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Legal implications of the qualification "best actual/constructive knowledge" in seller's warranties

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Introduction

In M&A transactions, the share purchase agreement (**SPA**) creates a great playing field for seller and purchaser (and their legal advisers) to try and allocate their respective risks. The preferred tool to do so is the warranty provision. The purchaser will want to include as many seller's warranties as possible in the SPA to (i) gain comfort about the company and the business it is purchasing and (ii) encourage the seller to reveal as much information as possible. In turn, the seller will aim to provide the purchaser with as few (non-essential) warranties as possible – or to limit a large part hereof to the facts it knows (the **best knowledge qualification**) – in view of the legal implications of breaching a warranty.

Although the use of warranties in M&A transactions is common practice, the concept remains undefined in the Dutch Civil Code (**DCC**). As each SPA is specifically drafted according to the needs and negotiating position of the respective purchaser and seller, there is no precise meaning of the term 'warranties' and the related legal consequences within the M&A practice. The influence of English contract law in Europe has not clarified the concept in the Netherlands. Nowadays, it is quite common to draft Dutch law SPA in English, in which certain seller's warranties are qualified as "*warranties to the best actual/constructive seller's knowledge*". To execute a successful M&A transaction, parties (and their legal advisers) need to have a good grasp of the warranties concept and the legal implications of the best knowledge qualification in Dutch law.

1. Warranties in SPA

1.1 Definition and legal implications

A contractual warranty can be defined as a statement made by one party to the other party regarding the existence or absence of a fact. The seller will usually give warranties about (i) the company that is sold (the **target**) and (ii) its authority to sell and deliver the target to the purchaser. The purchaser will usually only give warranties about its authority to purchase and accept delivery of the target.

Should a warranty provided by one party be incorrect (because a warrantied fact does not occur), then that party has breached one of its obligations under the SPA.[1] A reliance on force majeure will in principle be excluded for that party. Warranties therefore create a risk allocation of facts and circumstances occurring after the conclusion of the SPA and/or the transfer of the shares in the target from seller to purchaser.[2]

Seller's warranties regarding the target can be seen as a further interpretation of the rule of conformity as set out in Section 7:17 DCC. A breach of such a warranty would therefore constitute non-conformity. The purchaser is then in principle entitled to repair and/or replacement of the defective item pursuant to Section 7:21 DCC. The application of Section 7:21 DCC is generally excluded (at the request of seller) in the M&A practice. This Section, together with Section 7:17 (non-conformity) and paragraphs 1 and 2 of Section 7:23 DCC (purchaser's obligation to complain and the statute of limitations)[3], is not mandatory law between professional parties. It is therefore not unusual for a professional purchaser to waive its rights under these provisions. Since repair or replacement of the defective item is generally excluded in the SPA, the purchaser is usually only entitled to (limited) damages for breach of a seller's warranty.

By including or excluding seller's warranties in the SPA, parties also attempt to define the limits of the seller's duty to disclose and the purchaser's duty to investigate. The full set of seller's warranties gives insight into the target and its business that are important to the purchaser. If, for example, the IP rights held by the target are important to purchaser, it will want to include some IP rights-related seller's warranties in the SPA. If the purchaser requests such a warranty and the seller is unwilling to give it, the latter will have to explain the reasons for not including this warranty in the SPA. The purchaser will therefore be informed more quickly of any problem (defect) related to the target. The outlines of the seller's duty to disclose will become more defined.

The purchaser may, in principle, rely on the accuracy of the seller's warranties. If the seller agrees to include a warranty and it is clearly formulated, then the seller will not be able to invoke the purchaser's duty to investigate in the event of a breach of this warranty.[4] However, if the seller's statement is unclear, a professional purchaser should enquire with the seller as to the meaning of the warranty.[5]

1.2 Examples from the M&A practice

When including seller's warranties in the SPA, parties agree which properties the purchaser may expect from the target and its business.[6] Warranties are often not boilerplate clauses, but rather specifically tailored to the transaction at hand. As the seller in an SPA is the holder of the shares in the share capital of the target that are sold to the purchaser, warranties on the shares of the target are always included.

