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Carve-Out Transactions: Particularities under Swiss Law

Contributor

Bär & Karrer Ltd.

Dr. Christoph Neeracher

Partner | christoph.neeracher@baerkarrer.ch

Dr. Philippe Seiler

Partner | philippe.seiler@baerkarrer.ch

Raphael Annasohn

Partner | raphael.annasohn@baerkarrer.ch

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Carve-Out Transactions Particularities under Swiss Law

After the Swiss M&A market had experienced an extremely busy year 2021 caused by various factors and driven by the recovery from the COVID-19 pandemic, the Swiss M&A market started to cool off slightly in 2022. This decline continued in 2023 and was predominantly due to the macroeconomic headwinds, higher interest rates, instability in banking and financing markets, fears of a recession and uncertainty in energy prices as well as the ongoing war in Europe. In this uncertain, volatile environment, transactions with lean structures that enable faster and more targeted action are particularly popular. Consequently, carve-out transactions (put simply, transactions where a company sells or spins off a portion of its business, typically a subsidiary or division, while retaining ownership of the rest) have been of great practical relevance in recent months.

In general, the Swiss legal environment provides the involved parties with vast flexibility to structure a carve-out. However, certain particularities (non-comprehensive) which we would like to briefly touch on need to be considered.

Contract Transfer – Consent Required

In case a business unit is transferred by way of a singular succession according to article 181 of the Swiss Code of Obligations ("CO") (*e.g.* by way of an asset purchase agreement), generally the consent of each contractual counterparty is required for the transfer of the contracts relating to such business unit.

According to some scholars, this is not the case if the assets relating to the business unit are being transferred under the Swiss Merger Act. According to the Swiss Merger Act, the assets are transferred to the buyer upon entry of the transfer into the commercial register by way of partial universal succession, which does not require the consideration of the formal requirements that would otherwise have to be observed for the transfer of individual assets by way of singular succession. According to some scholars, also the contracts relating to such assets automatically transfer to the acquirer, *i.e.* without the consent of the contractual counterparties.

However, the Federal Supreme Court never decided on this matter and thus a residual uncertainty remains. Therefore, it is prudent – at least for the important contracts – to obtain an explicit consent from the contractual counterparties in any case.

Thus, given that even in case of a transfer of assets in accordance with the Swiss Merger Act the consent of contractual counterparties is required for the transfer of the respective contracts, it may be advisable to structure the entire asset transfer by way of a singular succession as the Swiss Merger Act may have certain disadvantages (such as joint liability of transferor and transferee or publication obligations related to the mandatory filing with the commercial register).

Transfer of Employees – Swiss TUPE Rules

As various other jurisdictions, Switzerland knows TUPE rules. If a business unit or part of a business unit is transferred by way of an asset deal, the pertaining employment agreements transfer by operation of law

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to the acquirer, including insurance and pension commitments, employee participation schemes such as option plans and all other rights and obligations relating to the employment relationship. The following applies to a transfer by operation of law:

Each employee may object to the transfer – the respective objection period is not fixed but a few weeks are generally considered to be appropriate. In this case, his/her employment relationship nevertheless transfers to the acquirer as a first step, but terminates with the applicable *statutory* (not contractual) notice period from the objection (*i.e.* 1-3 months depending on years of service), but earliest at closing.

Transferor and acquirer are jointly and severally liable towards the employees for claims becoming due (i) before closing or (ii) after closing until the employment relationship could have been terminated (with regular contractual notice period) or is actually terminated. Usually, Swiss asset purchase agreements provide for a vice versa indemnity / wrong pocket clause to allocate employment costs for pre-closing claims to transferor and post-closing claims to acquirer.

If a collective labor agreement (CLA) applies to a transferred employment agreement, the acquirer must comply with the CLA terms for one year post-transfer unless the CLA terminates earlier. If the CLA applies by law (*allgemeinverbindlicher GAV*) or is incorporated by an employment contract as part thereof, the CLA in principle remains applicable also thereafter (i.e. following the lapse of the one year period).

