Waiving of the hardship rule in a business acquisition agreement

This paper examines the contractual and strategic effects of waiving the hardship rule in a business acquisition agreement.

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In a share purchase agreement (SPA), a clause reads as follows:

> It is acknowledged and agreed that the obligation of the parties to complete the sale and purchase of the shares on completion pursuant to the terms and conditions of this agreement shall in no event be affected by any change of circumstances that may take place in the economic and financial markets, by the evolution of the business after the signing date, by any change in the regulations (or their interpretation thereof or the practice of the relevant authorities), by the covid-19 pandemic or any other pandemic, by the Ukrainian war or any other war or conflict or by any other fact or circumstance, even if any such change of circumstances was unforeseeable or unavoidable.

It must be postulated that a clause of this type is valid - and would be valid even in consumer contracts - because Article 1105 of the Civil Code (CC) allows the parties to assign the unforeseeable risk of an act of God entirely to the obligor and because in the only formulation of the hardship rule that exists in the Civil Code system (Art. 1575 CC:

possible exemption from the payment of rent for loss of proceeds of the leased property), it is expressly recognised by law that an agreement to the contrary of an exemption is possible.

Until now, a clause entirely excluding the hardship rule was uncommon in any type of commercial agreement, and more so in a share purchase agreement. What is the reason for its appearance now? Does it fill a gap in previous praxis? I do not think so.

A share purchase agreement is not a contract that can aspire to be a candidate for the application of a hardship clause. In fact, there is no example in the very extensive case law of the Supreme Court. There are several reasons for this: First, because it is a non-continuing contract, without exposure to the supervening risks inherent in a long time period. Secondly, because a purchase agreement is a type of agreement in which ordinarily all the possible risks are already distributed by provisions in law or contract. Since its first formulations, the Supreme Court excluded the application of the hardship rule when the agreement did not suffer from a lacuna as to the distribution of the risk involved. Thirdly, as far as the purchaser is concerned, case law has decided numerous times that the *payment of the price agreed in the sale* cannot be subject to a hardship contingency. And when it has been decided otherwise, it is because there are additional and sufficient reasons for such change. As in the Barcelona Companies Court no. 1 Judgment of 26 April 2021 (JUR 2021190062): the hardship clause was applied to *adjust* downwards the price of some properties whose sale was going to be put under seal. However, fifteen years had passed since the agreement was made under hand, with a very significant variation in the price of the properties to the detriment of the purchaser, as demonstrated by the fact that the sellers had assigned the loan for much less than the sale price. The properties were considered second-hand and not first-time occupation given the time that had elapsed and there was work to be done to finish the properties that the purchasers would have to undertake.

SPAs are not subject to hardship

In accordance with legal logic, a share purchase is a non-commercial sale of a thing (*res*) that forms part of a limited class and can therefore be treated as a sale of a specific thing. This is especially the case where a share purchase agreement comprises the entire available share capital, as a class specification is not necessary then. Consequently (Art. 1452 CC), as soon as the agreement is perfected - there is consent as to the thing and the price, determined or determinable - the risks of the thing have been transferred to the purchaser. If the risks of the shares are already the purchaser's, consequently, so is the risk of the business carried on by the company. More precisely, the *business* is a source of risk that does not appertain to the agreement as such, but which is attached to the risk inherent in the securities or shares of interest in the capital.

Consequently, ceteris paribus, the purchaser cannot refuse to close (consummate) the sale because of business risk contingencies occurring between the sale and consummation. And even less so, because of contingencies subsequent to consummation. Because in every agreement (not only non-continuing agreements), post-consummation risks are in any case risks of the owner of the asset in question (post-consummation, *res perit domino*).

Naturally, the parties are free to agree on the allocation and transfer of risk and on the extent or distribution of the supervening risk assigned in the agreement.

Let us imagine that the agreement contains, as is usual, *conditions precedent to performance at closing* and *conditions precedent to performance prior to closing* and after the date of the agreement. Strictly speaking, although in the existing models in practice the characterisation as precedent predominates, for practical reasons these conditions should be classified as subsequent. If they were properly precedent, there could not even be any obligations to be performed by the parties in the intervening time during which the seller still has the business and the purchaser has not yet paid. It would be absurd to refer to the existence of covenants when conditions precedent to closing are pending fulfilment.

Let us not insist on the correct characterisation of these conditions because for practical intents the issue is usually not important (except for tax purposes).

