a situation, the buyer and seller may provide that the employees of the transferred business continue to be insured with the pension foundation of the seller. For such purpose, the business that has been sold and the pension foundation of the seller will conclude a contract of adhesion ("*Anschlussvertrag*"). Pursuant to such contract, the transferred business will transfer employees' and employer's contributions for its employees to the pension foundation which will cover the pension claims of the employees concerned in accordance with its pension regulations. The advantage of such a solution is that the buyer can base the pension plan for his new employees on an already existing structure and does not incur the costs for erecting a new pension plan. The disadvantage of such a solution is that the buyer, who in such a situation normally can only appoint the minority of the employer's representatives in the foundation, has no influence on the pension foundation and in particular can also not influence the pension plan. Pension regulations determine the pensions to be paid to the employees. Therefore, such a solution is often only chosen for transitory period until the buyer builds his own pension foundation. In practice, only small businesses which do not reach the critical mass necessary for an independent pension foundation will continue such a solution.

It is also possible, and in most case advisable, to either integrate the pension fund of the transferred business into an existing pension fund of the buyer or to establish a new pension foundation for the employees of the transferred business. In such cases where the employees do not remain insured with their original pension foundation, such pension foundation must be partially liquidated. According to art. 23 of the Federal Act on the Occupational Old Age, Survivor and Invalidity Insurance (OIA), in a partial liquidation the original pension foundation has to transfer the assets necessary to cover the accrued claims of the employees and a proportioned part of its reserves to the new pension fund.

Due to the obligation to transfer also a proportional part of the reserves, the payment to be made by the original pension foundation is usually higher than the payment to be made if employees are individually transferred. Should the original pension foundation, however, have an actuarial deficit, *i.e.*, should its assets not be sufficient to cover the accrued claims of the employees, the new pension foundation takes over a proportionate part of such deficit.

The manner in which the sellers' pension fund is liquidated and the amounts to be paid to the new pension foundation are not determined by the buyer and seller. The foundation's board has to draft a plan for such partial liquidation together with a pension fund expert and submit such plan to the cantonal supervisory authorities. Such authority will examine the plan, and if it complies with applicable legislation, authorize its implementation; the supervisory authority may however also order measures protecting the employees and their accrued pension claims.

3.3 Economic Considerations for the Buyer

3.3.1 Assets of the Pension Fund

The assets of pension foundations may only be used to cover the pension claims of the insured employees. Therefore, the employer may not use the assets of a pension foundation for its own purposes, as for example, in the payment of salaries.

The assets of a foundation cannot be used to finance the business that has been sold or the purchase price itself. According to art. 57 of the Ordinance of the Federal Act on the Occupation Old Age Survivors and Invalidity Insurance (*OIO* 2), not more than 5% of the assets of a pension foundation may be lent to the employer as a non-secured loan with the provision that the assets necessary for the coverage of the accrued pension plans may not be used for such purpose. Therefore, a loan to the business is, in any event, only possible if the pension foundation has a sufficiently high surplus. Practice shows, however, that the limits are normally purely theoretical as the supervisory authorities immediately order the reduction of loans to the employer if they have doubts about the solvency of the employer. Loans to the employer in case of loss will normally also trigger the personal liability of the members of the foundation board and in particular of the employer's representatives as employees and supervisor authority will allege that such board members had a conflict of interest and when granting the loan did not act in the best interest of the foundation. Therefore, a buyer of a business cannot count on the assets of a pension foundation to cover his or the acquired business' financial needs.

A pension fund may also contain employer's contribution reserves. Such reserves are created where the employer make special contributions which exceed the statutory minimum. Such a special contributions can be deducted from taxable income in the year they are made and in later years can be used for the payment of the employer's contributions. These employer's contribution reserves therefore directly reduce the future pension plan expenses of the target company and will increase its earnings. Therefore, such employer's contribution reserves have to be taken fully into account in the valuation of a business.

3.3.2 Surpluses of Pension Foundations

The surplus of a pension foundations, *i.e.*, the amount by which the assets of the pension foundation exceed the amount that according to actuarial calculations is necessary to cover the accrued pension funds, are not at the disposal of the employer as the employer can neither demand that such surplus is paid to him nor use such surplus to pay his own contributions to the pension foundation. The surplus of a foundation, however, can be used to lower the employer's and employees' contribution if the foundation board consents to such use of the surplus. Therefore, the surplus has a certain economic value for the employer. Such value, however, is limited by the fact that employer's and employees' contribution has to be reduced proportionately if the surplus is used for reduction of the contributions and by the fact that the foundation board, 50% of whose members are employees representatives, has to consent to such use of the surplus. Due to these facts which limit the buyer's ability to use the surplus to reduce his future pension plan contributions and to increase its future profit only 15-30% of a surplus may be taken into account in the valuation of the business regardless of the accounting treatment of such surplus.

3.3.3 Deficits of Pension Foundations

A pension foundation can have a deficit if its assets do not cover the accrued pension claims of the employees. Such a deficit can be caused by an insufficient return on the assets of the pension plan or by a change in the actuarial basis on which the accrued pension claims are calculated, such as an increase in the life expectancy of the insured employees.

In principle, the employer has no legal obligations to cover such a deficit as long as the members of the foundation board that have been delegated by the employer cannot be held responsible for the investments that have led to such loss. There is, however, a considerable moral obligation of the employer to cover the deficit, an obligation that is usually strongly enforced by employees, their representatives and unions. If the employer does not make a special contribution to cover the deficit, the deficit will be covered by an increase of the employer's and employees' contributions. As the employer has to pay at least 50% of the total contributions, he therefore will by such increase cover 50% of the deficit. A deficit in a pension plan, therefore will lead to increased pension expenses of the buyer and to a corresponding reduction of the earnings of the business sold by an amount of at least 50% of such deficit. Deficits, therefore, are normally taken into account in the evaluation of a business.

3.4 Changes in the Pension Plan

For the transferred businesses, the accrued pension claims of the employees cannot be reduced regardless of whether the original pension foundation continues to cover such a pension claims or whether the buyer forms a new pension foundation.

If the buyer intends to change the pension plans because he wants to adapt it to the pension plans of his own employees, he can make such changes only with the consent of the employees. Alternatively, he can terminate their employment agreements in compliance with statutory and contractual notice periods and offer them new employment agreements which refers to the new pension plan. Experience shows that it is very problematic to change pension plans to the disadvantage of employees, *i.e.*, to decrease future pensions as such move will usually de-motivate the employees to a large extent. The buyer of the business, therefore, should never rely in his evaluation of the business that he can lower the future pension costs of the business by reducing pensions promised to the employees.

If the pension plan of the acquired business is less generous for the employees than the pension plan the buyer has instituted for its own employees, the employees of the acquired business will always press for an adaptation of their own pension plan to such higher level. Experience shows that over the long run, the buyer can seldom resist such pressure unless he does not keep the businesses totally separate. If the pension plan of the acquired business is improved, the buyer has to bear at least 50% of the costs of such improvement due to a corresponding increase in the employer's contributions. Therefore, a pension plan which offers pensions that are below industrial standard often presents a hidden cost for the buyer that should be taken into account in the evaluation of the business.

F. TAX ASPECTS

1. TAX CONSIDERATIONS FOR THE SELLER

- *If a private individual, who is resident in Switzerland, sells a company in a share deal, the capital gain realized through the sale is, in principle, tax-free. However, the following exceptions exist:*
 - *Sale of shares to the company itself (direct partial liquidation);*
 - *Sale of shares (i) to a company, a partnership or a private individual holding the shares as a business asset and (ii) which / who finances the purchase price with the existing assets of the company (indirect partial liquidation);*
 - *Sale of shares to a company controlled by the seller (transposition of reserves "Transponierung");*
 - *Sale of shares that constitute business assets of the seller;*
 - *Sale of real estate companies;*
 - *Sale of a company whose assets are in liquid form.*
- *If a company, which is resident in Switzerland, sells a participation in a company in a share deal, it realizes a taxable capital gain. If, however, a participation of more than 10% is sold, which was held for more than one year, the gain remains practically tax-free due to the participation exemption.*
- *If an individual sells a business in an asset deal, the whole gain is subject to income tax and social security contributions.*
- *If a company sells a business in an asset deal, the gain resulting from the sale is also taxable.*

As described in chapter A above, a business can be acquired in one of two ways: a purchase of the business with its assets and liabilities (asset deal) or a purchase of the entity, i.e., either a company or a limited liability company (*GmbH*), which owns the business (share deal). The tax treatment of these two transaction structures differs to a considerable extent as explained below:

1.1 Taxation of the Seller in a Share Deal

1.1.1 Private Individuals as Sellers: The Tax-Free Capital Gain – a Principle with Exceptions

If a private individual sells assets held as private assets, he realizes a tax-exempt capital gain.¹⁵⁸ This rule is set forth in art. 16 para. 3 DTA:¹⁵⁹

"The sale of private assets realizes a tax-free capital gain."

This principle applies also to the sale of shares in a company and the sale of quotas in a limited liability company (*GmbH*)¹⁶⁰ which is also tax-exempt, even for the sale of larger participations in the company or limited liability company. It enables a private individual to sell a company without having to pay income tax on the gain from the sale.

In contrast, the shareholders of a company pay income tax on the income from investments *i.e.*, dividends or other distributions from the company to its shareholders. If the private individual owns at least 10% of the capital of the relevant company, pursuant to art. 20 para. 1 *ciff* 1^{bis} DTA, such distributions are subject to only 60% direct federal tax.¹⁶¹ Art. 7 para. 1 THA, permits also the cantons to provide for an income tax reduction, in cases where the private individual owns a minimum of 10% of the capital of a company.¹⁶² With the exception of this relief for large shareholders, the income from investment is taxed both at a federal and cantonal level.

The different treatment of capital gain and investment income has the result that individuals with a equity share in a company, will avoid any dividends from the company during the time in which they hold the equity share, but will wait for the accumulated gain to be distributed on the sale of the company in the form of a tax-exempt capital gain. Traditionally, the tax authorities tried to re-classify such capital gain as investment income to be able to tax the distribution.¹⁶³

There are, however, certain important exceptions where the tax-free capital gain is re-qualified as taxable income and consequently subject to income tax:

¹⁵⁸ Art. 16 para. 3 DTA and art. 7 para. 4 THA.

¹⁵⁹ Art. 7 para. 4 lit. b THA, provides the same rule of the taxation on a cantonal level.

¹⁶⁰ Hereafter, reference made to shares includes also the quotas in the case of a limited liability company (*GmbH*).

¹⁶¹ If the private individuals' participation of 10% does not form part of his private assets but of his business assets (see chapter G.1.1.1.5.), the tax burden will be reduced to 50%, pursuant to art. 18d DTA.

¹⁶² In practice, nearly all cantons have followed this provision and imposed a tax between 40% and 60% on the distribution, making use of the reduced tax rate.

¹⁶³ These attempts of the tax administration have led to the rules on indirect partial liquidation and transposition of reserves (chapter G 1.1.1.2 and chapter C 1.1.1.3 below).

1.1.1.1 *Direct Partial Liquidation*

a) Principle

From a tax perspective, if a shareholder sells his shares in the company to the company itself, no sale has occurred. Such a transaction is considered a partial liquidation, in the same manner as if the company made a dividend payout to the shareholder. The difference between the price paid and the nominal value of the shares is considered taxable income of the shareholder who has sold the shares. The taxable income may be much higher than the actual gain realized by the seller if he has acquired the shares at a price above their nominal value. The difference between nominal value and the price at which the shares are sold is also subject to withholding tax, but persons resident in Switzerland can get a full refund for the tax paid. These tax consequences do not apply if the purchase price is debited against reserves of capital contributions which are accumulated after December 31, 1996.

b) Resale Exceptions

The tax consequences described above always apply when the company concerned cancels the shares after the purchase in a capital reduction, or if the number of shares reacquired exceeds the limits set by art. 659 CO, *i.e.*, if the company repurchases more than 10% of its share capital.¹⁶⁴ The tax consequences described above, however, do not apply if the number of shares reacquired does not exceed the limits set by art. 659 CO and if the company resells the shares within six years.¹⁶⁵ If the shares are held longer than the six year limit, withholding tax and direct federal tax will be levied, even if the shares are not cancelled by the company. If the company buys its shares to cover any option or share purchase programs for its employees, or any option on conversion rights for bond holders, such six year deadline is tolled for the time the shares are used to cover such programs, but, in case of employee programs, only for a maximum period of six years.

c) Practical Considerations

The direct partial liquidation theory applied to private persons hinders the parties, when a private individual is the seller, from structuring a share deal in such a way that the company repurchases part of the shares and, thereby, finances a part of the purchase price. Such a repurchase is only possible if the company holds reserves of capital contributions which can be distributed. If such reserves are not available, then a repurchase is only possible if the limits set by art. 659 CO are respected, *i.e.*, out of 10% of the capital and the company sells the shares again within six years. If the parties in a share deal actually provide for a partial repurchase of the shares by the company, the private individual sell-

¹⁶⁴ If the company repurchases shares, because it has withheld its consent to a transfer of shares to a third party and such consent is according to the provisions on restriction of transferability, the company may repurchase up to 20% of its shares.

