

# BAD BARGAINS AND BUSINESS COMMON SENSE: THE SUPREME COURT INTERPRETS THE MEANING OF AN INDEMNITY IN A SHARE PURCHASE AGREEMENT

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## BACKGROUND FACTS IN BRIEF

In *Wood v Capita Insurance Services Limited* [2017] UKSC 24, the parties had entered into a share purchase agreement (the SPA) for the sale and purchase of Sureterm Direct Limited (the Company). The Company carried on business as a specialist insurance broker, primarily offering motor insurance for classic cars. After the deal had completed, employees of the Company raised concerns that certain products had been mis-sold to customers. An internal review was conducted and the FSA was informed. The buyer and the Company agreed with the FSA that they would set up a remediation scheme to pay compensation to consumers affected by the mis-selling. The buyer sought to recover the costs associated with the remediation scheme (approximately £2.4m) from the seller.

## THE INDEMNITY

The claim was brought under an indemnity (the Indemnity) contained in the SPA, which provided:

*"The Sellers undertake to pay to the Buyer an amount equal to the amount which would be required to indemnify the Buyer and each member of the Buyer's Group against all actions, proceedings, losses, claims, damages, costs, charges, expenses and liabilities suffered or incurred, and all fines, compensation or remedial action or payments imposed on or required to be made by the Company following and arising out of claims or complaints [emphasis added] registered with the FSA, the Financial Services Ombudsman or any other Authority against the Company, the Sellers or any Relevant Person and which relate to the period prior to the Completion Date pertaining to any mis-selling or suspected mis-selling of any insurance or insurance related product or service."*

The seller pointed to the fact that the requirement to compensate customers arose, not from any claims or complaints made by customers to the FSA, but instead as a result an internal review conducted by the buyer and the Company which led to the requirement by the FSA that compensation should be paid to the customers. According to the seller, this meant that the buyer's losses were not covered by the Indemnity.

At first instance, the judge rejected that argument, holding that the seller was required to indemnify the buyer, even if there had been no claim or complaint by a customer. The Court of Appeal disagreed and overturned that decision. The buyer appealed to the Supreme Court.

## THE DECISION

The Supreme Court upheld the Court of Appeal's decision and dismissed the appeal. This note does not consider the Supreme

Court's textual analysis of the words used in the Indemnity because this will be of little relevance in other cases. However, Lord Hodge, who gave the only reasoned judgment, made a number of comments of wider interest about contractual interpretation generally and about the interaction between the Indemnity and the warranties in the SPA.

## CONTRACTUAL INTERPRETATION

A debate sometimes arises as whether the court should, on the one hand, focus on the words used in a contract and give them their literal meaning or, on the other hand, whether the court should consider the context in which a contract was agreed (often called the "factual matrix"). This debate is more than purely theoretical – see [here](#) for a discussion of some recent cases which have turned on the extent to which the judge has been willing to depart from the literal meaning of words used and to give them a more "purposive" interpretation.

In *Wood v Capita*, it was argued that the Supreme Court decision in *Arnold v Britton* [2015] AC 1619 (which has been interpreted as advocating a literal approach to contractual interpretation) had "rowed back" from the decision of the same court in *Rainy Sky SA v Kookmin Bank* [2011] 1 WLR 2900 (which is sometimes seen as advocating a more purposive approach). The Supreme Court rejected this analysis. Lord Hodge denied that there was any inconsistency between those cases or other recent decisions of the Supreme Court and said that "*the recent history of the common law of contractual interpretation is one of continuity rather than change*".

In Lord Hodge's view, "textualism" and "contextualism" are both "tools" which lawyers and judges can use when interpreting contracts. One approach is not more important than the other and the extent to which each tool is used will depend on the circumstances and, in particular, on the quality of the drafting of the relevant provision. For example where there is a sophisticated and complicated contract, which has been drafted with the help of legal advisers, an approach which focuses more on the words used, and less on the factual matrix, might be more appropriate. In other cases, for example where contracts are short, informal or not professionally drafted, there might be a greater emphasis on the factual matrix and on the application of business common sense.

## PUTTING THE INDEMNITY IN CONTEXT

Applying these rules, Lord Hodge made the following comments:

- ◆ The Indemnity had not been drafted with precision. Lord Hodge described it as "*avoidably opaque*". This explained why the first instance judge and the Court of Appeal had reached opposing conclusions.

- ◆ The Indemnity had to be considered in the context of the SPA as a whole and the wider factual matrix.
- ◆ Business common sense suggested that it was in the interests of the buyer to obtain as broad an indemnity against the adverse consequences of mis-selling as it could obtain. On the other hand, the seller's interest was in minimising his exposure. In resolving this tension between the parties' interests, there were limits to what resort to business common sense could achieve.
- ◆ *"Business common sense is useful to ascertain the purpose of a provision and how it might operate in practice. But in the tug o' war of commercial negotiation, business common sense can rarely assist the court in ascertaining on which side of the line the centre line marking on the tug o' war rope lay, when the negotiations ended."*
- ◆ However, the contractual context was relevant. The losses, which the claimant was seeking to recover, would probably have been recoverable under time-limited warranties contained elsewhere in the SPA. The time limit for claims under the warranties had passed. It made sense for the parties to have agreed on wide-ranging warranties, which would be time limited, and to agree a further indemnity, which would not be subject to a time limit, but which would be triggered in narrower circumstances. A different conclusion might have been reached if the losses had not been recoverable under the warranties.
- ◆ The fact that the buyer had not notified the seller of its claims under the warranty meant that the SPA had become a bad bargain for the buyer but it was not the function of the court to improve the parties' bargain.
- ◆ However, the court will not usually consider the words of an individual provision in a vacuum. The other provisions of a contract will be highly relevant, as will the "factual matrix". Where there are rival meanings of a contract, the court will reach a view as to which meaning is more consistent with business common sense.
- ◆ Where contractual provisions cover similar ground, the meaning of one provision will have an impact on how the other will be interpreted. This is sometimes forgotten when negotiations are conducted under time pressure and amendments are made to one provision without consideration being given to the impact that this will have on other provisions.
- ◆ In the context of a SPA, the court may take the view that indemnities will not cover claims, which are otherwise covered by time-limited warranties, if that is the meaning of the words used.
- ◆ Parties to a contractual dispute need to provide a commercial explanation which supports their interpretation of a contract. This needs to be remembered at the drafting stage because, in a contractual dispute, evidence of the parties' subjective intentions in entering into the contract will be neither relevant nor admissible. The court will only take into account facts which were known to all the parties at the time a contract was entered into (excluding evidence of prior negotiations). This means that, subject to concerns about weakening a negotiating position, relevant facts should be recorded in the recitals or made known to the other contracting parties. This will be all the more important where contracts are informal, lacking in detail or left deliberately ambiguous; in those circumstances a court is more likely to be influenced by the factual matrix and business common sense.

## CONCLUSION

The practical consequences of this decision are as follows:

- ◆ As always, clear drafting is essential – particularly where a contract is intended to achieve an outcome which might be considered to be surprising or onerous.

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