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NON-CONFORMITY IN AN ASSET DEAL AND A SHARE DEAL

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ABSTRACT

The acquisition of an enterprise is a cornerstone of M&A transactions. It usually occurs either as a direct sale of an enterprise (asset deal) or as a sale of shares in a company which manages the enterprise (share deal). In each case, the contract will usually be preceded by extensive negotiations and a due diligence process. This cannot always prevent the buyer from being dissatisfied with what it bought. However, Croatian case law severely restricts the buyer's ability to invoke the statutory provisions on material (and to a lesser extent legal) defects. This will leave the buyer largely without protection, unless it arms itself with an extensive list of representations and warranties. A legal system which aims to be comprehensive cannot leave this entirely to the parties' contract drafting skills, no matter how sophisticated they usually are. This paper aims to construe a solution on the basis of the general rules of the law of obligations. In the end, it will affirm the basic truth - regardless of the type of transaction, non-conformity exists as long as the buyer does not get what it bargained for.

***Key words**: non-conformity, asset deal, share deal, material defects, legal defects, commercial warranty, representations and warranties, guarantees.*

1. INTRODUCTION

In Croatian law enterprise or undertaking (Croatian: *poduzeće*; German: *Unternehmen*) is usually defined as an organised business unit which consists of objective (assets and obligations), subjective (personnel) and organisational

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elements.[1] This somewhat unwieldy definition reflects a commercial reality – an enterprise is a business venture organised to create value in the market. It could be anything from a manufacturing plant or a supermarket chain up to a travel agency or a start-up organisation.

Considering that it is organised to create value in the market, an enterprise has its own value, derived from the value it is expected to create. An enterprise is not a legal person but belongs to a natural or a legal person, usually a company, which is active in the market through its enterprise.[2]

However, one should always distinguish an enterprise from its "owner" (company).[3] After all, the market participants perceive them differently. For example, the clientele which regularly goes in a restaurant, values that restaurant as a unique combination of its name, location, food, chef and maître d'. The clientele is often not aware or at least does not care about the company that owns the restaurant. On the other hand, the value of the company which owns the restaurant depends on the value of the restaurant. Those values, however, do not have to be equal, since the company can have other assets, unconnected to the restaurant.

The distinction between the enterprise and the owner company allows for two basic models of acquiring an enterprise – an asset deal and a share deal.[4] In addition to mergers, those models are a cornerstone of M&A transactions.

In an asset deal, the previous owner (company) sells the enterprise as a whole to the new owner. This is a relatively complex operation which requires that

[1] Barbić, J.: *Pravo društava, knjiga prva - opći dio*, Zagreb: Organizator, 2008, pp. 223-224. Similarly, Visoki trgovački sud Republike Hrvatske: *Pž 5613/2015-4* (Judgment of 4/06/2018); Visoki trgovački sud Republike Hrvatske: *Pž 8331/08-3* (Judgment of 19/01/2009), 19.01.2009; Vrhovni sud Republike Hrvatske: *Revr 79/2017-3* (Judgment of 5/02/2020), 05.02.2020; Županijski sud u Zagrebu: GžR 940/14 (Judgment of 09/12/2014), 09.12.2014.

[2] Barbić, fn. 1, pp. 225-229; Županijski sud u Zagrebu: GžR 940/14 (Judgment of 09/12/2014), 09.12.2014; Visoki trgovački sud Republike Hrvatske: *Pž 5613/2015-4* (Judgment of 4/06/2018), 04.06.2018; Visoki trgovački sud Republike Hrvatske: *Pž 8331/08-3* (Judgment of 19/01/2009), 19.01.2009.

[3] Barbić, J.: Poduzeće u novijem hrvatskom zakonodavstvu, *Pravo u gospodarstvu*, (2) 2001, p. 10.

[4] More on an asset deal and a share deal see Barbić, fn. 1, pp. 238-239; Barbić, J.: Položaj članova, imovine i poduzeća u trgovačkom društvu, in: Barbić, J. (ed.): *Aktualnosti hrvatskog gospodarstve i pravne prakse*, Zagreb: Pravni fakultet, 1998, p. 38; Miladin, P.: Problem vraćanja poduzeća stečenog na temelju ništavog ugovora o kupoprodaji poduzeća, *Zbornik Pravnog fakulteta u Zagrebu*, 61(2) 2011, pp. 743-784. For German law, e.g. Canaris, C. W., Capelle, K. H.: *Handelsrecht*, München: CH Beck, 2006, para. 2; Heckschen, H., Scherz, A. (Eds.): *Beck'sches Notar-Handbuch* (§ 25), München: C.H. Beck, 2024.

each of the enterprise's elements is individually transferred to the new owner.[5] Once this is carried through, the enterprise can seamlessly continue to operate in the market.[6] To use the previous example, as long as the new owner steers the restaurant in the same direction, the customers will barely register the transition.

In a share deal, the object of sale is not the enterprise as such, but shares in a company that manages the enterprise. This will usually be a private limited company (Croatian: *društvo s ograničenom odgovornošću*, *d.o.o.*), but it can also be a public limited company (Croatian: *dioničko društvo*, *d.d.*).

From a legal perspective, a share deal is quite different from an asset deal, because the owner of the enterprise (the company) remains the same and the transfer occurs upstream – at the level of the owner's owner. From commercial perspective, however, the final result is relatively similar.[7] By acquiring the shares in a company, the new owner will be able to influence the direction and the fate of the enterprise. If the new owner decides to change the concept of the restaurant, the clientele will not care that the immediate owner (the company) remained the same.

The share deal will usually be a better option for both the seller and the buyer.[8] The shares are easier to transfer than the individual elements of an enterprise. If there is more than one share in the company, the buyer does not have to buy all of them. This can be especially important if the company has more shareholders and not everyone is willing to sell. Nevertheless, in order for the share deal to have comparable effects to an asset deal, the buyer has to acquire control stock, i.e. the shares that grant majority of votes in the shareholders' meeting.[9]

Although an asset deal also has certain advantages, in most cases they will not come to the fore. An asset deal allows for a sale of certain, precisely individualised assets.[10] However, considering that an enterprise is a complex organizational unit which consists of many elements, its sale implies transfer of the whole.[11] This is confirmed by Art. 102 of the Obligations Act (hereinafter:

5 Barbić, fn. 1, pp. 240-250; for Geman law Canaris, fn. 4, para. 1.

6 Barbić, fn. 1, p. 242.

7 Barbić, fn. 1, p. 239.

8 For Geman law, Canaris, fn. 4, para. 47.

9 Barbić, fn. 1, p. 259.

10 For German law, Canaris, fn. 4, para. 2.

11 Barbić, fn. 1, p. 240.

OA),[12] which provides that a person which contractually acquires an enterprise becomes jointly and severally liable for the obligations arising in connection with that enterprise.[13] In other words, at least in relation to the creditors, it is not possible to transfer the assets free of obligations.

An asset deal could also be used to bypass the company's shareholders and negotiate directly with the managing board. However, at least in a private limited company, the managing board is subordinated to the shareholders, and has to follow their instructions (Art. 422 (2) Companies Act, hereinafter: CA[14]). Moreover, if an asset deal includes the company's entire assets or the assets with a value higher than 25% of the company's share capital and if this amounts to a significant structural change of the company, as it will usually be the case, its validity is conditioned upon the approval of the shareholder's meeting by a majority of 75% of votes (Art. 552 (1) CA).[15] Therefore, if the sale of an enterprise is supported by shareholders with less than 75% of votes, the buyer could be better off with a share deal.[16]

Consequently, it does not come as a surprise that in Croatian M&A transactions share deals are more common.[17]

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[12] Narodne novine: *Zakon o obveznim odnosima*, Zagreb: Narodne novine d.d., 35/2005, 41/2008, 125/2011, 78/2015, 29/2018, 126/2021, 114/2022, 156/2022, 145/2023, 155/2023.

[13] For more details see Ivković, I.: Kontinuitet pravnih odnosa nakon promjene nositelja poduzeća, *Pravo u gospodarstvu*, (6) 2016, pp. 877-924; Ivković, I.: Kontinuitet pravnih odnosa nakon promjene nositelja poduzeća, *Pravo u gospodarstvu*, (1) 2017, pp. 35-78.

[14] Narodne novine: *Zakon o trgovačkim društvima*, Zagreb: Narodne novine d.d., 111/1993, 34/1999, 121/1999, 52/2000, 118/2003, 107/2007, 146/2008, 137/2009, 111/2012, 125/2011, 68/2013, 110/2015, 40/2019, 34/2022, 114/2022, 18/2023, 130/2023.

[15] If the buyer of shares is a company, Croatian courts have held that the (preliminary) contract of sale of shares does not require consent of the buyer's shareholders meeting, according to the Art. 441 (1) (10) CA, considering that the shares are not things or rights needed for the buyer's business (Visoki trgovački sud Republike Hrvatske: *Pž 2934/2018-4* (Judgment of 29/10/ 2019), 29.10.2019; Visoki trgovački sud Republike Hrvatske: *Pž 3990/2020-6* (Judgment of 20/04/2021), 20.04.2021).

[16] An asset deal might be useful if the company has several distinct business units and it intends to sell only one of them. However, even then it is possible to spin off the target business in a separate company and sell its shares.

[17] The available case law usually deals with the direct transfer of an enterprise (an asset deal) only in the context of worker protection (e.g. Vrhovni sud Republike Hrvatske: *Revr 1008/2016-2* (Judgment of 22/09/2020), 22.09.2020; Vrhovni sud Republike Hrvatske: *Revr 80/2017-2* (Judgment of 28/04/2021), 28.04.2021), see also Narodne novine: *Zakon o radu*, Zagreb: Narodne novine d.d., 93/2014, 127/2017, 98/2019, 151/2022, 46/2023, 64/2023, Art. 137. Also, an enterprise is sometimes directly transferred in the course of the insolvency proceedings (e.g. Visoki trgovački sud Republike Hrvatske: *Pž 2675/06-3* (1 Judgment of 7/05/2006), 17.05.2006; Visoki trgovački sud Republike Hrvatske: *Pž 90/06-3* (Judgment of 1/02/2006),

Regardless of their differences, considering their common purpose of acquiring control over an enterprise, both an asset deal and a share deal have many similarities. For example, they are usually preceded by detailed negotiations in which the parties define the supposed features of the target enterprise (and/or company) and its price. At the heart of the negotiations is a due diligence process in which the seller discloses and the buyer (i.e. its advisors) examines the enterprise's most important elements.[18] The due diligence findings are then reflected in the sales contract, usually a share purchase agreement.[19]

Considering the complex nature of an enterprise, due diligence does not offer an absolute certainty.[20] The buyer does not have an unlimited amount of time and resources to examine every single detail. Moreover, even the experienced due diligence advisors can make an oversight. Finally, the seller might misrepresent or hide certain information that would lower the price of the enterprise.