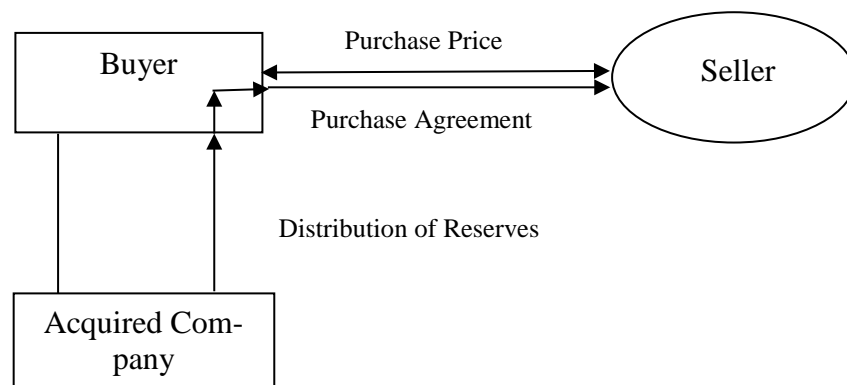
¹⁶⁵ Art. 4 a para. 2 of WTA and art. 20 para. 1 lit. c DTA.

ing the shares will normally include a provision in the purchase agreement that forces the company to sell the shares within the six year deadline, and demand that the company grants a repurchase right to the seller at a very low price, if the shares have not yet been sold to a third party at the time such deadline expires.

1.1.1.2 Indirect Partial Liquidation

a) Principle

If the seller is a private individual and the buyer is a company, a partnership or a private individual who purchases the shares as a business asset, and if such buyer afterwards refinances the purchase price by distributions of the company's preexisting reserves, the gain realized by the seller will not be regarded as a tax-free private capital gain but, at least as far as it is financed by the distribution of reserves that existed before the closing of the sale, as taxable income from the liquidation of the company (theory of "indirect partial liquidation").¹⁶⁶



The reason for this re-characterization of the capital gain as income is that by refusing to receive dividends, the seller is able to receive indirectly in the form of the purchase price the reserves accumulated in the sold company, and thereby, he is able to avoid the taxation of the dividend distributions.¹⁶⁷

The Federal Supreme Court and the Swiss Federal Tax Administration justify such taxation by the fact that, from an economic viewpoint, the seller does not receive a purchase price payment from the buyer but indirectly a distribution of the company's reserves, when the seller refinances the purchase price on a tax-free basis by distributing the reserves the company accumulated before the closing of the sale.

¹⁶⁶ Hereafter, these reserves are referred to as "preexisting reserves".

¹⁶⁷ This indirect appropriation of reserves has led to the terminology of "indirect partial liquidation".

b) Legal Requirements for the Re-characterization

Pursuant to art. 20a para.1 lit. a DTA,¹⁶⁸ only when the following conditions are fulfilled, will the proceeds from the sale of a company or respectively from a share participation be subject to the indirect partial liquidation theory:¹⁶⁹

(aa) Sale of a Participation of a Minimum of 20%

A sale of a participation of more than 20% will be deemed to be an indirect partial liquidation; therefore, the seller will have realized taxable dividend income. The sale of a smaller participation will not be subject to tax, *i.e.*, the capital gain realized on the sale of the participation will be tax-exempt even when the purchase price is refinanced from the preexisting reserves of the company. For these purposes, the share capital percentage is relevant and not the voting rights; thus, tax will not be levied in a situation where the voting rights sold exceed 20% but the share capital remains under this percentage.

When the same seller performs several single transactions, each one below the 20% threshold but with the overall effect of reaching 20% or if several sellers performing such transactions reach 20% together within five years, such transactions will be subject to the indirect partial liquidation theory. However, where several sellers sell their shares to the same buyer in parallel transactions, without having knowledge of one another, art. 20a para. 2 DTA will not be applied. Thus, the article will not be applied in a situation where the buyer acquires more than 20% by buying participations from different shareholders of the same company.¹⁷⁰

(bb) Sale by a Private Individual of Shares Held as a Private Asset to an Entity or Private Individual Purchasing the Shares as a Business Asset

A company, partnership or private individual holding shares as a business asset can receive dividend distributions from an acquired company tax-free. This is possible when the buyer is either a legal entity which receives dividends from investment deductions, or is a private individual who holds shares as business assets and who can compensate the distribution of preexisting reserves by depreciation. Therefore, the theory only applies in a situation where a private individual sells shares from his personal assets to a legal entity or as a business asset to a private individual. For this reason, it is always necessary to clarify if shares are sold to an individual as a private asset or as a business asset.

¹⁶⁸ This provision entered into force on January 1, 2007. Pursuant to art. 250 b DTA, the provision also applies to transactions which have been performed from the 2001 tax years onwards, but which have not yet been definitely assessed.

¹⁶⁹ The following explanations are also true for the taxation on a cantonal level, pursuant to art. 7a para 1. THA.

¹⁷⁰ Absent cooperation, shareholders which simultaneously sell their shares to a buyer, in a public auction of a listed company, will not be taxed, even if they together sell more than 20% of the share capital. Only shareholders who individually hold 20% of the share capital or who, together with other shareholders, form a group which would own a share capital percentage above the threshold, will be taxed.

Shares are sold as a business asset when a buyer acquires the shares in connection with a sole proprietorship or a partnership¹⁷¹ which enters the newly acquired shares into its books. The Swiss Federal Tax Administration takes the view that it is not necessary for the newly acquired shares to be entered into the books provided that they indirectly serve the daily operations of the sole proprietorship or partnership. This principle also applies in a situation where the seller is considered to be a "semi-professional share dealer".¹⁷² It is recommended, to obtain a tax ruling when shares are sold to a private individual, in order to be certain if such shares will form part of his private assets.

Art. 20a para. 2 DTA will not apply where the buyer is a private individual who purchases the shares as his private assets, even if the buyer finances the purchase price by distributions of the preexisting reserves of the company. The reason for this exception is that the private individual himself will be subject to a high tax burden. Therefore, private individuals who wish to buy an equity share will want to consider setting up an acquisition company which undertakes the transaction.¹⁷³

(cc) Existence of Distributable Reserves versus Operating Capital at the Time of the Sale

The application of art. 20a para. 2 DTA is only possible if the acquired company, at the time of the sale, contains reserves which can be distributed other than capital which is necessary for its operation. In particular, the following conditions must be fulfilled:

– ***Commercial Reserves Capable of Distribution at the Time of Sale***

At the time of sale, the company must possess reserves which are capable of being distributed, meaning that the last annual financial statements of the company prior to the sale, must show free reserves or accumulated retained earnings which can be distributed in accordance with art. 675 para. 2 CO. The gain accrued between the record date and the date of sale is not to be realized, pursuant to art. 675 para. 2 CO, since only reserves or accumulated retained earnings which have been approved as part of the balance statement for distribution at a general meeting of the shareholders may be distributed.

General legal reserves are reserves capable of being distributed, to the extent they exceed 50% of the share capital of an operating company and 20% of the share capital of a holding company.¹⁷⁴ However, special legal reserves created as the company's

¹⁷¹ Joint-stock partnership and general partnership.

¹⁷² Cf. chapter F.1.1.1.1.5.

¹⁷³ See chapter F.2.2.

¹⁷⁴ Art. 673 para. 3 and para.4 CO. The literature on this topic differs on the question whether the general legal reserves, which are the result of a capital contribution, are capable of being distributed. The prevailing opinion is that such reserves are general legal reserves and capable of distribution pursuant to the provision in art. 20 a para. 1 lit.a DTA.

own shares, pursuant to art. 671a CO, or reserves created by the appreciation of real property or participations, pursuant to art 671b CO, are not capable of distribution.

No tax will be levied, where no commercial reserves capable of being distributed exist. The statutory provisions clearly focus on distributable reserves and not on hidden reserves. A sold company which holds on its balance statement *e.g.*, real estate at fair market value (which is a hidden reserve), will be able to sell the real property at a later point in time without having to pay tax on the gain. Pursuant to art 20. para. 1 *ciff.* 3 DTA respectively art. 7b THA, reserves from capital contribution can be distributed free of tax, as reserves capable of being distributed tax-free, will not be re-characterized as taxable distributions on the basis of the theory of indirect partial liquidation.

– *Assets Not Necessary for the Operation at the Time of Sale*

Tax will not be levied if the acquired company had, at the time of sale, assets not necessary for its operations. These are assets such as cash, securities, finance participations, as well as not operationally used real estate.¹⁷⁵ Liquidity which does not exceed 10% of the annual operational expenditure is considered necessary for the operations.¹⁷⁶

The value of the distributable preexisting reserves and the non-operational assets, at the time of sale, provides the limit for the maximum tax imposed, whereas the lower amount will be used as the maximum tax. Thereby, and independent from a potential refinancing of the purchase price at a later point in time, it will not be possible to levy tax in a situation where the acquired company does not have reserves capable of distribution. Therefore, no tax will be levied other than if the acquired company holds in its liabilities distributable reserves by having realized gains before the sale, but which does not have any non-operationally necessary assets, due to having used the entire cash-flow to repay debts or to acquire additional operational assets.

(dd) Distributions of Preexisting Reserves within Five Years

If the sold company distributes reserves which existed at the time of sale within five years of the closing of the transaction, the theory of indirect partial liquidation will apply. The purpose of this time limit is that when the distribution occurs within five years, it can be presumed that the buyer refinanced the purchase price from distributions of preexisting reserves and that the seller, therefore, from an economical point of view, indirectly received reserves from the acquired company.

¹⁷⁵ The operational current assets can be considered, just as with operational fixed assets, as "non-operational assets" or "non-operationally necessary assets". If necessary, a comparison to the pervious years may be used to show an inflation in the net working capital (*e.g.*, cause by immediate payment of creditors and a delay in payment of debtors) which could be offset against the non-operational assets.

¹⁷⁶ This percentage is derived from the proposal of the Swiss Federal Council in the Corporate Tax Reform Proposal II.

A distribution will only be within the meaning of art. 20 para 1 lit DTA, if it is debited against the preexisting reserves. If the distribution is debited against the earnings of the company, which have been accumulated after the sale, there will be no tax imposed. This enables the buyer to refinance the purchase price from the future earnings of the acquired company, without causing negative tax consequences to the seller. The distribution of all earnings accumulated after the last record date prior to the sale, are admissible. This includes earnings accumulated between the last record date and the date of sale. However, the earnings accumulated after the last record date may not be distributed at the time of the sale. The distribution may only be made on the basis of an ordinary annual financial statement approved by the general meeting of the shareholders in which the respective profits were declared in accordance with art. 675 para 2 CO.

Distributions of reserves from the capital contribution which may be distributed free of tax, pursuant to art. 20 para. 1 *ciff* 3 DTA respectively art. 7b THA, are not covered by art. 20 para. 1 lit. a DTA and do not lead to the taxation of the seller. Given that the seller was able to receive such distributions tax-free prior to the sale, such distributions are also tax-exempt even in light of the theory of indirect partial liquidation.

A distribution can be effected in such a way that it is derived from the preexisting reserves at the time of the sale. However, every mechanism which leads to a liquidation of the reserves and a transfer of the relevant resources to the buyer will lead to taxation, as explained below.

