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Substantial illiquidity of the buyer's remedy in company acquisition agreements

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A liquidity gap is explored in the standard contractual liability for an inaccurate representation or a breach of warranty in company sales and purchases.

1. ***Purpose.*** It is the purpose of this section to recall, or explain to those who do not know, how illiquid a buyer's remedies ordinarily are in company acquisition agreements and how weak his position is under standard agreements drafted for such a purpose. For simplicity's sake, let us assume that the buyer only has a compensatory remedy (cannot terminate, void, etc.) or that, in any case, this is the remedy that he seeks. We shall bypass the particular case where the seller has acted with malicious intent.

2. ***R&W event.*** For the purposes of this section, "R&W event" refers to the occurrence of factual circumstances that are the content of a representation & warranty clause (R&W), that is, the disclosure of a R&W's falsehood. R&W events must always occur before closing, but may represent themselves before or after closing, in what we call the R&W "survival period".

3. ***When is the event disclosed?*** But what does "disclosure of the R&W event" mean in the R&W survival period? We shall ignore third party claims, where the circumstances are clear, and imagine a R&W that states that the seller or target has not engaged before the purchase in conduct prohibited by anti-money laundering rules. The "disclosure" of the event (say, within three years) may involve different things. First, the R&W event has been disclosed

within the time limit, but the buyer is not yet aware. Second, the buyer is *aware of a serious risk* that the event will occur, within or not within the time limit. Third, the event has been disclosed *prima facie* within the time limit, but the process of confirmation of the event has not concluded and there is no loss yet (for example, disciplinary proceedings have been opened by the competent administrative or criminal body). Fourth, the R&W event has been fully disclosed, but there is not yet a *loss event for the target* and it may never exist in the form of a penalty or other negative pecuniary consequence. Fifth. Financial loss has been disclosed, though it has not yet been quantified. Sixth, the loss event must be a *claim-for-damages* event within the R&W survival period.

4. ***A claim is the loss event.*** Which of these forms of disclosure is decisive and necessary? *Agreements do not always determine this issue.* Specifying in some manner what is meant by "loss" is customary. But this alone is not enough. If the agreement has framed, as is customary, a *compensatory remedy* for a R&W event, it is deemed that this compensatory remedy will not apply if there is no certain and non-contingent loss. If compensation (*or price adjustment*) is the remedy, it must be concluded that the financial loss event (even if not yet quantified) must have been disclosed within the R&W survival period, because the *buyer has no choice but to make a claim for damages, even if approximate, during this survival period*. It is not enough, therefore, that in the disclosure of a R&W event, that it is not a loss event, the sure occurrence of a loss is somehow latent. But an unclaimed loss is not enough either. The claim is the "loss event".

   "R&W events" are usually far from being "loss events", which means that the disclosure of the circumstances of falsehood (an inaccurate representation or a breach of warranty) during the R&W survival period will not usually lead to the determination of the occurrence of a liability event during the course of the R&W survival period.

5. ***R&W "survival period".*** The post-closing period in which the R&W survives may be configured in different ways in those R&W events that are not a third party claim. (1) A first or several post-closing periods, which is the maximum time limit in which a R&W event can represent itself, followed by one or several shorter limitation periods for an action against the seller. (2) One or several common time limits in which both the R&W event and the claim must have taken place. (3) One or more time limits for disclosure of the event, without establishing anything about the limitation periods for the appropriate action to be brought, it being understood that the latter would be governed by civil law. (4) Survival of the R&W without a special term and subject to the ordinary statute of limitations.

   If our agreement is one of those that states that the R&W *will survive until XX and that no (court or out-of-court) claim can be made once this period has expired,* our model is of the type (2) above. The same seems to be true if our agreement is expressed as follows: *the sellers' liability in relation to all other representations and warranties will be extinguished once a period of* three years from the date of closing has elapsed; or t*he duration of the obligation to indemnify will* last three years.

6. ***What claim?*** A court claim? Or does an out-of-court claim suffice? There are agreements in which it is specified that the loss event is understood to have occurred during the survival period if an out-of-court claim is made in this period or if the out-of-court claim is made within a short period of time after the expiry of the survival period. These agreements suffer from an insurmountable gap: when an out-of-court claim is made, how much extra time can run until the court or arbitration claim (that will almost certainly be made)? The statutory limitation period, which we deem to have been *interrupted* when the claim was made during the R&W survival period? What if the agreement does not specify that the loss event can be an out-of-court claim? The consequence is clear: whether it is one form of claim or another, a court claim must also be made within the R&W survival period, unless otherwise provided, because neither this time limit is a limitation period nor can it be civilly "interrupted". The foregoing equally applies to third party claims.

7. ***Precis.*** Let us bring to a close our line of reasoning with a precis. If the remedy for an inaccurate representation or a breach of warranty is compensatory, during the R&W survival period the claim for the actual loss event must have already been made. It is not enough that the occurrence of an event is seriously feared (there is no room for precautionary claims), it is not enough that the R&W event has been disclosed if this event is not strictly a loss event. It is not enough for the loss to be latent; it is not even sufficient for it to be patent. A claim for compensation must have been made and - unless the agreement provides otherwise - this claim must have been made before a court of law or court of arbitration before the R&W survival period expires, at least with stipulations in which the R&W survival period is expressed as a deadline for any liability or compensation.

   Since it is very difficult for all of these things to occur in the (ordinarily) short survival period of a R&W, the buyer is reduced to a highly compromised illiquid position; unless a remainder of the price remains to be paid and the buyer can *successfully raise a precautionary defence by analogy with art. 1502 of the Civil Code* or has the option and the intention to terminate the contract for breach or to void it for malicious intent.