The nature and governance challenges of share sale transactions

BUDD, MICHAEL,ADRIAN

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Michael Budd

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Contents

Introduction

This thesis looks at the way UK law does, and should, deal with contracts for the sale and purchase of shares in private UK companies.[1]

These share sale transactions concern the change of ownership of companies. Shares are how ownership of a company is expressed. As share sales concern the change of ownership of a company the buyer acquires the company subject to all its past and current liabilities.

Companies can be sold by way of a sale of shares for small sums of money or many millions or indeed billions. However, the process of doing so is broadly the same. In simple terms, the process involves the seller negotiating a price with the buyer, structuring when the purchase price will be paid, the buyer asking questions of the seller about the company (a process known as 'due diligence') and the buyer and seller negotiating a share purchase agreement.

Contract law, of course, provides the mechanism for enforcing the agreement the parties reach. This might suggest that contract law is rather 'neutral', merely giving effect to what the parties themselves decide. But, as this thesis will argue, this would hugely underestimate contract law's role in these transactions. Rather, the 'background rules' that make up the law of contract also significantly influence the *process* by which this agreement is arrived at in practice, as well as the *substantive terms* of the agreement itself.

To take one example (which will be elaborated in subsequent chapters), English contract law includes the doctrine of *caveat emptor* ('buyer beware'). This doctrine has a significant impact on the process that culminates in the share sale agreement – most obviously by requiring buyers to expend significant resources (of both time and money) on undertaking 'due diligence' to discover the condition of the company whose shares they are purchasing.

Likewise, contract law's adoption of the doctrine of caveat emptor also explains a central element within most share purchase agreements – namely their inclusion of extensive warranties given by the seller to the buyer. Warranties are contractual assurances about the state of what the buyer is buying, that is both the shares in the company and the 'condition' of the company itself. Warranties are extensive in share sales – and they are necessary as a response to caveat emptor. This is because of the broad range of matters that form part of a company's business, its operations and its compliance

[1] What is discussed in this thesis would also apply to non-traded public companies.

obligations. For example, warranties would cover matters such as the company's accounts, material contracts and agreements, major customers, tax, financial matters, assets, real estate, intellectual property rights, environment, health and safety, computer systems, data protection, employees, litigation and pensions, to name only some.

Warranties provide reassurance to the buyer but, as importantly, they also encourage the production of information by the seller to the buyer. For example, there would typically be a warranty that the company is not involved in any litigation. If the company is, in fact, involved in litigation, then the seller, in order to avoid becoming liable under the warranty, will want to communicate the existence of the litigation to the buyer. This it does through a process known as disclosure. By disclosing against warranties that the seller knows are untrue, it avoids liability for breach.[2]

Why address share sale transactions, and the law that governs them?

Why are share sales transactions – and the contract law that regulates them – worthy of study?

Starting first with the transactions themselves, these are, as noted, often high-value, but technically complex deals, which have significant impact on, and implications for, the legal practitioners who advise on them, the parties who enter into them, and the wider society which can be benefitted or harmed by them.

These transactions are important to the parties. Sellers have a range of reasons to sell, and in cases where the seller is not only the owner, but also a director of the company, they may have spent many years of their life establishing and then growing the company. They will want a fair price for the company. As for the buyer, the transaction will involve investment and risk for them and they will want to ensure that the company is in the shape they expect it to be.[3]

These transactions represent transfers of control of important commercial assets. There are economic benefits from facilitating the transfer of ownership of productive assets to those who value them most highly. In these private transactions there are not the same 'disciplinary/governance' effects that exist in hostile takeovers as there are in public companies. In private transactions, the existing owners are not being held captive by an underperforming management and there is no requirement for the threat

[2] This relief occurs if the seller's disclosure against the untrue warranties is sufficient to meet the standard of disclosure that is defined in the purchase agreement or, if there is no such standard, that it meets the default requirement in law of being 'fair'. See chapter 6.
[3] See the much-published case of *ACL Netherlands BV v Lynch* [2022] EWHC 1178 (Ch) where the transaction turned out to be a disaster for the buyer.

of a takeover to keep the managers performing well or to rescue the company's shareholders from underperforming managers if the latter persist in mismanaging the company. However, there are sound economic benefits from transfers of control. The existing owners may be old and need to sell to a more vibrant and committed owner and that buyer might have synergies with other businesses, for example.

So, that explains the significance of the transactions themselves. The significance of their regulation to some extent follows naturally on from that. Because the transactions have these major impacts on practitioners, on the parties, and on the wider society, getting their regulation right matters. Moreover, the role of contract law is not limited to a merely neutral, passive enforcement of whatever deal the parties happen to strike. Rather, contract law itself both shapes the process by which the deal is made and the eventual agreed content of that deal. It is legitimate, therefore, to ask what purposes and values contract law ought to be promoting in its regulation of these contracts, whether it is indeed now promoting those purposes and values and, insofar as it is currently failing to do so, how it ought to be reformed better to achieve these things.

What does this thesis do?

This thesis aims to describe the nature of share sale transactions, and then to describe, and to evaluate, the law which regulates them. Share sale transactions, despite their significance, are perhaps relatively unfamiliar to academic lawyers, as well as to many non-specialised legal practitioners and the wider public. It is valuable, therefore, to describe how these important deals are concluded, and the complex contractual documentation that records them. Part of describing these transactions entails explaining the commercial challenges which the parties face, and especially the important phenomenon of 'informational asymmetry' which exists between them.

The core of the work, however, focuses on the legal regulation of share transactions. Again, that regulation, like the transactions themselves, is complex. It rests on a foundation of company law, but the main building blocks for the structure are provided by contract law, with some embellishments from other legal subject areas (especially from tort law governing misrepresentations). The thesis describes this structure, and tries to clarify a (perhaps surprisingly large) number of uncertainties or controversies in the law (and especially in the voluminous case law that has arisen in this area).

In doing so, the thesis seeks to reveal a number of fundamental features that this law exhibits. The most important of these is that the law adopts what I shall call 'seller bias'. It tends – not invariably, but certainly predominantly – to favour sellers over buyers. This, in turn, tends to result in the prolonged and expensive negotiation and contracting process mentioned above.

Whilst there is value in seeing clearly and accurately the legal landscape that regulates share sale transactions, doing so does not tell us whether we should celebrate or condemn that landscape, preserve it or seek to reshape it. This is the final task of the thesis. It will argue that the law here ought to be primarily concerned with promoting efficiency (and, albeit to a lesser extent, fairness) but that the current law fails to do just that. Finally, a number of reforms are suggested.

In addressing the subject of share sales, this thesis seeks to do three things. The first is doctrinal/descriptive: it asks whether the law (primarily contract law, but also tort law) does indeed tend to favour sellers. As part of that assessment, at times, there is a light-touch reference to US law, which is generally thought to be buyer-friendly, as well as to the law of other jurisdictions.
The second thing the thesis does is explanatory: it considers the reasons why the law has adopted the pro-seller stance which the doctrinal part of the thesis sets out. The third is to evaluate the law's stance here and, following this evaluation, suggest some changes to the law's approach.

What are the research questions in this thesis?

The primary, and overarching, question this thesis asks is: how well does the law regulate share sale transactions? To work towards an answer to this, the following sub-questions need to be answered:

1. What is the nature of private share sale transactions, in terms of the process they follow, the commercial challenges which the parties to such transactions face, and the contractual documents they generate?

2. What are the most significant aspects of the law that regulates those transactions? How does that law address the key commercial challenges which face contracting parties, and does it overall tend to favour buyers or sellers? Again, this sub-question generates several sub-sub questions, namely:

    2a. Given that sellers tend to know much more about the company than does the buyer, to what extent does the law require the seller to disclose information to the buyer about either the shares it is selling or the company?

    2b. What terms, if any, does the law imply in relation to share sales?

    2c. Where the seller gives warranties to the buyer, do those warranties permit tortious, in addition to contractual, claims?

2d. Where the buyer is aware of a breach of warranty by the seller before completion (and assuming the seller has not disclosed against the warranty to relieve itself of liability) can the buyer bring, and succeed in, a claim for the known breach of warranty?

3. How effective is the current regulation of share sale transactions? This question – which concerns the evaluation of the current law – again produces a number of sub-questions. These are:

3a. what purposes and values should contract law promote?

3b. does the informational asymmetry that exists between buyers and sellers undermine the consent of the parties or the fairness of their transaction? Does the law prevent this?

3c. do informational asymmetry and transaction costs undermine efficiency in share sales transactions? Does the law prevent this?

4. if the law currently fails to uphold party autonomy/fairness, and efficiency, how might it be reformed better to do so?

4a. should the law require sellers to disclose to the buyer material problems that exist with either or both the shares being purchased or the company?

4b. should the law provide default rules which attempt to balance information asymmetry and if so, what rules should it provide?

What is the summary result of the research questions?

The law puts the onus on buyers at least to commence their own protection in share sale transactions. This it does in two ways, firstly by attempting to have sellers make representations to them and secondly, by including warranties in the contract. It is clear that both parties to a share sale transaction are left better off and contract law is itself promoting efficiency by enforcing these transactions. However, contract law can promote efficiency more than through simple contract enforcement. This improvement is to transaction costs. It is suggested the law should seek to lower transaction costs and make the transaction process more efficient by establishing implied terms to force the seller to reveal information to the buyer.

Methodology

The methodology adopted in this thesis is mostly doctrinal in that it involves consideration of journal articles, case law, legislation, academic and practitioner textbooks as well as materials published by leading law firms. It is also 'normative' – it seeks to evaluate the current law – and it does so by employing the insights of other disciplines – especially economics. It is not comparative, but it does occasionally note comparable features of how other jurisdictions deal with the same issues. Although it is not empirical it is based on the writer's own extensive experience in legal practice in three law firms in conducting numerous share sales. This gives an insight into the typical issues which the parties face and the frequency at which those issues arise.

Chapter overview

The chapter breakdown for the thesis reflects the research questions identified above.

Chapter 1 provides an overview of share sales. It focuses on three key aspects: the basic process of share sales, the commercial challenges the parties face and the contractual documentation that they typically generate.

Chapter 2 considers caveat emptor and the notable exceptions to the caveat emptor doctrine, namely misrepresentation and fraud. However, the chapter does not contain a detailed examination of misrepresentation. Instead, it briefly looks at some of the exceptions to the ability of the seller to remain silent regarding any issues with what it is selling (the shares) or the underlying asset (the company). The chapter also considers various aspects of fraud and the limited duty to disclose matters to the buyer. However, the disclosure obligations pertaining to fraud only apply where there is a civil obligation on the seller to disclose matters to the buyer. As share sale transactions provide no civil disclosure obligation, the law of fraud, like the civil law, does not undermine the caveat emptor doctrine.

The discussion, in chapter 3 then moves to consider whether the law implies terms for the benefit of the buyer. If it did, then that would operate to balance, in some respects, the effect of caveat emptor and the ability for the seller to keep superior information concerning the shares/the company to itself. Although for some other areas of contracting – especially consumer contracts – extensive implied terms substantially constrain the operation of caveat emptor, in share sales, implied terms are relatively limited and importantly require certain words to be used in order for the implied terms to be triggered. Therefore, the implied terms, even if used, do not substantially undercut the dominance of caveat emptor in share sales.

The fourth chapter looks at warranties and representations. Broadly, warranties give the seller a right to claim contractual damages, and a claim for misrepresentation allows the buyer to claim tortious damages. In summary, a misrepresentation claim will be based on what one party has communicated to the other which has caused the recipient to rely upon the false representations and be induced to enter into the contract. A warranty claim will be based on a claim for breach of the contract which the parties have entered into. These separate and distinct claims have sought to be merged in share sales by buyers claiming that warranties are also capable of being representations. If this claim is successful, it means that if the buyer can bring a claim for breach of warranty it may also have an alternative claim for misrepresentation. If it could substantiate both claims it could pursue the claim which has the greatest financial value to it. The chapter sets out the various scenarios and law applying to breach of warranty claims and misrepresentation. It concludes that the law is in a state of uncertainty as regards the buyer's ability to bring claims where warranties are also expressly stated as being representations in the contract itself (known as 'contractual representations'). On this point, there is conflicting case law on whether the buyer is able to choose the most valuable claim to bring – in other words, do contractual representations only provide a breach of contract remedy or do they also provide a tortious remedy.

In chapter 5 there is consideration of the existing law concerning the buyer's knowledge of breaches of warranty where that knowledge is held before completion of the transaction (and in respect of which the seller has not disclosed). Some share purchase agreements contain provisions that permit a buyer to bring a claim for such known breaches. However, there is uncertainty that the law will give effect to such provisions.

Chapter 6 looks at the seller's disclosure to the buyer of known breaches of warranties. The law has shifted from its position of requiring an overriding requirement of fairness to giving effect to the terms of the purchase agreement which specifies how detailed the seller's disclosure against warranty breaches needs to be.

In evaluating the law, chapter 7 considers each of the above chapters. In relation to the chapter concerning implied terms, this chapter argues that the implied terms are insufficient to balance the information asymmetry that exists between the parties. Whilst the required enabling words to invoke the implied terms will likely appear in the purchase agreement where the buyer is legally represented, an unrepresented buyer will not necessarily know to use the required words. Buyers may have no or limited legal representation in low-value transactions. This is due to disproportionate transaction costs. This is because the likely surplus from the transaction is at risk of being negative so the rational buyer seeks to reduce its transaction costs by limiting/ignoring certain aspects of the

transaction process (due diligence/warranties, for example, as these areas attract the greatest costs). As such there is a potential failure by buyers to protect themselves even to the limited extent offered by the statutory implied terms.

As regards an evaluation of contractual representations, the argument is that the intention is clear when parties bargain for these terms because buyers wish to provide for an alternative remedy (in tort) for breach of contractual representations. If the law is not giving effect to those bargained-for terms the law is creating inefficiencies due to the transaction costs associated with negotiating for those terms.

The evaluation of clauses that permit buyers to bring claims for known breaches of warranties is also looked at from an efficiency perspective. Identifying the efficiency of a rule that allows or does not allow the buyer to bring a claim for a known breach is difficult. This is because in either case one of the parties will seek to contract around the rule but there is no useful information signalled to the other party in their doing so which is a requirement to demonstrate a rule's efficiency. Given how significant the issue may be for the parties, costs will be incurred as the rule is likely to be the subject of much negotiation. Perhaps the only time when negotiation around such a rule will not occur (and so transaction costs are saved) is when the seller is giving only very limited warranties to the buyer.

On the subject of disclosure, the lack of an overriding sense of fairness undermines one of the central aspects of the buyer's bargaining, which is the information-forcing effect of warranties. This means that there are wasted transaction costs.

The primary focus of the evaluation chapter is whether the information asymmetry between the parties results in an inequality of bargaining power, and whether the law's failure to require disclosure of the seller's information is inefficient. It is suggested that there is no inequality of bargaining power where the parties are represented because the due diligence exercise and warranties in the agreement to some extent balance that inequality. However, in unrepresented cases, if information asymmetry exists until completion of the transaction, then an inequality of bargaining power will exist.

Perhaps more significantly, whether or not the parties are represented, the argument is that the law is inefficient because it creates excessive transaction costs by allowing the continuation of caveat emptor by not providing default rules which require sellers to disclose material information concerning both the shares and the company to the buyer.

The final chapter looks at the means by which it is suggested that the law should seek to balance, to some extent, the information asymmetry between buyer and seller. The suggested approach is through

the use of penalty defaults. The idea is that the law should imply certain terms in share sale transactions. It would be expected that such default rules would be expanded upon by the buyer including lengthy terms in the sale documentation in higher-value transactions, therefore following the current approach of extensive warranties in the share purchase agreement. This leaves the suggested penalty defaults to apply to lower-value transactions where the transaction costs of share sale and purchase transactions prevent or limit recourse to legal advice and so risk loss to the buyer.

What this thesis does not consider

This thesis does not consider the primary other means by which a buyer can acquire the business of a company, which is through the purchase of the business and assets from the company itself. There are similarities between both share sales and asset sales from the perspectives of due diligence, warranties and in certain other terms in the transaction documents. Unlike share sales, asset sales do not automatically involve the buying of the business with all of its obligations and liabilities unless the contract provides for that to be the case. Therefore, from the buyer's perspective, there is less risk although matters of information asymmetry still remain in asset purchases.

Chapter 1

The nature and challenges of share sale transactions

1.1 Introduction

This chapter describes the sale of shares in a company.

It looks at share sales from three perspectives: the basics concerning share sales, share sale challenges and the documentation involved.

Inevitably, this chapter has, at times, a quite 'descriptive', and practical, emphasis. It aims to describe, for a reader unfamiliar with the context of share sale transactions, what such transactions look like, why they happen, and the parties' contractual practices in relation to them. Sections 1.2 and 1.4, in particular, pursue these matters.

However, the chapter aims to do much more than that. More specifically, section 1.3 addresses the deeper commercial challenges that such transactions present. It draws on economic and other normative arguments to analyse the significance of these challenges. One benefit of doing this is to improve the explanatory power of the thesis: we can better *explain* the contractual practices that are addressed in section 1.4 if we understand first the commercial challenges that are set out in section 1.3. But more importantly, the theoretical material set out in section 1.3 provides some initial building blocks for the later chapters of the thesis which seek both to evaluate the current law addressing share sale agreements (chapter 7) and to offer improvements to that law (chapter 8).

As this thesis looks at the sale of shares in private companies, it is necessary to consider first the meaning of a share.

1.2 SHARE SALE TRANSACTIONS: THE BASICS

1.2.1 What is a share?

Share sale transactions involve, rather obviously, the buying and selling of 'shares'. But what exactly is 'a share' that is the subject of these transactions? The statutory definition of a share is rather unhelpful and somewhat circuitous. The Companies Act 2006, s 540 simply provides that a "share", in relation to a company, means "a share in the company's share capital". However, plainly, this provides little guidance as to what a share is, [4] but a little further description is provided by the

[4] Lee Roach, *Company Law* (2nd edn, OUP 2022) 450.

Companies Act 2006, s 541 which states that shares or other interests of a member in a company are personal property, but the meaning under this provision, is still unclear.

The meaning of interests which the seller has in a share was described in *Borland's Trustee v Steel Bros*:

> "A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with s. 16 of the Companies Act, 1862".[5] The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money settled in the way suggested, but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.[6]

This view was endorsed by Romer LJ in the Court of Appeal in *IRC v Crossman*:

> "With these observations I respectfully agree. It is impossible to treat a share as being an interest in the company's assets, or an aliquot share in the company's capital, and to regard the contract arising from and contained in the company's articles of association as a separate and independent thing. That contract and the rights and liabilities that flow from it are of the very essence of the share".[7]

These cases show that the seller's interest is not in what the company owns but rather in the terms of the articles of association. There is some degree of ambiguity about these descriptions. The *Borland's* formulation is "somewhat lacking: it identifies that a share provides contractual rights which are based on a quantum of money, but… not akin to holding a debt…".[8] Looking only at the articles to find the rights of the shareholder is incomplete as rights are also conferred by the Companies Act 2006.[9] Ownership of a share confers rights and duties under the Companies Act 2006 [10] as well as under the company's articles of association.[11]

In the recent case of *Blackwell v HMRC* [12] Briggs LJ summarised the nature of a share:

> "shares are a form of incorporeal or intangible property, properly to be regarded as a bundle of rights, including rights to vote, rights to share in distributions by way of dividend or upon

[5] The Companies Act 1862, s 16 has been repealed. The corresponding and materially the same provision is in Companies Act 2006, s 33 which provides "The provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions".
[6] [1901] 1 Ch 279, 288.
[7] [1935] 1 K.B. 26, 57 also known as *Re Paulin*; and *IRC v Mann.*
[8] Jonathan Hardman, Further legal determinants of external finance in Scotland: an intra-UK market for incorporation? Edin. L.R. 2021, 25(2), 192.
[9] Robert R. Pennington, Can shares in companies be defined? Comp. Law. 1989, 10(7), 140, 144.
[10] Morse and others, *Palmers Company Law* (Sweet & Maxwell) 6-007.
[11] "…Upon delivery of a signed stock transfer form and share certificate from a seller to the buyer, and payment of the price to the seller, beneficial interest in the shares transfers from the seller to the buyer. As such "the seller then becomes a trustee for the buyer and must account to him for any dividends he receives and vote in accordance with his instructions" Thus the share's ownership is split into legal ownership (held by the seller) and beneficial ownership (held by the buyer). Jonathan Hardman, 'Further Legal Determinants of External Finance in Scotland: An Intra-UK Market for Incorporation?' (2021) 25 Edin LR 192, 203.
[12] [2017] EWCA Civ 232.

> winding up and, because shares are a form of property, carrying with them rights to sell, lend or otherwise deal with them, subject to restrictions (if any) in the Articles of Association of the company concerned".

Therefore, the main rights of a share are the rights to a dividend, if declared, the right to vote at meetings or written resolutions of the members and the right to participate in the distribution of assets of the company on the company's winding up.[13]

Worthington, however, provides a fuller, and far more useful description of what a share is:

> "it is a fraction of the capital, denoting the holder's proportionate financial stake in the company and defining his or her liability to contribute to its equity funding. Secondly, it is a measure of the holder's interest in the company as an association of members or shareholders and the basis of his or her right to become a member and to enjoy the rights of voting, etc, so conferred. And, thirdly, it is a species of property, in its own right, a rather complex form of chose in action, which the holder can buy, sell, charge, etc, and in which there can be both legal and beneficial interests".[14]

In other words, "it is itself a "bundle of rights", giving the shareholder neither ownership of the company's assets nor ownership of the company as a "thing", but attracting to itself the protection of the law to a degree that warrants the label "property"".[15] A share is property. However, it does not give the shareholder any interest in the company's assets.[16] The bundle of contractual and statutory rights is considered to be "property" rather than "obligation" in part because commercial practice demanded that these rights be generally transferable, assignable and enforceable against third parties.[17] Fry LJ in *Colonial Bank v Whinney* [18] described a share as "the right to receive certain benefits from a corporation, and to do certain acts as a member of that corporation".[19]

Shares define a number of rights. These include income rights. Typically, these are rights concerning the participation of the shareholder in the company's profits, usually in the form of dividends.[20] They also include rights in relation to capital and control through voting rights.[21] In short, shares in a company therefore concern income, capital and voting rights. These descriptions are rather general. What does a share specifically mean for a company's shareholder? These different rights are an integral part of shares.[22] The income, capital and voting rights are determined by the terms upon

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[13] Morse and others Palmers Company Law (Sweet & Maxwell) para 6-009. More subsidiary rights include those provided by the Companies Act 2006 include those under ss 32, 228, 289, 303, 307, 314, 358, 423 and 561.
[14] Sarah Worthington and Sinéad Agnew, *Sealy & Worthington's Text, Cases, and Materials in Company Law* (12th edn, OUP) 644.
[15] Sarah Worthington, 'Shares and shareholders: property, power and entitlement: Part 1' [2001] Comp. Law. 22(9), 258.
[16] ibid 259.
[17] ibid 260.
[18] [1885] 30 Ch. D. 261, 286.
[19] Ibid.
[20] Fidelis Oditah, 'Takeovers, share exchanges and the meaning of loss' [1996] LQR 112(Jul), 424, 426.
[21] ibid.
[22] ibid.

which the shares are issued by the company to the shareholder.[23] They are subject to the company's articles of association, memorandum of association and the law.

What these rights look like in practice can be most readily seen from information filed with the registrar of companies, [24] and what appears in the company's articles of association.

As regards the registrar, when a share is allotted and issued [25] to a person, "prescribed particulars" of the rights attached to shares need to be notified to the registrar. In the case of a notification (known as a 'return of allotment') the prescribed particulars must be included in a statement of the company's share capital. These particulars are set out in the Shares and Share Capital Order 2009, art 2 (3).

The articles of association will usually set out the rights attaching to the shares and a company can have different classes of shares.[26]

It can be seen, therefore, that from a shareholder's perspective, their shareholding is held in units into which their rights of participation in the company's cash flow, management and on a return of capital, are divided.[27] In the case of a share sale, all that the documentation effecting the share sale will specify (see section 1.4 concerning documentation) is the number and class of shares that the shareholder holds and which it is selling. For example, '100 ordinary shares [28] of £1 each".[29]

1.2.2 Why sell – and to whom?

The owner of shares in a company may wish to sell their shares for several reasons. Not all owners of shares are involved in running the business that they own. They can be a shareholder but not a director. They may own their shares alone or with others. They may or may not receive dividends for their shareholding. They may or may not be on good terms with their fellow shareholders or the directors of the company. The potential seller may have decided that they want to simply 'cash in'

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[23] ibid.
[24] More colloquially known as Companies House.
[25] The distinction between the allotment of shares and the issue of shares was described in the recent case of *Chambi v Aristodemou* [2024] EWHC 1610 (Ch) where Insolvency and Companies Court judge Prentis said: " By section 558 shares are "taken to be allotted when a person acquires the unconditional right to be included in the company's register of members" Allotment is distinct from issue. See also Templeman L in *National Westminster Bank plc v IRC* [1995] 1 AC 119, 126:"
[26] An example of such rights can be seen in *Re Saul D Harrison &Sons plc* [1994] B.C.C. 475, 496 per Neill LJ.
[27] Oditah (n 20) 426.
[28] Companies Act 2006, s 560 states: ""ordinary shares" means shares other than shares that as respects dividends and capital carry a right to participate only up to a specified amount in a distribution." Unless the articles provide otherwise, ordinary shareholders will typically have: (i) the right to vote at general meetings; (ii) the right to a dividend once declared; and (iii) the right to surplus capital once the creditors have been paid in the event of a company's winding up. It is possible for a company to have multiple classes of ordinary shares (e.g. ordinary shares with voting rights and non-voting ordinary shares) – Roach (n 4) 468.
[29] Companies Act, s 542 provides that shares must have a nominal value. These are often £10, £1, £0.10 etc.

their shares for reasons such as retirement, age, ill health, loss of interest in running the company or financial necessity. They would typically want to achieve a clean exit from their company.[30] However, as there is no open market for the sale of shares in private companies [31] it can be difficult to determine a valuation without having to seek input from external advisers.[32] This thesis works on the assumption that the seller is a single shareholder so does not address, in detail, the various complications that can arise if some shareholders wish to sell their shares and others do not.

Typically, a seller will sell when a buyer is prepared to pay more for the shares than the seller expects. In simple law and economics terms, [33] using small numbers, if the seller is willing to sell for £100, but the buyer thinks the shares are worth £200 and pays the seller £150 then that, from a law and economics efficiency perspective, would be considered Pareto efficient [34] (a concept considered in chapter 7) as both parties are better off and neither is worse off.[35] The buyer may be interested in buying the seller's shares as it may value the shares in the company more highly than the seller for various reasons. These include the buyer wanting to expand its existing business faster than by organic growth, removing a competitor from the market or acquiring a particular supplier, obtaining a new customer market or geographical area, or diversifying into new product lines.[36] The buyer may have the ability to make the company more profitable, it may have better managers or the seller may no longer want to run the business. The buyer's valuation of the company will depend on what it knows about the company. Of course, sellers might also want to sell because they know of issues about the company which the buyer does not.

There are various ways in which a seller could go about finding a buyer for their company.[37] The seller may have received direct approaches from potentially interested parties in the past. They may have connections with competitors whom they can approach or they may use business brokers, who, rather like estate agents for the sale of a house, will market the target company for sale in return for the payment of a fee.

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[30] Paul Taylor, 'Nine steps to M&A success', 47 CSR1, 8.
[31] Datar, Srikant, Richard Frankel, and Mark Wolfson. "Earnouts: The Effects of Adverse Selection and Agency Costs on Acquisition Techniques." Journal of Law, Economics, & Organization 17, no. 1 (2001): 201, 210.
[32] Taylor (n 30).
[33] See more on law and economics in section 7.
[34] Pareto efficiency is dealt with in section 7.
[35] Raymond Wacks, *Understanding Jurisprudence* (5th edn OUP 2017) 267.
[36] https://www.weightmans.com/insights/how-to-buy-a-business/.
[37] DLA Piper, a large international law firm suggest potential buyers typically fall into one of two groups: (1) industry buyers (also known as "strategic" buyers); and (2) financial buyers such as private equity funds. Strategic buyers may have partnered with a private equity house – and so are "hybrid" buyers. "Industry buyers are usually looking to grow their existing businesses by acquiring, for example, the product lines, capital assets of complementary businesses. In contrast, financial buyers typically have access to less expensive capital than industry buyers. They tend to target businesses that will generate a desired level of return within a fixed investment horizon (for example, five years). They often look for companies that have solid businesses in place but whose valuation could be boosted by implementing operational efficiencies or by injecting new capital into the business." https://www.dlapiperaccelerate.com/knowledge/2020/getting-your-business-ready-to-sell.html.

The seller or broker may prepare an information memorandum [38] which will specify details about the company, its financial performance, number of employees and other information to help a prospective buyer gain an overview of the company and its business.

If the seller obtains an expression of interest from a prospective buyer, the buyer is likely to want to find out more information than that contained in the information memorandum. They may request some of the company's financial information, for example. If the seller has not already entered into a confidentiality agreement with the potential buyer, then before providing more details about the company, it will want such an agreement. The confidentiality agreement usually includes the company as a party to the agreement as it is its information, rather than the seller's, which is proposed to be provided to the potential buyer. If there is a breach of the confidentiality agreement then the company will be able to enforce the agreement.[39]

1.2.3 The mechanics of share transfers

A share sale is the transfer of shares in the company from the seller to the buyer. The use of the word "transfer" refers to the passing of shares from one person to another, other than via the operation of law.[40]

It is important to emphasise that what is transferred is the seller's shares – not the assets of the company itself. The shares in the company change hands (from seller to buyer) but the assets that the company owns (before the shares are transferred) continue to be owned by the company (after the shares are transferred). Some of the significances of this distinction – between a sale of the shares in the company – and a sale of assets owned by the company – are explored in more detail in section 1.2.4 below.

