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Corporate & Commercial Newsletter:

Concept Of Loss In Share Purchase Agreements

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Introduction

When negotiating share purchase agreements, the warranties which the seller grants to the buyer under the agreement are often, along with the purchase price mechanism, the most heavily negotiated. The warranties have two main functions. Firstly, warranties sought in respect of a particular subject require the seller to disclose information of any known matter which relates to the facts and circumstance warranted. Secondly, they are means of allocating risk as between the seller and the buyer since they provide the buyer with a remedy (i.e. the possibility to claim a warranty breach) if the statements made in the warranties are untrue and cause the buyer a loss.

The definition of loss under share purchase agreements is drafted in various ways in different markets, varies over time and also depends on the bargaining position of the parties and the current market conditions. The definition often includes terms such as direct and indirect loss and excludes consequential loss, punitive damages, use of multiples etc. In some markets the calculation of loss is left to the arbitrators, while other markets aim to specify the loss that would be compensated for in case of a warranty breach.

It is important as a counsel working in cross border transactions to have some sort of basic understanding of how the terms used to define loss would be interpreted under various jurisdictions. This leads us to the question which will be discussed below, how the buyer's loss in case of a warranty breach is defined and applied under share purchase agreements in various jurisdictions.

Holman Webb – Australia

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Australian courts have developed their own concept of loss, particularly regarding the concept of consequential loss in the context of exclusion or limitation for liability. This applies as much to loss in share purchase agreements as to any other legal agreement, and requires the parties to have a clear understanding of how loss is interpreted in Australia. The significance of this understanding is that, by correctly identifying loss in a share sale agreement, you can help ensure that the agreement reflects the commercial intention of the parties. However, as will be seen, Australia's federal system has led to some anomalies.

Loss was examined in the leading English case *Hadley v Baxendale*[i]. There, the court found two distinct categories of loss; direct and indirect. Direct loss referred to losses arising naturally from the breach of contract, while indirect (or consequential) loss was loss that a party suffered on account of a breach that was reasonably contemplated by the parties when they made their agreement. That is, the second limb of *Hadley v Baxendale* relates to special circumstances, where remoter losses are only recoverable if the defendant knew of the special circumstance when the contract was entered into. As such, indirect (or consequential) loss would only be recoverable where the loss of profits could be considered as one step removed from the breach[ii], and the probability of the loss was properly communicated to the defendant. Following this reasoning, Hadley's claim for loss of profits arising out of delay in the delivery of a mill shaft was considered to be too remote. Until last decade this decision led Australian lawyers to consider losses, such as loss of revenue, profit or opportunity on account of the breach, as usually consequential rather than direct.

However, this approach was rejected by the Victorian Supreme Court(iii) in Peerless Holdings(iv). In this case, Peerless successfully claimed for damages relating to the cost of labour and gas that it incurred while replacing a faulty oxidiser installed by the defendant. This saw the introduction of a different test: loss now could be considered as either nominal or consequential. Nominal loss referred to loss that every plaintiff in a similar situation will suffer, while consequential loss was redefined as any loss beyond normal measure. Nettle JA regarded the distinction as reflecting the way that ordinary reasonable business persons would naturally conceive of consequential loss. The Peerless decision has been followed in NSW(v) and in SA(vi).

Conversely, the Western Australia Supreme Court has departed from this analysis[vii]. This departure arose when, in a claim for damages for breach of a power purchase agreement, arising from the failure of the defendant to supply power to the Regional Power Corporation due to its power station being inoperative for 12 months. The argument that damages for the costs of arranging an alternative source of power was excluded as consequential was rejected. The construction of the exclusion clause was approached by reference to both the context and the contract as a whole, finding that the loss claimed was actually direct.

This decision had three important ramifications. Firstly, the Western Australia Supreme Court returned to the initial definition of direct loss, being loss which arises reasonably and naturally from the breach of contract. This remains the definition of direct loss today. Second, the court rejected the definition of consequential loss in Peerless, noting that such a construction could not have been intended. The court held that consequential loss must be defined ‘by construing the clause in accordance to its natural and ordinary meaning, read in light of the contract as a whole’[viii]. Third, the decision showcased the lack of consistency between Australian Supreme Courts on this issue.

Subsequently, in *Paterson Securities*[ix], the Western Australia court noted that ‘*the meaning of the terms of a commercial contract is to be determined by what a reasonable businessperson would have understood those terms to mean*’, and given this, ‘*it does not seem appropriate to construe terms by reference to general rules stated in previous cases dealing with different contracts*’[x].

One example of an exclusion clause might be: “Consequential Loss means loss of income, loss of revenue, loss of profit, loss of production, loss of goodwill, loss of use, loss of financial opportunity, financing costs, loss of business or loss of business opportunity, loss of contract, loss from third party claims or failure to realise anticipated savings (whether the loss is direct or indirect) other than any loss of profit under or loss of this agreement[xi]. “

Therefore, adopting the Western Australia position, the court would be required to ask, ‘what meaning would a reasonable business person give to indirect and direct loss, in context?’. This question does not seem to advance the debate in any helpful way.

The impact for share purchase agreements governed by Australian law is that, when drafting any exclusion clauses there is clarity as to what loss is excluded, leaving no ambiguity. It is not sufficient to say that 'consequential losses are excluded'. As there is no clear judicial guidance as to the meaning of the terms "consequential loss" and "indirect loss", parties to a contract should consider whether it is appropriate to specify the categories of loss that are to be excluded, rather than using the terms "consequential" or "indirect" loss.   A contract should define the categories of losses being excluded. Such categories of loss that might be excluded from recovery could include loss of profit or income, loss of opportunity or goodwill, loss of reputation, loss of anticipated savings or business, or loss of value of equipment, pure economic loss or increased operating costs.

Any failure to define loss, or defining of loss in an ambiguous manner, may result in the courts interpreting the commercial intention of the parties in a way that could lead to unintended consequences. These consequences can be easily avoided by providing appropriate definitions of loss within a share purchase agreement on a case-by-case basis

By Jonathan Casson (jonathan.casson@holmanwebb.com.au)

[i] (1854) 9 Exch 341, [354]

[ii] See GEC Alsthom Australia Ltd v City of Sunshine (Federal Court, Ryan J, 20 February 1996, BC 9600288, unreported

[iii] Victoria is one of eight states and territories in Australia, the others being New South Wales, Tasmania, Queensland, South Australia, Western Australia, the Northern Territory and the Australian Capital Territory. The various state courts are complemented by a Federal Court system. The ultimate Court of Appeal is the High Court of Australia.

