Who bears the risk?

Daniel Hayek and Alexander Flink of Prager Dreifuss discuss the differences between German and Swiss *culpa in contrahendo* liability in M&A

During the course of the acquisition of a company, the parties usually focus on establishing a liability regime that allocates the risks of the deal between seller and buyer. It is not surprising that other causes of liability outside of the contractual framework (such as statutory liability as provided by law) do not attract a lot of attention when a share or asset purchase agreement is negotiated. This may change in a post-closing dispute when the liability of the seller in connection with problems of the target company is alleged, and the buyer tries to justify its claim. Parties to an M&A deal usually waive, as much as possible, all legal remedies outside of the contractual framework.

Since companies tend to be complex targets and a due diligence requires the buyer to review a considerable number of documents, there is still a risk that the buyer will miss essential information or that the findings of the diligence are not properly addressed in the purchase agreement. This risk needs to be allocated between the buyer, who should usually have no claim based on known defects or defects that could have been detected in the due diligence process, and the seller, who represents and warrants certain qualities of the target company which cannot (or not easily) be examined by the buyer. However, a non-contractual liability regime may have unintended effects on the allocation of risks regarding defects of the target company between the parties at the conclusion of the agreement. In particular, *culpa in contrahendo*, which essentially describes the liability of a negotiating party in connection with the violation of obligations in the preliminary stages of contract formation, may be an additional source of liability.

Under German law, the concept of *culpa in contrahendo* may lead to an unexpected and high liability risk for the seller. For instance, if the seller's team declares in the negotiations that the target has obtained all required governmental authorisations and an important permit has been revoked in the meantime, the seller may become subject to *culpa in contrahendo* liability. This is the case even if only the seller's middle management knows about the revocation of the licence and the contractual representations and warranties do not cover this item. Such knowledge within the seller's group may be regarded as intentional non-disclosure of relevant information, even if the information was unknown to the negotiation team.

The question arises as to whether or not under an executed Swiss M&A contract, *culpa in contrahendo* (or another non-contractual remedy) could become an additional source of seller liability, if a defect of the target company is not detected by the buyer and not expressly disclosed by the seller, even though an employee of the seller's group had knowledge of the defect.

Attribution of knowledge

German law has a statutory liability regime which applies to M&A deals. While *culpa in contrahendo* liability is excluded to the extent that a defect of a target company is covered by the German statutory liability regime (or a guarantee), the concept may apply in case the seller acts with intent. Under German law, the attribution of a representative's knowledge to the representative is expressly codified in the German Civil Code. It also applies in relation to the negotiation team and the represented company. In order to prove intent, it is sufficient that the defect is known to the company, but not necessarily to the management or negotiation team.

Under Swiss law, however, this issue of the attribution of support staff (who are not also agents) to the principal is less clear. According to certain authors, the knowledge of supporting staff may only be relevant if they have positive knowledge of the M&A transaction. Other authors are of the opinion that the knowledge should be fully attributed to the principal. There are few precedents which point to general rules. The matter is, however, much less important than under German law (to the extent that M&A deals are concerned), because *culpa in contrahendo* liability does not apply for the reasons set out below.

Culpa in Contrahendo uncodified

The Swiss concept of *culpa in contrahendo* is supposed to address issues that may occur when two parties enter into contract negotiations which do not result in the conclusion of a valid contract, and one of the parties suffers damages because of the other party. Except for a few specific cases (such as the liability of a party acting in error and the contract being declared void), *culpa in contrahendo* is not expressly codified in the Swiss Code of Obligations. The Swiss Federal Supreme Court has, however, accepted *culpa in contrahendo* liability in a number of cases. The prerequisites are: (i) damages; (ii) violation of a pre-contractual obligation; (iii) a causal link between the damages and the violation of the pre-contractual obligation; and (iv) the fault of the violating party.