The share transfer can typically occur when a shareholder either agrees to sell their shares to another person (or gifts the shares to another person).[41] The Companies Act 2006, s 544 confirms that shares in a company are transferable in accordance with the company's articles. However, that does not

[38] The accountancy firm, BDO produces a guide to selling your business and states that the information memorandum should articulate: key investment considerations; business model; management team; addressable market opportunity; growth strategy and financial performance. https://www.bdo.co.uk/getmedia/ff659f4a-e802-4aa2-8018-08e50d9cf240/CF-Guide-A-Guide-to-Business-Exit.pdf.
[39] If it were not a party, then The Contracts (Rights of Third Parties) Act 1999 will assist if the company is named in the document.
[40] Roach (n 4) 474. Shares transfer by operation of law, also known as the transmission of shares. This is where shares pass from one person (the transmittor) to another person (the transmittee) not via the share transfer procedure discussed above. This occurs in three situations: when a shareholder dies or declared bankrupt or becomes a patient under the Mental Health Act 1983 - Roach (n 4) 481.
[41] Roach (n 4) 474.

mean that shares can be transferred freely.[42] A company's articles of association (or a shareholders' agreement [43]) can provide that there is a restriction on the ability of shareholders to transfer their shares. These are known as pre-emption rights on the transfer of shares, typically shortened to just 'pre-emption rights'.[44] These rights, if they do exist, apply to situations where there is more than one shareholder in the company. As the assumption in this thesis is that there is only one seller, no further mention is made of pre-emption rights and other provisions regarding the transferability of shares.[45]

In relation to the actual mechanics of the transfer of shares they can, in theory, be simply transferred. The seller needs to only send a completed stock transfer form, plus their share certificate to the buyer.[46] The buyer pays the purchase price to the seller and the required amount of stamp duty and requests the company to register the transfer.[47] The transfer is recorded by the company in the register of members and a new share certificate, made out in the transferee's name, is issued to the buyer.[48] The parties to the sale of shares do not include the company. It is simply the selling shareholder and the buyer who are the parties. The company is 'interested' in the transfer of shares from a registration of the transfer of the buyer as the new shareholder.[49]

When a stock transfer form has been provided to the company, the company must either register the transfer or give the transferee notice of refusal to register, together with its reasons for the refusal.[50] It is an essential feature of registered companies that their shares are freely transferable so the directors of a company do not have the power to refuse to register a transfer of shares unless they have been given such a power by the company's constitution.[51] However, as the buyer receives no assurances about either the shares it has bought or the state of the underlying company, it will seek a detailed

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[42] ibid.
[43] Lewison J in *Holt v Faulks* [2001] B.C.C. 50 at 56 said in respect of a shareholders' agreement before him containing pre-emption rights that the agreement "is a contract between particular shareholders. I cannot see any reason why a shareholder should not bind himself to operate a voluntary procedure for transferring shares if a particular contingency materialises.".
[44] Not to be confused with pre-emption rights on the allotment of shares under Companies Act 2006, s 561.
[45] Pre-emption rights "prevent sales of shares to strangers so long as other members of the company are willing to buy them" *Lyle & Scott v Scott's Trustees* per Reid L [1959] A.C. 763, 777 A different, but related, approach is to include within the articles of association 'drag-along' right. Again, these apply where there is more than one shareholder of the company. Such a right is a forced sale provision in the articles of association or a shareholders' agreement. It provides that if shareholders holding a certain percentage of the shares in the company (usually around 75%) want to accept the buyer's offer they can force the other shareholders to accept the offer as well Sean FitzGerald, Geraldine Caulfield, *Shareholders' Agreements 8th edn* (Sweet & Maxwell) part 2, chapter 6, para 6-140.
[46] Worthington and Agnew (n 14) 643.
[47] ibid.
[48] ibid.
[49] *Dawson International plc v Coats Patons* plc 1988 SLT 854, Lord Cullen said, at p 860: "I do not accept as a general proposition that a company can have no interest in the change of identity of its shareholders upon a takeover. It appears to me that there will be cases in which its agents, the directors, will see the takeover of its shares by a particular bidder as beneficial to the company. For example, it may provide the opportunity for integrating operations or obtaining additional resources. In other cases the directors will see a particular bid as not in the best interests of the company".
[50] Companies Act 2006, s 771(1).
[51] Derek Mayson, David French and Stephen Ryan, *Mayson, French, and Ryan on Company Law* (38th edn OUP 2023) 8.3.4.2.

share purchase agreement from the seller containing extensive warranties given by the seller to the buyer.

As this thesis looks at the sale of a one hundred per cent shareholding in a company to a third party buyer on arm's length terms, it does not consider the sale of either majority or minority shareholdings in a company. The result, in either of these cases, is that the buyer would jointly have a shareholding with one or more other shareholders in the company.

1.2.4 An aside – share sales distinguished from asset sales [52]

This thesis does not look at asset sales, however, it is mentioned as an aside here because when a buyer wishes to acquire a business it has two alternative purchase methods at its disposal. One is to acquire the shares in the target company from that company's shareholders. The other is to buy the business and assets from the company, in which case, notably, the company will be the seller, not the shareholders. Under a share sale method, the change in the identity of the shareholders of the company does not affect the liabilities and obligations the target company may have. The buyer will therefore take on such liabilities and obligations. However, under an asset sale, the result is different. An overview of the asset sale process is provided below.

The benefits and drawbacks of share sales and asset sales for both the buyer and seller appear in tables 1.1 and 1.2 below.

Advantages and disadvantages of asset sales:[53]

Advantages for buyer	**Disadvantages for buyer**
Buyer can choose which assets and liabilities (if any) it acquires from the seller	More complex transaction process and documentation
Transaction is unlikely to require shareholder consent or other shareholder involvement	Buyer must comply with the applicable employee protections imposed by the Transfer of Undertakings (Protection of Employment) Regulations 2006[54]
Buyer can limit its exposure to unknown or contingent liabilities, reducing the risk inherent in the transaction	
Buyers gain direct ownership and control over specific assets, allowing for a more seamless	

[52] Large part taken from Practical Law Acquisition Structures: comparing asset purchases and share purchases, but significantly re-written.
[53] Mixture from Practical Law Acquisition Structures: comparing asset purchases and share purchases and https://www.birketts.co.uk/legal-update/asset-sales-v-share-sales/.
[54] (SI 2006/246).

integration into their existing operations or expansion plan	
Advantages for seller	**Disadvantages for seller**
Transaction unlikely to require consent of buyer's shareholders	Corporate sellers do not receive the sale proceeds directly
	More complex transaction process and documentation
	Seller must comply with applicable seller obligations under the Transfer of Undertakings (Protection of Employment) Regulations 2006

Table 1.1

Advantages and disadvantages of share sales:[55]

Advantages for buyer	**Disadvantages for buyer**
Transaction structure is often simpler than an asset purchase as the buyer is acquiring a single asset (that is, the target company's shares)	Buyer acquires the target company subject to all its past and current liabilities
TUPE is unlikely to apply to the transaction, thus avoiding the need to inform and consult with the employees of the target business	If the buyer acquires 100% ownership of the target business, all of the target's shareholders must agree to the transaction
Advantages for seller	**Disadvantages for seller**
Seller makes a clean break from the target business, as buyer takes the target company subject to all its past and current liabilities	Transaction may be frustrated if any of the target's shareholders are not prepared to sell their shares to the buyer on the terms proposed
The seller receives sale proceeds directly	
Transaction structure is often simpler than an asset purchase as the buyer is acquiring a single asset (that is, the target shares)	
TUPE is unlikely to apply to the transaction, thus avoiding the need to inform and consult with the employees of the target business	

Table 1.2

Whilst a share or asset sale can broadly achieve the same commercial objective, there are significant differences in both the legal effect and the tax treatment of the two approaches. It is typically the differing tax implications of the two methods that dictate which one is chosen.[56] The buyer does not acquire the seller's tax history on an asset purchase. Therefore, there is no need for it to seek protection against pre-completion tax liabilities through a tax indemnity (known also a 'tax covenant' or 'tax deed' – see section 1.4.5) from the seller (which is typically required on a share purchase). As a broad generalisation, the tax advantages of a share purchase to the seller are likely to be greater than

[55] Practical Law Acquisition Structures: comparing asset purchases and share purchases
[56] Taylor (n 30).

the tax advantages of a share purchase to the buyer. Conversely, an asset purchase tends to be more tax efficient for the buyer than the seller.[57]

1.3 THREE SIGNIFICANT COMMERCIAL CHALLENGES THAT THE PARTIES, AND THE LAW, MUST ADDRESS:

1.3.1 The challenge of complexity

The due diligence process highlights the complexity of share sale transactions. Whilst a share is a relatively simple concept the share sale transaction is not. For example, the valuation of assets in the company is challenging [58] which is why share sales include the price adjustment mechanism and completion accounts described in section 1.4.3.4. Likewise, the company's profitability is also not necessarily easy to ascertain. The same problem also arises with trying to establish the full extent of a company's liabilities. It is also difficult for a buyer to establish the quality of the target company's relationships with suppliers, customers and staff members. All of these issues apply to all private companies that are being sold. Information asymmetry appears to be the main problem for the buyer and that continues until completion of the transaction.[59] It raises costs and makes transactions longer than they need to be.

1.3.2 The challenge of 'informational asymmetry'

1.3.2.1 What is informational asymmetry

Information asymmetry relates to the extent of information availability.[60] It is where a party possesses better or worse information about the potential value of the transaction than the other. A corporate acquisition is an example where the buyer is likely to be less well-informed than the seller".[61] "Private (or asymmetric) information is known to one party and unknown to the other party".[62]

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[57] According to Practical Law Company Asset purchases: tax issues for buyer and seller, this arises as a result of the interaction between the substantial shareholding exemption for the seller on a share purchase (or, if an individual seller, the availability of business asset disposal relief or investors' relief) and the buyer's ability to claim amortisation relief on the price paid for intangible fixed assets (excluding goodwill and customer-related intangible assets) on an asset purchase.
[58] The valuation of a private company can be a challenging process, where a number of key assumptions need to be considered. It is generally accepted there is no single correct way of valuing the shares of a private company. Accountancy firm Mercer & Hole https://www.mercerhole.co.uk/insights/private-company-valuation/ "Private company valuation is challenging, in part, because it does not have an observable stock price, nor may the company follow the stringent accounting and reporting standards that govern public companies. Corporate Finance Institute https://corporatefinanceinstitute.com/resources/valuation/private-company-valuation/.
[59] Albert Choi and George Triantis, 'Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions' Yale LJ, 2010 vol. 119, no. 5, 848, 861 Choi (Vagueness) (n 59).
[60] Mathieu Luypaert and Tom Van Caneghem, 'Exploring the Double-Sided Effect of Information Asymmetry and Uncertainty in Mergers and Acquisitions' (2017) 46 Financial Management 873.
[61] William Samuelson, 'Bargaining under Asymmetric Information' (1984) 52(4) Econometrica 995.
[62] Robert Cooter and Thomas Ulen, *Law and Economics* (6th edn), 355 http://www.econ.jku.at/t3/staff/winterebmer/teaching/law_economics/ss19/6th_edition.pdf.

English law does not impose on either the seller or buyer an obligation to disclose information to the other because neither party owes the other any general duties such as a duty of good faith, duty of loyalty or duty of cooperation during the respective negotiations.[63] It is also "unlikely that any duty to disclose information in performance of the contract would be implied [by law] where the contract involves a "simple exchange"".[64] Asymmetric information issues exist because the seller knows more about the target company and its financial condition than the buyer.[65] "Information asymmetry, the difference in information between the buyer and seller, exists in all deals"[66]

1.3.2.2 Why does information asymmetry exist in share sales?

Information asymmetry exists in share sales due to the seller possessing extensive private information regarding the shares being sold and the company as the underlying asset. If the buyer does not have sufficient information regarding the company it will not be able to pass a judgment on what is proposing to be bought.[67] Its knowledge of the company will therefore be limited. It will have relied on public information, information released to help the transaction – the information memorandum (see section 1.2.2) and perhaps discussions with the company's management.[68] The aggregate of that information is unlikely to be sufficient for it to make a proper assessment of the company.

1.3.2.3 The consequences and implications of informational asymmetry

1.3.2.3.4 Bargaining power concerns

What has been described above may lead to the conclusion that caveat emptor, and there being no disclosure duty, causes an inequality of bargaining power in law between the seller and buyer, with the seller having an advantage over the buyer. An agreement or contract between the parties can be evaluated in terms of its process, that is, how it was formed.[69] It could be said that the process is morally legitimate if the parties come to their agreement freely and with full, or relatively full, information.[70] It can also be evaluated on its substance, that is, its result or content.[71] Whether an inequality of bargaining power exists in share sales is considered in chapter 7.

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[63] Tugce Yalcin, 'Disclosure: The Contractual Aspects' (2021) 42(1) Comp Law 4, 12.
[64] *Yam Seng v International Trade Corporation Limited* [2013] EWHC 111 (QB) para 142 (speech marks added).
[65] Bobby Reddy, 'Boxing Clever: Explaining UK and US Private Equity Locked Box Perspectives' (2022) 43(12) Comp Law 385, 386.
[66] Kevin K Boeh, 'Contracting Costs and Information Asymmetry Reduction in Cross-Border M&A' (2011) 48(3) J Management Studies 604.
[67] FC Sharp and Philip G Fox, 'Caveat Emptor' (1936) 43 Int J Ethics 212.
[68] Peter Howson, Due Diligence, The Critical Stage in Mergers and Acquisitions, Routledge 2003, section 1.
[69] Alan Wertheimer, 'Unconscionability and Contracts' (1992) 2(4) Bus Ethics Q 479, 480.
[70] ibid.
[71] ibid.

1.3.2.3.5 Efficiency concerns

The quality and quantity of the information available to both parties are likely to influence important choices relating to the type of offer that a buyer may make, the amount of the offer and the means of payment.[72] The return on the acquisition that may be realised by the buyer depends upon it making an accurate assessment of the value of the company and the accompanying synergistic effects.[73] Finance literature has documented that the extent of information asymmetry and uncertainty in share sales strongly affects deal attributes, as well as the wealth generated by both parties.[74]

The standards based [75] economic concept of efficiency, which is discussed more fully in chapter 7, is achieved when more output is gained from use of the same resources.[76] The normative approach argues that decisions should be made based on efficiency criteria and seeks to justify an economic approach to legal decision-making.[77] Efficiency is the standard by which rules and laws are measured by economists but it does not bear the same meaning as the word in everyday language. However, its drawback is that it cannot specify when or if contractual terms are or should be enforceable.[78] The concept of efficiency, as a standards-based theory, evaluates the substance of a transaction in order to establish if it meets the standard demanded by the theory.[79] Efficiency is the relationship between the combined costs and benefits of a situation which is also known as the "size of the pie" and economists seek to maximise the size of the pie.[80] Legal rules and practices are analysed to see whether they increase or decrease the size of the pie.[81]

Cooter and Ulen describe what efficiency demands: "efficiency requires uniting knowledge and control over resources at least cost, including the transaction costs of transmitting information and selling goods".[82] To explain, private information held by one party can drive exchange. If a party knows how to get more production from a resource than its owner then, to increase production, knowledge must be united with control. In order to unite knowledge with control, the owner of the resource must either acquire the information from the informed party or the informed party will need

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[72] Luypaert (n 60) 875.
[73] ibid 873.
[74] ibid.
[75] Randy E Barnett, 'A Consent Theory of Contract' (1986) 86(2) Colum L Rev 269, 271.
[76] Suri Ratnapala, *Jurisprudence* (3rd edn, Cambridge University Press 2020), 305.
[77] Symposium on Efficiency as a Legal Concern Introduction, Hofstra Law Review: (1980) Vol. 8: Iss. 3, Article 1, page 1. See a heated exchange on the subject of efficiency between Richard A. Posner, 'A Reply to Some Recent Criticisms of the Efficiency Theory of the Common Law' (1981) Hofstra Law Rev, 775 and Richard S Markovits, 'Legal Analysis and the Economic Analysis of Allocative Efficiency: A Response to Professor Posner's Reply' (1983) 11 Hofstra L Rev 667 in which Markovits refers to Posner's reply as so inadequate that a response is required.
[78] Barnett (n 75) 279.
[79] ibid 277.
[80] A Mitchell Polinsky, *An Introduction to Law and Economics* (4th edn, Wolters Kluwer 2011), page 7.
[81] Barnett (n 75) 278.
[82] Cooter and Ulen (n 62) 355.

to acquire ownership of the resource.[83] In general, the transmission of information and the sale of goods unites knowledge and control over resources.[84] However, if there is no uniting of the knowledge of information and control of the resources then efficiency is reduced.[85] The role of normative economics concerns a number of points including allocative efficiency, the identification of situations where efficiency is not achieved and the prescribing of alternative corrective solutions".[86]

1.3.3 The challenge of 'transaction costs'

1.3.3.1 What are 'transaction costs'

Transaction costs are the costs of making an exchange. An exchange has three steps.[87] First, an exchange partner has to be located which involves finding a buyer or seller, as the case may be. Secondly, a bargain must be struck between the exchange partners.[88] A bargain is reached by successful negotiation, which may include the drafting of an agreement.[89] Third, after a bargain has been reached, it must be enforced.[90] Enforcement involves monitoring the performance of the parties and punishing breaches of the agreement. These three steps can be labelled information costs;[91] bargaining costs; and enforcement costs.[92] Of these, the first two are the most relevant in relation to completing a share sale. If bargaining is precluded due to high transaction costs, the law has an efficiency objective of reducing transaction costs and promoting a more efficient allocation of resources.[93] Efficient negotiations may not occur when transaction costs are high.[94] It is only when transaction costs are trivial can negotiations be certain to be efficient.[95]

If there are positive transaction costs then efficiency many not occur under every legal rule and so the preferred legal rule is one which minimises those costs.[96] However, that can go as far as actually incurring transaction costs.[97] The concept of transaction costs assumes zero costs which is unrealistic but it provides a useful model to consider legal issues, transactions and costs in order to assess which legal rule is to be preferred.[98]

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[83] ibid.
[84] ibid.
[85] ibid.
[86] Cooter and Ulen (n 62) 355.
[87] ibid 88.
[88] ibid.
[89] ibid.
[90] ibid.
[91] Ratnapala (n 76).
[92] Cooter and Ulen (n 62) 88.
[93] Cento G Veljanovski, 'The Economic Approach to Law: A Critical Introduction' (1980) 7(2) Br J L & Soc 158, 169.
[94] Jules L Coleman, 'Economics and the Law: A Critical Review of the Foundations of the Economic Approach to Law' (1984) 94(4) Ethics 649, 657.
[95] ibid.
[96] A Mitchell Polinsky, *An Introduction to Law and Economics* (4th edn, Wolters Kluwer 2011), 15.
[97] ibid.
[98] ibid 16.

1.3.3.2 How significant are transaction costs in share sale transactions: a practitioner's view

Share sale transactions are expensive for both buyer and seller. In the writer's experience, legal fees alone can start at around £10,000 for most transactions with a purchase price of up to £100,000 and increase from there. If the purchase price is in excess of £1million, legal fees could be £30,000 plus. On top of this would be tax and accounting fees, and if the seller or buyer used a broker the fees could be significantly more. An example of costs for a share sale from 2017 can be seen in *HMRC v Hotel La Tour*.[99] In that case, a company sold the shares it held in its subsidiary company for £16 million.[100] The seller engaged various third parties to provide professional services to assist with the sale including market research, buyer shortlisting, financial modelling and tax compliance.[101] The broker charged £255,000 plus VAT of £51,267.19; the solicitors charged £115,399.51 plus VAT of £23,055.76 for strategic advice and conveyancing costs, and the accountants charged £12,500 plus VAT of £2,500 for tax support in respect of the share sale.[102] When a transaction has a high purchase price, such as in this case, then the costs as a percentage of the purchase price are small. However, in far lower value transactions the same is not true. This is because, broadly, the amount of work that is required does not necessarily reduce proportionately with the purchase price. The purchase agreement is likely to be of a similar length to one for a higher value transaction, the buyer will still have information asymmetry issues. Lower value share sale transactions therefore suffer from disproportionate transaction costs. The share sale process described in this chapter applies to all transactions, so a seller selling for say £100,000 may need to spend £10,000 on legal and other professional advisers whereas a seller selling for say £10,000,000 may only need to spend £50,000 on such costs. In the first example, the costs represent 10% of the purchase price, whereas in the second example, the costs represent 0.5% of the purchase price.[103] In the *Hotel La Tour* case above, the legal fees, minus VAT, were 0.7% of the purchase price. The buyer is likely to incur higher costs than these due to its due diligence exercise. Of course, the actual cost of any transaction depends on its complexity and the scope of the services undertaken by the advisers.

1.3.3.3 The consequences and implications of transaction costs

1.3.3.3.4 Inequality of bargaining power concerns

In cases of inequality of bargaining power, the weaker party will need to incur costs in an attempt to balance the inequality. This, in cases of information asymmetry, will arise where the weaker party

[99] [2024] EWCA Civ 564.
[100] ibid [5].
[101] ibid [6].
[102] ibid.
[103] These figures are based on personal experience.

needs to investigate what it is buying, formulate questions and analyse the answers to those questions. It will incur transaction costs in seeking to negotiate contractual terms with the more informed party and apply the result of its information-seeking to the contractual documentation.

Gilson is of the view that it would be considerably cheaper for the seller, whose costs of information production are very low, to provide the information than for the buyer to produce it alone.[104] However, the seller's costs are not zero. While the information exists, there are still costs associated with finding out where within the company the information is located, putting it in a form that is useful to the buyer, and verifying it.[105] As a result, even some information that already exists may not be worthwhile to locate and transmit.[106]

1.3.3.3.5 Efficiency concerns

Cooter and Ulen suggest that lowering transaction costs "lubricates" bargaining.[107] The law needs to lubricate private bargaining by lowering the transaction costs for the parties which can be achieved by the law defining simple and clear property rights.[108] It is easier to bargain when legal rights are simple and clear than when they are complicated and uncertain.[109] Bargaining is costly when it requires converting a lot of private information into public information.[110] The law can encourage bargaining by lowering transaction costs.[111] The law should be structured to remove the impediments to private agreements.[112] Cooter and Ulen illustrate this numerically:[113] if the surplus from an exchange is £25 and transaction costs are £30, then the parties will obtain a negative net benefit of £25 minus £30 which equals minus £5. This means that at least one of the parties will lose from the particular exchange. The exchange will be unlikely to occur when the net benefit is negative, assuming, of course, that the parties are rational. If, however, the law lowers transaction costs to £10, then the net benefit of exchange is £25 minus £10 which equals £15. In this case, the surplus exceeds transaction costs, so the net benefit from the exchange is positive which means both parties can gain from the private exchange.[114]

1.3.4 Other potential challenges not addressed in this thesis

1.3.4.1 Fairness

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[104] Ronald J Gilson, 'Value Creation by Business Lawyers: Legal Skills and Asset Pricing' (1984) 94(2) Yale LJ 239, 271.
[105] ibid 239 fn 75.
[106] ibid 239 fn 75.
[107] Cooter and Ulen (n 62) 91.
[108] Ibid.
[109] ibid 92.
[110] ibid 89.
[111] ibid 91.
[112] ibid 92.
[113] ibid 91.
[114] ibid 92

Inequality of bargaining power is considered in chapter 7. The other forms of contractual unfairness are more extreme aspects of bargaining power inequality (duress, undue influence and unconscionability) and so, in rejecting that such inequality exists in share transactions, there is limited value in considering, and then rejecting, other types of unfairness.

1.3.4.2 Relational contracting in share sale transactions

This thesis does not consider relational contracts where, broadly, the parties have no past relations or future relations and the transaction is entirely discrete.[115] Such relational contracts typically occur when there are "continuing, highly interactive contractual arrangements" [116] between the parties but the concept of relational contracts is, in fact, difficult to define[117] and could encompass agency contracts, distribution contracts, franchises, joint ventures and employment contracts.[118] Relational contracts have specific characteristics which were described by Leggatt J[119]in *Yam Seng v International Trade Corporation*:[120]

> "…relational" contracts, as they are sometimes called, may require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence and involve expectations of loyalty which are not legislated for in the express terms of the contract but are implicit in the parties' understanding and necessary to give business efficacy to the arrangements".[121]

Leggatt J's description was developed by Fraser J in *Bates v Post Office* [122] who listed nine qualities as being relevant as to whether a contract is a relational one. These included:

> "1. There must be no specific express terms in the contract that prevents a duty of good faith being implied into the contract.
> 2. The contract will be a long-term one, with the mutual intention of the parties being that there will be a long-term relationship.
> 3. The parties must intend that their respective roles be performed with integrity, and with fidelity to their bargain.
> 4. The parties will be committed to collaborating with one another in the performance of the contract.
> 5. The spirits and objectives of their venture may not be capable of being expressed exhaustively in a written contract.
> 6. They will each repose trust and confidence in one another, but of a different kind to that involved in fiduciary relationships.

[115] Ian R Macneil, 'Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law' (1977-1978) 72 Nw U L Rev 854, 856.
[116] Charles J Goetz and Robert E Scott, 'Principles of Relational Contracts' (1981) 67 Va L Rev 1089, 1090.
[117] Robert Merkin, *Poole's Textbook on Contract Law* (14th edn, OUP 2019) 24.
[118] Charles J Goetz and Robert E Scott, 'Principles of Relational Contracts' (1981) 67 Va L Rev 1089, 1090, 1091.
[119] Since promoted to the Supreme Court.
[120] [2013] EWHC 111 (QB).
[121] ibid, [142].
[122] [2019] EWHC 606 (QB).

7. The contract in question will involve a high degree of communication, co-operation and predictable performance based on mutual trust and confidence, and expectations of loyalty.
8. There may be a degree of significant investment by one party (or both) in the venture. This significant investment may be, in some cases, more accurately described as substantial financial commitment.
9. Exclusivity of the relationship may also be present".[123]

A share sale is a transaction which will not typically contain the qualities set out by Fraser J. This may change, to some extent, where some of the purchase price for the shares is paid by way of an earn out as described in section 1.4.3.1. In that case, the seller will have a time-limited ongoing relationship with the buyer, the effect of which will, if the performance targets in the earn out are reached, result in the payment of a sum to the seller. Having an interest in and means of contributing to the company's future profit is a relational contract but only with respect to a discrete aspect of the contract. The contract which brings that relationship about is still transactional. In light of this limited relational contract, and because earn outs are not a part of all share transactions, there is little value in featuring relational contracts in this thesis.

So far in this chapter, it has been shown how shareholders may, for a variety of reasons, decide to sell the company they own – by selling their shares in that company. In section 1.4, there is a description of the contractual documentation that is typically produced by the parties to constitute, and to record, the terms of this transaction. First, however, it will be useful to understand more deeply the commercial challenges which this transacting process presents. Doing so will enable us better to *explain and understand* the parties' own contracting practices – in section 1.4. but even more importantly, these challenges are relevant not only to the parties, but also to the law which seeks to help – and to regulate – the parties' behaviour. The law itself must respond to these challenges. It must be judged by how effectively it addresses them. Insofar as it does so poorly, it should be reformed to improve its effectiveness. These normative/theoretical matters are central to the thesis. They are captured in research question 3 and are addressed respectively in chapters 7 and 8 of this thesis.

1.4 AN OVERVIEW OF THE TRANSACTIONAL DOCUMENTATION

1.4.1 The initial 'Heads of Terms' agreement

Once an agreement in principle is reached the buyer will set out its offer in a heads of terms.[124] This is usually a document which is divided into two parts. One part is designed not to have legal effect. The other part is expressed to be legally binding. The benefit of the parties agreeing heads of terms is to

[123] ibid [725].
[124] Also known as a term sheet, heads of agreement or letter of intent - Stilton (n 125) section 1, 3-01.

avoid misunderstandings and to identify any major impediments to the transaction [125] – what terms would be unacceptable to the parties. This has the benefit of saving time and costs if the relevant issue cannot be resolved.[126] It also provides some form of moral commitment by the parties to the transaction and provides some degree of comfort that the other party is serious about completing the transaction.