– ***Redemption of the Shares by the Acquired Company***

There will be no reduction in the reserves where the acquired company buys back part of its sold shares from the buyer. The re-acquired shares will be applied against the purchase price and on the liability side of the balance sheet, pursuant to art. 659a para. 2 CO; free reserves in the amount of the purchase price will be transferred to the reserves for owned shares.

However, in case the share capital is reduced and the reacquired shares are cancelled, the reserve for owned shares will definitively be cancelled which leads to taxation, provided that the cancelled reserves are preexisting reserves. The same principle must be applied, by analogous application of art. 20 para. 1 *lic.c* DTA respectively art. 4a WTA, in cases where the company buys back more than 10% of its proper shares or if it does not resell the reacquired shares within six years, provided that the shares are re-acquired using the preexisting reserves.

– ***Liquidation of the Acquired Company***

The liquidation of the acquired company, whereby the company transfers all its assets and liabilities to the buyer, has the same effect as the payment of a dividend equal to all its preexisting reserves, because in a liquidation all reserves of the acquired company are cancelled and all assets transferred to the buyer. Therefore, the liquidation of

the company and the distribution of its assets to the buyer will lead to the application of the theory on indirect partial liquidation, if the liquidation occurs within five years of the sale.

– ***Merger of the Buyer and Acquired Company***

If the buyer is a company which merges after the closing of the purchase agreement with the acquired company, this also leads to the application of the theory of indirect partial liquidation. With such a merger all the reserves and the total assets of the acquired company are transferred to the buyer; therefore, this has the same effect as if a distribution has occurred.

– ***Grant of Loan by the Acquired Company to the Buyer***

If the buyer finances the purchase price with a loan granted by the acquired company, such a loan should in principle not trigger the application of the theory of partial liquidation. The reason is that the grant of the loan does not lead to a final transfer of the reserves from the company to the buyer and, therefore, the purchase price has not been refinanced out of the reserves of the acquired company. However, the Swiss Federal Tax Administration will apply the theory if there is no serious undertaking to repay the loan within 10 years. Consequently, they will impose income tax on of the seller if the buyer does not repay the loan and the loan can also not be amortized with the dividends the acquired company pays out of the operative earnings realized after the closing of the purchase agreement.¹⁷⁷ Prior to the conclusion of the purchase agreement, a tax ruling from the Federal Tax Authority should be obtained to confirm that such financing does not lead to any taxation of the seller. The Federal Tax Administration will need to see a realistic business plan which shows that the loan granted by the company to the buyer can be repaid by the normal earnings of the buyer or later dividends of the company that are based on earnings realized after the closing of the purchase.¹⁷⁸

– ***Refinancing of the Purchase Price by Pledging Assets of the Acquired Company***

If the buyer secures a loan to finance the purchase price, by pledging the shares of the acquired company to the lenders, such pledge does not trigger any tax for the seller, as with such pledge no assets of the acquired company are transferred.¹⁷⁹ The pledge of assets in the sold company also, in principle, should not trigger the application of the theory of indirect partial liquidation as such pledge does not lead to a final transfer of

¹⁷⁷ Circular Letter Nr. 7 (Draft) of the Federal Tax Administration of February 14, 2005, p. 10.

¹⁷⁸ THA 2002, B. 24.4 Nr 63; ASA 72, p. 218.

¹⁷⁹ Some cantonal tax authorities, however, take the position that even such pledge may lead to the application of the theory of indirect partial liquidation as a third party who would purchase the shares in a forced sale by the lender could distribute preexisting reserves. Such an extension of the theory of indirect partial liquidation in our opinion has no legal basis as the forced sale by the pledgee is neither intended by the buyer nor the seller at the time the purchase agreement is concluded and the shares are pledged.

assets and reserves to the buyer. Like in the case of loans granted by the acquired company, such a pledge may, however, lead to the application of the theory, if it is clear that the buyer cannot repay the loan, and therefore, the pledged assets will have to be sold to cover the financing. To avoid taxation of the seller in such a financing structure, a pledge should only be made if, prior to the transaction, a tax ruling can be obtained from the tax authorities. As in the case of the refinancing of the purchase price by a loan of the acquired company, a positive tax ruling can normally only be obtained if the buyer can show on the basis of a reasonable business plan that he can amortize the loans taken out for the financing of the purchase with his earnings or the normal distribution of future earnings by the acquired company within a 10 years period of time.

– *Cooperation of the Seller in the Distribution*

A seller may be taxed, on the basis of the theory on indirect partial liquidation, only if he has cooperated to such partial liquidation. Active cooperation takes place when the seller has prepared the partial liquidation *e.g.*, by increasing liquidity and preparing the resolutions of the shareholders meeting which is the basis of the distribution of such liquidity to the buyer. Pursuant to art. 20a para. 2 DTA,¹⁸⁰ a scenario in which the seller did not actively prepare the distribution, but only tolerated it, will also lead to the application of the theory, if the seller knew or should have known, due to the transaction structure or the small equity base of the buyer, that the buyer would have to finance the purchase with the assets of the acquired company.¹⁸¹ Where a buyer has little equity, and where there is uncertainty whether the buyer will be able to refinance the purchase price from the future earnings and profits of the company within a reasonable time, the seller, in principle, has to assume that there is a high probability that the buyer actually has to finance the transaction with the assets of the company. The implementation of art. 20a para. 2 DTA has substantially lowered the threshold of "cooperation" and a court will most likely come to the conclusion that it was clear at the time of sale of the company that a dividend payout is necessary.

1.1.1.3 Sale to a Company Controlled by the Seller (Theory of Transposition / "Transpositionierung")

a) Concept

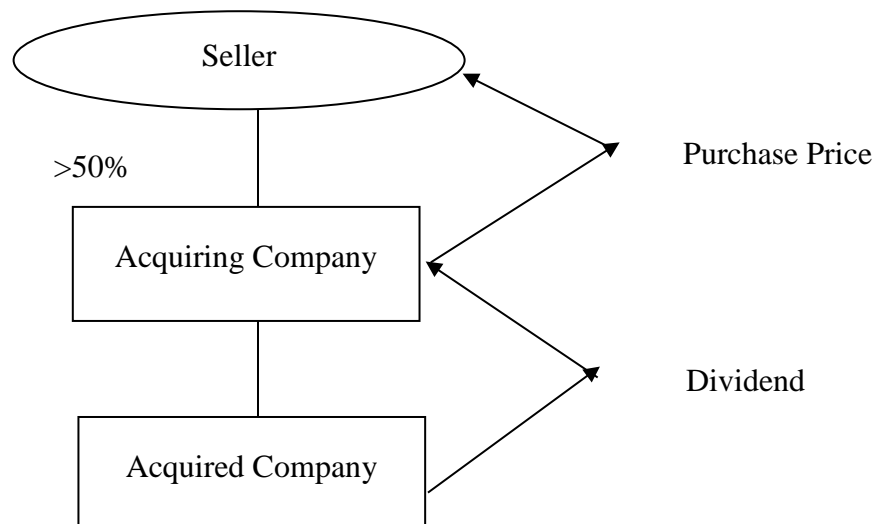
Transposition occurs when a private individual sells his shares to a company which he controls,¹⁸² at a price exceeding their nominal value; such a transaction is not perceived as a sale of shares but as a restructuring of the shareholders taxable assets with the result that reserves, subject to taxation on distribution, are converted into a tax-free repayment

¹⁸⁰ Art. 7a para. 2 THA, is formulated in the same manner with regard to cantonal taxes.

¹⁸¹ In the previous practice, this was considered "passive cooperation".

¹⁸² In the view of the tax authorities, the seller also controls a company if he controls such company jointly with other parties on the basis of a shareholders' agreement.

of a purchase price. The reason for taxation is that the seller, after such transaction, can cause the acquired company to pay out dividends to the new holding company which, due to the participation exception, can receive such dividends, without being taxed, and thereby repay the purchase price out of the reserves of the acquired company, without a tax charge on such reserves; further, the seller derives a tax-exempt capital gain. In such a transaction, the difference between the nominal value of the shares sold and the purchase price is taxed as income.



The transposition theory forms part of the theory of indirect partial liquidation, because in both cases, legally there is a purchase price payment, but the economic reality is that a dividend payout is made. Given that the seller controls the acquiring company, he is able to decide the amount of the distribution and when the distribution will be made.¹⁸³

b) Legal Requirements for Application of the Theory

Pursuant to art. 20a para.1 lit. b DTA,¹⁸⁴ only when the following conditions are fulfilled, will a transaction be subject to taxation:

aa) Sale of a Participation of a Minimum of 5%

The transfer of a participation in the capital in the company of at least 5% will be subject to tax. To determine the 5% threshold the share capital, not the voting rights, are determinant. Although the law does not clearly address this point, when the same seller performs several single transactions in a short period of time each of which is below the 5% limit but together they reach the 5% limit, the theory of transposition will most likely be applied to limit avoidance of the rule.

¹⁸³ With the Federal Act, art 20a para. 1 lit. B DTA and art 7a para. 1 lit. b THA where enacted, and have entered in force since January 1, 2007.

¹⁸⁴ Art. 7a para. 2 THA, is formulated in the same manner with regard to cantonal taxes.

Provided that the participation transferred by a private individual is below the 5% threshold, there will be no tax. This enables a private individual to sell such participations to a holding company controlled by the private individual for a price above the nominal value of the shares. Thereby, the private individual will be able to receive future distributions from the relevant shares through a steady payment of the purchase price free of tax. The disadvantage of such a strategy is that all future capital gains of the holding company will be subjected to direct federal tax¹⁸⁵ and distributions to the relevant shareholder will subject him to income tax. This may lead to a higher overall tax burden.

bb) Control over the Buyer

Only if the buyer owns at least 50% of the capital of the acquiring company will tax be levied. Again, the law focuses on 50% of the share capital and not 50% of the voting rights.

Pursuant to the provisions of art. 20 para. 1 lit. b DTA, the 50% can also be reached by formation of a group of shareholders, which transfer their share capital to a holding company which they control. Such a group of shareholders can be formed if the relevant shareholders have been given, on the basis of a shareholder's agreement or another similar agreement, for example, veto rights on important business decisions. There will be no control, if the seller obtains a participation that does not allow the seller to exercise any control over the buyer and if the parties do not conclude a shareholders' agreement which gives the seller the right to materially influence the buyer. A shareholders' agreement should regulate only a narrow number of issues such as the payment of a particular dividend.

cc) Purchase Price Exceeding the Nominal Value of the Transferred Shares and the Proportionally Transferred Reserves from Capital Contributions

Tax will only be applied if the consideration of the seller exceeds the nominal value of the shares sold. It is irrelevant in which form the purchase price is paid. The transposition theory will be applied even in a case where the contribution is in kind, *i.e.*, the seller does not actually sell his shares, but introduces, as consideration, the release of new shares, the nominal value of which is above the nominal value of the shares acquired. Using this method, the seller will be able to receive the reserves of the acquired company tax-free at a later point through a capital reduction in the acquired company.

Reserves from capital contributions which, pursuant to art. 20 para.1 *ciff.* 3 DTA respectively art. 7b THA, may be distributed free of tax will be treated the same way as nominal capital for the purpose of the theory, as those reserves may not be re-classified as taxable distributions even in light of the theory. For this reason, when calculating the taxable gain, consideration has to be given to both the nominal value of the transferred shares and the reserves from capital contribution relating to these shares.

¹⁸⁵

The participation exemption cannot be applied as the threshold required for its application is 10%.

