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ARTICLE

M&A Transactions in France: False Representation by Seller Regarding Ongoing Material Contract Generates No Loss to Buyer and Therefore Gives No Right to Indemnification

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Synopsis

The Commercial Chamber of the French Cassation Court recently rendered a decision denying the buyer of a French company from the benefit of various contractual representations and warranties. The buyer was denied indemnification following discovery, after closing of the transaction, that the seller had misrepresented that a material contract was ongoing, whereas the true position was that the contract in question had been terminated a few months prior to closing. On the face of matters, this situation risks defeating a primary purpose of an M&A transaction and causing serious financial problems to the target of the transaction and to the buyer. The author analyses the decision[1] ('the Ruling') and to what extent its outcome might have been different, if the wording of the documentation binding the seller and buyer had been different, or if the buyer had based his claim on other legal grounds.

The key facts and procedural steps which led to the ruling

- In September 2011, a French company ('the Seller') sold 100% of the shares of its wholly owned subsidiary, named STDU, to another French company ('the Buyer').
- STDU ('the Target') was in the mechanical engineering industry, specialising in the machining, milling and processing of automotive parts.
- Two agreements, subject to French law, were entered into on the closing date of the sale of the Target's shares ('the Transaction'). The first agreement addressed the transfer of the shares and the payment of the purchase price to the Seller. The second agreement provided for various representations and warranties (the 'Representations and Warranties') by the Seller to the benefit of the Buyer.
- The purchase price was apparently determined by reference to the Target's equity at the end of the financial year[2] preceding the transaction and as of 30 June 2011, reviewed by the Buyer.
- At the end of June 2011, an agreement entered into between the Target and Honda Manufacturing France ('HMF') was terminated apparently at the Target's initiative. According to the facts set out in the decision handed down by the Court of Appeal,[3] the turnover resulting from the HMF agreement represented between 7 and 18% of the Target's yearly turnover between 2008 and the first two quarters of 2011.
- The Buyer, after finding out about the undisclosed termination of the agreement with HMF (the 'HMF agreement') considered that he should have been informed of the termination of said agreement and claimed for damages against the (i) Seller, and (ii) managing director of the Seller, who also acted as the managing director of the Target (the 'MD') until the closing of the Transaction.
- A claim was filed before the Toulouse Commercial Court. The latter dismissed the Buyer's claim in February 2014, and ordered the Buyer to pay a portion of the Seller's and MD's legal fees.
- The Buyer appealed the decision of the Commercial Court, but the appeal was dismissed on all grounds of appeal on the basis:
  (i) regarding the MD, that the latter was not a party to the Transaction and that a tort action brought by a third party against an MD requires that a fault separable ('*faute détachable*') from the MD's functions be evidenced, which was not the case; and

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1 Cassation Court, Commercial Chamber, 21 March 2018, 16-13.867, in *MDE 95 v PG 96 and its Managing Director*.
2 31 December 2010.
3 Court of Appeal of Toulouse, 13 January 2016, 14/01598.

(ii) that there was no decrease in the Target's turnover as a result of the termination of the HMF agreement, nor any decrease in the Target's profitability due to the loss of HMF as a client. In that regard, the Court stated that the Target's turnover had in fact increased by 10% in 2011 (apparently compared to the previous financial year) and increased again in 2012.

The Cassation Court adopted the findings of the Court of Appeal regarding the absence of any decrease/the increase of the Target's turnover. On that basis, it ruled, in consideration of the wording of the representation and warranty provisions, that there was no evidence that the Target had incurred a loss resulting from termination of the HMF agreement. The Cassation Court consequently dismissed the claim for damages filed against the Seller and the MD and ordered the Buyer to pay a portion of the respondents' legal fees.

The Ruling was not published in the '*Bulletin*', reserved for reporting the Court's essential decisions. This is certainly because it is very much fact based and therefore lacks the leading authority of a ruling setting a precedent on general principles of law or deciding on the interpretation of statute. It is, however, a noteworthy decision which might be used by practitioners in post M&A related litigation and should be borne in mind when drafting transactional agreements in France.

The wording of the Representations and Warranties and the grounds of the Ruling

The Court of Appeal quoted the key provisions of the Representations and Warranties:

The extract in relation to the ongoing 'Contracts', quoted by the Court, was drafted as follows:

> 'All the agreements to which the Company is a party are valid and enforceable. The Company (i) has committed no breach of its obligations provided in these agreements, (ii) has not terminated any of these agreements, (iii) is not aware of any breach of the agreements by the other contracting party, and (iv) has not been informed of the other contracting parties' intention to terminate the agreements or to amend them in a way less favourable to the Company.'

