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WARRANTY CLAIMS: A RECENT CASE STUDY

LITIGATION AND DISPUTE RESOLUTION

Disputes about notification provisions and the measure of damages commonly arise in breach of warranty claims. Both these issues were considered in the recent case of *The Hut Group Ltd v Nobahar-Cookson & another* [2014] All ER (D) 215 Nov, as was an interesting point about whether the fraud of an employee could be attributed to a company.

This note considers the principles of general application that can be derived from this case, in the context of other recent case law, and sets out practical guidance on how some of these problems could be avoided in the future.

BACKGROUND FACTS

The claimant (the buyer) bought the entire share capital of the defendants' (the sellers) sports nutrition business. Under the share purchase agreement (the SPA), the consideration was paid partly in cash and partly in shares in the buyer. Both sides brought breach of warranty claims in relation to the shares they had acquired.

THE BUYER'S CLAIM – NOTIFICATION

The main point of interest arising out of the buyer's claim was whether it had complied with the notice provisions in the SPA. The relevant provision said:

"The Sellers will not be liable for any Claim unless the Buyer serves notice of the Claim on the Sellers (specifying in reasonable detail the nature of the Claim and, so far as practicable, the amount claimed in respect of it) as soon as reasonably practicable and in any event within 20 Business Days after becoming aware of the matter." (emphasis added)

Issues arose (amongst other things) as to:

1. what was meant by "becoming aware of the matter"; and

2. the level of detail required in the notices.

The first point arose because of a dispute about the meaning of the words "the matter". Did this, as the buyer argued, mean that the 20 day period began to run when the buyer became aware that there was a proper basis for advancing a claim? Or did time begin to run, as the seller argued, when the buyer became aware of the facts that would be relied upon in a breach of warranty claim (irrespective of whether it realised that these facts could give rise to a claim)?

The judge held that the 20 day period did not start to run until the buyer was aware that there was a proper basis for a warranty claim (as opposed to when it became aware of the underlying facts), which did not happen until after the buyer had obtained advice from its accountants that there was sufficient basis for advancing the claims. The distinction was crucial because it meant that notice was provided in time.

In reaching this conclusion, the judge made the following points of general application:

1. Where (as in this case) both parties are subject to time-bars in similar terms, there is no reason to apply the rule that such time bars should be construed against the party relying on them ("*contra proferentem*").

2. The fact that a deadline is tight does not mean that a court will be predisposed to interpret the relevant provision in a way that favours the notifying party. Breach of warranty claims can be costly and the parties are entitled to negotiate tight limitations in relation to them.

3. However, as a matter of commercial sense, without knowing that a claim has a proper basis, a party to a share purchase agreement would not expect to (or wish to) have to notify the other party of it. In this case, the notice provision should not be construed to have that effect.

On the second point, an obligation to specify "in reasonable detail the nature of the claim" meant that "not much was contractually required". The judge referred to the case of *ROK Plc v S Harrison Group Ltd* [2011] EWHC 270 (Comm) where it was held that this wording set a relatively low threshold as to the amount of information required to be provided. If more information is required, less general and more prescriptive language should be used. On the facts, the buyer had provided sufficient information in its notice.

The judge went on to find, on the facts, that the seller had breached its management accounts warranty and awarded the buyer £4.3m in damages.

OTHER RECENT CASES ON NOTIFICATION

The purpose of notice provisions is, at least in part, to provide the parties with certainty. The opposite will be achieved if it is not clear exactly what the notifying party is required to do. In *The Hut Group*, uncertainty over the meaning of the word *"the matter"* meant that it was not clear when time started to run for the purposes of the 20 day deadline. A number of other recent cases demonstrate other problem areas to watch out for:

Part 6 of the Civil Procedure Rules (the CPR) contains rules on service. Issues covered include, amongst other things, methods of service and times of deemed service. The relationship between the CPR and contractual notice provisions, in the context of service of legal process, is the subject of inconsistent case law. In *Ageas (UK) Ltd v Kwik-Fit* (GB) Ltd [2013] EWHC 3261, it was held that the word "service" in a contractual clause did not mean service in accordance with the CPR. On the other hand, it was held in *T&L Sugars Limited v Tate & Lyle Industries Limited* [2014] EWHC 1066 (Comm) that "issued" had to mean *"issued and sealed by the court in accordance with CPR 7.2"*. Such disputes could be avoided by the use of clear wording specifying whether the rules in the CPR (and the rules on deemed service in particular) are to apply. When faced with notice provisions where this is not clear, the obvious practice point is that notices should be served sooner rather than later so that they will be in time whichever regime applies.

Disputes about notice provisions often revolve around the issue of whether they are mandatory or permissive. In other words, do the provisions prescribe the only permitted methods of serving notices or can other methods still be used? Whichever approach is intended, the words used should be clear. Care should be taken when using the word "may". The normal meaning of the word is permissive but that will not always be the case. For example, in *Greenclose Ltd v National Westminster Bank Plc*, [2014] EWHC 1156 (Ch), it was held that the phrase *"may be given in any manner set forth"* meant that notice could be given in any manner that was listed but not in any other way.

