

# Company acquisitions: representations warranties and disclosure

## Latest Update

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In any business or company acquisition, the principle of caveat emptor (buyer beware) applies. In the absence of fraud or misrepresentation, a buyer of the share capital or business and assets of a target company is generally at risk of the shares or assets it thinks it is purchasing not being as expected or being subject to any defect or liabilities. It is accordingly customary for a buyer to receive certain contractual assurances from the seller as to the assets, liabilities and operations of the business or company it is acquiring. These assurances usually take the form of representations and/or warranties, and give a certain level of comfort and recourse to a buyer in the event that those assurances turn out to be untrue, incomplete or misleading. However, the extent to which the representations and/or warranties should be qualified by the buyer's awareness of any underlying circumstances regarding those assurances being breached, whether through the seller's disclosure or its own investigations, is something that is often debated at length on any M&A deal.

## Overview of Topic

1. A buyer of the share capital, or business and assets of a target company, receives very little protection under the law if it later transpires that it did not purchase what it expected, unless there has been fraud or misrepresentation by the seller. The buyer is generally at risk that the shares or assets which it thinks it is purchasing are not as believed, or subject to unexpected defect or liabilities, hence the principle of caveat emptor (buyer beware). Therefore it is customary to receive contractual assurances from the seller as to the assets and liabilities of the business or company, as the case may be. These assurances generally take the form of representations and/or warranties.
2. **Background to representations and warranties:** A warranty is a contractual statement of fact, made by a seller in an acquisition agreement, about a specific asset, liability or other aspect of the target business or company. Similarly, a representation is a statement made by the buyer asserting the truth of certain facts and operating to induce the contract. Whereas the remedy for breach of warranty is a claim in damages (calculated on the normal contractual basis of loss of bargain), a claim for breach of representation can be a claim in damages calculated on a tortious basis (broadly such as to put the claimant into the position in which it would have been had the misrepresentation not been made). A breach of representation may also give the buyer a right in law to rescind the contract, which would only be available for breach of warranty if specifically provided for in the sale agreement. Unlike a claim for breach of representation, a buyer does not necessarily need to prove that he relied on the warranty in question to bring a claim for breach of warranty.
3. It is often said in the negotiation of an acquisition agreement that the purpose of representations and warranties is to provoke the seller to disclose as much information as possible. A buyer will want assurances on a number of issues; for example, whether the target company is party to key contracts with customers or suppliers that can be terminated

upon a change or control, or whether any current or pending litigation has been initiated against the company. While representations and warranties provide an effective way for a buyer to obtain information regarding these key areas, their effect is to impose legal liability upon the seller and provide the buyer with a remedy if the statements are incorrect or inaccurate. Representations and warranties therefore allocate the risk between the respective parties to the acquisition: if they are given, the seller accepts the risk; whereas if they are not given, or they are restricted in their scope or are effectively qualified or disclosed against, the buyer takes the risk.

