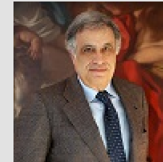
The Legal 500 Country Comparative Guides Hot Topic

Guarantee of performance in the acquisition of company shares

Contributing Firm

Studio Legale Lauro

Authors



Francesco S. Lauro
Managing Partner

francescolauro@studiolegalelauro.it

Guarantee of performance in the acquisition of company shares

1. ***The background –*** The complex economic scenario resulting from the 2008 global crisis has affected, in different ways, areas of business conduct that had previously been largely immune from uncertainty, inability or unwillingness of the parties involved to maintain and perform the actions required of them in order to properly implement their intentions and commitments.

While it is well known that areas of business exist where arrangements and agreements, whether binding or not, are consistently subject to review, withdrawals, disputes and non-performance, such situations have tended to be rather unusual in connection with the acquisition and disposal of interests in corporations, where the relevance and seriousness of such transactions and of the associated costs normally ensure a reasonably high degree of reliability in the relevant process.

Of course, there have always been transactions that are envisaged, structured or even initiated but ultimately cannot be finalized. And certainly, the increased average complexity of deals that are generated during a problematic economic cycle is a factor in pushing upwards the ratio of failed transaction. However, it is fair to say that the significant widespread impact of the 2008 crisis and the genuine difficulty of foreseeing its effects on specific corporations or entire business sectors or industries, have resulted in a degree of uncertainty and friction previously unknown.

This article does not intend to discuss specifically any case of non-performance connected to (even though not necessarily caused by) the 2008 crisis, but rather to generally review and consider the most common and effective ways for parties to protect their interests and focuses on specific instruments provided in certain legal systems that appear well suited to such purpose.

2. ***How to increase performance reliability –*** Deteriorated financial conditions may be the base reason for non-completion of an acquisition by a party. Such deterioration, actual or expected, may affect the ability of the purchaser to meet its financial obligations or may concern the target, possibly to an extent that determines a change in the intention of the prospective purchaser to complete the transaction. irrespective of any review of the price. Beyond such considerations, there are a variety of reasons and grounds which may constitute the basis for a change by one (or more) of the parties involved to finalize the deal, including obviously a disagreement regarding the relevant terms and conditions.

Each party engaged in negotiations, however, often wishes to ensure that the other party or parties are genuinely committed to apply their best endeavors to reach an agreement. We know that there is a fairly limited possibility, in practical terms, for one party to enforce the assumed obligation of the other participants to act on the basis of good faith to finalize and execute a share purchase (or similar) agreement. Different jurisdictions take different approaches, both in terms of their legal principles and in the way such principles are applied by the competent courts to concepts such as good faith in negotiations and pre-contract

liability.

Break-up fees – i.e. an amount to be paid to the other party by the party willing to withdraw from negotiations – are broadly recognized as acceptable, as a measure to restore to the non-withdrawing party the costs borne in the process, and would need to be made clearly binding in a specific agreement between the parties. Still, it is not obvious to find a distinction between a legitimate withdrawal from negotiations and a situation in which a withdrawal would result in an obligation to pay break-up fees and the search for objective elements as the basis for the application of such remedy may be complicated. Further treating break-up fees agreements as mere cost sharing arrangements rather than as penalties (which several jurisdictions subject to judicial screening) may not be an obvious conclusion. Of course, the mere existence of a break-up fees binding arrangement is likely to represent at least a disincentive to start negotiations without a genuine purpose and therefore afford a degree of "security" regarding the reliability (at least initially) of the parties' intentions.

3. ***Tools to strengthen delayed performance obligations –*** More relevant however, for the purpose of this article, are situations where the parties have concluded an acquisition by executing a share purchase agreement and each of them wish to ensure that the other will properly and timely perform its obligations. Clearly this is particularly important in those situations, which constitute however the normal circumstances in the largest majority of transactions, when the parties' fundamental obligations (i.e. payment of price and delivery of shares) are not to be performed immediately and simultaneously but rather are scheduled to be performed at different times.

Modalities of payment of the acquisition price which offer to the purchaser the possibility to delay payment in full or in part (e.g. a payment in installments) clearly represent a risk for the seller, which accepts exposure to a potential total or partial non-performance for a certain period of time. Such arrangements normally offer at the same time opportunities for the seller to offset the connected risk. Obviously, explicit or implied contractual terms, such as a reservation of title, combined with a requirement that shares are delivered only upon payment by the purchaser having been made in full, provide some protection for a seller against the risk of failure to pay.

