DAMAGES FOR BREACH OF WARRANTIES IN SHARE PURCHASE AGREEMENTS: AN OVERVIEW

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An overview of the law of damages for breach of warranties in a share purchase agreement (SPA). The note considers the main types of warranty that are commonly included in an SPA (warranties of quality and warranties of reasonable care) and, in each case, the general principles governing the calculation of the measure of loss for breach.

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RESOURCE INFORMATION

RESOURCE ID
w-029-1393

RESOURCE TYPE
Practice note

PRINTED ON
3 February 2021

JURISDICTION
England, Wales

CONTENTS

SCOPE OF THIS NOTE

The principal remedy in English law for breach of contract is an award of damages (see *Practice note, Damages for breach of contract: an overview*) and the same is true for breach of warranties in a share purchase agreement (SPA).

This note focuses on the law of damages for breach of such warranties, which are awarded to compensate for loss. It considers the main types of warranty commonly included in an SPA (see *Warranties of quality and Warranties of reasonable care*) and, in each case, the general principles governing the calculation of the measure of loss for breach (see *Measure of loss: breach of warranty of quality* and *Measure of loss: warranties of reasonable care*).

SPA warranty breaches may or may not also permit claims in the tort of negligent misstatement on the basis that the warranties were also representations inducing the contract (although often these are excluded as the parties do not wish to permit the sale to be avoided for misstatement, and wish to confine themselves to a financial compensation remedy). However, misstatement SPA claims are not covered by this note. As to the comparison and interaction between the two types of claim, see *Karim v Wemyss [2016] EWCA Civ 27* (see also *Legal update, Assessment of damages in sale of law firm (Court of Appeal)*).

For general information on misrepresentation claims, see *Checklist, Seller warranties and limitations on liability: commonly negotiated issues: share purchases: Warranties also actionable in misrepresentation, Practice note, Damages for misrepresentation: an overview* and *Checklist, Damages for misrepresentation: summary*.

For further information on the law in this area, see *McGregor on Damages (Sweet and Maxwell, 20th ed. 2020), Part 4A, Chapter 29: Sale of Shares and Loan of Stock*, which can be accessed with a subscription on Westlaw and, by the author of this note: Adam Kramer, The Law of Contract Damages (2nd edition 2017, Hart): Chapter 9.

OVERVIEW OF SPA WARRANTIES

Share sales, especially in M&A acquisitions (rather than market trading of minority share holdings), are carefully calibrated risk allocations based around warranties as to certain facts and figures, as qualified by express disclosures. For general information on the content of the warranties and the disclosure process in share purchase transactions, see *Practice notes, Warranties and indemnities: acquisitions* and *Disclosure: acquisitions*.

These risk allocations are focused (typically exclusively) on remediation through a contract claim for breach of warranty, which usually has to be notified or brought in a particular form, within a particular limitation period expressed in the SPA, and is subject to contractual deductibles, caps and exclusions (for further information, see *Practice note, Warranties and indemnities: acquisitions: Limitation of seller's liability under warranties and indemnities*). Nowadays such risk can even be offloaded through warranty and indemnity insurance (for further information, see *Practice note, Warranty and indemnity insurance*).

The principles applicable to measuring damages in the context of SPA warranty claims are not unique to such claims, but rather are the ordinary principles of contract law. However, there is an instructive body of case law that assists when formulating and adjudicating such claims that has arisen in the particular context of the warranties found in SPAs, and of the breaches of those warranties that are common in SPA cases.

IDENTIFYING THE TYPES OF WARRANTY AND ASSOCIATED MEASURE OF LOSS

As with any damages claim, it is essential to start by identifying the nature of the duty breached, and the nature of the breach, in order to answer the question: had the warranty been true, what would have been different?

In the SPA context, there are two main types of warranty likely to give rise to disputes, and they have different measures of loss:

- Warranties of quality.
- Warranties of reasonable care.

The issue of which category a warranty falls into can be important. For instance, *Lion Nathan Ltd v C-C Bottlers Ltd [1996] WLR 1438 (PC)* turned on the House of Lords' categorisation of the warranty that a forecast was achievable as being one of reasonable care not of quality. *Oversea-Chinese Banking Corporation Ltd v ING Bank NV [2019] EWHC 676 (Comm)* turned on a warranty that accounts were true and fair being a warranty of quality (although see further *Accounts warranties: true and fair view*).

WARRANTIES OF QUALITY

What is a warranty of quality?

The first type of warranty is the warranty of quality of the target company or shares, such as a warranty that:

- Certain figures are correct.
- The company faces no legal claims other than those disclosed (see, for example, *Standard document, Share purchase agreement: single corporate seller: simultaneous exchange and completion: Schedule 3: Part 1: paragraph 9.1 (No disputes or proceedings)*).
- The business has not deteriorated since the most recent management accounts (see, for example, *Standard document, Share purchase agreement: single corporate seller: simultaneous exchange and completion: Schedule 3: Part 1: paragraph 19 (Changes since the Accounts Date)*).

