

Key issues for breach of warranty claims and the potential impact of Covid-19

In the early part of 2020, Covid-19 entered all of our personal and professional lives and substantially changed the world (hopefully temporarily) in almost every respect. In the business world, it caused significant and almost unprecedented disruption to the way that businesses operate and to their turnover and profitability. At that time, some businesses were in the position where they had either recently completed the purchase of another business (whether by share or asset purchase) or were shortly due to complete such a purchase. Those share or asset purchases may have been based on assumptions, forecasts and/or valuations over which there may now be a question mark.

Some intended share or asset purchases may have aborted, but many will have completed with the buyer being left in an uncertain position in terms of whether the shares or assets that they purchased are substantially the same as what they set out to purchase, and whether they are still worth the price paid. In the coming months, these buyers are likely to reflect on the shares or assets that they purchased, and the warranties that were given to them by the seller in the purchase agreement. The question will be - ***is there a potential claim against the seller for breach of warranty that may recoup any diminution in the value of the purchased shares or assets?***

Key issues

Breach of warranty claims have some particular characteristics that need to be borne in mind. Each claim is likely to be slightly different from other similar claims as it will need to be brought in accordance with the precise terms of the applicable purchase agreement. When considering a claim for breach of warranty, it is important to check the applicable agreement very carefully.

Here are some issues which are likely to arise:

- 1. Process and timing.** The purchase agreement is likely to provide for a specific process which must be followed very precisely in order to bring a claim. There are likely to be strict rules on sending a notice of claim within a certain timeframe (often 12 months from completion) and what that notice must contain. There may also be strict rules on how legal proceedings for a notified claim must be issued and served and by what date. The contractual time limits in these agreements are often much shorter than the limit that would otherwise apply. If any of the rules set out in the purchase agreement are not complied with, the claim may fail.
- 2. Information and investigation.** The purchase agreement is likely to provide that the notice of claim must set out the claim in a reasonable

amount of detail. If it does, it is important that this is done and a failure to do so may cause the claim to fail. The notice would need to refer to the particular warranty that has been allegedly breached. There will most likely need to be a reasonably thorough investigation of the claim which can involve extracting quite a lot of information from internal systems. It is important that this is started as soon as possible to allow enough time for the process to be completed in time

- 3. Deferred Consideration and/or Retention Monies.** The purchase agreement may contain provisions dealing with deferred or adjusted consideration and/or retention monies. These provisions need to be considered carefully alongside any potential claim.

The impact upon valuation very much depends on the nature of the breach of the warranty. The loss for some breaches may be the 'cost of repair' of an item (which may justify a £ for £ adjustment). In other situations, particularly around breaches that impact on the ongoing profitability of the business, the reduction is more likely to be measured in terms of a multiple of profits.

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- 4. Measure of Damages.** The measure of damages for a breach of warranty claim is the diminution in the value of the shares or assets purchased compared to their value as warranted. **Quantifying the loss can often involve a complex assessment of the value of shares or assets at certain points in time and may require input from an expert valuer (see quote boxes).** The purchase agreement may contain de minimis hurdles and/or a cap on damages.
- 5. Mitigation.** The buyer may be under a duty to take reasonable steps to mitigate their loss and it is worth gaining an understanding of what the court would expect in this regard.
- 6. Insurance.** Consider whether there is any insurance in place that might cover the claim.

While multiple of profits based damages can be significant, sometimes we have to consider other factors as well in order to calculate the true loss that the breach has caused. For example, if the cumulative impact of the breaches change a prospective purchaser's view as to the risk profile of the business and/or their view of growth prospects then it may also be appropriate to make further adjustments reducing the valuation. These could include increasing the discount rate applied (as well as reducing the future cash flows) or reducing the multiple of profits (as well as reducing the amount of profits), thus having a ratcheting effect as well as a multiple of profits impact.

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Conclusion

Breach of warranty claims can be much more complex than they initially appear. There are often strict rules in the purchase agreement and fairly short time limits for taking certain steps. An early mistake in complying with the rules in the purchase agreement can be fatal to the claim. If you think there may be a potential claim, it is worth seeking legal advice and assistance as soon as possible.

The damages that could be obtained via a breach of warranty claim can be difficult to quantify and the claim may be worth a lot more or less than it first appears. Having reliable information about the value of the claim at an early stage should assist with making informed decisions about the claim and ensure that the wrong value is not being used, particularly if the parties are engaging in discussions or alternative dispute resolution. It can often be beneficial to involve an expert valuer at an early stage to assist with quantification of the claim.

Stephenson Harwood have lots of experience in helping clients deal with breach of warranty claims. If you would like to speak to us about a possible claim or if we can help in any way, please get in touch using the contact details set out below.

Contact us



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Donna advises on a broad spectrum of commercial and financial disputes. She has experience across a wide range of financial products and markets as well as with disputes involving shareholders, partnership joint ventures, acquisitions and investments.



Graham Hain is an accounting and valuations expert witness who regularly advises on both alleged breaches of accounting warranties and their consequential impact on business valuation.

For more details and to visit Graham's profile, please [click here](#).