Warning to buyers: non-disclosure of FDA warning letters in due diligence did not trigger sellers' liability

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Insufficient substantiation of claims by the buyer of shares of a homeopathic drugs company for damages caused by an alleged breach of contractual warranty (non-disclosure of FDA warning letters) in a share purchase agreement.

Judgment of the Federal Supreme Court of 18 February 2020
Case Reference : 4A_445/2019

Facts

The dispute arose out of a share purchase agreement ("SPA") concluded in 2007 for the shares of A., a company engaged in developing and marketing homeopathic drugs. Under the terms of the SPA, the sellers expressly guaranteed that they had obtained all required health authorizations in countries where its products are distributed and that no more stringent product distribution conditions had been officially announced or were known to the company. The sellers further guaranteed the absence of any pending or foreseeable judicial and administrative proceedings and that they had disclosed to the buyer in the course of the negotiations all important documents that could affect the value of the company and its future activity.

Between 2008 and 2011, the US Food and Drug Administration ("FDA") confiscated several homeopathic drugs due to improper labeling. Some drugs could be marketed in the US after re-labeling, whereas others could never be brought to market. The buyer lodged a notice of defects in 2009, invoking a violation of guarantees provided in the SPA. The buyer argued that A. had received warning letters from the FDA in 2003 and 2005 regarding the labeling of its products, which were never mentioned during the negotiation of the SPA ("the FDA Warning Letters"). The buyer claimed that it had suffered damages resulting from the obligation to relabel its products and from the lost profits that it had allegedly suffered as a result of this. On this basis, the buyer initiated legal proceedings against the sellers before the local court of first instance seeking damages (in the range of CHF 13 million) for expenses incurred in the relabeling of the products and loss of profit (Art. 97 and 197 et seq. of the Swiss Code of Obligations [SCO]), in the alternative (should the first claim be rejected) seeking reduction of the sale price (Art. 205 SCO) arguing that the sellers had intentionally deceived the buyer (Art. 203 SCO) by failing to disclose the FDA Warning Letters.

The local court of first instance rejected the claims of the buyer. On appeal, the cantonal court also rejected the claims and decided that, even though the FDA Warning Letters played an important role in assessing the value of the company, the sellers did not intend to deceive the buyer in their failure to disclose them. The court further held on subsidiary grounds that the buyer did not sufficiently substantiate the losses that it had suffered in the proceedings, since it merely alleged the elements for the calculation of the damage by globally referring to a private expert opinion that it submitted in the proceedings. In particular, the buyer failed to mention where the relevant information was to be found and did not outline the substance of the expert opinion in its briefs and court submissions. In its final subsidiary grounds, the cantonal court found that, in any event, the buyer had failed to prove the necessary causal link between the non-disclosure of the FDA Warning Letters and the damage that it had allegedly suffered. Indeed, it had failed to establish that the grounds of the confiscation of the products made by the FDA between 2008 and 2011 had any connection with the FDA Warning Letters received in 2003 and 2005.

Issue

The Federal Supreme Court had to decide (among various legal issues) whether the buyer had sufficiently substantiated its claims for damages resulting from the alleged breach of warranty.

This comment will focus on this procedural issue, which is of great practical importance. For other relevant aspects of this

case, see the other sources below.

Decision

The Federal Supreme Court first recalled that the legal provisions on sales of chattels apply to share purchase agreements (Art. 187 et seq. SCO). In this context, the legal warranty only covers the existence and extent of the rights attached to the shares. As a result, the seller is liable for the economic value of the shares under Art. 197 SCO only if a specific warranty was given to that effect. Following the reasoning of the cantonal court, the Federal Supreme Court held that the sellers had no intention to deceive the buyer (Art. 203 SCO). In particular, the buyer failed to demonstrate that the improper labeling which led to the confiscation of the products in 2008 and 2011 was already the subject of the FDA Warning Letters that were sent by the FDA in 2003 and 2005.