4. In practice, due to the time and cost of pursuing a claim for breach of representation or warranty through the courts, should due diligence or disclosure identify any specific issues or risks pre-signing, parties will often seek to manage the risk either through a reduction in the price or by way of a specific indemnity.
5. **Indemnities:** An indemnity is a contractual promise to reimburse the buyer on a pound for pound basis in respect of a particular type of liability should it arise. While in the UK current practice is generally to use indemnities to cover only known and/or specific risks (often those that are unquantifiable at the time of the acquisition), indemnities have also been used in light of the inherent limitation that a party claiming for breach of warranty is only entitled to recover for loss of bargain (namely the difference between the price it actually paid for the business and the price it would have paid had the warranty been true), which does not always provide adequate protection for liabilities that may be incurred by the target company (even if also framed as representations). The tortious basis of damages for misrepresentation (mentioned above) may operate to give a more favourable level of damages for a buyer that has struck a bad bargain, though again this would not give as much protection as a full indemnity for loss. In other markets, including in particular the U.S., it is common for all representations and warranties to be backed by indemnities.
6. As well as calculation of loss, the other principal advantage of indemnities is that the buyer's actual awareness of the circumstances surrounding the contractual liability to pay does not affect the obligation of the seller to compensate the buyer, as it could in respect of a claim by a buyer for breach of a representation or warranty given by the seller (see below). As noted above, indemnities are, therefore, commonly sought for material issues disclosed to or uncovered by the buyer.
7. It was also considered for some time that, unlike with a claim for breach of warranty or misrepresentation, a buyer is not generally required by law to mitigate its loss on an indemnity claim. The Court of Appeal in *Royscott Commercial Leasing Limited v Ismail* (not reported) CA, 1993 summarised the view that a claim pursuant to an indemnity is not one for damages but rather for a debt due and there is no duty to mitigate losses in relation to debts. However, the House of Lords ruled in the case of [Firma C-Trade SA v Newcastle Protection and Indemnity Association \(The Fanti\) \[1991\] 2 A.C. 1](#) that such analysis was not correct if a contract of indemnity was characterised as an action for unliquidated damages, to which there would be a duty to mitigate. Accordingly, much turns on the drafting of the indemnity itself in this regard.
8. **Buyer's awareness and disclosure:** It will usually be provided in a sale agreement that the seller will give representations and/or warranties subject to specific facts, events or circumstances disclosed (or deemed to be disclosed) to the buyer (often in a disclosure letter, or in the U.S., a disclosure schedule). The level of information and requisite standard of disclosure required to qualify as an effective qualification of the representation or warranty is also something that is usually negotiated (see below). The effect of the buyer's awareness of an issue or its ability to recover for a breach of representation or warranty is also usually the subject of negotiation.
9. **Disclosure - Knowledge:** In light of the absence of definitive case law on the point it has

historically been common for a buyer to seek the inclusion of a provision in the acquisition agreement that its ability to bring a claim for a breach of warranty is irrespective of its actual awareness as to the accuracy of the warranty (in the U.S. those types of clauses are sometimes referred to as "sandbagging" provisions).

10. [Eurocopy v Teesdale \[1992\] B.C.L.C. 1067](#) had an effect on this. In this case the Court of Appeal, in an interlocutory hearing, held as arguable the proposition that a buyer under a share purchase agreement with actual knowledge of certain facts or circumstances not disclosed by the sellers may be precluded from claiming for breach of warranty, despite a provision in the share purchase agreement stating that he should not be prejudiced by such knowledge. The clause which was the subject of that case read as follows:  
  
"The Warranties are given subject to matters set out in the Disclosure Letter but no other information of which the Purchaser has knowledge (actual, constructive or imputed) shall preclude any claim made by the Purchaser for breach of any of the Warranties or reduce any amount recoverable."
11. The argument put forward in Eurocopy to support this proposition was that, if a buyer enters into an agreement with knowledge of a particular fact, event or circumstance, that knowledge should, in theory, have been taken into account in the decision to proceed to enter into the agreement, and accordingly it becomes difficult for the buyer to argue that he has suffered a loss of bargain and that the value of the company or the business is correspondingly not the same as he paid for it by virtue of that breach of warranty.
12. The substantive claim in Eurocopy was settled before a full hearing so there is no decision on the merits; the court only had to decide at that stage whether the sellers' defence to the warranty claim (namely, that the buyer had knowledge, prior to signing, of the relevant facts or circumstances) was arguable such that it should not be struck out. Although the case was ultimately settled and a full judgment was not handed down, the judge in the interlocutory hearing did make it clear that any arguments would, of course, be construed in accordance with the actual provisions of the sale agreement and the buyer may have a strong argument that such knowledge should be precluded if it was so provided in the sale agreement.
13. In response to the Eurocopy decision, practice developed whereby buyers bolster these types of clauses to include a provision expressly allowing a buyer to claim even if it had awareness of the issue leading to a breach (thereby seeking to estop the seller from raising the buyer's knowledge as a defence to a warranty claim). Needless to say, such provisions are often strongly contested.
14. In [Infiniteland Ltd v Artisan Contracting Ltd \[2004\] EWHC 955 \(Ch\)](#), in obiter comments, Park J. at First Instance rejected the seller's argument that as a general proposition, and regardless of the provisions of the share purchase agreement on the effect of the buyer's knowledge, the purchaser can never make a claim for breach of warranty where it knew about the breach before completion. Park J. was of the view that regard must be had by the court to the terms agreed by the parties about the effect that the buyer's knowledge would have on a warranty claim.
15. However, argument before Park J. on this issue appears to have centred on a series of 19th century cases and it is unclear from his judgment as to whether any consideration was given to Eurocopy (which is not referred to). Park J's obiter comments were not reviewed by the Court of Appeal in Infiniteland (which rejected the purchaser's warranty claim, albeit on different grounds to those relied on by Park J.), although in considering (obiter) the effect of wording dealing with actual knowledge of the purchaser, Chadwick LJ in the Court of Appeal referred to the Eurocopy decision without suggesting in any way that it had been