[iv] Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd [2008] VSCA 26

[v] Allianz Australia Insurance Ltd v Waterbrook at Yowie Bay Pty Ltd [2009] NSWCA 224

[vi] Alstom Ltd v Yokogawa Australia Pty Ltd and Anor (No 7) [2012] SASC 49

[vii] Regional Power Corporation v Pacific Hydro Group Two Pty Ltd [No 2] [2013] WASC 356

[viii] See also Darlington Futures Ltd v Delco Australia Pty Ltd

[ix] Patersons Securities Ltd v Financial Ombudsman Service Ltd [2015] WASC 321

[x] at 128

[xi] This carve-out is required to clarify that any exclusion of loss of profit or loss of contract does not override any entitlements to loss of profit or loss of the particular contract (for example in the event of termination for breach or termination for convenience). See Macmahon Mining Services Pty Ltd v Cobar Management Pty Ltd [2014] NSWSC 502.

Ardent Advocaten – Belgium

Ardent
advocaten

1. Principles on liabilities in share purchase agreements under Belgian law

1.a. Issues within the scope of general contract law Under Belgian law, a share purchase agreement is subject to the general rules on contracts (or rather law of obligations under civil law) and the specific rules on sale of goods: both are incorporated into the Civil Code.

The seller is obliged to deliver the goods (shares): at the time of delivery the goods need to be conform, i.e. the goods need to comply with the quality, quantity, characteristics or qualities that were contractually agreed.

After the delivery the buyer is entitled to use and enjoy the goods: the seller then is held to safeguard the buyer from 1. latent defects (making the goods unfit for their intended use or reducing their use to the extent that the buyer would not have bought the goods in the first place or at least not under the same conditions) and from 2. claims from third parties (eg a restitution claim of a third party claiming ownership of the goods or a lien on the goods).

If the seller fails to deliver, the buyer is entitled 1. to claim the delivery or 2. to claim to dissolution of the contracts and damages from the seller.

If the goods appear to be affected by a latent defect, the buyer is entitled 1. to give the goods back and claim restitution of the price or 2. to keep the goods and claim a partial reimbursement of the price. In most cases the seller will be liable for damages.

If the possession of the buyer would be disturbed, then the buyer is entitled 1. to restitution of the full price and of the profits (if they should be handed over to the third party claiming restitution of the shares), 2. legal costs of the buyer and the claimant in restitution and 3. damages and legal costs of the contract.

1.b. issues outside the scope of the general contract law It is important to realize that the liabilities under 1.a. are limited to the inherent rights of the shares themselves (voting rights, the right to participate in the general assembly, the right to share in the profits of the company, ownership of the shares) and do not include the underlying assets/liabilities (tax issues, overvaluation of the assets, unknown staff related costs, environmental issues, ...).

In such cases, the buyer can only claim on the breach of contractual representation and warranties by the seller: For this reason it is vital for a buyer under Belgian law to include a wide range of reps and warranties in a share purchase agreement. In order to avoid further discussion in court, it is equally important to agree on the exact description of the losses/damage the seller will be liable for.

2. What damage / loss can be recovered?

2.a. The general rules on contracts specify the right to claim damages whenever a party to a contract breaches its obligations or in case of nullity (see under 1.a.). In general, the right to damages according to Belgian law is based on the principle of causation and emerges whenever a breach of contract is committed, causing the other party to suffer losses; final aim is to put a party into a position as near as possible to where he would have been if the contract had been duly performed (Cass. 26 January 2007, AR C.05.0374.N, TBBR 2009, 45; Cass. 26 January 2007, AR C.06.0232.N).

In general terms, “all losses suffered and all profits lost” caused by the breach of contract can be claimed: a party is entitled to full compensation and it is up to the court to value this (Cass. 8 October 1987, Arr.Cass. 1987-88, 164, RCJB 1991, 379).

However there are two limitations: 1. losses should be foreseen or foreseeable (as to causation, not to extent) at the time of the execution of the contract and 2. losses should be immediately and directly caused by the breach of contract.

The damages will be assessed at the time of the dissolution.

2.b. The application of these principles may be rather problematic: apart from the general rules, there are no specific pointers to determine liability or damages. Therefore, again, it is highly recommended to calculate/describe the potential damages for breaches of contract in advance and include them in the purchase agreement as compensation clauses in case of breach of warranty, since it gives a lot more certainty: a judge will only have a margin of appreciation competence to lower excessive compensation clauses.

2.c. Failing any contractual provision, the following guidelines for damages in case of dissolution of contracts can apply:

1. Lost profit from the dissolved contract:

Case law applies different methods, depending on the court and the circumstances:

Method 1: When the primary commitment of the debtor was the payment of the price, the lost profit is calculated as the agreed price minus the cost of performance

When the primary commitment of the debtor was the provision of a performance other than the payment, then the lost profit is calculated as the value of the shares minus the agreed price.

Method 2: (replacement agreement) When the primary commitment of the debtor was the payment of the price, the lost profit is calculated as the agreed price minus the price of the replacement agreement

When the primary commitment of the debtor was the provision of a performance other than the payment, then the lost profit is calculated as the price of the replacement agreement minus the agreed price.

2. Lost profit from missed agreements with third parties. Effective loss can be calculated if possible. If not possible, court may accept an ex aequo et bono amount for loss of an opportunity.

3. Damage to the aggrieved party's goods (e.g. loss of value due to faulty use of goods)

4. Damages claimed by to third parties

5. Costs for the dissolution of the agreement

6. Costs for the implementation of the restitution commitments after dissolution (shares have to given back and this may lead to costs)

7. Loss of time and internal costs (follow-up by the management)

8. Moral damage can be accepted (even for companies) when sufficient proof can be given. This may e.g. be the case for reputational damage.

9. Costs incurred when minimizing loss.

Interesting to note is what loss will not be accepted by court:

1. Expenses caused by the closing of the dissolved agreement

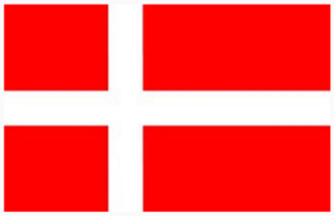
2. Loss of use/profits of the good that was transferred following the dissolved contract: this is logical because courts should assess damages as if the contract would have been properly performed.