Consequently, it is not uncommon that, after it closes the deal and it takes over the enterprise, the buyer is unpleasantly surprised. The aim of this paper is to explore whether and under which prerequisites the buyer can invoke the rules on non-conformity of a sales object.[21]

Considering that this is a typical M&A issue, one would expect that it has been extensively covered by Croatian jurisprudence. However, there are barely any scholarly writings which would discuss it. Jakša Barbić is one of the rare

01.02.2006), see also Narodne novine: *Stečajni zakon*, Zagreb: Narodne novine d.d., 71/2015, 104/2017, 36/2022), Arts. 230 (2) (1), 232, 233 and Barbić, fn. 1, p. 248.

[18] More about due diligence see Vitezić, N.: Detaljno ispitivanje sudionika u poslovnim odnosima (Due Diligence), *Računovodstvo, revizija i financije*, (4) 2004, pp. 57-63; Cinotti, K.: Due diligence – kvalitativna i kvantitativna ocjena poduzeća, *Suvremeno poduzetništvo*, 99(4) 2002, pp. 11-17; Cirkveni, N., Primjeren pregled društva (*due diligence*) pri preuzimanju, *Računovodstvo, revizija i financije*, (9) 2009, pp. 138-142; Salaj Ćetković, V.: Cjeloviti pregled poslovanja (dubinsko snimanje - "due diligence"), *Računovodstvo i financije*, 56 (5) 2010, pp. 91-95; Lasić, V.: Pregled društva prije preuzimanja ili spajanja (*Due diligence*), *Računovodstvo, revizija i financije*, (10) 2009, pp. 105-109; Visoki trgovački sud Republike Hrvatske: *Pž 2934/2018-4* (Judgment of 29/10/ 2019), 29.10.2019.

[19] Barbić, fn. 1, p. 254; Veršić, M.: Due diligence postupak u trgovačkim društvima, *Računovodstvo, revizija i financije*, (12) 2000, pp. 123-124.

[20] Sedemund, J.: Rizici due diligencea pri kupnji poduzeća, *Računovodstvo, revizija i financije*, (6) 2006, p. 118.

[21] Although Croatian statutes do not use the term non-conformity (Ernst, H.: *Odgovornost za materijalne nedostatke – Nacionalni izvještaj za Republiku Hrvatsku*, in: Schmid, C. U., Remien, O. (eds.): *Forum za građansko pravo za Jugoistočnu Evropu – Knjiga II*, Skopje: Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), p. 333), this notion is used in this paper as a common name for material and legal defects and other similar types of liability.

authors who wrote on the subject, albeit, primarily from the perspective of an asset deal.[22]

Situation is not much better with Croatian case law. There are practically no available court decisions on non-conformity in an asset deal, and only a few on non-conformity in a share deal. As it will be shown, those decisions severely restrict the buyers' reliance on non-conformity.[23]

The absence of scholarly output and case law can probably be attributed to the fact that in sophisticated M&A transactions the parties' legal advisors are careful to regulate non-conformity within the four corners of the contract. In particular, the provisions on seller's representations and warranties often contain a comprehensive list of features the absence of which leads to the seller's liability. Even if a post M&A dispute arises, it will be often settled by arbitration which offers confidentiality and a possibility to appoint specialised arbitrators.

Nevertheless, a general discussion on the attitude of Croatian law regarding non-conformity in an asset deal and a share deal is far from redundant. To begin with, the parties might leave room for a subsidiary application of the statutory provisions. Even if the parties exclude their application, such exclusion could be contrary to mandatory provisions, especially those which protect the buyer from seller's fraud or gross negligence.[24]

Furthermore, if the meaning of certain contractual clauses is unclear, they will have to be interpreted in accordance with the principles of the law of obligations (Art. 319 (2) OA).

Finally, as a civil law system, Croatian law should aspire to provide adequate default solutions for all contractual situations. The commercial transactions should be no exception. As a matter of principle, Croatian law should not withdraw and outsource its sovereign prerogatives to the parties. After all, even in an M&A transaction not every party will be equally well equipped to deal with the pitfalls of contract drafting.

Therefore, the aim or this paper should be of both theoretical and practical relevance. Ideally, it should advance the scholarly understanding and provide practical advice both to the buyers and to the sellers.

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[22] Barbić, fn. 1, pp. 256-258.

[23] Most prominently case Vrhovni sud Republike Hrvatske: *Rev 3152/2016-2* (Judgment of 5/11/2019), 05.11.2019; Vrhovni sud Republike Hrvatske: *Rev x 523/2018-2* (Judgment of 17/01/2024), 17.01.2024; Visoki trgovački sud Republike Hrvatske: *Pž 2043/2021-3* (Judgment of 13/05/ 2022), 13.05.2022; Visoki trgovački sud Republike Hrvatske: *Pž 6411/2014* (Judgment of 23/05/2017), 23.05.2017, excerpt from Pravo i porezi, 12, 2022, p. 76. Those decisions will be further discussed in subsection 3.3.2 Case law.

[24] E.g. *Zakon o obveznim odnosima*, Arts. 345 (1), 408.

2. NON-CONFORMITY IN AN ASSET DEAL

After an overview of an asset deal (2.1.), the question of what makes an enterprise non-conforming will be discussed (2.2.).

2.1. THE NOTION OF AN ASSET DEAL

The provisions of the OA which regulate sale and purchase contract (hereinafter: contract of sale or sales contract, Arts. 376-473 OA) mostly talk about the sale of goods or, to be more precise, "things" (Croatian: *stvari*). They do not mention the sale of an enterprise. However, without a doubt, the enterprise as such can be the object of a sales contract.[25]

First, considering that the OA also mentions the sale of a right (Art. 376 (2), Art. 383 OA), the sales contract is not limited to the goods. Further, the rules of contract law are largely non-mandatory and the parties are free to determine the object of sale as they see fit. Finally, the OA provides that when the buyer buys several things which constitute a unity, and only some of the things have defects, the buyer might have a legitimate interest to terminate the contract also in regard to non-defective things (Art. 414 (2), Art. 416 OA). A perfect example of such unity of things and other elements is the enterprise.

In a contract of sale of an enterprise (asset deal), the seller undertakes to transfer the entire enterprise to the buyer, and the buyer undertakes to pay the price to the seller (Art. 376 (1) OA). Despite the fact that it consists of many elements, the enterprise is a unitary object of the sales contract.[26] This does not follow from its nature, but from the intent of the parties. When they agree on the sale of an enterprise, they have in mind its potential use as a whole and they accordingly determine its price.

Unitary nature of an enterprise starts falling apart once it comes to the seller's performance – transferring of the enterprise to the buyer. Unlike the rules which govern contracts, the rules on transferring property rights from one person to the other are mostly of a mandatory nature.[27]

In particular, since the transfer of property rights also affects third parties (*erga omnes* effects), there has to exist certainty of whether the transfer indeed took place (principle of publicity). Thus, the ownership over a movable or immovable thing can be transferred only in accordance with to the rules of the

[25] Barbić, fn. 1, p. 240.

[26] Miladin, fn. 4, pp. 750-751.

[27] Similarly Miladin, fn. 4, p. 752.

Act on Ownership and Other Real Property Rights.[28] Similarly, a claim can be transferred only in accordance with the rules on assignment of the OA (Art. 80-89 OA). A trademark can be transferred only in accordance with the rules of the Trademark Act.[29]

Considering that the rules on transferring the property rights do not provide for a transfer of the enterprise as a whole, the seller can transfer the enterprise only in a piecemeal fashion.[30] E.g. it will have to transfer the real estate by registering such transfer in the land register, the movables by handing them over to the buyer, and the bank accounts and other receivables by an assignment. Potentially, the most problematic is the transfer of contracts and obligations since it requires consent of the other party to such contract or obligation (the creditor).[31] Only the transfer of labour contracts is relatively straightforward since it occurs by the operation of law.[32]

2.2. NON-CONFORMITY OF AN ENTERPRISE

Croatian law does not contain a single set of rules on non-conformity of a sales object, but several parallel regimes – on material defects of the goods ("things") (Art. 399.a-422.a OA),[33] legal defects of the goods (Art. 430-

[28] Narodne novine: *Zakon o vlasništvu i drugim stvarnim pravima*, Zagreb: Narodne novine d.d., 91/1996, 68/1998, 137/1999, 22/2000, 73/2000, 114/2001, 79/2006, 141/2006, 146/2008, 38/2009, 153/2009, 90/2010, 143/2012, 152/2014, Arts. 114-169.

[29] Narodne novine: *Zakon o žigu*, Zagreb: Narodne novine d.d., 14/2019, Arts. 22-24.

[30] Barbić, fn. 1, pp. 240-250; for Geman law Canaris, fn. 4, para. 1.

[31] Barbić, fn. 1, pp. 244-245.

[32] *Labour Law* (cro. Zakon o radu), fn. 17, Art. 137; Barbić, J.: Poduzeće - pojam i značenje, *Računovodstvo, revizija i financije*, (1) 2001, p. 119.

[33] For more details on material defects see Klarić, P.; Vedriš, M.: *Građansko pravo*, Zagreb: Narodne novine d.d., 2014; Vizner, B., Bukljaš, I.: *Komentar Zakona o obveznim (obligacionim) odnosima*, Zagreb: Informator, 1979; Cigoj, S.: *Komentar obligacijskih razmerij, III. knjiga*, Ljubljana: Časopisni zavod Uradni list Republike Slovenije, 1985; Blagojević, T. B., Krulj, V.: *Komentar Zakona o obligacionim odnosima I*, Beograd: Kulturni Centar & Pravni fakultet, 1980; Perović, S., Stojanović, D.: *Komentar Zakona o obligacionim odnosima* (Knjiga druga), Kragujevac: Pravni fakultet Univerziteta u Kragujevcu, 1980; Šoljan, V.: Odgovornost za materijalne nedostatke po Zakonu o obveznim odnosima i Bečkoj konvenciji, *Pravo u gospodarstvu*, (3) 2008, pp. 537-629; Slakoper, Z.: Primjena odredbi Zakona o obveznim odnosima o odgovornosti prodavatelja za materijalne nedostatke na razne vrste ugovora, *Zbornik Pravnog fakulteta Sveučilišta u Rijeci*, 25(1) 2004, pp. 445-480; Slakoper, Z., Nikšić, S.: Novo uređenje odgovornosti za materijalne nedostatke u hrvatskom obveznom pravu, *Zbornik Pravnog fakulteta Sveučilišta u Rijeci*, 43(3) 2022, pp. 531-558; Eraković, A.: Odgovornost prodavatelja za materijalne nedostatke stvari, in: BArbić, J., Vedriš, M. (eds.): *Zaštita vjerovnika: zbornik radova u povodu savjetovanja „Zaštita vjerovnika"*, Zagreb: Pravni fakultet Sveučilišta u

437)[34] and a commercial warranty (Art. 423-429 OA)[35]. The rules on material and legal defects of the goods constitute a default statutory regime. On the other hand, the rules on commercial warranty apply only if the seller issued such warranty.