wrongly decided.

16. Whilst the Eurocopy and Infiteland decisions (at First Instance) are not necessarily inconsistent, the tension between them has led to it being generally considered in practice that a buyer's actual awareness of relevant facts and circumstances at the time of entering into a contract to purchase shares may be an arguable defence against the buyer's claim for breach of warranty. As such, it is usually desirable for the parties to set out expressly in the acquisition agreement the extent to which the buyer's knowledge should qualify the warranties (recognising, of course, that if raised the seller is likely to resist the insertion and may well ask for an express provision to the contrary).
17. **Disclosure - Standard:** As noted above, it is common for the parties to agree a specific threshold which the seller must reach in order to effectively qualify its warranties. In Infiteland the High Court and Court of Appeal ruled that whether effective disclosure had been made would depend upon the express terms of the agreement and not on standards established by case law.
18. A seller would usually set the standard at "fair" disclosure; a buyer should consider negotiating a more robust level, along the lines of "full, fair and specific" disclosure in order to prompt the seller to draw the buyer's attention to specific aspects of a document. In [New Hearts Ltd v Cosmopolitan Investments Ltd \[1997\] 2 B.C.L.C. 249](#), the judge held that:

"mere reference to a source of information, which is itself a complex document, within which the diligent enquirer might find relevant information will not satisfy the requirements of a clause providing for fair disclosure with sufficient details to identify the nature and scope of the matter disclosed."
19. For instance, where documents are disclosed against warranties covering work and pensions matters, sellers would need to be aware of the complexity of such documents and whether the risks associated with key provisions would be reasonably understood by a buyer. It would be equally unlikely that a seller could justify a defence on the back of a document buried in a data room in which the buyer did not have sufficient time or opportunity to properly review. Other cases too have suggested that a seller may not be protected if a disclosure is not specific enough (see, e.g., [Levison v Farin \[1978\] 2 All E.R. 1149](#) and [Daniel Reeds Ltd v EM ESS Chemists Ltd \[1995\] C.L.C. 1405](#)).
20. In addition, sellers will often seek to make a general disclosure of information such as the contents of all public registers or all written documents sent to the buyer or information provided to the buyer's advisors; or, in other words, to make express what constructive knowledge the buyer will be deemed to have so as to effectively qualify the warranties. Again, it is open for the parties to agree this as a matter of general risk allocation as between themselves, and a buyer would usually look to keep the information of which it is deemed to be aware limited to information uncovered by searches or enquiries it has actually carried out and also the information known to it and not just its advisors.
21. In the Infiteland case, the Court of Appeal accepted a wide general or deemed disclosure provision in the disclosure letter in circumstances where reporting accountants appointed by the purchaser had been afforded open book access to the company's accounting records. The disclosure letter sought to make general disclosure (inter alia) of "all matters from the documents and written information supplied" to the reporting accountants. Chadwick LJ held in these circumstances that:

"it would have been open to the purchaser to refuse to accept disclosure made in general terms by reference to what had been supplied to its reporting accountants: and

to insist that it would only accept disclosure which was specific to each individual warranty. But the purchaser did not choose to take that course. It was content to rely on its reporting accountants to identify from the documents supplied to them - and to report on - the matters about which it needed to be informed. That is the effect of the terms in which disclosure was made under the Disclosure Letter; and, for whatever reason, those were the terms upon which the purchaser was content to accept disclosure. In those circumstances, the disclosure requirement was satisfied in relation to such matters as might fairly be expected to come to the knowledge of the reporting accountants from an examination (in the ordinary course of carrying out the due diligence exercise for which they were engaged) of the documents and written information supplied to them."