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1 View Parl. Gesch. Boek 6, p. 262 en 264, Asser-Hartkamp 4-I, nr. 21, M.M. van Rossum, in: 'Garanties in de rechtspraktijk', 2002, p.'37-38 (onder c) and D.A.H.W. Strik, 'Aspecten van schadevergoeding bij inbreuk op garanties in overnamecontracten', in: Geschriften vanwege de Vereniging Corporate Litigation 2003-2004, 2004, p. 396. See also HR 10 mei 1963, ECLI:NL:HR:1963:81, *NJ* 1963/288 and HR 5 januari 2001, NJ 2001, 79 (*Multi Vastgoed/Nethou*) (r.o. 3.5).

2 Rb Amsterdam 28 augustus 2019, nr. HA ZA 18-838, ECLI:NL:RBAMS:2019:6379 (*mr. Rombouts*) m.nt. P.G.M. Brouwer en mr. N.G. Dolk.

3 The provision of paragraph 3 is of mandatory law; according to T-M, Parl. Gesch. Inv., p. 147. Asser/Hijma 7-I* 2019/831.

4 M.A.J.G. Janssen, "De onderzoeksplicht bij een garantie", Garanties in de rechtspraktijk (R&P nr. CA12) 2015/2.4.

5 HR 4 januari 1991, *NJ* 1991, 254 (*AICNRG*).

6 R.P.J.L. Tjittes, *De uitleg van garanties en vrijwaringen in overnamecontracten*, Deventer: Kluwer 2008; HR 2 december 1994, NJ 1995, 288 (*Poot/ABP*) (to. 3.4.3).

Warranties on the shares and the authority of the seller to transfer these shares qualify as “fundamental warranties”. These warranties are often expected by the purchaser and given by the seller, usually without subjection to strict exoneration clauses. Warranties regarding the business of the company are, in principle, not recognised as fundamental warranties. The seller will often give an “information warranty”, where it warrants that it has provided the purchaser with all relevant information regarding the target and its business. The wording of this warranty is usually heavily negotiated by the parties, as it has a direct impact on the interpretation of the seller’s duty to disclose.[7]

Finally, the purchaser will also provide warranties regarding its authority to enter the SPA and accept the shares. Often these purchaser’s warranties will reflect the seller’s authority warranties.

2. The best knowledge qualification

2.1 Shift of the risk

It is customary in an SPA to qualify certain (non-fundamental) seller’s warranties to the (best) knowledge of the seller, when it is legitimate for the seller to not be aware of a breach of such warranty at the time the warranty is given.[8]

The addition of the term ‘best knowledge’ in the seller’s warranty means that the seller is not liable for facts of which he was unaware. The risk of those facts (which nobody knows about) then shifts to purchaser.[9] In the case of warranties qualified by the seller’s best knowledge, the purchaser must assert (and, in case of dispute, prove) two points: (i) the incorrectness of a warranty and (ii) the seller’s knowledge.

2.2 Interpretation

The seller’s best knowledge qualification has several wordings. This implies that the extent of the knowledge attributed to the seller under the terms “seller’s best knowledge” will vary from transaction to transaction. For this reason, attention needs to be paid to the definition of the best knowledge qualification in each SPA to get a clear picture of the risk allocation between parties.

The interpretation of warranties[10] (and the best knowledge qualification) in an SPA is subject to the Haviltex formula: *The question of how a guarantee is to be interpreted depends on what the parties in the given circumstances could reasonably attribute to it and what they could reasonably expect from each other in that respect*[11]. Following this rule, the court will consider all the circumstances of the case. If the takeover contract was entered into by professional parties who were both assisted by legal experts, much weight is generally given to the literal meaning of the wording of the clause.[12] Therefore, the more specific and clearly a warranty is formulated, the less inclined the Supreme Court is to interpret it based on the Haviltex formula.[13]

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7 R.P.J.L. Tjittes, *De uitleg van garanties en vrijwaringen in overnamecontracten*, Geschriften vanwege de vereniging corporate litigation 2007-2008, Deventer: Kluwer 2008; Hof Amsterdam 6 november 2012, ECLI:NL:GHAMS:2012:BY8291 (*Amodo/ING*).

