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Recovery of Damages arising out of M&A Transactions in Switzerland and China SCCC

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1. Damage definition according to Swiss law

Damage = the difference between

- i. the position in which the victim is as a result of the damaging event and
- ii. the position in which it would have been without the damaging event

plus there must be an "adequate line of causation".

Art. 208 CO distinguishes between direct and indirect damages (in the context of misrepresentations and breach of warranty):

² The seller must reimburse to the buyer ... compensation for litigation costs, expenses and the loss or damage incurred by the buyer as a result of the delivery of defective goods.

³ The seller is obliged to compensate the buyer for any further loss or damage unless he can prove that no fault is attributable to him.

Direct damage → owed irrespective of any fault

Indirect damage → only owed in case of fault

The concept in M&A-transactions is a risk allocation / cost allocation regime irrespective of any fault.

→ Therefore, the purchase contract should clarify that damages are owed irrespective of any fault

1. Damage definition according to Chinese law

Contractual damage in Chinese law follows the rule of “strict liability”, which also applies to consequential / indirect damage. The matter of culpability is irrelevant in the context of contractual damage.

→ Therefore, no need to clarify in the purchase contract that damages are owed irrespective of any fault.

Contract Law Art. 113

Where a party fails to perform its obligations under the contract or its performance fails to conform to the agreement and causes losses to the other party, the amount of compensation for losses shall be equal to the losses caused by the breach of contract, including the interests receivable after the performance of the contract, provided not exceeding the probable losses caused by the breach of contract which has been foreseen or ought to be foreseen when the party in breach concludes the contract...

The test of consequential damage “*has been foreseen or ought to be foreseen when the party in breach concludes the contract*” is the same to the common law tradition of *Hadley v. Baxendale*.

2. Types of damages addressed in Swiss purchase agreements

- direct damage
- costs, expenses
- diminution in value
- loss of revenue, lost profits
- litigation costs, attorney's fees
- Interest
- indirect and consequential damages
- punitive damages
- internal costs

Some terms originate from Anglo-Saxon countries and their extent is not clear.

Allocation to direct or indirect damages is often not clear.

Inclusion or exclusion from compensation obligation is often debated. Seller strives to exclude liability for damages that are furthest away in the chain of causation; Buyer strives to avoid over-exclusion.

The legal regime requiring an "adequate line of causation" may appear as adequate limit.

2. Types of damages addressed in Chinese purchase agreements

Types of damages are usually not explicitly listed in purchase agreement. Languages used in damage and liability clauses tend to be very general and are of a catch-all nature, for example:

“Unless otherwise provided in this Agreement, any Party who has breached any obligation provided in this Agreement, including without limitation the non-performance or partial performance or misrepresentation and breach of warranty, shall be liable for all damages caused by the breach to the other Party, including consequential damage such as loss of profit.”

→ Not to be confused with “late fee” or “default penalty”

3. Legal Limits to Damage Recovery

- Only net damage is recoverable
- Duty to Mitigate Damages
- No liability for defects that have been known

- Notification periods (duty to notify as soon as feasible in the normal course of business, but in any event within 2 years)

Contractual Limits to Damage Recovery

- Damage definition (see previous slides)
- De Minimis / Basket or Deductible / Cap
- Damages sometimes limited to those of Buyer or those of Target
- Fairly Disclosed Matters
- Recovery through insurance
- Tax benefit
- Damage increase resulting from the passing of new laws or the changing of existing laws or changed practices

Further contractual limitations

- Notice periods / prosecution period

4. Enforcement of Damage Claims

Overview

State Courts or Arbitration Tribunals

Switzerland and China are parties to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards

By contrast, no agreement concerning the enforcement of court judgment between Switzerland and China

→ It is therefore advisable to subject the transaction documentation to arbitration proceedings

Debt Enforcement / Bankruptcy Proceedings to enforce award → according to local laws

4. Enforcement of Damage Claims

Switzerland

Switzerland would recognize a foreign award issued by a Chinese court based on its statutory principles set forth in its code of Private International Law, subject to reservations such as public interest and due process.

China

No separate debt enforcement agency, all enforcement proceedings must go through courts.

In the absence of a bilateral treaty, Chinese courts can enforce foreign judgments based on the principle of reciprocity, subject to reservations such as public interest and due process.

Special procedure rules governing civil cases with “foreign element”, e.g. competent court

5. Typical Contractual Security Regimes for the Enforcement of Damage Claims

- Escrow Account → costs, blocking of funds
- Joint Account → similar solution as escrow, but no costs of escrow agent
- Earn Out structures (and set off right)
- Deferred payments (rarely seen) → there may be need for reverse security, e.g. shares in or assets of Target
- Acquisition of majority stake in a first step; option to purchase the remaining shares in a second step and right to set off purchase price with potential damage claims
- In China, third party guarantee is also often seen, especially when a SOE is the buyer