A Different Aspect of Buyer Due Diligence in Share Deals: Seller's Liability Level for Defects

Authors: Gönenç Gürkaynak, Esq., Selen Ermanlı Sakar and Nisa Aybüke Eroğlu

I. Introduction

The term of "mergers and acquisitions" (M&A) refers to a general concept that gathers different business transactions, such as transfer of shares (share deals), business unit or a corporate asset, consolidation with another entity or constitution of a new corporate structure, under a single roof.

In most M&A transactions including the share deals as well, the primary aim of a buyer side to reach sufficient knowledge about the target and identify the risks thereof. As due diligence conceptually serves this purpose of buyers, it is deemed an essential and significant step of M&A transactions. Accordingly, in this article, we will focus on buyer due diligence and evaluate its effects on the seller's liability level in share deals from Turkish law perspective.

II. Due diligence in Share Deals

Share deal is a typical M&A transaction that involves transfer of shares in a company from one party to another. Within the scope of a share deal, the buyer may acquire the shares issued by the company entirely or partially. Under Turkish law, share deals are mainly subject to the provisions of the Turkish Commercial Code No. 6012 ("**TCC**") and the Turkish Code of Obligations No. 6098 ("**TCO**"). These laws introduce specific obligations for buyers and regulates liability level of sellers for defects.

Due diligence is a systematic risk assessment, review and reporting method that detects and sets out the risks associated with the target, although it is not directly defined under Turkish laws. Within the scope of due diligence, the findings are generally gathered in a report called as "due diligence report". Due diligence enables buyers to assess the risks and benefits of the proposed transaction. The findings of due diligence may also take an active role in valuation of the target and conclusion of negotiations between the buyer and the seller. Therefore, there is a close and strong relationship between share deals as being a limb of M&A transactions and due diligence concept.

Depending on structure of the envisaged transaction and specific needs of buyer side, due diligence review in share deals may be structured in several ways and with different scopes. In this context, briefly the following classifications can be made:

a. In terms of the Party Arranging the Due Diligence Review

Due diligence review may be technically arranged by either buyer side or seller side. That said, as buyers usually prefer their designated advisors to provide first-hand knowledge about the target before the closing phase of the transaction, in practice buyer due diligence is relatively preferable than seller due diligence.

b. In terms of the Subject Matter

The subject matter of due diligence review may be allocated to certain fields. The most common due diligence types by subject matter are legal due diligence, financial due diligence, tax due diligence, environmental due diligence and technical due diligence. However, these are not *numerus clausus* and further due diligence types may be generated, as the case may be.

c. In terms of the Scope

Due diligence review may be also limited in respect of scope and to that end, certain items may be excluded from the due diligence. For instance, it may be decided by the seller and the buyer to exclude certain documents (*e.g.* agreements having insignificant monetary value) out of the review in order to accelerate the process and avoid the burden of unnecessary details.

Moreover, the advisors conducting the due diligence review may be instructed to provide full scope due diligence report or a red-flag due diligence report listing the significant risks and findings only. As it provides brief information to executives on significant issues only, in M&A transactions moving forward over a red flag due diligence report is a rising trend in practice.

III. Buyer Due Diligence and Seller's Liability for Defects in Share Deals

Within the scope of share deals, sellers and buyers usually enter into a share purchase agreement (SPA) which consists of certain provisions as to transfer of shares, representations, warranties, indemnities as well as other rights and liabilities of the parties. As SPA is basically a contract of sale, the seller's liability for defects becomes subject to certain provisions of the TCO and the TCC.

In accordance with Article 219 of the TCO, the seller is liable to the buyer for absence of the declared and confirmed qualifications and presence of material, legal or economic defects on the shares (and consequently the company in question) that eliminate or significantly reduce their value and benefits that the buyer reasonably expects. Such provision would apply even if the seller is not aware of existence of them. Therefore, the seller cannot be relieved from the liability asserting that the defect was out of its knowledge.

On the other hand, Article 222 of the TCO aims to bring liability level of the seller on a fair level. Thus, said article limits liability of the seller for the defects that are known by the buyer. In this context, the seller's liability may come into question for the defects only that are not known by the buyer at the time of execution of the SPA. Moreover, the seller may be held liable for the defects that could be detected upon a sufficient inspection of the buyer only if the seller explicitly assumes the liability thereof. If not, the seller could not be held liable for such defects. In terms of M&A transactions, this provision could be interpreted that said article drives buyer side to conduct due diligence review on the target.

It is also important to note that, in case of fraud or gross negligence of the seller in sale and transferring of the shares as defective, the agreement that excludes or limits liability of the seller for the defect would be null and void within the scope of Article 221 of the TCO. This provision is in line with general good faith principle of contracts law.

Article 223 of the TCO also requires the buyer to inspect the target as soon as it has opportunity to do so in the ordinary course of business and to notify the seller within a reasonable period of time if it finds out any defect attributable to the seller. If the buyer neglects to inspect and notify the seller, it shall be deemed that the buyer accepts the target with these defects as is. However, this provision is not applicable for the circumstances where the defects cannot be discovered by an ordinary inspection of the buyer. Such defects may exceptionally be notified to the seller once they are discovered. It is also worth to note that unlike Article 223 of the TCO, Article 23 of the TCC shortens the notice and inspection periods of the buyer and introduces two-day notice period for clear and apparent defects and eight-day inspection and notice periods for invisible defects. In share deals, as these notice periods would not be realistic and applicable due to nature of the transaction, buyer sides usually tend to determine extended notice periods.

IV. Conclusion

All in all, buyer due diligence enables buyer side to make a reasonable inspection on the target. Therefore, it has a significant role and function on seller's liability level for the defects. On the condition that the seller grants opportunity to buyer to carry out a due diligence review and also duly provides the buyer with all necessary information and documents, the seller could not be held liable for the defects unless provisions of the SPA stipulate otherwise. From this point of view, buyer due diligence indeed diminishes and limits liability level of the seller.

On a final note, most of the provisions of the TCO and TCC that are applicable to the share deals are not compulsory. As a consequence of this, the seller and the buyer may always agree on and determine different liability regime by stipulating certain representations, warranties and indemnities in the SPA.

Article Contact: Gönenç Gürkaynak, Esq. E-mail: gonenc.gurkaynak@elig.com

(First published by Mondaq on March 23, 2023)