THE SELLERS' CLAIM

The sellers' claim arose because, before the deal took place, a large scale accounting fraud had been committed by, amongst others, the financial controller of the buyer. As a result (and this was admitted by the buyer), the buyer was in breach of its warranties about the accuracy of its draft statutory accounts.

The main points of interest arising out of this claim related to the quantification of damages and whether the fraud could be attributed to the buyer for the purposes of a clause which limited the buyer's liability to £7.24m but did not cover claims which resulted from the buyer's fraud.

QUANTIFICATION OF DAMAGES

The judgment contains a useful summary of the general approach to be applied to the quantification of claims for breach of warranty. These principles are set out below, with some commentary:

1. The measure of loss for breach of warranty in a share sale agreement is the difference between the value of the shares as warranted and the true value of the shares.

   This approach, described by the judge as "warranty true" vs. "warranty false", will not necessarily enable a buyer to recover all the costs of rectifying a problem, which would not have existed if the relevant warranty had been accurate. If a buyer wishes to be able to recover such sums, it will need to include an indemnity against such expenses. It is unusual for parties to UK M&A deals to agree that warranties should be given on an indemnity basis. However, it is more likely to be possible to negotiate a specific indemnity in relation to known issues.

2. Damages will usually be assessed as at the date of the share sale agreement since that is the date when the breach of warranty occurs.

   In *The Hut Group*, the judge rejected an argument that post-completion trading could be taken into account when assessing the true value of the company, holding that the loss is suffered at the time of breach, and must be assessed at the time of the breach. Improvements in the state of the company following the breach and the knock-on effect on the value of the shares are not relevant.

   A similar approach was taken in the recent case of *Ageas (UK) Ltd v Kwik-Fit (GB) Ltd and another* [2014] EWHC 2178 (QB) (04 July 2014). In that case Popplewell J held that the "prima facie rule" is that damages are to be assessed at the date of breach and that only events which have occurred at that date can be taken into account. A departure from this approach could only be justified where the "overriding compensatory principle" requires it and where such a departure would be consistent with the contractual allocation of risk agreed between the parties.

3. Assessing the "warranty true" and "warranty false" values involves an exercise in valuation.

   The court's starting point for the "warranty true" valuation will usually be the price the claimant actually paid for the company. In practice, the defendant/seller will often

argue that this is incorrect, and that the claimant/buyer made a bad bargain (i.e. overpaid). When calculating the "warranty false" value, the court will endeavour to ascertain the objective value of the business on the valuation date of a sale between a willing buyer and a willing seller in an arm's length transaction, after proper marketing where the parties had each acted knowledgeably, prudently, and without compulsion. This will usually require detailed evidence from valuation experts.

The court will also consider factual evidence as to how the actual price was determined and evidence of the methodology/models as used by the buyer, although the value of such evidence will vary from case to case. In some cases, it will be clear that the overall purchase price was of more importance to the buyer than the method of calculating it and the price agreed may be more a result of negotiation than the application of scientific method (see the comment in Mann J in *Sycamore v Breslin* [2012] EWHC 3443 (Ch) that "…*one has to inject a haggle factor into the exercise.*").

The presence of another buyer in the market may also be relevant. As Mann J commented in *Sycamore v Breslin: "if another purchaser is in the wind, so that that purchaser's price has to be beaten to secure the transaction, then that goes to value too."*

A detailed analysis of the valuation methods adopted by the parties, and the disputes that arose out of them, are outside the scope of this note. For present purposes, it suffices to say that the sellers' damages were assessed at £10.8m.

ATTRIBUTION

Under the SPA, the buyer's liability was limited to £7.24m. However, the relevant provision stated that this cap did not apply to claims which resulted from the fraud of the buyer. Therefore, the court had to consider whether the acts of the buyer's financial controller, who was dismissed for gross misconduct as a result of his involvement in the accounting fraud, could be attributed to the buyer such that the cap would not apply.

Applying the well-known case of *MAN Nutzfarhrzeuge AG and others v Freightliner Limited* [2005] EWHC 2347 (Comm), the judge said that, in this context the issue was not one of vicarious liability, or whether the financial controller's knowledge should be attributed to the seller but whether the financial controller should be regarded as representing the seller. The judge was satisfied that this was the case. Although not a "front facing" part of the deal team, the financial controller was heavily involved in the transaction in that he had provided (fraudulent) information to the seller which was essential for the deal to go ahead. It was also relevant that this was not an isolated incident of one person acting alone – one other member of the finance department was dismissed and three others were disciplined. Perhaps most importantly, the judge also thought that the context in which the financial controller was operating could be taken into account. There was evidence that the buyer's finance team had been influenced by senior management demands to see results and forecasts which portrayed the company in a positive light. The financial controller was under pressure to come up with figures that would allow the deal to go ahead and the finance director, whose behaviour was described as "ill-advised" (although not fraudulent), had played a part in creating an atmosphere where fraud was allowed to flourish.

CONTACT DETAILS
If you would like further information or specific advice please contact:

LOIS HORNE
DD: +44 (0)20 7849 2956
lois.horne@macfarlanes.com

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MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT
T: +44 (0)20 7831 9222 F: +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com

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