The requirement that the purchase price has to exceed the par value of the sold shares leads to the avoidance of taxation on the establishment of a holding structure. If a private individual forms a holding company on the basis of preexisting equity shares, or would like to transfer his equity share to an already existing holding company, there will be no tax consequences if the consideration is a payment, or a share amount, which is lower than the nominal value of the transferred shares and the proportional amount of reserves from capital contribution. For the company which receives the relevant reserves to be able to account for the value of the contribution with corresponding own capital, the company may activate the transferred shares to their fair market value and book the difference between the purchase price and the fair market value as agio-reserves. Although these reserves are derived from capital contributions, they are not subject to the provisions of art. 20 para. 1 *ciff* 3 DTA respectively art. 7b THA, and therefore, not tax-free distributable reserves. These reserves are to be booked as "residual" reserves. This book entry will not allow the buyer to obtain the reserves of the sold company without a tax consequence, and therefore, this course of action will not lead to the imposition of tax based on the theory.

c) Sale of Shares to a Company Controlled by the Seller's Heirs

In a circular letter dated July 17, 1997, the Federal Tax Administration has extended the application of the transposition theory to the sale of shares to a holding controlled by the heirs of a seller. According to such circular letter, in such cases the difference between the sales price and the nominal value of the shares sold should be subject to income tax. This circular letter, which was not applied by the majority of the cantons in relation to cantonal tax, was withdrawn by Circular Letter Nr. 7 of February 14, 2005, on the basis of the decision of the Federal Supreme Court of June 11, 2004. Art. 20 para. 1 lit b DTA cannot be applied to a company which is controlled by the heirs of the seller, as the article requires, for the application of the transposition theory, that the acquired company is controlled by the seller himself. The purchase through an heir-holding is only subject to the theory of indirect partial liquidation.

1.1.1.4 Sale of Shares Held as a Business Asset of the Seller

If a private individual holds the shares as a business asset prior to their sale, the gain realized on the sale, *i.e.*, the difference between their sales revenue and the tax relevant book value, will be considered gain from self-employment. Furthermore, the gain will also be subject to social security contribution in the amount of 9,8%¹⁸⁶ so that the total charge on such gain is very high. After deducting the social security contribution, the remaining income will be subject to income tax on income derived from self-employment.¹⁸⁷ The combination of social security contributions and income tax lead to a high overall burden on the earnings.

¹⁸⁶ If the income exceeds CHF 77,400, the capital contribution will represent the tax, as the contribution will not lead to a pension increase.

¹⁸⁷ Art 18 para. 2 DTA, art 7 para. 1 THA.

Shares are considered business assets of a private person if such a person conducts business as a sole proprietorship or as a partnership and the shares are recorded as assets in the accounts of such businesses. Even if the shares are not recorded in the accounts of the business, they will be considered as business assets if there exists a functional connection between the shares and the business activities of the sole proprietorship or the partnership, or if such shares otherwise served such business as *e.g.*, they have been pledged for loans taken out for the business. Close business relations between the sold company and the relevant sole proprietorship or partnership also create such a connection.

This problem, whether assets form part of the private or business assets, can be avoided by incorporating the sole proprietorship or partnership in to a corporation or limited liability company, prior to the sale of the participation, and to keep the participation as a private asset. After the expiration of a five year period, the seller will be able to sell the participation without a tax consequence, as the seller no longer holds any business assets.

An individual, who conducts business as a sole proprietorship or partnership, is advised to obtain a private tax ruling before selling his participation in a company. The practice in this regard is not always clear, and the decision of the tax administration is not always as expected.

1.1.1.5 Individuals Treated like a "Semi-Professional Security Trader"

Pursuant to the practice of the Federal Supreme Court, a private person will be subject to tax on income derived from self-employment activities, if the person buys and sells assets, in particular, shares and participations, and where his actions are not considered "simple administration" of private assets; instead, he is considered to "act systematic and with the goal of making a profit".

If a private individual is seen as pursuing self-employment business activities rather than simple asset administration, he will be treated like a "semi-professional security trader". The profit will be subject to income tax and to social security contributions.

The wording of the formula has been criticized, as it is the goal of every successful investor to make a profit. For this reason it is not surprising, that this rule has not very often been put to practice by the Federal Supreme Court.

The court will evaluate the following points in making its determination on "act systematic and with the goal of making a gain":

- systematic and planned method of investments;
- use of special expertise / relationship between the investment activity and profession;
- use of substantial loans;
- reinvestment of the realized profits in similar assets.

To avoid uncertainty, the Circular Letter Nr. 8 of June 21, 2005, has provided clear criteria for the determination of the "semi-professional securities dealer", as follows:

1. *The holding period of the realized securities is at a minimum one year.*
2. *The transaction volume (sum of all purchases and sales) each calendar year, is together no more than five times the balance of the securities at the beginning of the tax period.*
3. *The realization of gain from the securities dealings is not a necessity for living; this is generally the case, if the realized capital gains are less than 50% of the entire income of the tax period.*
4. *The transactions are accessible to all investors and have no relation to the profession or to specific expertise.*
5. *The investments are not financed through a loan or the taxable income from securities (e.g., interest, dividends etc.) is larger than the interest to be paid back on the loan.*

Based on this criterion a court will decide if a private individual has satisfied the threshold to become a semi-professional securities dealer.

1.1.1.6 Sale of a Real Estate Company

If an individual person sells a real estate company, *i.e.*, a company or limited liability company whose actual purpose is to hold and manage real estate, such a sale will, pursuant to art. 12 para. 2. lit. THA, for the purpose of the cantonal real estate gain tax and real estate transfer tax, be regarded as a transfer of real estate so that such tax will be levied on the transaction. In such cases, however, neither cantonal income tax, nor federal income tax nor social security contributions will be charged. Federal income tax and social security contribution would, however, be levied if the transaction would have to be regarded as a business activity.

If a company is sold that conducts an operative business and at the same time owns real estate, such a transaction cannot be considered as indirect transfer of real estate, even if the real estate is the main asset of the company. The reason is that the theory applies only if the company has no other operational business, apart from holding the real estate. If the company has only minimal operative activities, the seller should, before entering into a transaction, obtain a private tax ruling on the characterization of the company as in certain cases, where the operative business was minimal, the cantonal tax authorities have re-characterized an operative company as a real estate company.

The rules on the taxation of real estate companies also apply when the company has an operative business at the time of closing of the transaction and the buyer liquidates such operative business immediately after the purchase; the company becomes at the liquida-

tion a real estate company. In such a case, the tax authorities would assume that the seller knew of the plan and sold the company with its operative business only to avoid the tax applicable on the sale of the real estate company. In view of this practice of the tax authorities, a seller who sells a company that owns valuable real estate should include a provision in the purchase agreement which obliges the buyer to continue the operative business for a certain period of time, if the value of a company would be positively influenced by discontinuing its operative business.¹⁸⁸

1.1.1.7 Sale of a Company with Liquid Assets

If a private individual sells a company whose assets consist mainly of cash or securities and which does not have an operative business, the sale will be regarded as a circumvention of the tax on liquidation proceeds, and the difference between purchase price and nominal value of the shares sold will be taxed as income of the seller. Such taxation usually prevents a private individual, who owns an operative company, to first sell the business of such company in an asset deal, and then sell the company that holds the sales proceeds; such sale would be taxed in the same manner as a liquidation of the company. In addition, stamp duty may fall due should the sale be deemed to be followed by an incorporation of a new company.¹⁸⁹

Reserves from capital contributions will not be subject to withholding or income tax, pursuant to art. 20 para. 1. *ciff.* 3 DTA respectively art. 7b THA.

1.1.2 Companies as Sellers

1.1.2.1 Taxation of the Capital Gains

If a Swiss company sells a participation in another company, it realizes a taxable gain in the amount of the difference between sales price and book value of such participation. Such gain is subject to cantonal income tax, as well as the federal income tax. If the company that is selling the shares is a holding or domiciliary company, it will be exempt from cantonal income tax and such gain will be subject only to federal income tax at the rate of 7,8%.¹⁹⁰ If the company fulfills the requirements for participation relief to applied *i.e.*, the sale of a participation of at least 10%, which was held for more than one year, it will be to reduce tax.

Investment capital, *i.e.*, capital on dividends and other distributions which reduce the company's participations, is subject to the same tax as the capital gains, *i.e.*, cantonal capital gains tax and federal direct tax. A company which meets the requirements of the par-

¹⁸⁸ A tax ruling should be obtained on how long the operative business should be continued, before liquidation may be undertaken.

¹⁸⁹ Pursuant to art. 69 DTA, the participation has to be capital share participation; alternatively, it may be participation with regard to the gain or reserves.

¹⁹⁰ The nominal tax rate amounts to 8,5% pursuant to art. 68 DTA. As according to art. 59 para. 1 lit. a DTA, the taxes paid can be deducted as an expense from income, and the effective tax rate after such deduction amounts to 7,8%.

ticipation relief, *i.e.*, the capital participation is at minimum 10% or has a fair market value of CHF 1 million, will be able to reduce tax.¹⁹¹

When a company is the seller the tax situation is very different, than when a private individual is the seller: investment capital and capital gains are taxed in a similar way. Contrary to the situation with a private individual as the seller, there is no pressure to structure the transaction in such a way as to avoid distributions and maximize the accrued capital gain. It is often attractive for a company selling a business in a share deal to structure this sale in such a way that in a first step all accrued reserves are distributed to the seller as a tax-free dividend and the taxable purchase price is reduced accordingly.

1.1.2.2 Participation Relief on Capital Gains

If the conditions of the participation relief set forth below are fulfilled, the exemption also applies to capital gains, so that only a fraction¹⁹² of such capital gains are taxed.¹⁹³

The participation exemption applies only if the following conditions are met:

– ***The Sales Proceeds Must Exceed the Acquisition Costs Paid by the Seller.***¹⁹⁴

The acquisition costs are equal to the purchase price paid and any later investments in the participation, such as payments made for additional shares in a capital increase or any other contributions made to the company.¹⁹⁵ The acquisition costs will, in addition, be received by appreciation, pursuant to art. 670 CO, as these are fully taxed. Acquisition costs are calculated without taking into account any later write-offs and depreciation of the participation or any provisions established for such participation. If a sale allows the seller to recuperate such depreciation or to dissolve provisions previously established, such part of the gain is normal income and cannot benefit from participation relief.¹⁹⁶

– ***The Participation Sold Must Amount to at Least 10% of the Capital of the Company.***¹⁹⁷

For participation relief to apply to dividends, it is sufficient if the participation has a fair market value of at least CHF 1 million or if it amounts to 10%. The participation

¹⁹¹ See chapter F.1.1.2.2 below.

¹⁹² Usually 5%.

¹⁹³ The new rules introduced with the tax reform act only apply to federal taxes. The cantons may, however, according to art. 28 para 1 lit. THA, adopt analogue rules for their taxes. The canton of Zurich has opted such rules with effect as of January 1, 2001. Other cantons which have not yet changed their cantonal tax acts often apply their normal rules on participation exemptions to capital gains.

¹⁹⁴ Art. 70 para. 4 lit. a DTA.

¹⁹⁵ Circular Letter of the Federal Tax Administration Nr. 27 of December 17, 2009, *ciff.* 2.5.1.

¹⁹⁶ Art. 62 para. 4 DTA.

¹⁹⁷ Art. 70 para. 4 lit. b DTA.

relief applies to capital gains only if the equity share amounts to 10% of the capital of the company. Furthermore, the participation exemption applies only if 10% or more of the capital is sold, the sale of a smaller part leads to taxable income; whereas, several sales in the same accounting year will be combined together.¹⁹⁸

In cases, where the participation amounts to less than 10%, the relief can be applied to each subsequent capital gain, if at the end of the tax year prior to the sale, the participation rights had a fair market value of CHF 1 million and previously a participation of at least 10% was disposed of.¹⁹⁹ This has the result, that a company with a large equity share which sells 10% of the share and which receives an investment deduction, *i.e.*, participation relief, but which still holds a participation of 10%, will be able to obtain another participation relief, so long as the remaining participation exceeds the minimum amount of CHF 1 million at the beginning of the relevant tax year.²⁰⁰ Pursuant to the practice of the Federal Tax Administration, the rule is valid for the sale of a participation of 10% or more, whereby the overall participation fell under 10%, which occurs only after December 31, 2010. With a sale prior to December 31, 2010, a participation of 10% will remain and no participation relief can be applied to the sold remaining participation.²⁰¹

– ***The Seller Must Have Held the Participation at the Time of Sale for at Least One Year.***²⁰²

The application of the participation relief has the consequence that the total tax paid by the seller is reduced as follows:

$$\begin{array}{l} \text{Taxes after participation relief} = \\ \text{Taxes on net profit prior} \\ \text{to participation relief} \end{array} \times \left(1 - \frac{\text{Net participation amount}}{\text{Net profit}} \right)$$

Prior to the application of the participation relief, the net profit of the participation, according to art. 70 DTA, is equal to the profit derived from such participation (*i.e.*, dividend and sales proceeds) minus interest charges contributable to the participation and minus 5% administration cost.²⁰³ Interest charges are interest paid by the company plus other expenses which economically have the same function, *e.g.*, the cost of repo-

¹⁹⁸ Circular Letter of the Federal Tax Administration Nr. 27 of December 27, 2009, *ciff.* 2.4.2.

