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Indemnification mechanisms in equity investment agreements

Critical overview with impact assessment of new legislation

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I. Abstract

The contribution examines the effect on standard investment agreement indemnification mechanisms of the newly revised provisions of the Swiss code of obligations applicable to companies limited by shares *(Aktiengesellschaft; société anonyme).* The authors discuss issues linked in particular to the payment by the company of damages in cash, and compensatory capital increases carried out by a company to cover direct or indirect damages suffered by investors for breaches of covenants or representations and warranties. The contribution focuses specifically on existing provisions protecting capital, and changes brought to provisions including those governing the issue price of shares, fluctuating capital and the possibility to pay shares in by way of set-off.

II. Introduction

Indemnification mechanisms in investment agreements are commonplace. The accepted wisdom is the same as in classic M&A: the investor (or buyer) has limited information as to the actual state of the assets when compared to the company (or seller), ergo some form of corrective mechanism is required in order to avoid adverse selection risk.[1]

Participants in the investment process, whether on the buy or on the sell side, will expend substantial resources in due diligence and then again in negotiation of representations and warranties as well as covenants. Under the market-unifying effect of Anglo-American practice, model contracts under Swiss law have come to include not only substantial lists of such representations, warranties and covenants,[2] but also detailed descriptions of the mechanisms whereby indemnification may ultimately be achieved in case of breach. Differences between jurisdictions, and in particular certain inflexibilities in Swiss corporate law, lead however to certain specificities. These include a reluctance to provide for cash indemnification where the indemnitor is the company having received the

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[1] The seminal article on the topic of information asymmetry leading to adverse selection risk remains that of George Akerlof, The Market for «Lemons»: Quality Uncertainty and the Market Mechanism, The Quarterly Journal of Economics 1970 84/3, 488–500, for which the Nobel Prize was awarded in 2001.

[2] See for instance the model documentation prepared by the Swiss Private Equity & Corporate Finance Association (SECA), available at https://www.seca.ch/Templates/Templates/VC-Model-Documentation.aspx (last visited on 2 May 2021). Whilst this does not go quite as far as the model documentation issued by the US National Venture Capital Association (NVCA), available at https://nvca.org/model-legal-documents/ (last visited on 2 May 2021), it is noteworthy that the list of representations and warranties is substantially in excess of that provided for early stage investments in the model documentation issued by the British Private Equity & Venture Capital Association, available at https://www.bvca.co.uk/Policy/Tax-Legal-and-Regulatory/Industry-guidance-standardised-documents/Model-documents-for-early-stage-investments (last visited on 2 May 2021).

primary investment, and a corresponding preference for share-based indemnification schemes.

In the following, we examine legal limitations on indemnification by the company through payments in cash (below III.) before reviewing indemnification through so-called «compensatory capital increases» (below IV.).

III. Cash Indemnification

1. An M&A import in investment transactions

In M&A transactions, indemnification often takes place through payment of a cash amount by the seller(s) to the buyer.[3] This can be achieved directly, through cash transfer from seller(s) to buyer, or indirectly, through final withholding in favour of the buyer of an as-of-yet unpaid or escrowed portion of the purchase price.

Beyond negotiation of the specific scope of indemnification, discussions in the M&A context will focus on the best mechanisms available to reduce non-performance risk. This may lead to much discussion between parties around purchase price holdbacks, escrows, availability of set-off against earn-outs, and whether having recourse to an insurer may be more appropriate. Shorter term fixes for information asymmetry available on the basis of accounts may lead to post-closing price adjustments within predefined parameters, which is also dealt with through money transfers (or withholdings of portions of the purchase price).[4]

Ultimately, however, there is little to no debate that a cash payment from the indemnifying party to the indemnitee or a withholding of a flow of cash in the opposite direction is an appropriate solution from a legal perspective for breaches of representations and warranties after closing:[5] barring marginal cases, there is nothing stopping a seller from undertaking to pay a cash indemnity to the buyer in case of breach.

This approach is replicated to an extent by the Swiss Private Equity & Corporate Finance Association (SECA) model documentation, which provides the following terms for venture capital investments:[6]

«With respect to a misrepresentation or a breach of warranty notified by an Investor to the Company in accordance with Section 10.1 and Section 10.2, [the Existing Shareholders] shall have the right, within [30] calendar days after receipt of such notice of breach by the Company, to put the Company or, with the prior written consent of [all] Investors (such consent not to be unreasonably withheld or delayed in case the damage, loss, expense, or cost was incurred by that Investor and not by the Company), that Investor, at [the Existing Shareholders'] own expense, in the position it would have been in had no such misrepresentation or breach of warranty occurred.

If and to the extent the remedy set forth in the preceding paragraph cannot be effected or is not effected within such period of time, then that Investor, subject to the exclusions and limitations set forth in this Agreement, shall have the right to claim that [the Existing Shareholders] pay, and [each Existing Shareholder] shall be […] liable to that Investor to pay, damages to the Company (or, if the damage, loss, expense, or cost is incurred by that Investor and that Investor so elects in accordance with the foregoing paragraph, to that Investor) in the amount which is necessary to put the Company (or, subject to the foregoing requirements, that Investor) in the position it would have been in had no such misrepresentation or breach of warranty occurred. Such damages shall include all duly documented external costs and reasonable expenses of the Company (or, subject to the foregoing requirements, that Investor) including reasonable attorneys' fees[, but shall exclude lost profits].»