Although an enterprise is not a good or a thing, the above-mentioned regimes should apply analogously (*mutatis mutandis*). In particular, if an enterprise as such can be an object of a sales contract, the seller has to be liable for its material and legal defects.[36] This is all the more so considering that the rules on seller's liability for material and legal defects analogously apply to other bilateral (synallagmatic, reciprocal) contracts (Art. 357 OA).

Moreover, as already mentioned, the OA provides that if the buyer bought several things that constitute a unity, and only some of those things have material

Zagrebu, 1994, pp. 85-98; Ernst, fn. 21, pp. 333-346.; Čuveljak, J., Odgovornost prodavatelja za materijalne nedostatke prodane stvari, Prvi dio, Hrvatska pravna revija, (5) 2022, pp. 1-22; Čuveljak, J.: Odgovornost prodavatelja za materijalne nedostatke prodane stvari, *Hrvatska pravna revija*, 14(7) 2022, pp. 84-91; Čuveljak, J.: Novote kod instituta odgovornosti prodavatelja za materijalne nedostatke prodane stvari, *Hrvatska pravna revija*, 6(9) 2006, pp. 20-31; Milotić, I.: Materijalni nedostatci u Noveli Zakona o obveznim odnosima iz 2021. godine, *Pravo i porezi*, (12) 2021, pp. 11-18; Matijević, B.: Odgovornost prodavatelja za materijalne nedostatke stvari, *Hrvatska pravna revija*, (6) 2017, pp. 14-21.

[34] In addition to the general commentaries from the fn. 33, also Slakoper, Z.: Odgovornost za pravne nedostatke u Zakonu o obveznim odnosima i izabranim pravnim porecima, *Zbornik Pravnog fakulteta Sveučilišta u Rijeci*, 28(1) 2007, pp. 363-405; Rosenberg Volarić, V., Zubčić, S.: Odgovornost za pravne nedostatke – pozitivnopravne i praktične implikacije, *Pravo u gospodarstvu*, (34) 1995, pp. 678-690; Čuveljak, J.: Odgovornost prodavatelja za pravne nedostatke, *Hrvatska pravna revija*, 1(8) 2022, pp. 35-41; Matanovac Vučković, R., Kuštrak, I.: Odgovornost za pravne nedostatke - Nacionalni izvještaj za Hrvatsku, in: Schmid, C. U., Remien. O. (eds.): *Forum za građansko pravo za Jugoistočnu Evropu – Knjiga II*, Skopje: Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), 2012, pp. 381-393; Marečić, A.: Pravni nedostatci kod ugovora o kupoprodaji, *Pravo i porezi*, (6) 2020, pp. 75-81; Golub, A.: Odgovornost za pravne nedostatke, *Hrvatska pravna revija*, (4) 2016, pp. 12-20.

[35] In addition to the general commentaries from the fn. 33, also Ledić, D.: Garancija za ispravnog funkcioniranje stvari, *Zbornik Pravnog fakulteta Sveučilišta u Rijeci*, 15 1994, pp. 37-50; Matijević, B.: Osiguranje jamstva (garancije) za ispravnost prodane stvari, *Hrvatska pravna revija*, (4) 2017, pp. 10-15; Marečić, A.: Novosti u odgovornosti trgovca za materijalne nedostatke i jamstva za ispravnost proizvoda, *Računovodstvo, revizija i financije*, (7) 2008, pp. 131-136; Hruška, A.: Prava kupca na temelju jamstva za ispravnost prodane stvari (garancije), *Pravo i porezi*, (3) 2020, pp. 33-38 Hruška, A.: Jamstvo (garancija) za ispravnost stvari, *Računovodstvo, revizija i financije*, (4) 2020, pp. 223-227; Basić, G.: Jamstveni list - prava i obveze potrošača i izdavatelja koje proizlaze iz jamstva, *Računovodstvo, revizija i financije*, (6) 2004, pp. 101-106; Čuveljak, J.: Garancija za ispravno funkcioniranje prodane stvari, *Hrvatska pravna revija*, 2(7) 2022, pp. 44-52.

[36] Barbić, fn. 1, pp. 240, 256; for German law, Canaris, fn. 4, para. 16.

defects, the buyer may terminate the entire contract (Art. 414 (2), Art. 416 OA). This means that the enterprise can be seen as a single object for the purposes of applying the rules on material defects.

It is not easy to propose general criteria according to which an enterprise would be non-conforming. The rules on material and legal defects of the goods are numerous and complex, and their detailed analysis would exceed the scope of this paper.[37] Moreover, those rules have to be adapted to the specific object of each contract of sale. An enterprise is a complex object with many and diverse elements. In addition, enterprises significantly differ from each other, e.g. as local café differs from a multi-national business. Unlike some other, standardised goods, two enterprises will rarely be the same.

The scholarly writings usually state that a defect of an individual element of the enterprise does not automatically constitute a defect of the entire enterprise.[38] This follows from the fact that the parties agreed on the sale of an enterprise as a whole and not its individual elements. After all, the enterprise is not just a sum of its parts. To give an obvious example, a supermarket will not be defective just because some of the apples on its shelves are rotten.[39] This is not just because the value of the apples is comparatively insignificant,[40] but because the buyer could not have reasonably expected that every piece of fruit is in edible condition.

The situation is not substantially different if the enterprise is burdened with a bank loan. In the absence of an indication to the contrary, the buyer could not have simply presumed that the enterprise is free of obligations. It is well known that businesses are financed not just through equity but also through debt.[41]

The extreme conclusion would be that an enterprise cannot have defects. No matter the nature of its problems, they have surely occurred before in other enterprises and the buyer could have counted on them. E.g. even if the debts of an enterprise are higher than the value of its assets, this is just a common (pre-)insolvency situation.[42]

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[37] See fn. 33, 34.

[38] Barbić, fn. 1, pp. 256-257; for German law, Canaris, fn. 4, para. 22, 35.

[39] For a similar examples in German law, Faust, F.: § 453, in: Mansel, H.-P. (ed.): *Beck'scher Online-Kommentar BGB*, München: C.H. Beck, 2025, para. 29; Canaris, fn. 4, para. 35.

[40] After all, in civil law does not apply the principle *de minimis non curat lex* (*praetor*), i.e. the parties are entitled to pursue even their insignificant claims.

[41] For a relatively similar example see Barbić, fn. 1, p. 257.

[42] For German law, Verse, D. A.: § 15, in: Henssler, M., Strohn, L. (eds.): *Gesellschaftsrecht*, München: C.H. Beck, 2024, para. 18.

It is a truism that the optimal approach lies somewhere between the extremes. However, its contours remain to be determined. Among scholars there is a widespread opinion that an enterprise is non-conforming only if its economic basis is disrupted or destroyed.[43] E.g. if the seller sells a power plant with a broken core machinery, the plant will not be able to perform its primary function.

Although this is a clear example of non-conformity, it is doubtful whether "disruption of the economic basis" can serve a viable test.[44] E.g. if one would apply this test on the sale of a car, the car would be defective only if it was unable to drive properly. However, a car can also have minor defects, such as broken air-conditioning or a stereo system. In other words, if this was the test, unlike with other goods, the seller of an enterprise could get away with all but the most egregious defects and the buyer would bear the burden of convincing the seller to accept a different risk allocation.[45]

In order to offer a potential solution, it is first necessary to examine the idea behind non-conformity of an object of sale (2.2.1). Subsequently, this idea will be applied to the sale of an enterprise (2.2.2.).

2.2.1. THE IDEA BEHIND NON-CONFORMITY OF AN OBJECT OF SALE

Although the concept of non-conformity of a sales object is of paramount importance, it has been broken down in too many provisions so that the underlying idea has faded beyond recognition.

At the outset, there is the distinction between material and legal defects. Although rooted in legal history and recognised in other legal systems,[46] the merits of such dichotomy are questionable. Probably the main difference is that the buyer has a duty to examine the goods against material defects (Art. 403 OA) while it does not have a corresponding duty regarding legal defects (Art. 431 OA). This is probably based on the idea that, unlike legal defects, material defects are detectable upon examination. However, this is not always true. Not only that material defects can be hidden (Art. 404 OA), but they do not even

[43] Barbić, fn. 1, p. 256; for German law, Canaris, fn. 4, para. 36; Heckschen; Scherz, fn. 4, § 25, para. 33.; Merkt, H.: Vorbemerkungen zu §§ 25-28, in: Hopt. K. J. (eds.): *Handelsgesetzbuch*, München: C.H. Beck, 2025, para. 6; Picot, C. M., Römermann, V. (eds.) *Münchener Anwaltshandbuch GmbH-Recht*, München, C.H. Beck, 2022, para. 172.

[44] For German law, Canaris, fn. 4, paras. 36-37.

[45] That non-conformity of an enterprise should be generally subject to the same rules as non-conformity of things, Canaris, fn. 4, para. 23.

[46] E.g. *Bürgerliches Gesetzbuch (BGB)*, Reichsgesetzblatt, 1896, §§ 434, 435.

have to be "material", i.e. grounded in the physical world.[47] On the other hand, some of the legal defects are quite easily detectable, e.g. third parties' rights registered in an official register. Thus, it would be advisable to interpret the material and legal defects in a similar if not the same way.[48]

Furthermore, material defects are regulated in 28 lengthy articles (Arts. 399.a-422.a OA). They commence with a list of definitions which *inter alia* transpose EU consumer protection rules, such as those on digital content and services. In such a multitude of legal provisions it is easy to overlook that there is no definition of material defects. Something closest to a definition can be found in Art. 401 (1, 2) OA which lists ten (again, quite complex) situations where material defects are considered to exist.