¹⁹⁹ Circular Letter of the Federal Tax Administration Nr. 27 of December 27, 2009, *ciff.* 2.4.3.

²⁰⁰ This rule is only applicable if the remaining participation is below 10%; if it is above 10% after the first sale, then at the second sale a minimum of 10% have to be sold to be able to profit from the exemption.

²⁰¹ Circular Letter of the Federal Tax Administration Nr. 27 of December 27, 2009, *ciff.* 2.4.3.

²⁰² Art. 70 para. 4 lit. b DTA.

²⁰³ If the company can show that administration costs are below 5%, such percentage can be lowered.

transactions. To calculate the interest costs attributable to the participation, total interest charges of the company must be allocated proportionately to all assets. From the net profit from the participation, the amount of any depreciation and provisions established for such participation in the same year will be deducted.

1.1.3 Seller Incorporated Outside of Switzerland

1.1.3.1 *Gain on Disposal*

If a seller is incorporated outside of Switzerland, the gain he realizes on the sale of shares in a Swiss company is not subject to Swiss income tax. The taxation of the gain is subject to the tax laws applicable to the country of incorporation of such foreign seller. Switzerland would, however, tax a seller incorporated outside of Switzerland, if he has a permanent establishment in Switzerland and the shares are assets attributable to such a permanent establishment, pursuant to both Swiss tax laws and to relevant double taxation agreements. If a foreign company, however, sells a real estate company,²⁰⁴ the canton in which the real estate is located may levy real estate gain tax and real estate transfer tax, if such taxation is not excluded by a tax treaty between Switzerland and the country where the seller is resident. The fact that the seller is outside the reach of the cantonal tax authorities will not hinder tax authorities to levy the tax as they have a first lien on the real estate to secure such tax. A buyer of a company holding real estate, has to pay attention to whether the foreign seller has paid real estate transfer and real estate gains tax.

1.1.3.2 *Distributions*

Since dividend and liquidation proceeds are subject to Swiss withholding tax,²⁰⁵ foreign sellers, contrarily to Swiss companies who sell participations, are normally interested in structuring a sale in such a way that the distribution of dividends and liquidation proceeds can be avoided. A foreign seller should not only avoid structures which provide for the direct payment of dividends or liquidation proceeds, but any structure where the purchase price directly or indirectly is paid by the means of the sold company.²⁰⁶

1.1.3.3 *Taxation by the Country of Incorporation of the Seller*

If a person or entity resident outside of Switzerland sells shares in a Swiss company, it is always important to carefully analyze the tax rules applicable in the country in which the seller is incorporated. If a favorable tax treaty exists between such a country and Switzerland, it is often possible to optimize the taxation of the transaction to a considerable extent.

²⁰⁴ Cf. chapter F.1.1.1.6.

²⁰⁵ The foreigner may recuperate part of such withholding tax in accordance with the applicable double tax treaty between Switzerland and the country of the foreign seller's domicile.

²⁰⁶ Cf. chapter F.1.1.1.2 on the indirect partial liquidation above.

1.1.4 Stamp Duty

If the seller, the buyer or an intermediary is a security dealer as defined in the STA,²⁰⁷ the sales price is subject to stamp duty which amounts to 0,15% of the purchase price where shares of a Swiss company are sold, and to 0,3% if shares of a foreign company are sold. Not only banks and professional security dealers are considered security dealers for the purpose of the STA; according to art. 13 para. 3 lit. d THA, any company which according to its last annual balance sheets owns securities²⁰⁸ with a book value of more than CHF 10 million is considered to be a security dealer.

1.1.5 VAT

No value added tax is levied in a share deal as the sale of securities is exempt from value added tax.²⁰⁹

1.2 Taxation of the Seller in an Asset Deal

1.2.1 Private Individuals as Sellers

1.2.1.1 *Gains Subject to Income Tax / Deduction of Social Security Contributions*

If a private individual sells a business held through a sole proprietorship or in a partnership, the gain he realizes²¹⁰ is subject to cantonal capital gains tax and federal income tax, pursuant to art. 18 para. 2 DTA respectively art. 8 para. 1 THA.²¹¹ In addition, the gain is also subject to social security contributions which are levied at the rate of 9,8% as the gain is considered as earned income.²¹² In view of the fact that the gain is not only subject to income tax but also to social security contributions, the total amount of tax charged to the seller is prohibitively high.

When an entity is the buyer, the entity will be able to balance part of the tax disadvantages with its tax advantages, as the buyer will be able to charge his interest cost to the pre-tax earning of the acquired business and also to amortize the purchase price (including goodwill) against the income of the acquired business.²¹³ Such tax advantages justify

²⁰⁷ Cf. art. 13 para 3 STA.

²⁰⁸ The notion of securities encompasses short term holdings of securities, as well as, long term holdings and all participations in other companies.

²⁰⁹ Art. 18 *ciff* 19 lit e VAT.

²¹⁰ Such gain is equal to the purchase price plus any debt taken over by the buyer minus the book value of the assets sold.

²¹¹ If real estate is sold as part of the assets, in many cantons the real estate gain tax will be levied instead of cantonal income taxes.

²¹² The social security contributions paid can be deducted from the taxable income.

²¹³ If a company is acquired in an asset deal, the buyer can enter the assets he has acquired in his books at their fair market value. The difference between such fair market value on one hand and the total of the debt assumed in the transaction and the price paid on the other hand, can be entered as goodwill. The goodwill, as well as, the value of the assets can be depreciated by the buyer with the depreciation charges being deducted from pretax earnings which include the earnings of the company he has acquired.

the payment of a higher price which partially compensates the seller for the disadvantages he suffers. The tax advantages of the buyer, however, are considerably smaller than the tax burdens incurred by the seller, as the seller has to pay the tax in the next tax year, whereas the buyer will only enjoy the advantages of higher depreciation over a number of years so that such tax advantages have to be discounted. Furthermore, the income tax of private individuals, together with social security contributions, are significantly higher than the tax a company has to pay so that the seller in any event pays higher tax than the buyer will save through increased depreciation.

1.2.1.2 Relief in Cases of Retirement or Invalidity from Self-Employment Activities

If the seller on the sale of his company retires from self-employment, due to having reached the age of 55 years or having become incapacitated, the gain realized in the previous year, as well as the hidden reserves, will be subject to tax on the sale separately.

1.2.1.3 Incorporation of a Business into a Company

The sale of a business by a private individual in an asset deal is a sub-optimal tax structure making the sale unattractive. To avoid the high tax associated with an asset sale transaction, it is advisable to convert, prior to the sale, a sole proprietorship or a partnership into a company.²¹⁴ Although the seller realizes a tax-free capital gain when he later sells the shares of the company such a conversion can be made at book value, *i.e.*, on a tax-free basis. A later sale of the shares leads to a tax-free capital gain only if such sale takes place at least five years after the conversion of a sole proprietorship or a partnership into a company.²¹⁵ This conversion from sole proprietorship or partnership to a corporation, therefore, cannot be made shortly before an intended sale, but has to be undertaken as a long term project.

1.2.2 Companies as Sellers

1.2.2.1 Tax on the Gain

A company will be the seller if it sells part of its business in an asset deal. The gain it realizes is subject, pursuant to art. 58 DTA respectively art. 26 THA, to cantonal capital gain and federal income tax.²¹⁶ The gain is equal to the difference between the purchase price and any debts assumed by the buyer on one hand, and the book value of the assets sold on the other hand. If part of the assets sold consists of real property, the gain realized

²¹⁴ See Circular Letter Nr. 5 of the Federal Tax Administration of July 1, 2004, p. 20ff.

²¹⁵ If a taxpayer sells his participation in the relevant company within five years, the hidden reserves, which were not used in the transfer of the business to a company, will be subject to tax, pursuant to art. 19 para. 2 DTA, respectively art. 8 para. 3^{bis} THA.

²¹⁶ The cantonal income taxes are reduced or eliminated if the company that sells the company enjoys a tax privilege. Since a fully operative company that has a company with assets normally cannot qualify for the privileged status of a holding or auxiliary company, asset sales are usually subject to full cantonal taxes. An exception is auxiliary companies who enjoy tax privileges as they are mainly active within a group of companies in an auxiliary function and mixed companies whose customers are located outside Switzerland; these companies, in spite of their business activities in Switzerland, are exempt from cantonal taxes.

on the sale of such property is not subject to income tax in several cantons, but to a special real estate gains tax.

1.2.2.2 *Compensation in the Form of Depreciation*

If the gain realized cannot be offset, in the same or a previous taxation period, with a tax loss carryforward, the tax can only be reduced if the tax authorities allow the seller to use such a gain for extraordinary depreciation of other assets. Although the sellers normally will have no right to such extraordinary depreciation, it is sometimes possible to negotiate a positive solution with the tax authorities.

1.2.2.3 *Roll-over Relief*

Pursuant to art. 64 para. 1 DTA respectively art. 24 para 4 THA, a company realizing a gain from the sale of fixed operationally necessary assets can transfer the gains to newly acquired fixed assets, so long as these are also operationally necessary and located in Switzerland. This rule can also be applied to the sale in a share deal. If, after the sale, the seller in turn acquires operationally necessary fixed assets, the seller can transfer the hidden reserves which are realized to the new assets. For this purpose, the newly acquired fixed asset will, immediately after the purchase, be depreciated by the previously realized gain.

1.2.3 Seller Incorporated or Resident Outside of Switzerland

If a seller, who is resident or incorporated outside of Switzerland, sells a business located in Switzerland in an asset deal, the same tax rules apply as in the case where an individual person or a company located in Switzerland sells a business as a permanent establishment. Switzerland subjects the owner to tax on all earnings attributable to such permanent establishment and since the gain from the sale of the business must be allocated to such permanent establishment, will also tax such gain.

1.2.4 Stamp Duty

If a business is sold in an asset deal, the stamp duty is only levied if securities are sold as a part of the assets and if either the seller, the buyer or an intermediary is a security dealer for the purpose of the STA.²¹⁷

1.2.5 VAT

In an asset deal, the seller has to charge and to deliver VAT on all assets that are not exempt from VAT, such as securities or liquidity. Such VAT is usually added to the purchase price and can be deducted by the buyer in the next VAT return he files. If the VAT paid in the asset deal exceeds the VAT obligations of the buyer in a given quarter, the excess will be repaid to the buyer. Therefore, VAT does not lead to a final charge but rather must be considered as a liquidity issue as the seller must pay a purchase price that is 7,6%

²¹⁷ As defined in art. 13 para 3 STA. Cf. chapter F.1.1.4 above.

higher than the price agreed and can recuperate such surcharge only after having filed his own VAT return.

According to art. 47 para. 3 of the VAT Act, no VAT has to be paid if all the assets that constitute a business are transferred in connection with a restructuring, a merger or the formation of a company,²¹⁸ but the parties just have to file a notification with the Federal Tax Administration.²¹⁹ Unless major assets of the business are kept by the seller, most asset deals qualify for the notification procedures. It is, however, recommended to discuss the issue with the Federal Tax Administration before the transaction is carried out and to obtain a private ruling on the application of the notification procedure.

²¹⁸ In such cases, the parties just have to file a notice with the federal tax authority.

²¹⁹ See "MWST-Info 11, Meldeverfahren" EStV Hauptabteilung MWST, January 1, 2001.

