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CORPORATE LAW NEWSLETTER

I THE REPRESENTATIONS & WARRANTIES CLAUSES IN THE SALE AND PURCHASE OF CONTROLLING STAKES AGREEMENTS

Recently, the Supreme Court of Justice has ruled on the applicable regime in case of default regarding Representations & Warranties clauses, concluding that the applicable penalty shall be the one stipulated by the parties instead of the legal regime of civil liability. In light of this Supreme Court decision, one may conclude for the regulatory and limitative role of said warranty clauses with regard to the otherwise applicable legal regimes, without prejudice of the imperative legal norms which may not be removed by the parties.[1]

Increasingly, Representations & Warranties clauses are a fundamental contractual discipline regarding the execution of shares sale and purchase agreements and consist of true expressions of the parties' private autonomy. In effect, each of the parties attempt to shape said clauses in accordance with its own interests, often leading to varied types of clauses both in form and complexity, since they specify both essential and non-essential aspects of the company object of the transaction and eventually define the legal discipline governing the parties' misleading or inaccurate declarations.

The reason for including Representations & Warranties clauses in sale and purchase agreements generally transferring the control of the company to the buyer is the need to ensure that the company object of the transaction presents certain features and qualities. On the other hand, Representations & Warranties clauses are deemed to guarantee that no substantial contingencies capable of impairing the company's activity and/or its economic value exist.

Thereby, Representations & Warranties clauses may be seen as contractual instruments with a purpose of its own, that is, to ascertain and share the risks parties are willing to accept in the framework of the projected transaction. In other words, they constitute essential instruments to balance the buyer's asymmetrical position regarding the vendor, who owns and controls the information of the company's economic and financial structure.

In general terms, one may distinguish two essential types of Representations & Warranties clauses: (i) the "*formal warranties*", which refer to the vendor's power and capacity to execute the agreement and, on the other hand, to its rights over the shares of the company object of the transaction; and (ii) the "*business warranties*" which refer to the juridical-economic peculiarities of the company at stake (*e.g.* operations, transactions, juridical situations, assets and liabilities).

In the contractual architecture, Representations & Warranties clauses perform different roles, namely, the protection of the buyer, where the vendor is liable for the discrepancies between its declarations and reality, assuming the entire risk for the non-existence of the

[1] Cf. the Supreme Court Decision of March 1, 2016 (Case No. 4915/04.9TVLSB.L1.S1).

features and qualities warranted, regardless of fault or negligence. It is a true warranty obligation instead of an obligation of result.

The writing of Representations & Warranties clauses is mostly influenced by two factors. On one hand, it reflects the results of a previous due diligence review, where the disclosure of complete, accurate and up-to-date information will allow the parties to freely and clearly determine their willing to contract. On the other hand, a due diligence review allows the disclosure of the necessary elements to fix the price of the transaction and eventually it will have an evidential function. The knowledge of the contingencies as a result of the due diligence review negatively limits the liability for the violation of the warranty obligations emerging from the Representations & Warranties clauses.

Likewise, the writing of Representations & Warranties clauses greatly depend on the strength and the bargaining power of each party since it will ultimately determine the content of the clauses, which can be more or less protective of the buyer. As an example, one may find agreements whereby the buyer undertakes to act with due diligence, meaning that those situations where the buyer knew or should have known a specific contingency shall not be considered events of default giving rise to indemnifications.[2] On the opposite side, one may find agreements whereby the buyer is entitled to indemnification even if it knew the contingency. *In extremis*, one may find non-warranty clauses whereby the vendor warrants very little or nothing regarding the company's features.

In reality, the judgement rule imposes the adoption of a *full and fair disclosure* principle, whereby the vendor shall be liable only if the contingency at stake was not disclosed in good faith and in an objective and clear manner, thus being possible to conclude that said contingency was not considered in the price determination.

In order to clearly understand the importance of the Representations & Warranties discipline in the merger and acquisition of companies, one should look at the legal regime of contractual responsibility whereby both doctrine and jurisprudence more or less equate the transfer of the company' share capital, *maxime*, the transfer of the company's control to the sale of the enterprise itself, pursuant to different criteria, namely the quantitative criteria and subjective interpretation.

Based on the quantitative criteria, the equation is possible when the acquisition refers to the totality – or the *quasi*-totality – of the company's share capital. Nevertheless, this criteria appears to be simplistic since the buyer will hardly acquire a controlling stake without takin into account the business situation.

On the other hand, the subjective interpretation criteria is based on the idea that through the acquisition of shares the buyer intends to benefit from the set of the company's assets

[2] Notably, the buyer is not obliged to disclose the results of the due diligence review it undertook to the vendor and thus the latter will hardly prove the buyer's knowledge of a certain defect of the contract.

and liabilities. Therefore, there is an inexorable connection between the company's shares and the company itself.[3]

The abovementioned comparison is relevant for the purpose of applying the legal regime of warranty against defects in the framework of the sale of companies. Assuming that the sale and purchase legal regime, as provisioned in articles 874 and followings of the Portuguese Civil Code (hereinafter, "PCC"), applies, the question is whether to apply the legal regime of sale of encumbered goods or defective goods (cf. articles 905 and 913 of PCC, respectively) since, in reality, the encumbrances or defects do not refer to the shares *per se* but to the underlying company, *rectius*, the set of rights and obligations owned by the legal person whose share capital is the object of the transaction.

