The Long-Running Battle: Limitations of Liability in M&A Transactions

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I. Introduction

Allocation of liabilities between the parties in merger and acquisition ("**M&A**") transactions is of utmost significance, in order to ensure that the buyer will be sufficiently protected, and the seller's liabilities limited as much as possible. Under Turkish laws, the sellers` liabilities are subject to the provisions of the Turkish Code of Obligations No. 6908 ("**TCO**"). Having said this, Turkish laws are not designed to save commercial parties from a bad bargain, thus the parties often resort to adding certain clauses to their share purchase agreements ("**SPA**") such as representations and warranties, indemnities, amount-based restrictions such as *de minimis* and baskets clauses, setting forth specific procedures and time limits for claims, and so on. Accordingly, this article aims to provide a general understanding as to the sellers' liabilities in M&A transactions, the general liability provisions most commonly used in SPAs, and how they are dealt with under the Turkish laws.

II. Selling with Liabilities

Under the TCO, the seller is liable for *defective goods;* in this case, defects would be those matters that result in the diminution of the value of the shares subject to the M&A transaction. The extent of this liability however, consists only of those issues that could not be discovered upon inspection, incorporating the principle of *caveat emptor i.e.*, "let the buyer beware."

The liabilities of the seller arise mainly from the seller's so called "representations and warranties." Representations and warranties are usually express guarantees and fundamental statements of the seller in an SPA, whereby they undertake that the target company has certain qualities. Depending on nature of the business, as well as the discussions and negotiations between the parties, warranties may cover various topics such as incorporation, authority, compliance with applicable laws, data protection, material agreements, immovable assets, licenses, litigation, insurances, insolvency and tax.

According to Article 219 of the TCO, the seller is not only liable for any deficiency in the qualities that it has confirmed existence of to the buyer, but also for the physical, legal or economic defects, even if the seller is not aware of them. The liabilities of the seller are limited by Article 222 of the TCO, which mirrors the *caveat emptor* principle. Under this article, the seller is only liable for those defects that the buyer did not know about at the time it entered into the contract; or could not have discovered with sufficient inspection. The position is further explained in Article 223 of the TCO, putting the onus on the buyer to carry out a due diligence on the target, or conduct other means of inspection suitable for the nature of the transaction, and to notify the seller upon finding out any irregularities or defects that fall under the seller's liability. This means that failing to carry out such inspections or notifications will be deemed as the buyer accepting the target "as is" with defects/breaches included, and forfeiting any grounds to a claim (except for any hidden defects). It should be noted that as per Article 23 of the Turkish Commercial Code No. 6102, the time periods for notifying the seller of the defects are specified as 2 (two) days for "apparent" defects and 8 (eight) days for those which could not be easily discovered, starting from the date of delivery (which can be translated as the completion of share transfers in an M&A transaction). Indeed, these notification periods specified under Turkish laws do not really give sufficient time to the buyer; therefore it is of utmost importance for the parties to determine their customized notification period for the liabilities in an SPA.

Protection of the buyer against risks in an M&A transaction is often achieved by adding an "indemnities" clause into the SPA, where the seller undertakes to reimburse the buyer in case of a breach, on a pound-for-pound basis, mostly for known and specific risks. The difference between the (representations and) warranties and the indemnities is that the warranties act as guarantees on certain aspects of the target company and grant the right to a compensation with respect to the consideration, provided that the value of the target company is diminished, whereas the indemnities are designed to indemnify the exact losses that arise in relation to the matters contained in the clause. Under indemnities, the buyer will be able to recover those losses that would not have been recoverable under warranties (due to their awareness of the facts disclosed to them or for what the buyers ought to have known). In practice, the indemnity option is mostly preferred for future tax liabilities and matters willfully concealed

by the seller. The parties may extend the scope of indemnities, as the case may be. The warranties and indemnities must be drawn carefully to exclude the adjustments to consideration (purchase price) already made through closing mechanisms.

For liabilities arising out of breaches of warranties and representations under the SPA, Article 227 of the TCO grants discretionary remedies to the non-breaching party to choose from, such as right to rescind the contract or to ask the purchase price to be reduced in proportion to the defect. The non-breaching party will also have a contractual right to be compensated for its losses arising from the breach.

III. How to Limit Liability?

Surely, the parties are free to determine the precise scope of their liabilities and the limitation period, so long as they are compatible with the laws, *e.g.*, they cannot waive or limit their liabilities for fraud or gross negligence. Consequently, the parties customarily choose to employ contractual provisions regarding the scope of liabilities and disclosures, caps for individual and aggregate claims, specific time period of limitations and obligations for mitigating loss.

The scope of liability will primarily be based on the results of the due diligence carried out by the buyer. Also, parties usually add a provision stipulating no liability for disclosed matters for avoidance of doubt. In order to clarify the matters revealed to the buyer, parties opt to sign a "disclosure letter" prior to signature of an SPA. This letter lists the matters disclosed or deemed to be disclosed by the seller and expresses that the buyer has been made aware of such matters. The disclosure letter also provides the basis for construing the representations and warranties. As a means of limiting the seller's liability, the SPA might refer to this disclosure letter, where the buyer waives its rights to claim with respect to the facts and matters included in the letter.

Another key provision for limiting the monetary amounts of potential claims is the *de minimis* clause, which stipulates a minimum amount for an individual claim to be brought. In addition to the *de minimis*, the practice is to set a further threshold to establish a minimum amount for

the total to be claimed, by what is called a "basket clause." Accordingly, the buyer will be able to make a claim to the seller, subject to the agreed individual and aggregate thresholds being exceeded. As a result of *de minimis* and basket clauses, the seller will be relieved from the burden of dealing with multiple claims concerning trivial amounts, saving cost and time. The overall liability of the seller for claims arising from the SPA may be also capped with a clause.

Lastly, it is important to ensure that the parties will not be entitled to multiple compensation or claims for the same loss, by simply adding a clause to the SPA to prohibit double recovery.

IV. Conclusion

Parties should be mindful that in Turkey, the consequences of M&A transactions in terms of liabilities are not addressed under a separate legislation; they are governed by the TCO which allows the buyer and the seller to freely determine the limits of their liabilities. For this reason, albeit resulting in a very lengthy transaction document, it is important that the buyer ensures that the potential risks will be indemnified or compensated, and the provisions regarding the extent of the seller's liabilities are not ambiguous.

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