3. Future losses: this is logical as the valuation of the loss is done at the time of the dissolution.

Apart from this, a claimant should also bear in mind his duty to minimize damage, by taking measures that any reasonable and cautious person would take.

Be aware that all the above items are subject to the judicial appreciation of every judge deciding in a specific dispute and that this article only offers a very general outline of the matter!

By Filip Duwaerts (f.duwaerts@ardent.be)



Keller Advokatfirma- Denmark

KELLER ADVOKATFIRMA

The sale and purchase of businesses in Denmark - whether by acquisition of shares in a company or by acquisition of the company's activities - is regulated by the Danish Sale of Goods Act, and therefore, the law's definition of loss is applicable for share purchase agreements. Section 19 of the Sale of Goods Act even specifically regulates dividends on purchased shares, allotting to the buyer any dividends which are not yet due to be paid at the time of purchase.

The Act's general definition of loss is found in section 25, which stipulates that, where a purchase agreement is cancelled on the grounds of breach on the part of the seller, and where no other loss has been proven, the buyer's loss is to be calculated as the difference between the agreed purchase price and the price of goods of the same kind and quality at the time of purchase.

This definition is evidently unsuited for use within share purchase agreements, as breach of a share purchase agreement on the part of the seller is more often settled by economic compensation rather than cancellation of the agreement. Furthermore, the individual and specific nature of companies would make it difficult to estimate the price of "goods of the same kind and quality".

Therefore, as one might expect, this definition has little practical use when drafting and interpreting share purchase agreements. Furthermore, the definition is in and of itself a "fallback", as its wording directly states that it is only to be used "where no other loss has been proven". For all practical purposes, the law therefore leaves the parties of a share purchase agreement to rely on the ordinary definition of loss under Danish law.

Danish law distinguishes between on the one hand loss incurred between contracting parties (contractual liability), and on the other hand loss incurred between parties who have not entered into a contract (tortious liability). When dealing with contractual liability, and when the agreement is not cancelled as a result of the breach, loss is generally measured according to the positive interest of the agreement. That is, what would the state of affairs and economic situation of the non-breaching party be had the breaching party performed according to the contract.

This is therefore the general basis for the parties' definition of loss in a share purchase agreement, which can then be modified according to the parties' wishes and negotiating skills. It is not uncommon for a clause in a share purchase agreement to stipulate that "the buyer is entitled to claim damages according to Danish law", with subsequent clauses modifying the general principles as necessary.

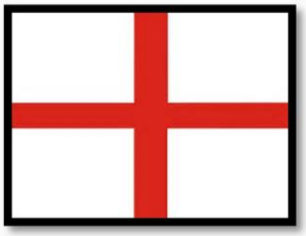
This freedom to modify the definition of loss is supported by section 1 of the Sale of Goods Act, which stipulates that the provisions of the law only apply to the extent that other terms have not been expressly agreed upon or otherwise follow from the parties' agreements or trade usage in general.

One example of a supplement to the ordinary definition of buyer's loss in a share purchase agreement could be that loss is calculated according to the net loss suffered after deduction of possible tax credits, insurance claims, recourse claims or other sums which might limit the buyer's loss. The key word in this instance is "possible". Where the general rule would state that such credits or claims could only be deducted from the buyer's loss if they were actually recovered by the buyer, this modification firmly places the interest of obtaining such credits or claims on the buyer, leaving the seller free from having to pay any amount which the buyer could have recovered through other means, even if the buyer ultimately fails to do so.

This already partially follows from the general principle of the buyer's duty to limit any incurred losses to the best of his ability, which, although similar in purpose to the above example, is subject to an individual assessment of whether or not it is reasonable to expect that the buyer would be able to obtain such a credit or claim. The abovementioned clause would therefore favor the seller compared to the general rule of measuring loss according to the positive interest of the agreement.

The ordinary definition of loss is further modified by the principle of buyer's fault, according to which a court may deduct an estimated share of the loss incurred from the buyer's claim owing to breach on the part of the seller, if the buyer is partly to blame for the loss. Parties contracting under Danish law, excluding those who enter into contracts with consumers, generally enjoy a high degree of freedom to modify the terms of and definitions in their agreements according to their wishes, which is reflected in the variety of clauses on and limitations of loss in share purchase agreements under Danish law.

By Josias Svendstorp (js@kellerlaw.dk)



Mundays LLP – England

MUNDAYS.

When a buyer acquires a business or shares in a company it is common for the buyer to seek various warranties and indemnities about the business and its affairs. These give the buyer comfort that it will in fact acquire what it is expecting to acquire and if it does not ensure it has recourse against the sellers. Warranties are statements about the current situation and past activities of the business or company and can be very detailed. For example, it is normal for the business/company accounts to be warranted as giving a true and fair view, that the business/company is not being sued or investigated and that it has complied with relevant laws etc.

Of course no business is perfect and there will be exceptions or qualifications that the sellers will need to make to the warranties. This is usually done in a disclosure letter where various general and specific disclosures are set out with the intent of giving the buyer the same level of knowledge about the business/company as the sellers have. Many disclosures will not be a cause for concern and are taken on as part of the rough and tumble of business life. Some however may be more serious, for example litigation or public authority investigations. In these circumstances the buyer will seek specific "indemnities" whereby the sellers agree to satisfy all losses and costs that arise from the subject matter of the indemnity.

The negotiation of the terms of the warranties and indemnities can, quite understandably, become quite complex and none more so than the provisions aimed at limiting the sellers' liability.

It is common practice for the parties to an acquisition agreement to negotiate various financial and other limitations on the sellers' liability for warranty, indemnity and tax covenant claims. Whether these limitations will apply to all three types of claims will usually depend on the negotiating powers of the parties involved, the specific details regarding the claim and the points listed below. It is also important to note that most tax covenants will contain their own limitations for claims made under the tax covenant. Therefore, it is important to check these alongside the limitations included in the acquisition agreement to ensure there are no inconsistencies.

The sellers of a company/business will want to limit their liability for claims under an acquisition agreement for a number of reasons, including:

- to ensure claims are limited to a certain amount so they know what their maximum liability will be;
- to ensure claims are not left open-ended in terms of the time frame within which claims can be brought. For example, a tax related claim can normally only be brought during the 7 year period following completion; and
- to ensure that the buyer is obligated to observe the common law duty to mitigate its loss.

The sellers will also want to make sure that any information they disclose or is deemed disclosed to the buyer limits their liability for any claims brought under the warranties. On the flip side the buyer will want to ensure that it is adequately protected and will not want to take on any unnecessary or unreasonable risk.