The non-legally binding part will state the amount of the offer, that it is subject to contract and a number of other factors. Once the heads of terms are agreed it will be more difficult, from a negotiation perspective, for either the buyer or seller to go back on a point contained in the heads of terms, without good reason.[127]

The legally binding part of the heads of terms will potentially concern a number of matters. The buyer may want to include a requirement for the seller to reimburse its legal costs if the buyer withdraws from the purchase due to an adverse finding about the company, or breach by the seller of any exclusivity provisions. This is where the buyer requires the seller to provide it with a period when the seller is not able to sell the company to another buyer or even discuss a potential sale with a third party.[128]

1.4.2 The due diligence process

Due diligence is a central feature of share purchases. It is an important part of the transaction. All business transactions, whether a merger, acquisition or a simple investment, carry risks.[129] Identifying, understanding, and addressing these risks is fundamental to ensuring the security and success of the transaction.[130] The undertaking of comprehensive due diligence can be expensive, especially for smaller businesses or start-ups.[131]

Due diligence is the process by which a buyer ascertains what it is buying before entering into a legally binding transaction.[132] The buyer will conduct due diligence, due to the common law concept of caveat emptor, on the target company to learn as much as possible before entering into the

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[125] ibid.
[126] ibid.
[127] Burges Salmon https://www.burges-salmon.com/news-and-insight/publications/guide-to-private-company-sales-and-acquisitions.
[128] See *Walford v Miles* [1992] 2 AC 128 where it was held that parties cannot be 'locked in' to negotiating with each other but can be 'locked out' of negotiating with any other for a finite period of time.
[129] LexisNexis https://www.lexisnexis.com/blogs/gb/b/compliance-risk-due-diligence/posts/essential-steps-in-conducting-due-diligence?srsltid=AfmBOoq5z4bJ1yTq8WWScwlEXsGha4_6_BqDGE5b9K43Ks6cDIVmvwuv.
[130] ibid.
[131] ibid.
[132] Funmi Adesanya, 'Due Diligence and the UK and US Approach to Disclosures' (2018) 29 ICCLR 652.

transaction.[133] Due also to caveat emptor, the buyer will perform due diligence to obtain a thorough understanding of the target company.[134] Due diligence identifies risks against which the buyer should negotiate some sort of protection.[135]

The buyer will want to undertake financial, legal and commercial due diligence. The buyer asks questions of the seller and has access to documents relating to the business and assets of the target business and company.[136] This will mean the buyer will need to formulate and ask appropriate questions of the seller about the company in relation to these areas. Due diligence identifies and quantifies the risks associated with the purchase as well as determining the value of the assets and the protections to be required from the seller.[137] The purchase of shares requires the buyer to assume a financial risk so it is prudent for it to obtain sufficient information on the conduct and affairs of the target.[138]

Conducting legal due diligence will involve reviewing documents made available by the seller to the buyer. It will usually include reviewing various types of contracts (some of which may be of a specialist nature), as well as various records, ledgers and lists.[139] According to LexisNexis, the buyer's legal advisers will focus on "title (seller's title in sale shares, as well as title to key assets, property and rights); licences and consents (existence and continued availability of licences, permissions and consents required to carry on the business); material contracts (whether there are any unusual contractual terms in key contracts with main customers/suppliers, especially price/payment and term/termination); change of control (whether the acquisition will trigger a change of control clause that will lose the business a key customer or supplier); conditions to completion (identify whether any conditions to completion will be required that are not already known about, such as third party consents); finance and security (target's financing arrangements and associated security granted over the target's business and assets); employees (whether there are unusually long notice periods and remuneration provisions, especially in the terms of employment of key personnel); and known liabilities (litigation or any key potential liabilities)".[140]

Due diligence is sometimes a frustrating process for both parties. The buyer needs to spend time and resources asking the correct questions of the seller. The seller will need to commit significant time

[133] Tugce Yalcin, 'Disclosure: The Contractual Aspects' (2021) 42(1) Comp Law 4, 12.
[134] Mehdi Tedjani, 'Indemnities in Private Share Deals' (2019) 40(2) Comp Law 39.
[135] Peter Howson, *Due Diligence: The Critical Stage in Mergers and Acquisitions* (Routledge 2003).
[136] The law firm, Weightmans has produced a note on preparing a company for sale: https://www.weightmans.com/insights/preparing-your-company-for-sale/.
[137] Fabio Solimene, 'Asset Deals v Share Deals in the Oil and Gas Industry' (2013) 7 IELR 277, 281.
[138] Umakanth Varottil, 'Due Diligence in Share Acquisitions: Navigating the Insider Trading Regime' [2017] 3 JBL 237.
[139] Lexis Nexis Conducting a legal due diligence review in a share purchase transaction.
[140] Lexis Nexis Conducting a legal due diligence review in a share purchase transaction.

and resources responding to the buyer's enquiries.[141] Without making the enquiries the buyer will not know where the risks with the company may be and due diligence also helps to avoid litigation which is expensive and uncertain.[142] The more that is known about the seller's business, the better the buyer is equipped for the forthcoming negotiations.[143] To make a return on the transaction, a buyer must either know more than the seller does or be able to do more with the business than the seller can.[144] Due diligence findings should therefore also assess the strategic rationale of the deal, the business's standalone value and growth prospects and the size, timing and achievability of synergies.[145]

Further enquiries are likely to be asked by the buyer of the seller as the seller is unlikely to be able to adequately answer all of the questions first posed to it. Due diligence is therefore a funnelling process by which the questions and answers reduce over time. It is initiated by the buyer who ensures that the right questions are asked and reviews the seller's answers, asks more questions based on the answers given, reviews documentation provided in support of the answers and asks questions about that and re-asks questions which the seller has not answered properly or at all.

As a result of due diligence, in some cases, significant issues are identified. These result in changes to the transaction structure, amendments to the purchase agreement, reduction of the purchase price, or perhaps the transaction being abandoned. Whilst Akerlof's view was that information asymmetry results in a reduction of the purchase price, [146] this it may do, but the response in shares sales may instead more typically be for the buyer to seek more onerous terms from the seller which has the effect of increasing both parties' transaction costs.

There are risks to both buyer and seller during the due diligence process. As regards the seller, information could be leaked to competitors which may negatively impact the company.[147] If the transaction does not proceed there is a loss of time and money for both parties as properly undertaken due diligence demands a lot of manpower and effort.[148] There may also be a loss of business and loss

[141] Burges Salmon https://www.burges-salmon.com/news-and-insight/publications/guide-to-private-company-sales-and-acquisitions.
[142] Peter Howson, *Due Diligence: The Critical Stage in Mergers and Acquisitions* (Routledge 2003).
[143] ibid.
[144] ibid.
[145] ibid.
[146] George A Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84(3) Q J Econ 488, 489. Laurence Capron and Jung-Chin Shen, 'Acquisitions of Private vs Public Firms: Private Information, Target Selection, and Acquirer Returns' (2007) 28(9) Strat Mgmt J, 896 state that when a buyer "targets a private firm, even if it has private information on that specific target that no one else has, it may discount its offer to reflect the possibility that the target will turn out to be a lemon. In addition, the value of the target's shares may be discounted to reflect their illiquidity.
[147] Sven De Cleyn and Johan Braet, 'The Due Diligence Process—Guiding Principles for Early Stage Innovative Products and Venture Capital Investments' (2007) 10(3) J Priv Equity 43, 44.
[148] ibid.

of focus due to the process.[149] The seller will also be concerned that the buyer, in receiving information, wishes to steal it.[150]

As regards the buyer, its main risk is losing the deal it is pursuing.[151] When a due diligence process is initiated, there is a net interest in the opportunity offered.[152] Many companies' expansion strategy and business development may rely on making the acquisition in question. Losing the deal is a setback and may mean a loss of competitive strength in the buyer's industry.[153] There will also be lost time and money, as substantial resources have likely been expended in the due diligence process including on paying external advisers such as lawyers, tax advisers and accountants.[154] The buyer will be concerned that only partial disclosure has been achieved as the seller has not disclosed everything to the buyer. There may be a risk that the seller may hide a liability of the company.

1.4.3 The 'Share Sale Agreement'[155]

During the due diligence process, the buyer will draft the share purchase agreement. The share purchase agreement is the principal document in a share sale.

The share purchase agreement is made up of a number of parts ranging from the main body of the agreement to its separate schedules.

The main body sets out various aspects. It contains provisions dealing with the number of shares being sold, the price adjustment mechanism (if any), any indemnities that the seller may give, reference to the warranties the seller will give to the buyer, restrictive covenants and boilerplate provisions.[156] If the transaction will have a separate exchange [157] and completion, as opposed to a simultaneous exchange and completion, there will be additional provisions dealing with that which will specify whether the seller repeats at completion the warranties that it gave at exchange and provisions that control the way the target company is operated between exchange and completion. If

[149] ibid.
[150] ibid.
[151] ibid.
[152] ibid.
[153] ibid.
[154] ibid.
[155] Also known as a 'share purchase agreement'.
[156] Practical Law, Boilerplate agreement: "Boilerplate clauses deal with those generic contractual provisions which are generally found in commercial contracts, whatever the nature of the transaction. For example, matters such as the choice of governing law, the mechanism for serving notices, and requirements that any amendments be agreed and documented in writing".
[157] Concluding an acquisition usually involves a two-stage process: signing and exchange - the parties make a legal commitment to proceed with the transaction by delivering their signed acquisition agreement to the other party by way of exchange and 'completion' where necessary formalities to conclude the transaction are performed.

the seller is to repeat the truth of the warranties at completion the parties will need to agree if the seller can disclose against the warranties.

There will be a schedule to the agreement containing warranties. The buyer will want to obtain assurances from the seller. In an acquisition, the buyer will want the seller to provide the buyer with numerous warranties about the condition of the target company's business and assets.[158] However, the buyer has no automatic entitlement to wide-ranging warranties.[159] These warranties will typically appear in a schedule to the main body of the acquisition agreement and will cover many pages. They can typically be up to 40 pages in length and are often one of the most negotiated aspects of the transaction.[160]

1.4.3.1 The consideration clause

The key aspect of a transaction will, of course, be the purchase price. The buyer may want to defer some of the purchase price rather than paying it all to the seller on completion of the purchase. This will be to cover at least some of the costs of any claims that the buyer may have against the seller arising under the share purchase agreement. Deferment also means that the buyer does not have to pursue the seller for recovery of sums paid in the event of the seller's breach of the agreement.

There are various ways of structuring the payment of the deferred purchase price. One could be to simply delay in making the payment, for example, a payment in one year or two years or an annual payment for a few years in the same or differing amounts. Another way is for the remaining purchase price to be paid subject to the performance of the target company following completion. This is typically known as an earn out. It is a contingent portion of the purchase price that is paid to the seller after completion of the sale upon the company achieving certain agreed financial or non-financial benchmarks within a specified period of time.[161] An earnout limits the buyer's risk that it is overpaying for the company, while also providing the seller with what it considers appropriate consideration if the company's projected performance is achieved.[162] An earnout has the potential to lead to a win-win situation where the seller achieves a higher purchase price by capturing value from the future growth of the target and the buyer gets what it paid for.[163] In an earn out, payment of the purchase price is delayed until after completion of the transaction. The payment is only made if

[158] Daniel Rosenberg, *Practical Commercial Precedents* (Sweet & Maxwell) D5-130.
[159] ibid.
[160] Burges Salmon https://www.burges-salmon.com/news-and-insight/publications/guide-to-private-company-sales-and-acquisitions.
[161] Kevin Levy, Angelo Bonvino, and Prem Amarnani, 'Return of the Earnout: An Important Tool for Acquisitions in Today's Economy' (2011) Business Law Today, 1.
[162] ibid.
[163] ibid.

certain performance targets are achieved by the target company within a specified period, which may be a number of years after completion.[164] The performance targets of the company may be financial based on its future profit, cash flow or revenue.[165] Alternatively, it could be non-financial such as being based on future order levels or customer numbers.[166] In the United States, there are typically more earn outs than in the UK.[167] This means that earn-outs move the allocation of risk to the seller.[168] An earn out may have relational aspects – see section 1.3.2.

Where any part of the purchase price is deferred then, subject to the financial worth of the buyer and how long the seller has to wait for payment, it is usual for the seller to require the buyer to provide security in the event of non-payment by the buyer. This can take the form of a debenture over the target company, a debenture over the buyer, a personal guarantee perhaps with such guarantee having a legal charge over real estate owned by the person giving the guarantee. Alternatively, the seller and buyer may agree for the deferred part of the purchase price to be placed into escrow.[169]

1.4.3.2 Warranties

A warranty is a term of a contract which, if breached, may give rise to a claim for damages but not a right to treat the contract as repudiated.[170] To give itself protection, the buyer introduces warranties in the share purchase agreement which has the effect of shifting the burden for unknown risks from the buyer to the seller [171] but they do not offer guaranteed protection for the buyer. A warranty is a subsidiary term of the contract used for less important contractual terms.[172] Its breach may give the buyer the right to a claim in damages.[173]

A buyer would want warranties to be drafted so they cover each aspect of the target company proposing to be purchased [174] as any failure to do so will leave a hole in the extent of the warranty cover meaning the buyer assumes the risk of there being issues with the target company in respect of that particular omitted matter. Warranties mitigate against the risk of there being asymmetry of

[164] Reddy (n 65) 391.
[165] ibid.
[166] Reddy (n 65) 391.
[167] ibid.
[168] ibid.
[169] A deposit account in a bank opened on terms under which there may be no withdrawals from the account without the agreement of both sets of solicitors, which means that both parties should be able to feel confident that it cannot be taken by the other - Stilton (n 125) 10-102.
[170] Hugh Beale, *Chitty on Contracts* (vol 1, 33rd edn, Sweet & Maxwell 2018) 13-031. Repudiation occurs in relation to "a breach of contract by one party which gives the other party the option to terminate the contract. A repudiatory breach is either a breach of a condition, or a serious breach of an innominate term" - TT Arvind, *Contract Law* (2nd edn OUP 2019) glossary. See Ewan McKendrick, *Contract Law Text, Cases, and Materials* (9th edn, OUP 2020) page 757.
[171] Tedjani (n 134).
[172] Beale (n 170).
[173] Beale 33rd (n 206) 13-031.
[174] Stilton (n 125) 5-01.

information between the parties as to the nature of the target company.[175] As Hodge L noted in *Wood v Capita* [176] about the buyer's lack of knowledge and so it requires warranties from the seller:

> "[the sellers] were the people who knew or ought to have known how the Company had operated its business; Capita [the buyer] would in all probability not have that knowledge. The parties to the SPA would have known this. That lack of knowledge explains why [the buyer] required the disclosures in the disclosure letter and the detailed warranties".[177]

Warranties have become the customary means by which a buyer obtains assurance from the seller as to the assets of the company or the business as to the liabilities which attach to the target company.[178] The reason for warranties is that in the share (or asset) sales, the buyer receives little protection under the law if what they thought they were buying subsequently turns out to be not what they expected. This is the case unless there has been misrepresentation or fraud by the seller.[179]

1.4.3.3 Indemnities

In this context, an indemnity is an express obligation on the seller to compensate the buyer for a defined loss or damage.[180] The "term merely connotes the right of one party to look to another to satisfy his losses".[181]

A risk identified during due diligence might lead to a price adjustment (if the risk is quantifiable) or (if non-quantifiable) to an indemnity, determining which party bears the risk.[182] Once identified in the disclosure letter, the disclosed fact is usually no longer covered by the warranties. The buyer might then require an indemnity to be protected against losses resulting from that fact.[183]

The second situation is where the buyer becomes aware of matters during the acquisition process, typically identified by the buyer's due diligence, in respect of which it is not prepared to accept the risk relating to the matter identified.[184] In those situations, the buyer will seek an indemnity from the seller to cover such risks. An indemnity, and its interpretation, was the central point in the Supreme Court decision in *Wood v Capita*.

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[175] Tedjani (n 134) 40.
[176] [2017] A.C. 1173, [28].
[177] ibid.
[178] Tedjani (n 134) 40.
[179] Robert Thompson, Sinclair on Warranties and Indemnities on Share and Asset Sales (10th edn, Sweet & Maxwell 2017) introduction.
[180] Tedjani (n 134) 40.
[181] *Pitts v Jones* [2008] Q.B. 706 [21] Smith LJ.
[182] Tedjani (n 134), 40.
[183] ibid.
[184] ibid.

1.4.3.4 Completion accounts

In addition to the various ways of structuring the deferred purchase price, it is usual for the purchase price to be subject to the production of completion accounts. These provide for either payment of an additional sum by the buyer to the seller, or repayment of a sum by the seller to the buyer. This is because, in many transactions, the precise amount of the purchase price is not fixed when the share purchase agreement is entered into.[185] Instead, the parties agree on a figure which is subject to later adjustment by reference to a set of accounts of the target company prepared as at (or shortly before or shortly after) completion.[186] For example, the buyer may have agreed to acquire the entire issued share capital of a company for a purchase price of £5 million. The purchase price may have been decided upon by the buyer (and agreed by the seller) on the basis that the company will have net assets of at least £4 million.[187] The target company will continue to trade until and after completion.[188] It is unlikely the buyer will be confident the company will have net assets of at least £4 million on completion. Therefore, the parties agree that the purchase agreement will provide a provisional purchase price of £5 million that will reduce on a pound for pound basis if the net assets of target company, as shown by completion accounts, are less than £4 million.[189] Therefore, if the completion accounts showed net assets of £3.5 million the purchase price would reduce to £4.5 million.[190] Using completion accounts to adjust the purchase price is a true-up of the company's financial position as at completion.[191] Likewise, there may be a similar price adjustment if the company's net assets are above £4 million. In that case, if the completion accounts show net assets of say £4.25 million, the purchase price will increase to £5.25 million.[192] On this basis, the buyer does not take the risk of any losses made by the company before completion, and the seller is compensated for any net profits the company makes before completion.[193] The principles concerning completion accounts are heavily negotiated and the share purchase agreement will specify how the completion accounts will be prepared.[194]

There is an alternative method to completion accounts known as 'locked box'. Locked-box mechanisms do not involve any post-completion adjustment of the purchase price. Instead, the company's financial position results from a historic set of accounts (locked-box accounts), dated on a

[185] Stilton (n 125) 12.05.
[186] ibid.
[187] ibid.
[188] Reddy (n 65) 386.
[189] Stilton (n 125) 12.05.
[190] ibid.
[191] Reddy (n 65) 386.
[192] Stilton (n 125) 12.05.
[193] Reddy (n 65) 386.
[194] ibid.

date prior to completion of the transaction. If figures change, whether up or down, between the accounts date and completion, the buyer takes the risk or the reward, as the case may be.[195]

1.4.3.5 Limitation of Liability clauses

A schedule containing limitations on the seller's liability will deal with a large number of matters. The important ones will include a financial cap on the seller's liability which is often expressed as a percentage of the purchase price.[196] The parties usually agree a 'de minimis' in relation to the value of warranty claims.[197] This is typically based on a percentage of the purchase price.[198] This means that where a warranty is breached and the value of the claim is below the de minimis the claim cannot be brought by the buyer. In addition, it is usual to include a 'claims basket'.[199] This provides that claims cannot be brought if the value of them when taken together do not exceed the agreed threshold. For example, the de minimis may provide that the claims value needs to be at least £1,000 per claim but the basket may provide the combined claims value is at least £30,000 in total.

Other provisions in the seller's limitations of liability include a time limit for bringing claims.[200] There are usually different time limits applying to claims under the warranties, indemnities and tax covenant. These can range from 18 to 36 months for warranty claims, [201] varying periods for indemnity claims but typically up to 2 or 3 years and between 4 and 7 years for tax covenant claims.[202] In each case this is usually from the date of completion, rather than from the date of the breach which is when time runs under the Limitation Act 1980.

1.4.4 The 'Disclosure Letter'

Related to the warranties is the concept of disclosure. As part of the acquisition the seller will provide the buyer with a disclosure letter which qualifies the warranties, in that to the extent the warranties are untrue the disclosure letter will state how and why such warranties are untrue. Where the seller discloses against the warranties in the disclosure letter to the required standard of disclosure specified in the acquisition agreement the seller is relieved of liability to the extent of the disclosure. For such a

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[195] ibid 387.
[196] Baker's 2020 Guide to Navigating Global Private M&A United Kingdom guide says https://www.bakermckenzie.com/-/media/files/insight/guides/2021/2020-gpma-all-jurisdictions-updated.pdf#page=542&zoom=100,65,240.
[197] Practical Law Company: Seller warranties and limitations on liability: commonly negotiated issues: share purchases.
[198] ibid.
[199] ibid.
[200] "It is not contrary to business common sense for the parties to agree wide ranging warranties, which are subject to a time limit" *Wood v Capita* [2017] A.C. 1173 [40] per Lord Hodge.
[201] Farrer & Co A basic guide to the legal process - selling your business page 9.. https://www.farrer.co.uk/globalassets/clients-and-sectors/businesses/a-basic-guide-to-selling-your-business-april-2020.pdf
[202] Practical Law Company: Seller warranties and limitations on liability: commonly negotiated issues: share purchases.

known risk, the seller can disclose against any warranty that the seller knows is untrue which, in turn, shifts the specific risk back to the buyer.[203] Disclosure is discussed in more detail in chapter 6.

1.4.5 The 'Tax Covenant'

A further schedule contains the tax covenant. That covenant requires the seller to pay any tax that should have been paid by the company and applies to all pre-completion tax liabilities of the target company.[204]

1.4.6 Conclusion

Share sale transactions are lengthy and complex both in relation to valuing the company in which the shares are held as well as the transaction process and documentation. Significant costs arise in share sales which are largely due to the buyer seeking to acquire information about the company and negotiating protections, in the form of warranties and indemnities, from the seller.

[203] Tedjani (n 134).
[204] Practical Law Company – share sales: reasons for the tax indemnity.

Chapter 2

How Seller-Friendly is English Law?

This chapter is doctrinal. It establishes how the principles of contract law deal with the rights and obligations of the parties to a contract to buy and sell shares in a company. In doing so, it seeks to show that this body of law is, in a number of significant ways, more favourable to sellers than to buyers.

To do this, section 2.1 begins by noting the key contract law principle that instantiates this bias towards sellers, namely the caveat emptor principle. It observes the scope of caveat emptor and there being no obligation on the seller to disclose issues to the buyer.

The situations in which the law does impose a duty to disclose are dealt with in section 2.2, but these do not include the sale of shares.

Section 2.3 acknowledges that the scope of the caveat emptor doctrine is considered in light of its limitations of misrepresentation and fraud. This section looks at the definition of misrepresentation but concludes a broad consideration of misrepresentation would have limited value in this thesis. Instead, it suggests considering whether silence amounts to a misrepresentation, which is dealt with in section 2.4.

Having noted that there is no general principle of silence amounting to a representation, section 2.5 examines the exceptions to that principle.

Finally, section 2.6 looks at fraud. It refers to civil and criminal fraud and notes that neither make an inroad in the caveat emptor doctrine.

2.1 The starting point: caveat emptor

The caveat emptor doctrine is favourable to the seller. This is due to a well-known maxim: "caveat emptor qui ignorare non debuit quod jus alienum emit" (meaning let a purchaser beware [without relying on any remedy by law], for he ought not to be ignorant of [the amount] of that other person's interest which he is to purchase".[205] This is typically shortened to "caveat emptor", meaning "let the buyer beware". This maxim is the starting point of English contract law [206]. A more modern statement of the doctrine is that it is for the buyer to decide what protection it requires, not for the law

[205] 'Law Maxims - Caveat Emptor, &c. (etc.)' (1843) 30 Law Mag Quart Rev Juris 289.
[206] Beale 33rd (n 206) 2-220.

to provide it.[207] Practically, it means, "…there is no obligation in general to bring difficulties and defects to the attention of [the buyer]".[208] As the seller is not required to communicate deficiencies in what it intends to sell to the buyer, the buyer needs to make its own inquiry as to the subject matter of its proposed purchase. It has been said that buying "is a game of chance".[209] As regards share sales, the UK is seen as seller-friendly due to caveat emptor, and the US as buyer-friendly".[210] However, this may not be due to the non-existence of caveat emptor in the US, as caveat emptor applies there too.[211] Instead, it is due, in part, to the market practice of giving far-reaching warranties" [212] which, as stated in chapter 1, have a dual effect of giving the buyer protection and encouraging the release of information to the buyer. As Andrew Baker KC (sitting as a High Court judge) noted in a recent case regarding a share purchase agreement, "the common law rule being caveat emptor, no promise about the Company, its activities or finances, its transactions or liabilities, was purchased by [the buyer] except such promises (if any) as might be made by [the seller to the buyer in the SPA].[213] The giving of warranties is an aside and is based on the buyer and seller agreeing to the provision of them in the acquisition agreement. In share sales, the application of caveat emptor does not require the seller to provide any warranty to the buyer or require it to disclose information to the buyer.[214]

However, the caveat emptor doctrine is not without its limits. It is subject to the exceptions of misrepresentation or fraud on the part of the seller.[215] In application of these exceptions, it would be possible to restate the position for the buyer as follows: in the absence of fraud or misrepresentation by the seller, a buyer of the shares in a company is generally at risk of the shares it thinks it is purchasing not being as expected or being subject to defects or liabilities.[216] The buyer is also at risk

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[207] Thompson (n 179) 1-01.
[208] Beale 33rd (n 206) 2-220 citing ING Bank NV v Rosa SA [2011] EWCA Civ 353, [92].
[209] Walton H Hamilton, 'The Ancient Maxim Caveat Emptor' (1931) 40 Yale LJ 1133, 1187.
[210] Daniele D'Alvia, Book review: Carve-out M&A Transactions: A Practical Guide, by Robbie McLaren, 41 Bus. L. Rev. 36 (2020) 36.
[211] Jon Grouf, Scott Newman, Mark Doets and Joyce Leemrijse, 'Due Diligence in International M&A Transactions: The Team of Experts' (2002) 2002 Bus L Int'l 59, 60.
[212] Hans-Jorg Ziegenhain, 'Caveat Emptor' (2015-2016) 34 Int'l Fin L Rev 47.
[213] *Idemitsu Kosan v Sumitomo Corporation* [2016] EWHC 1909 (Comm) [7].
[214] The provision of a warranty would be one means in which to impinge on the scope of caveat emptor. Hamilton noted that the doctrines of deceit and warranty "increased measurably the seller's responsibility" Walton H Hamilton, 'The Ancient Maxim Caveat Emptor' (1931) 40 Yale LJ 1133, 1186.
[215] Thompson (n 179). Little has changed. As long ago as 1793 John Fonblanque said that "the general rule of the common law of England is caveat emptor, upon which rule it seems, that the vendor, without an express warranty, merely undertakes to make a good title to the vendee: to show that the goods delivered are such as where contracted for, that no deceit was practiced to disguise their defects" John Fonblanque, *Treatise of Equity* 109 https://archive.org/details/bim_eighteenth-century_a-treatise-of-equity-wi_1793_1/page/108/mode/2up?view=theater.
[216] Ross McNaughton, Matthew Poxon, Alexandria Dempster, 'Acquisitions: representations, warranties and disclosure' (2018) Westlaw Insight accessed 30 July 2019. Although stated in relation to German law the same applies to English law: "the principle of caveat emptor, or buyer beware, influences German M&A [mergers and acquisitions] deals in a manner that is diametrically opposed to fundamental principles of German statutory law; the latter hold the seller responsible for any defects of the object of purchase, while the purchaser is generally not obliged to perform checks. In German M&A, however, the purchaser has to scrutinise the business it intends to acquire by way of a due diligence review, to ensure they can live with minimal warranty claims against the seller. In contrast, in US private M&A, market practice is to give far-reaching warranties." Hans-Jorg Ziegenhain, 'Caveat Emptor' (2015-2016) 34 Int'l Fin L Rev 47.

that the company it is proposing to buy is subject to onerous liabilities.[217] This means there are two matters in play here – there may either be potential problems with the seller's ownership of the shares it is selling, or there may be problems with the company which the shares concern, or indeed both.

As Hamilton neatly expresses it, "the meaning of the [caveat emptor] maxim is to be discovered along the unstable and changing line which separates the buyer's protection from the seller's immunity".[218] As such, and to navigate this line, the doctrine of caveat emptor is best understood when consideration is given to its limitations of misrepresentation and fraud. Only then can its scope be properly understood. Before doing so, it is worth turning to briefly consider where the law does impose a duty to disclose.

There are three reasons for doing so. The first is to complete the picture as to when the law imposes such an obligation. The second is to highlight that a buyer in share sales does not benefit from the duty. The third is to show that the law has put its mind to imposing a duty to disclose in certain corporate-related situations, but not in relation to the sale of shares.

2.2 Where the law imposes a duty to disclose

The law imposes a duty of disclosure in other situations because knowledge of material facts remain with one party and so they are required to disclose those facts.[219] Those situations include contracts of utmost good faith [220] and statutory exceptions.[221] Under each of these two headings, there are a number of specific types of contracts such as insurance contracts, family settlements, contracts for the sale of land, contracts for suretyship and partnerships where some degree of disclosure is required.[222] The corporate situation in which disclosure is required is in relation to a subscription for shares in a public company by an investor. This is where an investor is issued shares in the company by the company.

This obligation concerning the subscription for shares in a public company imposes a duty of disclosure under Financial Services and Markets Act 2000, s 80(1). The main aspect of the duty of disclosure in that section is the document given to investors (known as the listing particulars) must contain such information as investors and their professional advisers would reasonably require, and reasonably expect to find for the purpose of making an informed assessment of the assets and

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[217] Thompson (n 179).
[218] Walton H Hamilton, 'The Ancient Maxim Caveat Emptor' (1931) 40 Yale LJ 1133, 1186.
[219] Beale 33rd (n 206) 7-158.
[220] ibid 7-018.
[221] ibid 7-172.
[222] ibid 7-158.

liabilities, financial position, profits and losses, and prospects of the company. As Chitty notes, the underlying reason for this position is because knowledge of material facts lies with one party alone, being those involved with the company.[223] In the same way that material information concerning the company lies with one party in a listed company investment, so too does that material information in relation to the company in a share sale situation lie with one party (either the seller or the directors of the company). Likewise, the obligation is imposed in a company investment scenario because the law recognises material facts remain with one party. Conversely, in a share sale situation, the material facts also sit with one party alone, but a similar obligation is not imposed. There is a difference, however: a buyer of shares in a listed company, which includes members of the public, is not easily able to undertake due diligence on the company in the same way as the buying of shares in a private company but this, in itself, does not seem to justify the difference. The law in an investment situation obliges the company's directors to provide information about the "assets and liabilities, financial position, profits and losses, and prospects of the company" to the investor but does not impose the same obligation in a share sale situation. To some extent, this is likely to be the same information that the buyer of shares in a company would wish to know.

So far, this chapter has considered caveat emptor and there being no duty on the seller to disclose and the situation where a duty to disclose does exist. It turns now to consider the meaning of misrepresentation.

2.3 Misrepresentation defined

Although it is, in fact, difficult to define misrepresentation and there is no single meaning of the word, [224] it can broadly be said that a misrepresentation is a false statement [225] of fact (past or present) [226] or law made by a party to the other party to the contract [227] with the intention that the recipient of the representation would act upon it.[228] There are three categories of misrepresentation – fraudulent, negligent and innocent. If a person has been induced to enter into a contract as a result of a fraudulent misrepresentation by the seller they may be able to rescind the contract, or claim damages, or both.[229]

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[223] Beale (n 223) 7-158, 10-184. In *Emile Erlanger v The New Sombrero Phosphate Company* (1877-78) L.R. 3 App. Cas. 1218, [1255] Lord O'Hagan said in relation to subscribing for shares in a company (that is buying them from the company rather than the shareholders), that "that involved obligations of a very serious kind [for those promoting the company]. It required, in its exercise, the utmost good faith, the completest truthfulness, and a careful regard to the protection of the future shareholders."
[224] John Cartwright, Misrepresentation, Mistake and Non-Disclosure (6th edn, Sweet & Maxwell) 2-02.
[225] Beale (n 223) 7-006.
[226] ibid 7-007.
[227] ibid 7-027.
[228] ibid 7-032.
[229] Beale (n 223) 10-156.

That explains the meaning of misrepresentation. As for the damages regime for misrepresentation, this is described below.[230]

In respect of fraudulent misrepresentation (also known as the tort of deceit), dishonesty must be proved. If it is, the misrepresentee is entitled to damages for all losses directly caused by the misrepresentation.