Most warranties as to a fact will be a warranty of quality. A warranty of this type is a promise that something is the case, rather than a promise to do or not do.

Measure of loss: breach of warranty of quality

Compensatory damages for breach of a warranty of quality compare the actual position the claimant is in and the position it would have been in, but for the breach: here, the position the claimant would have been in had the warranty been true.

The breach of this type of warranty means that the actual position involves a company with a worse financial position (due to fewer assets, lower profitability or greater liabilities) than it would have had in the warranted (that is, the non-breach) position. The measure of damages is the difference between the value of the shares as warranted (that is, had the warranty been true), and the actual value of the shares (the true position now being known or established at court). This is similar to the standard sale of goods warranty claim for breach of satisfactory quality, fitness for purpose or failure to comply with the description: how much more would the goods have been worth had they in fact been of satisfactory quality etc, as promised (see *Karim v Wemyss*).

In contrast with a tort claim for negligent or deceitful misstatement, in a contractual warranty claim there is no room in this analysis for an inquiry into or allegations as to what the purchaser would have done if told the truth: the damages are based on the difference between the position where the warranted information is true, and the actual position. Thus, the claim in *Oversea-Chinese Banking Corporation Ltd* for loss based on a claim that but for the breach the claimant would have negotiated an indemnity into the SPA had the purchaser known the truth failed for exploring the wrong counterfactual (see *Legal update, No departure from established measure of damages for breach of warranty on share sale (Commercial Court)*).

The non-breach position: the "as warranted" value

The question of the value the shares the claimant acquired would have had if the warranty had been true is one of fact. That said, given that the claimant bought the shares on the understanding that the warranties were true, the price actually paid by the claimant is good evidence of the true value, since it is actual recent market evidence of a sale established on the exactly counterfactual concerned (since although the warranties were not true, the parties who negotiated their price believed that they were). This will often be the beginning and end of the enquiry (see, for example, *Sycamore Bidco Ltd v Breslin [2012] EWHC 3443 (Ch), Mann Jat paragraph 391*, but see also the same case at *[2013] EWHC 38 (Ch)*).

It is, however, open to the parties to seek to show that the true value of the company was more or less than was in fact paid for it: *Eastgate Group Ltd v Lindsey Morden Group Inc [2002] 1 WLR 642 (CA) at paragraph 18* and *116 Cardamon Ltd v MacAlister [2019] EWHC 1200 (Comm)*.

The breach position: the actual value

The non-breach position (the as warranted value) must be compared with the position that has resulted from the breach (the actual value).

The measurement of the actual value of the shares or company (that is, in the true world (and with restated figures where the warranted accounts were false or not true and fair)) is at large, and is similar to that for valuing shares in any other context. It will be largely a matter for expert evidence, although the approach to valuation adopted by the parties when setting the price will be a natural place to start (albeit that the end figure will typically be lower than the price). See further *The Hut Group Ltd v Nobahar-Cookson [2014] EWHC 3842 (QB), Blair J at paragraph 180*.

It is worth mentioning that for this measure, and in contrast with a tortious misstatement case for example, it should not matter that the buyer knew the truth. Providing there is still a breach of warranty (which is not automatic, as knowing the truth may, on the wording of some SPAs, prevent there being a breach of warranty at all), the seller is obliged to make good the difference in value where there is a warranty of quality whether or not the buyer knew the truth. The essence of the complaint is not that the buyer has been tricked, but merely that the seller promised that the shares had a quality that they do not in fact have. (For the contrasting position for warranties of reasonable care, see below *The price that would have been paid if reasonable care had been taken*.) That said, if the buyer knew the truth that may be evidence that the price paid is evidence of actual value, not as warranted value (see the discussion in *Eurocopy plc v Teesdale [1992] BCLC 1067*).

The date of assessment

As with sale of goods and other cases, the date of assessment depends upon the law of legal causation, including the law of mitigation (for further details, see *Practice note, Damages for breach of contract: an overview: Date of assessment of damages*).

Arguably, the date of assessment should usually be the date of discovery of the untruth (since the purchaser did not know the shares were defective, in that there was a breach of warranty, until that date, and so cannot be expected to have sold them until after learning the truth). However, the standard date for share sales, even more than goods sales, is the date of acquisition, perhaps given the fungible nature of shares and the risk allocation in the contract (that is, the parties contemplate that the shares will not be sold even if defective, and the claimant will be confined to its directly anticipated warranty claim).

However, there are share sale cases where the date of assessment should be later, such as because:

- The purchaser was locked into the purchase for a period of time due to a fraud in the company (see the leading case of *Smith New Court Securities Ltd v Scrimgeour Vickers (Asset Management) Ltd [1997] AC 254 (HL)*, a share sale case albeit in deceit).
- The reasonable thing to do on learning the truth was to investigate the problem and replenish the company and wait for a time (*Intrum Justitia BV v Legal and Trade Financial Services Ltd [2009] 4 IR 417*, an Irish High Court share warranty decision).