The following additional limitation provisions are also normally negotiated between the parties:

- provisions requiring the buyer to seek recovery or reimbursement from a relevant third party (such as an insurer) before it can pursue a claim against the seller;
- providing for claims to be reduced by amounts recovered from third parties where such recovery relates to the claim in question;
- excluding liability for matters known to the buyer. This is linked to the disclosure point mentioned above, however, it is normal for the parties to negotiate whether the buyer's knowledge (whether actual or construed) should limit a sellers' liability;
- excluding liability for claims that arise (or are increased) as a result of the buyer's voluntary acts;
- giving the sellers control of the conduct of third party claims that may lead to a claim under the acquisition agreement.

Whether or not these limitations are included (and to what extent) will vary from transaction to transaction and will usually depend on:

- the bargaining position between the parties;
- the buyer's and the sellers' attitude to risk;
- the extent of the buyer's due diligence exercise and the sellers' replies to the buyer's enquiries;
- whether warranty and indemnity insurance is being sought;
- the nature and complexity of the business being purchased;
- whether any amount is to be held in escrow or if there is some form of deferred consideration which the buyer can use to offset any claims; and
- the buyer's future plans for the business.

Mundays' corporate team has vast experience in acting for both sellers and buyers. We will be able to advise you on the above points and assist you in bringing your transaction to a satisfactory conclusion.

By Howard White (howard.white@Mundays.co.uk)

Bernards - France

One of the most important clauses in a share purchase agreement ("SPA") is the indemnification clause that provides that the vendor will indemnify and hold the buyer harmless for damages resulting from any breach or inaccuracy of the representations and warranties. The right to make a claim for indemnification under a SPA is often heavily negotiated. An indemnity is basically a promise to pay damages to the indemnified person (the buyer of the shares or the target company, which is legally possible under French law, even such company is a third party to the SPA). Under article 1205 of the French Civil Code, one may likewise stipulate for the benefit of a third party when such is the condition for a stipulation that one makes for oneself or for a donation which one makes to another.

Under French law, some specific statutory provisions come into play to determine the obligations of the contractors. For instance, in a share transfer transaction, French law provides guarantees to the buyer such as guarantee against eviction ("garantie d'éviction") and guarantee against hidden defects for the shares ("garantie des vices cachés"). But, the practical benefits for buyers resulting from theses legal guarantees in case of loss or damage within share transfer agreements are limited. Therefore, buyers usually seek to improve their conditions by imposing a higher contractual standard based on other legal provisions.

The French Civil Code clearly sets forth the type and quantum of damages that can be recovered by a party who suffers damages. With respect to contractual claims in the context of SPA, the French Civil Code permits plaintiffs to recover damages only when such damages are directly caused by a breach or a delay in the performance of the defendant's contractual obligations provided that the breach or delay is not owing to an outside factor not attributable to the defendant and the defendant did not act in bad faith. Article 1231-2 of the French Civil Code states that damages can include lost profit.

Under French law, the plaintiff can only recover direct and foreseeable damages at the time of the conclusion of the SPA, except in certain circumstances such as gross negligence. Article 1231-3 of the French Civil Code states that the defendant is liable only for damages that were foreseen or that could have been foreseen at the time of the contract.

To be recoverable, the plaintiff must prove that the incurred damages are the immediate and direct consequence of the breach by the defendant of an obligation. The plaintiff must prove a direct cause and effect between the fault and the harm that occurred. French law excludes indirect damages. So, it is not in principle necessary to exclude or limit indirect damages. As foreseeable damages, the amount of damages to be awarded will not generally exceed the amount of proved loss.

The damage must be also certain. Such legal provisions exclude the possibility to indemnify incidental and consequential damages.

Under French law, it is possible to contractually cap damages, a cap corresponding to the maximum amount of damages, a fixed amount or a percentage of the purchase price of the shares. But French law is very strict with respect to such limitation (or exclusion) of liability clauses. Based on case law, limitation (and exclusion) clauses will be deemed not written if they deprive the contactor's essential obligation of its substance. That means that if the clause allows a party not to commit to perform its essential obligation under the contract, the negotiated cap will not be valid.

By Bernard Berdou (bberdou@bernardsfirm.com)

Eugene F Collins – Ireland

Under Irish law, the level of damages available to a buyer as a result of a breach of warranty in a share purchase agreement, and indeed the right to claim damages for such a breach, will depend on the specific contractual terms of the share purchase agreement and the application of certain contract law principles to it. In rare circumstances, an alternative remedy may be available, namely rescission.

The principle of caveat emptor applies and it is therefore incumbent upon a buyer of shares to ensure that it is properly and adequately covered by the warranties, indemnities and other protections negotiated by it and set out in the share purchase agreement. A buyer will seek to hold a seller responsible for all damages, costs and expenses (including consequential loss, loss of profit and professional fees) suffered as a result of a warranty breach but a properly negotiated share purchase agreement will usually contain a range of limitations on the seller's liability for any proven claim for a breach of warranty.

In addition to an agreed disclosure mechanism against the warranties, those limitations may, for example, include matters such as a cap on the overall liability figure (which may be less than the consideration paid to the seller but not, in the absence of fraud, more than that amount); time limits within which a claim for breach of warranty must be made; the exclusion of liability for consequential losses; the exclusion of liability for insignificant (de minimis) warranty breaches; the exclusion of liability where the loss is covered under the target's insurance policies (save to the extent of any increase in the premia for such policies following the making of an insurance claim); and the exclusion of liability for warranty claims where specific provision has been made in the financial statements of the target company or in completion accounts.

It is possible that a buyer may agree with a seller that the warranties would be given on an indemnity basis but this is not the normal convention and it is usually the case that damages for breach of contract would be the appropriate remedy. If the indemnity basis (which would set out the parameters of the compensation payable to a buyer) does not apply, a share purchase agreement governed by Irish law would typically be silent on the measure of damages. This preserves the common law basis for compensation, which involves the formulation of a claim by a buyer, the issuing of the appropriate legal proceedings followed by a court hearing for the purpose of deciding on the level and measures of damages payable by a seller.

As a starting point in founding a claim for breach of warranty, the buyer will need to quantify its net loss arising from the alleged breach. It is this measure of net loss that needs to be proven in any claim for a breach of warranty.