Other common arrangements are based on the request by the seller for some form of guarantees to secure payment of the price by the purchaser. Typically, bank guarantees are used to this end, although the connected costs and the financial institutions' requirements may restrict the willingness and the ability of the parties to resort to such instruments.

It is to be noted that in acquisitions the object of the transaction is (with rare exceptions) the relevant shareholding as a whole; i.e. whatever the percentage of share capital or number of shares that are the object of the deal, such percentage or number is treated as one single inseparable object. As much as this may appear obvious it is important to keep in mind that while money constituting payment for such one inseparable shareholding may be fractioned over time, the shareholding such money is directed to acquire will not be split and will be transferred in its entirety at one time.

An effect of this is that, in the event that the seller has acquired appropriate protection through one or more of the methods mentioned above, a fractioned payment would end up as a risk for the purchaser who may find itself in the position of having paid to the seller over time a (possibly significant) portion of the acquisition price, not only prior to having acquired the target shareholding, but also without having acquired any proportional entitlement to any asset, in particular to any of the shares of the target.

4. ***The Italian caparra confirmatoria*** – It is interesting therefore to note, as the focus of this article, that legal systems in a number of civil law jurisdictions have historically offered to contracting parties instruments that take into account – on one side the frequent practice of facilitating payment by spreading the same over a period of time and, on the other side, the common expectation that a (non-negligible) part of the payment be made in advance to strengthen reliability of the contract – and are directed at creating a form of mutual guarantee against non-performance to the benefit of both parties, or better, of each party acting toward a due and proper performance of the contract.

An example of this, that we wish to briefly review, is the practice of the *caparra confirmatoria* provided in various forms and with different legal names under a number of civil law jurisdictions, including France, Italy, Germany and Switzerland.

In particular, it is interesting to consider the features of such practice as provided under Italian law, which is particularly clear in defining the concept and the scope of the *caparra confirmatoria*. In fact the Italian law *caparra confirmatoria* has been chosen to expressly apply in international share acquisition agreements (normally with a degree of Italian connection) precisely because of its implications in terms of seller's protection against failed or incomplete payment by the purchaser.

Under Italian law, a *caparra confirmatoria* is a sum of money given by one party to a contract to the other party with the effect that in case the contract is duly performed the *caparra* is returned or put toward payment, while in case the contract is not performed (i) if the non performing party is the party that has given the *caparra*, the other party may rescind the contract and retain the *caparra*, and (ii) if the non performing party is the party that has received the *caparra*, the other party may rescind the agreement and demand twice the amount of the *caparra*. The *caparra confirmatoria* may also in principle consist of fungible goods instead of money, although this would be rather uncommon in the context of share acquisitions. Therefore, in essence, the effect of a *caparra confirmatoria* is that each party is entitled to cash a net amount corresponding to the amount of the *caparra* in case the other party breaches the contract. The performing party has in any event the option to seek damages from the non-performing party by waiving the right to the *caparra confirmatoria* and pursuing its claim according to the ordinary rules.

The practical purpose of the *caparra confirmatoria* is therefore a broad one: to strengthen the parties' mutual obligations; to provide protection to the contract parties and the transaction; and to pre-determine an agreed amount of liquidated damages resulting from a potential breach of contract. It is generally perceived as an instrument directed at regulating the

consequences of a breach of specific contractual obligations – in the interest of both parties. In fact the *caparra confirmatoria* is an alternative remedy to ordinary damages suffered as a result of breach of contract, which remain available to the performing party subject to the waiver of its rights in favour of the *caparra confirmatoria*. It intends to facilitate the resolution of a potential conflict in case of a breach, giving the innocent party an opportunity to avail itself of a "pre-packed" solution. Further, as an *alternative* remedy, the *caparra* does not result in a limitation to the debtor's liability, and does not therefore contradict the principle of the Italian civil code, embedded in the laws of many other civil law jurisdictions, by which an agreement cannot contain a clause that excludes or limits in advance the potential liability of the debtor for willful misconduct or gross negligence. According to such principle, a pre-determination of liquidated damages would be void to the extent that it applied to damages caused by the debtor's willful misconduct or gross negligence and excludes the possibility of the claimant demanding higher compensation.