The solution is constructed to work as an indemnity provided by the existing shareholders. The drafting assumption (even if placed in square brackets) is that the relevant underlying representations are provided by such shareholders in the same manner as would be provided by share sellers in the context of a secondary transaction or of an M&A deal. In that approach, it is therefore log-

3 This simple statement is of course without prejudice to the actual nature of the payment, the conceptualisation of which may vary on the terms of the contract or on the applicable laws – and also purposefully ignores the matter of specific performance given the emphasis on indemnification (for an examination of specific performance issues, see for instance Rudolf Tschäni, Specific Issues in Different Types of Contractual Relations: Corporate Disputes, in: Schneider/Knoll (eds.), Performance as a Remedy: Non-Monetary Relief in International Arbitration, ASA Special Series No 30, 2011, 211 *et seqq.*). In this context, some legal orders, such as Switzerland, may grant claims for «positive damages» (see for instance Rudolf Tschäni, Post-Closing Disputes on Representations and Warranties, in: Kaufmann-Kohler/Johnson (eds.), Arbitration of Mergers and Acquisitions Disputes, ASA Special Series No 24, 2005, *passim*), a position close to «performance interest» under the laws of England and Wales (most classically expressed in Robinson v. Harman, (1848) 1 Exch. 850, 855; 154 E.R. 363, 365, as follows: «[t]he rule of the common law is, that where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation with respect to damages, as if the contract had been performed.»; for a detailed review of the topic, see for instance Brian Coote, Contract Damages, Ruxley, and the Performance Interest, 1997 Cambridge Law Journal 56(3), 537–550). Alternatively, claims may be available for «negative damages» or «reliance damages», which aim to put the party not in breach in the situation in which it would have been had it not entered into the contract at all (for the American position, see of course Lon Fuller/William Perdue, The Reliance Interest in Contract Damages, The Yale Law Journal 46(1), 52–96).

4 Increasingly, M&A transactions also rely on insurance policies to replace indemnification mechanisms entirely. So far, these are rarely, if ever, seen in venture capital transactions and investment agreements on the Swiss market.

5 Pre-closing, the consequence of a breach of representations and warranties may also be managed through conditions precedent as an alternative «circuit breaker».

6 Available at https://www.seca.ch/Templates/Templates/VC-Model-Documentation.aspx (last visited on 2 May 2021).

ical for the payment of any indemnity to also come from the existing shareholders.[7] The target of the payment is perhaps more noteworthy of comment: if the investor is suffering indirect damage due to loss of value of the acquired shares[8], then the liability is of the existing shareholders towards the investor, but their payment may be expected to be made to the company. From a corporate law perspective, given that there is no corresponding liability of the company according to the investment agreement, this would become an *à fonds perdu* contribution by the existing shareholders or by the investor to the company.[9] In turn, this would arguably have to be accounted for as part of the company's legal reserves.[10]

The net result of the payment in such scenario is an increase of the company's equity *(Eigenkapital, fonds propres)* based on the finding that the company's valuation is, in fact, lower than was agreed at the time of closing the investment. The solution proposed is perhaps not the most intuitive from an accounting perspective, but does have the benefit of reinforcing the company's financial situation and protection of the company's capital rather than weakening it – which would be the direct consequence of the company instead paying damages to the investor.[11]

In practice, VC investments are however often carried out with representations and warranties being provided by the company itself, i.e. by the target of the primary investment, alongside or in lieu of representations and warranties which may be provided by its existing shareholders.[12] Furthermore, the representations and warranties provided by «non-operational» shareholders are frequently reduced to core items such as capacity and ownership. Conversely, the «operational» shareholders (usually the founders of the company and C-level executives) may more often be put on the hook for a wider variety of items – sometimes even the entire catalogue of representations and warranties – but are typically seen as a «bad risk» given their (relative lack of) capacity to indemnify, due to minimal financial resources.[13]

The balance between the representations and warranties provided by the company vs those provided by the founder(s) and shareholders will most often vary depending on the level of development of the company. Early-stage investments will often have the founders exposed, whereas growth/late-stage investments may see more emphasis on company representations and warranties. A total exclusion of the founders and existing shareholders from the indemnification regime is rarely achieved and remains more prevalent (in relative terms) in late-stage transactions. In situations where the company becomes a relevant, and perhaps even primary indemnitor, the legal questions we examine below are of particular importance.

2. Capital protection

2.1 Art. 680 SCO as a limitation on indemnification mechanisms

Cash indemnification of an investor by the company runs the risk of falling foul of legal provisions protecting company capital, most specifically of art. 680(2) of the Swiss Code of Obligations (SCO) forbidding reimbursement of capital payments to shareholders. In such case, the transaction is considered null and void from the outset[14] and may trigger potentially drastic consequences for the persons enabling the operation.[15]

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7 This is also the position taken by certain authors for whom the assumption remains that the principal counterparties for any representations and warranties would be the main shareholders of the company at the time of investment, see for instance Edgar Philippin/Nicolas Loepfe, Zusicherungen und Garantien zugunsten von Investoren im Rahmen einer Finanzierungsrunde, SZW 2016, 295 *et seqq.*, 296, who nonetheless acknowledge that the trend is towards increasing liability of the company itself: «[z]unehmend ist es aber auch die Zielgesellschaft selbst, welche als Schuldnerin der zur Absicherung der Investoren notwendigen Gewährleistungsversprechen auftritt.»

8 This would be the most likely scenario in case of a breach of representations and warranties concerning the company in which the investment is made.

9 Depending on whether we consider the indemnification obligation of the existing shareholders in this context to have been entered into for the benefit of the company (in which case the contribution is of the existing shareholders) or whether we consider the payment to be to the company but for the benefit of the investor (in which case the contribution is of the investor).

10 See Peter Böckli, Schweizer Aktienrecht, Zurich 2009, § 8 N 308; Schweizer Handbuch der Wirtschaftsprüfung (HWP), Vol. 1 IV 6.26.2.2.