The extract in relation to the 'Business Material Adverse Effect', quoted by the Court, was drafted as follows:

> 'Since the date of the interim accounts at 30 June 2011 and until the closing date, i.e 14 September 2011, there has been no change in the business activity, except during the vacation period. The Guarantor is not aware of events or facts which materially and negatively impact as of the date hereof the business activity, the financial situation and the assets of the Company.'

The extract in relation to the warranties on the 'Factual Representations', quoted by the Court, was drafted as follows:

> 'The Guarantor warrants that all statements are complete and accurate and agrees to indemnify the Beneficiary from any and all losses incurred by the Beneficiary arising out of the inaccuracy in any representations or the omission of material information in relation to the Company.'

Surprisingly, and this was pointed out by the Court of Appeal, no list of Material Agreements including agreements with strategic clients was attached as an exhibit to the Representations and Warranties and the *Contracts* clause addressed all the ongoing agreements.

On the basis of this finding, the Court of Appeal considered that all the Target's clients were 'interchangeable'[4] and that the end of the business relationship with HMF did not per se, as under the Factual Representations provisions, qualify as an omission to provide material information in relation to the Company, which would have required (implicitly for the Buyer) to determine which agreements were material and to list them in an exhibit to the Representations and Warranties.

The Cassation Court took a different view, even though it eventually dismissed the Buyer's appeal. Indeed, it stated that the parties to the Transaction had made indemnification by the Seller subject to a loss incurred by the Beneficiary (apparently the Buyer). In that respect, as mentioned above, it ruled that the Court of Appeal 'had legitimately inferred, in exercising its discretion,[5] that there was no evidence that the Target had incurred a loss resulting from the termination of the HMF agreement'. This enabled the Cassation Court to set aside, without considering it, the Buyer's argument that the increase of the Target's turnover after the closing of the Transaction was only and solely the result of his efforts and dedication to develop the Target's business and remedy the significant loss in

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4 '*Il apparait ainsi que l'ensemble des clients de STDU ont été lors de la cession considérés comme interchangeables et que la fin des relations avec HMF ne constituait pas au sens de l'article 2.1.1 de la convention, l'omission d'informations significatives … qui aurait imposé au cédant d'en faire état en annexe des documents contractuels.*'

5 '*Qu'en l'état de ces seuls motifs, dont elle a souverainement déduit qu'il n'était pas démontré que la perte de ce client ait eu des conséquences dommageables sur l'activité de la société STDU, la Cour d'Appel a pu rejeter les demandes d'indemnisation formées …*'.

turnover which resulted from the termination of the HMF agreement.

Lessons to be drawn from the Ruling

The question, as often, is whether the Buyer's legal situation could have been different and improved and if litigation could have been avoided, if the Buyer had proceeded differently, or if the Transaction had been entered into after the implementation of the Reform Bill[6] on contracts, which came into force on 1 October 2016.[7]

Here are some guidelines for reflection in that respect:

1. It would probably have been useful (subject to the agreement of the Seller and Buyer and this might not have been easy to achieve in this matter) to:
   (i) Determine a list of the Target's strategic customers, which would have obviously included HMF, considering its substantial contribution to the Target's turnover, and
   (ii) Request confirmation (in the form of a condition precedent) from each strategic customer, between the signing and closing of the Transaction, that they had no intention of terminating their agreement with the Target because of the Seller and Buyer closing the Transaction.

   Had this been agreed and carried out, the termination of the HMF agreement would certainly have been disclosed and the Buyer would have been in a position to either renegotiate the purchase price, or not close the Transaction.

   Interestingly, neither the Court of Appeal, nor the Cassation Court determined in their rulings whether the representations in relation to the contracts were made as of the interim accounts, i.e after the occurrence of the termination of the HMF agreement, or as of an earlier or a later date. Obviously, this was not an issue which was debated.
2. Unfortunately, neither the Court of Appeal, nor the Cassation Court made a reference in their rulings to the definition of a loss ('*un dommage*') as per the Representations and Warranties.

   We assume that this is because the loss, as defined in the documentation, was of no use to solving the case.

   Indeed, a loss, or an indemnifiable loss is often defined as 'any and all actual losses liabilities, claims, damages, reasonable costs and expenses including reasonable fees and expenses of counsel, incurred or suffered by the Buyer and arising from or related to any inaccuracy of any of the representations and warranties made by the Seller [and the Seller's parent company]'

   In the present case, such a definition would have been of little help to the Buyer, considering the Ruling.

