Current issues in Warranty & Indemnity market (2024) - Insights from recent case law

Introduction

In late 2023, our Forensic M&A Services team held a number of Roundtable discussions with leading M&A lawyers, insurance underwriters and brokers to discuss key themes and trends in the Warranty & Indemnity ('W&I') market. Our discussions focused on three main areas:

- Valuation issues
- Material adverse change warranties, and
- Knowledge and disclosure issues.

Each of these areas were relevant in two significant cases where judgments were handed down in 2023; namely *Finsbury Food Group Plc v AXIS Corporate Capital UK Ltd & Ors* ('Finsbury Food') and *Decision Inc Holdings Proprietary Ltd & Anor v Stephen Garbett & Anor* ('Decision Inc').

We are delighted to present our findings in this article which we hope you find interesting and informative. We would like to express our gratitude to all those that participated in our Roundtable discussions.

Valuation issues

As part of our Roundtable, we covered three current issues in relation to valuation aspects of claims, namely:

- Establishing the basis of valuation
- The treatment of recurring versus non-recurring items, and
- Adjustments to both EBITDA multiples and valuation EBITDA (ie 'a double dip').

Establishing the basis of valuation

When pursuing a claim, it is important for the buyer/seller to be able to demonstrate and evidence the basis of valuation applied and the underlying methodology and assumptions used when estimating the offer/purchase price. If an earnings-based valuation was used, then there should be a clear trail to support the expected future earnings of the target and the earnings multiplier being used as buyer/seller knowledge can become important, in any claim made. As due diligence and negotiations progress, the end purchase price is often different from the original price considered or offered.

Establishing the basis of valuation is important as the amount of damages in a W&I claim is commonly calculated as the difference between the value of the business as warranted (the 'Warranty True Value') (i.e. the value if all the warranties given are in fact true) and the actual value of the business with the warranties not being true (i.e. a breach of the warranties) (the 'Warranty False Value').

It is not uncommon to assume that the Warranted True Value of a business is represented by the price actually paid. However, it can sometimes be demonstrated that the market value was actually lower than the price paid, indicating that the buyer was a 'special purchaser' and therefore prepared to pay a premium over the market value.

The approach to assessing the Warranty False Value is to adjust the Warranted True Value for the financial impact of the breach, whether as a recurring impact (applying a multiple) or as a one-off (£ for £) impact.

In this regard, we continue to see instances where the claimants seek to advance a claim suggesting that they based their valuation on a particular earnings figure (commonly an adjusted EBITDA) and a set EBITDA multiple with the aim to quantify their claim on that basis. The earnings figure may be based on historical earnings or projected or forecast earnings. This is sometimes the case even where there is contemporaneous evidence to suggest that is not how they valued the business at the time. Our Roundtable attendees were not surprised by this so called 'reverse engineering' which appears to be a common issue.

Further comments from our Roundtable attendees were that:

Underwriters ought to seek more information on basis of valuation, including supporting documents	More transparency required from the Insured in providing information on the key drivers of value	Typically, PE investors are more transparent on valuation than private investors
Responses to questions of the insured prior to completion around valuation matters vary widely in terms of quality	The sooner insurers are provided with the necessary information and evidence around the basis of valuation the better	Where claims are submitted on a different valuation basis to that advised at the time of the transaction, further investigative work will be necessary

Treatment of recurring versus non-recurring items

A common issue that we've seen is claimants seeking to advance a claim that all the alleged breaches of warranties have led to an ongoing and recurring impact on earnings despite little or no evidence to support the position. Similar to the above issues in respect of establishing the basis of valuation, insureds may then seek to quantify the claim by using a multiple. Further, where there isn't evidence to support a multiple being used, the claimants are often reluctant to accept that losses ought properly to be adjusted on a '£ for £' basis.

We have seen an insured advance a claim for a recurring impact on EBITDA despite contemporaneous evidence that similar items were accounted for in the locked box and EV to Equity bridge as '£ for £' adjustments.

Our Roundtable attendees also highlighted that:

- It's very beneficial for claimants (and insurer respondents) to get forensic accountants involved at an early stage to make an assessment of quantum (and liability issues where relevant) to enable the lawyers/insurers to consider how realistic the quantum claimed is
- An early assessment of quantum is important to 'focus minds' around negotiations for a settlement, and
- The claimant needs to be able to articulate how an issue has occurred, and its effect, to enable insurers to consider how it impacts quantum.