In case one opts to apply said regime it is important to distinguish, in general terms, the sale of encumbered goods legal regime from the sale of defective goods legal regime. Thereby, encumbered goods are those goods subject to burdens or limitations which the buyer is not aware of and which exceed the normal limits of the acquired right. On the contrary, defective goods are those goods whose defect or irregularity devaluates them or impedes the accomplishment of their purpose or those goods lacking the qualities warranted by the vendor or necessary to accomplish their purpose.

Notwithstanding the similarities between these regimes one should note that the buyer may exercise its rights against the sale of encumbered goods within one year from the day he or she acknowledged the encumbrance; on the other hand, with regard to defective goods, the buyer only has 30 days to report the defect or irregularity from the day it acknowledges it and, in any case, six months since the delivery of the good. In both situations the time limit to exercise the respective rights seems too tight when it comes to the sale of a juridical reality as complex as the sale of a business, whose defects will most probably be revealed within a longer period, even though legal security and celerity concerns shall also be considered.

In our opinion, the application of the legal regime of sale of encumbered goods to the merger and acquisition discipline is more defensible, since the good at stake does not present any defect and one could only speak of defects of the right itself, considering that the sale and purchase of shares consists in a sale and purchase of rights – even though one may consider that it is not merely rights but instead a set of rights and obligations.

In a good legal practice the application of this regime is shaped and limited by the Representations & Warranties clauses set forth by the parties, clarifying their intentions regarding the object and the agreement, thus having an interpretative role of the latter and helping the effective application of the coercive regime in case of default.

[3] Thereby, the acquisition of a controlling stake in order to indirectly acquire the control of the company or the business is comparable to the direct acquisition of the business through transfer.

In case one concludes for the non-applicability of neither the encumbered goods sale regime nor the defective goods sale regime, the buyer's protection, if not provisioned in the agreement, will only be achieved through the legal institutes of error (cf. article 274 and followings of PCC), pre-contractual liability for the violation of information obligations (cf. article 227 pf PCC) unjust enrichment (cf. article 473 and followings of PCC) or the liability regime for providing information (cf. article 485 of PCC)

With regard to the above mentioned error legal regime one could argue for the application of the error concerning the object of the business (article 251 of PCC) when said error attains the reasons determining the willingness to contract, in which case the contract is annullable pursuant to article 247 of PCC (error in the declaration).

Notwithstanding the above, some authors argue that these are not situations of error per se but instead situations of disconformity between the contract and the underlying reality, since the parties willingness was correctly formed and expressed.
On the other hand, with regard to the pre-contractual liability, the doctrine call for cautiousness when applying this regime to valid agreements, even though it should not completely hinder the application of article 227 of PCC. Yet, this regime has the advantage of being applicable regardless of the transaction being qualified as an indirect sale of the business.

In light of the above, one may conclude that the regime applicable to the sale and purchase of controlling stakes is ill-defined and lacks the intervention of the legislator in order to avoid jurisprudential fragmentation and casuistic, which hamper legal certainty and business promptness. Most importantly, it lacks good legal practice in shaping the agreements and, in particular, the Representations & Warranties clauses and their respective *ad hoc* liability regimes.

II NATIONAL LEGISLATION

Decree-Law no. 20/2016 – Official Gazette no. 77/2016, Series I of 2016-04-20

In compliance with the Program of the XXI Constitutional Government, specifically with regard to the compromise to take initiatives aiming to promote foreign investment in Portugal, and considering the understanding according to which the corporate governance model is one of the decisive factors to obtain financing, Decree-Law no. 20/2016, 20 March 2016, which shall enter into force in July 1 2016, is published and produces the 41st amendment to the Legal Framework of the Credit Institutions and Financial Companies (hereinafter, "LFCIFC"), aiming to grant the credit institutions shareholders the possibility to re-evaluate the justification of statutory limits on ownership and exercise of voting rights.

This diploma adds article 13-C to the LFCIFC, under which a deliberation on the maintenance or withdrawal of the statutory limits to holding and exercise the voting rights

of the shareholders of credit institutions is now mandatory at least once every five years. Moreover, this resolution, when proposed by the management board, shall not be subject to any limits on ownership or exercise of voting rights, nor to any quorum or aggravated majority requirements in relation to what is stipulated by the Law.

Under paragraph 3 of the same article, in case a deliberation did not take place until the end of each period, the statutory limits to holding and exercise the shareholders voting rights shall automatically expire. However, said resolution does not have to be express and can be implied from the rejection of the amendment or termination proposal.

The mutual agricultural credit banks and savings banks are excluded from the above.

III CASE LAW

Judgement of the Supreme Court of Justice of March 17, 2015
Intermediation Agreements – Banking and Contractual Liability – Limitation Period

The present decision analyzes, on one hand, issues related to the expiry period of the intermediary's liability for agreements in which he has intervened in this capacity and, on the other hand, the civil liability of the intermediary for damages caused to the client.

Regarding the intermediary's liability, the appeal court determines that, although the marketing of a financial product with guaranteed capital primarily holds the issuer of the product responsible, the liability is extended to the financial intermediary when and if, within the relationship he develops with the client, he also assumes the repayment of the invested capital.

Concerning the liability expiry period, the court determines its inapplicability since the Bank acts with gross negligence when, using aggressive sales techniques, *rectius*, through the use of misleading information or by hiding information, seeks the client's consent to certain hazardous products that he would never subscribe in case he knew all the product features.

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