Protection of the Purchaser of Shares/Interest in Italy: A Significant Step Forward

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A country's competitiveness depends in part on its capacity to attract foreign investors interested in the acquisition of local companies.

Making reference to acquisition agreements and to the relevant regulation under Italian Law, this article aims to draw the attention of investors and advisers interested in the acquisition of Italian-based companies on an important development in Italian case-law concerning the matter of business warranties contained into acquisition agreements and, in particular, with the duration of those warranties and the relevant indemnification rights.

In lack of any legal provision that specifically deals with acquisition agreements, these ones are subject to the general provisions set forth in the Italian Civil Code (CC) – enacted by Royal Decree No. 262 of 16 March 1942 – for the sale and purchase agreements of goods (provisions contained in Articles 1470–1547 CC).

Therefore, unless the purchasers of shares/interest provide for any specific and detailed contractual protection, the purchasers may exclusively rely on the mere legal protection reserved to the purchasers of goods under the CC.

The sale and purchase agreement reflects the purchaser's and seller's aim to realise not only the mere transfer of the shares/interest, but also the transfer of the package of assets and liabilities which represent the contents of the participating interests but which are only indirectly represented by these latter.

However, Italian case-law – on the basis of legal reasons which will be examined in more detail below – constantly states that a company's net worth is different from the shares/interest, pointing out that shareholders/quota holders cannot assert any right over the company's assets which, for this reason, are to be regarded as the company's exclusive ownership (see, inter alia, Court of Cassation judgement No. 27346 of 24 December 2009).

As a consequence, the legal warranties (for flaws, defects, etcetera) provided for by the CC to protect purchasers apply exclusively to the subject matter of the agreement, i.e. the shares/interest and do not cover the company's net worth.

Substantially, the protection afforded to purchasers applies to those limited cases in which the shares/interest sold and purchased, for example, are not exactly the same

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and/or do not have the qualities indicated in the agreement (e.g. they are pledged in favour of a third party while the agreement provides that they are free from any burden).

Therefore, it is plain from this case-law that such divergences in the company's net worth as to cause even a noticeable decrease in the value of net worth and, therefore, in the value of the shares/interest, cannot be considered to be relevant flaws or defects for the purposes of the legal protection of purchasers.

However, on closer inspection, the qualitative and quantitative extent of the corporate net worth (therefore, the property's value) is crucially important (for purchasers).

Due to this stance and in order to make up for the lack of legal protection, the practice of the sale and purchase of shares/interest has progressively witnessed the introduction in purchase agreements of specific clauses – taken from Anglo-Saxon legal systems – to protect the purchaser in share (or quota), which draw on detailed representations and warranties and relevant indemnification rights (so called 'business warranties'). As is the position in the international best practices in merger and acquisitions, such obligations aim to obtain that the seller guarantees to the purchaser the company's economic-financial situation and assets/liabilities and that, if any, to the purchaser is granted an indemnity, i.e. a right to damages arising from breach of warranties.

However, notwithstanding the provision of business warranties, the protection granted to purchasers of shares/interest in Italy was facing the following grave limitation; the Italian case-law was used to adjudicate that business warranties were mandatorily subject to a one-year statute of limitation.

As a matter of fact, in relation to sale and purchase agreements, the CC provides that the warranty to protect the purchaser against flaws and defects shall lapse after one year from delivery. In particular, Article 1495 CC, paragraph 3, states that:

> In all cases, the action is prescribed in one year from delivery; but the buyer who is sued for performance of the contract can always plead the warranty, provided that the defects in the thing was notified within eight days from discovery and within one year from delivery.

The one-year statute of limitation also applies to the qualities and characteristics of the goods sold and purchased which – even if not amounting to either flaws or defects – are in any case relevant in that the parties have contractually agreed that the seller shall ensure their existence. Article 1497 CC indeed provides that:

> When the thing sold lacks the qualities promised or those essential for the use for which it is intended, the buyer is entitled to obtain dissolution of the contract according to the general provisions on dissolution for non-performance, provided that the defect in quality exceeds the limit of tolerance established by usage. However, the right to obtain dissolution is subject to the forfeiture and prescription established in Article 1495.