If, as a result of the transfer, measures with negative consequences for the employees are intended (*e.g.* layoffs, reduction of benefits going forward etc.), the employee representation or absent the same all employees must be consulted: *i.e.* they must have the opportunity to submit suggestions. These are not binding, but the transferor and the acquirer must duly assess them and may not take a final decision prior to the end of the consultation (be careful regarding communication!). If no negative measures regarding employees are intended, they need only be informed regarding the transfer. Consultation or information must take place before closing; usually this is done between signing and closing of the asset purchase agreement (APA).

Perpetual Licenses – Maximum Term Required

Often in carve-out transactions license agreements between the involved parties are required. A Swiss particularity is that other than under various other jurisdictions, no perpetual licenses are permitted. The maximum permitted term of licenses depends on the specific circumstances:

The Swiss law provision that may limit the admissible term of a contract and allowing a party to terminate early (other than for reasons like cause) is article 27 para. 2 of the Swiss Civil Code ("CC"), which reads as follows: "No person may surrender his or her freedom or restrict the use of it to a degree which violates the law or public morals."

In a relatively recent decision (2017) the Swiss Federal Supreme Court dealt with the question whether and after which period termination of a "perpetual" (or very long term) agreement must be possible. While in this specific case the Swiss Federal Supreme Court decided that an individual who was a party to a shareholders' agreement could terminate such shareholders agreement after some 30 years based on article 27 para. 2 CC, it made clear that article 27 para. 2 CC does not protect a party against a long-term contract, but only against excessive commitments. In this respect it stated that as far as the freedom of

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commercial activities is concerned, the Federal Supreme Court is restrictive in assuming that article 27 para. 2 CC is violated. Further, in this context it needs to be noted that it appears generally acknowledged by the courts and scholars that legal entities (as opposed to individuals) may invoke article 27 para. 2 CC only under more restrictive conditions.

However, there is a decision of the Commercial Court of the Canton Zurich rendered in 1998 dealing with an agreement that has at least some similarities to a license and supporting a significantly longer term. In this case the claimant tried in 1995 to terminate on the basis of article 27 para. 2 CC an agreement that had been concluded in 1961 and renewed in 1966 for a term until 2050. The Commercial Court had to assess whether the claimant (a commercial entity) was excessively bound by an agreement continuing still for a period of 54 years (contract term remaining after claimant's notice until 2050), and came in its assessment to the conclusion that this is not the case, i.e. protected a (remaining) contract term of over 50 years.

Thus, the relevant question is less the term as such, but whether the commitments a party has assumed under the contract unduly restrict its commercial freedom if it remains bound until the expiry or next possible termination date. In this regard it is important to note that the relevant factor for the assessment of excessiveness is not the time at which the contract is concluded, but the time at which a termination on the basis of article 27 para. 2 CC is being sought.

TSA Services – Termination Without Notice Period

The CO does not set forth termination rights specific to (transition) services agreements. Therefore, the general termination right applicable to general mandate agreements pursuant to article 404 para. 1 CO is generally applicable also to transition services agreements (TSAs). Article 404 para. 1 CO reads as follows (free translation): *"The mandate can be revoked or terminated at any time by either party."*

The Swiss Federal Supreme Court has consistently held this provision to be mandatory, i.e. not subject to party agreement and has consistently invalidated contractual agreements that sought to limit article 404 para. 1 CO, including penalty clauses that would have been triggered by exercising this revocation / termination right. Consequently, this right is available to the parties of a carve-out transaction at any time.

There is no difference in legal effects between revocation and termination, typically, therefore both terms are used synonymously and generally reference is made only to termination. Termination under article 404 para. 1 CO operates prospectively (*ex nunc*). This means that the terminated contract does not have to be unwound.