It is probable that a buyer will have negotiated a number of means of potential redress in respect of a breach of warranty. Leaving aside the possibility of a rescission of the share purchase agreement (which is not usually feasible after the share purchase agreement has been concluded as it can be very difficult to substantially put the parties back to the position they each were in prior to its conclusion and which is often therefore contractually excluded by the parties as a remedy), a buyer may have the right to sue for damages for breach of contract or for misrepresentation (where a buyer can demonstrate, and where an Irish court accepts, that the warranties were also representations as well as contractual promises). Each action gives rise to different measures of damages and a buyer may wish to prefer one over the other in any given case.

In assessing the level of damages, an Irish court would likely look to the contract to establish how the parties initially valued the shares in the target company. If, for example, those shares were valued based on an earnings multiple (EBITDA), or the value of the net assets of the target, an Irish court may decide to use the same formula in its assessment of the damage caused by the breach of warranty.

In addition to its consideration of the agreed terms of the share purchase agreement which deal with warranty provisions and claims (and possibly liquidated damages clauses) and depending on the types of damages and costs sought by a buyer in its claim, there are a number of other factors that an Irish court may take cognisance of in assessing the level and measure of damages. For example, the court may look at what was reasonably contemplated by the parties at the time of the negotiation of the share purchase agreement as to what would amount to a loss (issues of foreseeability and remoteness). The court may also seek to establish that a buyer had mitigated its loss insofar as this was possible (as a buyer is obliged to do under common law principles) and that the buyer had not indirectly received any benefit arising out of the alleged breach of warranty. As mentioned above, the level of damages awarded by an Irish court will be based on the total net loss suffered by a buyer. It is, in most cases, for the court to decide the appropriate level of damages to be awarded.

By Gavin Doherty (gdoherty@EFC.ie)

Corlett Bolton & Co. – Isle of Man

The Manx model of loss follows the UK model very closely. While the Isle of Man has a separate legal system and courts and is a separate jurisdiction from the UK, UK common law, practice, and legal interpretation is seen to be highly persuasive in the Manx system. In regards to loss specifically, the definition emanates in the Isle of Man from the Sale of Goods Act 1983 ("the Manx Act").

This Act is so similar to the UK statute (Sale of Goods Act 1979, "the UK Act") that at first glance it would appear indistinguishable. For the purposes of defining loss, it is. Where this occurs in Manx statute, English case law based on the English statute should be followed. While the remedy for a breach of warranty is found in the UK Act in s 53, the same is found in s 52 of the Manx Act. Both apply to share sales by virtue of s 1 (1) of both Acts, which states that the respective act "applies to contracts for sales of goods". "Goods" here refers to personal chattels according to Halsbury's Laws of England, which also handily includes "shares in joint stock companies" in its definition of "personal chattels". Therefore, both jurisdictions share a common definition of loss in terms of a share sale.

By Julie Ronan (Julie.ronan@corlettbolton.com)

Studio Legale Afferni Crispo & C. – Italy

slac studio legale afferni crispo & c.

The transfer of shares is subject to the rules applicable to sale and purchase contracts pursuant to s. 1470 et seq of the Italian Civil Code.

The most sensitive issues arising out of such agreements usually concern matters in which the price paid by the buyer for the shares does not correspond to the value of the company. This may be due to the fact that some pre-existing circumstances emerged after the execution of the agreement thus affecting the value of the purchased shares, including for example loss accounts originating before the purchase but discovered only at a later stage.

The rules provided by the Italian Civil Code have been proven, under certain circumstances, inadequate to cope with the scenario under consideration because of the very tight deadlines within which the relevant legal action has to be pursued.

This, however, is not the greatest risk run by the buyer who happens not to be covered by appropriate contractual warranties.

In fact, the prevailing view (also confirmed by the Italian Supreme Court of Cassazione) tends to exclude any risk of economic loss from the warranties that are implied in a sale and purchase contract as such. Indeed, according to the general understanding, those “vices” and “defects in quality” that the Italian Civil Code refers to, cannot concern the economic value of the object of the sale, since the latter pertains to the realm of the subjective appraisal of the parties involved, rather than to the subject matter of the contract and has, in itself, no autonomous legal relevance. A vice and/or the defect in quality may be said to exist when there is an impact on the quality of the rights or obligations conferred by the shares and thus the actual participation of the shareholder to the company.

According to a minority view, the shares of a company represent “second degree” assets and therefore the legal status of shareholders (also) with regard to the assets of the company.

In reply, it has been argued that the assets of a company are owned by the company and not by its shareholders, who have therefore no rights on the company’s assets. As a consequence of a loss suffered by the company, the shareholders undergo (a mere) consequential damage because of the decrease in value of their shares.

Hence, the importance of including specific warranty clauses in the contracts for the sale and purchase of shares.

Whilst it cannot be technically qualified as a warranty, mention should be made as a matter of practice of due diligence exercises which should normally carried out by the buyer before committing to the purchase of the shares with a view to gathering detailed information on the status of the company. It should however be said that, unless the sale concerns the shares owned by a person who is "in control" (in the legal sense) of the company, the company itself is "a third party" towards the parties to the sale and purchase agreement and may therefore be unwilling to provide information on its own performance. As to the shareholders, their right to seek information on the company varies also depending on the type of the company involved, being more effective in case of a "Società a Responsabilità Limitata" (SRL) or "joint stock company" (s. 2476 para. 2 of the Italian Civil Code) than it is in case of a "Società per Azioni" (SpA) or "limited liability company" (s. 2422 of the Italian Civil Code).

With regard to warranties, a distinction has to be made between legal warranties and business warranties. The latter usually relate to the capital, financial and income aspects of the company whereas the former concern the shares, their ownership and the right to freely dispose of them.

The warranties regarding the "content" of the participation (so-called business warranties) may have a multiple object and relate to the accuracy of the budget, the relations with tax authorities, the existence of labour disputes and the status of environmental safeguards. Such clauses ensure the buyer a more extensive protection than the warranties that Italian law accords by default. The prevailing view is, in fact, that in the absence of specific warranties such as those that have briefly been mentioned, the buyer will not be protected in case the price paid for the shares does not correspond to the actual value thereof. The error in evaluating a company cannot be regarded as essential; thus, a legal action aimed at the annulment of the contract or at a judicial reduction of the price will be hardly conceivable and will in any event be subject to a very tight deadline.