A further advantage of the *caparra confirmatoria* is its flexibility. The nature of the *caparra confirmatoria* under Italian law is that of a contract itself, separate from (although connected and ancillary to) the principal contract to which it relates. As an ancillary contract to the principal contract the enforceability of the *caparra confirmatoria* is affected by elements that impact the validity of the principal contract. However, it is also a bilateral agreement and the parties are free (with some limitations) to determine which obligations of the principal contract are in fact protected by this remedy; i.e. in which cases the non-performance of the agreement by one of the Parties triggers the option to enforce the *caparra confirmatoria*.

In connection with the effect of pre-determining the consequences of a breach of contract, the the *caparra confirmatoria* is different from that of the *clausola penale* (i.e. penalty clause), and the Italian civil code distinguishes the two concepts very clearly, not only by using a different term in the relevant section but also by regulating the two concepts under separate articles.

In legal literature there exists an extensive debate regarding similarities and differences between the *caparra confirmatoria* and penalty clauses. In summary, while the similarity is mainly in the broad purpose that both concepts have of pre-determining the consequence of a breach of contract, the differences have been underlined from various angles, in particular, that (i) the *caparra confirmatoria* implies an advance on the main payment obligation and becomes part of such obligation in case of due performance of the agreement; (ii) the *caparra confirmatoria* is bilateral in nature, for the protection of both parties so limiting the risk of disproportion; and (iii) a penalty clause may be supplemented by the right to seek further damages, i.e. the innocent party may retain the penalty and claim further damages, while the enforcement of the *caparra confirmatoria* is alternative to an action in damages, i.e. the innocent party may either enforce the *caparra* or claim damages for breach of contract under the ordinary action rules but not both.

A further point of distinction, which in many legal systems is a matter of particular sensitivity and is founded on the substantially different nature of the two instruments, is that while the Italian civil code expressly provides that an excessive penalty clause may be reduced by a Court this is not the case with respect to a *caparra confirmatoria*. The Italian Supreme Court in several decisions has confirmed that the amount agreed by the parties as *caparra*

confirmatoria cannot be subject to Court review primarily on the basis of (i) the significant differences between a *caparra confirmatoria* and a penalty clause, and (ii) the refusal to extend by analogy the power of a Court to re-determine the amount of a penalty clause also with respect to the amount of a *caparra confirmatoria*. The power of Courts to reduce the amount agreed by the parties as a penalty, which is explicitly provided by the Italian civil code with respect to penalty clauses only, must be considered as an exceptional limitation to the general principle of freedom of contract and as such, in accordance with general principles of Italian law, its application cannot be extended by analogy to other matters, in particular to a substantially different instruments such as the *caparra confirmatoria*. This results in a further advantage of the *caparra confirmatoria*; i.e. its reliability.

5. **Similar tools in other jurisdictions** – It would be interesting to explore how other jurisdictions approach instruments similar to the caparra confirmatoria. That would, however, be a fairly complex exercise as the shape that the same broad concept of the caparra has taken in different systems may differ substantially. As an example, Swiss law accepts, at least in a number of areas, that the caparra may be additional, and not only alternative, to damages. Austrian law (and, to a somewhat lesser extent, Swiss law) also recognizes that the amount of the caparra confirmatoria may be equitably reduced. While the legal effects and implications of the “arrhes” in French law appear to rely primarily on the specific contract wording rather than on established general principles.

In summary then, the legal framework provided by Italian law appears to offer an effective and reliable instrument to deal with the sellers’ exposure to the risk of incomplete payment by the purchaser, in particular in situations when an advanced partial payment occurring at closing may be qualified by the parties as a caparra confirmatoria. It also does not prejudice the position of the purchasers, that in fact would be afforded the same degree of protection, and would be able to count on the simplicity of the caparra system (perhaps also relying on an escrow arrangements with respect to the advanced payment) in case of a breach by the seller. And, ultimately, mindful of the principle of freedom of contract, Italian law devolves to the negotiations between the parties (with only exceptional limitations) the definition of the obligations protected by the caparra and the significance in economic terms that the parties intend to the compliance to or breach of those obligations, making the caparra confirmatoria a helpful instrument to protect the rights of the parties in an acquisition agreement.