The limitation period of one year is mandatory, as made clear by Article 2936 CC: 'Any agreement intended to modify the legal regulation of prescription is void'.

Therefore, even if the parties to the agreement have provided for a longer term of validity of the warranties and indemnification rights, these shall in any case be valid only for the one-year period.

According to the mentioned line of case-law, the statute of limitation of one year generally applied on the assumption that such system of contractual warranties included a set of qualities of the good sold and purchased (participating interest) falling within the scope of Article 1497 CC, with the consequent applicability of the one-year limitation period under article 1495 CC.

In particular, this traditional stance is based on the following legal reasoning: the shares/interest are the immediate subject matter of the sale and purchase agreement, while the target company's net worth, only indirectly represented by the shares/interest, is the agreement's mere mediated subject matter. Business warranties are warranties ultimately intended to guarantee the value of the shares/interest; the value of the shares/interest is a quality thereof, therefore the warranty in question is a warranty of the quality of the good sold and purchased pursuant to Article 1497 CC; hence the necessary, implied application of the one-year statute of limitation pursuant to Articles 1495 and 2936 CC.

As an example of this line of argument see the following principle laid down by the Court of Cassation judgment No. 3370 of 20 February 2004 (a similar ruling is to be found in the Court of Cassation judgment No. 18181 of 9 September 2004):

> The express or implied warranty, provided by the seller of participating interests about the extent or composition of the net worth involves the application of the provisions set forth in article 1497 CC due to a lack of the qualities of the good sold and purchased; hence the subjection of the consequent rights of the purchaser to the lapse and statute of limitations provided for by article 1495 CC.

In other words – regardless of the longer terms of effectiveness of the business warranties agreed by the parties in the purchase agreements – there was the actual risk that the effectiveness of said warranties and indemnification rights had in any case to be considered limited to one year.

This principle has been fiercely criticized by academic commentators, in that it has basically deprived the purchaser of participating interests of protection for a long time and has ultimately resulted in a critical precaution affecting foreign and domestic investments in Italy.

As a matter of fact, it is clear that by their very nature the discrepancies between the company's net worth and the warranted situation may emerge perhaps even years after completion and the purchaser of shares/interest needs to be protected throughout the period of risk (or at least for most of it).

The legal framework described above has been recently changed by the Court of Cassation judgment No. 16963 of 24 July 2014, which has finally overruled previous case law, stating that:

> With reference to participating interests, the clauses under which the seller

> undertakes the obligation to hold the purchaser harmless from the risk connected with company's losses or contingent liabilities after the conclusion of the agreement, regard obligations ancillary to the transfer of the right forming the subject matter of the agreement, which aim to ensure the economic outcome of the transaction; therefore, as such understandings do not fall within the coverage of the legal warranty related to the lack of the promised qualities under article 1497 CC the ordinary ten-year limitation period (not the limitation period under article 1495 CC, referred to by article 1497 CC) does apply.

In particular, said decision is based on the following legal reasoning; the shares/interest are the subject matter of sale and purchase agreements, whereas the company's net worth is only a mediated subject matter of the agreement given that corporate assets/liabilities are only indirectly represented by the shares/interest; the business warranties regard the extent of the corporate assets and liabilities, not the shares/interest; the value of the shares/interest – which business warranties ultimately aim to warrant – is only indirectly connected with the net worth, therefore it cannot be stated that it (the value) is a quality of the shares/interest pursuant to Article 1497 CC because, pursuant to this last provision, qualities are only the characteristics of the good forming the subject matter of the sale and purchase existing at the time of the sale (whereas business warranties often regard future and uncertain events which may occur even a long time after the closing). Therefore, business warranties do not fall within the scope of application of Article 1497 CC and thus the one-year statute of limitation under Article 1495 CC does not apply to them.

It seems, therefore, that this judgement has solved the described problem of the duration of the business warranties contained in the agreements for the purchase of shares/interest, thus contributing to afford greater protection and certainty to both domestic and international investments in Italy.