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GarfieldBennett

The drafting and interpretation of Jersey share purchase agreements is largely informed by English legal practice and principles and, as far as we are aware, there is no distinct "Jersey practice". In the event that an action is brought under a share purchase agreement for breach of warranty, the definition of a buyer's loss is more likely to depend upon the bargaining position of the parties than current market conditions.

In Jersey, there are two common scenarios that give rise to the use of a share purchase agreement. The first is a pure local deal with a Jersey governed share purchase agreement negotiated between the parties. Even where the governing law is Jersey, such agreements are often based upon an English law precedent which has been adapted for use in Jersey. The definition of loss would usually include damages, losses, liabilities, costs (including indirect and consequential losses and reasonable legal and other professional costs), charges, expenses, actions, proceedings, claims, penalties, fines and demands incurred or suffered by the buyer. Under Jersey law, the parties are free to agree whatever terms they wish to agree provided that the agreement is made in good faith, it is not contrary to public policy and is not contrary to the law.

The second and more common scenario is where there is an English or cross border transaction with a Jersey element which requires some local due diligence and warranties that reflect the local context, but where the terms of the transaction, the governing law and the definition of loss would be English law based and not driven by Jersey lawyers or Jersey practice.

In the main, whether looking at pure Jersey or cross-border deals, Jersey closely follows English common law principles for the assessment of damages in contract and differences in Jersey are likely to be matters of substantive law of the claim itself rather than assessment of loss or damages.

We are not aware of any Jersey case law which deals with the definition of loss specifically or the application of such a definition in a claim for a warranty breach. However, English law exercises an important influence in the Jersey court's approach to damages, remedies and rescission other than specific performance. Loss of chance (but not expected profits) is recoverable provided that the chance in question is real or substantial as opposed to fanciful or speculative.

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In the Netherlands the compensation for a breach of contract is regulated in Section 6.1.9. DCC which section also governs the effects of a non-performance regarding a share purchase agreement.

Due to Article 6:74 DCC any breach attributable to the seller causes seller's liability. A breach cannot be attributed to the seller if the seller is not to blame for it nor accountable for it by virtue of law, a juridical act such as an agreement, or generally accepted principles (article 6:75, Force Majeure). Since this is a fairly open norm, warranties are usually agreed upon in order to make the seller accountable for specific circumstances.

Warranties also serve to describe the quality of the shares and the company they represent. Not agreeing on warranties leaves a purchaser with the open norm of article 7:17 DCC specifying that a sold object must be in conformity with the sale agreement and that it is not in conformity with the agreement if it does not have the qualities that the purchaser, given the nature of the object and the statements of the seller about it, could have expected on the basis of the agreement. The purchaser may expect that the object has the qualities that are necessary to be able to use it in a normal way and of the presence of which he did not need to doubt as well as the qualities that are necessary to be able to use it in the particular way that the purchaser intends to make of it as provided for in the agreement.

Since this formula leaves too much room for post-closing conflicts article 7:17 DCC is usually ruled out in an SPA. Instead warranties are used to define the specifics the purchaser should rely on.

A purchaser cannot rely on a warranty once he discovers a breach of this warranty in the pre-closing stage or after a specific disclosure by the seller in a pre-closing stage. A remedy then has to be found in agreeing on a lower purchase price, on an indemnification for losses occurred in connection with this indemnification or in the rescindment ("ontbinding") of the SPA.

The wording of the warranties should be clear, and the more specific the better. In general a Dutch judge has the freedom and the duty to determine what the parties reasonably have meant with a provision and what they reasonably could have expected from each other. In operating this so-called "Haviltex formula", all facts and circumstances are taken into account, including the conduct of the parties before and after entering into the contract, despite the presence of an entire agreement clause.

Once a breach of warranty occurs and presuming that this warranty survives the Haviltex test, section 6.1.9. DCC does not restrict on the type of damages a purchaser can claim. Article 6:95 DCC holds the non-compulsory rule that the damages that have to be compensated consists of material losses and other disadvantages, the latter as far as the law implies that there is an additional entitlement to a compensation for such damage. These additional entitlements are summed up in Article 6:96 DCC. Usually losses to be compensated in case of breach are defined as "all damage, losses, liabilities, costs, charges, expenses, claims and demands assessed in accordance with article 6:96 et seq. BW and all reasonable legal costs and reasonable experts' and consultants' fees". This definition covers for indirect losses due to Article 6:96.1 DCC stating that a material loss includes losses suffered and profits missed.

As the Seller's losses are usually not easy to determine in case of a breach, it is standard practice in the Netherlands that warranties are released both to the purchaser and (the group of) the target. As a result in case of breach also the losses of the target group will have to be compensated by the seller. Discussions between the parties regarding this practice do usually end in a compromise on a cap on the compensation in case of losses.

Beside the limitation using a cap, the compensation is usually limited in several other ways. It is usual to include a threshold for claims. Any loss can usually be set off with tax refunds and other monetary benefits attributable to the facts giving rise to a claim. Furthermore losses covered by insurance policies are usually not taken into account.

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Share Purchase Agreement constitutes a specific type of the sales contract. The sale contract in Poland is regulated by the Civil Code. The provisions of the Civil Code are general in nature though and do not refer specifically to this type which concerns sale of shares.

The standards of the share purchase agreements have been as the consequence developed by legal practitioners and in many aspects derive from the UK and US legal regimes. One of the most important aspects of the share purchase agreement is the question of the seller's liability in case the shares or the company in which the shares are being transferred is not in a state as expected by the purchaser. If the parties would not regulate the question of the seller's liability in the agreement itself then the purchaser would need to rely on general provisions on contractual liability. This would leave him further with the cumbersome obligation to prove that the shares are defective, that he suffered a loss, what was the exact amount of the loss and casual link between the shares being defective and the loss he suffered. This might be fairly difficult if a loss is not defined in the agreement and in particular in case the problem lies not in shares themselves (such as lack of legal title on side of the seller) but in the company (e.g. a post-closing claim addressed by third party which was not known to the purchaser and which concerns pre-closing activity). Theoretically if the parties to the share purchase agreement do not provide otherwise a purchaser if able to prove the above conditions of seller's liability is entitled to full compensation which shall cover not only damnum emergens (direct loss) but also lucrum cessans (loss of profit).

