Time to Negotiate: Delving Into "De Minimis" and "Basket" Clauses of Share Purchase Agreements

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I. Introduction

In terms of Turkish laws, liability level of parties in a merger and acquisition ("**M&A**") deal is mainly governed under the Turkish Code of Obligations No. 6098 ("**TCO**"). Nevertheless, terms of the TCO might be incapable or might not fulfil expectations of the parties sometimes especially in complex deals. Accordingly, it is generally preferred by the parties to customize the share purchase agreement ("**SPA**") by setting forth deal-specific representations and warranties considering the nature of the business and clauses called "*de minimis*" and "*basket*" in practice to cover the significant risks, limit the overall liability and regulate the liability levels within the scope of freedom of contract principle.

In this regard, this article aims to provide an overview of the general liability framework in share deals (*i.e.* share transfers) in terms of the seller under Turkish laws along with M&A practice in Turkey, and the main function of "*de minimis*" and "*basket*" clauses in SPA.

II. General Liability Framework of Seller in Share Deals

In accordance with Article 219 of the TCO which also applies to share deals, the seller is liable to the buyer for absence of the declared qualities on the sold item as well as its material, legal and economic defects which remove or significantly reduce its value in terms of the intended purpose and benefits normally expected by the buyer. The relevant article also states that the seller is liable for such defects regardless of being aware of them.

As "*representations and warranties*" that essentially originate from English law and we often encounter in SPA negotiations of M&A practice are generally the detailed statements made by

the seller to the buyer at a given time which exhibit the qualities of the business in question along with the other significant facts and the guarantees about the target, they might be considered as the qualities represented by the seller to the buyer in the sense of Article 219 of TCO, unless otherwise specifically disclosed by the seller. As the liability of the seller in share deals mainly arises from a breach or inaccuracy of the representations and warranties, they are of utmost significance, and they constitute a basis for a potential claim.

Article 222 of the TCO introduces an exemption to general liability framework of seller by stating that the seller is not liable for the defects where such defects have been known by the buyer while the agreement was being concluded or existence of such defects could have been discovered by the buyer with sufficient inspection. Accordingly, the TCO fairly and reasonably limits liability of the seller with Article 222 if the defect was known or could have been known by the buyer, and it does not grant further protection to the buyer in case of existence of such circumstances.

Given that carrying out due diligence review in M&A deals enables buyer side to make a proper assessment on the transaction and measure the risks associated with the liability for defects and manage them, due diligence might represent a function diminishing liability level of the seller side, as the case may be.

III. Main Function of "De Minimis" and "Basket" Clauses

As opposed to the general liability framework of the seller stipulated under TCO, in practice the parties try to engage and adopt certain mechanisms when drafting an SPA to illustrate and limit potential claims in case of a breach or inaccuracy of representations and warranties. In this context, two opposing objectives become a subject of negotiation. In other words, the seller generally aims to predict and limit its overall liability, while in contrast the buyer aims to cover all potential risks and uncertainties. Nevertheless, pursuing every breach of representations and warranties might become laboursome for both parties and at the end cause graver losses due to legal costs and time spent by also considering the value and size of the actual deal at hand. Accordingly, during drafting SPAs, the parties mostly agree on "*de minimis*" and "*basket*" clauses to determine in advance and before occurrence of any dispute which breach of

representations and warranties would be significant enough to be pursued, that eventually results in the limitation of the seller's liability. Similar to the concept of "*representations and warranties*", "*de minimis*" and "*basket*" clauses do not originate from Turkish laws, however the use of such clauses in SPAs is a common practice in M&A deals in Turkey.

"*De minimis*" clause of an SPA usually refers to a material threshold with fixed amount which should be reached to bring forward an individual claim based on the breach of representations and warranties. Therefore, indeed it protects the seller from receiving separate individual claims which could be deemed insignificant compared to the value and importance of the deal.

On the other hand, with the "*basket*" clause, all individual claims exceeding the "*de minimis*" threshold are accumulated in a basket, and metaphorically speaking when the basket is full, in other words, the additional threshold stipulated in the "*basket*" clause is exceeded, the claims can be brought forward and reimbursed. Therefore, "*basket*" clause is generally included in SPAs as an integral part and in connection with "*de minimis*" clause.

In light of the above, if the seller and the buyer eventually agree on inclusion of "*de minimis*" and "*basket*" clauses to the SPA, then the buyer would not be entitled to claim unless the relevant thresholds are exceeded. Therefore, while keeping "*de minimis*" and "*basket*" thresholds at a minimum level is in favour of the buyer side, the seller side prefers to set upper thresholds to limit its liability to the greatest extent possible. These positions of the parties make "*de minimis*" and "*basket*" clauses one of core and important negotiation points of SPA in share deals.

It is also important to note that although the seller and the buyer might agree on certain limitation of liability structures such as inclusion of "*de minimis*" and "*basket*" to the SPA within the scope of freedom of contract principle, Article 221 of the TCO stipulates that in case of fraud or gross negligence of the seller, such agreements would be deemed null and void. Considering that nature of Article 221 is imperative and surpass in the freedom of contract principle, fraud or gross negligence of the seller might trigger "*de minimis*" and "*basket*" clauses to be null and void, as the case may be.

IV. Conclusion

Since Turkish laws do not address the question of liability of sellers in M&A transactions with a separate and specific legislation, the concepts and measures introduced by TCO might be inadequate and unpractical when encountered with large and complex deals and there might be a need to follow the international M&A practice considering the parties to the transaction. Having reasoned and customized clauses such as "*representations and warranties*" and "*de minimis*" and "*basket*" clauses for limitation of liability might play a crucial role for both sellers and buyers, and provide them predictability and clarity against the risks and uncertainties of the transaction.

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