   The question then, considering the alleged importance of the strategic customers and more specifically of HMF to the Buyer, is whether it would have made sense to include an ad hoc clause in the Indemnification provisions specifying how to calculate a loss in the case of an undisclosed loss of a strategic client, or of any client, as provided in the Representations and Warranties.

   Obviously, adding very specific and tailor made wording to the various indemnification provisions, when the deal is of a minor size, as was the case in this matter or when the solution suggested above under 1 (i.e requesting confirmation from the strategic customers) can be implemented, may trigger tedious discussions and make little sense.

   An alternative solution could have consisted in widening the definition of a loss in the contractual documentation and including therein that a revenue shortfall resulting from the failure to disclose the termination of an ongoing agreement would qualify as a loss, whatever the subsequent profits generated by the Target. But again, such an addition may trigger serious discussions which could be avoided by implementing the modus operandi suggested under 1 above.
3. The claim filed against the Seller was of a contractual nature and based on the breach of the Representations and Warranties made and agreed to by the Seller. It failed because of the Buyer's inability to evidence that he suffered a loss resulting from the non-disclosure of the termination of a strategic customer agreement.
4. The Seller's intentions, if any, relating to the termination of the HMF agreement was not evidenced and not even debated in this matter. None of the court rulings therefore are instructive in this respect.[8]

   However, in relation to future cases brought before the courts, if the facts lead to a finding of an intention to conceal, deceive or lie then other relief may be pleaded.

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6 Ordonnance 2016-131 du 10 janvier 2016.
7 Further changes were added to the Reform Bill, in April 2018, and will enter into force on 1 October 2018.
8 The Court of Appeal, however, made an interesting statement in its ruling: It noticed that the Buyer had not grounded its claim on fraudulent deceit and was not therefore asking for a price reduction.

In the event that evidence exists, a purchaser may assert a claim against a selling party based on general contract law principles and, more specifically, based on the concept of fraud by deceit ('*dol*') subject always to evidencing intent.

Article 1137 of the French Civil Code provides that 'fraud by deceit is the fact for a party to obtain consent from the other party to a contract by deception or lies. Intentional concealment by a party to a contract of information which he knows to be decisive for the other party also constitutes fraud by deceit'.

As from 1 October 2018, a further section, added to Article 1137 of the Civil Code, limiting the scope of fraud by deceit will be effective. This further section reads as follows: 'the fact for a party not to disclose his estimation of the value of the service does not constitute fraud by deceit'.

When '*dol*' can be established, the plaintiff may either ask for the nullity of the agreement, or for damages based on the loss of an opportunity ('*perte de chance*') of having been in position to reach a better deal.

In the event that a buyer opts for this course of action, in an appropriate case, rather than filing a claim for damages consequential to loss occasioned by a breach of contractual representations and warranties, then damages would be calculated in accordance with the possible rebate on the purchase price for the shares paid by the buyer and the loss of the opportunity of negotiating and obtaining this rebate. However, the damages resulting from the loss of an opportunity are usually substantially lower than those resulting from a loss further to a breach of a representation, because of the method used by French courts to appraise their amount.

According to a working document recently issued by the Paris Court of Appeal, when a judge is required to appraise the damages resulting from the loss of an opportunity, he must:

(i) first determine the value of the lost gain resulting from the lack of disclosure (e.g: 15% of the purchase price),

(ii) determine the probability (e.g: a one in three chance) of the favourable event happening, for example, the negotiated rebate on the purchase price of the shares, and

(iii) multiply the value of the lost gain by the probability of the favourable event happening, being in this example (a 15% reduction divided by three) a 5% reduction on the purchase price.

5. Finally, it is worth adding that since October 2016, there has been a statutory duty of disclosure of information, imposed on the party to a contract who is aware of said information and of its decisive nature to the other party's consent. This duty of disclosure, provided by Article 1112-1 of the Civil Code, can neither be waived nor limited by contract. The Code adds that, beyond the liability of the party bound by the duty of disclosure, the failure to disclose decisive information may trigger the nullity of the agreement. Furthermore, Article 1130 of the same Code provides that, 'the decisive nature of the information is appraised in consideration of the parties and the circumstances in which consent was given'.

In conclusion, therefore, beyond the need of an in depth review of the target's business, key agreements and financials, serious consideration – depending on the wording of the documentation and the breach by a selling party of his contractual and/or statutory duties – must be given to the nature of the claim to be filed against the Seller in an M&A transaction.

This Ruling also shows to what extent a loss, as defined in the contractual representations and warranties, may be unexpectedly difficult to evidence.