In respect of negligent misrepresentation under the Misrepresentation Act 1967, s 2(1) provides that if someone enters into a contract after a non-fraudulent misrepresentation has been made the misrepresentor has the burden of showing a reasonable basis for the representation. Otherwise, it seems the misrepresentee is entitled to damages on the same basis as for fraud.[231]

Finally, concerning innocent misrepresentation, Misrepresentation Act 1967, s 2(2) allows the court to refuse rescission of a contract if it appears, having regard to the loss suffered by the misrepresentor if the contract is rescinded and the loss suffered by the misrepresentee if the contract is not rescinded, rescission appears inequitable. If rescission is refused the court should award damages in lieu of rescission. There is no clarity about how these damages should be calculated. As the misrepresentation is innocent there is no tort so the measure cannot be one of restoring the misrepresentee to the position it would have occupied if the misrepresentation had not been made. In *William Sindall v Cambridgeshire County Council* [232] Hoffmann LJ (as he then was) suggested damages could be calculated as per breach of a minor contractual warranty. But this is still the measure for breach of contract which misrepresentation is not.

There is also the separate principle of negligent misstatement. This is unlikely to arise because the seller will not owe the buyer a duty of care. If a duty of care is owed, the buyer will have to prove negligence. If it can its damages are limited by the remoteness principle.

Therefore, and returning to the meaning of misrepresentation, to express it simply and obviously, the central aspect of misrepresentation is the making of a statement by one party to cause another party to enter into a contract. It is because a statement is required to be made to meet the definition there seems little to be gained in undertaking an in-depth consideration of the law of misrepresentation. To do so would require an analysis of the various elements of misrepresentation. Such an exercise would have limited value as it would not reveal the limits of the scope of caveat emptor. If analysis were to be undertaken it would show, for example, a statement of a future intention does not ordinarily

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[230] Summarised from Beale (n 223) 10-154. For a discussion on remedies generally, see David Capper, 'Remedies for Misrepresentation' in Larry A. Di Matteo, Qi Zhou, Severine Saintier, and Keith Rowley (eds), Commercial Contract Law – Transatlantic Perspectives (Cambridge University Press, 2013), 385-415.
[231] *Royscot Trust v Rogerson* [1991] 2 QB 297.
[232] [1994] 1 WLR 1016.

amount to a fact and so would prevent a claim.[233] It would show that a representation does not have to be entirely correct, meaning a partially true representation may not permit a claim.[234] It would be noted that the misrepresentation must have induced the party to rely on the representation when entering the contract.[235] These three examples show the limits of certain principles of misrepresentation (and there are many others) so that on one hand it may be possible to demonstrate that these examples have the effect of favouring the seller. On the other hand, the mere existence of the principles – the elements of the definition of misrepresentation – could be said to favour the buyer. The result of any such analysis would therefore be inconclusive and unhelpful as to whether the law of misrepresentation is buyer or seller-friendly. Instead, it is suggested, it is better to assess misrepresentation's effect on caveat emptor where the seller remains silent as to what it is selling. How, and if at all, does the law assist the buyer or seller in that situation?

2.4 Silence does not amount to a representation

Broadly, if the seller remains silent and makes no representation then it has no liability in misrepresentation. The key aspect of the misrepresentation definition is it needs the seller to have "spoken"[236] to the buyer, hence the use of the words, "a statement made" in the definition of misrepresentation. As Chitty notes, silence does not amount to a misrepresentation:

> "The general rule is that mere non-disclosure does not constitute misrepresentation, for there is, in general, no duty on the parties to a contract to disclose material facts to each other, however dishonest such non-disclosure may be in particular circumstances".[237]

Lord Cairns was equally direct when he expressed the position over 150 years ago:

> "Mere non-disclosure of material facts, however morally censurable … would in my opinion form no ground for an action in the nature of an action for misrepresentation".[238]

Chitty's view, and Cairns's statement, are a general reflection of the doctrine of caveat emptor and show the application of the seller-favouring doctrine in legal principle.

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[233] In *Bisset v Wilkinson* [1927] AC 177 the seller of land notified the buyer that the land was capable of supporting a certain number of sheep, but neither the seller nor anyone else had used the land in question for sheep farming. The court held that the seller's statement amounted to an expression of opinion and not a statement of fact upon which the buyer could substantiate a claim for misrepresentation.

[234] See *Avon Insurance v Swire Fraser* [2000] EWHC 230 (Comm) in that case a two-fold test was laid down regarding the extent that a representation needs to be true. Firstly, that "…a representation may be true without being entirely correct, provided it is substantially correct…". Secondly, "…the difference between what is represented and what is actually correct would not have been likely to induce a reasonable person in the position of the claimants to enter into the contracts".

[235] The House of Lords case of *Attwood v Small* [1838] 7 E.R. 684 sets down a limitation on what amounts to an inducement. A party cannot claim misrepresentation if they have not been so induced. This is highlighted by the case of *Horsfall v Thomas* [1862] 5 WLUK 14.

[236] "At its heart, whether express or implicit, an actionable representation involves the communication of information" Thomas Grant KC and David Mumford KC, *Civil Fraud* (1st edn, Sweet & Maxwell 2022) Section A. Chapter 1, Section B1-065.

[237] Beale (n 223) 7-018; 10-022.

[238] *Peek v Gurney* [1873] LR 6 HL 377, 403.

Specific application of the principle was demonstrated in *Ward v Hobbs* [239] where the seller did not disclose to the buyer that the animals being sold were suffering from a fatal disease. The court concluded that a seller is not bound to disclose to the buyer every defect of which it is aware even though that may deceive the buyer. In *Ward v Hobbs*, Lord O'Hagan said:

> "Although a vendor is bound to employ no artifice or disguise for the purpose of concealing defects in the article sold, since that would amount to a positive fraud on the vendee; yet, under the general doctrine of caveat emptor, he is not ordinarily bound to disclose every defect of which he may be cognisant, although his silence may operate virtually to deceive the vendee".[240]

Remaining silent, separately described as "passive deception" [241] may be morally wrong, but the law will not conclude that the seller has deceived the buyer.[242]

Silence in a share sale context occurred in *Percival v Wright* [243] in relation to a sale of shares by some shareholders in a company to the company's directors. The directors of the company were also the buyers of those shares and did not disclose to the sellers that the directors were having discussions with another party about the sale of all of the company's shares at a higher price than the directors were paying for some of the shares from the sellers. The court held that the directors were under no obligation to disclose to the sellers that negotiations were taking place with another party.

There is a distinction between *Ward* and *Percival*. In *Ward* the silence concerned issues with the subject matter being sold. In the latter, the buyers remained silent about how they would profit from the purchase.[244] Arguably, caveat emptor more concerns the former situation. Merely remaining quiet about the state and condition of what the seller is proposing to sell to the buyer does not amount to an actionable misrepresentation. At the heart of the doctrine is the lack of legal obligation on a seller to bring the difficulties and defects in what they are selling to a buyer's attention. However, there are some limited exclusions to this position. None of these exceptions impose a duty of disclosure on the seller provided the seller has not previously made a representation to the buyer. If it has then, in respect of that representation, the seller has some obligations.

2.5 Exceptions to silence not amounting to a misrepresentation

[239] [1878] 4 App Cas 13.
[240] ibid 26.
[241] FC Sharp and Philip G Fox, 'Caveat Emptor' (1936) 43 Int J Ethics 212, 213.
[242] *J D Wetherspoon v Van De Berg* [2007] EWHC 1044 (Ch) [17].
[243] [1902] 2 Ch 421.
[244] There may be issues around the directors being in breach of fiduciary duties and a duty of disclosure arising from that which are not explored here.

One exception to silence not amounting to a representation concerns 'half-truths', in other words, statements which are literally true but misleading.[245] In *Tapp v Lee*, [246] Chambre, J was of the view that "if a man, professing to answer a question, selects those facts only which are likely to give a credit to the person of whom he speaks, and keeps back the rest, he is a more artful knave than he who tells a direct falsehood".[247] In *Tapp*, the defendant had stated to the sellers of goods that a person known to the defendant, who was intending to buy goods from the sellers, was an honest man but he did not inform the sellers that person was in fact bankrupt. This amounted to a misrepresentation. Arguably, this case is simply more of a typical misrepresentation claim than a requirement to disclose.

A more convincing exception concerns a representation which is no longer true. In *With v O'Flanagan* [248] the parties had entered into negotiations in relation to the sale of a business during which the seller represented to the buyer that the turnover of the business was a specified sum. The parties entered into a contract some five months later at which point the turnover of the business had reduced. The change in the business's turnover had not been communicated by the seller to the buyer. The representation as to the business's turnover was true when it was made but the question was whether the change in turnover should have been communicated to the buyer. In concluding that the seller should have notified the buyer of a change in the circumstances of the business, and its reduced turnover before the transaction was completed, Lord Wright, MR referred to several previous cases.

The first previous case was that of *Davies v London and Provincial Marine Insurance* [249] citing the words of Fry J in relation to a representation ceasing to be true:

> "… if a statement has been made which is true at the time, but which during the course of the negotiations becomes untrue, then the person who knows that it has become untrue is under an obligation to disclose to the other the change of circumstances".

In, *With v O'Flanagan*, Lord Wright MR discussed a subsequent case *Re Scottish Petroleum* [250] in which Fry LJ (as he had then become), referred to *Traill v. Baring* [251] to underpin his view relating to the effect of a representation becoming false:

> "… if a person makes a representation by which he induces another to take a particular course, and the circumstances are afterwards altered to the knowledge of the party making the representation, but not to the knowledge of the party to whom the representation is made, and are so altered that the alteration of the circumstances may affect the course of conduct which may be pursued by the party to whom the representation is made, it is the imperative duty of the party who has made the representation to communicate to the party to whom the representation has been made the alteration of those circumstances".

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[245] John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (6th edn, Sweet & Maxwell) section II 16-05.
[246] [1803] 127 ER 200.
[247] ibid 203.
[248] [1936] Ch 575.
[249] [1878] 8 Ch D 469.
[250] [1883] 23 Ch D 413, 438.
[251] [1864] De G J & S 318, 329.

Lord Wright MR went on to state that the underlying principle for his view was laid down by Lord Blackburn in *Brownlie v. Campbell* [252]:

> "When a statement or representation has been made in the bonâ fide belief that it is true, and the party who has made it afterwards comes to find out that it is untrue, and discovers what he should have said, he can no longer honestly keep up that silence on the subject after that has come to his knowledge, thereby allowing the other party to go on, and still more, inducing him to go on, upon a statement which was honestly made at the time when it was made, but which he has not now retracted when he has become aware that it can be no longer honestly persevered in".

There are some points to note about *With* and its reference to previous cases.

There are conditions contained in each of the above judgments cited in *With*. In each case it is "that the person knows [the representation] has become untrue" *(Davies)*; the "circumstances [of the representation] are altered to the knowledge of the party making [it]" *(Traill)*; and "the party who has made [the representation] comes to find out it is untrue" *(Brownlie)*. Each of these cases requires the seller to know that the previously made representation has become untrue in order to be liable for misrepresentation. If the seller does not know, then it may have no liability to the buyer. As the state of the mind of the person making the representation is relevant there is no strict liability applying to the making of the statement if the representor does not know it is untrue. In other words, and unlike the giving of a warranty, the representor's liability is not attached to the statement, whether or not it is true. In essence, liability only arises if the seller knows (or should have known) it is not true.[253] This may be problematic for a buyer. The more time that passes between the time of making a representation and entering into a contract as a result of it, the less confident a buyer may feel about being able to rely on the representation. Delay would not be unusual in a share sale due to a period of contractual negotiations taking place and completion occurring. Representations given by the seller may be untrue by the time completion occurs but this will not result in liability for the seller provided that it does not know that the representations have become untrue. However, practically, it may be difficult for a seller to support the position of not knowing the truth of an earlier representation had changed.

The case of *With* does not appear to erode the caveat emptor doctrine. In *With*, the seller had already made a representation to the buyer, namely a statement as to the turnover of the business. The caveat

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[252] [1880] 5 App Cas 925, 950.

[253] Knowledge of the change of the truth of the representation has been carefully and extensively examined by Bigwood. He noted that the change in the truth of the representation arises whenever there is an appreciable interval between the date of the representation and the date of its reliance by the buyer. The question Bigwood posed was whether the knowledge of the changed circumstances is required for legal liability to be triggered but concludes buyer's recourse is not in misrepresentation but in contractual mistake Rick Bigwood, 'Pre-Contractual Misrepresentation and the Limits of the Principle in With v O'Flanagan' (2005) 64(1) CLJ 94.

emptor doctrine does not obligate the seller to make any form of representation to the buyer or disclose anything to the buyer as to the state or condition of what the seller proposes to sell to the buyer. It is perfectly permissible for the seller to simply remain silent. *With* highlights that if the seller chooses *not* to remain silent and to make a representation to the buyer, then the seller needs to either correct the statement if it knows the representation has subsequently changed, or withdraw it. *With* is at odds with liability for misrepresentation generally, i.e. rescinding the contract for misrepresentation where all that is required is a false statement of material fact or law that induces the other party to enter the contract. Knowledge and other states of mind are only relevant to damages claims.

The analysis turns now to consider fraud, which is the second limitation on the scope of the caveat emptor doctrine.

2.6 Fraud

Fraud is either civil or criminal. The actionable wrong most closely identified with the civil law concept of fraud" [254] is the tort of deceit, also known as fraudulent misrepresentation.[255] Whether liability for fraudulent misrepresentation arises is based on the state of mind of the person making the representation.

The case of *Derry v Peek* [256] set out the definition of fraudulent misrepresentation. Lord Herschell in that case said that "fraud is proved when it has been shown that a false representation has been made (1) knowingly, or (2) without belief it is truth, or (3) recklessly, careless whether it be true or false".[257] This means that "however negligent a person may be, he cannot be liable for fraud provided that his belief is honest; mere carelessness is not sufficient".[258] More recently, the Court of Appeal in *ECO3 Capital v Ludsin Overseas* [259] considered *Derry v Peek* and the cases of *Nocton v Lord Ashburton* [260] and *Armstrong v Strain* [261] and set out what these cases show as being the four ingredients of deceit:

> "i) The defendant makes a false representation to the claimant.
> ii) The defendant knows that the representation is false, alternatively he is reckless as to whether it is true or false.
> iii) The defendant intends that the claimant should act in reliance on it.
> iv) The claimant does act in reliance on the representation and in consequence suffers loss.

[254] Thomas Grant KC and David Mumford KC, *Civil Fraud* (1st edn, Sweet & Maxwell 2022) 1-001.
[255] ibid.
[256] (1889) 14 App. Cas. 337.
[257] ibid 374.
[258] Beale (n 223) 10-057.
[259] [2013] EWCA Civ 413.
[260] [1914] AC 932.
[261] [1952] 1 KB 232.

> Ingredient (i) describes what the defendant does. Ingredients (ii) and (iii) describe the defendant's state of mind. Ingredient (iv) describes what the claimant does".[262]

It can be seen from the definition that what has generally been said above about misrepresentation, and its limits, also applies in respect of fraudulent misrepresentation.[263] As such, it does not create a duty of disclosure because there is no duty to reveal information. On that point, the Law Commission report on fraud noted that a substantial minority of respondents to its consultation stated that "from the victim's point of view, a failure to reveal material facts can be just as devastating as, and tantamount to, deception by conduct".[264] Whilst the Law Commission noted that "secrecy can be regarded as a kind of deception by omission" [265] it concluded that non-disclosure should qualify as fraud in just two cases.[266].

First, when there is a legal duty to disclose, such as those mentioned above in section 2.2 being from statute, utmost good faith (such as a contract of insurance), from the express or implied terms of a contract, from the custom of a particular trade or market, or from the existence of a fiduciary relationship between the parties (such as that of agent and principal).[267]

Second, when there was no duty to disclose but when one party trusts the other to disclose certain information of that kind [268]. The essence of that requirement is that the parties are not at arm's length.[269] That would therefore exclude the parties in a share sale because their contractual relationship would be on an arm's length basis. The *EC03 Capital* test provides a remedy for fraudulent misrepresentation effectively on the "moral basis that people cannot be allowed to tell lies with impunity" [270] but it does not cut into the scope of caveat emptor in relation to share sales.

The Law Commission's above comments concerning when there is a duty to disclose are restated in the Fraud Act 2006's explanatory notes [271] concerning section 3 of the Act. That section provides:

> "3 Fraud by failing to disclose information

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[262] *ECO3 Capital v Ludsin Overseas* [2013] EWCA Civ 413, [77].
[263] Cases concerning fraudulent misrepresentations specifically in share sales include *Belfairs Management v Sutherland* [2010] EWHC 2276 (Ch); *Parallel Media v Chamberlain* [2014] EWHC 214 (QB); *Next Generation v Finch* [2023] EWHC 2383 (Ch).
[264] Law Commission, *Fraud* (Law Com No 276, 2002) para 7.23.
[265] ibid an antique dealer calls on vulnerable people and buys their heirlooms at unrealistically low prices, making no misrepresentation as to the value of the items but exploiting the victims' trust. There may be no legal duty to disclose the truth, but there is clearly a moral duty to do so.
[266] Law Commission, *Fraud* (Law Com No 276, 2002) para [7.27].
[267] ibid [7.28].
[268] ibid [7.31].
[269] ibid [7.32].
[270] Thomas Grant KC and David Mumford KC, *Civil Fraud* (1st edn, Sweet & Maxwell 2022, 1-06.
[271] Explanatory Notes are prepared for each Act of Parliament by the Government Department primarily responsibility for the Act. The Notes generally provide some policy background to the purpose of the Act, as well as an analysis of the purpose and effect of individual provisions - see Daniel Greenberg, *Craies on Legislation*, (12th edn, Sweet & Maxwell 2022).

A person is in breach of this section if he –

(a) dishonestly fails to disclose to another person information which he is under a legal duty to disclose, and

(b) intends, by failing to disclose the information–

(i) to make a gain for himself or another, or
(ii) to cause loss to another or to expose another to a risk of loss".

A comparison of s 3 and the *EC03 Capital* definition of fraudulent misrepresentation shows the difference is one of obligation to disclose information. Under s 3, the offence is triggered if the duty to disclose is breached. However, in the case of a share sale, the duty would only arise if the seller had made a representation and failed to disclose that the facts had changed. This would occur if the seller had made a pre-contractual representation and did not correct it. Alternatively, it would occur if the seller had given a warranty in the agreement for the sale of shares and deliberately not disclosed against it in the disclosure letter (see chapter 6) [272] (which relates to the Law Commission's note that fraud can arise from breach of an express term of a contract). The similarity between both s 3 and fraudulent misrepresentation is the requirement for there to be a statement made by a party in order for liability to be triggered. As such, and because liability does not arise when the seller remains silent, there is no incursion into caveat emptor.

This was recognised as such by the Solicitor-General in the Standing Committee B Debates on the Bill for the Fraud Act 2006 in the House of Commons who remarked:

> "When people are engaged in commercial relationships, there is the principle of caveat emptor, which has been restricted by various pieces of legislation over the years by Parliament. Let the buyer beware. That will still be the case. When people engage in normal commercial relationships, the buyer will need to be beware, to be aware of what the person who is selling the product says" [273]

The Attorney-General, Lord Goldsmith also noted that s 3 does not impact caveat emptor:

> "The Government have also made changes in the light of the consultation to ensure that the offence in Clause 3 of failure to disclose information will be fraud only when a legal duty is breached. We accepted the arguments of those who said that to include other types of case, where the duty was only moral, would be stretching the criminal law too far and would intrude on the principle of caveat emptor".[274]

[272] Thompson (n 179) 9-35.
[273] https://publications.parliament.uk/pa/cm200506/cmstand/b/st060620/am/60620s02.htm Column 0.
[274] https://publications.parliament.uk/pa/ld200506/ldhansrd/vo050622/text/50622-04.htm#50622-04_spmin1 22 Jun 2005 : Column 1655.

Even if s 3 did impact caveat emptor, the Fraud Act 2006 creates a criminal offence and so attracts a prison sentence [275] and so there is therefore no financial redress for a buyer if a seller is found guilty of the offence. The buyer would no doubt prefer recompense under the civil law.[276]

Fraud Act 2006, s 2 is also potentially relevant to share sales. There is considerable overlap between the sections, but section 3 is narrower than section 2.[277] Section 2 concerns fraud by false representation and provides that a person commits an offence if they dishonestly make a false representation. Like s 3, s 2 requires a representation to be made and again, does not impinge upon the caveat emptor doctrine. However, despite the clear drafting of ss 2 and 3, and the comments about them, there is subsequent criminal legislation which may impact caveat emptor, despite seemingly not obviously applying to share sales but rather to the financial services industry.

Certain provisions of the Financial Services Act 2012 [278] may make, at first appearance, an inroad into caveat emptor from a criminal law perspective. The Financial Services Act 2012, s 89 [279] provides:

> "89 Misleading statements
> (1) Subsection (2) applies to a person ("P") who —
> (a) makes a statement which P knows to be false or misleading in a material respect,
> (b) makes a statement which is false or misleading in a material respect, being reckless as to whether it is, or
> (c) dishonestly [280] conceals any material facts whether in connection with a statement made by P or otherwise".

As the explanatory notes to the Financial Services Act 2012 state, "section 89 creates a criminal offence relating to the… dishonest concealment of any material fact.[281] Section 1(c) is the key provision in this regard and the use of "or otherwise" in s (1) (c) seemingly, at first glance, has the effect of expanding the misleading statement to beyond the making of a statement and into a general disclosure requirement. Concealment suggests the inclusion of not only the taking of positive steps to

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[275] 3 Fraud Act 2006, s 3.
[276] Omerod and Williams argue that "As a matter of principle, it is submitted that it should not be criminal to withhold information which one is entitled to withhold under civil law." David Ormerod and David Huw Williams, The Fraud Act 2006, Arch. News 2007, 1, 7 [8].
[277] David Ormerod and David Huw Williams, 'The Fraud Act 2006' (2007) Arch News 1, 7.
[278] The explanatory notes to the Act state: "We will reform the regulatory system to avoid a repeat of the financial crisis. We will bring forward proposals to give the Bank of England control of macro-prudential regulation and oversight of micro-prudential regulation." Clearly, this has nothing to do with share sales but as will be shown certain provisions are capable of applying to share sales.
[279] As the explanatory notes to the Financial Services Act 2012 states, s 89 was largely restates the effect of the Financial Services and Markets Act 2000, s 397(2).
[280] The test for dishonesty was laid down by the Supreme Court in *Ivey v Genting Casinos* [2018] A.C. 391 replacing the previous test in *R v Ghosh* [1982] Q.B. 1053.
[281] https://www.legislation.gov.uk/ukpga/2012/21/notes para 546. The authors of suggest that withholding information causes harm to investors, who may base decisions to buy or sell on information which is incomplete - Karen Anderson and Andrew Procter, *A Practitioner's Guide to the Law and Regulation of Market Abuse* (4th edn, Sweet & Maxwell) 7-001.

ensure that facts are not disclosed but also a failure to disclose them when they ought to be disclosed.[282] The authors of Arlidge and Parry on Fraud expand upon this:

> "… s.89(1)(c) makes it clear that there may be concealment of material facts even if no statement, promise or forecast is made in which those facts should have been disclosed. The concealment may consist in the failure to make a statement (etc) which should have been made".[283]

Subsection 1 creates the criminal offence of making a misleading statement or concealing a fact and the following subsection specifies how the offence is committed:

> "(2) P commits an offence if P makes the statement or conceals the facts with the intention of inducing, or is reckless as to whether making it or concealing them may induce, [284] another person (whether or not the person to whom the statement is made) —
> (a) to enter into or offer to enter into, or to refrain from entering or offering to enter into, a relevant agreement…".

This leads to other sections of the Financial Services Act 2012, as well as statutory instruments. That process begins by looking s 93(3)(a) which states that a "relevant agreement", as referred to in s 89 (2), is defined by a Treasury order. That order [285] refers to a "controlled activity" [286] and that in turn is referred to as a "relevant investment". The Financial Services Act 2012 (Misleading Statements and Impressions) Order 2013, reg 4 states that a "relevant investment" is a "controlled investment". That, in turn, means an investment falling within the Financial Services and Markets Act (Financial Promotion) Order 2005, para 14 of Part II of Schedule 1. It includes shares in the share capital of any body corporate".[287] This convoluted process of referring to multiple legislative sections and definitions eventually reveals that "dishonestly concealing material facts" applies to share sales. It does so in legislation where it is not immediately apparent from the language used in it that it is intended to apply to private companies.[288] However, it is unlikely that there is any civil claim in respect of an offence under the section.[289] That said, the important question is does s 89 apply to any material fact that the seller has not disclosed or only to material facts the seller is required to disclose? The answer is not clear.

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[282] Jonathan Fisher KC, Alexander Milne KC, Jane Bewsey KC, Andrew Herd, *Arlidge and Parry on Fraud* (6th edn, Sweet & Maxwell 2020)11-014.
[283] ibid 11-015.
[284] "Note that the intended inducement need not be successful. It is enough that a statement was made, or a concealment was undertaken with "intention" or "recklessness" to induce. No one actually needs to be induced—no relevant agreements need to be entered into, or rights under relevant investments exercised." Karen Anderson, Andrew Procter *A Practitioner's Guide to the Law and Regulation of Market Abuse* (3rd end, Sweet & Maxwell) 7.3.9.
[285] Financial Services Act 2012 (Misleading Statements and Impressions) Order 2013/637, paragraph 2.
[286] Being an activity which falls within Financial Services and Markets Act (Financial Promotion) Order 2005 (SI 2005/1529), Part 1 of Schedule 1.
[287] A contract to buy the shares is a relevant agreement - Karen Anderson and Andrew Procter, *A Practitioner's Guide to the Law and Regulation of Market Abuse* (3rd edn, Sweet & Maxwell) 7.3.10.2.
[288] For example, the heading of The Financial Services Act 2012, part 7 is 'Offences relating to financial services'.
[289] John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (6th edn, Sweet & Maxwell) 17.63 and Thompson (n 179) 9-35.

One author considers that "concealing must be interpreted to include failing to disclose facts which the defendant is under a contractual, legislative, regulatory or customary obligation to disclose".[290] Likewise, another suggests that "it is arguable that concealment requires no more than mere silence or omission, provided there is a contractual, statutory, or regulatory duty to disclose that information, or it is common market practice to do so"[291] It appears to be the case that the general criminal law provides there should be no criminal liability for omissions except where there is a duty to act [292] which suggests that s 89 makes no greater erosion of caveat emptor than the law of misrepresentation generally.

On the other hand, when comparing the Fraud Act 2006 with s 89 specific reference in the former was made to the obligation to disclose information that a party was under a legal obligation to disclose. No such similar wording appears in s 89. However, if the concealment relates to matters that a person is not required to disclose, that leaves as too uncertain whether or not they have concealed information that should have been shared, and as such there may be no meaningful and attributable basis for the damaged party to substantiate a claim. Those required to make a statement would not know what they are required to disclose. Therefore, it seems possible that concealment relates to matters that the person in question is required by law to disclose.[293]

2.7 Conclusion

The law of misrepresentation does not undermine the caveat emptor doctrine. Likewise, nor does the criminal law with respect to fraud. The Fraud Act 2006 is clear about this. The position under the Financial Services Act 2012 is less clear but it would be questionable if the criminal law imposed an obligation to disclose that is not reflected in the civil law.

As a result, the law does not impose a general duty on the seller to disclose even material information to the buyer. However, the law does impose an obligation on a company to share material information with any investor under the listing particulars in respect of investment in public companies, some of such information, in a private company setting, a buyer of shares would no doubt be desirous of obtaining.

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[290] Mark Lucraft, *Archbold Criminal Pleading Evidence and Practice* (2024 edn Sweet & Maxwell) para 30.76.
[291] Karen Anderson and Andrew Procter, *A Practitioner's Guide to the Law and Regulation of Market Abuse* (3rd edn, Sweet & Maxwell) 7-013.
[292] Ibid.
[293] In US law: "In order to invoke the special facts doctrine so as to give rise to duty on the part of one party to inform the other of certain information, one party must have superior knowledge, that knowledge must not be readily available to the other party, and the party with the knowledge must know that the other party is acting upon the basis of mistaken knowledge. *Cong. Fin. Corp. v. John Morrell & Co.,* 790 F. Supp. 459 (S.D.N.Y. 1992).

The law of misrepresentation's best attempt at undermining, to some limited extent, the caveat emptor doctrine is given by the decision in *With*. This is to require the seller to disclose information to the buyer if information that the seller has already given to the buyer has subsequently changed. That, however, does not extend to the seller being required to disclose information generally but rather correcting or withdrawing a statement that has already been made.

Chapter 3

Implied Terms

This chapter considers a further legal principle that might initially be thought to redress the bias in favour of sellers as evidenced by the caveat emptor doctrine, namely implied terms.[294] It shows that, at least in the context of share sales, the law does not have a significant impact in balancing the effect of the caveat emptor doctrine.

Section 3.1 will consider certain terms that are typically implied in share sales. Section 3.2 will show that those implied terms will only be implied by law if specific words are used.

In section 3.3 there will be consideration of the "proper instrument of transfer" to transfer shares and it will be shown that none of the implied terms appear in that document.

Section 3.4 will demonstrate that in the alternative to a share purchase, an asset purchase, a buyer can automatically obtain the benefit of certain implied terms.

3.1 Typical implied terms for the benefit of the buyer

In share sales, it is common for share purchase agreements to include the words "full title guarantee". Those words typically appear in the operative part of the agreement that deals with the fundamental aspect of the purchase, namely the shares that are being bought and sold, as these extracts from precedent share purchase agreements show:

> "In consideration and subject as follows the Sellers will sell or procure the sale of all (but not part only) with full title guarantee and the Purchaser will purchase all (but not part only) of the sale shares on the completion date at the said price…".[295]

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[294] The discussion in this chapter concern terms implied by legislation. There are other types of implied terms such as those implied by custom, trade or business practice and by law - Merkin (n 117) 6.4.2 but none appear relevant to this chapter. For terms implied in other jurisdiction see the Appendix to this thesis.

[295] Rosenberg (n 158) precedent 28.6 Agreement for sale and purchase of shares.