22. Chadwick LJ reached this conclusion despite language in the agreement by which the seller warranted that the contents of the disclosure letter and all accompanying documents were true and accurate in all respects and that they fully, clearly and accurately disclosed every matter to which they related. He held that the test in the acquisition agreement under consideration was not whether disclosure made in the disclosure letter was sufficiently full, accurate and clear so as to enable the purchaser itself to have a complete understanding of the matter in dispute. The disclosure letter was written in the context that documents and other written material had been supplied to the reporting accountants and Chadwick LJ found that that the required disclosure test was satisfied by the contents of the disclosure letter "and of all accompanying documents ...". Chadwick LJ found there was ample material in the documents supplied to the reporting accountants to satisfy the test.
23. Again, this is further guidance as to the importance of specifying in the sale agreement the risk allocation principles as between the buyer and seller, including as to principles of effective disclosure, as these terms will be the primary determinant of the court's assessment of any claims and, following *Infiniteland*, widely construed deemed or general disclosure provisions are often strongly resisted by buyers. In addition, in light of the nature of disclosure that was deemed sufficient in *Infiniteland*, earlier decisions which suggested that a seller may not be protected by the disclosure of certain facts if such disclosure is not specific enough also now tend to be treated with a higher degree of caution.

## **Key Acts**

None.

## **Key Subordinate Legislation**

None.

## **Key Quasi-legislation**

None.

## **Key European Union Legislation**

None.

## Key Cases

[Eurocopy v Teesdale \[1992\] B.C.L.C. 1067](#): Court of Appeal decision in relation to an interlocutory application made by Eurocopy to strike out Teesdale's defence that Eurocopy had actual knowledge of the breach of warranty for which it was suing Teesdale. Eurocopy had bought the entire issued share capital of a company from Teesdale. The purchase agreement provided that the warranties given by Teesdale were subject "only to the matters set out in the Disclosure Letter" and no other information of which Eurocopy had "actual, constructive, or implied knowledge" would preclude them from claiming breach of warranty or reduce any amount recoverable in respect of breach of warranty. Eurocopy brought proceedings against Teesdale for breach of warranty for failure to disclose material facts in the disclosure letter. Teesdale contended that the facts were not material and Eurocopy had knowledge of them before entering into the Purchase Agreement. It was held that Teesdale had an arguable case, and the Court refused to strike out Teesdale's defence that Eurocopy had actual knowledge of the breach, despite the knowledge-saving provision.

[Infiniteland Ltd v Artisan Contracting Ltd \[2004\] EWHC 955 \(Ch\)](#): Court of Appeal decision regarding Infiniteland's claim for breach of warranty against Artisan, from whom Infiniteland had bought three companies. Under the purchase agreement, Artisan warranted to Infiniteland that "save as set out in the Disclosure Letter", the Principal Accounts gave a true and fair view of the assets and liabilities of the companies in all respects, and provided that Infiniteland's rights in respect of a breach of warranty would be subject only to Infiniteland's "actual knowledge of the relevant facts or circumstances". During the due diligence exercise, Artisan provided accounts to Infiniteland which, if they had been examined "in an ordinary way", would have revealed that one of the companies Infiniteland bought had an operating loss of £500,000. This loss was in fact revealed to Infiniteland's accountants. Infiniteland claimed that it had been unaware of the problems and that their accountants had not informed them of the matter. It was held that Infiniteland did not have actual knowledge of the breach of warranty; neither constructive or imputed knowledge would defeat a claim for breach of warranty unless the purchase agreement specifically stated that the seller was taken to have known all that his agent knew. The Court of Appeal also held that there had been no breach of warranty in this case: the warranty that all information supplied was true and accurate save as qualified by the Disclosure Letter (which included the Principal Accounts) effectively disclosed the operating loss. The Court also held that the standard of disclosure in a Disclosure Letter must be defined by the purchase agreement, and that there is no objective standard of disclosure in such cases.

## Key Texts

None.

## Further Reading

None.