The 'double dip'

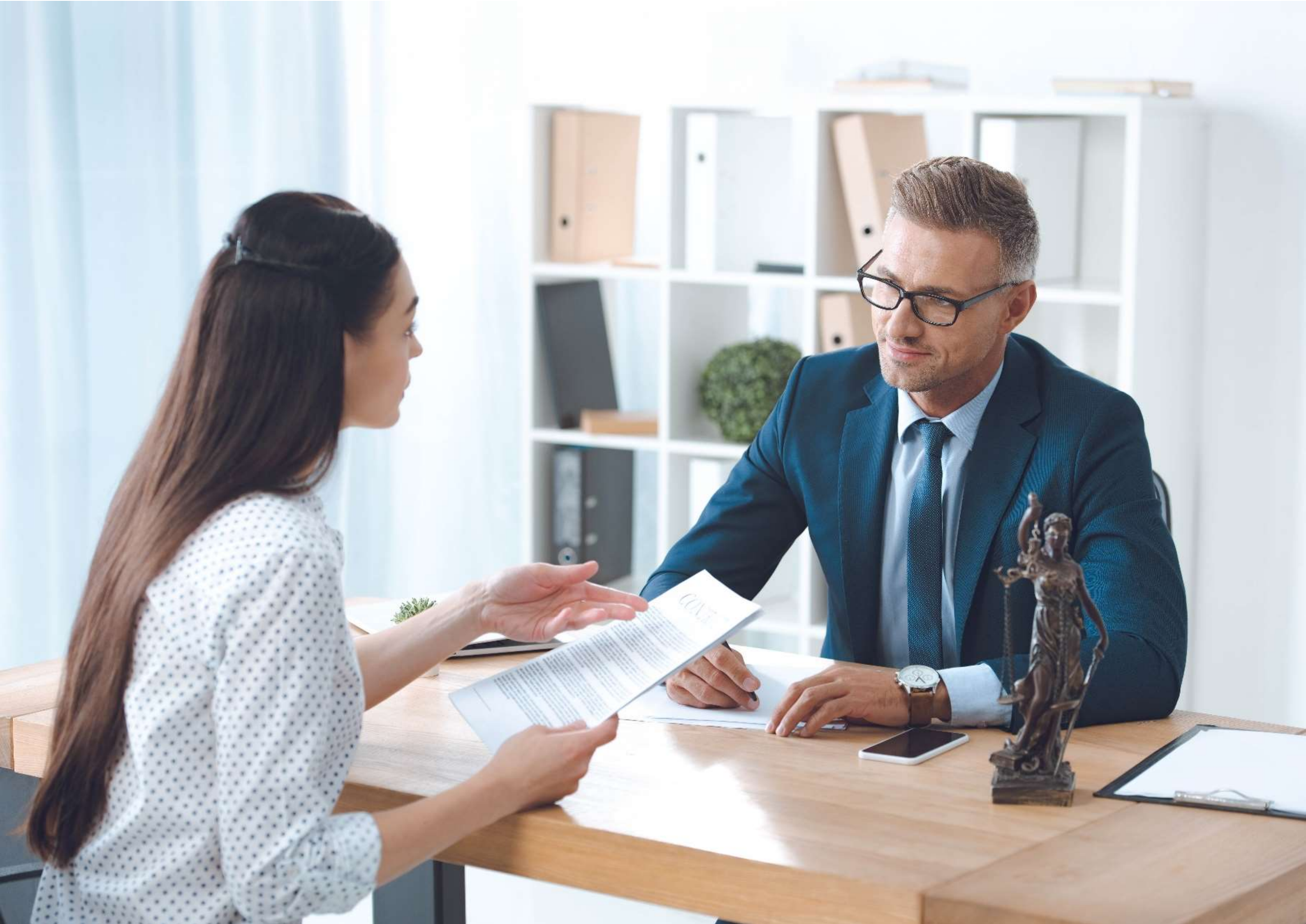
We have seen examples of claimants seeking to argue that had the true position been known, they would have applied a lower multiple when arriving at their original valuation. As a result, a claim for the reduction in earnings as well as a claim for a reduction in the multiplier is maintained, which has the impact of increasing the loss claimed.

Factual evidence from the basis of valuation adopted is key. Knowledge of known financial matters that impacted the transaction value (or not) before the completion date is an important consideration when assessing the materiality of any adjustment to both EBITDA and the multiple arising from a breach. The impact on the multiple following a breach also needs to consider the risk of both the breach itself and any widespread accounting practices, poor governance, and business risk.