> "On the terms of this agreement, at Completion the Buyer shall buy and the Sellers shall sell the Sale Shares with full title guarantee…".[296]

The term "full title guarantee" appears in the Law of Property (Miscellaneous Provisions) Act 1994 s.1 ("LPMPA"). The term implies certain covenants into the sale of property:

> "1. — Covenants to be implied on a disposition of property.
> (1) In an instrument effecting or purporting to effect a disposition of property there shall be implied on the part of the person making the disposition, whether or not the disposition is for valuable consideration, such of the covenants specified in sections 2 to 5 as are applicable to the disposition.
>
> (2) Of those sections—
> (a) sections 2, 3(1) and (2), 4 and 5 apply where dispositions are expressed to be made with full title guarantee;"

Several words in the above section need to be defined to show that they do not only apply to real property transactions. In LPMPA, s 1(4) 'property' includes a thing in action and an interest in personal property (as well as real property). A 'thing in action' includes a share in a company.[297] A covenant is a promise.[298] Furthermore, the effect of the implied term being expressed as a covenant is, for limitation purposes, the same for that as a simple contract which means the period for bringing a claim is 6 years from the date on which the breach occurred.[299] If the covenant is contained in a contract which is a deed [300] the period is 12 years from the date of breach.[301] The terms implied by the LPMPA therefore provide a buyer of shares with a contractual assurance which, if it turns out to be untrue, will give it a remedy.

Whilst LPMPA, s 1 introduces the term 'full title guarantee', LPMPA, s 2 sets out its meaning:

> "2. — Right to dispose and further assurance.
> (1) If the disposition is expressed to be made with full title guarantee or with limited title guarantee there shall be implied the following covenants —

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[296] Practical Law Company: Share purchase agreement: multiple individual sellers: simultaneous exchange and completion.
[297] *Cambridge Gas Transportation v Official Committee of Unsecured Creditors of Navigator Holdings* [2007] 1 A.C. 508 [26] and Michael Bridge; Louise Gullifer, Gerard McMeel; Kelvin F.K Low, *The Law of Personal Property* (3rd edn Sweet & Maxwell, 2021) Chapter 4, Section C 4-004.
[298] "It may be positive, stipulating the performance of some act or the payment of money, or negative or restrictive, forbidding the commission of some act" Mick Woodley, *Osborn's Concise Law Dictionary* (12th edn, Sweet & Maxwell 2013). This definition also suggested that a covenant needs to be made by deed as too does the following definition: A covenant is an agreement between two or more parties, by deed in writing, sealed and delivered, by which either of the parties pledges himself to the other that something is either done or shall be done, or stipulates for the truth of certain facts - Daniel Greenberg, *Jowitt's Dictionary of English Law* (5th edn, Sweet & Maxwell 2019).
[299] Limitation Act 1980, s 5. There are some other sources which suggest, by implication, that a covenant would not be required to be a deed. Arguably, it depends on the classification of covenant of which there are possible three types - see Kim Lewison, *The Interpretation of Contracts* (8th edn, Sweet & Maxwell, 2023)16.81 and whether or not the covenant is supported by consideration, being an essential requirement for a valid contract. Consideration is not required if the contract is a deed. Therefore, it is suggested that if the covenant is not in a deed but the contract is supported by consideration then it would still be a valid covenant.
[300] A deed effects the transfer of an interest, right or property and creates an obligation binding on a person; or confirms some act where an interest, right or property has already passed. Beale (n 223) 1-099.
[301] Limitation Act 1980, s 8.

(a) that the person making the disposition has the right (with the concurrence of any other person conveying the property) to dispose of the property as he purports to, and

(b) that that person will at his own cost do all that he reasonably can to give the person to whom he disposes of the property the title he purports to give".

In the application of this provision to a share sale, what is being provided by LPMPA, s 2 is that the seller can sell the shares and will do what it reasonably can to give title to the shares to the buyer.

The above meaning of 'full title guarantee' is expanded by LPMPA, s 3. It provides that a disposition made with full title guarantee also protects a buyer in respect of charges and incumbrances affecting the sale shares:

"3.— Charges, incumbrances and third party rights

(1) If the disposition is expressed to be made with full title guarantee there shall be implied a covenant that the person making the disposition is disposing of the property free —

(a) from all charges and incumbrances (whether monetary or not), and

(b) from all other rights exercisable by third parties,

other than any charges, incumbrances or rights which that person does not and could not reasonably be expected to know about".

Again, in application to share sales, this provision extends the meaning of full title guarantee to provide that the seller is making a promise that the shares are not charged in favour of a third party and are not incumbered. It also provides that there is no kind of interest in the shares that restricts the seller's right to freely deal with the shares and a third party does not have rights over the shares. This promise is not absolute and excludes any charges, incumbrances or rights unknown to the seller. This would therefore have the effect of the buyer assuming liability for any of these unknown matters.

There are further exceptions to the seller's liability and it will not be liable in the following circumstances under LPMPA, s 6:

"6.— No liability under covenants in certain cases

(1) The person making the disposition is not liable under the covenants implied by virtue of —

(a) section 2(1)(a) (right to dispose),

(b) section 3 (charges, incumbrances and third party rights), or…

[not applicable]

in respect of any particular matter to which the disposition is expressly made subject".

This section provides that the parties can contract for something other than the seller having the right to dispose of the property. The same applies to the shares being subject to charges, incumbrances and third-party rights. In both cases, this shows that the covenant the seller gives under the LPMPA as to full title guarantee can be contracted around. The full title guarantee covenant is therefore not a mandatory rule.[302]

In addition to the limitation in LPMPA, s 6 (1) above, LPMPA, s (6) (2) excludes liability concerning matters known to the buyer:

> "(2) Furthermore that person is not liable under any of those covenants for anything (not falling within subsection (1)) —
>
> (a) which at the time of the disposition is within the actual knowledge, or
> (b) which is a necessary consequence of facts that are then within the actual knowledge, of the person to whom the disposition is made".

This means that if the full title guarantee covenant is given by the seller, and the buyer knows that the seller does not have the right to dispose of the shares, or the shares are charged to a third party, for example, then the seller has no liability in respect of the buyer's knowledge of such matter. The Law Commission in its report concerning implied terms, and upon which report the LPMPA is based, expressed the rationale for this:

> "…one unsatisfactory feature of the present law is that the implied covenants can make a covenantor liable for a defect in title which was known in advance to the person in whose favour the disposal is made. We do not consider that this should continue. If a matter is expressly drawn to the attention of the person with the benefit of the guarantee or he already knows of it, he has the chance to bargain for such protection as he feels is justified. As long as all relevant information is available, no unfairness is involved in limiting the terms of the guarantee. We therefore recommend that the implied covenants for title should not impose any liability for matters actually known to the person in whose favour the covenants are made".[303]

The Law Commission therefore rejected the idea of a buyer being able to rely on an implied term if it knows that the relevant term is not true.

In summary, the LPMPA implies terms for the sale of shares if the words 'full title guarantee' are used in an agreement between the buyer and seller. These words provide that the seller is selling the shares free of charges, encumbrances and third party rights and the seller will do what it reasonably can to provide the buyer with title to the shares. The implied terms do not apply to matters unknown to the seller and are disapplied in matters known to the buyer. An incursion into caveat emptor is

[302] Such rules are mentioned in chapter 8.
[303] Transfer of Land: Implied Covenants for Title (Law Commission Report No. 199 para 4.30.

made by the provision of the LPMPA implied terms. However, that is balanced because the terms are not automatically implied by law.

3.2 Implied terms do not apply unless the words "full title guarantee" are used

The LPMPA implied term of full title guarantee [304] does not apply to a share sale unless certain terminology is used in the agreement between the parties. The LPMPA provides for two types of title guarantee – full and limited which means that the parties must select which guarantee, if any, is to apply. The implied terms make clear that they are not automatically imposed as the LPMPA, s 1(2) states they apply "where dispositions are *expressed* to be made with full title guarantee".[305] When the Law of Property (Miscellaneous Provisions) Bill [306] was being debated in the House of Lords 5 May 1994, the Lord Chancellor, Lord Mackay of Clashfern, said that the covenant is "implied into the documents by statute when certain 'key words' appear on the face of the documents"[307] It is clear that the "type of guarantee must be expressed, i.e. by disposing "with full/limited title guarantee" as appropriate".[308] This would mean that for the relevant implied covenant to apply, the contract between the parties would need to use that term (see the example extract from a share purchase agreement in section 3.1 above) or some other document passing between the parties would need to contain the term.

3.3 LPMPA implied terms do not appear in the "proper instrument of transfer"

Where a buyer purchases shares there may or may not be a contract for the sale. However, in either case, the purchase is completed by a transfer of the shares.[309] The document that completes the transfer is a stock transfer form. Neither of the terms implied by the LPMPA appear in that document. To explain this further, the Companies Act 2006, s 770 (1) (a) provides that a share is to be transferred by way of a proper instrument of transfer, the usual form of which is specified in the Stock Transfer Act 1963 ("STA"), although a company's articles of association may provide for a particular form of transfer. The STA, ss 1 (1) and (3) refer to the stock transfer form:

> "1.— Simplified transfer of securities

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[304] And limited title guarantee also.
[305] (emphasis added).
[306] The proposed changes are contained in the two Law Commission reports from which the Bill derives: Transfer of Land: Implied Covenants for Title (Law Commission Report No. 199), and Property Law: Title on Death (Law Commission Report No. 184). See The Lord Chancellor (Lord Mackay of Clashfern) https://hansard.parliament.uk/Lords/1994-05-05/debates/d3fa4343-32f2-4f19-9b63-53baf11bf5fd/LordsChamber#contribution-4e370f1e-5f34-424c-9f9d-603fb9f540b2.
[307] https://hansard.parliament.uk/Lords/1994-05-05/debates/d3fa4343-32f2-4f19-9b63-53baf11bf5fd/LordsChamber#contribution-4e370f1e-5f34-424c-9f9d-603fb9f540b2.
[308] Julian Farrand, Alison Clarke, *Emmet & Farrand on Title* (Sweet & Maxwell) 16.005.
[309] *Skinner v City of London Marine Insurance Corporation* (1885) 14 QBD 882, 887.

> (1) Registered securities to which this section applies[310] may be transferred by means of an instrument under hand in the form set out in Schedule 1 to this Act (in this Act referred to as a stock transfer), executed by the transferor only and specifying (in addition to the particulars of the consideration, of the description and number or amount of the securities, and of the person by whom the transfer is made) the full name and address of the transferee.
>
> (2) Nothing in this section shall be construed as affecting the validity of any instrument which would be effective to transfer securities apart from this section; and any instrument purporting to be made in any form which was common or usual before the commencement of this Act, or in any other form authorised or required for that purpose apart from this section, shall be sufficient, whether or not it is completed in accordance with the form, if it complies with the requirements as to execution and contents which apply to a stock transfer".

A "proper transfer" as required by the Companies Act, s 770 can be in accordance with the company's articles of association.[311] If the articles of association provide for a particular form of transfer, then by virtue of the STA, s 3, the company's own form must still meet the contents and signing requirements of the form of transfer in the STA, Sch 1. Even if the company's articles of association require a certain form of transfer, the transfer will still be valid if the Sch 1 form is used. An examination of the stock transfer form reveals there is no mention of the implied terms under the LPMPA.

The stock transfer form contains several sections requiring completion. It refers to the amount paid for the shares, the name of the company in question and the description of the shares, the number of the shares, the name of the holder of the shares, the signature of the person transferring the shares and the name and address to whom the shares are being transferred. The reverse of the form contains certificates to be signed if the transfer is exempt from stamp duty.[312] There is no reference to the implied covenants under the LPMPA or "full/limited title guarantee" As such, the proper instrument of transfer does not require the seller to confirm to the buyer that it has the right to sell the shares nor to take reasonable steps to give title of the shares to the buyer, nor that the shares are free from charges or third party rights, as the LPMPA demands. Neither is there any other assurance given by the seller to the buyer about the shares being sold. In light of this silence as to assurances in the stock transfer form, and now looking outside of the LPMPA, is there anything else that the buyer receives in terms of assurances in respect of a share transfer that may be implied by law?

The decision in *Stray v Russell* [313] implies a term in the case of a transfer of shares. In *Stray*, the buyer instructed his broker to purchase shares in a company on his behalf. The buyer subsequently

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[310] Stock Transfer Act 196, s 1(4): "This section applies to fully paid up registered securities of any description, being—(a) securities issued by any company". S 4 states 'securities' includes shares.
[311] A company, whether private or public, limited or unlimited, and whether limited by shares or by guarantee must have articles of association prescribing regulations for the company (s.18(1) of the Companies Act 2006).
[312] https://webarchive.nationalarchives.gov.uk/ukgwa/20130605091641/http://www.hmrc.gov.uk/news/changes-stock-trans-form.htm.
[313] [1859] 120 E.R. 1144.

changed his mind about the purchase in light of matters he had found out about the company and the questionable value of the shares. The broker told the buyer that it was not able to terminate the purchase contract and provided the buyer's name to the defendant as rules at the time required it to do. In return, the defendant provided transfers for the shares and the share certificates in respect of the shares being purchased. The broker paid the purchase price on behalf of the buyer but the buyer refused to pay the broker for the shares. The company also refused to register the transfer as notice of the transfer had not been provided to it. In relation to the provision of the share transfer and the share certificate for the shares being sold, Campbell CJ in the Court of Queen's Bench said:

> "What does the vendor contract to sell and deliver? Genuine transfers and certificates, with the interests and rights which they convey".[314]

This case suggests that when the seller provides the stock transfer form and share certificate for the shares in question to the buyer there is an implied term that the seller is selling to the buyer the seller's rights and interests in those shares. However, what is not clear from this is what those rights and interests are. It is therefore necessary to understand the rights and interests which a seller has in a share and which it transfers to the buyer. Is there anything at least resembling the terms in the LPMPA?

In addition to the meaning of a share described in section 1.2.1, a shareholder has some secondary liabilities such as being required to pay the amount remaining unpaid on their shares [315] and to repay any dividend received which the shareholder knew or ought to have known was made in contravention of the rules as to distributable profits.[316] A shareholder can also make a petition to the court to wind up the company, seek a remedy for unfair prejudice, bring a derivative action on the company's behalf or continue such a claim.[317]

Therefore, when shares are transferred to the buyer the buyer is acquiring a series of rights both under the company's articles of association and the Companies Act 2006. As part of that purchase, it does not acquire any assurances as to the shares being incumbered or subject to third party rights, nor are there terms given by the seller similar to those under the LPMPA, unless the company's articles of association say so. The model articles of association for private companies do not contain such terms.[318] The model articles simply refer to the stock transfer form (or some other form the directors approve) as the method of transfer, no fee is charged to register a transfer, the company may keep the

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[314] ibid 1149.
[315] Insolvency Act 1986, s 74(1).
[316] Companies Act 2006, s847.
[317] Morse and others, *Palmers Company Law* (Sweet & Maxwell) 6-012.
[318] The British Venture Capital Association's (BVCA) model articles of association provide that share transfers are made with full title guarantee https://www.bvca.co.uk/Policy/Industry-Guidance-Standardised-Documents/Model-documents-for-early-stage-investments.

stock transfer form, the seller owns the share until the company registers the transfer and the directors may refuse to register a transfer.[319] By comparison, the British Venture Capital Association [320] produces "standardised documents for early stage venture capital investment"[321] which contain several references to the seller selling their shares with full title guarantee.[322]

So, whilst neither the stock transfer form, nor the package of rights that the seller transfers to the buyer contain any assurances about what is being sold, the share certificate provided by the seller to the buyer may do so.

The Companies Act 2006, s 768(1) provides that a share certificate "…specifying any shares held by a member is prima facie evidence of his title to the shares". A company's articles of association may require additional information.[323]

As can be seen from model article 24, there is no provision in it which provides assurances in addition to the one given to the buyer under the Companies Act, s 768. So, whilst it might be the case that the buyer would have a claim against the seller for breach of the implied term that the share certificate carries the rights and interest it purports, [324] ascertaining those rights requires a search of both the company's articles of association and the Companies Act 2006 but provides no assurance that the shares are not incumbered or subject to third party rights.

3.4 Corporate transactions where terms are implied by law

It has already been noted in section 1.2.4 that an alternative way for a buyer to acquire the business and assets of a company is to purchase them from the company rather than buy shares in the company from the company's shareholders. In asset sales, depending on what is being sold, there may be implied terms concerning the seller owning the assets it is selling, no third party rights existing over those assets and the assets being of satisfactory quality, and if demanded by the buyer, being fit for a particular purpose. In contrast to the LPMPA, the Sale of Goods Act 1979 (SGA) automatically implies certain terms for the benefit of the buyer, but only with respect to asset sales. The SGA will only apply to those assets being sold which fall within the definition of "goods" in the SGA. The

[319] Article 26 of The Companies (Model Articles) Regulations 2008.
[320] In its governance handbook the BVCA describes its mission as the "industry body and public policy advocate for the private equity and venture capital industry in the UK". https://www.bvca.co.uk/Portals/0/Documents/Policy/2004%20BVCA%20Governance%20Handbook%20update.pdf.
[321] https://www.bvca.co.uk/Policy/Industry-Guidance-Standardised-Documents/Model-documents-for-early-stage-investments The BVCA goes on to say that in respect of these documents "Our aim is simple: to promote industry-standard legal documentation in the UK so investors and entrepreneurs can focus on deal-specific matters. This will inevitably save both time and money and follows the precedent seen in the US."
[322] For example, article 14.4.
[323] For example, see model article 24.
[324] Philip Pillai, 'Current Developments in Corporate and Securities Law in Singapore and Malaysia' (1974) 16(1) Malaya L Rev 107, 121.

terms implied by the SGA, s 12 are that the seller has a right to sell the goods, they are being sold free from any charge or encumbrance and the buyer will enjoy quiet possession of them. SGA, s 14 also implies terms about the state of the goods being sold under SGA, s 14. These concern the goods being of satisfactory quality, fit for their purpose and corresponding with their description.

3.5 *Conclusion*

Implied terms only apply automatically for the benefit of the buyer when it comes to asset sales.

When it comes to the sale of shares the buyer is left exposed to the doctrine of caveat emptor in relation to the quality of what it is buying as implied terms to its benefit only apply if certain words are used. This may be troubling for the buyer when it is remembered that a share sale amounts to the buyer stepping into the shoes of the seller and taking on all of the liabilities of the company, without assistance from the law.

Chapter 4
Warranties and Representations

4.1 Introduction

This chapter is doctrinal. It considers several situations in relation to warranties and representations. It seeks to show that the law is, in a number of significant ways, more favourable to sellers than to buyers.

Section 4.2 starts with a brief consideration of the several reasons why buyers would want to bring a claim for misrepresentation.

There are 4 sections each dealing with a different, specified situation. The object is to look at different scenarios concerning misrepresentations, particularly their interrelation with warranties, and show the court's treatment of misrepresentations in share sales.

Firstly, section 4.3 briefly looks at the situation where there is a pre-contractual representation made by the seller, but the share purchase agreement contains no warranty on the same or similar terms as the representation. This scenario, however, is not the main focus of this chapter. This chapter is instead primarily concerned with situations where there are contractual warranties which may either replicate, or may be argued to function also as, representations.

Secondly, section 4.4 looks at the situation where there is both a pre-contractual representation made by the seller and also a warranty on the same or similar terms in the contract. In such a case, the buyer will have a claim for misrepresentation and breach of warranty and can choose which claim to bring.

Thirdly, section 4.5 addresses the scenario where there is no pre-contractual representation made by the seller, but there is a warranty in the contract but the contract does not state the warranty is also a representation. It will be shown, in this case, that the courts will likely reject a buyer's attempt to have the warranties interpreted also as being representations.

Fourthly, section 4.6 looks at the situation where the contract expressly states warranties also constitute representations (known as 'contractual representations'). In looking at the section, there is consideration of whether the courts will give effect to representations stated in the contract and it will be shown the law is somewhat confused in this area.

Following this, in section 4.7 there is an analysis of the court's approach to limitation of liability provisions in favour of the seller and which limitations are usually expressed to apply to warranty claims. However, the courts have also applied the limitations provisions to claims for untrue contractual representations based on the concept of 'commercial purpose'.

Linked to section 4.7, section 4.8 will consider that the use of the tool of commercial purpose in contractual interpretation may have been too readily employed when limitation of liability provisions were being considered in respect of contractual representations.

Finally, section 4.9 will suggest that the use of deeming provisions in the contract's drafting will need to be employed if the buyer wants to increase the likelihood of the enforceability of contractual representations.

4.2 Why might buyers want to sue for misrepresentation?

As a reminder, a representation is a statement of fact or law which induces the representee to enter into the contract. A warranty is a provision in the contract: a promise made by one party to the other as a term of the contract. So, to constitute a misrepresentation, a buyer would need to show that a statement was false, it was material and induced the recipient of the statement to enter into the contract. Whereas, for a breach of warranty claim, no materiality and inducement are required, the liability of the warrantor is a strict one. Therefore, a warranty breach is potentially easier to claim. The main similarity between founding a misrepresentation claim versus a breach of warranty claim is that the representation or warranty needs to have been false.

There are at least five reasons why a buyer might want to be able to bring a claim for misrepresentation.

Firstly, depending on the value of the company, and the price paid for it, there could be a financial advantage for the buyer in bringing a claim for misrepresentation. In respect of misrepresentation, generally, damages are only available for fraudulent and negligent misrepresentation and not for innocent misrepresentation.[325]

A little more consideration is given here to an "innocent misrepresentation" as it is relevant to the discussion in section 4.6 in respect of contractual representations as a claim for their breach may be made for that type of misrepresentation. An innocent misrepresentation means a representation which

[325] *Heilbut, Symons & Co v Buckleton* [1913] A.C. 30, 48; Merkin (n 117) 5.1.2.1.

is neither fraudulent nor negligent.[326] However, under the Misrepresentation Act 1967, s (2) (2) damages may be available for an innocent misrepresentation at the court's discretion. Atiyah and Treitel commented on s (2) (2) that it:

> "…gives the court a discretionary power to award damages for innocent misrepresentation in lieu of rescission. The subsection excludes fraudulent misrepresentation, which will still allow a right to rescind and to claim damages. But the subsection extends to all other misrepresentations, so that it will be possible to award damages even for a perfectly innocent misrepresentation".[327]

Despite the possibility that a court may award damages for innocent misrepresentation, it is not clear if such damages would be awarded on the contractual rather than tortious measure.[328] Under the Misrepresentation Act 1967, s (2) (1) liability is imposed "in damages on a party to a contract who has induced the other to enter into the contract by means of a negligent misrepresentation" [329] on the tortious basis [330] (rather than on a contractual) basis. Accordingly, it appears possible the same tortious basis also applies in relation to an innocent misrepresentation under s (2) (2), but such damages are likely to be lower than if the misrepresentation was fraudulent.[331] By contrast, damages for breach of warranty are calculated to put the claimant in the financial position they would have been in if the statement had been true.[332]

The contrast between the types of damages (misrepresentation and breach of warranty), and their means of assessment, was well described in *Care Tree Invest v Bell* concerning a share purchase:

> "The measure of damages in tort and contract is different. In contract it is the difference between the value of the shares as warranted and the actual value at the date of the SPA. In tort it is the difference between the consideration paid under the SPA and the actual market value of the shares".[333]

And clarified by Lewison LJ in *Project Angel Bidco v Axis*:[334]

> "It must be borne in mind that the relevant difference in value is between the shares themselves on the two different bases, not the loss (if any) suffered by the target company itself. Accordingly, if the company is subject to a liability which ought to have been disclosed but has not been, the resulting loss to the buyer of the shares may be greater than the amount of the target company's own undisclosed liability. Equally there may be a breach of warranty which has caused the target company no loss, but which nevertheless causes a diminution in the value of the shares".[335]

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[326] Beale (n 223) 10-112.
[327] PS Atiyah and GH Treitel, 'Misrepresentation Act 1967' (1967) 30(4) MLR 369, 375.
[328] Beale (n 223) 10-117; PS Atiyah and GH Treitel, 'Misrepresentation Act 1967' (1967) 30(4) MLR 369, 376 - an amendment to apply the contractual measure for innocent misrepresentation was not supported by the government at the time.
[329] Atiyah and Treitel (n 329) 372.
[330] Beale (n 223) 10-117.
[331] ibid.
[332] John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (6th edn, Sweet & Maxwell) 2-08; Merkin (n 117) 5.1.2.2.
[333] *Care Tree Invest v Bell* [2023] EWHC 1151 (Comm).
[334] [2024] EWCA Civ 446.
[335] ibid [25].

So, whilst damages may be recoverable for different types of misrepresentation, and there is a difference between the assessment of damages for misrepresentation and breach of warranty, this impacts the extent of the buyer's recovery depending on the price paid for the shares.

Broadly, it can be said that if the buyer has overpaid for the company, the measure of damages would be higher in a claim for misrepresentation than it would be for breach of warranty.[336] This was explained by Treitel:

> "If the plaintiff's bargain would have been a bad one, even on the assumption that the representation was true, he will do best under the tortious measure. If, on the assumption that the representation was true, his bargain would have been a good one, he will do best under the first contractual measure (under which he may recover something even if the actual value of what he has recovered is greater than the price)".[337]

Treitel provided a worked example of this view:

> "If he pays £100 for something which would have been worth only £40 if it had been as represented, but is in fact worth only £10, the tortious measure would give the plaintiff £90 and the contractual measure £30.[338]
>
> If he pays the £100 for something which would have been worth £150 if it had been as represented, but is in fact worth only £90, the tortious measure would give the plaintiff £10 and the contractual measure £60.[339]

Secondly, another reason a buyer may want to claim in misrepresentation is that the buyer may also be entitled to rescind the contract and possibly also claim damages. In a case of rescission, both future obligations are released as well as those which have accrued. Those which have been performed are nullified and any performance which has taken place by the parties to the contract is reversed.[340] In a share sale, rescission means that the seller would have the shares in the company returned to them and the buyer repaid the purchase price.[341] Rescission puts the parties back in their pre-contractual position as regards the rights and obligations passing under the contract. Consequential losses would be for losses not made good by rescission and these would be available in any case where there was a right to claim damages for misrepresentation.

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[336] Stilton (n 125) 10-08.
[337] GH Treitel, 'Damages for Deceit' (1969) 32 MLR 556, 558 approved by and repeated by Lewison LJ in *Sameer Karim, Karim, Douglas Wemyss Solicitors v Douglas Macduff Wemyss* [2016] EWCA Civ 27, [24].
[338] GH Treitel, 'Damages for Deceit' (1969) 32 MLR 556, fn 20.
[339] ibid fn 21.
[340] John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (5th edn, Sweet & Maxwell) 8-41.
[341] As was unsuccessfully attempted by the seller in *Thomas Witter v TBP Industries* [1996] 2 All ER 573.

Thirdly, the buyer may be out of time to bring a claim for breach of warranty due to time limits in the contract imposing a limited time to bring the claim, [342] so formulating a misrepresentation claim would be its only option.[343]

Fourthly, and related to the third reason above, it is usual for the share purchase agreement to contain limitations on the seller's liability for breach of warranty, including a financial cap on their liability.[344] Construing warranties as also representations may result in those limitations (including the financial cap) being circumvented. In an example in respect of a share sale, the potential difference between the value of the misrepresentation and breach of warranty claims was noted by Mann J in *Sycamore v Breslin*, [345] because warranty claims were limited under the terms of the agreement, but misrepresentation claims were not:

> "the point has a real significance in terms of the measure of damages (and also the date at which damages should or can be assessed), so it is necessary to deal with it. If the claimants are right about it, and can otherwise put their claim successfully in misrepresentation, then they may be entitled to recover damages which would not be available under a contractual claim. At their highest, the misrepresentation claim damages are equivalent to or exceed the consideration paid [being £16 million] [346]. At its highest the warranty damages claim is about £6 million. Hence the point's importance".[347]

Fifthly, the buyer will have the ability to select which of the two claims it will pursue. A claim for pre-contractual misrepresentation can potentially be based on any aspect of the buyer's due diligence on the target company.[348] For a buyer, having the ability to make a contractual claim for a breach of contract and a tortious claim for misrepresentation provides a greater prospect of success in a dispute.[349]

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[342] Usually before 18 or 24 months from completion as opposed to 6 years from the date the breach occurred – Limitation Act 1980, s 5 or 12 years if the agreement was a deed – Limitation Act 1980, s 8.
[343] As happened in the case of *Idemitsu Kosan v Sumitomo* [2016] EWHC 1909 (Comm), [8] where the buyer was arguing for warranties to be representations as it had failed to notify the seller of a breach of warranty claim within the 18-month time period specified in the agreement.
[344] For a limited extract example of some typical limitations in a share purchase agreement see the end of the judgment of *Idemitsu* (n 343).
[345] [2012] EWHC 3443 (Ch).
[346] ibid [1].
[347] ibid [201].
[348] Rod Cowper, 'How Reliable Are Warranties?' (2013) 208(Mar) IHL 3, 5 although this is unlikely to be the case where the seller is asked to verify information pre-completed by the buyer As in that case no representation would have been made by the seller. John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (5th edn, Sweet & Maxwell) 3-03 fn 10. This was highlighted in *Parallel Media v Chamberlain* [2014] EWHC 214 (QB) where the seller's populating of a spreadsheet created by the buyer did not amount to a representations by the seller. In that case the buyer wanted the seller to verify the buyer's propositions in relation to a number of matters. The result would likely have been different, and treated as a representation, if the seller had itself created the spreadsheet and provided it to the buyer.
[349] Adam Chaffer, 'High Court Clarifies Whether Warranties Are Representation in Share Purchase Agreements' (2017) 38(9) Comp Law 290, 291.

Having considered the possible reasons a buyer may have for wanting to bring a claim in misrepresentation, analysis will be made of the various situations when a misrepresentation claim may be able to be brought in relation to a share purchase.[350]

4.3 Pre-contractual representation made by the seller but the purchase contract contains no warranty on the same terms as the representation.

> ***Situation 1*** *Prior to A selling his car to B, A tells B that the car has done 10,000 miles from new. B relies on that statement in agreeing to buy the car. The car had in fact done 50,000 miles.*

The above is an example of a pre-contractual representation which would fit the standard definition of a misrepresentation. This scenario is outside of the scope of this chapter. This chapter is primarily concerned only with situations where there are contractual warranties which may either replicate, or may be argued to function also as, representations.