The definition of material defects (and non-conformity in general) can only be construed by generalising those ten situations. It could be something along the following lines – the object of sale is defective (non-conforming) if it lacks the features which the buyer could have reasonably expected under the contract. Those features could either be stated in the contract (Art. 401 (1) (1) OA) or they could be implied from the circumstances known to the parties at the moment of the contract conclusion (Art. 401 (1, 2) OA). Thus, an object of sale will be defective if it is not fit for a particular purpose of which the buyer had informed the seller before the contract conclusion and which the seller accepted (Art. 401 (1) (2) OA), if it is not fit for a purpose for which the object of the same kind would ordinarily be used (Art. 401 (2) (1) OA), or if it does not have the features which are customary for the object of the same kind and which the buyer could have reasonably expected according to the nature of things, especially based on the seller's public statements (Art. 401 (2) (4) OA).

Similarly, legal defects could be defined as legal obstacles which the buyer could not have reasonably expected under the contract. In particular, an object of sale has legal defects if there is a right of a third party which excludes or limits the buyer's right, and of which the buyer was not notified nor did it accept to receive the object burdened by such right (Art. 430 (1) OA). Moreover, when the object of sale is a right, it has legal defects if it does not exist or if there are legal obstacles for its enforcement (Art. 430 (2) OA).

Consequently, both material and legal defects should be defined in relation to the buyer's reasonable expectations at the moment of the contract conclusion.

[47] See subsection 3.3.3. Critical analysis of case law.

[48] Similarly, Slakoper, fn. 34, p. 370; Matanovac Vučković; Kuštrak, fn. 34, p. 381; for German law, Canaris, fn. 4, para. 38.

2.2.2. THE APPLICATION OF THAT IDEA TO AN ENTERPRISE

When this is applied to the sale of an enterprise, the enterprise is defective (non-conforming) if it does not have the features which the buyer could have reasonably expected under the contract. Those features could either be stated in the contract or implied from the circumstances known to the parties at the moment of the contract conclusion.

The situation is relatively straightforward if the enterprise's features are clearly listed in a written contract. This can occur in the form of seller's representations and warranties,[49] or some other comparable clauses, in which the parties describe the features of the sold enterprise.

It is less obvious if the contract does not describe the features of an enterprise or does not describe them comprehensively. Then, it becomes necessary to interpret the implied intent of the parties outside of the written contract (Art. 319 (2) OA), especially which they manifested during their negotiations. E.g. if during the due diligence process the buyer learns that an enterprise does not have a certain feature and continues negotiations, it can be presumed that it accepted that this feature is absent and the seller will not be liable (Art. 402 (1, 2) OA). *Vice versa*, if the seller learns that the buyer specifically needs a particular feature and leads it to believe that the enterprise has such feature, the seller will be liable for its absence (Art. 401 (1) (2) OA).

If the parties intend the enterprise to have a certain feature, it is not necessary that this feature is objectively important for the functioning of the enterprise. The defect can concern even a single element of the enterprise provided that the parties specifically had in mind such element. E.g. if the buyer was particularly interested and praised the enterprise's state-of-the-art conference table, the seller will be liable if such table is eventually broken.

Properly understood, this is not just a defect of an individual element on which the parties agreed in addition to their agreement on the features of an enterprise, but the defect of the enterprise as a whole. To be specific, the parties are free to define the enterprise's features as they see fit. If they agree that the enterprise will have a state-of-the-art conference table, this becomes the intended feature of the enterprise even if the absence of such table would not objectively hinder the enterprise's productivity.[50]

The parties' intent can *inter alia* be determined based on the price for the enterprise, including the method of its calculation. E.g. if the value of the con-

[49] For more details see subsection 6. Representations and warranties.

[50] For German law similarly Verse, fn. 42, para. 23.

ference table was specifically included in the price calculation, this suggests the parties' agreement to have a conference table in a certain condition. Although the parties are free to depart from the principle of equal value of their performances (Art. 7 OA), in the absence of an indication to the contrary, it should be presumed that they intended them to be equal.[51] After all, this is the reason why ambiguous clauses in a bilateral contract should be interpreted in a way which achieves a fair balance between the reciprocal obligations (Art. 320 (2) OA).

An enterprise will rarely be non-conforming just because it is not fit for the purpose for which the enterprise of the same kind would ordinarily be used (cf. Art. 401 (2) (1) OA).[52] This is due to the fact that each enterprise is highly individual, with different levels of mechanisation, capitalisation, indebtedness and personnel. This is true even within the same industry. E.g. a grocery store can range from a mom-and-pop store up to a large supermarket chain.

However, an enterprise will usually not be fit for its ordinary purpose, if it is fundamentally broken, i.e. not able to create new market value. It is difficult to imagine that a reasonable buyer would want to buy such an enterprise. Such scenario explains the statement that an enterprise becomes non-conforming only after its economic basis is disrupted.[53] However, even then the exceptions are possible. E.g. a buyer could have bought a ruined industrial facility only for its parts, which would probably reflect on the contractually agreed price.

To conclude, non-conformity of an enterprise is not much different from non-conformity of any other sales object. The main difference arises from the complexity and individual nature of an enterprise. The problems which might arise can be solved only by studying each contract carefully and interpreting the real intent of the parties.

3. NON-CONFORMITY IN A SHARE DEAL

In this section, share deal will be explained in more detail (3.1.), followed by a discussion of what constitutes non-conformity of shares (3.2.), especially, whether the defects of the underlying enterprise can also represent the defects of shares (3.3.).

[51] This is why one of the goals of the rules on material defects is to uphold the equal value of performances of both parties (Ernst, fn. 21, p. 333; for German law, Canaris, fn. 4, paras. 34, 36, 37, 42).

[52] For German law, Canaris, fn. 4, para. 24.

[53] See the text above.

3.1. THE NOTION OF A SHARE DEAL

Share deal is, in principle, more straightforward than an asset deal. The object of sale is not a somewhat nebulous concept of an enterprise, but one of the basic elements of every company – a share. Moreover, the sale of shares has its statutory basis.[54] Art. 412 (3) CA provides that a contract which creates an obligation to transfer a share has to be concluded in the form of a notarial deed.[55]

Not every contract of sale of shares will be considered as a share deal. A share deal should encompass the shares which enable their owner to control the company and its enterprise.[56] These are often all shares in the company or, at least, the shares which carry more than 50% of votes and/or share capital. Thus, a share deal could be defined as a contract in which the seller undertakes an obligation to transfer control stock to the buyer, and the buyer undertakes to pay the price (Art. 376 (1) OA).

From the perspective of contract law, it might seem unusual to differentiate a share deal from a contract of sale of a lower amount of shares. After all, the prerequisites for the contract conclusion are the same no matter whether the seller sells 1% or 100% of the shares in a company. However, the purpose which the parties intend to achieve with those contracts is different.

If the buyer buys 1% of the shares, it cannot, at least for the time being, hope to control the company and its enterprise. It can only intend to profit from the distribution of dividends or from the increase of the shares' value. Accordingly, the price of the shares will primarily be calculated on the basis of the buyer's expected financial gains.

On the other hand, if the buyer buys 100% of the share capital, it will assume control over the company and its enterprise. Especially in a private limited company, it will be able to issue binding instructions to the management board and steer the enterprise in a direction of its choice (Art. 422 (2) CA). In that respect a share deal becomes relatively similar to an asset deal. The buyer buys controlling shares as a whole, similarly as it would buy the enterprise as a unity of many elements. If the seller partially performs, and transfers only some

[54] For more details on the sale of shares see Bego, T.: Prodaja i prijenos poslovnog udjela u društvu s ograničenom odgovornošću, *Računovodstvo, revizija i financije*, (8) 2015, pp. 169-175.

[55] For more details on the transfer of shares see Markovinović, H.: Prijenos poslovnog udjela – što jest, a što ne bi trebao biti, *Zbornik Pravnog fakulteta u Zagrebu*, 72(1-2) 2022, pp. 213-244; Kovač, V.: Ustup poslovnog udjela, promjene podataka u trgovačkom društvu i prijave nadležnim institucijama, *Pravo i porezi*, (10) 2015, pp. 49-54.

[56] Barbić, fn. 1, p. 253.

of the agreed shares, the buyer would have a legitimate interest to terminate the entire contract (Art. 414 (2), 416 OA).

Consequently, the price of the shares in a share deal will incorporate the control premium, i.e. a premium which the seller requires for giving away the control over the company. Thus, the shares which carry 51% of the votes could be much more expensive than the shares which carry 49% of the votes.

The transfer of shares is usually much simpler than the transfer of all elements of an enterprise.[57] It does not require diverse and complicated procedures or third parties' consent.[58] All shares are transferred in the same way, usually at the same moment. Practically the only formality is that the shares are transferred in the form of a notarial deed (Art. 412 (3) CA).

3.2. NON-CONFORMITY OF SHARES

There are no specific statutory rules on non-conformity of shares. The statutory provisions on material and legal defects only mention the goods, more precisely, "things" (Arts. 400, 401, 430 OA). As already discussed, those rules should be analogously applied to the sale of rights and other objects of sale. In case of a share deal such rights are shares in a company.

Simply put, the shares are defective if they do not have the features which the buyer could have reasonably expected under the contract. Shares are, in themselves, much simpler than an enterprise. They primarily represent a part of the company's share capital and grant their holder certain property and managing rights.

Consequently, the shares' defects will typically concern those features. The shares will be non-conforming if they represent a lower amount of the share capital than the buyer could have expected, either in an absolute number or in a percentage.[59] E.g. if the seller told the buyer that the nominal amount of its shares is 10.000 EUR, which amounts to 75% of the share capital, the shares will be non-conforming if those number are actually lower.

[57] For German law, Heckschen; Scherz, fn. 4, § 25, para. 46.

[58] It is possible that the transfer of shares is conditioned upon the approval of the company (Arts. 227 (2), 413 *Companies Act* (cro. Zakon o trgovačkim društvima). However, considering that the seller is usually the controlling shareholder, this consent will not be difficult to acquire.

[59] For German law, Ebbing, F.: § 15, in: Michalski, L. (ed.): *GmbH-Gesetz: Kommentar* (4th ed.). Munchen: C.H. Beck, 2023, para. 177.

Furthermore, the shares will not be conforming if they do not grant the property and managing rights which the buyer was entitled to expect.[60] This will more often be the case in a private limited company where the rights arising from the shares are not necessarily standardised and could be distributed differently by the articles of associations. E.g. the share could be non-conforming if they are not transferrable without the approval of the company (Art. 227 (2), Art. 413 CA) or they grant their holder a disproportionately low number of votes or the amounts of dividend.

Finally, the shares could be defective if the third parties' rights prevent or diminish the seller's rights arising from the shares. E.g. this could be the case if the shares did not belong to the seller but to a third person or if the shares were burdened by a mortgage or pledge.