Our Roundtable attendees further noted that:

Non-accounting matters such as allegations of fraud tend to be more likely to engage judges in relation to reduction in multiples	Information on multiples for competitors or comparable companies is useful in demonstrating whether the attempt to reduce the multiple is justified	Before seeking to advance a claim for a reduction in multiple (as well as earnings), tactically it is important to question how it will be received

	Finsbury Foods	Decision Inc
Case Background	In this case, the buyer (Finsbury Foods) had brought a breach of warranty claim under its W&I policy alleging there had been a breach of material adverse change warranty, (referred to in the Judgment as the ‘Trading Conditions Warranty’). Legal arguments were made as to the interpretation of the Trading Conditions Warranty and the Judge found it constituted two separate warranties (firstly re loss of custom and, secondly, relating to the loss of a specific customer). The Judge found that for a material adverse change to have occurred, it must exceed 10% of total group sales. The Judge ultimately found there was no liability for a breach of the warranty.	This was a case heard at the start of 2023, where it was alleged by the Buyer that there had been a breach of the ‘Prospects Warranty’ in the SPA which stated: *“Since the Accounts Date … there has been no material adverse change in the turnover, financial position or prospects of the Company.”* The Judge at first instance found that there had been a material adverse change in the prospects of the company and thus a breach of the Prospects Warranty. The defendants appealed against that finding, and in November 2023 the Court of Appeal handed down judgment in favour of the defendants, upholding the appeal.
Valuation Issues	The Judge found that even if breach had been proven, there was no loss as the buyer would have proceeded in any event, with the acquisition at the agreed price £20 million.	The Judge did not permit the claimed reduction in multiple as well as a reduction in EBITDA, as it could, in his view, amount to a double impact.



Material Adverse Change

We have seen an increasing number of cases related to breach of the material adverse change ('MAC') warranty. The issues around what constitutes a MAC have been exemplified in a number of recent cases, in particular Decision Inc. and Finsbury Foods.

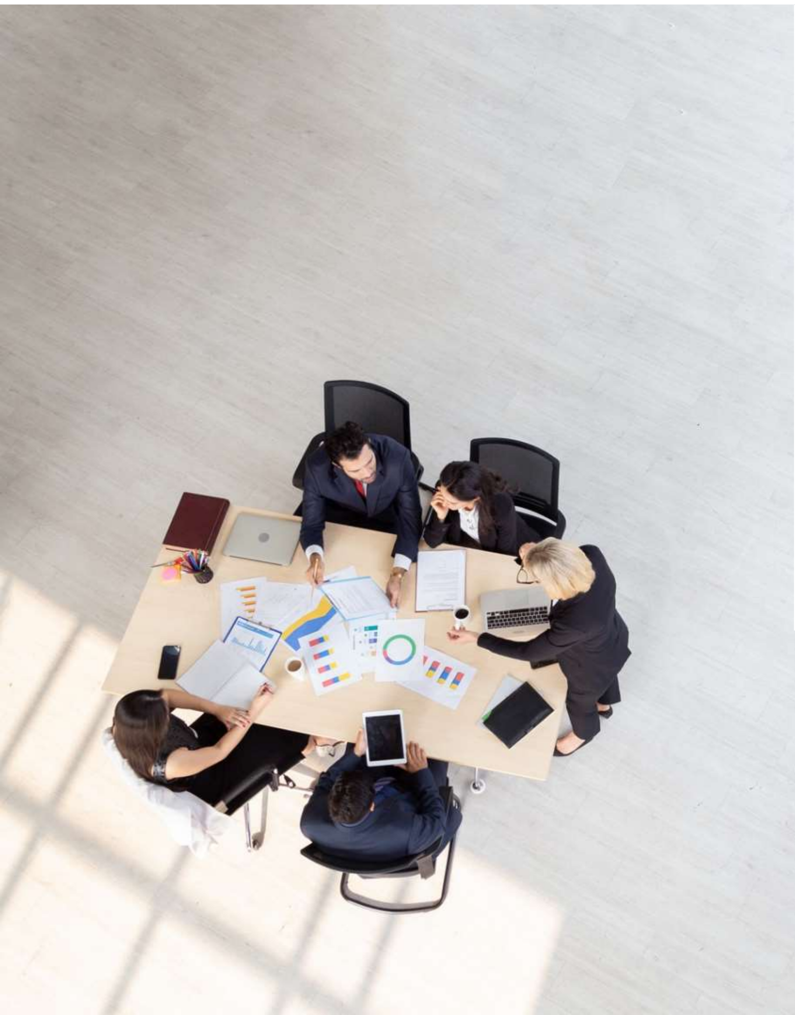
Defining a MAC

Is it generally accepted that a 'material adverse change' means something that is substantial or significant, as opposed to something of a de minimis level. However, in our experience it is rare for the SPA to contain any specific guidance around what constitutes 'material' and MAC clauses are often left relatively vague as to what actually constitutes a MAC.