At this point, it is also worth noting that a pre-contractual representation can become a term of the contract by operation of law. In brief, this occurs when the representor did more than just make a false statement on which the claimant relied in entering into the contract.[351] They must have intended to be bound in the contract with regard to the statement – the promise about the truth of the statement became part of the bargain.[352] It is simply the case that "no representation is a warranty unless 'intended' as such".[353] The importance of the statement is such that, if it had not been made, the representee would not have entered into the contract at all.[354] In such cases, it appears the representee would have a claim against the representor in tort for pre-contractual misrepresentation and an alternative claim for breach of contract.[355]

It can be seen, therefore, that if the seller makes an untrue pre-contractual representation which causes the buyer to buy, then the statement may remain a pre-contractual representation or become a term of the contract. Where the pre-contractual representation becomes a term of the contract the buyer has the advantage of the ability to bring two claims and can choose which one will give it the best result. Of course, not every pre-contractual representation will amount to a term. Determining whether a

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[350] The following italicised situations of "A seller representing/warranting to B" is based on a version of one used in *Idemitsu* (n 343), [17] which was put forward by the buyer in that case as part of its amended particulars of claim and has amended been accordingly.
[351] John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (5th edn, Sweet & Maxwell) 8-05.
[352] ibid.
[353] P S Atiyah, *Essays on Contract: Misrepresentation, Warranty and Estoppel* (OUP 1986) 280.
[354] G H Treitel, *Treitel on The Law of Contract* (15th edn, Sweet & Maxwell) 9-060.
[355] *New York Laser Clinic v Naturastudios* [2019] EWHC 2892 (QB) [235-236], [241-243], [273-274].

pre-contractual representation has become a term is very imprecise.[356] In any event, even in cases where numerous pre-contractual representations have been made to a buyer, the possibility of turning them all into terms because the seller had met the necessary requirement of promising the truth is remote.

Whilst in Situation 1, there was no warranty expressed in a written contract, the next scenario again concerns a pre-contractual representation, but, in addition, a warranty.

4.4 A pre-contractual representation made by the seller and also a warranty on similar terms in the contract

> ***Situation 2*** *Prior to A selling his car to B, A tells B that the car has done 10,000 miles from new. B relies on that statement in agreeing to buy the car. A also warrants in the contract the car has done 10,000 miles. The car had in fact done 50,000 miles.*

In this situation, there is both a pre-contractual representation and a warranty. An example of a case reflecting this Situation 2 is *Wemyss v Karim*.[357] In that case, a business was sold to the buyer [358] who alleged misrepresentation and breach of warranty.

The misrepresentation claim concerned a pre-contractual representation made by the seller to the buyer 4 months before completion of the transaction. That representation that the profits of the business were on course for two specified sums of money was untrue.[359] The seller had stated in an email to the buyer the following regarding the turnover and profits of the business:

> "Not that you asked for it but I have done the following analysis of the accounts. The essential features are that the last 4 years gross and net income have been
> 2004 559k/69k
> 2005 682k/156k
> 2006 527k/99k
> 2007 647k/100k* (see my notes re 2007 accounts)
> 2008 On course for 640k/120k…"

[356] Merkin (n 117) 174.
[357] [2014] EWHC 292 (QB).
[358] "What Mr Wemyss in fact sold was his entitlement as a member of the LLP, which was more akin to a sale of shares in a limited company." [2014] EWHC 292 (QB), [2].
[359] ibid [45].

The judge found the words that the turnover was "on course" for £640,000 and profits of £120,000 to be untrue [360] when it was made, with the correct figures respectively being £547,000 [361] for turnover and £92,000 for profit.[362]

In respect of the warranty claim in *Wemyss*¸ that was based on two warranties which provided that the seller warranted to the buyer "to the best of his knowledge and belief [that] each of the Warranties is true accurate and not misleading" that:

> "1.1 All information contained in this agreement, and all other information relating to the Business given by or on behalf of the Seller to the Buyer… are true accurate and complete in every respect and are not misleading.
>
> 1.2 There is no information that might reasonably affect the willingness of the Buyer to buy the Business and the Assets on the terms of this agreement".[363]

In respect of these warranties, the judge found that:

> "…the warranty that the same statement was true "to the best of Mr Wemyss's knowledge and belief" as at the date of the sale and purchase agreement… was untrue, because by then he had access to the subsequent monthly management information which showed that the outcome for the year would be well below the stated figures".[364]

In other words, the judge found that the pre-contractual statement regarding the business turnover/profits being £640,000/£120,000 was also warranted by the above warranties. So, the buyer had both a misrepresentation claim and a warranty claim.

When *Wemyss* reached the Court of Appeal on an appeal concerning damages, Lewison LJ explained the choice the buyer had as regards the finding of misrepresentation and breach of warranty and how damages were assessed:

> "[the buyer] was entitled to damages on both the tortious measure and also the contractual measure. Which he chooses will be that which produces the better result for him. The tortious measure is the difference between (a) the price that Mr Karim paid and (b) the true value of the Business. The contractual measure is the difference between (a) the value of the Business if the warranted information had complied with the warranty: i.e. it had been true, complete and not misleading and (b) its true value".[365]

Wemyss illustrates that in the case where the buyer can show the seller has made a pre-contractual representation, and also provided a warranty on materially the same terms, the buyer has a choice of which claim to bring. It can bring a claim either for misrepresentation or for breach of warranty.

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[360] *Wemyss v Karim* [2014] EWHC 292 (QB), [45].
[361] ibid [39].
[362] ibid [32].
[363] ibid [34].
[364] ibid [46].
[365] [2016] EWCA Civ 27, [40].

This is useful for the buyer. It serves to give them two claims. They can choose the most valuable claim to pursue.

Situation 2 concerned both a pre-contractual representation and a warranty in the contract. In the next situation there is no pre-contractual representation made by the seller.

4.5 No pre-contractual representation made by the seller but there is a warranty in the contract but the contract does not state the warranty is also a representation

> ***Situation 3*** *Prior to A selling his car to B, A does <u>not</u> tell B that the car has done 10,000 miles from new. B has <u>no</u> pre-contractual statement on which to rely. B warrants in the contract the car has done 10,000 miles. The car had in fact done 50,000 miles.*

Unlike Situation 2, the buyer has no pre-contractual representation on which to found a claim (or a pre-contractual representation was made but liability for it is excluded).[366] The buyer, therefore, argues that the warranty does nevertheless also constitute a representation on which the buyer relied when entering into the agreement and which the buyer sues for in tort. Three High Court cases will be considered in relation to such a situation where the buyer seeks to claim that the warranties in the contract also amount to representations.

The first case is *Invertec v De Mol Holding BV*.[367] The buyer had purchased the entire issued shareholding in a company from the seller. As is typical, the share purchase agreement contained a number of warranties. The buyer argued that the warranties were also representations. The buyer made claims against the seller for misrepresentation on the basis of the warranties in the agreement. In respect of the warranties in the agreement also amounting to representations, Arnold J [368] said:

> "the warranties in question also amount to representations of fact… The warranties were negotiated between [the parties] over a considerable period prior to the execution of the [agreement]. As a result, [the buyer] knew prior to signing that the agreement it was about to enter into contained those warranties. In those circumstances I cannot see any reason in principle why [the buyer] cannot claim that it was induced to enter into the agreement by the representations made by those warranties so as to found a misrepresentation claim if they were false… ".[369]

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[366] This would be where the contact excludes the ability for the buyer to bring claims for misrepresentation (other than fraudulent misrepresentation).
[367] [2009] EWHC 2471.
[368] Arnold J was promoted to the Court of Appeal in 2019.
[369] *Invertec* (n369) [363].

Arnold J then went on to consider and find that the buyer had relied upon the warranties that he said had a dual character as representations.[370] It is worth mentioning that Arnold J had separately found that the seller had made certain pre-contractual misrepresentations regarding different matters. This means that certain parts of the case fell into the above Situation 2. Arnold J concluded that the warranties were also representations (Situation 3) for three reasons.

Firstly, the warranties were negotiated over a long period.[371] Secondly, the buyer knew that before entering into the agreement it was going to enter into the agreement which contained those warranties.[372] Thirdly, Arnold J considered whether or not the buyer had relied on the warranties.[373]

On Arnold J's reasoning, any extensively negotiated agreement (whatever that may mean, and in shares sales negotiation is extensive) containing warranties could have those warranties take on an additional character as representations. This would leave open the possibility of a misrepresentation claim if the buyer can show it relied on the warranties.[374] This would seem to run counter to what the parties had agreed, which was the giving of warranties, rather than the making of representations. Whilst *Invertec* was good news for buyers, the subsequent case of *Sycamore Bidco v Breslin* [375] did not support Arnold J's view.

In *Sycamore* (the second case concerning Situation 3), the buyer purchased the shares in a company for £16 million and claimed that the seller made misrepresentations concerning the accounts of the company, and claimed damages.[376] Mann J was required to consider the buyer's claim that the warranties were also capable of being representations.[377] He concluded that "It does not seem to me that they have that dual quality"[378] and so the warranties were not also representations. He gave several reasons for this view:

> (i) There is a clear distinction in law between representations and warranties, and that would be understood by the draftsman of the SPA. That is likely to be the case in any transaction of this nature, but is also apparent from the SPA itself. Representations are referred to in clause 16.3 [379], and Warranties (with a capital "W") are referred to elsewhere.

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[370] ibid [365] to [377].
[371] ibid 363.
[372] ibid [363].
[373] ibid [365] to [377].
[374] This point was noted in the recent case of Keyser QC in *Wiggin Osborne Fullerlove v Bond* [2021] EWHC 1381 (Comm) [112].
[375] *Sycamore* (n 345).
[376] ibid [1].
[377] ibid [200].
[378] ibid [203].
[379] Clause 16.3 contained an entire agreement clause which included the wording: "Each party acknowledges that it has not relied on or been induced to enter into this agreement by a representation other than those expressly set out in the Transaction Documents. A party is not liable to the other party (in equity, contract or tort, under the Misrepresentation Act 1967 or in any other way) for a representation that is not set out in the Transaction Documents".

> (ii) The warranties in this case are clearly, and at all times, described as such, and are nowhere described as representations…
>
> (iii) The words of the warranting provision (clause 5) are words of warranty not representation. There is a legal distinction between the two and (subject to a point made about a later reference to representations, as to which see below) there is no reason to extend the words beyond their natural meaning. In order to make the relevant material a representation one has to find something in the SPA which is capable of doing that. It is not enough that the subject matter of the warranty is capable of being a representation. One has to find out why those words are there. One finds that in clause 5 [380]; and what one finds is words of warranty, not words of representation.
>
> (iv) The Disclosure Letter (itself referred to in the SPA) also distinguishes between representations and warranties — "The disclosure of any matter shall not imply any representation, warranty or undertaking not expressly given in the Agreement …".
>
> (v) Clause 8 of the SPA contains significant limitations on the liability under the "Warranties". It does not refer to representations. The clause is obviously a significant part of the overall structure of liability. If the warranties were capable of amounting to representations as well, then on the strict wording of this clause it would not apply to any such misrepresentation. The sellers would thus be deprived of a large part of their protection and limitation…
>
> (vi) There is a conceptual problem in characterising provisions in the contract as being representations relied on in entering into the contract. The timing does not work. The normal case in misrepresentation involves the making of a representation, and as a result the entering into of the contract. That does not work where the only representation is said to be in the contract itself. Miss Newman expressly disclaimed the relevant representations being made at any earlier time. In some cases that problem is solved by an express provision making certain contractual statements representations. In such a case the parties have agreed as to their nature and how they should be treated. However, that is not the present case.

Mann J appreciated there was a clear difference in law between warranties and representations.[381] He did not interpret warranties as equating to representations.[382] He noted that the warranties were not labelled as representations.[383] Mann J was of the view that reference needed to be made to the agreement to see if it also included representations. The operative clause in the agreement where the seller gave the warranties stated the seller "warrants"[384] and the disclosure letter [385] said that disclosure does not imply any representation not set out in the agreement. In addition, the agreement contained limitations, including a financial cap on the seller's liability.[386] Mann J

[380] Clause 5 said that the sellers warranted to the buyer in terms of the warranties contained in a separate schedule.
[381] *Sycamore* (n 375) [203].
[382] Adam Chaffer, 'High Court Clarifies Whether Warranties Are Representation in Share Purchase Agreements' (2017) 38(9) Comp Law 290, 291.
[383] *Sycamore* (n 375) [203].
[384] ibid.
[385] The letter from the seller to the buyer in which the seller details how the warranties are untrue.
[386] For an example of the typical limitations in a SPA see the end of the judgment of *Idemitsu* (n 343).

directly addressed his different view to that of Arnold J in *Invertec* and the parties' expectations of what the purchase contract was to include:

> "The difference between the result in that case and in this is because, with respect, I disagree with the views of Arnold J. For the reasons given above, I think that there is no satisfactory answer to be given by those claiming representations to have been made, to the question which has to be asked: Why have the warranty provisions been inserted in the contract? The answer is to be found in clause 5 in each case – they are there because they are warranted. There is nothing more to make them into representations. I do not think it affects the position that in the present case, as in Arnold J's, the parties (and in particular the warrantors) knew what was coming because drafts have been exchanged and the terms of the contract negotiated. What the warrantors knew to be coming, or more precisely knew they were going to be providing, were expressed to be warranties, not representations".[387]

Mann J was clear in his rejection of Arnold J's reasoning but the result of these two cases was opposing High Court views, with one favouring the buyer, the other, the seller. These differing views in *Invertec* and *Sycamore* were considered in *Idemitsu Kosan v Sumitomo Corporation* [388] with the reasoning in *Sycamore* being followed.

In *Idemitsu* (the third Situation 3 case), the buyer had bought a company for US $575 million and sought damages for misrepresentation against the seller. The seller applied for summary judgment dismissing that claim. That was on the basis that the claim had no real prospect of success and that there was no other compelling reason why the claim should be dealt with at a trial.[389] The buyer's arguments that the warranties were also representations were:

> "i) The statements of fact in the Warranties were by nature capable of founding an action for misrepresentation.
>
> ii) The designation of those statements as contractual warranties did not derogate from their inherent quality as representations.
>
> iii) Mann J.'s conclusions in Sycamore Bidco, supra, were therefore wrong in principle; and Arnold J.'s view in Invertec Ltd, supra, is to be preferred, even if Arnold J. expressed himself more briefly or instinctually than Mann J. did in the later decision.
>
> iv) Nothing in the SPA – in particular none of the particular provisions relied on by Sumitomo – robbed the statements made in Schedule 4 to the SPA [390] of their status as representations…"

The buyer argued four points, the first two of which were effectively saying the same thing. That was that there was a similarity between warranties and representations and that could justify the warranties

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[387] *Sycamore* (n 375) [209].
[388] [2016] EWHC 1909 (Comm).
[389] ibid.
[390] The relevant warranties on which the claim was based is appended to the judgment.

being classed as representations. In other words, they were statements. The fourth point appears to be a suggestion there was nothing in the agreement which indicated that the warranties could not be representations.

In response to the above, deputy judge Andrew Baker QC said, "these propositions beg the real question in this case, because they assume that if "seller warrants X" is a term of a contract of sale, the seller thereby makes a statement, to the effect of X, to the buyer".[391] He rejected that warranties in an agreement would have that effect:

> "I do not think that by concluding a contract on terms which include contractual warranties the warrantor makes any relevant statement to the counterparty. The act of concluding a contract is constituted by, and amounts to a communication only of, assent to and intention to be bound by the terms agreed".[392]

Baker QC quoted Mann J's reasoning in *Sycamore* as to what is needed to make a warranty into a representation:

> "In order to make the relevant material a representation one has to find something in the SPA which is capable of doing that. It is not enough that the subject matter of the warranty is capable of being a representation. One has to find out why those words are there".[393]

Contrasting this with Arnold J's approach in *Invertec*, Baker QC said:

> By contrast…Arnold J. simply asserts the conclusion that contractual warranties, if they be as to matters of past or present fact, "also amount to representations of fact". With respect, it seems to me, as it did to Mann J., that Arnold J. there confused a finding of material that is by nature factual, so that a statement in terms thereof could be in law a representation, with a finding that there was a communication amounting to or involving such a statement in the first place.

Here, the deputy judge disagrees with Arnold J's approach that contractual warranties can be representations if they fit the definition of misrepresentation, which is that they relate to matters of the past or present – statements as to the future cannot found a claim for misrepresentation.[394] Baker QC is in effect stating, using the scenarios described in this chapter, that Arnold J confused Situation 2 with Situation 3. He considers the conclusion that Arnold J made concerning the parties expecting the contract to contain warranties:

> "Arnold J. further concluded that the fact that the warranties in Invertec Ltd had been negotiated over a period prior to the conclusion of the contract (as is typical) might be an answer to the possible conundrum that a representation only made by the act of concluding a contract could not induce that act".[395]

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[391] *Idemitsu* (n 343) [16].
[392] ibid.
[393] ibid [19].
[394] Merkin (n 117) 375.
[395] *Idemitsu* (n 343), [20].

In response to that, Baker QC said:

> "But even if prior knowledge of what was to be in a contract might be used to claim that representations made by it induced its conclusion, the question will remain whether indeed any representations were so made in any given case. For the reasons I have expressed, and those of Mann J. in Sycamore Bidco, in my judgment if a contractual provision states only that a party gives a warranty, that party does not by concluding the contract make any statement to the counterparty that might found a misrepresentation claim".[396]

Baker QC concluded that "I am firmly of the view that Mann J. was right, I am following him in respectfully disagreeing with Arnold J".[397]

The deputy judge focussed on the conceptual differences between warranties and representations. He rejected the notion of warranties having a dual existence, unless either provided for in the contract, or there being a pre-contractual statement reflecting the terms of the warranty. He dismissed the approach in *Invertec*.[398] The deputy judge's view was that a warrantor does no more than warrant when giving a warranty. To explain this Baker QC also used the example of a seller selling grain which is "warranted at the date of contract [as being] free from some identified impurity" [399] and concluded that, in the absence of additional facts, the buyer would have no claim for misrepresentation. A seller offering a warranty is doing nothing more or less than providing a contractual promise which does not involve the making of a representation and for which the seller would only be liable for breach of contract.[400] The deputy judge stated that by the parties concluding the contract on terms which contain contractual warranties no other statement is made by the party giving the warranties. That party is only communicating assent and intention to be bound by the terms agreed.[401] So, the existence of a warranty does not have the effect of negating a representation if a representation on materially the same terms has been made.[402]

Subsequently, Hochhauser QC, sitting as a deputy High Court judge in *Arani v Cordic Group*, [403] considering the above cases as part of a strike-out application said "a warranty, without more, is not a representation".[404] Further, in *Ivy Technology v Martin* [405] Teare J said that an allegation that warranties were also representations would founder on the analysis of a warranty in *Idemitsu*.[406]

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[396] ibid [20].
[397] ibid [21].
[398] Simon Rainey QC, 'Drafting Bespoke Commercial Contracts—A Review for JWELB' (2018) 11(2) J World Energy L & Bus 182, 184.
[399] *Idemitsu* (n 343) [14].
[400] ibid [14].
[401] ibid [16].
[402] ibid [17].
[403] *Arani v Cordic Group* [2021] EWHC 829 (Comm).
[404] ibid [121].
[405] [2020] EWHC 94.
[406] ibid [34].

In summary, *Sycamore* and *Idemitsu* found that warranties are not also representations. Pure contract terms do not take effect as misrepresentations.[407] This would be disappointing for buyers.

It would be thought, therefore, that expressly stating the warranties are also representations in the contract (rather than the buyer arguing that they are) would make them such. Doing so was suggested by Mann J. His view was that in that case the parties have agreed as to their nature and how they should be treated. However, from the buyer's perspective, as will be shown next, there are some problems with this approach.

4.6 Contract states warranties also constitute representations

> ***Situation 4*** *Prior to A selling his car to B, A does <u>not</u> tell B that the car has done 10,000 miles from new. B has no pre-contractual statement on which to rely. B warrants in the contract the car has done 10,000 miles. The contracts explicitly also says the warranty is a representation. The car had in fact done 50,000 miles.*

This situation concerns representations stated in the contract for the first time which have been specified as also being warranties.

As a brief reminder, the elements of a claim in misrepresentation are a statement of fact or law which induces the representee to enter into the contract. The damages for a representation being untrue are damages or rescission.

Why might a buyer wish to specify in the share purchase agreement that the seller warrants and represents (or vice versa)? The following drafting note to the definition of "Warranties" in a template share purchase agreement is reflective of many other examples. It usefully explains the reason. It gives the reader the belief that adding the word "representations" into the definition of "warranties" provides a dual remedy in damages to the buyer:

> "The reference in this definition to "representations" is intended to keep open the possibility of an action for misrepresentation based on the warranties in addition to a contractual claim for breach of warranty. Depending on the circumstances, the remedies for misrepresentation (that is, damages calculated on a tortious basis and possibly rescission) may be preferable to the remedies for breach of contract, and so the buyer may want to preserve the possibility of bringing a misrepresentation claim if any of the sellers' warranties are breached".

To summarise the above, some precedent agreements provide that sellers "warrant and represent" to give the buyer parallel claims in contract and tort.[408] Or perhaps, that is simply dressing up

[407] Merkin (n 117) 9.1.2.1.
[408] Rosenberg (n 158) D5-113.1.

warranties as representations on a "just in case basis".[409] As will be seen, this latter view seems the more accurate. Typically, this attempt at the dual status of warranties being representations is simply expressed that the seller "warrants and represents" (or vice versa) or if these words are not used there are some other words expressing that warranties in the contract are to be treated as representations.

With that dual remedy intention in mind, it is necessary, firstly, to consider whether the courts have held that any such elements of misrepresentation, or tortious remedies for breach, could not – in principle, as a matter of logic (and regardless of the reading of the particular contract in the case) be established for a 'contractual misrepresentation'.

As far as Chitty is concerned, on the subject of remedies for untrue contractual representations, it states:

> "If the representations were made for the first time in the contract, or if the representee had not relied on an earlier iteration of them, the position is less clear. Subject to other provisions of the contract, the separate inclusion of representations in the contract seems to make sense only if the representor is implicitly agreeing that the representee will have a remedy for misrepresentation — for example, rescission — if the representation turns out to have been incorrect.[410]

However, this view does not appear to necessarily be borne out in at least some of the relevant cases. There are several cases where the courts have indicated that effect may be given to contractual representations. Conversely, there are others which suggest tortious damages may not be recoverable. There have also been questions over the characterisation of contractual representations as not meeting the requirements of a misrepresentation. This is because they have not induced the entering into of the contract. Instead, they appear only in the contract and do not repeat an earlier representation. In the cases that follow, the warranties were stated as having a dual status also as representations.

In the purchase contract in the Scottish case [411] of *BSA v Irvine* [412] the contract stated the seller both represented and warranted to the buyer. Lord Glennie said that certainly there may be a claim for breach of warranty, but the existence of such a claim did not exclude the possibility of a claim for misrepresentation based upon the same statement.[413] He concluded that both the breach of warranty and misrepresentation claims could be put before the court at trial.[414]

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[409] Jeremy Thomas, 'Recent Cases Concerning Accounting Warranties in Mergers and Acquisitions' (2000) 11 ICCLR 273, 276.
[410] Beale (n 223) 10-015.
[411] And so only of persuasive value as it is not binding on English courts. The case was an interlocutory hearing.
[412] [2010] CSOH 78.
[413] ibid [9].
[414] ibid [12].

Also positive for the buyer was the Court of Appeal decision in *Bottin v Venson Group* [415] where the agreement stated that the warranties were to be treated as representations:

> "The Warrantors acknowledge that the Investor is entering into this Agreement in reliance upon the Warranties and agree that the Investor may treat them as representations inducing them to enter into this agreement".[416]

In *Bottin*, Peter Gibson LJ did not comment on whether tortious damages would be available for breach of the contractual representations, [417] but said the final words of the above clause "…would permit a claim for rescission of the Agreement". He went on to say, "That gives sufficient effect to those words… ".[418] If this view is correct, rescission is seemingly available for contractual representations, but damages on a tortious basis may also be available, as indicated by the next case.

In *Care Tree Invest v Bell* [419] the contract provided for the following in relating to contractual representations:

> "a. Mr Bell warranted and represented to Care Tree that, "except as Disclosed, each Warranty is true, accurate and not misleading on the date of this agreement ": clause 9.2.
>
> b. He acknowledged that Care Tree was "entering into this agreement on the basis of, and in reliance on, the Warranties ": clause 9.1.
>
> c. By clause 9.2 of the SPA, the parties expressly agreed that the Warranties took effect as representations and not merely as contractual warranties;
>
> d. By clause 9.1 of the SPA, the parties agreed that the falsity of the representations could give rise to a claim in misrepresentation and that the Buyer was entering into the SPA in reliance upon such representations".[420]

As the above extract of the contract shows, there were various references in the contract to contractual representations. The deputy judge, Charles Hollander KC, noted, in the paragraph of the judgment following the above extract, that the trial was concerned with quantum. He remarked that the measure of damages in tort and contract was different, [421] seemingly indicating that the buyer was able to claim for either. He later noted, like Peter Gibson LJ in *Bottin* above, that the buyer would have been entitled to rescind the contract, although, in the case before him, the buyer had elected not to do so and to claim damages instead.[422]

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[415] [2004] EWCA Civ 1368.
[416] ibid [11].
[417] As he was of the view that due to other terms of the contract only a claim for breach of contract could be made in respect of the contractual representations.
[418] *Medical Limited v Millar* [2022] EWHC 2303 (KB) Deputy Master Grimshaw - An employee warranted and represented certain matters [162] that were found the be untrue which the court concluded allowed the contract to be rescinded [176].
[419] [2023] EWHC 1151 (Comm).
[420] ibid [11].
[421] ibid [12].
[422] ibid [21].

The case *MAN Nutzfahrzeuge AG v Freightliner* [423] provides a clear description of the consequence of contractual representations and warranties from a remedies perspective. In that case, article 4 of the contract provided the familiar representations and warranties in the following terms:

> "4.1 [the seller] represents and warrants as follows to [the buyer] and acknowledges and confirms that [the buyer] is relying upon such representations and warranties in connection with the purchase by [the buyer] of the… Shares"

Moore-Bick LJ (sitting in the High Court) provided a view of the effect of the use of the words represents and warrants in a contract:

> "[it was] submitted that where it can be shown that any of the statements in Article 4 was untrue the agreement allows the injured party to choose whether to claim for misrepresentation or breach of warranty and thereby to elect between the contractual and reliance measures of damages. Although I would not put it in quite that way, I think that is broadly the effect of the agreement as a whole. By drafting the clauses in question as both representations and warranties the parties have attached different characteristics to the statements they contain which, depending on the circumstances, may give rise to different consequences and different measures of loss".[424]

Although Moore Bick LJ is somewhat restrained in this view, this statement, and those from the preceding cases, indicate a promising position for the buyer. Taking these cases in aggregate, tortious damages and rescission are available even if none of the ingredients of a misrepresentation cannot be satisfied.

This promising position continued in the High Court in *Yukos v* Georgiades [425] where Moulder J considered whether the claimant relied on the contractual representation. The contract did not concern the sale of shares, but was rather a settlement agreement, and contained a clause which stated the defendant "…warrants and represents that it is not aware of any facts or circumstances which might give rise to any claim… ".[426] The claimant alleged the representation was untrue. Moulder J said "…the key issue in the circumstances of this case, in relation to misrepresentation, is whether there was reliance on the representation".[427] Moulder J considered the elements of a misrepresentation [428] and a number of authorities confirming the need for the representee to have relied on the representation.[429] She considered the evidence of the relevant individual who caused the claimant to enter into the contract and found they had not been induced to enter into the contract.[430] Therefore, Moulder J found that there had been no misrepresentation.[431]

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[423] [2005] EWHC 2347 (Comm).
[424] ibid [192].
[425] [2020] EWHC 173 (Comm).
[426] ibid [212].
[427] ibid [278].
[428] In that case the alleged misrepresentation was fraudulent.
[429] [2020] EWHC 173 (Comm) [279-280].
[430] ibid [285-290].
[431] ibid [291].

By contrast, on the issue of reliance Mann J, in *Sycamore*, questioned the characterisation of untrue contractual representations as meeting the requirements of a misrepresentation:

> "There is a conceptual problem in characterising provisions in the contract as being representations relied on in entering into the contract. The timing does not work. The normal case in misrepresentation involves the making of a representation, and as a result the entering into of the contract. That does not work where the only representation is said to be in the contract itself".[432]

This is despite Mann J's earlier comment in *Sycamore* that the parties could include in the contract "an express provision making certain contractual statements representations. In such a case the parties have agreed as to their nature and how they should be treated".

Likewise, reliance was also mentioned in *BSA v Irvine*. Whilst allowing the contractual misrepresentation claim to proceed to trial, Lord Glennie questioned the issue of reliance. The seller asked how the terms of the contract establish the very things upon which the buyer claimed to have relied in entering into it. This is questioning how there can be reliance on a statement that only appears in the contract, rather than before it was made. Lord Glennie said this point had some superficial attraction.[433] He noted the representation relied upon was a representation contained in the contract rather than one made before it was concluded.

The issue of reliance also featured in the Court of Appeal in *Leofelis v Lonsdale Sport*.[434] Lloyd LJ said:

> "The point taken is that, insofar as reliance is placed on a statement made in the contract, the person relying on the statement cannot say that he "has entered into a contract after a misrepresentation has been made to him". The representation is made in the contract and therefore is not made until the moment when the contract comes into being. That appears to me to be correct".[435]

Sycamore, *BSA* and *Leofelis* all question how a party can be said to have relied on a representation when it first appears in the contract.

In *Leofelis*, Lloyd LJ also casts doubt on the ability to claim damages under the Misrepresentation Act 1967, s (2) (1) in the case of a contractual representation.:

> "Accordingly, though it is unnecessary to decide the point, and I do not, it seems to me that Mr Leggatt is right to submit that damages under section 2(1) of the 1967 Act are not recoverable in respect of a misrepresentation which is made in a contract, as distinct from one which is made before the contract is entered into".

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[432] *Sycamore* (n 375) [203].
[433] [2010] CSOH 78, [7].
[434] [2008] EWCA Civ 640, [141].
[435] ibid.

Lloyds LJ's indication that damages may not be recoverable under the Misrepresentation Act 1967 for contractual representations appears to be due to the opening words of the Misrepresentation Act 1967, s (2) (1):[436] "Where a person has entered into a contract after a misrepresentation has been made to him…". A contractual representation is at odds with this sub-section. This is because it will be problematic to argue that the misrepresentation was made before entering into the contract, as the representation is made only in the contract itself, rather than before it. Like Lloyd LJ, Simon J in *Bikam* was "…doubtful that a representation which only appears in a contract can fall within the terms of s.2(1) of the Misrepresentation Act 1967 in the light of the wording of the statute".[437] However, his view, like Lloyd LJ's, was only indicative.

