Fundamental error in the context of M&A transactions: reversing the irreversible?

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Rescission with retroactive effect of a share purchase agreement because of a fundamental error.

Judgment of the Federal Supreme Court of 14 October 2021

Case reference : 4A_92/2021

Facts

With a plan to relocate from Germany to Switzerland, A contacted B (the "Seller"), who is the sole manager and quotaholder of a Swiss limited liability company (LLC) offering tax services in Switzerland (the "Target"), to discuss the acquisition of the Target. On January 4, 2016, the Seller and a Swiss LLC, incorporated by A for the purpose of the transaction (the "Buyer"), entered into a share purchase agreement (the "SPA"), under which the Buyer acquired the Target's entire quota capital for a price of EUR 480,000.00. The transaction was completed upon the execution of the SPA.

The parties entered into the SPA on the basis that the 2014 financial statements of the Target were the basis for the transaction and on the common understanding that the business volume for 2015 would develop substantially in the same way as in 2014. However, shortly after the closing, the Buyer became aware that the Target registered a loss of CHF 40,000.00 in 2015 compared to a net profit of CHF 65,000.00 in 2014, and that the Target's turnover had dropped by 26% in 2015 compared to 2014.

Given the significant discrepancy between the 2014 and 2015 financial results, the Buyer served a notice to the Seller on August 9, 2016, in order to rescind the SPA with retroactive effect (among other claims). On May 31, 2017, the Buyer filed a claim against the Seller, requesting, *inter alia*, the reimbursement of the purchase price, against the retransfer of the Target's shares. The Court of First Instance granted the Buyer's request. The Seller filed an appeal, which was dismissed. The Seller then brought the case before the Federal Supreme Court.

Issue

The Federal Supreme Court had to determine whether the Buyer had acted under a fundamental error within the meaning of Art. 23 et seq. of the Swiss Code of Obligations (SCO) when it entered the SPA and was thus entitled to retroactively rescind the SPA.

Decision

The Federal Supreme Court first reminded the general conditions allowing a party to retroactively rescind a contract if it entered into an agreement acting under a fundamental error within the meaning of Art. 23 et seq. SCO. A contract is not binding upon a party which entered into it acting under a fundamental error (Art. 23 SCO). An error is fundamental, for example, if it "relates to specific facts which the party acting in error considered in good faith to be a necessary basis for the contract" (Art. 24 para. 1 no. 4 SCO). The facts at the origin of the error should also objectively appear, in view of, or according to the requirements of fair commercial dealings, as a necessary basis for the contract. This is the case of a false perception of a fact, which was, for both parties, consciously or not, and objectively, an essential condition for the conclusion of the contract.

The Federal Supreme Court further reminded that a party may not raise a fundamental error in breach of good faith (Art. 25 para. 1 SCO). This is the case, in particular, when the rescission of the agreement would result in an obvious imbalance of the interests of the parties. To assess whether the rescission resulted in an obvious imbalance of the parties' interests, the Federal Supreme Court compared the consequences of the rescission of the agreement for each party. If the rescission

entails only a limited advantage to the party invoking the fundamental error, but results in particularly negative consequences for the other party, invoking the fundamental error will be considered to be made in breach of good faith and will thus not be possible (ATF 132 III 737, cons. 3.1). Further, a party's negligence in causing the error does not generally prevent it from raising the fundamental error and in rescinding the agreement. However, in such a case, the party has to indemnify its counterparty for damages resulting therefrom (Art. 26 para. 1 SCO). Nevertheless, if a party fails to clarify specific and obvious questions arising in the negotiations, the other party may in good faith assume that the party does not consider these unclarified facts as a necessary basis for the conclusion of the agreement. In such case, the party is prevented from raising a fundamental error with respect to the unclarified facts, because doing so would be contrary to the principle of good faith.

Applying these legal principles to the facts, the Federal Supreme Court first noted that the parties entered into the SPA on the common understanding that the Target's financial situation in 2015 would be substantially similar to that of 2014. When executing the SPA, the Buyer thought that the Target's financial situation in 2015 would be similar to that of 2014 and had no reason to believe this would not be the case. However, after the closing when the Buyer ultimately got access to the Target's 2015 financial statements, it became aware of the Target's actual financial situation: i.e. a loss of CHF 40,000.00 in 2015 compared to a net profit of CHF 65,000.00 in 2014, and a decrease of its turnover by 26% in 2015 compared to 2014. The Buyer however did not act negligently given that it had requested up to date financials for 2015, but was assured by the Seller that these were not yet available.

The Federal Supreme Court then deemed the profitability of a target in the year prior to a transaction as being objectively a decisive element for a prospective buyer. An average person would not have left its home and professional activity in Germany for a loss-making company in Switzerland.