2. TAX CONSIDERATIONS FOR THE BUYER

- *The Buyer has the following goals when structuring the purchase of a business:*
 - *Tax optimisation during the period of ownership of the business: deduction of financing costs from the taxable profit, depreciation of the business against taxable profit, continued use of tax loss carryforward;*
 - *Tax optimisation for a later sale: tax-free sale of the business.*
- *A regular depreciation of the purchase price against the taxable profits of the business is only possible if the business was acquired in an asset deal. For a business acquired in a share deal, depreciation is only possible if the buyer can prove that the value of the company acquired has actually deteriorated.*
- *The buyer can deduct the interest costs on loans he has taken out to finance the purchase from his own taxable income. If the buyer is company that is financed by associated persons (shareholders or companies pertaining to the same group of companies), the extent of the loan financing, as well as the interest rate that can be charged are limited. Any interest in excess of such limits cannot be deducted.*
- *If a buyer buys a company with tax loss carryforward, the acquired company may use such losses also after its purchase. If a buyer buys a business in an asset deal, the tax loss carryforward remains with the seller and cannot be used by the buyer after the purchase.*
- *If a buyer is a company, it should structure the purchase in such a way that it can later sell the business in a share deal and take advantage of the participation exemption. A private individual, on the other hand, should structure the purchase in such a way that he holds shares that he can later sell in a share deal and achieve a tax-free capital gain.*

2.1 Goals of the Buyer

The purchase of a business normally does not trigger any immediate tax consequences for the buyer. However, when structuring the transaction, the buyer will be concerned to minimize the tax charges for the future. The buyer will have the following two goals:

- **Tax Optimisation during the Period of Ownership of the Business by the Buyer**

The buyer's first aim is to minimize the tax consequences during the time in which he owns the acquired business. This means, in particular, to charge the costs incurred during the purchase transaction and any depreciation on the purchase price against taxable income of the acquired business and, if possible, to use tax loss carryforward by the acquired business.

- **Tax Optimisation for a Later Sale by the Buyers**

A buyer, who does not intend to hold a business for a long time but rather has the goal to sell the business for profit after a few years, will want to find a structure to resell the business with little or no tax exposure.

Depending on which of the two goals mentioned above is more important to the buyer, a different tax optimisation strategy is followed. An industrial buyer who purchases a business to strengthen its own business will emphasize the tax optimisation for the period it owns the business, whereas for a financially-oriented buyer who intends to resell the business at a profit within a relatively short period of time, the tax optimisation of the later sale is at least as important as the tax optimisation during the period it owns the business. As business strategies, however, may change over time and as external factors sometimes make it necessary to make changes, it is advisable that the industrial buyer also chooses a structure which does not lead to the imposition of a large tax in case of a later sale.

2.2 Taxation of the Buyer during the Period of Ownership of the Business

2.2.1 Depreciation of the Purchase Price

Whether it is possible to depreciate the purchase price against the taxable income depends primarily on the transaction structure:

2.2.1.1 *Depreciation in a Share Deal*

a) Private Individuals as Buyers

If a private individual buys shares of a company with his private assets, he may not take any depreciation charges against the taxable income, because private assets may not be depreciated under Swiss tax laws.

If a private individual purchases shares with his business assets or if the acquired shares later become business assets, he may take depreciation charges against his taxable income only if he can prove that the value of the company acquired has permanently diminished because the earnings from the company are much lower than expected, or negative factors have occurred so that the valuation which justified the payment of the purchase price cannot be defended any more. In such circumstances, where a third party would pay a much lower purchase price than the purchase price paid by the buyer, depreciation is possible. Therefore, depreciation for an acquired business has to be justified in any case with a subsequent loss of value. However, the mere fact that the buyer has paid for goodwill, *i.e.*, that the price paid exceeded the equity of the acquired company, is not sufficient to justify depreciation.

b) Companies as Buyers

If a company purchases another company in a share deal, the same rules apply with respect to depreciations of and provisions on the purchase price paid as for the purchase by a private individual who holds the shares of the acquired company as business assets:

– Depreciation only in Cases of Actual Loss of Value

If a company purchases another company in a share deal, the acquiring company may depreciate the price paid only if it can prove that the value of the acquired company has permanently diminished. The mere fact that it has paid for goodwill is not sufficient to justify depreciation charges, as the acquiring company cannot plan for depreciation at the time of purchase (an unwanted value loss of the company cannot be planned for).

The tax status of the buyer determines whether depreciation of the purchase price actually leads to a tax relief. If the buyer is a holding company without taxable income,²²⁰ depreciation of the purchase price will not reduce tax since the company has no taxable income which could be reduced. The depreciation charges will only marginally reduce tax payments where the buyer, *e.g.*, a holding company with interest income, has taxable income only for the purpose of federal tax but, due to the holding

²²⁰ A holding company has no taxable income, if it has only dividend income or capital gains sheltered by the participation exemption; due to its privileges as a holding company, it does not pay any cantonal income taxes, and due to the participation exemption on dividends also no federal income taxes.

privilege, does not pay any cantonal tax. Therefore, the depreciation in such cases will reduce the federal tax only. Depreciations of participation will lead to a sizable reduction of tax charges only in cases when the buyer is a fully taxed operative company. However, even in such cases, there will be no reduction of tax charges, if the acquired company pays a dividend that is not taxed due to participation relief. In such a case, the depreciation will be primarily deducted from such dividend and cannot be off-set against the taxable income.²²¹

– ***Reversal of Depreciation***

Should the value of the company, after the purchase price has been depreciated, increase again *e.g.*, due to an increase in earnings, the tax authorities, may, according to Art. 62 para 7 DTA and art. 28 para. 1^{bis} THA, reverse the earlier depreciation and consequently increase the taxable income if the participation of the buyer amounts to more than 10% of the capital of the company concerned.²²² Therefore, depreciation on a company acquired in a share deal, often does not lead to a permanent decrease of the taxable income.

– ***Deduction of a Merger Loss***

From an accounting the point of view, a merger between the buyer and the acquired company, at book value, appears to be an alternative to the depreciation of goodwill, as it will lead to a merger loss which minimizes the earnings of the buyer. If the share purchase price, entered into the buyer's balance sheet, is higher than the equity of the acquired company, then the difference between the book value of the participation and the equity must be treated as a merger loss which is either set off against the equity of the acquired company or activated as goodwill and depreciated.²²³

However, according to the practice of the tax authorities, neither a merger loss, nor the depreciation of goodwill can be deducted from the buyer's taxable income. In their opinion, the value of the acquired company has not changed between the time it was acquired and the merger, and the fact alone that the price paid exceeded the equity of the acquired company does not justify the depreciation. Therefore, a merger loss is only tax deductible, if the company proves that it has actually permanent loss in value since the merger and that, therefore, depreciation is possible. This shows that the merger of the buyer and the acquired company leads to the same result subjecting the participation to depreciation: in both cases a permanent loss in value has to be established.

²²¹ In the case of a substantial distribution, depreciation and distribution occur, *i.e.*, when a large amount of assets are distributed, it will lead to a reduction of the value of the company. *Cf.* chapter F.1.1.2.2. above.

²²² In case of such a reversal of depreciation, the tax book value of the participation concerned increases by the amount of the depreciation made.

²²³ This will occur, if due to the net value, which is above the net assets value, a goodwill is paid or a company shows hidden reserves which are satisfied in the purchase price.

The fact that goodwill was acquired does not suffice. Therefore, the merger loss does not lead to an indirect depreciation of the purchase price.

If a buyer planning a merger intends to charge a part of the merger loss to its taxable income, because the acquired company has permanent loss in value, it is advisable to first discuss the transaction with the tax authorities in order to obtain a tax ruling. In cases where the merger is carried out immediately after the purchase, the authorities will assume that, due to the short time period, the company cannot have suffered a permanent loss in value, and a positive tax ruling will be difficult to obtain.

2.2.1.2 Depreciation in an Asset Deal

If a business is acquired in an asset deal, the buyer will recognize the total purchase price in its balance sheet by entering onto the balance sheet the assets that have been acquired at their fair market value and by entering the difference between the total fair market value of such assets and the purchase price paid (plus the amount of any liabilities taken over) as goodwill.²²⁴ The goodwill can, in such a situation, be depreciated against the taxable earnings within five to ten years. The assets that have been entered at their fair market value can be depreciated in accordance with the depreciation rates available for the assets concerned. The buyer in an asset deal may depreciate the whole purchase price against his operative earnings of his other businesses or of the acquired company itself.²²⁵ Therefore, the tax treatment of an asset deal is much better for the buyer than the tax treatment of a share deal. As shown in chapter F.1.2 above, in an asset deal the seller suffers hefty disadvantages as he has to pay tax (and in case of a private individual also social security contributions) on the whole difference between the purchase price and the tax book value of the assets sold. These disadvantages usually outweigh the tax advantages for the buyer.²²⁶

2.2.2 Tax Treatment of Interest Deductions

2.2.2.1 Private Individuals as Buyers

If a private individual purchases a business and for such purpose finances a part of the purchase price with loans, he can, in principle, deduct the interest from his income. This applies to both share and asset deals.

If a private individual purchases a business in an asset deal or if he buys shares for his business assets, the interest deduction will be unlimited for the financing of business as-

²²⁴ This accounting principle is applicable independent of whether the buyer is a private individual or a company. If a private individual directly purchases a company in an asset deal, the business becomes part of the business assets of such private individual which in fact enables also the private individual to take depreciation charges.

²²⁵ The part of the purchase price which is allocated to land cannot be depreciated, as land is not subject to the regular depreciation rules, but can only be depreciated if the owner proves that the fair market value has dropped below the tax book value.

²²⁶ The purchase of a business through an asset deal leads in practice to disadvantages for the seller which outweigh the advantages for the buyer, since the buyer realizes the taxable income immediately, but the seller's advantages only materialize after several years.

sets. If a private individual, however, buys shares that become part of his private assets,²²⁷ interest deductions according to art. 33 para. 1 lit. a DTA and art. 9 para. 2 lit. a THA are limited to the amount of the income from movable and immovable assets plus CHF 50,000. The buyer can avoid such limitation if he purchases a participation of more than 20% in a company and declares such participation as a commercial asset.²²⁸ Such election has, however, the consequence that any gain realized on the sale of these shares will be subject to income tax as well to social security contributions.²²⁹

2.2.2.2 Companies as Buyers

a) Deduction of Interest Expenses

If a company purchases another company, then the acquiring company can deduct the interest paid on loans, taken out for the financing of such purchase, from its taxable income. Loans are any amounts a third party puts at the disposal of the company, if such third party has a legal right to repayment of the amount. Loans which participate in the business risk are also regarded as loans for these purposes. Subordinated loans, loans with interest payments that depend on earnings and loans with an equity kicker are also considered as loans on which the interest payments are deductible.

The tax deductibility on the interest of loans has, however, no practical value if the buyer has no taxable income but only dividend income which, due to participation relief is, for practical purposes, tax-free. Therefore, if possible, it is advisable to acquire companies with an acquiring company that has taxable earnings since only in such a case will the deduction of interest payments actually lead to a decrease in tax.²³⁰

b) Limitations on the Deduction of Interest Expenses

So long as loans to a company are granted by third parties, the deductibility of the interest charges, irrelevant of the amount of the loans and the interest rate to be paid, cannot be disputed.

Loans to a company which is the buyer and which is granted the loans by its shareholders or persons and companies affiliated with the shareholders (*e.g.*, finance companies belonging to the same group), cannot exceed, according to art. 65 DTA and art. 24 para. 1 lit. c THA, the limits set for financing by a third party. The Swiss Federal Tax Administration has on the basis of Art. 75 DTA issued a Circular Letter²³¹ which clarifies the Federal Tax Administration's view on the maximum loans normally agreed by third par-

²²⁷ In an asset deal, the business automatically becomes part of the business assets; therefore, an acquisition of a business as a private asset is not possible.

²²⁸ Art. 18 para. 2 DTA and art. 8 para. 2 THA.

²²⁹ Cf. chapter F.1.1.1.5

²³⁰ For a later sale, the purchase with a fully taxable company has no disadvantages since also such a company can shelter a profit from the sale with the participation exemption and, thus, can realize a tax-free gain.

