

THE ITALIAN SUPREME COURT'S NEW APPROACH TO BUSINESS WARRANTIES UNDER A M&A TRANSACTION.

A. Introduction

The Italian Supreme Court has recently clarified that representations and warranties (R&Ws) referring to the business and financial position of the target company (the so-called “business warranties”) do not fall under the Italian contract law regulation on promised qualities for the sale of goods.

As a consequence, in cases of breach of the business warranties under a stock purchase agreement, the buyer’s right to claim for indemnification against the seller is subject to a ten-year statute of limitations term instead of the one-year term applicable to so-called “legal warranties” (i.e. the R&Ws referring to the characteristics of the interests transferred under an stock purchase agreement).

The above mentioned judgment by the Italian Supreme Court represents an important precedent for any future court’s decisions, considering that in the past Italian courts have not followed a consistent approach to the R&WS’ qualification under Italian law, causing uncertainty regarding applicable remedies and statutes of limitation.

B. Overview on the legal nature of the representations and warranties under Italian law

Since the R&Ws have been imported into Italian M&A law from US practice and are not specifically regulated by Italian law, their status, and the legal remedies available in the event of an infringement, has long been debated by academics and the Supreme Court. Significantly, most decisions in disputes arising from representations and warranties are the result of arbitration, as acquisition agreements commonly include arbitration clauses.

Two main theories have been advanced on the legal nature of representations and warranties.

1. R&Ws as Promised Qualities under the Sale of Goods Regulation

According to the first theory, the acquisition of interests in the corporate capital of a target constitutes an indirect purchase of the target’s business and assets. Consequently, representations and warranties should be regarded as promises about the qualities and characteristics of the target’s assets. According to this interpretation, the rules on the sale

of goods in the Italian Civil Code apply, which means that the buyer is entitled to sue the seller pursuant to section 1495 of the Italian Civil Code in the event of misrepresentation by the seller. This would give the buyer the right to seek compensation for damages, termination of the agreement or a reduction in the purchase price within the statutory limitation period (namely one year from closing), provided that the buyer has informed the seller of the misrepresentation within eight days of becoming aware of it. Although the parties may extend the eight-day term, the one-year statutory limitation cannot be modified by agreement.

2. R&Ws as additional contractual warranties

Under the second theory, representations and warranties are not deemed to be promises made by the seller to the buyer, as the acquisition of the target's interests is not an indirect sale of goods. Rather, the sole purpose of the acquisition agreement is to acquire interests in the target; the representations and warranties are merely a contractual obligation. In this case, the one-year statutory limitation period and the eight-day term do not apply. According to this analysis, in the event of a breach or misrepresentation, the buyer may sue the seller within the ordinary ten-year statute of limitations period (as in the case for any other breach of obligation). The parties cannot modify the statute of limitations term under the relevant contract

C. The recent resolution of the Supreme Court

By its judgment dated July 24, 2014, the Italian Supreme Court has ruled on the legal nature of representations and warranties, and the consequent applicable regulations and remedies, by providing an important precedent for any future court's decisions.

As a starting point, the Supreme Court has adhered to the distinction made by major Italian commentators between the so-called legal warranties and the so-called business warranties. Therefore, since business warranties do not relate to the actual subject of the stock purchase agreement (which is the transfer of interests) but instead to the financial and business position of the target company, the business warranties cannot be qualified as promised qualities of "sold goods" under Italian contract law.

In light of the above, in case of a breach or misrepresentation of business warranties the one-year statutory limitation period and the eight-day term do not apply as provided under Italian contract law on the sale of goods, and the buyer may sue the seller within the ordinary ten-year statute of limitations period.

Indeed, the Italian Supreme Court has considered that the one-year statutory limitation does not give the buyer adequate legal protection in view of the indemnification needs under a M&A transaction (e.g. a breach of R&Ws regarding tax would probably arise after one year from the closing).

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