> Non-contractual remedies have little impact on the seller's liability in Standard Swiss M&A deals

Pre-contractual duties to inform

From these four prerequisites, damages, causal link and fault may raise difficult questions, but there are plenty of precedents and legal literature that cover most of the issues. The scope of pre-contractual obligations of the seller is less clear and needs to be seen in the light of the risk allocation of an M&A contract. In a deal, the buyer needs to compensate for the seller's advance in knowledge for the assessment of the value of the purchase object and to calculate an offer or, as the case may be, terminate negotiations. Also, the seller is well advised to examine its company if it wants to avoid liability risks deriving from misrepresentations.

Each party that enters into contractual negotiations is responsible for gathering the information about the target company

that it needs to conclude a balanced contract. This is particularly true when the parties try to achieve opposing goals, as is the case in most M&A deals. Swiss law contains no universal obligation for the seller to expressly disclose all factors that may be relevant to the buyer in connection with the envisaged share purchase or the asset purchase agreement, and the buyer must bear the risk of not having obtained all the required information. This is why, except for the most straightforward M&A deals, conducting due diligence is key for a successful transaction. Only in exceptional cases is there a duty for the seller to inform the buyer, namely when the inherent advance in knowledge of the seller results in the buyer's specific need for protection. Such obligation is based on good faith and the specifics of each individual case.

The extent of this duty to provide information is controversial, but it should cover the qualities of the target company which the seller knows are of substantial interest to the buyer. It goes without saying that any answer provided by the seller with respect to an information request by the buyer must be correct and complete. In addition, any duty to disclose must be limited to facts that the buyer does not know and is not obliged to know, because the seller is obviously not obliged to safeguard the buyer's interest more than the buyer itself. Therefore, there is no duty to disclose any defects that could have been detected by the buyer in the due diligence process, unless the seller positively realises that the buyer has missed a material defect of the target company. If both parties act negligently and fail to see a material defect of the target company, the seller is not violating its information duties and the buyer will have to bear the consequences.

Absence of parallel liability

A number of aspects of the concept of *culpa in contrahendo* are not clear and have not yet been tested in court. Since *culpa in contrahendo* liability is based on a violation of obligations before the conclusion of a valid contract, it is in dispute whether or not *culpa in contrahendo* can apply if negotiations result in a valid agreement. In Swiss legal literature, several approaches are discussed, but it seems that most Swiss legal writers agree that such liability should be absorbed by the parties' contractual liabilities under the agreement. Certain authors are also of the opinion that *culpa in contrahendo* remains a source of liability, if it cannot manifest itself under the contract. If the contract is declared void, *culpa in contrahendo* liability will resurge.

In a decision of June 8 1998 (SJ 1999 I 116, E 3a) the Swiss Federal Supreme Court took a stance in connection with a business takeover. The effectiveness of the underlying contract was subject to the buyer entering into a tenancy agreement for the existing business premises. The tenancy agreement could eventually not be concluded for a lack of funds by the buyer, a fact it had not disclosed. Consequently, the agreement between the litigating parties was valid, but could not become effective because the condition precedent was not satisfied. The instance before the Swiss Federal Supreme Court decided that in the light of the contractual liability of the buyer, there could be no *culpa in contrahendo* liability, and it therefore adopted the theory of absorption outlined above. However, based on article 31 paragraph 3 of the Swiss Code of Obligations, the Swiss Federal Supreme Court held that this theory of absorption was not applicable when the pre-contractual claim based on *culpa in contrahendo* was not covered by the contractual liability. Since the Swiss Federal Supreme Court acknowledged an exemption of the theory of relative absorption, it also implicitly acknowledged the theory itself.

In light of the above, there can be no parallel liability of the seller based on *culpa in contrahendo*, as a valid share purchase agreement (or asset purchase agreement) exists and the *culpa in contrahendo* liability derived from a not expressly disclosed defect of the target company is fully covered by the contractual liability regime.

Swiss law provides for a system of material defects liability and warranty of title liability that determines the liability of the seller in connection with purchase agreements. This includes rather short deadlines for the buyer to notify the seller of any breach of warranty in quality by the seller and for any defects that would materially or legally negate or substantially reduce the fitness for the designed purpose

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of the object, and to establish the liability of the seller for such breaches.