One should be particularly careful if the shares did not belong to the seller. Croatian courts held that the seller who failed to transfer the shares to the buyer, because it was not the shareholder, was not liable for the legal defects but for non-performance.[61] The difference had serious consequences, considering that, had this been a legal defect, the buyer would have been time-barred from enforcing its rights (Arts. 437 OA). However, such solution is difficult to reconcile with the text of Art. 430 (2) OA. According to that provision, even if a right which is the object of sale does not exist, this is considered as a legal defect (and not non-performance). Logically, this would have to apply all the more so if the right exists but does not belong to the seller. [62]

In any case, it might seem relatively easy to detect the share's defects either before the conclusion of the share purchase agreement or at the latest after the shares are transferred to the buyer. It practically suffices to check the court register, articles of association and the share register. The court register and the articles of association are publicly available and always true, considering that the publicly available version is considered authentic. Provided that the share register was duly managed, the danger of shares' non-conformity might seem slight.

[60] For German law, Ebbing, fn. 59, para. 177.

[61] Vrhovni sud Republike Hrvatske: *Revt 456/2015-2* (Judgment of 23/03/2021), 23.03.2021; Visoki trgovački sud Republike Hrvatske: *Pž 389/2022-3* (Judgment of 6/04/ 2022), 06.04.2022.

[62] That problem has also been discussed by Slakoper, fn. 34, p. 379. and Matanovac Vučković; Kuštrak, fn. 34, p. 381. German law is of the same opinion as Croatian courts (Verse, fn. 42, para. 19). However, § 435 BGB has a rather different wording from Art. 430 (2) Obligation act (cro. *Zakon o obveznim odnosima*.

3.3. DEFECTS OF THE UNDERLYING ENTERPRISE AS THE DEFECTS OF SHARES

In a share deal, the acquisition of shares is not an end in itself. The buyer buys shares in order to achieve profit through the company and its enterprise. If the enterprise is not profitable, the buyer will not achieve its financial interests even if it has 100% of the shares.

In other words, the buyers' contractual expectations depend not only on the features of the shares but also on the features of the underlying enterprise. Thus, its expectations are rather similar to the expectations of a buyer in an asset deal. The buyer could probably protect those expectations by requiring from the seller that it represents or warrants certain features of the enterprise.[63]

However, it is questionable whether the buyer can protect those interests within the statutory framework on non-conformity. It could be argued that the fundamental difference between the share and the enterprise merits a different kind of protection. If the buyer chose to buy the shares and not the enterprise, it cannot complain that it is not protected against non-conformity of the enterprise.[64]

The discussion will commence with brief note on the scholarly opinion (3.3.1.), proceed with an overview of case law (3.3.2) and a critical analysis of such case law (3.3.3.) and, finally, opine whether there is a bright line between shares and an enterprise (3.3.4.).

3.3.1. SCHOLARLY OPINION

Practically, the only Croatian scholar who has examined this issue, Jakša Barbić, is inclined to allow the buyer in a share deal to rely on non-conformity of the enterprise. It starts by noting that, according to the rules on assignment (Arts. 86 and 87 OA), unless otherwise agreed, the seller of a right is liable only for the existence of such right and not that such right can actually be exercised.[65] This means that, unless otherwise agreed, the seller would be liable only for the existence of a share and rights arising from such share, but not for the features of the underlying enterprise. However, Jakša Barbić considers that the rules of the OA on material defects of the enterprise should be applied if

[63] As suggested by the Visoki trgovački sud Republike Hrvatske: *Pž 1359/07-4* (Judgment of 17/05/2011), 17.05.2011. On the other hand, Visoki trgovački sud Republike Hrvatske: *Pž 2043/2021-3* (Judgment of 13/05/ 2022), 13.05.2022 put such protection in doubt (more details in the following text). About the representations and warranties see subsection 6.

[64] For German law, Canaris, fn. 4, para. 49.

[65] Barbić, fn. 1, p 261.

the state of the enterprise is an express or implied basis for determining the price of the shares.[66] If the rules on material defects could not be applied, the seller could be liable for its conduct of negotiations (*culpa in contrahendo*). Jakša Barbić backs this up by a reference to German law.[67]

3.3.2. CASE LAW

Croatian case law is much more conservative. Considering that there are not many publicly available decisions on this issue, those few deserve a special attention.

In one case, the plaintiff (buyer of the shares) and the defendants (sellers of the shares) concluded a share transfer agreement for the shares in a company that was engaged in extraction of mineral raw materials (stone). The agreement *inter alia* stated that the defendants warrant to the plaintiff that the company had concession approvals for the exploitation of a certain amount of stone. This turned out to be false since the county where the quarry was supposed to be located had deleted this location from its spatial plans. Thus, the plaintiff did not get what it expected under the contract.

Nevertheless, the lower instance courts rejected the plaintiff's claim for the price reduction. They held that, since the defendant gave the plaintiff all the documents concerning the company and the plaintiff stated that it knew about those documents, it could not have been unaware that the company does not have the concession approval.[68]

The Supreme Court agreed with the lower instance courts. It added: "*In connection with that, it should be established what kind of legal defect is at stake. The plaintiff purchased shares in the company K. i.-e., so in this case one can only speak of a legal defect of the share of that company. Based on the proceedings conducted so far and the established facts, and all based on the factual basis of the claim, it should be said that there is no such defect here, because the plaintiff acquired shares in the company K. i.-e. d.o.o., whose shares are not burdened with the rights of third parties, which would restrict it, and which would result in the right to reduce the price. Therefore, there is no public law restriction on the share of the company, and the possibility of exploiting technical-construction stone, i.e. the concession that the company K. i.-e. d.o.o. had, was in any case not the object of sale.*"[69]

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66 Barbić, fn. 1, p 261.

67 Barbić, fn. 1, p 261, especially fn.131.

68 Županijski sud u Puli: Gž 1321/2016-2 (Judgment of 11/12/2017), 11.12.2017.

69 Vrhovni sud Republike Hrvatske: *Rev x 523/2018-2* (Judgment of 17/01/2024), 17.01.2024.

Two points deserve to be particularly emphasised. First, the court concluded that shares could have only legal defects. Second, since the object of sale were only the shares, and not the enterprise, the absence of the concession was irrelevant.

This left the buyer helpless. Although it calculated the price of the shares based on the value of the enterprise, it did not get what it paid for. It was unable to invoke Art. 402 (4) OA, according to which the seller is liable even for those material defects which could have been easily detected by the buyer if the seller stated that the object of sale ("thing") did not have any defects or that it had certain features.

Similarly, the High Commercial Court stated that "*business share is not thing in material sense, so in relation to it, does not apply the provisions of the OA on material defects of things. Specifically, a share is an amalgamation of membership rights and obligations which are acquired by paying a contribution (or its transfer) and, if the articles of association do not provide otherwise, it is defined by the amount of the assumed share capital, in accordance with Art. 409 of the CA. Therefore, by transferring a share (on the basis of a sales contract or any other contract) the rights and obligations are transferred, which in their totality represent that share. Accordingly, possible defects are correspondingly governed by Art. 430 (2) OA, which deals with the issue of the seller's liability for the existence of legal defects*."[70]

Simply put, the shares can have only legal defects, and the buyer cannot rely on the provisions on material defects.

In another case, the plaintiff (buyer of the shares) and the defendant (seller of the shares) concluded a share transfer agreement by which the defendant undertook to pay all the company's taxes originating from the fact that the company acquired a real estate from the defendant's other company. However, it was the plaintiff who paid the taxes and sued the defendant for the corresponding amount. The County Court in Pula (partially) accepted the claim, arguing that the tax debt is a material defect of the company for which the defendant is liable.[71]

The Supreme Court disagreed. It held that the County Court exceeded the statement of claim (*ultra et extra petita*), because the plaintiff did not rely on the liability for material defects but requested performance of the contract. It reasoned that, in any case, the County Court failed to establish that there was

[70] Visoki trgovački sud Republike Hrvatske: *Pž 6411/2014* (Judgment of 23/05/2017), 23.05.2017, Except published in Pravo i porezi, 12/2022, p. 76.

[71] Županijski sud u Puli: Gž 2547/14-2 (Judgment of 16/03/2016), 16.03.2016.

a material defect within the meaning of Art. 401 OA. Specifically, it noted: „*debts of the company whose shares are transferred could indicate a lower value of the share and thus a possible violation of the principle of equal value of performances within the meaning of Art. 7 OA, and not on the existence of a material defect*".[72]

This sentence is rather cryptic. It suggests that, although the company's tax debt could lower the value of the company's shares, this does not constitute their material defect but only a violation of the principle of equal value of performances. However, it failed to state what would be the consequences of such violation.

In general, the principle of equal value of performances is non-mandatory and the parties are free to depart from it in their contract. However, it is something completely different if, after the contract is concluded, one party breaches its obligation and lowers the value of its performance. This would typically be a material defect (because the seller did not get what it was entitled to under the contract), but the court explicitly stated that it was not.

The High Commercial Court went even further and denied that the existence of debts affects the value of the shares. In that case, the plaintiff (buyer of the shares) and the defendant (seller of the shares) concluded a share transfer agreement in which the defendant warranted that the company did not have any obligations towards the third parties. This proved to be false, and the company had to pay a certain amount of debt. The plaintiff claimed that money for itself. The court accepted that the plaintiff, as a contractual party, is entitled to seek the compensation of damage. However, since it was not the plaintiff who paid the debts, but its company, the plaintiff did not suffer any damage.

The court is right insofar as the money paid by the company is not plaintiff's damage. However, the court also stated: "*The fact that t.d. S. d.o.o.* [the company]*, whose shares were purchased by the plaintiff as a natural person, had debts toward third parties, does not imply that the value of the share of the said company is thereby decreased. The value of the share of t.d. S. d.o.o. cannot be linked to the payments that the same company has to third parties*." Specifically, the court held that the value of the shares could not have decreased since the company received a counter-performance from third parties in return for its obligations towards those third parties.

By doing so, the court made the same mistake as the plaintiff, only in reverse. The plaintiff presented the money paid by the company as its own damage. This is obviously incorrect, since the company with its assets is distinct from

[72] Vrhovni sud Republike Hrvatske: *Rev 3152/2016-2* (Judgment of 5/11/2019), 05.11.2019.

its shareholders and their assets. On the other hand, the court concluded that, since the company did not suffer any damage, the plaintiff could not have suffered any damage either. Thus, it disregarded that the plaintiff could have suffered damage regardless of the damage suffered by the company and even regardless of the fact whether the value of the company shares objectively decreased.

The plaintiff's rights and expectations were derived from its contract for the sale of shares. The price for the shares was *inter alia* based on the defendant's warranty that the company did not have any debts. If the plaintiff knew that the company had debts, the price would, in all likelihood, be lower. Without going into the question of quantum, the plaintiff's damage consisted in the fact that the shares were overpaid.