²³¹ Circular Letter No. 6 of June 6, 1997.

ties. Pursuant to such Circular Letter, for companies engaged in manufacturing, services or trade, the following limits apply (maximum loans as percentage of the assets concerned):

- Cash: 100%
- Receivables: 85%
- Stock: 85%
- Other current assets: 85%
- Bonds: 80-90%
- Participations: 70%
- Loans to third parties: 85%
- Plant and equipment: 50%
- Real estate: 70-80%
- Formation and organization costs: 0%
- Other intellectual property: 70%

The maximum loan a manufacturing, service or trading company may assume, therefore, must always be calculated on the basis of its assets. For finance and holding companies a debt / equity ratio of 6:1 applies, *e.g.*, an equity quota equal to 14,3% of their total assets.

If the total debt of a company exceeds the maximum amount calculated pursuant to the above limits and if part of the total debt consists of loans granted by the shareholders or persons and companies affiliated with the shareholders, the interest paid on such loans is not deductible. Since the above listed limits constitute only guidelines issued by the tax administration to clarify the general principle expressed in art. 75 DTA, it is possible to deduct interest payments exceeding these limits if the company can show that a third party in the same position would also have granted such high loans.

If the total debt of a company stays within the above listed limits, interest payments on loans granted by the shareholders or any persons and companies affiliated with the shareholders can generally be deducted. In order to avoid that the whole profit of a company is taken out by the shareholders through excessive interest rates, interest rates on such loans are, however, limited to the interest rates a third party would charge for such loan. The Swiss Federal Tax Administration periodically defines in a circular letter the maximum

interest that may be charged on loans by shareholders and persons and companies affiliated with the shareholders. Currently, the following maximum rates apply:²³²

- Loans secured by mortgage on real estate:²³³ 2 ½% p.a.
- Unsecured loans for industrial companies:²³⁴ 4 ½% p.a.

The above maximum rates may be exceeded to the extent the company can prove that a third party lender would also charge higher interest rates.²³⁵

c) *Withholding Tax*

The above rules on the deductibility on interest payments apply also for the purposes of withholding tax. If according to such rules interest payments are not deductible, such payments are considered constructive dividends for the purpose of withholding tax. This is particularly problematic if loans are granted through an offshore finance company and if such company cannot reclaim the Swiss withholding tax due to the absence of a double tax treaty between Switzerland and the offshore jurisdiction. If withholding tax is levied on such interest payments, the offshore recipient is, therefore, not able to recover the withholding tax.

2.2.3 Tax Loss Carryforward

2.2.3.1 *Share Deals*

If a Swiss company is sold in a share deal, such transaction does not affect its tax loss carryforward, *i.e.*, the company may use it also after a change of control.²³⁶ The possibility to use tax loss after the sale of the business, leads to an increase of the after-tax earnings. A tax loss carryforward can be used against future profits and is, therefore, a positive factor in the valuation of a business.²³⁷ In cases where the earnings of the acquired company are not sufficiently high to use the tax loss carryforward, the buyer may transfer his other profitable business assets to the acquired company to increase the companies' taxable profits to be able to use the full tax loss carryforward of the acquired company. It is, in principle, also possible to merge a company that has a tax loss carryforward with a

²³² Merkblatt "Zinssätze für die Berechnung der Geldwerten Leistungen" (Circular on the Calculation on Constructive Dividends) of February 3, 2011.

²³³ For commercial real estate, the first mortgage cannot exceed 2/3 of the fair market value of the real estate and the second mortgage cannot exceed 3 ¼% of the fair market value. For residential property, the first mortgage cannot exceed 2% of fair market value and for the second mortgage 2 ¾% of fair market value applies.

²³⁴ For commercial and industrial companies, 4% for holding and asset management companies.

²³⁵ In the practice, this is only the cases with written offers.

²³⁶ In several foreign countries, tax loss carryforward is extinguished in a change of control or can be maintained only if certain conditions are fulfilled. When a Swiss company with foreign subsidiaries is sold, in each case it must be examined whether tax loss carryforward on these foreign subsidiaries can still be used after such change of control.

²³⁷ For the valuation the tax loss carryforward, it cannot be simply multiplied by the applicable tax rate; given that the positive saving effects only occur in the future, tax saving must be discounted for. As the taxable income may be lower than expected and therefore the tax loss carry forward may not be fully used, a risk premium will also be subtracted.

profitable subsidiary of the buyer to use the tax loss carryforward. In such a case, the Swiss Federal Tax Administration may, however, view the merger as a circumvention of tax and as a consequence disallow the use of the tax loss carryforward for the earnings generated by the profitable company if there are no business reasons for the merger other than a reduction of tax. Before a company undertakes such a merger, it is advised to obtain a tax ruling on the use of the tax loss carryforward.

2.2.3.2 *Asset Deal*

If a business is sold in an asset deal, a tax loss carryforward cannot be used by the buyer, instead it will remain with the seller who may use it for his remaining business activities.

2.3 Tax Burden on the Buyer on a Later Sale

The buyer should structure the acquisition of a business in such a way that he can sell the business later on with minimal tax consequences. This aspect of the tax planning is most important for a buyer who does not intend to hold the business for a long time. If the seller is a financial buyer or an MBO-Team, it can be assumed that such buyer will sell the business again within the next three to ten years. An industrial buyer who does not intend to sell the acquired business but plans to integrate it into his own activities should also consider in his tax planning the possibility of a later sale, as he may later change his strategy and sell the business.

The taxation of the seller has been treated in chapter F.1. Pursuant to these principles, the buyer has the following possibilities to structure the purchase transaction:

2.3.1 Companies as Buyers

A company which purchases a business will have the lowest tax burden at a later sale, if it forms a special subsidiary which carries out the asset deal. As discussed in chapter F.1.1.2 above, the acquired company, respectively the company which owns the business, can sell it practically tax-free using participation relief, as long as it holds the acquired company for at least one year.

If for the acquisition of a business in an asset deal a new subsidiary is formed, the financing must be structured in such a way that thin capitalization rules described in chapter F.2.2.2.2 apply. Furthermore, financing should be planned in such a manner that the interest to be paid does not exceed taxable income, as otherwise, the positive tax effect of the deductions is lost or shows up only in a tax loss carry-forward. If interest payments are likely to exceed the taxable income, it is advisable to give the newly formed subsidiary more equity than required under the thin capitalization rules and to refinance such equity at the level of the parent company with loans which allow the parent company to take an interest deduction.

2.3.2 Private Individuals as Buyers

Private individuals should structure a purchase in such a way that they can in a later sale realize a tax-free capital gain. Therefore, a private individual should avoid structures which may lead to a requalification of the capital gain as taxable income. In view of the tax authorities' practice, the buyer should, in particular, avoid excessive debt financing at the private level as otherwise the later sale could be regarded as a commercial activity with the consequence that the capital gain would be taxed as income and furthermore also would be subject to social security contributions.²³⁸ A private individual who has to finance the acquisition of a business with relatively high debt should form a holding company that purchases the business and also takes out the necessary loans. The holding company can later be sold by the private individual with a tax-free capital gain.

If a private individual purchases a business in an asset deal, he has to form a company that purchases the business and takes out the loans. The private individual will later be able to sell such company with a tax-free capital gain. If a private individual purchases a business directly in an asset deal, the whole gain from a later sale would, as shown in chapter F.1.2.1, be considered as taxable income and also be subject to social security tax.²³⁹

²³⁸ Cf chapter F.1.1.1.5 above.

²³⁹ If a buyer forms a new company to buy a business in an asset deal, this is considerably better than the purchase of the business in a direct asset deal and the later conversion of the proprietorship into a *GmbH*. In such a case, the buyer would have to wait five years until he could sell the shares of such company tax-free, whereas he can sell a company he has formed for the purchase of a business in an asset deal after any time after the transaction for a tax-free capital gain.

3. TAX OPTIMIZATION STRATEGIES

- *The goal of tax optimisation must be to reduce to a minimum the total tax burden of the transaction for the seller and the buyer. A one sided tax planning that favours only one party usually will meet resistance of the other party or prompt such party to increase the purchase price.*
- *The seller is primarily interested in structuring the transaction in such a way that he realizes a tax-free capital gain, whereas the buyer desires a structure which allows him to depreciate the purchase price and to charge interest expenses against taxable income.*
- *The goals of the buyer can only be fully achieved in an asset deal. Such transaction structure, however, normally causes high tax consequences for the seller, exceeding the advantages the buyer can derive from such structure. In a share deal, the interest charges on loans, the buyer has incurred for financing the transaction can be deducted from the taxable income of the buyer. Such interest charges may be deducted also from the taxable income of the company the buyer has bought if the buyer is a company and mergers after the transaction with the acquired company. Such a merger, however, can have negative tax consequences for the seller if the seller is a private individual (theory of indirect liquidation) and may also, under certain circumstances, be regarded by the tax authorities as avoidance of tax with the effect that the interest cannot be deducted from the earnings of the acquired company. There are, however, other methods which allow to charge at least a part of the interest expenses to the taxable income of the company that has been acquired even if a merger is not possible (distribution of reserves, direct partial liquidation, reduction of capital, sale of associated companies to the newly acquired company, etc.). The solution must, however, be tailored to the tax situation of buyer and seller.*
- *A private individual as seller has to structure a transaction in such a way that the gain he realizes qualifies as a tax-free capital gain. The various theories the tax authorities have developed to re-qualify such gain into income limit the buyer's ability to find a tax efficient structure.*
- *A company as seller should structure the transaction in such a way that the gain realized is covered by participation relief. If the company sells a participation that has been acquired before January 1, 1997, the seller should, before the sale, distribute, through dividends or partial liquidation, all existing reserves as the receipt of such dividends due to participation relief is, for practical purposes, tax-free.*

3.1 Goal of Tax Optimization: Reduction of Total Tax of the Buyer and the Seller

The goal of tax optimization is to reduce to a minimum the total tax paid by the buyer and the seller in the transaction. Experience shows that a transaction structure which allocates tax charges and risks to one party is never accepted in negotiations as normally all the parties involved in the transaction have advisers and therefore have clear understanding of their interests. If, for example, a tax structure proposed by the buyer favors his interest at the expense of the seller by subjecting the seller's capital gains to income tax, the seller will either demand an increase of the price which would compensate him for such tax cost or withdraw from the transaction altogether. In optimizing the total transaction, the following interests have to be considered:

– Interest of the Seller

The seller is interested in realizing a gain that is tax exempt or subject only to minimal tax.

– Interest of the Buyer

The buyer is interested in deducting the interest payments on the loans taken out to finance the acquisition from the taxable income of the business acquired and to depreciate the purchase price paid against such income,²⁴⁰ or as an alternative to charge interest expenses and depreciation against his own taxable income. Furthermore, the buyer also wants to structure the acquisition in such a way that he has the possibility to resell the business on a tax-free basis.

In view of the tax rules applicable to the parties, as described in chapter F.1 and chapter F.2 above, in most cases it is not possible to fully attain the goals of both buyer and seller. Therefore, tax planning in acquisitions is always a problem: optimizing between contradictory interests with the aim to find a solution that allows minimizing the total tax charge for both parties. Due to the often contradictory interests of the buyer and the seller, the tax optimization problems can not be normally solved by applying a standard solution to all cases. It is necessary to find an individual solution that is tailored to the possibilities and the constraints of the parties. Therefore, the following concepts on the tax optimization of acquisition structures can only be taken as a starting point for the development of individual solutions.

3.2 Tax Optimization from the Perspective of the Buyer

As shown in chapter F.2.2 above, the buyer's ultimate goal is to deduct the interest charge on the loans he has taken up for financing the acquisition from the taxable profits of the acquired business and also to depreciate the purchase price. Another major goal of the

²⁴⁰ Which is possible, if depreciation has been used against the pre-tax gain, making a tax-free cash flow available.

buyer is to apply the purchase price against the taxable profit of the acquired business; this will reduce the tax burden once more and allow the buyer to amortize the acquisition financing with tax-free cash flow. To achieve these goals within the rules described in chapter F.2 above, the following strategies can be pursued by the buyer:

3.2.1 Purchase of a Business in an Asset Deal

The maximal goal of the buyer, to depreciate the purchase price against the taxable profits of the acquired business and also to charge interest paid on the acquisition loans against such income, can only be attained if the buyer buys a business in an asset deal. In such case, the acquired assets will be entered into the balance sheet of the buyer (or balance sheet of an acquisition company specially formed for such acquisition) at their fair market value and the difference between the fair market value of the assets and the amount on the assumed liabilities on one hand, and the purchase price on the other hand, will be entered as goodwill. The assets can then be depreciated over the normal depreciation period defined by the tax authorities for such assets, whereas the goodwill can be depreciated over a period of five to ten years against normal taxable profits. At the same time, the interest the buyer (or the special purpose company formed for the acquisition) has to pay on the acquisition loans, can also be deducted from the taxable income of the acquired business. An asset deal, therefore, allows the buyer to charge nearly all acquisition costs to the pre-tax profit.