The same opening words that appear in s (2) (1) as regards damages also appear in s (1) as regards rescission: "Where a person has entered into a contract after a misrepresentation has been made to him…". If Lloyd LJ is right about damages not being recoverable under the Misrepresentation Act 1967 for a contractual representation, then the same would apply to a rescission claim under that Act because the same opening words apply. That too would be unavailable. Instead, a rescission claim would have to be brought either under the common law or equity.

However, a stronger suggestion of the inability to recover tortious damages generally [438] was expressed by Bingham MR in *Senate Electrical Wholesalers v STC Submarine Systems.*[439] The contract contained warranties and contractual representations.[440] The seller argued that the buyer was not entitled to rely on both breaches of contractual obligations and the same breaches in tort.[441] The seller argued that point by stating:

> "… it is unsustainable that the breaches can be both, that they must be one or the other, and that they are plainly, in all the circumstances, contractual claims. As a second limb he [the seller's counsel] contends that it is a manifest absurdity for the entering into the agreement to be relied upon when it is the very agreement in which the representations for the purposes of the tortious claim are said to be contained. That, he submits, is nonsense and accordingly it should be struck out".[442]

In expressing almost complete agreement with this submission, Bingham MR obiter said that:

> "Speaking for myself, I go almost the whole distance with [the seller's counsel] in regarding the claims in tort as almost certainly, if not certainly, doomed to failure. It is not, I think, suggested, and could not be suggested, that there is any duty in tort wider or in any way different from a contractual duty. Therefore, it appears quite plain that the plaintiffs either succeed in establishing a contractual duty or they do not succeed at all. Furthermore, it does not appear to me that the tortious claims add anything to the strength of this case claim *[sic]*

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[436] ibid.
[437] *Bikam v Adria Cable* [2012] EWHC 621 (Comm), [39].
[438] Meaning both under the Misrepresentation Act 1967 and common law.
[439] [1994] Lexis Citation 3630, a case concerning leave to appeal.
[440] ibid.
[441] ibid.
[442] ibid.

> by seeking to base them on an agreement, which is both the source of the misrepresentations and the act of reliance".

The final sentence of the above quotation concerns the contract itself containing the representations and there being no reliance by the buyer on any pre-contractual representation. Bingham MR therefore concluded that the contractual representations were only contractual in the same way as a warranty. As such, they could not substantiate a tortious claim. Bingham MR did go on to state "I am willing to express the tentative opinion that the claims, in so far as they are based in tort, are almost certainly hopeless".[443]

In summary, some of these cases say that a misrepresentation claim can be brought for a contractual representation, [444] that rescission is available [445] and that damages may be recoverable [446] or indeed, are recoverable.[447] Others have said there is a timing issue because the buyer cannot say they have relied on a contractual representation.[448] Others say that a claim under the Misrepresentation Act 1967 cannot be brought [449] or that damages in tort cannot be sought at all.[450] Whilst it must be remembered that in a number of the above cases comments were expressed only indicatively, it is worth considering where that leaves a buyer in terms of what they may be able to claim for breach of a contractual representation.

Even if the buyer has a misrepresentation claim there will often be a problem with the bars to rescission. The worst case for the buyer, based on these cases other than *Senate*, is that a buyer has a claim for recission in common law or equity. If the position in *Senate* is accepted then the buyer has no tortious claim based on contractual representations. However, assuming that *Senate* is wrong and a rescission claim is possible, no matter what type of recission claim is brought the buyer may be unsuccessful due to one of more of the bars to recission applying. These are affirmations which, in this case would be the buyer treating the contract as continuing, [451] or lapse of time [452] or the impossibility for restoring the parties to their pre-contractual position.[453] This final point may be the most problematic in respect of a sale of shares.

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[443] ibid.
[444] *BSA v Irvine* [2010] CSOH 78.
[445] *Bottin v Venson Group* [2004] EWCA Civ 1368 and *Care Tree Invest v Bell* [2023] EWHC 1151 (Comm).
[446] *MAN Nutzfahrzeuge AG v Freightliner* [2005] EWHC 2347 (Comm).
[447] *Care Tree Invest v Bell* [2023] EWHC 1151 (Comm).
[448] *Sycamore* (n 375) and *Bikam* (n 437).
[449] *Leofelis v Lonsdale Sport* [2008] EWCA Civ 640.
[450] *Senate Electrical Wholesalers v STC Submarine Systems* [1994] Lexis Citation 3630.
[451] Merkin (n 117) 389.
[452] ibid 390.
[453] ibid 391.

In a share sale situation, Jacob J in *Thomas Witter v TBP Industries* [454] expressed the view that rescission may not be possible. In the case before him that impossibility was due to personnel changes within the company, the passing of time (4 years) and mortgages having been taken on the business.[455] The key point was the sellers could not take back their shares as a result of recission as the business was not the same as the one conveyed.[456] Of course, not all cases of rescission would result in the same impossibility. Much would depend on what changes the buyer had made to the company since completion and the effect on third parties of the shares returning to the sellers.

As has been demonstrated, there is uncertainty around whether contractual representation claims can result in the recovery of tortious damages and whether the potential impossibility of rescission is correct. Questions therefore might be asked as to why a buyer will seek to negotiate for the inclusion of contractual representations in a contract if the courts may not give effect to them and instead treat them in the same way as warranties**.** As has been said, to be actionable, a representation must be made before the agreement is entered into but if the representations are instead given in the agreement, they are not given before the agreement is entered into".[457] A commentator has summarised the position that it problematic to argue that the representation in the agreement induced the entering into of the contract [458] and to get a remedy in tort for breach of contract by calling warranties "representations".[459] However, as at least some of the cases have shown, there appears to be the availability of rescission, but it might be difficult to obtain.

There may also be some other issues from the buyer's perspective that impact upon contractual representations. In the above case of *Yukos v Georgiades*, Moulder J looked at whether the claimant had relied on the contractual representation. Whilst that case accepted the inclusion of the contractual representation, the approach of considering if the claimant had relied on the representation acts to reduce the effect of contractual representations. In that case, it may have been open to the court to accept that the claimant had relied on the representation without inquiring if the claimant had in fact done so. Doing so would have meant the court considered that the parties, using Mann J's words in *Sycamore*, would have agreed how the contractual representations should be treated.[460] This effectively deems that the claimant had relied on the representation. However, considering whether the claimant had in fact relied on the representation implies that reliance is one further condition the buyer will need to satisfy in order to successfully bring a contractual misrepresentation claim. In this

[454] [1996] 2 All ER 573.
[455] ibid 588.
[456] ibid 588.
[457] Jeremy Thomas, 'Recent Cases Concerning Accounting Warranties in Mergers and Acquisitions' (2000) 11 ICCLR 273, 276.
[458] ibid.
[459] ibid.
[460] *Sycamore* (n 375) [203].

case, by considering reliance, the court effectively looked at the contractual representation as though it were a pre-contractual representation (Situation 1).

However, this approach of the court of considering reliance also prompts the question whether the courts will need to look at other principles of misrepresentation. For example, assume for a moment the seller made a pre-contractual representation (Situation 1) that "none of the tax notices which have, or should have, been submitted by the Company to a tax authority is likely to be the subject of any material dispute with any tax authority". [461] That, arguably, is a representation of opinion or belief. Such representation, at least in relation to pre-contractual misrepresentation, cannot found a claim in misrepresentation.[462] Therefore, if, instead, the contract contained a contractual representation on precisely the same terms (Situation 4), is the court going to look at the terms of that representation and conclude that such wording cannot amount to a misrepresentation because it is a representation of opinion or belief? The point is not clear. But if the court were to do so it would further limit the scope, and therefore the value to the buyer, of contractual representations because it introduces another requirement for the buyer to satisfy. On the other hand, should the buyer avoid the requirements or limitations that exist within the law of misrepresentation simply by having bargained for the inclusion of contractual representations? Some may argue not if the buyer wants the different measure of damages, and the possibility of recession, which a successful misrepresentation claim provides.

It is also worth noting that the parties might want and have agreed that the statement in the contract is a misrepresentation. However, as the Privy Council made clear in *Re Brumark Investments Ltd* [463] and the House of Lords confirmed in *Spectrum Plus* [464] a charge over book debts is not fixed just because this is the label the parties attach to it. Its essential features must conform to a fixed charge and if the charge's essential features are those of a floating charge then it will be a floating charge. Whilst these cases concern legal charges, not contractual representations, there may be an argument that if the parties call something a misrepresentation when it is not then it may not become one.

So far, each of the above scenarios has looked at various situations regarding representations. This has concerned representations made both without and with a similarly expressed warranty (Situation 1 and Situation 2). There have been differing judicial opinions concerning whether warranties can have a dual purpose as representations (Situation 3) and whether a representation stated as appearing in the

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[461] Practical Law Company: Share purchase agreement: single corporate seller: simultaneous exchange and completion.
[462] See *Bisset v Wilkinson* [[1927] A.C. 177 the seller of land had notified that buyer that the land was capable of supporting a certain number of sheep, although neither the seller or anyone else had used the land in question for sheep farming. The court held that the seller's statement amounted to the expression of opinion and therefore did not amount to a statement of fact upon which the buyer could substantiate a claim against the seller.
[463] [2001] UKPC 28.
[464] [2005] UKHL 41.

contract, but not made before entering it, will be given effect (Situation 4). Now we turn to consider a further point concerning Situation 4 in respect of the application of limitations of liability to contractual representations. In that case, the courts have interpreted limitations of liability applying to breach of warranties as also applying to misrepresentation claims where the claim is for breach of a contractual representation. These limitations of liability are usually quite broad and typically cover time limits for bringing claims, [465] the value of the claim having to be more than a certain amount[466] and a maximum liability of the seller, [467] to name a few.[468]

4.7 Limitations of liability and contractual representations

The courts appear minded to interpret provisions which are expressed to apply to warranties, to contractual representations too. As such, even if a buyer can bring a claim for tortious damages or rescission the claim may be rejected due to the application of the contract's limitation of liability provisions.

In *Bikam v Adria Cable* [469] the contract provided for the following in relation to warranties and representations, the first sentence reflecting the template wording described above and the other cases already considered in this chapter:[470]

> "'Sellers' Warranties' means the representations and warranties of the Sellers contained in Schedule 2 [471]
>
> 7.1 Each of the Sellers represents and warrants to the Buyer that each Seller's Warranty is true and accurate as at the date of the Agreement and as at Completion [472]
>
> 7.3 The Sellers acknowledge that the Buyer is entering into this Agreement in reliance upon the Sellers' Warranties".[473]

Simon J thought that clause 7.3 above was not an acknowledgement that the buyer was relying on either contractual or pre-contractual representations, but only on warranties given by the seller.[474] The contract provided that the buyer's sole remedy for breach of the sellers' Warranties was limited to the

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[465] Thompson (n 179) 11-03.
[466] ibid.
[467] ibid 11-07.
[468] See chapter 1 for further details.
[469] [2012] EWHC 621 (Comm) a case concerning an application to strike out the buyer's counterclaim or for summary judgment in relation to the counterclaim or alternatively a declaration that the Defendant's counterclaim is subject to a contractual limitation of liability.
[470] ibid [16].
[471] ibid [8].
[472] ibid [9].
[473] ibid [9].
[474] ibid [42].

€6,450,000 purchase price. The buyer claimed that this, and other limitations, [475] did not apply to misrepresentation claims.[476] On the other hand, the sellers claimed that the parties had not intended different results would arise depending on whether the claim was for breach of warranty or misrepresentation.[477] Simon J remarked, "the provisions of the [agreement] with which I am concerned involved a calculated allocation of risk and remuneration".[478] Whilst acknowledging that misrepresentation claims concern matters of fault and a different measure of damages to warranty claims[479] he dismissed the significance of those differences when he said:

> "…court should at least have in mind the contractual allocation of risk and reward when deciding whether the parties are to be taken to have intended that claims for misrepresentation based on the same facts as give rise to the claim for breach of warranty are to fall entirely outside the confined liability prescribed by the SPA".[480]

Simon J stated that the court needs to take into account the seller's limitation of liability provisions, which the contract states apply to warranties, and to apply them also to misrepresentation claims. This conclusion was influenced by the contract specifying that the warranties were also representations, the existence of provisions limiting the seller's liability for breach of warranty and the waiving of liability for pre-contractual representations. *Bikam* suggests that, although contractual representation claims in tort may, in principle, be brought, the court is not inclined to allow such claims. To do so would avoid the restrictions on liability that the contract, interpreted in a commercially common-sense way, provides. *Bikam* was an interlocutory hearing and did not give these points extensive consideration.

A more thorough analysis of contractual representations was provided by the Court of Appeal in *Bottin (International) Investments v Venson Group* [481] where the contract provided that the warranties may be treated as pre-contractual representations, this time not as part of the definition of warranties, as in *Bikam*, but as a separate provision that the warranties were to be treated as representations and the buyer has relied on them in entering the agreement, [482] though seemingly, in the court's view, nothing appeared to turn on this.

As in *Bikam*, the investor [483] in *Bottin* argued that the limitations on the warrantor's liability in the contract did not apply to claims for misrepresentation.[484] The judge concluded there was no

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[475] Which provided that individual claims had to be of a minimum value and when taken together had to be over a financial threshold.
[476] *Bikam* (n 437) [28].
[477] ibid [29].
[478] ibid [37].
[479] ibid [38].
[480] ibid.
[481] [2004] EWCA Civ 1368.
[482] ibid [11].
[483] There is no distinction between buyer and investor for these purposes but the investor will be referred to as a buyer for reason of consistency.
[484] Some of the limitations are set out verbatim in paragraph 11 of the judgment and were summarised as "provisions requiring notice to be given of a breach of warranty and imposing time limits for giving such notice and for commencing proceedings and limiting liability for breach of warranty".

commercial sense in the limitations applying only to warranty claims and not also to misrepresentation claims:

> "To my mind it makes no commercial sense for the Agreement to impose conditions as to the giving of notice of a breach of warranty and as to the commencement of proceedings for such breach and limiting the maximum liability if Bottin was intended to be left free of those conditions and those time limits and the limits on liability by treating the same warranties as representations".[485]

Peter Gibson LJ went on to conclude, however, that the above-quoted provision which stated that the warranties may be treated as representations did permit a claim for rescission.[486] Without that conclusion, no meaning would have been given to the provision which stated the warranties were also representations. However, Gibson LJ's view conflicts with Bingham MR's view in *Senate Electrical* that contractual representations do not permit a claim in tort. The contractual wording in *Bikam* and *Bottin* was not materially different and both cases show the reluctance of the courts to give effect to contractual representations in the context of limitations of liability applying to breaches of warranty, albeit a rescission claim may be permitted.

The commercial purpose of the limitation of liability provisions heavily influenced the court in both cases. However, the application of limitations of liability to claims of misrepresentation appears only to apply to Situation 4 where representations and warranties are expressed in the same terms. In Situation 2 (pre-contractual representations) the courts have not applied the limitations of liability provisions to misrepresentation claims.

In the case of pre-contractual misrepresentation claims (Situations 1 and 2) this non-application of liability limitations occurred in *MDW Holdings v Norvill*.[487] The buyer claimed certain of the seller's pre-contractual representations were false. Deputy judge Keyser KC distinguished *Bottin* and rejected the suggestion that allowing a claim for pre-contractual misrepresentation was contrary to the commercial purpose of the agreement. He said:

> "there is a clear difference between, on the one hand, allowing a party to evade a time limit on claims for breach of warranty by re-casting a contractual falsehood as a misrepresentation and, on the other, recognising a party's right to bring a claim based on pre-contractual falsehoods outside the time limit applying only to contractual claims".[488]

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[485] *Bottin* (n 445), [65].
[486] ibid.
[487] [2021] EWHC 1135 (Ch).
[488] ibid [247].

Likewise, in the earlier case of *Thomas Witter v TBP Industries*, [489] Jacob J, when considering a limitation provision, said that it had no effect on a pre-contractual misrepresentation claim.[490]

It can be seen that there is a different approach between limitations of liability and the type of misrepresentation being claimed. In the case of contractual misrepresentation claims (Situation 4), the courts seem willing to apply to them the limitation provisions that are expressed to apply to breach of warranty claims. However, that same approach does not apply where the claim is for a pre-contractual misrepresentation (Situations 1 and 2). The reason appears to be due, in the case of contractual representations, to the fact that the claim was based on the same wording as the warranty. Whereas, in the case of pre-contractual misrepresentations the matter concerns a statement that was made to induce the entering into of the contract and may be the same as, or different to, the wording of the warranty. In that case there is an independent and separate event between the representation and the warranty. The pre-contractual misrepresentation claims are not necessarily borne out of the precise same term as in the case of contractual representations and warranties, but even if they are, they have been separately made and given by the seller.

The commercial purpose featured in the decisions to include contractual representations in the limitations of liability. The application of commercial common sense may not be justified. This will be considered next.

4.8 Commercial common sense/purpose

Business or commercial common sense arises as part of contractual interpretation. The general purpose of interpreting contracts is to ascertain the meaning that the document would convey to a reasonable person having all the background knowledge which is reasonably available to the person, or class of persons, to whom the document is addressed.[491] Against this objective approach, the application of business common sense presents itself when there are rival interpretations of provisions in a contract. A business sense is given to business documents.[492] If there are two possible constructions of the relevant parts of an agreement the court should prefer the one with business

[489] [1996] 2 All ER.
[490] ibid 599.
[491] G H Treitel, *Treitel on The Law of Contract* (15th edn, Sweet & Maxwell) 6-041: This principle is derived from those laid down by *Lord Hoffmann in Investors Compensation Scheme v West Bromwich Building Society* as refined by him in *Homburg Houtimport BV v Agrosin Private (The Starsin)* [2003] UKHL 12; [2004] 1 A.C. 715, [73].
[492] G H Treitel, *Treitel on The Law of Contract* (15th edn, Sweet & Maxwell) 6-041.

common sense.[493] Business common sense [494] resurged in Lord Wilberforce's speech [495] in *Prenn v Simmonds* [496] but existed long before [497] and is no novelty.[498]

In the above case of *Bottin*, Gibson LJ suggested the buyer's arguments flouted commercial good sense.[499] These words originate from Lord Diplock [500] who said:

> "…if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense".[501]

Writing extra-judicially, Lord Sumption has criticised Lord Diplock's view as it looks to override the language of the contract rather than understand it.[502] Sumption considers this approach both unnecessary and wrong.[503] Although no such detailed semantic analysis took place in *Bottin* or *Bikam*, the reference to commercial common sense raises a question as to whether the courts interpreting the inclusion of contractual representations within limitations applying to warranty claims was justified.

The governing principle when interpreting a contract is that the parties mean what they say [504] and in both cases it was clear that the respective agreements contained contractual representations. Commercial common sense is not an overriding criterion [505] but in both *Bottin* and *Bikam* the courts displayed an eagerness to apply it. The purpose of interpretation is not to redress a bad bargain:

> "…commercial common sense is not to be invoked retrospectively. The mere fact that a contractual arrangement, if interpreted according to its natural language, has worked out badly, or even disastrously, for one of the parties is not a reason for departing from the natural language. Commercial common sense is only relevant to the extent of how matters would or could have been perceived by the parties, or by reasonable people in the position of the parties, as at the date that the contract was made".[506]

In *Bottin*, whilst the contract limited the seller's liability for breach of warranty, it made no mention of limiting the seller's liability for contractual representations. Contrast that with *Bikam* where the definition of warranties also included representations. In *Bikam* it was clearer that the limitation of

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[493] Beale 33rd (n 206) 6-046.
[494] Neil Andrews notes that there is no distinction between "commercial" and "business" common sense - Neil Andrews, 'Interpretation of Contracts and "Commercial Common Sense": Do Not Overplay This Useful Criterion' (2017) 76(1) CLJ. 36, fn 6 .
[495] ibid.
[496] [1971] 1 W.L.R. 1381.
[497] Kim Lewison, *The Interpretation of Contracts* (8th edn, Sweet & Maxwell, 2023) 2-50, section 7].
[498] *Bottin* (n 445) 42.
[499] *Bottin* (n 445), [65].
[500] Neil Andrews, 'Interpretation of Contracts and "Commercial Common Sense": Do Not Overplay This Useful Criterion' (2017) 76(1) CLJ 36, 47.
[501] *Antaios Compania Naviera SA v Salen Rederierna AB* [1985] AC 191, 201.
[502] Lord Sumption, 'A Question of Taste: The Supreme Court and the Interpretation of Contracts', Harris Society Annual Lecture, Keble College, Oxford 8 May 2017.
[503] ibid.
[504] *Lucie Marie-Antoinette Campbell v Daejan Properties* [2012] EWCA Civ 1503, [37].
[505] Kim Lewison, *The Interpretation of Contracts* (8th edn, Sweet & Maxwell, 2023) 2.77.
[506] *Arnold v Britton* 2015 A.C. 1619, [19] per Lord Neuberger.

liability included claims for contractual misrepresentation. However, the court in *Bottin* was required to make a bigger leap in its analysis to conclude the representations were included in the limitations. Buyers may believe that including contractual representations gives them a claim in tort. If so, the possibly greater recovery that such a misrepresentation claim may bring would mean it may not be commercially sensible for the buyer to agree to one financial limitation of liability which applies to two areas of law which have different measures of damages. This was not considered by the courts in either case. Instead, commercial common sense was applied to favour the seller because it was not thought a seller would have agreed to the limitations not also applying to contractual misrepresentation claims.

However, there may be some reasons why a seller would agree to the limitations not so applying to contractual misrepresentation claims. It may simply be unaware of the distinction between warranties and contractual representations and the buyer's desire for their inclusion. Even if it is aware, then if the seller was in an inferior bargaining position they may have had no choice but to accept contractual representations without the benefit of limitations of liability applying to them. Further, like *Wemyss* and *MDW* indicate, not all contracts exclude claims in cases of pre-contractual representations, so should they necessarily do so in cases of contractual representations? In cases of contractual representations, the seller has more awareness of the terms of the representation than it might have in relation to pre-contractual representations. Many statements may be made as part of due diligence responses without careful consideration or appreciation of their consequences and that can lead to pre-contractual misrepresentations being made. Even if these reasons are unconvincing, the point does remain that a negotiated contract in both *Bikam* and *Bottin* did not directly address whether or not the limitations applied to contractual misrepresentation. As such, should they have been read as doing so?

It may be argued that the court ventured into repairing a bad bargain in *Bottin* and did not follow Neuberger's LJ's suggestion to exercise restraint in the use of commercial common sense:

> "…commercial common sense do[es] not represent a licence to the court to re-write a contract merely because its terms seem somewhat unexpected, a little unreasonable, or not commercially very wise".[507]

Furthermore, there is a case for arguing that the agreements in both cases were well-drafted and in such situations "there is probably less scope for the use of the apparent commercial purpose as an aid to construction".[508] Hogg looks at the matter in terms of commercial stupidity by working on the

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[507] *Skanska Rashleigh Weatherfoil v Somerfield Stores* [2006] EWCA Civ 1732, [21].
[508] Kim Lewison, *The Interpretation of Contracts* (8th edn, Sweet & Maxwell, 2023) 2.85 referring to *Minera Las Bambas v Glencore Queensland* [2019] EWCA Civ 972; *Malone v Birmingham Community NHS Trust* [2018] EWCA Civ 1376.

assumption that if a party allows the inclusion of wording to its disadvantage it has been unwise in doing so.[509] Arguably, this approach might be justified only if the wording is clear. He wonders why a party should be protected from the ill effects of foolishness through a court giving the clause a commercially sensible interpretation, rather than allowing that party simply to suffer the results of its commercial fecklessness [510]. This point is easily made where fecklessness is the assumed reason for the clause's existence, but commercial or financial pressure to complete the deal, concessions during negotiations or simply poor advice may be the real reason. Against such alternatives there may be more or less of a case to apply commercial common sense, but if the language is clear these other contextual reasons for the clause's existence would be ignored.

Hogg also considers why commercial common sense should be shown to a party who has not shown commercial common sense in the drafting as they may get a better deal than the one they negotiated.[511] If a party has acted uncommercially, applying commercial common sense may provide them with unwarranted assistance.[512] This criticism may be justified when the courts use commercial common sense when the language is clear. Hogg's approach appears to suggest there is no judicial room to resolve drafting errors or even extreme and entirely unexpected consequences of the drafting and a judge must be wedded to the contractual wording, no matter what the result. Applying commercial common sense can have the effect of balancing the interpretation of the contractual wording in dispute. Its effect may be to make one party better off to the disadvantage of the other.

In both *Bottin* and *Bikam* alternative views of the effect of the contractual representations were argued by the parties and whether they fell within the contractual limitations of liability that applied to warranty claims. As Moore-Bick LJ has noted, alternative views might amount to ambiguity and so invoke commercial common sense:

> "…if a clause is reasonably capable of bearing two possible meanings (and is therefore ambiguous), the court should prefer that which better accords with the overall objective of the contract or with good commercial sense".[513]

As the Supreme Court has noted, if the language is unambiguous, the court must apply it.[514] However, the problem is that deciding if there is an ambiguity is not always easy.[515] In *Bottin* it is not clear whether there was a genuine ambiguity given the wording of the provision in question and that the limitations were not expressly stated as to include claims for misrepresentation.

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[509] Martin Hogg, 'Fundamental Issues for Reform of the Law of Contractual Interpretation' (2011) 15(3) Edin LR 406, 419.
[510] ibid.
[511] ibid 420 .
[512] ibid.
[513] *Procter & Gamble v Svenska Cellulosa* [2012] EWCA Civ 1413, [22].
[514] *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50, [23] per Clarke L.
[515] Kim Lewison, *The Interpretation of Contracts* (8th edn, Sweet & Maxwell, 2023) 2.83.

Moore-Bick LJ has cautioned against using commercial common sense:

> "…the starting point must be the words the parties have used to express their intention and in the case of a carefully drafted agreement of the present kind the court must take care not to fall into the trap of re-writing the contract in order to produce what it considers to be a more reasonable meaning".[516]

Contractual re-drafting, in Moore-Bick LJ's view, should be avoided and the importance of the contractual language was lucidly expressed by Lord Neuberger:

> "The exercise of interpreting a provision involves identifying what the parties meant through the eyes of a reasonable reader, and, save perhaps in a very unusual case, that meaning is most obviously to be gleaned from the language of the provision. Unlike commercial common sense and the surrounding circumstances, the parties have control over the language they use in a contract. And, again save perhaps in a very unusual case, the parties must have been specifically focussing on the issue covered by the provision when agreeing the wording of that provision".[517]

This is a cautionary approach to invoking commercial common sense and appears at odds with the approaches taken in *Bottin* and *Bikam* and the judicial eagerness in those cases to consider the matter from a commercial common sense perspective. It has also been said that before *Arnold v Britton* (which *Bikam* and *Bottin* were) there was an increasing tendency to determine wording was ambiguous and for the court to reach a conclusion based on commercial common sense.[518] If the wording is clear, as it appears to have been in *Bottin* and *Bikam*, the court should not speculate on the commercial common sense behind those words and should not reconstruct an abstract commercial purpose to rewrite the contract.[519]

That said, if the words are unclear, it is natural that the court will explore the commercial context in order to understand what the parties reasonably intended and in that case justifying giving overriding weight to the parties' chosen words is not valid.[520] Grabiner proposes a solution if there are competing common sense answers, and so two competing interpretations, both of which are grounded in business common sense. He says the court should prefer the construction that had the most support in the contract wording.[521] This is hardly revolutionary and reflects the court's approach anyway.[522]

As Lewison LJ notes, provided that a consideration of the commercial purpose of the contract is tempered by loyalty to the text, it is a useful tool of interpretation".[523] However, the courts in more

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[516] *Procter & Gamble v Svenska Cellulosa* [2012] EWCA Civ 1413 [22].
[517] *Arnold v Britton* [2015] UKSC 36, [17].
[518] Richard McMeeken, 'Is Commercial Common Sense Still a Problem?' (2021) 159 Civ PB.
[519] Lord Grabiner, 'The Iterative Process of Contractual Interpretation' (2012) 128 LQR 41.
[520] ibid 47.
[521] ibid 62.
[522] See *Wood v Capita* [2017] AC 1173 Lord Hodge.
[523] Kim Lewison, *The Interpretation of Contracts* (8th edn, Sweet & Maxwell, 2023) 2.83.

recent times have exercised caution in giving weight to commercial common sense.[524] It cannot be used to undervalue the contractual language.[525] The courts must apply unambiguous language even if the result is commercially improbable.[526] If the contract contains unambiguous language the court must apply it.[527] On that basis, it seems possible that in future the courts may be less likely to apply commercial common sense in cases of agreements containing "warranties and representations". However, even if commercial common sense continues to be applied, perhaps in more limited circumstances, are the judiciary competent to properly apply it?

The judiciary may not be the first choice for anyone wanting business advice. Criticism of judicial commercial common sense competency originates not only from academic circles. Perhaps surprisingly, it comes from some members of the senior judiciary itself. Writing extra-judicially, Lord Sumption does not consider judges well-placed to determine the requirements of commercial common sense.[528] Other judges hold a similar view. Lord Neuberger has remarked that judges were not always the most commercially minded or experienced.[529] It might also be added that business people may agree on terms for such reasons that they simply want to finalise the deal or consider the issue is not worth worrying about. Also writing extra-judicially, Lord Neuberger has said that "judges should be diffident before pontificating about the commercial realities of any particular interpretation" [530] There is a substantial danger that a judge will assess commercial common sense by reference to the circumstances that have occurred, which is an unsafe way to assess what the parties would have thought when entering into the contract.[531] What can also be said is that judges, in their pre-judicial experience as counsel, are not likely to have been involved in negotiating and finalising sale and purchase contracts as that task typically falls to solicitors. As such, there may be less of a judicial appreciation of the cut and thrust of commercial negotiations and the positions which parties adopt to protect their own interests.