Defining specifically what constitutes a MAC within the SPA can be very difficult due to the number of elements that materiality can depend upon. As noted by our lawyer attendees, when drafting an SPA arriving at a definition of what constitutes a MAC can be a block to finalising the SPA as the parties are often unable to agree on the definition.

This is often an issue we experience when reviewing the terms of SPAs prior to completion, with sellers looking for more specific wording, whereas a buyer often wants more general wording to give them increased flexibility in relation to any possible MAC claim they may want to bring post completion.

The Decision Inc. case highlights some of the issues that can arise in relation to warranting prospects and the difficulty of assessing a change in prospects. Indeed, as part of our pre deal SPA review work, we often see sellers understandably refusing to provide a MAC warranty in relation to prospects, and it is a common area of negotiation between the buyer and the seller.



Assessing a MAC

In assessing whether or not there has been a MAC, it can be tempting to reduce this exercise to merely a numerical measure of examining the change in performance against percentage change thresholds. Our broker attendees stated that in their experience, this is the approach taken by a number of insurers when assessing a MAC, and indeed our insurer attendees confirmed that is often their starting point as it simplifies the exercise.

However, a crucial point around assessing a MAC is that what is material very much depends on the specific circumstances of each case, and something which is material in the context of one transaction for a particular buyer may not be material for a different buyer. In each case it is important to consider the perspective of the actual buyer, for example, are they buying for a long-term investment (in which case a shortfall of profits in two months may not be material if the long-term prospects are not impacted) or are they a short-term speculator (in which case the same two-month shortfall may be material).

Whilst accounting materiality in mathematical terms (ie a set percentage change in profits or sales) can be a useful starting point to assess a MAC, what is material in a transaction is what is material to those particular parties, and in particular if either party had known about the issue, would the party either have declined to proceed with the transaction at all, or agreed to proceed only after a renegotiation of the financial terms and the transaction value. This can mean that even if something was material in accounting terms, it may not be material in the context of the transaction.

In our view, assessing materiality should not just be reduced to purely a mathematical exercise. Given that a buyer would generally prefer to keep this definition broadly worded for a wider coverage against the seller who may prefer to limit it, SPAs do not commonly have any specific mechanisms to address materiality thresholds for a MAC.

Summary

There is no set single definition of what a material adverse change is or whether something is material, either in law or accounting. Unless specified in the SPA or the W&I policy, courts will interpret what they consider constitutes a material adverse change based on the particular circumstances of the case. This is an area which is often not clear cut and requires an element of judgement, which can thus sometimes lead to unexpected results for parties.

MAC & Materiality

Finsbury Foods

In the SPA, there was a general warranty that there had been no material adverse change in the trading position or turnover of the Target, which stated:

"There has been no material adverse change in the trading position of any of the Group Companies or their financial position, prospects or turnover and no Group Company has had its business, profitability or prospects adversely affected by the loss of any customer representing more than 20% of the total sales of the Group Companies…" [Emphasis added] but what constituted a MAC was not defined in the SPA.

The dispute around this warranty concerned what constituted a material adverse change, and did it have to be a change of 20% of total sales (as argued by the insurer).

The Judge noted that whilst the SPA was not well drafted, he considered the specific disputed warranty consisted of two parts, a general warranty that there had been no material adverse change, and a separate warranty that there had been no loss of any customer representing more than 20% of total sales.