In order to put the purchaser in the better position in terms of addressing and enforcing the claims towards the seller legal practitioners in share purchase agreements to be governed by Polish law very often provide for a detailed regime of seller's liability which is connected with the seller's breach of representation and warranties. On the other hand such detailed regulation acts also to the benefit of the seller in many ways (limitation on liability provisions). The purchaser's lawyers often insist that part of this regime includes the definitions of two basic terms: the loss and the compensation. As a general rule in most M&A transactions in Poland the loss for which seller is liable includes only damnum emergens (direct loss). It is a standard that the seller's lawyers tend to exclude from the loss definition so-called lucrum cessans (loss of profit).

The definition of the compensation is connected and fairly often one may be found with the compensation being understood as the amount by which the value of an asset of the company in which shares are being sold is or becomes less than its value would have been had the warranty breach not occur; or the amount of any liability or any increase in liability to which the company would not have been subject to, had the warranty breach not occur, or the amount by which the value of the shares is or becomes less than their value would have been had the breach of seller's warranties. It is rather standard in M&A transactions in Poland that the purchaser's loss which is subject to seller's liability is not only limited by excluding from it the loss of profit or other consequential damages but also by other different mechanisms which derive from UK and US regimes (such as: cap on liability, thresholds, and others).

As results from the above, due to limited statutory regulation regarding sale of shares contracts one should pay a close attention to detailed regulation of many aspects of the transaction in the share purchase agreement itself, with the loss and its compensation being the most important both for the seller and the purchaser.

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The historical background

Prior to 2015, when a raft of changes were introduced into the Russian Civil Code, there was no "warranties" concept under Russian law. Consequently, for "warranty–style" claims, purchasers instead tended to rely on certain general remedies that Russian law provides in respect of sale and purchase agreements. These remedies are available where there is some sort of defect with the subject of the sale and purchase, for example if the asset is damaged or unfit for purpose. Such remedies apply to shares in the same way in which they apply to goods or other chattels/assets. Unfortunately, this often led to unsatisfactory results, because the application of the remedy to the shares themselves, as opposed to the underlying company, provided unscrupulous sellers with a defence: they could argue that the shares themselves were not defective.

This problem was generally resolved by using English law as the governing law for share purchase agreements in respect of Russian companies' shares, thereby affording the purchaser access to English law representations and warranties in order to protect it against undisclosed defects.

Recent legislative amendments

In 2015, however, new rules were introduced into the Russian Civil Code providing for the concept of warranties.

In accordance with article 431.2 of the Civil Code a purchaser can claim losses caused by the seller warranting certain facts to it, provided that: (1) the underlying facts to which such warranties related could not be established in fact; and (2) the seller knew, or should reasonably have known, that the purchaser was relying on such warranties (in fact, there is a presumption at law, that the seller thinks in this way). It does not matter whether the seller knew that the warranties in question were false, unless otherwise provided for in the agreement.

Claims for damages

In case of breach of warranty, a purchaser is entitled to claim for losses from the selling party. Under the relevant Russian legislation (article 15 of the Civil Code), "losses" means: (i) the expenses that the suffering party incurred, or will have to incur, to restore his or her violated rights; (ii) actual losses i.e. damage to assets; and (iii) any loss of expected gain that the purchaser would have obtained had there been no breach. In practice, however, it is extremely challenging to prove loss of expected gain in the Russian courts, largely due to the fact that it is very difficult to persuade the judge of the certainty of the occurrence of the expected gain, had the breach not indeed taken place.

An alternative remedy is for the purchaser to include in the share purchase agreement, a fixed penalty amount for breach of warranty. It should be noted, however, that the court may reduce this amount, should the judge consider it to be unreasonably high when placed within the context of the actual breach. Given that breaches of warranty may vary wildly, it makes it complicated to predict an adequate and reliable penalty amount.

Further, in circumstances where the warranty which has been breached was of material importance to the purchaser, then he or she can claim not only for losses or fixed penalty, but can also repudiate (or withdraw from) the share purchase agreement, unless this right has been excluded within the text of the agreement itself. Please note that the term "material importance" is undefined, meaning that materiality of importance will have to be considered on a case-by-case basis.

In certain cases, breach of warranty can give grounds for challenging the agreement on the basis of the seller's deception or misrepresentation (articles 178 and 179 of the Civil Code). In such cases the purchaser can choose, instead of withdrawal from the agreement, to challenge it in court. Accordingly, once the transaction has been declared void by court, the parties shall be put back into the positions in which they found themselves before they entered into the share purchase agreement, i.e. the shares would be returned to the seller while the price, if already paid, would be refunded to the purchaser.

Repudiation, may be a better option in cases when the purchaser has not yet performed his or her obligations under the share purchase agreement, whilst challenging the agreement may be a suitable option when the purchaser's obligations have already been fulfilled. In any case, it is always advisable to review each case on its facts, before deciding which legal remedy is most suitable.

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Under Swedish law, the starting-point for damages is the principle of compensation within the limits of adequate causation. The right to damages between a buyer and a seller of goods is governed by the Sales of Goods Act. The Sales of Goods Act also governs the sales of shares.

The Sales of Goods Act distinguishes between direct and indirect losses. The purpose of the differentiation between direct and indirect loss is to reduce the risk for the breaching party having to pay substantial damages. It is distinctive of indirect losses that they are dependent on individual conditions of the party suffering a loss. A loss could for example to a large extent be dependent on the injured party's decision on how to organize its business, and indirect losses are therefore difficult to assess in estimations of the risk.

The differentiation between direct and indirect loss under the Sales of Goods Act is made by defining indirect losses. An indirect loss is a loss resulting from reduction or loss of production or turnover, other loss resulting from the goods being unfit for use in the intended manner, loss of profit resulting from a contract with a third party lapsing or not being properly performed, and other similar loss, if such loss was difficult to foresee.

Direct losses are not defined in the Sales of Goods Act but are usually explained as losses which regularly incur as an immediate consequence of a breach and not as a consequence of the injured party's intended or future purpose of the contract matter. In the bill to the Sales of Goods Act, direct losses are exemplified as expenditures due to the breach including cost for investigating the breach such as telephone and traveling costs and costs for localizing defects in the goods, costs of repairs and re-delivery and costs due to the buyer's effort to procure a substitute such as rent of substitute goods, remunerations for third parties, and costs for keeping the own personnel at overtime work. As you can see, the described conditions relate more to sale of machines than shares.