8 S.F. Reed & A.R. Lajoux, *The art of M&A. A merger/acquisition/buyout guide*, New York: McGraw-Hill 1998, p. 463.

9 G.C. Linse, ‘Naar beste weten van verkoper’ in garantiebepalingen’, *V&O* 2009.

10 HR 4 februari 2000, *NJ* 2000/258 (*Kinheim/Pelders*): *In the absence of a clear definition by the parties of what is tob e understood by the term “guarantee”, the content of the guarantee obligation will have to be determined each time by way of interpretation*.

11 HR 13 maart 1981, *NJ* 1981, 635 (Haviltex) en later bevestigd door HR 7 februari 2014, JOR 2014/92, m.nt. P.S. Bakker.

12 HR 17 en 24 september 1993, *NJ* 1994, 173 en 174, HR 11 juni 1999, *NJ* 1999/750 (*VHS/Akzo Nobel*), HR 5 januari 2001, *NJ* 2001/79 (*Multi Vastgoed/Nethou*), HR 20 februari 2004, *NJ* 2005, 793 (*DSM/Fox*), HR 19 januari 2007, *NJ* 2007, 575 (*Meyer Europe/Pontmeyer*) en HR 29 juni 2007, *NJ* 2007, 576; Hof Amsterdam 24 april 2018, ECLI:NL:GHARL:2018:3872.

13 HR 5 januari 2001, *NJ* 2001/79 (*Multi Vastgoed/Nethou*); G.T.M.J. Raaijmakers, “Garanties in het contractenrecht”, *Rechtsgeleerd Magazijn THEMIS*, 2005-3.

The best knowledge qualification can be interpreted in different manners, depending on the circumstances of the case.[14] As early as **1986**, the Dutch Supreme Court interpreted in Ernst and Latten v. Crombag-Spaai the term "to the best of one's knowledge" as actual knowledge of the seller, without the need to make enquiries. The Supreme Court thus opened the way to an interpretation of the best knowledge qualification as primarily factual knowledge.[15]

In **2007** the Supreme Court ruled in its judgement Philips/Phoenix that the term 'to the best of one's knowledge' is interpreted as actual knowledge of the seller, having made enquiries.[16] The provisions on the qualification of "*Knowledge*" in the relevant SPA are not written in the Supreme Court judgement. It is therefore unclear whether the definition of "*Knowledge*" in the SPA in this case refers to "*reasonable enquiry*".

Advocate General Keus added that, in his opinion, the interpretation of the Court of Appeal (which has been followed by the Supreme Court) implies that "*Knowledge*" within the meaning of the SPA refers to an already sufficient knowledge of a person on its own and not to a hypothetical sum of inadequate fragments of knowledge present in various persons. In other words, individual factual knowledge must be present and not cumulative normative knowledge.[17]

In 2012, the Court of Appeal ruled that the best knowledge qualification is interpreted as attributing the knowledge of the target's management to the seller. Such knowledge is then not attributed to the purchaser as from the moment that the shares in the target are transferred to the purchaser.[18]

In its judgment of 24 April **2018**[19], the Court of Appeal gave a limited meaning to the term "*Seller's Knowledge*". In its judgement of 24 April 2018, the Court ruled that it does not follow from the definition of *''Seller's Knowledge''* in the SPA that the seller had to submit the business plan to the second-tier management, nor that relevant knowledge of employees can be attributed to the seller without further argument.

Based on the above case law, it seems to me that the best knowledge qualification should be interpreted as the factual knowledge of the seller without enquiry, unless it is otherwise agreed in the takeover contract.[20] If parties have defined the term 'seller's best knowledge' as "*knowledge after reasonable / due and careful enquiry*", then the seller will be expected to make enquiries. In that case, if a warranty has been breached and seller should have known this had he made reasonable enquiries, the seller has breached the SPA, even if it does not have the actual knowledge. The addition of 'seller's best knowledge after reasonable enquiry' in a warranty limits the purchaser's risks compared to the best knowledge qualification without enquiry. The purchaser no longer needs to claim (and, in the event of a dispute, prove) that the seller was aware of the breach of warranty. It must now only claim (and prove) that the seller should have known about the breach of warranty, had it made enquiries.

When determining which enquiries should be made, all circumstances of the case shall be considered.[21] In practice, we usually look at the people within the target who gather information during the due diligence process and the people who answer the purchaser's questions during the expert sessions and Q&A rounds. The seller will, in principle, have to enquire with these individuals.