11 Direct payments by the company to an investor may also trigger other considerations, such as potential board liability under art. 754 SCO, due not only to the damage caused to the company, but also due to potential breaches of the duty to treat shareholders equally.

12 This can be due to a variety of factors. In early-stage investments, investors with aligned interests may have no difficulty in imposing representations and warranties on the founders of a company. As the number of investors in the company increases and the founders are diluted, it may become less and less justified to have the founders carry the risk of representations and warranties. At the same time, it may become increasingly complicated to impose representations and warranties on the other shareholders who are non-operational and may resist representations and warranties as a matter of principle (many investment funds would fall into that category). As a result, the company itself tends to become a prime candidate to provide representations and warranties in later stages.

13 The fact remains that representations and warranties are not an entirely satisfactory way of covering risk for early-stage investments, except in the scenarios where the founders may have deeper pockets than the average university graduate setting up their first business. Risk in early-stage ventures is therefore more adequately covered – though on the basis of an entirely different legal logic – through recourse to measures such as milestone based investing (with company valuation determined for different tranches of investment on the basis of performance) or through anti-dilution clauses to cover against the risk of a down-round. In the same sense, see Frank Gerhard, Private Investments in Public Equity (PIPEs) in der Schweiz, in: Reutter/ Werlen (eds.), Kapitalmarkttransaktionen V, Zurich 2010, 197 *et seqq.*, 261 *et seq*.

14 Cf. BSK OR II-Kurer/Kurer (4th ed), art. 680 N 25; CRO CO II-Chenaux/Gachet, art. 680 N 56.

15 The reimbursement of capital in breach of art. 680(2) SCO may be considered as criminal mismanagement (*gestion déloyale*; *Unget-*

The position has been held in some minority scholarship that the entire share price (nominal value plus premium) should be protected by art. 680(2) SCO,[16] resulting in the basic illegality of any payment from reserves constituted on the basis of share premiums. The matter was however finally laid to rest by the Swiss Supreme Court in 2014 with the finding, aligned with majority scholarship,[17] that a literal (though *a contrario*) reading of art. 671(3) SCO would allow the amount of premium exceeding half of the company's share capital to be used to make indemnification payments to the shareholders.

With the entry into force of the modifications to legislation governing companies limited by shares,[18] this interpretation will be confirmed and reinforced by art. 671(2) nSCO which states in affirmative terms (and therefore without needing to rely on *a contrario* reasoning) that the amount of reserves resulting from capital contributions and profits in excess of half of the company's share capital (after deduction of any losses) can be reimbursed to the shareholders.[19]

The new legislation also specifies the means of recourse to obtain repayment of any excess payment: art. 678(1) nSCO governing the shareholders' obligation to return undue payments of dividends and profits now has a scope which expressly extends to the return of payments made from reserves resulting from capital contributions.[20] This has several consequences which we examine further below.

2.2 Limiting factors: the low impact of art. 680(2) in practice

The impact of art. 680(2) SCO should however not be overstated even in the context of an indemnification by the company, due to the valuations at which shares are commonly issued in the venture capital context: share prices in venture capital investments generally consist of a fairly low nominal value plus a very large premium paid by the investors, meaning that capital reserves will likely be far in excess of the threshold currently set by art. 671(3) SCO or its successor provision.

A typical Series A financing round in Switzerland can be expected to raise funds at a pre-money valuation of CHF 10 million or more. Assuming a limited company with the minimum share capital of CHF 100,000 in compliance with art. 621 SCO, this will mean that 99 % or more of the value of any issued share can be expected to be allocated to the payment of a premium (*agio*) over the nominal value.[21] Using the pre-money valuation indicated above, if CHF 1,000,000 is raised, this would lead to a capital increase of only CHF 10,000 with a premium of CHF 990,000, all of which would be allocated to the company's general reserves in accordance with art. 671(2)(1) SCO. Once we deduct half of the capital as the amount «locked and unusable» in conformity with art. 671(3) SCO (i.e. CHF 55,000), the company would have a very substantial buffer of CHF 935,000 (the difference between the total premium and the «locked and unusable» amount) with which to potentially pay damages immediately as of the date on which the capital increase is consummated.

With the figures provided, this amounts to a coverage of 93.5 % of the total investment value without breaching capital protection provisions such as art. 680(2) SCO, assuming that the company has not used its reserves to already offset losses and that it actually has access to cash with which to pay damages. Availability of the amount from an accounting perspective will obviously not equate to the company being liquid and able to actually pay.

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reue Geschäftsbesorgung) by the board members under art. 158 of the Swiss Criminal Code (SCC) (cf. BGE 117 IV 259), may represent a forgery of a document under art. 251 SCC (*faux dans les titres;* or the obtention of a false certificate by fraud under art. 253 SCC (*obtention frauduleuse d'une constatation fausse; Erschleichung einer falschen Beurkundung*); see CRO CO II- Chenaux/Gachet, art. 680 N 67.

16 See for instance Böckli (FN 10), § 12 N 526; Roland von Büren/Walter Stoffel/Rolf Weber, Grundriss des Aktienrechts, Zurich 2011, N 1093.

17 See, inter alia, David Oser/Hans-Ueli Vogt, Die Ausschüttung von Agio nach geltendem und künftigem Aktienrecht, GesKR 1/2012, 10 *et seqq.*; Urs Kägi, Kapitalerhaltung als Ausschüttungsschranke, Zurich 2012, 290 *et seq.*; Lukas Glanzmann/Markus Wolf, Cash Pooling – Was ist noch zulässig?, GesKR 2/2014, 264 *et seqq.,* 270 and sources cited at FN 81 thereof; Peter Binder, Das Verbot der Einlagerückgewähr im Aktienrecht, Diss. Zurich 1982, 26 and 29; BSK OR II-Kurer/Kurer (4th ed), art. 675 N 19; BSK OR II-Neuhaus/Balkanyi (4th ed), art. 671 N 36.