The Federal Supreme Court stated that each fact must be broadly laid out or outlined. Nevertheless, any allegation of fact should be formulated in such a way that the defendant can take a position on the factual allegations made. Should the defendant dispute the allegations, the claimant has the burden to substantiate its claim (*Substanziierungslast*), which goes beyond a mere burden to submit facts (*Behauptungslast*). Therefore, the arguments of the claimant should be developed and set out in a clear and detailed manner for each fact so that the defendant can collect evidence or present counterevidence.

In this case, the buyer did not meet these requirements, as it failed to detail in its presentation of the facts the damage it claimed to have suffered, even after the sellers disputed the allegations made in the claim. In its claim, the buyer referred to annual financial statements and statistics and after the sellers cited grounds to challenge these documents, it referred in its rejoinder to different accounting records without demonstrating where the relevant information was to be found.

Furthermore, the Federal Supreme Court held that the buyer did not sufficiently substantiate its subsidiary request for a reduction of the sale price, for which it had relied upon an expert opinion.

Under Swiss law, the general rule is that reference to an exhibit does not meet the requirement to produce and substantiate facts supporting a claim unless the opposing party and the court can ascertain the necessary information without file notes on the submitted document. In the case at hand, the buyer failed to demonstrate that the allegations of facts contained in the 32-page expert opinion were sufficiently self-explanatory that they could be understood without providing a file note in the submission. In particular, although the expert opinion was clearly structured, this did not change the fact that the relevant information contained within had to be incorporated into the submission and duly explained. The buyer failed to demonstrate that this information was readily accessible and not subject to interpretation.

The Federal Supreme Court also ruled that the cantonal court did not infringe Art. 8 of the Swiss Civil Code (SCC) or Art. 29 of the Federal Constitution of the Swiss Confederation by refusing to order an expert witness. The buyer could not be released from its obligation to substantiate its claim by requesting that the court order an expert witness, since the process of taking evidence is not intended to make up for poorly-formulated allegations and a court is free to decide whether it is to appoint an expert (Art. 183 para. 1 of the Swiss Civil Procedure Code [CPC]). Without substantiated factual statements in the submission, a defendant is not in a position to understand them, challenge them in a substantiated manner, and present counter-evidence where required.

Additionally, according to the Federal Supreme Court, the cantonal court decided held without being arbitrary that the necessary causal link between the breach of warranty and the damage had not been proven.

Therefore, the appeal was rejected.

Key takeaway

This case is an important reminder of the need to substantiate claims for damages under Swiss law and to duly establish all legal conditions supporting a claim for damages (including the causal link between the alleged breach of contract, here the non-disclosure of the FDA Warning Letters, and the damage that was allegedly suffered).

Comments

As in many previous decisions[1], the Federal Supreme Court seems to adopt a two-step reasoning, finding that the claimant is only required to substantiate its claim after the defendant has disputed the allegations. The practitioner is nevertheless advised to substantiate its claim from the outset, by setting out and developing each fact in a clear and detailed manner where necessary. The practitioner is also well advised to be careful when referring to a party-appointed

expert opinion that is filed as an exhibit in the proceedings. A general and imprecise reference to such report will only meet the requirement of allegation and substantiation if the information contained therein is self-explanatory, readily accessible, and not subject to interpretation. In all other cases, the relevant content of the expert opinion must be incorporated into the submission and duly explained.

Other sources presenting the case

https://globallitigationnews.bakermckenzie.com/2020/05/07/swiss-federal-supreme-court-confirms-strict-interpretation-of-duty-to-substantiate-facts-an-introduction-to-a-swiss-specialty/

https://www.walderwyss.com/user_assets/publications/Unterlassene-Offenlegung-von-Warning-Letters-in-der-Due-Diligence.pdf

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[1] E.g. Judgment of the Federal Supreme Court 4A_659/2018 of 15 July 2019; judgment of the Federal Supreme Court 4A_449/2018 of 25 March 2019.