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Private Company M&A: Warranties and the Disclosure Process

by **Jennifer McGuire**

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A recent case in the English High Court, 116 Cardamon Limited v MacAlister [2019] EWHC 1200 (Comm), highlights the importance of disclosure and the difficulties that may arise when there is an expedited sale process.

Background

Motorplus Limited, a company regulated by the Financial Conduct Authority in the UK (FCA), dealt in the sale of insurance policies. Between April 2014 and May 2014, a deal was negotiated and concluded for the sale of Motorplus to Cardamon (the Buyer).

As part of a fast-tracked sale process there were the following unusual departures from standard practice in these types of sales:

- The Buyer did not conduct any due diligence for fear of tipping off the management team, who were known to be formulating an MBO.
- The sellers gave the warranties 'blind', i.e., without undertaking a detailed disclosure exercise to identify exceptions to the warranties.
- The Buyer's offer of £2,300,000, a reduction from the initial asking price of £5,000,000, was accepted on the basis of completing the transaction quickly.
- There was an unusual de minimis arrangement on the sellers' liabilities, which rendered the first £500,000 of any claim non-recoverable.

The share purchase agreement (SPA) signed on 23 May 2014 contained warranties relating to the content and preparation of the statutory accounts of Motorplus. One such warranty stipulated that the statutory accounts did not understate any liabilities, adequately provided for bad debts, and were prepared in accordance with generally acceptable accounting standards.

Post completion, the Buyer discovered material inaccuracies in the accounts, and its auditors recommended the prior year accounts for 2013 be restated, resulting in the Buyer believing that Motorplus was insolvent at the time of the acquisition.

Three Claims: One Successful, Two Dismissed

The Buyer made three claims in relation to (1) an underprovision in the accounts, (2) a failure to write off a debt, and (3) a failure to disclose a change in remuneration practices for insurance brokers during the accounting year.

(1) Underprovision Claim

It was discovered that the 2013 statutory accounts only made provision for claims notified by 31 August 2013, and not by 19 February 2014 which was the mutually agreed position. The Court found the significant underprovision in the accounts put the sellers in breach of warranty.

Although the error in the accounts made the Court's task of calculating damages much more difficult, it determined the damages flowing from such error exceeded £2.8 million. The sellers' liability under the SPA was capped at the purchase price of £2.3 million. Therefore the Court found that the Buyer's claim succeeded in the amount of the full purchase price (i.e. the Buyer was entitled to recover the entire £2.3 million purchase price).

It is noteworthy that the Court found that the sellers' liability cap was not reduced by the de minimis threshold. The Court confirmed that the Buyer was not entitled to the first £500,000 of a claim as a result of the de minimis threshold, but it was entitled to recover the remainder of the claim up to an amount equal to the seller's liability cap.

(2) Bad Debt Claim

It was found on the facts of the case that the bad debt in question had been fairly disclosed to the Buyer, and therefore this claim was dismissed. The SPA standard for fair disclosure was that a matter be "fairly disclosed … (with sufficient details to identify the nature and scope of the matter disclosed)".

In this case the disclosure letter delivered by the sellers stated the relevant bad debt provision represented only one-half of the amount outstanding, adding "that does not mean the other half is considered recoverable".

There was also general disclosure of all communications between the transacting parties and their advisers. Email correspondence between the parties showed the financial controller of Motorplus stating that "it's likely the remaining balance will be written off", and also showed the Buyer's finance director seeking a reduction in the consideration by way of response.

Though it was recognised that general disclosure of all communications between the sellers and the buyers is quite unusual in typical transactions, the Court found that the standard of fair disclosure was clearly met as evidenced by the disclosed correspondence in this instance.

(3) Change in Broker Remuneration Practices

This claim was dismissed because the only notice of claim served in respect of this claim by the cut-off date had failed to "summarise the nature" of the claim.

The SPA required that any claim must be notified in writing "summarising the nature of the [claim] (in so far as it is known to the Buyer) and, as far as reasonably practicable, the amount claimed".

The written notice served by the Buyer asserted a claim relating to a change in broker remuneration that made the Management Accounts misleading. However, the written notice did not state a claim in relation to the statutory accounts or relating to unusual or non-recurring items. By the time the claim was formulated in this way, the cut-off date for claims had passed and the Court found that the claim lapsed.

Significance

This case illustrates the repercussions of failing to give serious consideration to the warranties and disclosures on the sale of a business.

The sellers' failure to undertake a proper disclosure exercise resulted in the following issues arising:

1. The sellers warranted accounting matters that they apparently had no familiarity with and they did not seek to inform themselves. The error was so grievous in this instance that the sellers had to repay the entire purchase price.
2. Notwithstanding that the sellers had clearly made the Buyer aware of certain doubtful debts in the statutory accounts, it is unclear as to whether the specific disclosure itself would have been sufficient on its own to meet the standard of fair disclosure in disclosing that the entirety of the relevant debt was unrecoverable. In this case, the Court considered the specific disclosure in conjunction with the generally disclosed email correspondence, and on that basis found the standard of fair disclosure was met. However, it would be uncommon for a disclosure letter to treat all communications between

the Buyer and sellers as being generally disclosed.

This case also illustrates that it is crucial to set out all relevant claims in the notice of claim, as failure to do so may result in a claim lapsing. Other recent case law has also illustrated this point.

Conclusion

Although this is a judgment of the High Court in England, its findings are likely to be persuasive in the Irish Courts.

Many transactions are completed within a pressurised timeframe, but the importance of a thorough due diligence and disclosure exercise to protect the interests of the sellers and the buyers should not be overlooked.

If you have any questions in relation to issues raised in this article, please contact Jennifer McGuire, Partner, or James Byrne, Associate Solicitor.

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