Let us assume that the conditions are precedent at closing and that one or more of them are not fulfilled. According to Article 1122 CC:

> When the conditions were placed with the intention of suspending the effectiveness of the obligation to give, the following rules shall be observed, in the event that the thing improves or is lost or deteriorated whilst the condition is pending fulfilment:
>
> 1st If the thing was lost through no fault of the debtor, the obligation shall be extinguished. [...]
>
> 3rd If the thing deteriorates through no fault of the debtor, the impairment is borne by the creditor. [...]
>
> 5th If the thing is improved by its nature or by time, the improvements shall be assigned to the creditor.
>
> 6th If it is improved at the expense of the debtor, the latter shall have no other right than that granted to the usufructuary.

The correct interpretation of these rules is that in the case of (no-fault) "loss", the seller is released from the obligation to deliver, but the purchaser can *terminate* his obligation to pay due to supervening disappearance of the reason for the agreement (*causa*); in the case of no-fault "deterioration", the risk is entirely the purchaser's; in the case of supervening "improvement" of the value of the shares, the advantage is the purchaser's. It is clear then that, without the need for the "improvement" of the value of the shares, the purchaser has the advantage. It is clear then that, without further elaboration, the risk in the intervening time is borne by the purchaser when the hardship contingency is not a contingency of "destruction" of the things sold. This is the case if the parties have not expressly agreed a risk clause for the interim period, either a material adverse change (MAC) clause or a formula that takes into account all or part of the hardship contingencies.

If the conditions at closing were to be characterised as subsequent, Article 1122 CC provides that "in the case of loss, deterioration or improvement of the thing, the provisions contained in the preceding article with respect to the obligor shall apply to the one who must make restitution". In other words, the structure of the risk is not altered.

Consequently, the contractual exclusion of the application of the hardship rule has no practical effect on a share purchase agreement.

Let us now see how the contractual exclusion of this clause can affect the strategy of the parties, assuming now by hypothesis that the hardship rule could naturally be applied to a share purchase agreement. In other words, the strategic difference of such an agreement with and without a hardship clause.

In my opinion, there are no major strategic differences either, and those that do exist demonstrate the superiority of a contractual world without a hardship rule. Let us start with a share purchase agreement to which the hardship rule applies. If the factual requirements of this rule have occurred (occurrence of unforeseeable risk of extraordinary scope in the balance of the agreement), the parties should initially negotiate a satisfactory solution. This is what the courts say: first negotiate, then attack the agreement. If no agreement is reached, the judge could *terminate* the agreement or *adjust* it to the new risk situation. If the parties negotiate in good faith and do not find a point at which the agreement could still be (albeit less) profitable for both parties, it will not be enough for the judge to simply terminate (end) the agreement, because this would *relieve the debtor of all the supervening risk, the cost of which would be unfairly borne by the creditor*. Therefore, in addition to terminating the agreement, the judge should succeed in spreading the remaining risk in the form of a partial duty to pay the costs of this risk to the obligor. And how is this done? Let us assume that *the supervening risk to be distributed is worth one thousand*. If four hundred is passed on to the creditor, the judge will have to recompose the original agreement and increase the payments due by the debtor, to the extent that *already "ex ante"* it would have been acceptable for the creditor to take on this additional risk which, without a provision in law, is all the debtor's. But the solution to which the hardship rule finally leads is irrational: it now appears that finding a point of fairness that the parties, who were the most interested in it, have not achieved is predicated on the wisdom and good will of a judge.

Who can waive hardship?

If there is no hardship clause in the share purchase agreement, the parties will negotiate - out of self-interest, not in compliance with a supposed legal mandate - to find a point at which the agreement could still be mutually beneficial. It is clear that the parties are in the best position to examine and put a price on their own interests. Much more so than the judge. And, if they do not find this point, it is more efficient to let the agreement fall apart - which it will, law or no law. The debtor will default, certainly, and will be subject to paying damages, but in the real world this is a future course that a rational creditor should never count on. If there is no hardship clause, both parties have strong incentives to negotiate in good faith up to the limit of what is possible. And beyond this limit there is no point in intuitive fairness at the stroke of a sentence. If the creditor can withdraw by means of a business option more profitable for him than a judge's "adjustment" by virtue of a hardship rule, it is only right to let him take advantage of this alternative business opportunity.