The Judge stated that there is no set meaning to the term material adverse change but referred to a number of other recent cases which considered similar terms. Ultimately, the Judge considered that in this specific case a MAC had to exceed 10% of total group sales. The Judge did not give any detailed reasoning for how he arrived at 10%, but merely stated to his mind this would be:

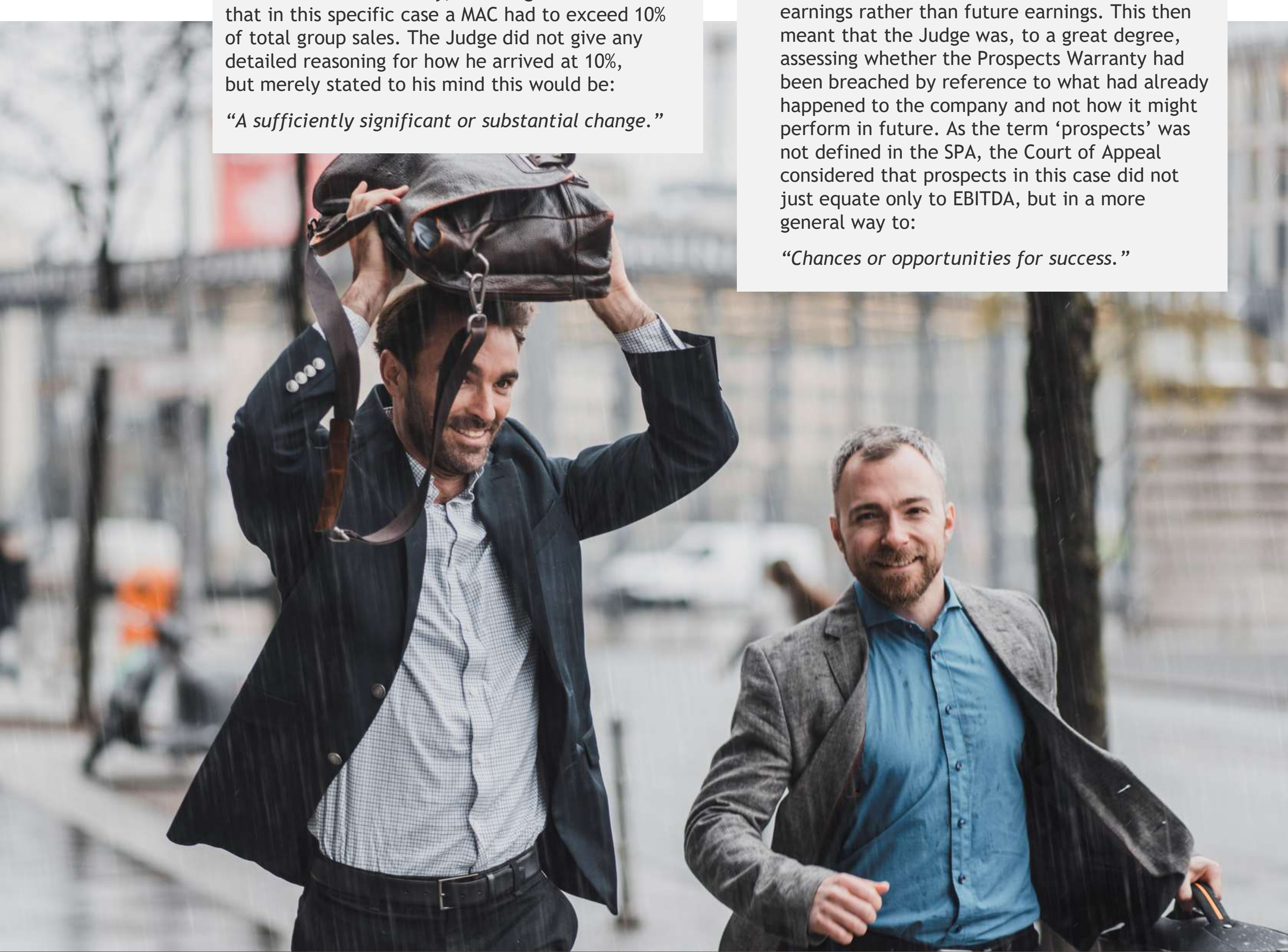
"A sufficiently significant or substantial change."