The Federal Supreme Court further found that the retroactive rescission of the SPA by the Buyer had not resulted in an obvious imbalance of the interests of the parties. The Buyer would be paid back the purchase price. However, it would have to rebuild its professional activity after having spent four years managing the Target. On the other hand, the Seller would be reinstated as owner of the Target against reimbursement of the purchase price. The possible lower value of the Target would not change this balance of interests given that the Target was already making losses in 2015, and that the Seller had refused a quick and amicable reversal of the transaction by the Buyer in 2016 to avoid a subsequent litigation and any potential negative consequences thereof on the parties and the value of the business.

The Federal Supreme Court thus upheld the judgment handed down by the Court of First Instance, holding that the Buyer had the right to rescind the SPA on the grounds of a fundamental error within the meaning of Art. 23 et seq. SCO .

Key takeaway

This case constitutes an important reminder of how the principles of fundamental error under Art. 23 et seq. SCO can apply to M&A transactions with respect to an error about the financial health of the target company. As shown in this case, a buyer can rescind the SPA on the ground that the financial results of the target are below the legitimate expectations of the buyer.

Lessons learned: in order to avoid these types of disputes, the Buyer should have clarified more carefully and diligently the financial results achieved in 2015 and shouldn't have relied on statements made by the Seller. The Buyer could have negotiated a system by which it would have adapted the purchase price depending on the actual financial results achieved in 2015.

In other circumstances, where the evolution of the target or its business activities in the (near) future is uncertain, the Buyer could negotiate a purchase price structured with a fixed component and a variable or conditional component. The fixed component is paid at the closing of the transaction and the variable or conditional component may be due at a later stage, depending on whether milestones specified in the SPA are met. This component can be fixed, meaning that a fixed amount is due if the milestone is met. It can also be flexible, meaning that the amount of the additional consideration will depend on the extent to which the milestone is met. The milestones can be set based on the financial performance of the target, or depend on the achievement of specific R&D, operational or commercial objectives (as this is common for transactions in the life sciences industry).

Comments

This ruling implicitly raises the question of whether the remedies provided for by the Swiss legal system offer satisfactory

resolutions to M&A disputes. Here, the issue was whether a retroactive rescission of the SPA, half a decade after its execution, was a satisfactory outcome for the parties. In the case at hand, it might be satisfactory. That said, in most circumstances, it probably is not. On the one hand, a seller, by selling its company, shows its desire to get out of its former business activities. On the other hand, as long as the litigation is not finally resolved, the buyer has to manage the company, but certainly does not do it with its initial impulse because it ultimately desires to return it to the seller.

If the principles relating to fundamental errors generally apply to M&A transactions, the parties can contractually avoid its – sometimes undesired – effects: they may contract around it and waive in advance their right to retroactively rescind the contract on the basis of a fundamental error or because of a default in various way. These tools may be used individually but also cumulatively within a single transaction.

First, the parties may limit the legal remedies available to them in the transaction agreement. This can be achieved by including a "sole remedy" clause, which substantially provides that the legal remedies set forth in the agreement are the only remedies available to the parties (see Tschäni Rudolf/Wolf Matthias, Vertragliche Gewährleistung und Garantien – Typische Vertragsklauseln, *in* Mergers & Acquisitions VIII, Zurich (Schulthess) 2006, pp. 94 ff., pp. 119-120). The effect of such clause is to prevent the buyer from rescinding the SPA based on a fundamental error or terminating the agreement for a breach by the seller. The only remedy available to the buyer under the SPA will be a reduction of the purchase price, to the extent required to compensate the damage it suffered from the seller's breach.

Second, the parties may specify that the representations and warranties ("R&Ws") provided for in the acquisition agreement are the only R&Ws given by a party to the other, to the exclusion of any R&W non expressly set forth therein. If a fact is not covered by the R&Ws, a party implicitly acknowledges that such fact is not a necessary element to the party's decision to enter into the agreement. Accordingly, that party may not raise a fundamental error with respect to facts that are not part of the R&Ws (see, for example, Tschäni/Wolf, p. 109 or Schenker Urs, Risikoallokation und Gewährleistung beim Unternehmenskauf, *in* Mergers & Acquisitions VII, Zurich (Schulthess) 2005, pp. 240 ff., pp. 263-264).

Third, the buyer may carry out a due diligence on the target or – especially in the context of auctions – the seller may make a vendor due diligence report available to the potential buyers. Given that a fundamental error presupposes the misrepresentation of a fact, the buyer will not be able to claim it would fall under a fundamental error as long as the information provided to the buyer is true, complete and not misleading (see Tschäni Rudolf/Frey Harold/Müller Dominique, Streitigkeiten aus M&A-Transaktionen, Zurich (Schulthess) 2013, pp. 16 and 120).

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