However, the court continued: "*The provision in question, Article 6 of the Share Transfer Agreement, does not give rise to any contractual obligation for the defendant. Namely, the fact that by the aforementioned contractual provision the defendant, as the transferor of the shares of t.d. S. d.o.o., warranted the plaintiff, as the transferee of the shares of that company, that there were no debts of t.d. S. d.o.o. towards third parties does not constitute a contractual obligation, but rather circumstances warranted by the defendant in the context of which the Agreement was concluded*."[73] Thus, it seems that, although part of the contract, the warranty does not produce any effects whatsoever, but only explains the reasons why the contract was concluded. Instead of being one of the essential clauses, it becomes something akin to a preamble.

To sum up, the highest Croatian courts are consistently buyer-unfriendly. First, they consider that the shares can have only legal defects.[74] Second, they consider that the potential defects of the enterprise, even if the seller gave a specific warranty, do not constitute defects of the shares. Both of these considerations merit a closer examination.

[73] Visoki trgovački sud Republike Hrvatske: *Pž 2043/2021-3* (Judgment of 13/05/ 2022), 13.05.2022.

[74] Visoki trgovački sud Republike Hrvatske: *Pž 1359/07-4* (Judgment of 17/05/2011), 17.05.2011 is somewhat ambiguous and simply states that the buyer of shares can exercise toward the seller all rights arising from the liability for defects which it has under the Obligations Act (cro. Zakon o obveznim odnosima)..

3.3.3. CRITICAL ANALYSIS OF CASE LAW

The first consideration is based on the fact that the shares are rights and not a "*thing in material sense*".[75] This is probably based on the distinction between words "material" and "legal". The word "material" suggests that the defect has to be corporeal of physical, i.e. connected with things. The word "legal" suggests an immaterial defect, somehow connected with rights. The courts drew a conclusion that the rights without corporeal form cannot have material but only legal defects.

However, this is not true. The notion of material defects does not require that the defects are corporeal, i.e. that they can be physically detectable.[76] Art. 401 (1) (1) OA states that a material defect exists if the thing (or other object of sale) does not correspond to the description, type, quantity and quality, or does not have the functionality, compatibility, interoperability and other features determined by the sales agreement. Some of those features, especially functionality, compatibility, interoperability, may be non-corporeal.

On the other hand, legal defects are not defects when the object of sale is a right, but defects which are themselves of a legal nature. Thus, they can plague both things and rights. In particular, legal defects are present where there are third parties' rights which exclude or limit the buyer's rights on the object of sale (Art. 430 (1) OA). Legal defects are also present if the right as an object of sale does not exist or if there are legal obstacles for its enforcement (Art. 430 OA). However, legal defects do not cover a situation where a right cannot be factually exercised or where the quality of the exercise is unexpectedly low.[77]

In other words, material and legal defects are not two symmetrical, mutually exclusive aspects of non-conformity. Instead, material defects are a general, catch-all notion which could (theoretically) also encompass legal defects. Namely, if a third party has a right which excludes or limits the buyer's right (Art. 430 (1) OA), the object of sale will usually be non-functional (Art. 401 (1) (1) OA). Thus, material defects largely overlap with the wide notion of non-conformity. On the other hand, legal defects are *lex specialis*, which contains specific rules regarding third parties' rights and other legal obstacles.

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[75] Visoki trgovački sud Republike Hrvatske: *Pž 6411/2014* (Judgment of 23/05/2017), excerpt from Pravo i porezi, 12, 2022, p. 76.

[76] Thus, some authors propose the term "factual" defects instead of material defects (Slakoper, Z.: Primjena odredbi Zakona o obveznim odnosima o odgovornosti prodavatelja za materijalne nedostatke na razne vrste ugovora, *Zbornik Pravnog fakulteta Sveučilišta u Rijeci*, 25(1) 2004, p. 449; Klarić; Vedriš, fn. 33, p. 415)

[77] Similarly, Rosenberg Volarić, Zubčić, fn. 34, p. 682.

Thus, not only that corporeal things can have legal defects, but non-corporeal rights can have material defects as well. E.g. if the seller of a claim warrants to the buyer that the claim can be collected (Art. 87 OA), but this turns out to be false, the "uncollectibility" has to be qualified as a material and not a legal defect of the claim.[78]

Consequently, there are no obstacles which would prevent the application of the rules on material defect to the sale of shares.[79]

The second consideration of Croatian courts arises from the fact that, in a share purchase agreement, the enterprise and its features "*was in any case not the object of sale*."[80] The object of sale are indeed only shares. However, the parties did not buy any shares, but the shares which relate to a particular company and its enterprise.

In this context, it is instructive to consult the German law. The majority of scholars and case law allow the buyer to invoke non-conformity of the enterprise only if the buyer bought shares which represent 100% or almost 100% of the share capital.[81] In that case, it is considered that the parties' intent was to transfer the enterprise,[82] and the buyer can rely on its non-conformity.

If the buyer buys a lesser amount of shares, it cannot rely on non-conformity of the enterprise since the object of the share purchase agreement are only the shares.[83] This is the case even if the buyer acquired over 50% of the share capital,[84] or even 100%, but gradually, with several share purchase agreements[85].

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[78] Because, in that case, the right exists and there are no legal obstacles for its enforcement (Art. 430 (2) Obligation Act (cro. Zakon o obveznim odnosima). The obstacles are merely factual, e.g. the debtor could not perform its obligation. Somewhat similar, Golub, fn. 34, p. 16.

[79] For German law, Canaris, fn. 4, para. 43. Although there are also other opinions, see Heckschen, Scherz, fn. 4, § 25, para. 62; Verse, fn. 42, para. 17; Ebbing, fn. 59, para. 177; Picot, fn. 43, para. 171.

[80] Vrhovni sud Republike Hrvatske: *Rev x 523/2018-2* (Judgment of 17/01/2024), 17.01.2024.

[81] Canaris, fn. 4, para. 48-49; Heckschen, Scherz, fn. 4, § 25, para. 62a; Merkt, fn. 43, para. 6; Faust, fn. 39, para. 34; Verse, fn. 42, para. 21; Federal Court of Justice of Germany (Bundesgerichtshof): VIII ZR 87/17 (Judgment of 26/09/2018), *Neue Zeitschrift für Gesellschaftsrecht (NZG)*, 2018, p. 1305.

[82] Canaris, fn. 4, para. 48; Faust, fn. 39, para. 34; Ebbing, fn. 59, para. 179; Maultzsch, F.: § 453, in: *Münchener Kommentar zum BGB*, München: C.H. Beck, 2024, para. 31; Federal Court of Justice of Germany (Bundesgerichtshof): VIII ZR 87/17 (Judgment of 26/09/2018), *Neue Zeitschrift für Gesellschaftsrecht (NZG)*, 2018, p. 1305.

[83] Federal Court of Justice of Germany (Bundesgerichtshof): VIII ZR 87/17 (Judgment of 26/09/2018), *Neue Zeitschrift für Gesellschaftsrecht (NZG)*, 2018, p. 1305.

[84] Merkt, fn. 43, para. 6; Faust, fn. 39, para. 34; Maultzsch, fn. 82, para. 31; Verse, fn. 42, para. 21.

[85] Faust, fn. 39, para. 34; Ebbing, fn. 59, para. 179.

For the time being, Croatian courts would be well advised to follow the German example. Considering that share deals often encompass all shares in a company, at least those buyers would gain protection they have so far been lacking.

Nevertheless, the German solution may not be optimal. First, it does not protect the buyers of a lower percentage of share capital. Perhaps more importantly, it still firmly distinguishes different objects of sale by their nature.[86] Thus, it considers the shares to be inherently different from the enterprise.

3.3.4. IS THERE A BRIGHT LINE BETWEEN SHARES AND AN ENTERPRISE?

However, the firm distinction between the share and the enterprise is based upon an erroneous understanding of the object of sale. Even if the parties had in mind a specific, individualised object, the object of sale is not that object as such, but rather the parties agreed upon idea of that object.

This is especially obvious in case of non-conformity. A sales object is non-conforming if it does not have the features which it was supposed to have under the contract. One could say that there are actually two objects – the object which exists in the real world and the object as it was contractually envisaged by the parties. The non-conformity exists precisely when the real-world object does not correspond to the contractually envisaged object.

Considering that the parties are free to describe the object of their contract however they want, they are not bound by the typical categories which exist outside of that contract. Thus, the parties might combine features of different categories or even invent a whole new category.[87] The only limit is that it has to be objectively possible that such object exists (Art. 270 (1) OA).

E.g. the parties could agree on the sale of organically produced oranges. If that is the case, the organic production is not a separate obligation to produce the oranges in a certain way but the feature of the oranges themselves. This

[86] E.g. Canaris, fn. 4, para. 43, which states that the shares should be legally sharply distinguished from the enterprise, and para. 48, which states that interpretation of the contract cannot dispense with the amount of the shares, considering that this is not an issue of the contracts's content but its "typological qualification". Similarly, also Maultzsch, fn. 82, para. 30.

[87] Differently, Canaris, fn. 4, paras. 43, 48; Maultzsch, fn. 82, para. 30 (see fn. 86). However, already from the principled standpoint, the parties' intent should be given precedence over scholarly and statutory qualification. The scholarly and statutory qualification should protect the specific parties, and not the other way around. The reasons of legal certainty do not speak against this. Otherwise the whole idea that parties are free to regulate their contracts to their liking (Art. 2 Obligation act (cro. Zakon o obveznim odnosima) would become obsolete.

holds true regardless whether the sustainably produced oranges are physically or even molecularly different from any other oranges. If the buyer did not get what it wanted (and, presumably, additionally paid), it has the right to request the replacement oranges or lower the price.

Similarly, the parties can define the object of sale as "shares in the company X which has a state-of-the-art conference table". If the conference table is broken, the object of sale will be non-conforming. There might be nothing wrong with the shares as such and their market value might be the same. Nevertheless, these are not the shares which the parties had in mind when they concluded the contract, and which presumably influenced the price.[88]

Simply put, when interpreting the contract, one should put aside the preconceived ideas of different objects and primarily focus on the parties' intent. Those preconceived ideas can be useful only inasmuch as they help to determine what the parties indeed wanted. E.g. in the absence of indications to the contrary, it can be presumed that the parties wanted an object of sale which is fit for a purpose for which the object of the same kind would ordinarily be used (Art.401 (2) (1) OA).