18 Obligationenrecht (Aktienrecht). Änderung vom 19. Juni 2020, AS 2020 4005.

19 Art. 671(2) nSCO reads: «Die gesetzliche Kapitalreserve darf an die Aktionäre zurückbezahlt werden, wenn die gesetzlichen Kapital- und Gewinnreserven, abzüglich des Betrags allfälliger Verluste, die Hälfte des im Handelsregister eingetragenen Aktienkapitals übersteigen.»

20 See Dispatch of the Swiss Federal Council on the Amendment of the SCO dated 23 November 2016, BBl 2017 353, 477, which specifically cross-references art. 671 nSCO as part of the scope targeted by art. 678(1) nSCO.

21 The calculation to reach this is as follows: with CHF 100,000 in capital, a valuation of CHF 1 million implies a price of CHF 10 (valuation divided by outstanding capital) for each CHF 1 of capital increase (this is irrespective of the share price: if the nominal value per share is CHF 0.01, the new shares would be issued at CHF 0.10, if the nominal value per share is CHF 1, the new shares would be issued at CHF 10 per share). This results in CHF 10 – CHF 1 = CHF 9 being allocated to the premium for each CHF 10 of capital increase, i.e. 90 %.

3. Protection against disproportionate payments

3.1 Art. 678 SCO as a limitation on indemnification mechanisms

As noted by scholarship, art. 678 SCO may also limit indemnification mechanisms.[22] This provision states, in its current form, that shareholders and members of the board of directors and their close associates must return any dividends, or shares of profits received unduly and in bad faith (art. 678(1) SCO; *indûment et de mauvaise foi; ungerechtfertigt und in bösem Glauben*), as well as any benefits received from the company that are manifestly disproportionate *(en disproportion évidente; in einem offensichtlichen Missverhältnis)* to the performance rendered in return and to the company's economic situation (art. 678(2) SCO).

It appears clear on the surface that art. 678(1) SCO as currently conceived would not apply, as an indemnification for a breach of representations and warranties would in principle not constitute a dividend or payment of any share of profits that is captured by the wording of the provision.[23]

Art. 678(2) SCO, however, may be relevant. According to the Swiss Supreme Court, the criteria that the benefits received are manifestly disproportionate to the performance in return and to the company's economic situation are in fact close enough that the second can be ignored: the company's economic situation is not, in this context, an independent item to be examined to determine whether art. 678(2) SCO is triggered.[24]

3.2 Manifest disproportion of benefits vs performance rendered in return

As to the determination of whether the benefits received are manifestly disproportionate to the performance rendered in return in the investment context, scholarship is united in considering that the transaction needs to be considered on an arm's length basis,[25] but draws differing conclusions from this.

Given that Swiss corporate law does not, as a matter of principle, establish any particular warranties in the context of an issuance of shares, one approach has been to consider that the representations and warranties regime would represent an advantage provided by the company in addition to the issuance of shares. As the issuance of shares represents full payment by the company against the subscription price under applicable principles of corporate law, the contractual promise of indemnification provided by the company could only be justified by reference to additional advantages obtained by the company through the investment. This could be, for instance, access obtained to know-how of the investor, or new sales opportunities or strategic cooperation opportunities.[26]

Needless to say that this sets an extremely high standard which is not always met in practice, as many investors bring nothing more than cash to the table (despite their claims of contributing «smart money» to the target). This approach also assumes that the issue price for the shares is set on an arm's length basis, ignoring any representations and warranties. The assumption of the valuation process for venture capital investments is however not that the representations and warranties are absent, but that there are no negative factors which would impact the valuation at which investors accept to make their investment. It is in that perspective that a breach of representations and warranties and the consequent indemnification by the company function as a downwards adjustment of the valuation.[27]

A different conclusion drawn by scholarship on this topic so far has been to consider that the indemnification may trigger art. 678(2) SCO, and therefore need to be reimbursed, if it is so far beyond the quantum of damages actually suffered by the investor that it is manifestly disproportionate – with the basic assumption that this would not be the case if the indemnified damages are determined by reference to applicable principles of Swiss law.[28] There are two principal flaws with this logic. The first is that it comes full circle: (i) a transaction which is manifestly disproportionate may trigger an obligation to reimburse, (ii) a transaction is not manifestly disproportionate if it is at arm's length, (iii) an arm's length transaction is one that is not manifestly disproportionate, taking into account its quantum. The second is that by focusing on the notion that an arm's length transaction repre-

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22 See for instance Gerhard 2010 (FN 13), 260 *et seq.*; previously Frank Gerhard, Private investments in public equity (PIPE) – Ein Blick auf PIPE-Transaktionen in der Schweiz, GesKR 4/2006, 286 *et seqq.,* 305; see also Philippin/Loepfe (FN 7), 297 *et seq.*

23 As we have seen above, in its new form art. 678(1) nSCO will however be directly relevant in the context of a potential breach of the limits set for payments from capital reserves through art. 680(2) SCO and art. 671(3) SCO.

24 BGE 140 III 602 E. 9.3.

25 Gerhard 2010 (FN 13), 260; Philippin/Loepfe (FN 7), 298.

26 Gerhard 2006 (FN 2222), 305.

27 Or, in the M&A context, as a «price reduction». It is noteworthy that this conceptual framework only makes sense where the parties receiving the money and those providing the representations and warranties are in direct relationship: i.e. between a buyer and seller, or between the investor and the company. If the indemnification is being provided in a «triangular» relationship by existing shareholders for an investment being made by the investor into the company, then the «price reduction» framework does not make sense. If the existing shareholder indemnifies the investor directly, then this is directly compensating the investor for a damage. Conversely, if the existing shareholder injects cash into the company to put the investor in the same position as before the damage, then this is to maintain the same company valuation.

