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Recent Case Law on Warranty and Indemnity Claims

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This update examines French warranty and indemnity claims case law. It should help foreign companies to assess the importance of the terms of agreement whenever a stock purchase agreement is subject to French law, and thereby to avoid pitfalls. As the 2008 Court of Cassation decisions were in line with current case law, this review of a few sample decisions illustrates the importance of careful drafting and strict performance of the warranty terms in share purchase agreements.

Disregard of Actual Damages

In a decision dated January 29 2008 the Court of Cassation held that a warranty and indemnity claim was enforceable despite the fact that the buyer had suffered no prejudice due to the breach of warranty.

Facts
Two French companies sold 100% of their shares in a general partnership to another company on March 31 1999. The share purchase agreement provided two separate warranties, one stating that as of December 31 1998 the net cash situation of the partnership was Fr3 million and the other certifying that as of March 31 1999 the net cash situation was at least equal to Fr300,000. An expert evaluation revealed liabilities for an amount of Fr2,617,092 as of March 31 1999, in part due to a loss of Fr1,098,092 (approximately €167,482) in a joint venture company in which the partnership held 25% of the shares. Ultimately the joint venture became a profitable operation and the partnership gained profits from the venture.

The issue was whether the buyer could obtain indemnification from the sellers for breach of warranty under the terms of the purchase agreement even though it had not suffered any monetary damage - in other words, whether the recognition of a temporary loss followed by positive net earnings could give rise to indemnification.

Decision
The Paris Court of Appeals supported the sellers' argument and found that because the buyer had suffered no damages it was not entitled to indemnification for breach of warranty. However, the Court of Cassation held that because the purchase agreement provided a warranty for a net cash situation of Fr3 million, and the loss of the joint venture - equivalent to €167,482 for the partnership - had not been taken into account in the net cash situation by the sellers, the buyers were entitled to obtain indemnification under Article 1134 of the Civil Code.

Comment
Pursuant to Article 1134, agreements lawfully entered into bind parties to the same extent as laws. It is therefore irrelevant whether the buyer had suffered actual damage as long as the warranty provided in the agreement was breached, and such breached warranty provided for indemnification. In any situation where there is a difference between the warranted net cash situation and the real net cash situation, in the absence of any requirement to show evidence of damage, the indemnification is automatically granted. Parties to an agreement seeking to restrict the scope of indemnification may therefore wish to include an additional requirement to show actual damage in order to trigger indemnification under the warranty. This decision further illustrates that the judge may not place any fairness consideration above the terms of the agreement entered into by the parties. Even if a judge finds that an indemnification provision is triggered by a party in 'bad faith' as no loss has occurred, the judge nevertheless remains limited in his decision by the terms of the agreement.

Agreed Notification Periods

The agreed notification period to obtain indemnification for breach of warranties is binding upon the parties and the judge.

In a decision dated February 12 2008 the Court of Cassation held that the indemnification procedure agreed upon in a share purchase agreement was binding upon the parties and could under no circumstance be sidestepped - not even by way of exception.

Facts
The sellers had sold their shares in a company holding 95% of the shares of a restaurant to the buyers. The share purchase agreement regarding the sale provided for an eight-day notification period after discovery of an event giving rise to a possible

indemnification claim. In addition to this transaction, the sellers offered to sell the remaining 5% of shares in the restaurant, which they held directly, in exchange for the financial and professional contribution of the buyers into the company. Almost a year after the closure of the share purchase agreement, the buyers filed a claim against the sellers for misrepresentation, requesting that the purchase agreement be declared void and that an expert be designated. The buyers stopped paying sums due to the sellers' shareholder account and asked for a set-off between their payments due and the sums due to them by the sellers for breach of warranty. The Versailles Court of Appeals ordered an expert investigation and, noting that the indemnification provision of the warranty had to be triggered within an eight-day notification period from discovery of the underlying triggering event, asked the expert to take this warranty provision into account to determine whether a set-off in the amounts due by, and due to, the buyers was possible.

The issue in this case was whether the judge could validly order a set-off between the amounts due by and to the buyers (the latter being based on the breach of warranty), despite the fact that the eight-day notification period to trigger indemnification under the warranty had lapsed.

Decision
The expert found that the restaurant was worth only Fr936,000, whereas it had been valued at Fr1.45 million in the share purchase agreement, and the Versailles Court of Appeals ordered the set-off of the sums due by the buyer with the indemnification sums available under the warranty. The Court of Cassation rejected that decision and held that even if a warranty provision is raised by way of exception (ie, by a court in due course of proceedings), the parties and the court remain bound by the terms of the parties' agreement in accordance with Article 1134.