Decision Inc

The Judge at first instance found that there had been a material adverse change in the prospects since the Accounts date of the company and thus a breach of the Prospects Warranty. The defendants appealed against that finding, and in November 2023 the Court of Appeal handed down judgment in favour of the defendants, upholding the appeal. In relation to the method used by the original Judge to assess the Prospects Warranty, the Court of Appeal noted the following:

- The original Judge had misinterpreted and misapplied the Prospects Warranty, as he had essentially made the wrong comparison in assessing that warranty. In assessing whether a MAC had occurred, the Judge had erroneously compared the expectation of prospects of a reasonable buyer with the actual prospects as at the Completion Date (i.e. a comparison of **expectation** versus **actual** prospects at the **same date**), whereas the Court of Appeal found that they should have instead compared actual prospects on the Accounts Date and the Completion Date (i.e. a comparison of **actual** prospects at **two different dates**)
- The Court of Appeal also had issue with the Judge's use of EBITDA to assess prospects, in particular as the specific EBITDA figure the Judge had used consisted primarily of historical earnings rather than future earnings. This then meant that the Judge was, to a great degree, assessing whether the Prospects Warranty had been breached by reference to what had already happened to the company and not how it might perform in future. As the term 'prospects' was not defined in the SPA, the Court of Appeal considered that prospects in this case did not just equate only to EBITDA, but in a more general way to:

  "Chances or opportunities for success."



Knowledge and disclosure issues

Issues around knowledge and disclosure often arise in W&I claims and as a result knowledge and disclosure clauses in SPAs and W&I insurance policies are an important consideration for all parties.

In the context of a warranty claim we regularly see defences raised regarding knowledge and/or disclosure. For example:

- The Buyer having actual knowledge of the alleged breach prior to the transaction, based on information that formed part of Disclosure
- Actual knowledge of the issue would have had no impact on the purchase price in any case, since it was a 'fixed price' deal, or the buyer was a 'special purchaser'
- Policies requiring it necessary to demonstrate that the Warrantor had knowledge of the subject breach.

Knowledge

Our roundtable attendees highlighted the important distinction between disclosure and knowledge and noted:

It can be difficult to prove actual knowledge, absent a clear document as proof of the matter in question, and there can be grey areas around knowledge of what (albeit this may sometimes be addressed to an extent in SPA/ policy definitions)

From an insurance perspective, there is unlikely to be a pay out if there is evidence that the Buyer was aware of something. An insurer is likely to consider any knowledge as relevant, and if there is knowledge, there is no cover

In recent deals the specification of knowledge has been further limited to certain warranties for each individual named. This would inevitably limit the enforceability of knowledge exclusions and make it harder for Sellers to defend breach of warranty claims on grounds of Buyer knowledge

At inception of a deal, a Buyer may have an underlying concern or knowledge of an underlying issue but may not fully understand potential financial impacts of that issue and/or impact on valuation. If the Buyer can link the two together then they are potentially in knowledge of the breach. However, where this is not practical/feasible there is no knowledge exclusion

Disclosure

- Considerations of whether disclosures are 'fair disclosures' are critical, and this is not always clear cut. This is increasingly the case with ever-increasing volumes of electronic documents deposited prior to a deal in the Data Room
- Documents contained in the Data Room are not automatically considered 'fair disclosure' (from a legal or insurer perspective)
- If a party is required to piece together a number of documents in the Data Room to fully understand the relevance, this may not be considered as fair disclosure
- This can be complicated further, however, as our attendees have seen 'fair disclosure' being defined differently under each of the SPA and the W&I policy.

Summary

Knowledge and disclosure, and the relevant policies thereon in the SPA and the W&I Insurance Policy, are areas of key focus for parties, lawyers and insurers prior to a deal. Recent cases have highlighted the importance of these in relation to W&I claims and hence for parties to understand the full scope of the specific exclusion clauses, as it is clear that claims can be rejected on these issues alone.

Knowledge & Disclosure issues

Finsbury Foods

The Judge considered whether the buyer's knowledge exception in the SPA and the Policy would operate to prevent cover even if a breach of warranty were established.

The knowledge test specifically related to disclosures which the Defendants claimed demonstrated the very thing that was subject to part of the warranty claim.

In this case 'Actual Knowledge' was defined in the Policy and did not include constructive or imputed knowledge.

The Judge found that the evidence of two key Finsbury witnesses relevant to knowledge was 'untruthful' and was satisfied that a member of the deal team (specified in the SPA) did have sufficient information available to him for the buyer Knowledge Exclusions to apply.

Decision Inc

In the Decision Inc matter, the SPA included an 'anti-sandbagging' clause, designed to ensure that the buyer cannot walk into an acquisition when aware of breaches of warranty and then claim compensation.

The buyer had expressed concerns regarding financial data relating to key contracts pre deal, but ultimately signed the deal.

The judge's decision was that although the buyer could arguably have discovered the true position if it had made further enquiries, based on the information it had actually received pre deal, it had not actually been aware of the true position or, therefore, the breach of warranty.

A highly experienced team specialising in W&I

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