28 Philippin/Loepfe (FN 7), 298 and footnote 18 stating that there would be no manifest disproportion «wo der Schaden – wie nach schweizerischer Rechtsprechung und Praxis üblich – nach der sog. Differenzmethode berechnet wird.»

sents a form of «safe harbour» within which art. 678(2) SCO does not apply, we are no closer to determining the boundaries of what is *manifestly* disproportionate and beyond which art. 678(2) SCO would be triggered.

3.3 Conclusions on the relevance of art. 678(2) SCO in light of art. 678(2) nSCO

Given the difficulties encountered to justify a coherent application of art. 678(2) SCO as it currently stands, one may even consider whether said application makes any sense in the context of an indemnification for a breach of representations and warranties in an investment transaction.

As stated above, Swiss corporate law considers the issuance of the shares, without additional undertakings of the company, as the sole obligation of the company to be discharged against the issue price of which represents full and complete payment. An indemnification for a breach of representations and warranties can therefore be conceived, as is very often the case, as compensation for a finding that the valuation was, in fact, too high with due regard to the assumptions made at signing and/or closing.

Seen that way, there is no «benefit received from the company» within the meaning of art. 678(2) SCO. Any indemnification would not be a *«prestation de la société»* or *«Leistung der Gesellschaft»* but a true price adjustment that is based on the finding that the investor's payment was too high. This is also implied by the typical language found in most investment agreements – also an import from M&A transactions – to the effect that the indemnification shall function as a reduction of the purchase price.

So long as the other capital protection provisions are protected, and in particular art. 680(2) and art. 671(3) are respected, it would therefore appear that any additional recourse to art. 678(2) SCO is neither useful nor legally justified.

The replacement provision art. 678(2) nSCO does away with the idea that the company's situation is relevant, by removing the corresponding wording (the terms *«situation économique de la société»* in the French version and *«wirtschaftlichen Lage der Gesellschaft»* are accordingly eliminated). The clause maintains the notion of manifest disproportion, and ties it to the idea that this needs to be evaluated in the context of an acquisition of assets from the concerned party *(«Si la société a repris des biens de ces personnes […]; «Übernimmt die Gesellschaft von solchen Personen Vermögenswerte […]»)* or in the context of another legal relationship the company may have entered into with said party *(«[…] ou si elle a conclu d'autres actes juridiques avec elles […]»*; *«[…] oder schliesst sie mit diesen sonstige Rechtsgeschäfte ab […]»).* This was implied to an extent in the previous, shorter wording of the existing art. 678(2) SCO, the extension of the provision to cover acquisitions of assets being one of the consequences of the disappearance from the law of the rules previously applicable to such acquisitions at the time of constitution or increases of capital.[29]

4. Claims for restitution

Claims for restitution based on a breach of art. 671(2) nSCO or due to a manifestly disproportionate payment under art. 678(2) SCO (assuming that the provision is relevant to indemnification mechanisms in investment agreements) are subject to the conditions set forth in art. 678 SCO.[30] This has several consequences.

First of all, the new art. 678(1) nSCO does away with the notion that only payments made unduly *and* in bad faith (as specified in the current art. 678(1) SCO) need to be reimbursed. The principle now extends to all payments covered by art. 678(1) nSCO on the sole basis that they are undue. As such, any controversy as to whether good faith can be presumed in this context, in accordance with art. 3 SCC, is moot.[31]

This apparent simplification of the process is somewhat complicated by the reference from art. 678(3) nSCO to art. 64 SCO: any claim for restitution is subject to the same limitations as in case of unjust enrichment. There is no right of restitution where the recipient can show that she is no longer enriched at the time the claim for restitution is brought, unless she alienated the money benefits in bad faith or in the certain knowledge that she would be bound to return them. A comprehensive review of the consequences of the application of this provision in the context of indemnification claims in investments would exceed the scope of this article.

The application of the process set forth in art. 678 nSCO also has several procedural consequences. Firstly, the shareholders are enabled to act directly against the (excessively) indemnified investor in case of breach, on the basis of art 678(4) nSCO, requesting payment to the company. Secondly, the general meeting of shareholders can decide that the company shall act to obtain the return of any amounts. The general meeting may even bypass the board of directors in the process by appointing a representative to manage the claim (art. 678(5) nSCO).

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29 Art. 628(2) SCO; see also the Dispatch of the Swiss Federal Council on the Amendment of the SCO dated 23 November 2016, BBl 2017 353, 477.

30 The removal is justified by the difficulty to bring proof of bad faith, see the Dispatch of the Swiss Federal Council on the Amendment of the SCO dated 23 November 2016, BBl 2017 353, 478.

31 Philippin/Loepfe (FN 7), 298, 299 with references to Hans Caspar von der Crone/Yves Mauchle, Rückerstattung von Leistungen nach Art. 678 OR, SZW 2015, 199 *et seqq.,* 203 and Peter Forstmoser/Arthur Meier-Hayoz/Peter Nobel, Schweizerisches Aktienrecht, Bern 1996, § 50 N 122; for observations on the new legislation on this topic see Hans Caspar von der Crone, Aktienrecht, Bern 2020, N 541.