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14 G.C. Linse, 'Naar beste weten van verkoper' in garantiebepalingen' *V&O* 2009.

15 HR 7 september 2007, ECLI:NL:HR:2007:BA2014 (Philips/Phoenix), waarover ook N. Vles, 'De toevoeging to the seller's knowledge in commerciële overnamecontracten: een slag om de arm', *V&O* 2007, p. 203-205.

16 HR 7 september 2007, ECLI:NL:HR:2007:BA2014 (Philips/Phoenix), waarover ook N. Vles, 'De toevoeging to the seller's knowledge in commerciële overnamecontracten: een slag om de arm', *V&O* 2007, p. 203-205.

17 G.C. Linse, 'Naar beste weten van verkoper' in garantiebepalingen', *V&O* 2009, p. 122-125.

18 Hof Amsterdam 6 november 2012, ECLI:NL:GHAMS:2012:BY8291 (*Amodo/ING*).

19 Hof Arnhem-Leeuwarden 24 april 2018, ECLI:NL:GHARL:2018:3872.

20 See in this context: N. Vles, 'De toevoeging to the seller's knowledge in commerciële overnamecontracten: een slag om de arm', V&O 2007, p. 203-205. For a different interpretation: Mr. G.C. Linse, "Naar beste weten van verkoper' in garantiebepalingen', *V&O* 2009, p. 122-125, die ervan uitgaat dat 'weten van verkoper' verwijst naar feitelijke kennis na navraag.

21 G.C. Linse, 'Naar beste weten van verkoper' in garantiebepalingen' *V&O* 2009.

2.3 Further normative interpretation of the best knowledge qualification

The jurisprudence on the best knowledge qualification mainly concerns SPAs in which this term is defined as 'actual knowledge of the seller after he has made enquiries'. There are, however, other ways to add a normative element to the definition of "seller's best knowledge". For example, parties may use the term "*constructive knowledge*" as opposed to "*actual knowledge*" based on facts.

The knowledge of the seller may also be attributed to the knowledge of the target if parties so agree in the SPA.[22] The best knowledge qualification will then refer to the knowledge present within the organisation of the target and this knowledge will be attributable to the seller.

In the cases mentioned above, it will become increasingly easier for the purchaser to prove that the seller should have known (based on the normative element) about the breach of the relevant warranty. The added value of the seller's best knowledge qualification for the seller will drastically decrease as normative elements are accepted in the definition of "seller's best knowledge".

Conclusion

Warranty clauses are an important tool for the parties in M&A transactions to allocate their risks. If a seller's warranty is incorrect, the seller has failed to comply with the SPA and the purchaser will, in principle, be entitled to compensation. The risk of an incorrect warranty therefore lies with the seller. This is however not the case if the warranty has been given with a best knowledge qualification. In that case, there will only be a breach of contract by the seller if the seller knew that the warranty was incorrect. The purchaser must now make two claims: (i) that the warranty is incorrect and (ii) that the seller is aware that the warranty is incorrect.

At first glance, this seems like a great way for seller to protect himself against incorrect warranties in the SPA. However, it is not that easy. The purchaser will often not accept a best knowledge qualification for the seller's warranties and will try to limit the definition of this qualification by supplementing it with normative elements. For example, the knowledge of certain individuals within the target could be attributed to the "seller's best knowledge".

In case law on the best knowledge qualification, it is often ruled that seller's knowledge refers to the seller's actual knowledge after (reasonable) enquiry. In my opinion, this jurisprudence has arisen partly because the disputes presented to the courts concern an SPA in which the best knowledge qualification refers to the knowledge of the seller after enquiries. The normative element of this best knowledge qualification occurred from the wording chosen by the parties. In any event, in M&A practice this means that the seller's protection is not particularly strong when including a best knowledge qualification in the SPA, as the purchaser often adds normative elements to the definition of the "seller's best knowledge". The seller will still have to consider carefully whether a seller's warranty can be given to the best of the seller's knowledge.

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22 Hof Amsterdam 6 november 2012, ECLI:NL:GHAMS:2012:BY8291 (*Amodo/ING*).