It follows that, in a share deal, there are no principled obstacles for the defects of an enterprise to spill over and constitute the defects of shares. Similarly, as in an asset deal, the buyer would have to prove that it could have reasonably expected certain features of an enterprise under the contract. This can be done in many ways. The easiest one is if the contract explicitly mentions those features. If the contract is silent, the buyer could rely on negotiations, especially the elements which influenced the price calculation. E.g. if the price of the shares was calculated based on a certain asset or a certain amount of debt, but it turns out that they do not belong to the enterprise, the shares could be non-conforming.

If there are no specific indications of the parties' intent, one could resort to the parties' typical expectations. Similarly, as in an asset deal, it can be presumed that the buyer bought the shares in a company in order to profit from the market potential of the enterprise. If the enterprise is no longer able to perform its activities, the shares are, in all likelihood, non-conforming.

The same logic could be applied to any share purchase agreement, regardless of how many shares have been bought.[89] Naturally, one would have to consider different expectations arising from different shareholder's position. E.g. buyer

[88] For German law, Faust, fn. 39, para. 34 and Maultzsch, fn. 82, para. 30 have a different opinion, i.e. that it is not decisive whether the certain element of the enterprise influenced the price of the shares.

[89] For German law, somewhat similar, Canaris, fn. 4, para. 46, although in the context of *rebus sic stantibus*, and not non-conformity (for which it is of a different opinion).

of 1% of the share capital will rarely be in a position to conduct a due diligence and its idea of the enterprise's features could be quite vague. However, if, for example, the seller convinced such buyer that the company has a prime real estate, which turns out to be untrue, the share will be non-conforming. Only in such way it is possible to protect the buyer's legitimate expectations and bring the sale of shares with the ambit of the general rules on non-conformity.

4. EXAMINATION AND NOTIFICATION ABOUT NON-CONFORMITY

In their contract, the parties might envisage the rules on the buyer's notification of non-conformity to the seller, especially the time limits for the notification. If the contract is silent, the parties can still try to rely on the general statutory rules on material (Arts. 403, 404, 406 OA) and legal defects (Art. 431 OA).

In a commercial contract of sale, in order to be able to hold the seller liable for the apparent material defects, the buyer has a duty to examine the delivered goods as soon as possible and notify the seller about the defects without delay (Art. 403 (1) OA). Only if the defects are of such nature that they could not have been discovered upon the usual examination (hidden defects), the buyer can notify the seller upon the discovery (again without delay) and at latest within six months from the day of the delivery (Art. 404 (1, 2) OA).

These general rules can be applied to an asset deal and a share deal only with certain adjustments. Both the enterprise and the shares are complex objects which cannot be simply examined upon delivery. An enterprise is composed of many elements, which are not necessarily in one place and not always tangible. The shares are usually intangible. Although their existence might be verified in the articles of association and the share register, inasmuch as their features depend on the features of the enterprise, they face similar challenges.

The closest thing to the examination of an enterprise is a due diligence process by which the buyer inspects some of its elements. However, due diligence occurs before, and not after the conclusion of the sales contract. Thus, it does not help the buyer to detect non-conformity but to reach a decision whether to enter into the contract in the first place and under which conditions.

If the buyer conducted a due diligence before the contract conclusion, it would be unrealistic to expect another due diligence after the transfer of the enterprise or the shares to the buyer. This is especially the case if the transfer occurred soon after the conclusion of the sales contract. Therefore, in most cases, the buyer's duty of examination can be considered excluded either by the parties' implicit agreement or by commercial usages (Art. 12 OA).

If it later turns out that the enterprise or the shares have defects, they should be considered as hidden defects. This would give the buyer six months from the transfer to notify the seller. If such "hidden" defects were actually quite obvious, the buyer has to notify the seller without delay after it discovered or had to discover them. This should strike a reasonable balance between the rights of both parties.

In a commercial contract of sale, the buyer's notification to the seller has to contain a detailed description of the defect and an invitation to examine the goods (Art. 406 (1) OA). This should also apply to an asset deal and a share deal. It is not sufficient that the buyer simply states that there is a defect, but it has to describe it and provide a reasonable amount of details. Otherwise, the buyer could preventively declare a defect and buy itself time to discover (or allege to discover) a defect at some later stage.

As to the legal defects, the buyer has to notify the seller after it learns about the defect (Art. 431 OA). Those rules should also apply to an asset deal and a share deal.

5. REMEDIES FOR NON-CONFORMITY

The parties will often envisage the remedies for non-conformity in their contract. If they omit to do that, they can avail themselves of the statutory remedies for material (Arts. 410-422 OA) and legal defects (Arts. 432-437 OA).

There are, however, specific circumstances that arise from the nature of the enterprise and the shares. The remedy of specific performance, i.e. performing the contract as initially agreed (Art. 410 (1, 3, 4, Art. 410.a, Art. 431 OA,), will often be difficult if not outright impossible.[90]

This is especially the case with the delivery of a substitute object of sale. Considering that an enterprise is not generic but highly individualised, it is practically impossible to deliver another, "conforming" enterprise.[91] On the other hand, shares are, as such, often generic. However, there could be a difference between the shares in a public and a private limited company. In a public limited company, especially if its shares are traded in a regulated market, there will often be a large number of fungible shares. If some of those shares are non-conforming, e.g. because they are burdened by a mortgage or a pledge, the seller could probably substitute them with conforming ones. On the other

[90] For German law, Canaris, fn. 4, para. 17; Heckschen, Scherz, fn. 4, § 25, para. 67; Merkt, fn. 43, para. 8.

[91] For German law, Canaris, fn. 4, para. 17.

hand, in a private limited company, there will often be fewer shares and they might not be fungible, e.g. because they represent a different amount of share capital. Even if the shares are fungible, the seller might not be able to obtain them, e.g. because the other shareholders do not want to sell them.

Naturally, the buyer will request substitute share only if non-conformity affects only certain and not all of the company's shares. The latter will be the case if non-conformity of the shares is caused by defects of the enterprise.[92] In that case, the delivery of substitute shares would be pointless.

The other type of specific performance – repair of the defects (Art. 410 (1, 3, 4), Art. 410.a Art. 431 OA) – will sometimes be a viable option.[93] E.g. if the seller warranted that the company (enterprise) had certain assets or that it was free from certain debts, such defect can be effectively remedied. It would suffice that the seller supplies those assets to the company or that it pays the company's debts. Also, if the shares are burdened with a third party's right, the seller could succeed in removing that right.

In other situations, it will be impossible to repair the defects, e.g. if the enterprise does not meet certain financial indicators[94] or if the shares do not represent the intended amount of the share capital.

Consequently, although they are envisaged as a last resort, more common remedies will be the reduction of the price[95] and the termination of the contract[96] (Art. 410 (1, 5), Arts. 411-414, Art. 432 OA).[97] In addition, the buyer may also claim the compensation of damage (Art. 410 (2), Art. 432 (3) OA).[98]

The reduction of the price can be particularly suitable since it leaves the contract alive by equalising the value of parties' performances. Naturally, the parties might disagree about the appropriate value and this could end up in a

[92] See subsection 3.3. Defects of the underlying enterprise as the defects of shares.

[93] For German law, Canaris, fn. 4, para. 39.

[94] As an example of such defect for German law, Canaris, fn. 4, para. 31

[95] Vrhovni sud Republike Hrvatske: *Rev x 523/2018-2* (Judgment of 17/01/2024), 17.01.2024; Županijski sud u Puli: Gž 1321/2016-2 (Judgment of 11/12/2017), 11.12.2017.

[96] For termination c.f. Visoki trgovački sud Republike Hrvatske: *Pž 8892/2011-3* (Judgment of 10/10/2012), 10.10.2012; Visoki trgovački sud Republike Hrvatske: *Pž 1359/07-4* (Judgment of 17/05/2011), 17.05.2011 and Vrhovni sud Republike Hrvatske: *Revt 456/2015-2* (Judgment of 23/03/2021), 23.03.2021; Visoki trgovački sud Republike Hrvatske: *Pž 389/2022-3* (Judgment of 6/04/ 2022), 06.04.2022. Although in most of those cases the reason for termination was material or legal defects but other "problems" with performance (failure to pay the price, failure to transfer the shares).

[97] For German law, Canaris, fn. 4, para. 17.

[98] Županijski sud u Puli: 858/17-2 (Judgment of 02/10/2017), 02.10.2017.

dispute. Since the true value of an enterprise (or shares) is notoriously difficult to determine and there are different valuation methods,[99] the parties would be well advised to agree on valuation criteria in their contact.

The reduction of price will not be appropriate if the buyer is substantially deprived of what it expected under the contract. In that case, the termination is the only reasonable solution. However, the termination is potentially problematic since each of the parties has to return everything it received from the other party (Art. 368 OA).[100] In an asset deal, this means that the parties have to transfer back all the elements of the enterprise – real estate, movables, bank accounts, receivables, intellectual property rights, employees etc. This requires cooperation from both parties, which might be difficult to expect after the relationship turns sour. Even in a share deal, the shares can be returned to the seller only if the parties enter into a new share transfer agreement.[101] Consequently, the contracts sometimes exclude the possibility of termination after the enterprise has been transferred to the buyer.[102]

The compensation of damage faces similar problems as the reduction of price. The amount of damage and the appropriate way to calculate it are not always obvious. Thus, it could be helpful if the contract contains detailed indemnity clauses or liquidated damages clauses.

6. REPRESENTATIONS AND WARRANTIES

The seller will often issue statements in the sales contract with which it guarantees to the buyer certain facts or occurrences regarding the object of sale – the enterprise or the shares.[103] Modelled upon the Anglo-American legal tradition, those statements are often called "representations and warranties". In Croatian law it has not been so far discussed what their legal nature is and how they fit together with the statutory provisions.

At the outset, it is important to note that there is no magic formula which could automatically qualify all those statements in the same way. Following the well-

[99] Barbić, fn. 1, p. 233; Babić, I.: Pristupi i metode procjene vrijednosti poduzeća, *Osiguranje; hrvatski časopis za teoriju i praksu osiguranja*, 46(7-8) 2005, pp. 37-44; Cvjetković, N.: Procjena vrijednosti poduzeća i poslovnih rezultata, *Računovodstvo, revizija i financije*, (5) 2010, pp. 67-75.

[100] Heckschen, Scherz, fn. 4, § 25, para. 68.

[101] Visoki trgovački sud Republike Hrvatske: *Pž 1359/07-4* (Judgment of 17/05/2011), 17.05.2011.

[102] Miladin, fn. 4, p. 746.