Although this is intended to be a tool to manage conflicts of interest, its scope of application would be relatively limited: the decision remains subject to ordinary majority rules. As a consequence, except in some limited constellations where the articles of association of the company or a shareholders' agreement may require a qualified majority for board appointments, the same majority of shareholders may also simply replace the board. It appears likely for now that the possibility given to shareholders to take control of the legal action will not be put into practice very often.[32]

IV. Issuance of shares as indemnification

1. The nature and function of the compensatory increase mechanism

Due to the pressure of having the company itself provide the representations and warranties and corresponding indemnification whilst being faced with the difficulties outlined above, the Swiss market has developed share issuance as a mechanism of choice for indemnification in investment agreements. The idea of such a mechanism is to reach a lower average price paid per share for the investor to be indemnified in order to reflect the loss of value triggered by the breach of a representation or warranty, by issuing additional shares to the investor.

Specific scholarship on this issue has reached the conclusion that the issuance of new shares instead of cash indemnification presents substantial advantages by avoiding the legal issues described above (see part III).[33] Given that the whole point of the mechanism is to reach an average price that is more in line with the expected valuation by issuing supplemental shares, there is little place for the notion that an indemnification of this type would represent a «reduction of the subscription price». The investor will have maintained the initial subscription price as is and is simply being provided with the opportunity to subscribe additional shares at a lower value. Accordingly, there is no reason to consider the issuance as being in breach of capital protection rules in and of itself.

Whilst the possibility of any breach of art. 678(2) SCO may be seen as theoretical in this context,[34] we would go even further and say that it is conceptually not possible (to the extent that the someone other than the company pays at least the nominal value of the shares being issued).

The precise determination of the number of shares to be issued depends on the circumstances of the agreement, as there are several «types» of clauses in circulation on the market. The following two methods of calculation already show that the differences between clauses are far from theoretical:

- the issuance of a number of shares calculated based on the fair market value of such shares at the delivery date of the notice of claim, whereby the total indemnified loss is simply divided by the fair market value per share minus the nominal value per share; or
- the issuance of a number of shares such that the average price paid per share by the indemnitee (including the new shares to be issued in the compensatory capital increase) reflects the decreasing value in the company compared to the pre-money equity valuation used for the financing round.[35]

A detailed examination of the various options on the table would far exceed the scope of this article. Suffice it to note at this juncture that, in any event, the shares are issued at nominal value (hence the deduction in the first example above). The corresponding subscription price may be payable by the indemnitee or paid for by the company itself (within the legal limits described in part III above for use of capital reserves to do so).

The following will examine some of the consequences of new legislation on compensatory capital increases.

2. Some consequences of new legislation on compensatory capital increases

2.1 Waiver of preferential subscription rights

The mechanism strongly relies on compliance by existing shareholders with the issuance. This is ordinarily secured by having the existing shareholders themselves waive their preferential subscription rights under art. 652b(1) SCO, whilst simultaneously undertaking to vote in fa-

32 On a related note, the Swiss Federal Council states at BBl 2017 353, 479 that the shareholders wishing to use this right would have to exercise their rights to obtain information pursuant to art. 697 nSCO, which states in a nutshell that the shareholders can obtain information at the general meeting (unchanged from current art. 697(1) SCO), or outside of a general meeting to the extent that they hold at least 10 % of shares or voting rights (art. 697(2) SCO). In stating so, the Swiss Federal Council is basically ignoring that the shareholders would still be relying on the feedback received from the board, in a situation of open conflict of interest (which is the assumption underlying the appointment of a third party to conduct proceedings in the first place) and through a process affording substantial leeway to the board to delay giving information or block it entirely.

33 Philippin/Loepfe (FN 7), 301.

34 *ibid*.

35 Note that the issuance based on an adjusted pre-money valuation may appear coherent with the notion that the representations and warranties are given at that point in time and against a certain company valuation but causes other conceptual issues. In particular, this mechanism creates an uneasy relationship between the damage suffered by the investor (which may include legal or other fees) and the loss of value suffered by the company, as it hardly seems justified to adjust a company valuation by the amount of investor loss. At the same time, the mechanism does not account for the current value of the shares being issued in compensation.

vour of the compensatory capital increase at any relevant general meeting.[36]

If all shareholders are not a party to the investment agreement or shareholders' agreement underpinning the mechanism, then the only way in which to obtain a mechanism which would function would be by waiving the other shareholders' preferential subscription rights. This could theoretically be achieved in one of several manners: at the time of an ordinary general meeting convened specifically for such purpose, through use of authorised capital (soon to be replaced by a capital fluctuation margin), or through use of conditional capital.

a. Ordinary general meeting

Pursuant to art. 652b(2) SCO, the general meeting may cancel the preferential subscription rights of existing shareholders for good cause *(pour de justes motifs; aus wichtigen Gründen).* Without going too far into the finer details of this complex topic, the following points are of particular relevance to indemnification mechanisms in investment agreements.

Firstly, the cancellation of preferential subscription rights must be carried out respecting equal treatment of shareholders. Equal treatment remains a relative concept and needs to be evaluated in context.[37] As such, if the parties intend to rely on a subsequent «forced» cancellation of preferential subscription rights, they would be well advised to ensure that the investor benefits from a specific share class (which is often the case for investments from Series A onwards).

Secondly, the determination of whether there is good cause may be problematic due to timing issues. Although the issuance of shares to a third-party investor may, with relative ease, be seen as constituting good cause at the time of the original investment, the same thing cannot be said at the time of a compensatory capital increase. At the time of the original investment, the shareholders will have a clear view of the value (issue price) being brought to the company against the shares issued, and the value is expected to be positive through an increase of company value. Conversely, the compensatory share issuance mechanism has literally no other function than to grant additional shares to one shareholder (the investor) at the sole (or principal) cost of the others.