To mitigate this risk of an unexpected termination or at least the resulting costs, there are a couple of different approaches. First, should such termination be declared at a highly sensitive and detrimental point in time to the other party, the termination remains valid and effective, but the terminating party is liable for damages caused by the termination of the contract (reliance / negative interest) (article 404 para. 2 CO). To determine whether a termination has been declared at a highly sensitive and detrimental point in time, the overall context of the carve-out transaction as well as the agreed terms under the TSA may be relevant. Second, the structuring of the contract may be relevant. If the TSA is not structured as a pure mandate or mandate-like agreement but as a mixed agreement with, for example, elements of a purchase

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agreement, the mandatory termination right according to article 404 CO may not be applicable. Third, in critical cases, the parties may agree that the TSA is governed by non-Swiss law and jurisdiction (if there are valid reasons for choosing non-Swiss law).

Tax Considerations – Tax-neutral Demerger Possible

Swiss tax laws offer a tax-efficient option to structure a carve-out, i.e. a tax-neutral demerger of a Swiss company to a Swiss sister company. Such demerger generally implies a transfer of assets to a sister company of the transferring entity at (tax) book values, without any compensation being granted in return to the transferring company. As the demerger does not trigger any blocking period, the shares in the receiving sister company may subsequently also be sold by the shareholder via a share deal without triggering any adverse tax consequences. This can especially be beneficial for a Swiss tax resident individual shareholder, as a share deal in general results in a tax-free capital gain. In comparison, an asset deal is a taxable event for the company and a potential subsequent dividend distribution leads to taxable dividend income for the individual shareholder.

Tax-neutrality of a demerger is possible in case the following conditions are met:

i. The concerned assets and liabilities remain subject to Swiss tax liability;
ii. The income tax book values of the assets are retained;
iii. The transferred assets represent one or more going concern business operations or partial businesses; and
iv. The legal entities resulting from the demerger (transferring and acquiring entities) each carry on a going concern business operation or partial business after the demerger.

Pension – Partial Liquidation

Separation transactions may also trigger a separation of the company's pension fund. While this is typical for asset deals (carve-out), such a separation of the pension fund is necessary for certain share deals as well, e.g. where a seller group of companies sponsors or is affiliated with a group pension scheme and the shares in one or several – but not all – group companies are transferred.

Within such pension fund separation context, a partial liquidation of a pension scheme is typically triggered if (i) the number of employees is reduced significantly, (ii) the company is restructured or (iii) the affiliation contract is terminated. The pension scheme is obliged to provide the exact prerequisites for such a partial liquidation.

Where a partial liquidation is triggered, the employees have a right to their accumulated individual shares of the plan assets as well as certain reserve positions in the pension fund's balance sheet (if any). The pension fund must seek a fair allocation of assets and liabilities between its pensioners and the active insured population, whereas all insured persons have the right to be informed and the right to object against the allocation decision. A partial liquidation may only be executed once the objection procedure is over (or if no objection has been raised). If the pension fund is underfunded for Swiss law purposes at the time of the partial liquidation, this might lead to a reduction of the pension benefits of the insured persons (up to the amount of the retirement assets).

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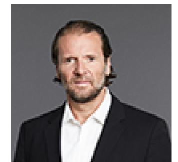
Further to that, upon a separation on the level of the pension fund, the employer often needs to find a new pension solution whereby employee consent will be required. In some cases, the conversion of a group pension scheme into a collective pension scheme may be a suitable option. It is recommended to carefully evaluate all alternatives, while considering also the actuarial aspects of the existing and potential future pension solutions. Specific attention should also be given to the retiree's population and their financing situation.

In light of the above, it is recommended that any pension aspects around a separation transaction are carefully reflected in the negotiations and the SPA or APA and that sufficient time is allocated also for implementation steps – not only but particularly in underfunding situations.

Contributors

Dr. Christoph Neeracher
Partner
christoph.neeracher@baerkarrer.ch


Dr. Philippe Seiler
Partner
philippe.seiler@baerkarrer.ch

Raphael Annasohn
Partner
raphael.annasohn@baerkarrer.ch

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