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M&A disputes: purchaser's constructive knowledge and damages for misrepresentations in excess of the purchase price

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Spanish case law on M&A claims deriving from breaches of representations and warranties is not abundant. SPAs of Spanish companies or businesses tend to follow international M&A standards (definition of the business purchased, completion accounts or locked-box clauses, adjustment of the purchase price, earn out clauses, representations and warranties, indemnities, etc.); however, only in recent years have lower courts and the Supreme Court (SC) taken a modern approach to what the purchase of a company or a business through a sophisticated SPA entails.

A judgment rendered by the SC on 27 March 2019 -substantially endorsing a previous Madrid Court of Appels (CA) judgment- keeps the right approach to M&A disputes.

The case at hand is as follows[1]. Purchaser and Seller entered into a SPA for the acquisition of several companies in the construction business. Prior to the SPA the parties signed a letter of intent and Purchaser carried out a due diligence, the result of which led to a reduction of the price initially discussed due to certain circumstances, including in particular an excessive book value of the work in progress (WIP).

The SPA contained representations and warranties on the correctness of the information provided by Seller, and Seller undertook to compensate Purchaser for damages resulting from any difference between the book value and the real value of the assets or the liabilities or from any "contingency" not disclosed in the information provided to Purchaser; according to the SPA this was an "essential condition" of the deal.

Following completion of the acquisition, Purchaser claimed that the information provided by Seller was incorrect because, among other circumstances, the WIP entailed heavy losses that had not been accounted for in the financial statements represented by the Seller nor otherwise disclosed to the Purchaser. As a consequence, Purchaser claimed a compensation that was substantially higher than the purchase price.

Seller opposed that, prior to the SPA, Purchaser knew about certain circumstances affecting the value of the business which, precisely, led to a reduction of the purchase price initially discussed; hence, no compensation was due; it further submitted that (i) claiming a compensation for losses embedded in the WIP amounted to claiming a compensation for loss of profit, for which there was no base, and (ii) the net worth of the purchased companies was still higher than the purchase price despite any adjustments to be made to the book value of the WIP.

The key points of the CA and the SC judgments are:

- The final purchase price had been agreed not only on the basis of the net worth of the purchased companies, but also on their "operational viability"

[1] Taking into account the purpose of this note, we only refer to some of the circumstances of the dispute in order to draw some practical conclusions.

(namely its WIP, "production system" and "management") and potential for profits; thus, it is possible to claim damages in excess of the price;

- The court has to take into account not only the letter of the SPA, but also the correspondence between the parties during their negotiations prior to the SPA in order (i) to conclude whether, before signing the contract, Purchaser was or was not aware of the relevant "contingencies", and (ii) to determine which accounting, economic and operational circumstances of the acquired companies led the parties to agree upon the final purchase price;
- The CA found that Purchaser was entitled to be compensated only for those "contingencies" it was not aware of prior to the SPA; Purchaser's prior knowledge of the relevant "contingencies" overrides Seller's liability; this is still the case even if prior knowledge was not "exact";
- Circumstances or "contingencies" leading to an adjustment of the initial price prior to the SPA cannot give rise to Seller's liability pursuant to the representations and warranties;
- Incorrectness of precontractual information of the representations made in the SPA amounts to a breach of contract; contractual provisions on this matter and in particular on the consequences of such a breach trump the legal regime that would otherwise be applicable by default.

And some basic, practical conclusions one may draw from these judgments are:

- Fully-fledged SPAs are advisable[2];
- Precontractual correspondence and documents between the parties and their advisors are key (i) to determine which circumstances or "contingencies" had or had not been disclosed by the seller and, irrespectively of express disclosure, which ones were or were not actually known by the purchaser, and (ii) to interpret the SPA (this has to do with the principles of good faith the forthright negotiator);
- Parties should be mindful of constructive knowledge as a valid argument to be used by the other party;
- When the purchaser is aware of certain circumstances or risks it wants to be covered from it is advisable to include in the SPA specific provisions dealing with them and seller's responsibility (a sort of indemnity);
- It is important that the SPA or other contractual documents explain the elements that the parties have used to agree the final purchase price;
- Seller's liability for misrepresentations or other breaches of the SPA may go beyond the purchase price;
- It is advisable to define well which types of damages are or are not covered by the seller's warranties.

[2] Thre was a view in Spain that because Spanish law -as any other civil law regime- contains a complete set of legal rules applicable to sale and purchase contracts, Spanish SPAs do not need to follow the usual international standard of comperhensive SPAs; this view does not seem right nowadays.