Thirdly, the compensatory capital increase indemnification mechanism ordinarily relies, as described above, on an issuance of shares at nominal value. This allows the issuance to be achieved at minimal cost to the investor (if the investor is required to pay for the shares) or to the company itself (to the extent that the company is using freely disposable reserves to pay for said shares). The payment of shares at nominal value does not cause any particular issues under legislation as it currently stands. Only the issuance of shares below nominal value is restricted.[38]

Although the legislative changes will not bring anything new to the table on the topic of issuances *below* nominal value,[39] it is noteworthy that the issuance of shares *at* nominal value – or indeed at any price above – may be restricted under art. 652(4) nSCO if such price is found to represent an unjustified disadvantage.

How this will play out in practice is a different matter altogether. The preliminary project of 2014 foresaw restrictions on issuances at a price «substantially below the real value» of a share. The rule was intended to protect shareholders from dilution when they are neither willing nor able to participate in a given transaction.[40] This was understandably and quite strongly criticised by scholarship.[41] The new legislation does away with the ideas that the share price must not go «substantially below the real value» of a share to trip the applicability of special rules. Instead, it specifies that the determination of the share price and the limitation of preferential subscription rights are intended to be subject to the same conditions in order to avoid legal uncertainty, whilst justifying this position with the self-same formulation as in the original explanatory report (confusingly now applied to what should be a different system).

In other terms, the objective of the new provision is therefore, quite ostensibly, to ensure that shareholders cannot be diluted against their intent, whereas the limitation of preferential subscription rights – which is supposed to be subject to the same conditions – is relevant *only* to deprive shareholders of their preferential subscription rights against their intent. It remains to be seen in practice how the courts will interpret the additional condition, and in particular whether they will consider it to have any independent relevance at all.

Given the above, it seems likely that art. 652b(4) nSCO will have a limited impact, if any, on compensatory increases.

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36 Philippin/Loepfe (FN 7), 300 *et seq.*

37 CRO CO II-Zen-Ruffinen/Erben, art. 652b N 25; BSK OR II-Zindel/Isler, art. 652b N 23; von der Crone (FN 31), N 668 *et seqq.*

38 Art. 624(1) SCO.

39 Art. 622(4) nSCO provides that shares must have a nominal value above zero. It will therefore be possible to subscribe at lower prices than currently possible, but still at least at nominal value – however low that may be. It remains to be seen how this will work in practice and what the limits in terms of potential abuse will be, and whether we will see issuances of large numbers of shares for symbolic prices in extreme scenarios.

40 «*Mit dieser Regelung wird zum Schutz des Eigentums der Aktionärinnen und Aktionäre ausgeschlossen, dass durch eine Kapitalerhöhung der Substanzwert ihrer Aktien verwässert wird, wenn sie sich nicht an der Erhöhung beteiligen können oder wollen*», cf. the Swiss Federal Council's explanatory report relating to modifications to be brought to the Swiss code of obligations, issued on 28 November 2014, 81.

41 See in particular Dieter Gericke, Mindestausgabebetrag bei der Kapitalerhöhung, GesKR 2/2016, *passim.*

In short, a compensatory share issuance by way of an ordinary capital increase requires, at the very least, obtaining waivers from existing shareholders: a decision to cancel subscription rights down the line[42] will likely be difficult to justify on the basis of an agreement which, from the perspective of the shareholders who are not contractually bound, has already been «fully paid for» through the initial issuance.

b. Authorised capital increases and fluctuating capital

The above leaves open the possibility for the general meeting to cancel subscription rights in view of a future increase through recourse to authorised capital. The justification for such a cancellation may be found at the time the authorised capital clause is introduced in the acknowledgment by a qualified majority of shareholders that this is a necessary component of an investment to be carried out simultaneously with said introduction.

This requires, however, a maximum dilution to be specified in the authorised capital clause, as an authorised increase cannot exceed the half of the outstanding capital *immediately prior to the introduction of the clause* is introduced as per art. 651(2) SCO. A further limitation arises pursuant to art. 651(1) SCO which limits the lifespan of the authorised capital clause to two years. The new provisions on fluctuating capital do not bring more flexibility which would be relevant to our situation: art. 653s(2) nSCO specifies that the upper limit of the margin of fluctuation is equal to 1.5 times the registered capital, which is identical to saying the increase is equal to 0.5 times the same amount.[43]

The new legislation is in fact arguably more restrictive than the previous, as it specifies that fluctuating capital provisions become void in case of any capital increase decided by the general meeting in the interim (art. 653v(1) nSCO), whereas the current authorised capital system does not suffer from any such limitations. As a consequence, the general meeting would need to readopt any fluctuating capital provisions at such time, with the result that any «good cause» leading to limitations on preferential subscription rights would need to be reassessed at such time – which may prove to be a moving target.

Any breach of the conditions in art. 652b SCO by the general meeting opens the way to an appeal by shareholders under the ordinary rules of art. 706 SCO – which provision remains unaffected by legislative change. Similarly, if the decision to limit preferential subscription rights is delegated to the board of directors, then any breach by the board of directors of legal principles governing such limitations is not open to challenge by the shareholders, but may (as is the case today) open the way to a liability claim against the board of directors.[44]

2.2 Use of conditional capital

Although it is rarely seen in practice, conditional share capital could also be used to accommodate a compensatory capital increase. An investor's right to obtain the issuance of shares at nominal value may be conceived as a form of warrant or option. Given the limited amount of information that needs to be provided within the conditional increase clause itself according to art. 653b SCO,[45] this would, at least at first, seem to be a proper manner in which to create a practical framework within which to achieve an efficient compensatory capital increase.