Under section 70 of the Sales of Goods Act, the injured party has an obligation to mitigate loss, and if the injured party neglects to do so, the party will bear a corresponding share of the loss. Under the Sales of Goods Act, section 67, paragraph 3, it follows that indirect loss that arises a consequence of a direct loss having been mitigated is to be regarded as a direct loss. This is where it gets complicated. The rationale for the provision as stated in the bill to the Sales of Goods Act is reasonable, namely that the buyer must not be placed in a worse position on the ground that he, to mitigate a direct loss, chooses a course of action that causes such a loss which is referred to in section 67, paragraph 2, i.e. an indirect loss.

However, this means that the distinction between what is referred to as a direct and indirect loss (and consequently whether the buyer will be entitled to compensation or not) is dependent on the actions of the buyer. If the buyer decides to procure a substitute for the contracted performance, i.e. a replacement machine, this is to be regarded as a direct loss. However, if the cost for a replacement machine, totalling SEK 700,000, exceeds the loss of production due to the defective machine, totalling SEK 500,000, and the buyer refrains from leasing the replacement machine due to its obligation to mitigate loss, the buyer will be entitled to compensation for the direct loss in an amount of SEK 500,000. Hence, section 67, paragraph 3, provides the buyer with an opportunity to convert an indirect loss into a (recoverable) direct loss. In view of this, a mere exclusion of indirect losses under a share purchase agreement governed by Swedish law may in practice be hard to uphold.

During the last couple of years, there has been a change to the way loss definitions are drafted under Swedish share purchase agreements. In the early 2000s, the definition of loss was often limited to the buyer's direct loss, which, when buying shares, normally would be the diminished value of the shares. However, since a diminished value of a share is very difficult to determine, today's market practice would also include also the target's direct and reasonably foreseeable indirect loss in the definition of loss under share purchase agreements.

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Protection for specific losses under share purchase agreements is typically provided by indemnification clauses. Indemnifications typically cover damages resulting from breaches of representations, warranties, and covenants. However, US law allows much latitude to the selling and purchasing parties in negotiating indemnification provisions, including with respect to claims covered, damages recoverable, and who can make claims and against whom. Constraints on indemnifications are typically set by designating claim types as fundamental or non-fundamental, limiting the time period in which to bring claims, setting materiality thresholds, and capping damages recoverable.

Fundamental representations and warranties are those so essential to the deal that if the buyer knew they were untrue or if they were absent, the transaction would not go through. The survival period for fundamental claims is typically longer than for other claims. However, more debate arises in deciding which claims are fundamental, with buyers seeking coverage of items which may have significant financial effect or which may arise long after expiration of the ordinary survival period. Breaches that are not designated fundamental may instead be indemnified as special items on an individually determined basis.

In addition to distinguishing between fundamental and non-fundamental representations and warranties, damages payouts are usually also limited by type of damage. At minimum, US courts will typically award non-breaching parties direct or actual damages, which are intended to put the non-breaching party in as good as a position as he would be had the breach not occurred. However, beyond direct damages, buyers may also be awarded incidental damages (compensating for costs arising as a direct result of the seller's breach, such as attorneys' fees), consequential or special damages (compensating for costs not predictable ex ante based on known circumstances, but which are directly attributable to the breach), and punitive damages. According to the ABA's 2015 Private Target Mergers & Acquisitions Deal Points Study (which, along with the counterpoint Public Target study, also published biennially, is a valuable resource in monitoring trends in M&A agreements), incidental damages were expressly excluded from 22% of deals in 2014, with only 4% of deals including them and a majority of agreements remaining silent on their award. In contrast, punitive damages have been expressly excluded with increasingly frequency in recent years, with 78% of 2014 deals containing such language and a mere 1% expressly allowing for them. Consequential damages were expressly excluded under approximately half of all 2014 deals, with only 7% of deals expressly allowing them and the remaining 49% remaining silent.

In order to limit payout on claims of all sorts, sellers seek to set damages caps and minimum thresholds for bringing claims. Damages caps, which denote the maximum amount of indemnity coverage, are often set at a percentage of purchase price for non-fundamental claims. For fundamental claims, buyers will often seek no cap. Sellers typically agree to a higher cap for such claims, though sometimes limit it to the amount of total consideration received in the transaction.

While damages caps seeks to limit the seller's potential liability, minimum thresholds for bringing claims serve to prevent buyers bringing insignificant claims. Such thresholds are described as "baskets." A basket is the minimum amount the indemnitee's total claims must exceed before it can bring a claim. There are two types of baskets: deductible and tipping. An indemnitor is obligated to pay only claims in excess of a set amount if the indemnification provision uses a deductible basket. However, if a tipping basket is used, the indemnitor must pay all claims up to and exceeding the threshold amount. An agreement may also include a mini-basket, which means an individual claim must exceed a set amount in order to be deemed sufficiently significant to bring to the indemnitor.

Countering sellers' preference for quantitative materiality thresholds set by baskets, buyers typically seek to include a materiality scrape in the indemnification provision. Materiality scrapes remove representations and warranties in the agreement from subjectivity to qualitative materiality qualifications; any misrepresentation or inaccuracy constitutes a breach, no matter how trivial. This allows a claim to be brought for any breach of a representation or warranty, provided any basket-set monetary threshold is reached.

Though less common, a buyer may also try to insert a knowledge scrape, which negates any knowledge requirement contained in seller's representations and warranties. Sellers can seek the obverse by inserting an anti-sandbagging provision, which prevents a buyer with pre-closing knowledge of a claim then bringing a claim for damages against seller following closing. This presents the issues of subjective knowledge and buyers not being able to rely fully upon the representations and warranties in the agreement for a breach which may have existed pre-closing. As such, anti-sandbagging provisions may lead to more litigation.

Indemnifications are usually funded in one of three ways: indemnification escrow account, setoff, or holdback. Indemnification escrow accounts temporarily divert a portion of the amount paid by buyer. Following expiry of the survival period, the seller is paid the balance. While escrow accounts provide the buyer secure knowledge that there are funds to pay any claims, this security exists only for as long as the escrow period lasts, meaning any fundamental or special claims with a longer survival period are not protected. Additionally, sellers tend to prefer not to have funds generated from the sale of their assets tied up.

As an alternative, setoffs may be incorporated into a sale structure where payments are scheduled into the future, allowing the buyer to reduce such future payments by the amount of any claims. Holdbacks create a future payment specifically for purposes of ensuring availability of funds to cover any injury resulting from a breach. A holdback functions much like an escrow account, but with the buyer acting as escrow agent rather than an impartial third party.

In the absence of an indemnification provision, parties may have recourse to general breach of contract claims. Another alternative is for the buyer to purchase representation and warranty insurance.

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