[103] Barbić, fn. 1, p. 258.

known adage of *falsa nominatio non nocet*, the mere label such as a "representation", "warranty" or a "guarantee" is only the first step in the process of contract interpretation.[104] One should always examine the whole text of each of those statements and the underlying intent of the parties.[105]

Nevertheless, it is reasonable to start from the assumption that those statements describe the desired features of the enterprise and that their breach results in seller's liability for material or legal defects.[106] As already discussed, the rules on material and legal defects are at the very core of a sales contract. They serve as a benchmark for determining whether the object of sale is conforming, i.e. whether the seller got what it contracted and paid for. Thus, one has to assume that the parties especially had in mind the liability for material and legal defects.[107]

The notion of material defects is also quite wide. The intended features of a sales object can be determined in a number of ways, both explicitly and implicitly (Art. 401 OA). Furthermore, material defects do not have to affect the sales object directly. It is sufficient that they concern additional equipment, instructions, packaging, installation etc. (Art. 401 (1) (3, 4), Art. 401 (2) (3, 5, 6) OA). Thus, even if the representations and warranties do not relate to the enterprise or shares as such, but something connected with the enterprise or shares, this should still be seen as a feature of that enterprise or shares. After all, as already discussed, what a feature of a sales object primarily depends on is the intent of the parties.

Sometimes the seller will represent and warrant that certain features of the enterprise exist "to the best of its knowledge". This is rather different from the typical liability for material defects, for which the seller is liable even if it did not know about the defects (Art. 400 (1) OA). This can be understood as a limitation of seller's liability – the seller is not liable for a certain defect unless it knew (or had to know) about its existence. Such limitation is, in principle, valid since the parties are allowed to limit or exclude the seller's liability unless the seller knew about the defect, but failed to notify the buyer, or the seller imposed the exclusion due to its monopoly position (Art. 408 (2) OA).

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[104] For German law Picot, fn. 43, para. 171.

[105] For German law similarly, Maultzsch, fn. 82, para. 44.

[106] Visoki trgovački sud Republike Hrvatske: *Pž 1359/07-4* (Judgment of 17/05/2011), 17.05.2011; Županijski sud u Puli: 858/17-2 (Judgment of 02/10/2017), 02.10.2017. Although Vrhovni sud Republike Hrvatske: *Rev 3152/2016-2* (Judgment of 5/11/2019), 05.11.2019 suggests differently.

[107] It seems that Barbić, fn. 1, p. 258 considers that the representations and warranties will more commonly be independent guarantees (more below).

Seller's representations and warranties will sometimes be accompanied by an explicit exclusion of seller's liability for any other feature of the enterprise or shares. Such exclusion is, again, restricted by Art. 408 OA. Even if there is no explicit exclusion, the list of representations and warranties can sometimes be interpreted as comprehensive, i.e. as a sole source of seller's liability (at least for material and legal defects). This is even more likely if the contract contains an entire agreement clause (merger clause). This will not be the case if the list contains an open formulation, e.g. that the seller is liable "in particular" or "including, but not limited to".

Seller's representations and warranties could possibly also be understood as a commercial warranty for the goods (Art. 423-429 OA).[108] Although a commercial warranty exists in addition to and parallel with the liability for material defects (Art. 423 (1) OA), their content is rather similar. It makes the seller (and/or producer) liable when the object of sale does not satisfy certain specifications or other requirements stated in the commercial warranty. If the seller breaches the commercial warranty, the buyer can request it to repair or replace the goods (Art. 423 (5, 6), Art. 424 OA), and if the seller fails to do that within a reasonable period of time, the buyer can reduce the price or terminate the contract (Art. 426 OA).

One notable distinction is that the rules on commercial warranty do not require that the defect existed at the moment of the passing of the risk to the buyer (cf. Art. 401 (1) OA). Consequently, it is not necessary that the buyer examines the goods and notifies the seller about the defects.[109] However, this is not so different from the seller's liability for hidden defects (Art. 404 OA) or for the defects that appeared after the passing of risk to the buyer, if their cause had existed before such passing of the risk (cf. Art. 401 (2) OA).

It seems that the main difference lies in how those two legal concepts are used. The commercial warranty is usually issued with consumer goods, often those which are of a technical nature.[110] It has to be stored on a durable data carrier, usually as a separate document, and it is often accompanied by advertising material (Art. 423 (1, 7-9) OA). It has to be simple and understandable, and it has to contain: a) a clear statement that it does not affect the buyer's rights arising from the material defects; b) the name and the address of the person which issued the commercial warranty; c) the procedure that the buyer must follow in order to enforce the commercial warranty; d) designation of the goods to

[108] See fn. 35.

[109] Ledić, fn. 35, p. 49; Hruška, A.: Jamstvo (garancija) za ispravnost stvari, *Računovodstvo, revizija i financije*, (4) 2020, p. 223.

[110] Ledić, fn. 35, p. 40.

which the commercial warranty applies; e) and the terms of the commercial warranty (Art. 423 (9) OA).

Such amount of detail which serves to protect the buyer makes the commercial warranty best suited for consumer contracts. It is difficult to expect that the exact formula will be used in an asset deal or a share deal. Thus, one should not start from the assumption that the warranties and representations are a commercial warranty.

Nevertheless, representations and warranties might be at least akin to a commercial warranty if they state that they are "in addition" or "parallel" with the seller's liability for material defects. They might also be akin to a commercial warranty if the seller warrants a future occurrence and not something which existed at the moment of the passing of the risk. E.g. the seller might warrant a certain financial performance of the enterprise in the upcoming years.

In addition, representations and warranties might be understood as the seller's independent *sui generis* guarantees.[111] Thus, they would be similar to a commercial warranty, while dispensing with the unnecessary formalism.

Independent guarantees are not regulated in the OA. However, a demand guarantee issued by a bank (Art. 1039-1043 OA) can be viewed as an example of such guarantees. With it, a bank (guarantor) undertakes to pay a certain amount of money to the beneficiary upon the beneficiary's written request, provided that the requirements from the guarantee are met. The parties are free to determine what those requirements are. Thus, although it is called a "demand guarantee", the parties could consider a demand not to be sufficient and envisage additional prerequisites.

In the context of an asset deal and a share deal, this means that the seller (guarantor) could guarantee that certain facts exist or that they will occur. If this does not happen, the buyer (beneficiary) could claim a sum of money from the seller. The parties might agree on a method on how the buyer can prove that the requirements for the payment are met. The parties might also engage a third person guarantor, usually a bank, which would pay the money to the buyer.

Considering that there are no detailed rules comparable to those on the material and legal defects, the independent guarantees could provide the parties

[111] This is quite often in German law, e.g. Weyland, P.: Garantieversprechen (Warranties) und "Erklärungen ins Blaue hinein", *Neue Zeitschrift für Gesellschaftsrecht (NZG)*, 2022.; Möller, J.: Offenlegungen und Aufklärungspflichten beim Unternehmenskauf, *Neue Zeitschrift für Gesellschaftsrecht (NZG)*, 2012, p. 842.

with more flexibility.[112] Similarly to a commercial warranty, the independent guarantees do not have to be limited to the facts which existed at the moment of the passing of the risk to the buyer.[113] Also, they can apply in addition to the seller's liability for material and legal defects. Thus, they broaden and do not limit the seller's overall liability from an asset deal or a share deal.

If the parties want to establish an independent guarantee in favour of the buyer, it would be advisable that they emphasise its independent legal nature, or that it applies in addition to the seller's liability for material and legal defects. Sometimes, this will be visible already from its content, e.g. if the seller guarantees something which is totally unconnected with the enterprise or the shares.

The representations and warranties could sometimes also be understood as a contractual penalty (Art. 250-356 OA). In one case, the seller of the shares guaranteed to the buyer that it will unburden the buyer's real estate from mortgages with which the buyer secured the loan given to the target company. In case it failed to unburden the real estate, the seller undertook to pay to the buyer a certain amount of money. The High Commercial Court considered this to be a contractual penalty for non-performance and found the buyer liable.[114]

To sum up, although there is an initial assumption that the representations and warranties regulate the seller's liability for material and legal defects, one should always look at their specific wording and the underlying intent of the parties. Sometimes they will show that the parties intended them as a commercial warranty, an independent guarantee or some other legal concept, such as a contractual penalty.

7. CONCLUSION

Croatian law regulates non-conformity of a sales object with several layers of rules – those on material defects, legal defects and commercial warranties. In addition, the parties are free to introduce their own rules, which might belong to one of those categories or represent an independent guarantee.

However, such copious regulation can blur the initial purpose of non-conformity – to protect the buyer's contractual expectations. The buyer should get what it wanted and made known to the seller. After all, this is what the buyer paid for. Legal provisions should not be an end in itself but reflect commercial

[112] For German law, Picot, fn. 43, para. 202.

[113] For German law, Canaris, fn. 4, para. 31; Picot, fn. 43, para. 193.

[114] Visoki trgovački sud Republike Hrvatske: *Pž 5735/04-3* (Judgment of 7/09/2005), 07.09.2005.

aspects of the transaction. Detailed legal rules can be useful only inasmuch they serve to realise that purpose.

This fundamental proposition should not be lost amid the intricacies of an asset deal and a share deal. The parties can structure the acquisition of an enterprise in different ways. They can buy the enterprise directly, or they can buy control stock in a company which manages that enterprise. The parties' choice can have various legal implications, especially from the perspective of company law.[115] However, no matter which road the parties take, the buyer should always get what it agreed to.

Thus, from the perspective of seller's liability for non-conformity of a sales object, there is no bright line between an asset deal and a share deal.[116] One needs to determine which features of the enterprise or the shares the parties had in mind when they entered into a contract. It will often be the case that the parties to a share deal had in mind certain features of the enterprise and calculated the price accordingly.

Unfortunately, this fundamental proposition is not recognised in Croatian case law. The courts consider that the shares can have only legal defects. Thus, they protect the buyer only against third parties' claims and disregard other possible aspects of non-conformity. Even more importantly, the courts regularly fail to recognise that the features of an enterprise can affect the conformity of the shares. The courts were of this opinion even in cases where the seller explicitly warranted that the underlying enterprise would have or not have certain features.

A shortcut to this problem would be to insert an arbitration clause in the share purchase agreement (or an agreement on the purchase of an enterprise). However, if Croatia wants to nurture an investor-friendly climate, it is of a paramount importance that its judiciary begins to understand and protect the buyer's legitimate contractual expectations.

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[115] It can also have different tax law implications, Schmidt, H., Čuček, S.: Kupnja udjela u društvu naspram kupnje imovine pravne osobe - rizici prividnog pravnog posla, Financije, pravo i porezi, (5) 2012, pp. 72-81.

[116] Similarly, for German law Canaris, fn. 4, para. 3.

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