Issues may arise, however, linked to timing: art. 653b(3) SCO specifies that any option right granted before the relevant provision of the articles of association is entered into the commercial register is void. Scholarship warns that the provision should not be interpreted literally, but the flexibility one may have is mostly limited to listed companies or those who have access to treasury shares, as they are able to «cover» the risk associated with convertible securities without having recourse to conditional capital.[46] That being said, it may be accepted that conversion or option rights which are not covered by conditional capital are not so much void as simply ineffective until such time as the conditional capital clause is introduced.[47]

Given the substantial agreement in scholarship as to the counterintuitive (and very nearly *contra legem*) interpretation to be given to art. 653b(3) SCO in many cases, as well as the recognition that the drafting of the provision is perhaps not the best,[48] it is surprising that the replacement provision uses the exact same terms.[49]

It is unlikely that changes to legislation concerning conditional capital increases will encourage any use of the

[42] Indeed, up to several years from the initial capital increase date depending on the duration of the representations and warranties at issue.

[43] On this point, the new legislation is geared mostly towards simplifying capital reductions instead of simplifying capital increases.

[44] Opening a decision made by the board of directors under art. 653u nSCO to challenge would have represented a major change of system, which was considered but rejected (see BBl 2017 353, 449).

[45] CORO CO II-Zen-Ruffinen/Erben, art. 653b N 14 *et seqq.*; BSK OR II-Zindel/Isler (4th ed), art. 653b N 20 *et seqq.*; Böckli (FN 10), § 2 N 210 *et seqq.*

[46] CORO CO II-Zen-Ruffinen/Erben, art. 653b N 18; BSK OR II-Zindel/Isler (4th ed), art. 653b N 28.

[47] CORO CO II-Zen-Ruffinen/Erben, *loc. cit.*; Böckli (FN 10), § 2 N 204 – instead emphasizing the duty of the board of directors in this context to make all necessary undertakings towards ensuring that the option rights are covered by the time shares are required to be delivered.

[48] Böckli (FN 10), *loc. cit.*: «Der Wortlaut der Gesetzesbestimmung ist anerkanntermassen unglücklich […]»

[49] Changes introduced by art. 653b(3) nSCO are limited to the insertion of a reference to the conditional capital clause itself, a point which changes nothing at all to the current interpretation to be given and can barely even be considered a clarification of the existing text.

institution to provide cover for a compensatory capital increase mechanism, and we do not expect to see any more instances of what can already be considered a very marginal approach.

V. Conclusions

It is customary for shareholders and private companies to grant representations and warranties to investors subscribing shares at a price often reflecting its potential, rather than its actual, value. Should the representations and warranties be breached, hurting the value of the equity position, indemnification in one form or another is the rule.

The list of representations and warranties, as well as the modalities for indemnification, may be the object of lengthy (and costly) negotiations. The principle and legitimacy of indemnification – whether in cash or in shares – is, however, rarely challenged. Investors will put pressure on the existing shareholders and the target company as if they intend to actually enforce remedies and their right to sue and obtain indemnification. At the same time, existing shareholders and the company will be advised that the principle is basically not open for discussion, and that any negotiation needs to take place on the terms. Due to structural similarities between investment agreements and share purchase or asset purchase agreements, lawyers may (and often do) lose sight of key differences which should inform their approach to such matters as representations and warranties as well as any indemnification regime: (i) the investment agreement involves a transfer of value to the target of the investment, whereas a share purchase agreement will involve a transfer of value to a third party – meaning that any recovery for a breach in an investment agreement is likely to destroy value for the investor,[50] whereas recovery in a share purchase agreement should not; and (ii) contrary to a share purchase agreement which may take a «clean break» approach or one that usually contemplates a transition, the outcome of an investment agreement is that all parties will be required to «live together».

Our article has identified certain legal limitations linked to the recourse to such remedies against the company receiving the investment. In particular, the provisions protecting company capital may represent one such limitation, though their impact should not be overstated due to practical considerations. We have also concluded that additional recourse to provisions protecting against disproportionate payments to shareholders may not be justified, and that their utility is debatable. Finally, we have arrived at the conclusion that the modifications brought by new legislation, including in particular to conditional and authorised capital – to be replaced by a fluctuating capital – are unlikely to make it any simpler to proceed with compensatory capital increases.

Going further, and based on our regular representation of founders, companies and equity investors across the aisle, we would welcome a more thorough assessment of the use and indeed the relevance of indemnification mechanisms based on breaches of representations and warranties. Practical obstacles to enforcement are numerous. To cite but a few issues from different angles:

- investors are often represented at the board of the company, creating important conflict of interest issues and potential liabilities;
- for returning investors, enforcement might lead to suing a co-investor, a prior investor or even an affiliated investor's representative;
- the company may need refinancing on short notice (through convertible debt or an additional equity round) in relation to the event triggering an indemnification: pushing down the valuation of the company to issue new shares at a lower price might not help achieve a quick injection of fresh money at acceptable levels for prior investors;
- compensation through assignment of shares from the founders may be counterproductive, as their motivation is often key to the renewed success of the company and the confidence and faith that new investors might put into the venture;
- etc.

In any event, if there is indeed an indemnity due, it is also likely that the company is in crisis. In such a situation, it is usually in the best interest of the parties to work together and avoid disputes between founders and investors, as well as to avoid capital outflows, rather than to generate further crisis and bleed the company.

For these reasons, and many more, enforcement is rarely sought in practice, rendering the indemnification mechanisms – and indeed any debate as to their legal implications! – mostly irrelevant.

Ultimately, value may be better protected through a thorough evaluation of the investment prospect (including technical, financial and legal due diligence), pre-investment restructuring, and through post close anti-dilution mechanisms allowing protection to investors who may have overpaid for their shares.

50 This is equally true where the representations and warranties are provided not by the target itself, but by, for instance, its founders. To the extent that founders of a company, in particular in early stages of its development, are the key drivers behind its (potential) success, it is doubtful that a claim against them will have any positive effect on future value.