WARRANTIES OF REASONABLE CARE

What is a warranty of reasonable care?

The second category of warranty is warranties of reasonable care. It is not uncommon in SPAs to include warranties not that figures are true, but that they have been prepared with reasonable care, especially as regards forecasts, projections and similar. For example, in *Triumph Controls – UK Ltd v Primus International Holding Company [2019] EWHC 565 (TCC)*, there was found to have been a breach of a warranty that "the forward looking projections relating to the Companies have been honestly and carefully prepared".

In the case of warranties of reasonable care, the non-breach position (that is, had the warranty been true) does not involve the relevant figures that had been included in the accounts or other documents being true, because that is not what was promised, but rather a counterfactual world in which different figures were forecast or presented because more care had been taken in their preparation.

Accounts warranties: true and fair view

While the common warranty that accounts were prepared properly on a true and fair basis looks like a warranty of reasonable care (given that there is no single true and fair basis, but rather a range of presentations and figures that can satisfy that standard), it is tolerably clear that it is treated by law as a warranty of quality: see Oversea-Chinese Banking Corp Ltd, also (without discussion of the point) *Senate Electrical Wholesalers Ltd v Alcatel Submarine Networks Ltd [1999] 2 Lloyd's Rep 423 (CA)* and *Sycamore Bidco Ltd v Breslin*; but see *Macquarie Internationale Investments Ltd v Glencore UK Ltd (No 2) [2010] 1 BCLC 238* (affirmed *[2011]1 BCLC 561 (CA)*) pointing the other way.

Measure of loss: warranties of reasonable care

In the case of warranties of reasonable care, damages are measured by reference to what would have happened had reasonable care been taken; which is essentially the same as the measure in cases of the tort of negligent misstatement cases (that is, where a tortious duty to take reasonable care over the truth of statements has been breached).

Typically this means an award of the difference between the price actually paid, and the price that would have been agreed and paid had the relevant figures been prepared with reasonable care (for example, because the careful forecasts would have been lower and so have induced a lower price): see Lord Hoffmann in *Lion Nathan Ltd* at 1441-2, also *Triumph*.

This is the ordinary measure because, ordinarily, the taking of reasonable care would have led to the sale going ahead, but at a lower price. But this is a question of fact (see, for example, *Triumph* at paragraphs 471-481). If the claimant would not have bought the shares or company at all, then the measure must be on the "no transaction"' basis: that is, put the claimant in the position it would have been in if it had not purchased at all. In practice, this means an award of the difference between the price paid (but for the breach, the claimant would have had that money, not spent it) and the value of the shares acquired (but for the breach, the claimant would not have had the shares so must give credit for that) (*Esso Petroleum Co v Mardon [1976] QB 801 (CA)*).

There could possibly be other consequences that would have occurred if reasonable care had been taken, beyond paying less or not buying at all, such as avoiding liabilities or obtaining indemnities, and if so, damages must compare the actual position with the position if those consequences had flowed.

What does a reasonably careful figure or other information look like?

To calculate loss (the impact of the breach on price) it is necessary to work out what the forecast or other information would have said if reasonable care had been taken (see, for example, *Triumph* at paragraphs 464-470). In doing that, although there are a range of outcomes that could all have been produced by reasonable care, the most likely reasonable forecast must be identified, which will often by the middle of a normal distribution of values that could have been given. One must not, for example, identify the minimum reduction in the figure that would bring it into the reasonable range: see *Lion Nathan Ltd* at 1446.

(This is the same as in a negligent valuer case, where, once it has been established that a valuation falls outside the reasonable range, one then asks what valuation a reasonable valuer would be most likely to have given, which is probably the middle of the range, not the lowest non-negligent valuation at the edge of the reasonable range.)

The price that would have been paid if reasonable care had been taken

The question of what price would have been paid if reasonable care had been taken is one of fact, but the obvious starting point is evidence of how the purchaser in fact formulated its price, and how the negotiations went.

If, as is often the case, the purchaser's bid price was calculated broadly arithmetically by reference to the purchaser's understanding of the business's figures (for example, a multiple of the company's EBITDA figure), then it may be relatively straightforward to adjust the price to that which would have been paid. One merely alters a part of that calculation (such as increasing a costs figure or reducing a revenue figure, and so altering the resulting EBITDA) to reflect the figures that would have been disclosed had reasonable care been taken: see, for example, *Macquarie Internationale Investments and Triumph Controls UK Ltd v Primus International Holding Co [2019] EWHC 2216 (TCC)* at paras 490ff (where a discounted cash flow calculation was rerun with the new figures, as that was the method the parties had used when fixing the actual price paid).

However, it may be that the cut and thrust of negotiations, the purchaser's keenness to buy, that the purchaser in fact knew the truth, or the relative unimportance of the careless information, mean that the same price would have been paid anyway: no loss was caused by the breach of warranty.