Comment
Pursuant to Article 1291 of the Civil Code, the set-off of two debts is automatically possible provided they are both due and liquid (ie, monetary). However, if one of those conditions is not met, the judge may order a judicial set-off. In the decision above, the buyers asked for the set-off of sums allegedly owed to them by the sellers under the terms of the warranty provision against a sum owed by them to the sellers. If the indemnification procedure had been complied with, the set-off would have been possible. More generally, parties to a share purchase agreement should keep in mind that such set-offs are not possible where, on the one hand, the company is a creditor of the seller (eg, because of a tax audit revealing unpaid tax liabilities that were due before the closing, triggering a warranty provision) and, on the other hand, the seller is a creditor of the buyer (eg, because full payment of the purchase price has not been made). This decision once again illustrates the importance of complying with all terms - including the procedures - agreed upon in a share purchase agreement.

'Absence of Undisclosed Liabilities' Provisions

The seller must indemnify the buyer for payments ordered by a court decision delivered after the date as of which financial results are warranted if the agreement contains an overall 'absence of undisclosed liabilities' provision.

On March 4 2008 the Court of Cassation held that the sellers had to indemnify the buyer even though the payment of sums had been ordered by a judgment after the date on which the accounts had been closed - the date as of which the results of the fiscal year were covered by the sellers' warranty. The reason for this decision was the existence of a representation for absence of liabilities against employees elsewhere in the share purchase agreement.

Facts
In a warranty agreement entered into pursuant to a share purchase agreement - both dated August 28 2003 - regarding the sale of several companies, the sellers each represented and warranted the taxable profit of the fiscal year ending on June 30 2002. An employee of one of the companies who had been dismissed for gross negligence in 2004 filed a claim against the company and won his case. The company was ordered to reimburse back-pay and accrued salaries due since July 1 2001. The buyers then asked the sellers to indemnify them for these reimbursements on a pro-rated basis.

The issue at hand was whether the buyers could obtain pro-rated payment from the sellers even though the verdict had been delivered after the date as of which the financial profits were warranted.

Decision
The Montpellier Court of Appeals found that the buyers were not entitled to indemnification because the verdict of the labour court had been delivered after the closing date of the accounts, and the warranty covered the existence of sufficient reserves in the accounts to cover likely risks and liabilities in light of past and current events. However, the Court of Cassation noted that the purchase agreement contained a representation stating that as of the signing of the purchase agreement, the companies had no liabilities against employees with the exception of those mentioned in the accounts, and that all sellers warranted the accuracy of all representations contained in the purchase agreement. Therefore, the buyers were entitled to indemnification.

Comment
This rather classical decision is consistent with current French case law and shows that the Court of Cassation sticks to its strict line of interpretation of agreements entered into by parties. Again, it is irrelevant that the accounts contained reserves to cover certain risks rendered likely by then current events, as a representation as to the absence of possible claims for payment by employees for reasons originating at the time of the signing of the warranty agreement was also given. It is therefore crucial for sellers to draft very carefully the representations and warranties sections, as a literal application of the agreement is enforced by French courts.

Change of Ownership

In a decision of March 11 2008 the Court of Cassation reminded that an indemnification for breach of a warranty provision is

enforceable by the buyer beneficiary of the warranty even if the company had changed owners at the time of the indemnification claim.

Facts
Through a share purchase agreement dated October 22 1999 a seller sold 100% of the shares of a company and granted the buyer a warranty for all liabilities deriving from actions, facts or events before signing. In October 2001 the buyer was ordered by a court of arbitration to pay an earn-out, and the buyer's shares were seized and sold in order to make this payment. In August 2001 the French tax administration notified a tax reassessment for lack of payment of various taxes for fiscal years 1997, 1998 and 1999, which were paid by the buyer. When the buyer sought indemnification from the seller under the terms of the warranty, arguing that the warranty was a price warranty (ie, a price adjustment provision) due to the buyer disregarding the fact that the shares had been sold to a third party, the lower court (*Tribunal de commerce Meaux*) denied the buyer's petition for lack of personal cause of action finding that the warranty was a liabilities warranty bound to shares that no longer belonged to the buyer.

The issue was whether the warranty clause was a price warranty, calling for a possible reassessment of the price to the benefit of the buyer, or a classical liabilities warranty that would be linked to the shares and benefit the company's current shareholder.

Decision
The Rennes Court of Appeals found that the warranty was a liabilities warranty strictly linked to the shares and that the buyer was therefore not entitled to ask for indemnification without having any actual title to the shares. The Court of Cassation disagreed and found that in the absence of a particular third-party beneficiary provision in favour of the company, a warranty provision regarding liabilities entered into between the seller and the buyer where the latter is designated as the beneficiary of the warranty is a price adjustment provision and therefore enforceable by the buyer, notwithstanding that the shares have been sold to a third party.

Comment
This decision, which is in line with current case law, shows how important it is for a buyer to specify who - either the company or itself - will be the beneficiary of a warranty provision. Although both price adjustment and classical liability warranty provisions aim to protect against unknown liabilities as of the day of the closing, only the buyer is entitled to file a claim for indemnification under the terms of a price adjustment provision designed to protect it against payment of an unfair price in light of the company's depreciated value because of an undisclosed liability at the time of the purchase. However, if the warranty provision benefits the company, it will be tied to the company's shares and only current shareholders will be entitled to file a claim for indemnification. Nevertheless, it is recommended that sellers be very explicit in contractual documents.

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