The majority of legal writers are of the opinion that the default liability regime of the Swiss Code of Obligations covers the seller's liability to expressly disclose defects (if any) of the target company. Consequently, the seller's *culpa in contrahendo* liability is superseded when the contract becomes effective and the buyer has no claim based on *culpa in contrahendo* with respect to a violation of the seller's duty to inform in the early stages of contract formation, to the extent that an undisclosed defect of the target company is concerned. Reintroducing this liability based on *culpa in contrahendo* would not be compatible with the Swiss system of contractual freedom. The only cases of application of such uncodified liability would, therefore, be if the seller positively recognises that the buyer negligently misses a material defect of the company.

A minority of Swiss legal writers criticise this view and are of the opinion that *culpa in contrahendo* liability exists alongside the statutory liability regime of the Swiss Code of Obligations. It is acknowledged by the courts and doctrine that the buyer may base its potential claim against the seller on the default liability regime of the Swiss Code of Obligations with respect to the purchase agreement, the general fault-based liability or, as a third option, the challenge of a contract based on error. Therefore, it seems inconsistent to deny a *culpa in contrahendo* liability. Additionally, in the view of those authors, claims based on the default liability regime of the Swiss Code of Obligations concerns the correct fulfilment of a contract, while *culpa in contrahendo* liability is based on the violation of an obligation in connection with the conclusion of a contract. Consequently, *culpa in contrahendo* liability cannot be superseded and should be regarded as an alternative source of the seller's liability.

In our view, the minority opinion is not convincing. It seems that these authors want to avoid the strict obligations of the buyer to examine the purchase object and to notify defects and the short deadlines which are generally perceived as too restrictive. However, the relevant part of the Swiss Code of Obligations has been amended recently and is now more buyer-friendly when it comes to deadlines provided for by the Swiss law liability regime, and there is no need to strengthen the buyer's position by allowing additional claims based on uncodified law.

> **The seller does not incur a risk to become liable for undisclosed defects of a target company based on *culpa in contrahendo***

It should be noted that, while the default liability system for purchase agreements works very well in connection with purchases of moveable goods, it falls short in meeting the needs and expectations of the parties in a complex share or asset deal. Therefore, parties of a Swiss (cross-border) M&A deal usually replace the system provided for in the Swiss Code of Obligations by tailor-made solutions based on a standard Swiss law share purchase agreement. This includes a catalogue of representations and warranties and indemnities for certain specific risks (such as tax and environment), deadlines for notifications, and dispute resolution mechanisms. In our opinion, there is no difference between a fully fleshed-out set of liability rules agreed between the parties, as is standard in Swiss M&A deals, and the default liability regime. Both cover the violation of pre-contractual obligations of the seller with respect to defects of the target company and therefore, the *culpa in contrahendo* liability is superseded.

Additional non-contractual remedies

In addition to the contract itself, sources of a seller's liability may be mandatory law and tort. According to Swiss mandatory sales law, a contract may, among other reasons, be declared void because of error or fraudulent behaviour. In most cases, the relevant party shies away from trying to declare the share purchase or the asset purchase agreement void, because this may prove to be difficult in court and, more importantly, nobody wants to reverse the integration of a company. Such cases are very rare as due diligence processes would not leave room for buyer error. In practice, it is rather uncommon in a standard Swiss M&A deal that non-contractual remedies have an impact on the Seller's liability.

Swiss/German law divergence

Under German law, *culpa in contrahendo* liability may exist in addition to the contractual liability as agreed between the parties of an M&A deal. The sellers must be aware that they may become liable based on *culpa in contrahendo* if their negotiation team fails to recognise that the target company has a defect that is known to its middle management, for example, even if the defect is not covered by the representations and warranties catalogue of the share or asset purchase agreement.

As far as Swiss law is concerned, the seller does not incur a risk to become liable for undisclosed defects of a target company outside of the framework of an executed contract based on *culpa in contrahendo*. The problematic parallelism of contractual liability and *culpa in contrahendo* under German law does not apply to closed M&A under Swiss law, because the parties' agreement supersedes the *culpa in contrahendo*.

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