Such an optimization strategy, however, usually is incompatible with the goals of the seller. The tax consequences of an asset deal are usually prohibitive for a seller who is a private individual²⁴¹ and may also be relatively high if a company sells a business in such a transaction.²⁴² Such a deal structure is normally only possible if a company sells a part of its business and, therefore, has no other possibility than to structure such sale as an asset deal.

3.2.2 Charging Interest Payments to the Profits of the Acquired Company in a Share Deal

If the target company cannot be acquired in an asset deal, but the buyer has to purchase a company in a share deal, as shown in chapter F.2.2.1, he will not be able to amortize the goodwill paid against the taxable income of the business acquired, as Swiss tax law does not allow a step-up of the tax book values in the acquired company. The merger of the buyer and the acquired company will also not allow the buyer to depreciate the goodwill paid; under the Swiss accounting rules the difference between the purchase price paid by the buyer and the equity of the acquired company has to be accounted for as merger loss or must be shown as goodwill that is depreciated over five to ten years. Neither a merger loss nor the depreciation of goodwill that is created by merger may, however, be charged against taxable income.²⁴³

²⁴¹ Cf. chapter F.1.2.1 above.

²⁴² Cf. chapter F.1.2.2 above.

²⁴³ Cf. chapter F.2.2.1.3 above.

The buyer may, however, within the limits described in chapter F.2.2.2 above, deduct depreciation and interest charges from its own taxable income. Such deduction, however, has no value if the buyer, *e.g.*, a holding company which derives its income mainly from dividends, has no or only very little taxable income. With the following methods it is, however, possible to achieve that the interest payments be, at least partially, charged to the taxable income of the business that has been acquired:

3.2.2.1 *Merger of Buyer and Acquired Company*

A merger between the buyer and the acquired company has the consequence that taxable profits and interest charges accrue in one single company so that the interest payments can be charged to pre-tax profits. Sometimes the federal and also cantonal tax authorities, however, try to characterize mergers between buyer and acquired companies as a move to avoid tax and consequently disallow the deduction of interest payments. In order to avoid such a result, the merger has to be justified with business reasons beyond tax savings (*e.g.*, synergies *etc.*) and a tax ruling should be obtained in advance.

If the buyer and the acquired company merge within five years after the buyer has bought the company from a private individual, such merger will cause the tax authorities to re-qualify the tax-free capital gain of the private individual as taxable income pursuant to the theory of indirect partial liquidation.²⁴⁴ Such merger can therefore only be made after a five year period has expired. If the seller, however, is a company, the buyer and the acquired company may merge immediately after the closing of the purchase agreement.

Should a merger not be possible due to tax or other legal reasons, the following transaction structures allow the shifting of part of the interest payments to the acquired company:

3.2.2.2 *Distribution of Reserves or Partial Liquidation of the Acquired Company*

When the buyer is a company, after the sale the acquired company can distribute its preexisting reserves to the buyer, due to the participation relief, practically tax-free, and use such income to repay the acquisition loans. The acquired company has to refinance the distribution by loans, so that, such a distribution, therefore, shifts a part of the acquisition financing to the acquired company and allows it to deduct the cost of such financing from its own pre-tax income.

A company, as buyer, may after the completion of the purchase also resell a part of the shares it has acquired to the acquired company which then reduces its capital accordingly. Such a partial liquidation has the same financial effect as a distribution of dividends and the buyer can reduce the acquisition loans with the proceeds from the sale whereas the acquired company will refinance itself with loans and, thereby from an economic view, take over part of the purchase financing. The buyer is not taxed on the liquidation proceeds as the proceeds, like dividends distributions, are sheltered by the participation relief.

²⁴⁴

Cf. chapter F.1.1.1.2 above.

Like in a merger, the payment of a dividend out of preexisting reserves or a partial liquidation after the sale, has the effect that the gains of a private individual on the sale of the shares is re-qualified as taxable income based on the theory of partial liquidation,²⁴⁵ if such distribution or partial liquidation is made within five years after the completion of the sale. If the seller is a private individual, such a distribution or partial liquidation, therefore, may be made only if the five year period has elapsed. If the seller, however, was a company the dividend distribution or the partial liquidation can be made immediately after the completion of the sale.

3.2.2.3 *Sale of Shares to the Target Company*

The seller may, before or concurrently with the sale of shares to the buyer, sell a part of the shares to the target company. In this way, the target company will pay a part of the purchase price itself and can charge the interest on the loans necessary to finance such a purchase to its taxable income. If the seller is a company such transaction even leads to a tax optimization for the seller: if the seller sells a part of the shares to the target company, the purchase price is regarded as income from partial liquidation and, due to the participation relief, remains practically tax-exempt in a situation where the share capital of the target company is afterwards reduced by the nominal value of the shares that have been re-acquired by the company.

If the seller is a private individual, the possibility to sell shares to the target company is, however, severely restricted; as described in chapter F.1.1.1.1, a private individual may sell not more than 10% of the shares to the company and the company has to sell such shares again within six years. If these limits are exceeded, the difference between the price paid by the company and the nominal value of the shares sold, will be regarded as taxable income from partial liquidation.

3.2.2.4 *Capital Reduction of the Acquired Company*

After the sale, the acquired company can reduce its capital to the statutory minimum of CHF 100,000 and can pay the amount of the reduction (*i.e.*, the difference to the original capital) to the buyer. The buyer is not taxed on the amount he receives in the capital reduction as he can reduce the tax book value at which he has entered the shares in his accounts by the same amount. The buyer can use the amount received in the capital reduction to repay the acquisition loan, whereas the acquired company will refinance itself with new loans. This capital reduction, therefore, shifts a part of the acquisition financing from the buyer to the acquired company. Such a capital reduction is also possible if a private individual has sold the company, as such capital reduction by the buyer has no negative tax consequences for the seller and in particular does not lead to a requalification of a private capital gain as taxable income. A private individual, as shareholder, could also reduce the capital before the sale without being taxed as such payment is not regarded as a taxable distribution or liquidation but as a return of capital.

²⁴⁵ Cf. chapter F.1.1.1.2 above.

3.2.2.5 *Payment of Reserves from Capital Contributions*

The acquired company can repay the buyer with all reserves from capital contributions, which could have been distributed prior to the sale free of tax pursuant to art. 20 para. 1 *ciff.* 3 DTA respectively art. 7b THA.

The distribution of these resources has the same effect as the capital deduction described in chapter F.3.2.24 above. From an economic perspective, the loan of the buyer will be shifted to the acquired company. This distribution will not lead to taxation, even where the seller is a private person subject to the theory of indirect partial liquidation. Further, the buyer can make use of the participation relief.

3.2.2.6 *Staggered Sale of Several Companies*

If the buyer does not purchase one company but several companies, a positive tax effect can be achieved if the buyer first purchases the company with the highest earnings and then such company purchases the other companies. This procedure may even be repeated, *e.g.*, the second company may purchase the third company. Such transaction structure has the effect that the company that acquired the second company can charge the financing cost incurred for such purchase to its own taxable earnings.

Such transaction structure can be used with a seller that is a company as well as with a private individual since a staggered sale does not lead to the requalification of a private capital gain as taxable income.²⁴⁶

3.2.2.7 *Sale of Assets to the Acquired Company*

The buyer can shift part of the financing of the acquisition to the acquired company by selling company assets he held before the sale. Such a sale of assets has the effect that cash is shifted from the acquired company to the buyer, which the buyer can then use to reduce the acquisition loans. As the acquired company will need new loans to refinance the outflow of cash, a part of the financing of the acquisition loans will be shifted from the buyer to the acquired company.

3.3 Tax Optimization from the Perspective of the Seller

3.3.1 Private Individuals as Sellers

If the seller is a private individual, the goal of his tax optimization is to realize a tax-free capital gain. This can be achieved with the following measures:

²⁴⁶

Nevertheless a tax ruling should be obtained for such transaction as otherwise the tax authorities may later challenge the allocation of the total purchase price between the various companies.

– Conversion of a Sole Proprietorship or a Partnership into a Company

For a private individual to avoid the high tax burden caused by selling a business in an asset deal, such individual should, before a sale, convert the sole proprietorship or partnership into a company²⁴⁷ which the individual then would sell with a tax-free capital gain. The gain on sale will be tax-free, so long as the company is not sold within five years of the conversion.

– Accordance of Direct or Indirect Partial Liquidation and Transposition

The seller should avoid situations, as described in chapter F.1.1.1, which lead to the requalification of a tax-free private capital gain into taxable income, using the following measures:

- A sale to a buyer who has a legal obligation to keep records should not be completed before a tax ruling is obtained that the requirement of the indirect partial liquidation theory are not, in this case, fulfilled;
- If shares are sold to a company or a private individual, who holds such shares as business assets, all transactions that the tax authorities regard as partial liquidation must be prohibited in the purchase agreement;
- The seller should avoid a participation in the company that purchases his shares or, if the seller takes a participation in the buyer, the rights of the seller should be defined in such a way that he can not be regarded as having joint control, with other parties, in the buyer. Even if the seller does not conclude a shareholders' agreement with the shareholders of the buyer or only a shareholders agreement that does not give the seller any controlling rights, the parties, in such a case, should always obtain a tax ruling confirming that the transaction structure does not lead to the application of the theory of transposition.

3.3.2 Companies as Sellers

Companies as sellers should always structure a sale in such a way that the gain realized on such sale is sheltered by the participation relief *i.e.*, only participations held for over one year should be sold. In addition, a participation of minimum 10% should be sold, respectively the rules described above for participations which have fallen below 10% capital should be followed. Such a strategy is also positive for the buyer as it, in effect, shifts a part of the acquisition financing to the company that is acquired.

As the sale of a business in an asset deal leads to the taxation of the gains realized on the sale, it is advisable to incorporate businesses in to separate subsidiaries early on, which later can be sold tax-free under the participation exemption. Such a strategy cannot, however, be realized immediately prior to a sale, as although the transfer of a business to a

²⁴⁷

Includes a limited liability company (*GmbH*).

new subsidiary can be realized at book value, *i.e.*, on a tax-free basis, the gain realized on the later sale of such new subsidiary will be taxed so long as the subsidiary is sold within five years after it has been formed.

3.4 Tax Optimization as a Long-Term Process

The possibilities to optimize the transaction shown above have always to be tailored to the individual situation of the buyer and the seller and to the possibilities the business itself offers. It is, therefore, not possible to describe a standard method that fits all the transactions; it is necessary to analyze the individual situation in each a case to find the best structure.

For the seller, in particular, the tax optimization of a later sale is a long-term project if he first has to restructure his business or convert a directly held business into a company, as such restructuring usually leads to waiting periods. Therefore, the seller should begin early with the divestiture procedure or even better structure his business from the beginning in such a way that a sale is possible with little tax impact.

G. SERVICES OF WALDER WYSS

With regard to the sale and purchase of businesses, Walder Wyss offers a complete range of services, covering the tax and legal aspect of such transactions:

- Planning and structuring of a transaction; tax optimization for seller and buyer;
- Drafting of the necessary documents (confidentiality agreement, letter of intent, purchase agreement, *etc.*);
- Support in negotiations;
- Support in the due diligence;
 - Preparation of the due diligence for the seller, vendor due diligence
 - Legal due diligence for the buyer, due diligence report
- Support in auction procedures, including the drafting of all necessary documents;
- Advice on merger control and the drafting of the necessary applications;
- Advice on further authorizations necessary to complete the transactions and the drafting of the necessary applications.

Walder Wyss does not act as broker for the sale of businesses and it does also not conduct financial, operative or environmental due diligence.