This links to the idea of parties being unreasonable in negotiations. This point is picked up by Lord Hoffmann writing extra-judicially. Commercial parties can be unfair and they can also be entirely unreasonable. The fact that a party would not have made the slightest concession to the other party to the contract which was not spelt out in the clearest language, is filtered out of the process of

[524] ibid 2.70.
[525] *Arnold v Britton* [2015] UKSC 36.
[526] ibid.
[527] Richard McMeeken, 'Is Commercial Common Sense Still a Problem?' (2021) 159 Civ PB.
[528] Lord Sumption, 'A Question of Taste: The Supreme Court and the Interpretation of Contracts', Harris Society Annual Lecture, Keble College, Oxford 8 May 2017.
[529] Lord Neuberger at the Banking Services and Finance Law Association Conference, Queenstown, The impact of pre– and post-contractual conduct on contractual interpretation, 11 August 2014 https://www.supremecourt.uk/docs/speech-140811.pdf (accessed 21 April 2022) 19.
[530] ibid.
[531] ibid.

interpretation. Instead, the parties are assumed to be reasonable.[532] Lord Sumption argues that judges are shaped by fairness, but fairness has nothing to do with commercial contracts where parties to contracts serve their own interests and are competitively cooperative [533]. Lewison LJ notes that as the parties cannot give evidence of their intentions in entering into the contract and the court cannot receive evidence of the negotiations between the parties, a judge cannot discover whether the matter had been the result of bargaining between the parties.[534] Neither judges nor advocates are commercial people. Considerations of commercial purpose place dangers that the real intention of the parties will be frustrated.[535] This could occur by applying preconceived ideas of what contracts of the type in question generally seek to achieve, and a resulting tendency to force the words of the particular contract to fit that preconception.[536]

Recent cases have shown the apparent readiness of the judiciary to invoke commercial common sense in cases where contractual representations are being considered alongside limitations of liability provisions. Commercial common sense may even encourage judges to make contracts rather than interpret them.[537] One unstated issue, but one which perhaps influenced the judges in both *Bikam* and *Bottin*, is the likely uncomfortable position in which the court in each case found itself. In light of the seller protection provisions in those cases, it is perhaps not surprising that both courts rejected claims based on contractual misrepresentations which effectively sought to circumvent such protections. Even if the criticisms levelled at the judiciary are justified, it perhaps should be appreciated that the application of commercial common sense is a device to interpret contracts in certain situations. It is imperfect and artificial but properly employed offers assistance in interpreting disputed language. There is also a case that even when its use is justified, commercial common sense should be carefully employed in light of the judiciary's lack of business experience. However, the point remains that if sellers "warrant and represent" then contractual representations could be included within limitations that apply to warranties even though not expressly stated as such, Such an approach to interpretation, if the caution in the application of commercial common sense is exercised in line with Supreme Court decisions, may mean that a future buyer will not suffer the same fate as the buyers in *Bottin* and *Bikam* and the representations will fall outside the contractual limitations applying to warranties.

However, in light of the position that buyers find themselves, what approach to drafting should buyers adopt?

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[532] Lord Hoffmann, 'The Intolerable Wrestle with Words and Meanings' (1997) 114 S African LJ 656, 664.
[533] Lord Sumption A Question of Taste: The Supreme Court and the Interpretation of Contracts Harris Society Annual Lecture, Keble College, Oxford 8 May 2017.
[534] Kim Lewison, *The Interpretation of Contracts* (8th edn, Sweet & Maxwell, 2023) 2.88.
[535] ibid.
[536] ibid.
[537] Martin Hogg, 'Fundamental Issues for Reform of the Law of Contractual Interpretation' (2011) 15(3) Edin LR 406, 420.

4.9 The use of 'deeming clauses' to bring more certainty to contractual representations

One approach is to use a deeming clause. These can be used in a large number of ways from explaining the meaning of a word or phrase, [538] prescribing the consequence of an event, [539] putting beyond doubt whether an event is within a contractual term, [540] creating a contractual estoppel,[541] to qualify contractual obligations that would arise [542] or to create a fiction.[543] It is the creating of a fiction and the contractual estoppel effects which appear the most relevant here.

In *Trident Turbo v First Flight Couriers* [544] the contract contained a clause which stated that the relevant party "has not and shall not be deemed to have made any warranties or representations" [545] As Aikens J said in respect of it: "The parties who agree such a clause are thus agreeing that no representations were made… or, if any representations were made, then it is "deemed" that they were not".[546] Although not contended by the buyer in *Bottin*, arguably the clause which in that case stated that the buyer "may treat [the warranties] as representations had the effect as a clause containing the word deemed, although the buyer used the word 'treated' instead. This is because "deemed" means "treated".[547] In *Trident* the clause simply stated that no representations were made, so the issue ends there. In *Bottin*, if the clause had said something like "'representations' in this agreement shall be deemed to be pre-contractual representations made by the Seller to the Buyer which if untrue shall entitle the Buyer to claim tortious damages and recission" the buyer would have had more on which to make an argument. The clause would likely have the effect of operating as a contractual estoppel. One problem that might exist with creating such clarity is that it might sit uncomfortably with a draftsperson who, as part of the reality of commercial life drafts words which are deliberately obscure to reflect the parties' compromise.[548] Setting aside intentionally unclear drafting, in addition, a buyer should also make it clear whether or not any of the limitations of liability that apply to warranty claims also apply to claims for contractual misrepresentation. That approach would then address the issues raised in *Bikam* and *Bottin* and eliminate the need for the application of commercial common sense by the judiciary.

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[538] Kim Lewison, *The Interpretation of Contracts* (8th edn, Sweet & Maxwell, 2023) 14.98.
[539] ibid 14.102.
[540] ibid 14.103.
[541] ibid 14.104.
[542] ibid 14.105.
[543] ibid 14.99.
[544] [2008] EWHC 1686 (Comm).
[545] *Trident Turbo v First Flight Couriers* [2008] EWHC 1686 (Comm), [32].
[546] ibid 33.
[547] *The Hotgroup v The Royal Bank of Scotland* [2010] EWHC 1241 (Ch), [19].
[548] Kim Lewison, *The Interpretation of Contracts* (8th edn, Sweet & Maxwell, 2023) 2.84. See also Lord Neuberger's comments in *Re Sigma Finance Corporation (in Administrative Receivership)* [2008] EWCA Civ 1303, [100].

If the view of the Court of Appeal is correct it brings into question what effect will be given to contractual representations stated only in the contract. It is clear that where the representations are given alongside warranties in relation to the same subject matter, such as the use of the words "warrants and represents" effect will be given to the warranties. If the representations were given alone, without separate reference to their being also warranties, the position is not clear, but it is suggested the courts will simply treat the contractual representations as warranties because the representations will tend to relate to the same subject matter as that of a warranty. On this basis, there is little apparent value in a buyer seeking to negotiate the inclusion of contractual representations. One commentator suggests in passing when discussing *Sycamore*, that the courts have "conflated the meaning of "representation" in law and the meaning of the term "representation" as used by the parties".[549] It may be more accurate to say that the courts may have ignored the purpose of contractual representations, at least from the buyer's perspective. In the cases discussed in this chapter, the courts have refused to give effect to contractual representations in part on the basis that the representations were made in the contract and not before it was entered into so there can be no reliance by the buyer on the representation. Clearly, the buyer has negotiated the inclusion of the word so that it has the ability to bring a claim in tort which, it has already been said, gives the buyer options to pursue the most valuable claim against the seller. Whilst the following was expressed obiter by Mann J in the context of a different issue, [550] it remains an accurate general summary of the position in corporate transactions in relation to the typical respective position of the parties:

> "The [share purchase agreement] was part of a suite of documents, negotiated at arms length by commercial parties… where both parties were assisted by experienced professionals (solicitors and accountants). The structure of potential liabilities was clearly set out, and the claimants must be taken to have satisfied themselves as to what they needed".[551]

As the parties were professionally represented, and negotiated an agreement, they would understand the basis of the deal, so there is arguably reason to give effect to the words the parties have used. Put simply, if the parties have included contractual representations, the buyer, at least, will expect the court to give effect to it.

4.10 Conclusion

In Situation 1 cases, a buyer, if they can satisfy the various elements of a pre-contractual misrepresentation, can bring a claim. They may also have an additional claim for breach of contract if they can show the truth of the representation was promised, and so become a contractual term.

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[549] Sarayu Satish, 'Representations and Warranties: An Analysis through the Prism of M&A Transactions' [2016] 27(1) ICCLR 24, 27].
[550] *Sycamore* (n 375) [210] discussing whether a provision excluding liability for misrepresentation would satisfy the test of reasonableness in s11(1) of the Unfair Contract Terms Act 1977].
[551] ibid.

In Situation 2, where the buyer has negotiated the inclusion of warranties, it may have a breach of warranty claim and possibly, if a representation was made, a pre-contractual misrepresentation claim. In having claims for breach of contract and misrepresentation the buyer has two claims that it may bring and can choose the one which will give it greatest recovery. The extent of recovery is one of the reasons why buyers have sought to argue that warranties are also representations (Situation 3). However, some decisions suggest that warranties do not have such a dual identity. The extent of recovery is likely to be the main reason why buyers bargain for the inclusion of contractual representations (Situation 4). However, despite bargaining for them to be included in the contract the courts are unclear if they will give effect to contractual representations. And seemingly, even if they do, they will be treated as falling within limitations of liability that are expressed to apply to breach of warranty claims.

The law around contractual representations is far from clear and if a buyer wants to establish some certainty around the court's treatment of them then buyers will need to change the way in which contractual representations are expressed in contracts.

Chapter 5

Buyer's Knowledge of Warranty Claims

5.1 Introduction

This chapter considers whether a buyer can claim against a seller for a breach of warranty where the breach is known to the buyer at completion of the purchase of the shares in the target company.

This chapter will show that the law in this area is uncertain. Commentators have provided opposing views regarding the two cases in this area. This chapter will conclude that both views are wrong and opinions as to what the courts have decided have been exaggerated.

Section 5.2 looks at the common law default position where there is a known breach of warranty and section 5.3 considers why the buyer might want to include a provision in the contract allowing it to bring claims for a known breach of warranty (known as a 'knowledge saving clause').

Sections 5.4 to 5.7 analyse two cases where the courts have looked at such clauses. A close analysis of the Court of Appeal's analysis in one of these cases is made in section 5.8 and 5.9 with a conclusion about them reached in section 5.10.

The opposing views of commentators as to what these cases decided is in section 5.11.

Section 5.12 looks at some of the reasons cited in one of the cases to potentially prevent a buyer from either relying on, or bringing a claim based on, a knowledge saving clause.

As described in chapter 1, the acquisition agreement will contain warranties given by the seller to the buyer about the shares and the company. As a reminder, a warranty does not impart information or make a statement to the buyer, but rather it is a promise which will be actionable as a breach of contract [552] should it prove to be untrue. Warranties are usually expressed as positive statements and cover a wide range of matters relating to the company the buyer proposes to purchase.[553] Warranties allocate risk [554]. In relation to the warranties the seller gives to the buyer, the seller accepts the potential liability if the warranties are not true.[555] In respect of matters where no warranties are given the buyer accepts the risk. For example, in a share purchase the buyer will desire warranties covering

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[552] *Idemitsu* (n 343), [14].
[553] For example, in the precedent book, *Encyclopaedia of Forms and Precedents* (5th edn), the share purchase agreement contains warranties that are 24 pages in length and total 15,700 words – see Encyclopaedia of Forms and Precedents > COMPANIES vol 11 ACQUISITIONS, MERGERS, DEMERGERS > Forms and Precedents > (1) TAKEOVERS > 4 Share purchase agreement—acting for the buyer—long form.
[554] Thompson (n 179) 1-03.
[555] ibid.

the target company and its business. If, for example, it fails to secure any warranties in respect of the company's employees then the buyer will have accepted the risk of there being issues with any of the employees, such as a claim by one of them against the target company. The consequence of this may have an impact on the value of the shares being purchased. By way of example, taken from the case discussed in section 5.6 of this chapter, the warranty which it was alleged was untrue in that case was in the following form:

> "The Principal Accounts…give a true and fair view of the assets and liabilities of each Group Company at the Last Accounts Date".[556]

However, as is common, warranties are usually given subject to a disclosure letter, [557] so where a warranty is untrue the seller can disclose against the warranty in the disclosure letter and relieve itself of liability for breach of that particular warranty, to the extent of that disclosure.

The issue in this chapter concerns the buyer's knowledge of a breach of warranty not referenced in the disclosure letter. Instead, it is knowledge that the buyer has acquired itself, whether through due diligence on the target company, or as a result of or information imparted by the seller or its advisers or during discussions with the seller.

It is firstly necessary to understand what knowledge means for the purpose of the discussion in this chapter. "Knowledge" falls into three categories.[558] The first is actual knowledge which would be the actual knowledge of the buyer.[559] The second, constructive knowledge is knowledge which the law states the buyer ought to have, [560] and thirdly imputed knowledge which is knowledge of the buyer's agent.[561]

In the absence of contractual terms, and a knowledge-saving clause, what does the law state is the position regarding a buyer being able to bring a claim for a known breach of warranty?

5.2 The common law default position

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[556] *Infiniteland Ltd v Artisan Contracting Ltd* [2005] EWCA Civ 758, [7].
[557] As was the case in *Eurocopy v Teesdale* [1992] WL 895057, 2 where clause 3.3 of the acquisition agreement provided that, "The Warranties are given subject to matters set out in the Disclosure Letter…" and in clause 7.1.8 of the agreement in *Infiniteland* [7] stated that "…save as set out in the Disclosure Letter, the Warranties in Schedule 3 are true and accurate in all respects".
[558] As will be seen in the cases of *Eurocopy* and *Infiniteland* the knowledge-saving clause referred to different types of knowledge.
[559] Carnwath LJ in *Infiniteland* [87] referred in his judgment to the various types of knowledge to the Law Commission Part III of its Final Report of Limitation of Actions, Law Com 270, April 2001 Carnwath was Chairman of the Law Commission at the time of the report.
[560] *Infiniteland* [87].
[561] ibid.

It is believed to be the case that actual knowledge of a warranty breach prevents a claim.[562] This is where no knowledge-saving clause is provided in the agreement, so the agreement is silent as to the effect of the buyer's knowledge of a warranty claim. As such, in this regard, the law favours the seller. In *Infiniteland v Artisan Contracting*, the case of *Margetson v Wright* was cited for the proposition that a known breach of warranty would prevent a claim, [563] though Park J in *Infiniteland* thought this was obiter dicta.[564] In *Margetson*, a warranty that a horse had sound limbs was taken to exclude the actual knowledge of the buyer in relation to a defect that was apparent to the buyer. In *Margetson*, Tindal CJ said: "A party, therefore, who should buy a horse knowing it to be blind in both eyes could not sue on a general warranty of soundness". Similarly, in *Lexmead v Lewis* [565] the House of Lords held that once the warrantee becomes aware that the goods were damaged they could no longer rely on the warranty that the goods were safe, [566] and a warranty does not extend to covering obvious defects.[567] Whilst these cases concern claims for defective animals or goods, rather than share sales, they reflect a position seemingly accepted by the courts that a known warranty breach will prevent a claim. However, in *Infiniteland*, Park J thought "…that there is no room for a more generalised proposition that, if the purchaser knew something and still went ahead with the contract, it cannot say that it was a breach of warranty".[568] By brief contrast, there are numerous states within the United States that permit buyers to bring a claim where they have knowledge of a warranty breach.[569]

Due to the common law position, under English law, from the buyer's perspective, including a knowledge-saving clause will be important. If such a clause is held to be valid it will allow the buyer to bring a claim despite having knowledge of the breach. Why does the buyer seek to contract around the law and not accept the position that it cannot make a claim for a known breach of warranty?

5.3 What does a knowledge-saving clause look like and why might a buyer want one in a share purchase agreement?

[562] Jacek Jastrzebski, 'Sandbagging and the Distinction Between Warranty Clauses and Contractual Indemnities' [2019] 19 UC Davis Bus LJ 207, 213.
[563] (1831) 131 ER 233, 234 Tindal CJ.
[564] *Halsbury's Laws* (5th edn, 2017) vol 2 para 3(ii) cites a number of cases ranging from the years 1471 to 1877 which support the apparent principle that a known warranty breach prevents a claim.
[565] [1982] AC 225 (also known as *Lambert v Lewis*).
[566] ibid 226.
[567] Michael Bridge, *Benjamin's Sale of Goods* (10th edn, Sweet & Maxwell 2019) 10-019 citing *Baily v Merrell* 81 ER 81.
[568] [2004] EWHC 955 (Ch), [115].
[569] The following article lists some of the US states where the default rule does or does not permit buyers to bring claims for a known warranty breach: Lord Daniel Chase, 'M&A after Eagle Force: An Economic Analysis of Sandbagging Default Rules' (2020) 108 Calif L Rev 1665 fn 3, 4. For a more detailed description of the default rule in different states see: Charles K Whitehead, 'Sandbagging: Default Rules and Acquisition Agreements' (2011) 36 Del J Corp L 1081. Chase and Whitehead hold opposing views of the economic efficiency of having a default which permits or does not permit a buyer to bring a claim for a known warranty breach (permitting the buyer to do so is known as "sandbagging" in the United States). This is discussed further in chapter 7.

The following knowledge-saving clause is taken from a precedent share purchase agreement. It provides that matters about which the buyer has knowledge shall not prevent a claim for breach of warranty, or reduce the amount that the buyer can recover from the seller for the breach:

> "Except for the matters Disclosed, no information of which the Buyer (or any of its agents or advisers) has knowledge (in each case whether actual, constructive or imputed), or which could have been discovered (whether by investigation made by the Buyer or on its behalf), shall prejudice or prevent any Claim, or reduce the amount recoverable under any Claim".[570]

The drafting notes to the above clause from the precedent suggest that a seller should resist accepting this provision. It suggests that if a buyer knows of a problem it can seek a price reduction. Sellers may argue that it is unfair for the buyer to go through a due diligence process, for it to withhold information that it has discovered and to then seek to recover damages for breach of warranty.[571]

By contrast, the drafting note advises the buyer that it should include a knowledge-saving clause. This is because the buyer may not have control over the information given to those involved with undertaking due diligence on the seller. The buyer's reason for wanting to include a knowledge-saving clause could be that it will not have control over the information which the seller gives the buyer's officers, employees or advisers and those individuals may not be able to understand and evaluate such information.[572]

There is also another reason due to the terms of the warranties typically being very lengthy and still being negotiated when the information is received. As such, to be able to consider whether the information in hand amounts to a warranty breach would likely involve frequent reference to the latest draft of the warranties being negotiated to try to determine the effect of that information on the value of the company.

A buyer is unlikely to obtain a price revaluation for every breach it may discover during due diligence and the simultaneous process of negotiating the share purchase agreement and the warranties it contains. The transaction costs of doing so would be excessive. It may also be too large a task for a buyer to fully appreciate information amounts to a warranty breach in light of the volume of information it would have likely been provided on the target company. The information the buyer

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[570] Practical Law: Share purchase agreement: single corporate seller: simultaneous exchange and completion. A substantially similar provision appeared in *Tactus Holdings Ltd v Jordan* [2024] EWHC 399 (Comm) [28]; *Decision Holdings v Garbett* [2023] EWHC 588 (Ch) [12]; *Arani v Cordi Group* [2023] EWHC 95 (Comm) [23]; *Cardamon v Macalister* [2019] EWHC 1200 (Comm) [36]; *McMullen Group v Harwood* [2011] CSOH 132 [81] (Scottish) and also (but excluding reference to actual knowledge) in C*apital Green Recycling v Bird* [2023] EWHC 760 (Comm), [46].

[571] Aleksandra Miziolek and Dimitrios Angelakos, 'From Poker to the World of Mergers and Acquisitions' (2013) Mich B J July, 31.

[572] Lexis PSL Disclosure – share and asset purchases.

discovers "may be unclear as to whether a breach has really occurred, or even if the breach is clear".[573]

If a buyer knows of a warranty breach, it is likely a seller would say that the "buyer should have reduced the price" before entering into the purchase. The seller would no doubt want a known warranty breach to have the effect of qualifying the warranties and so prevent a warranty claim. This would put the onus on the buyer to share its knowledge with the seller. In that case, in the same way a seller does not have to disclose matters to the buyer due to caveat emptor, the buyer might ask why it needs to do so.

One commentator, discussing the American equivalent of a knowledge-saving clause (known as a sandbagging provision), puts forward additional rationale for the inclusion of a knowledge-saving clause in the agreement from a buyer's perspective:

> "… buyers contend that the responsibility for accurate disclosures rests squarely on the shoulders of the seller, and a buyer's ability to rely on the accuracy of a seller's warranty is an integral part of the bargain struck between the parties when entering into the purchase agreement. Furthermore, buyers maintain that any inquiry into a buyer's knowledge regarding the accuracy of the seller's warranties would significantly complicate the [recovery of damages] process and allow the seller to stymie a buyer's legitimate damage recovery with a mere allegation that someone in the buyer's organization had knowledge of such inaccuracy".[574]

It could also be said that a knowledge-saving clause reduces the uncertainty related to enforcement of warranty claims [575] and would reduce transaction costs.

Having considered what a general knowledge-saving clause looks like, and the specific reasons a buyer might desire one, how the courts have treated such clauses will be considered.

It will analyse the two cases (*Eurocopy v Teesdale* [576] and *Infiniteland Ltd v Artisan Contracting* [577]) which considered the situation where the agreement permitted the buyer to claim for a known warranty breach. It will, in addition, contend that the law has separately developed since these cases in the area of estoppel and if a knowledge-saving clause were to come before the courts, and perhaps depending on the type of knowledge to which the clause was said to apply, it may be considered valid.

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[573] Glenn D West and Kim M Shah, 'Debunking the Myth of the Sandbagging Buyer: When Sellers Ask Buyers to Agree to Anti-Sandbagging Clauses, Who Is Sandbagging Whom?' (2007) 11 M&A Lawyer 1.
[574] Aleksandra Miziolek and Dimitrios Angelakos, 'From Poker to the World of Mergers and Acquisitions' (2013) Mich B J July, 31.
[575] Jastrzebski (n 562) 240.
[576] [1992] WL 895057.
[577] *Infiniteland* CA (n 556).

However, despite that validity it may be that the buyer's award of damages may be adversely impacted by its knowledge of a breach.

5.4 Eurocopy v Teesdale

Eurocopy concerned an application for leave to appeal against a decision of a deputy judge. The deputy judge had dismissed an application by the buyer to strike out certain parts of the seller's defence on the ground that it provided no reasonable ground of defence.

In *Eurocopy*, the warranty which the buyer alleged the seller had breached, was onerously worded. It required the seller to disclose information to the buyer which may affect the buyer's willingness to purchase the shares:

> "There are no material facts or circumstances in relation to the assets liabilities obligations business or financial condition of the Company which have not been fully and fairly disclosed in writing in the Disclosure Letter which if disclosed might reasonably have been expected to affect the decision of the Purchaser to enter into this Agreement or the decision of any purchaser to purchase the Shares or any of them".[578]

The knowledge-saving clause in *Eurocopy* was expressed in the following terms:

> Clause 3.3: "The Warranties are given subject to matters set out in the Disclosure Letter in accordance with Clause 4 below but no other information relating to the Company of which the Purchaser has knowledge (actual constructive or imputed) shall preclude or affect any claim made by the Purchaser for breach of any of the Warranties or reduce any amount recoverable".[579]

The key terms of the knowledge-saving clause are that except for matters contained in the disclosure letter, none of the information about the target company about which the buyer knew would prevent or affect the buyer's claim for a breach of warranty.[580] In other words, if the buyer knows something which amounts to a breach of warranty, the buyer can bring the claim and damages awarded for the breach will not be reduced.

The contract also contained a similarly worded clause relating to the effect of the seller's disclosure against the warranties:

> Clause 4: "The Purchaser shall not be entitled to claim that any fact omission circumstance or occurrence constitutes a breach of the Warranties if such fact omission circumstance or occurrence has been fairly disclosed to the Purchaser in the Disclosure Letter but no other information of which the Purchaser has knowledge (actual or constructive) shall prejudice any claim by the Purchaser under the Warranties or operate to reduce any amount recoverable and

[578] *Eurocopy* (n 576) 2.
[579] ibid.
[580] *Eurocopy* (n 576) 2.

> accordingly the Disclosure Letter contains all material details of the matters disclosed therein".[581]

The buyer claimed the seller failed to disclose material facts or circumstances under the above clause. As such, it claimed the shares were worth far less than the sum which it paid for them. The seller denied they failed to disclose material facts but claimed the buyer had actual knowledge of the facts or circumstances which it claimed had not been disclosed. The buyer's response was that clauses 3.3 and 4.1 (both reproduced above), precluded the seller from relying on that defence.[582]

The seller's argument that the buyer had actual knowledge of the breach, and that knowledge prevented the buyer from bringing a claim, appeared contrary to the wording of the agreement. The seller was attempting to prevent the buyer from bringing a claim despite the agreement permitting the buyer to do so. The Court of Appeal listed the possible objections to this argument that had been stated when the matter was before the High Court:

> "It is also arguable that the clauses are no more than representations which cannot be enforced without reliance and not promises to be enforced per se . A similar argument was successful in the Court of Appeal in Lowe v. Lombank [1960] 1 W.L.R. 196 . It is also arguable that the clauses cannot be relied on by a party who knew that the disclosure letter was incomplete because to do so would be dishonest. A similar argument was accepted in Pearson v. Dublin Corporation [1907] A.C. 351.[583]
>
> It is also arguable that the allegations are material to the pleas of estoppel and affirmation in paragraph 9 and 15 of the Defence and that clauses 3.3 and 4.1 have no relevance to those pleas.[584]

Neither the High Court nor Court of Appeal sought to examine the merits of the items listed by the High Court such as the case of *Lowe v Lombank* and *Pearson v Dublin* or estoppel or affirmation.

The seller's defence stated that as a result of a meeting between the buyer and seller, the buyer acquired certain information in respect of the specific matters it claimed amounted to a breach of warranty.[585] Nourse LJ's view of this was that there was an agreement or understanding between the parties that the matter in question was not to be treated as being material for the purposes of the warranty.[586] His view was that if the seller could establish the facts of the meeting having taken place, it would be arguable that the sellers were to that extent entitled to escape the literal application of the agreement. He said the buyer may be able to rely on clause 4, and the words "no other information of which the Purchaser has knowledge… shall… operate to reduce any amount recoverable and accordingly the Disclosure Letter contains all material details of the matters disclosed therein".

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[581] ibid 3.
[582] ibid.
[583] ibid 4.
[584] ibid.
[585] ibid.
[586] ibid.

However, Nourse LJ concluded "it appears well arguable that those words do not apply at all to a matter which is treated by the parties as not being material".[587] This suggests that if the buyer acquired knowledge outside of the contract, that knowledge overrides the terms of the contract. If the seller's allegation is correct then if the buyer had earlier agreed that certain information was not material it cannot later say the seller should have disclosed it as required by the warranty. This is also despite the contract stating that no information outside of the disclosure letter of which the buyer had actual or constructive knowledge shall prejudice its warranty claim.

The seller also said that in any event it would be unconscionable and unfair, and additionally or alternatively, fraudulent, for the buyer to complain of non-disclosure of matters of which it had actual knowledge when it entered into the contract.[588] Nourse LJ's response to that was that "it is not plain and obvious that the [seller] should be prevented… from making that plea and seeking to rely on it at the trial".[589] Here, the court is allowing the seller to run, at trial, the defence that for the buyer to bring a breach of warranty where it had actual knowledge would be unfair, or worse, fraudulent.

The seller's final line of defence concerned the effect on the award of damages of the buyer's knowledge. The seller said that if the buyer knew of the matters of which it now complained, the buyer cannot claim that it paid more than the fair value of the shares. In that allegation "the implication being that it cannot be heard to say that it paid too much".[590] Whilst agreeing with the suggestion that the fair value of the shares is something which must be assessed objectively, Nourse LJ said that he was unpersuaded that it is certain that a valuer would decline to take into account the amount of the offer actually made by the buyer. Having done that, the valuer may consider the fact that the buyer's offer must have been influenced by its knowledge of the material facts and circumstances.[591]

Nourse LJ concluded that, at trial, in order for the seller to make a plea on this last point that the buyer cannot claim it paid too much, the seller has to be able to also claim that the buyer had knowledge of the material matters.[592]

Nourse LJ's specific response to the knowledge-saving clauses 3.3 and 4 was:

> "That is certainly an argument — it may be a strong one — which will enable the [buyer] to contend at trial that whatever view a valuer might take as to the relevance of the purchaser's knowledge of material circumstances in making his bid, the [seller is] nevertheless precluded from relying on that matter by the terms of the contract. However, I am far from satisfied that

[587] ibid.
[588] ibid 5.
[589] ibid 5.
[590] ibid 6.
[591] ibid.
[592] ibid.

> that point is so plainly and obviously against them that the [seller] should be prevented from taking it at this stage".[593]

Here, Nourse LJ is simply taking a balanced view as between buyer and seller. On the one hand, the buyer may be able to say that the contract's terms prevent the seller from arguing that knowledge of a breach of warranty has a negative effect on the value of the shares. On the other hand, the ability of the seller to make that argument is one that the seller should be allowed to make.

It is apparent in *Eurocopy* that there was no attempt to distinguish between the different sorts of knowledge – actual imputed or constructive and how the validity of a knowledge-saving clause might vary depending on which sort of knowledge is being considered. Actual knowledge is seemingly accepted by the High Court and Court of Appeal. It is not clear if either or both the High Court or Court of Appeal thought that some or all of the reasons listed by the High Court – *Lowe v Lombank*, *Pearson v Dublin* or estoppel or affirmation might apply only to actual knowledge, or to other forms of knowledge too.

What Nourse LJ stated in *Eurocopy* should not be overstated. The court only had to consider whether or not the seller's defence "disclosed no reasonable cause of action or defence".[594] The Court of Appeal had the same task as that of the High Court in *Eurocopy* which was to decide whether there was a "clear and obvious case for striking out" the defence.[595] In *Eurocopy*, Nourse LJ said that the question for the court was whether the law on which the defendants were seeking to base facts, was "bound to fail" [596] and he was of the view that was not the case.[597]

The meaning of "reasonable cause of action or defence" can be gleaned from cases referred to by the Court of Appeal in *Williams and Humbert Ltd v W. & H. Trade Marks* [598] which require the defence to be "obviously unsustainable"; "obviously and almost incontestably bad"; "unarguable"; "quite unsustainable" and "hopeless". A claimant seeking to strike out a defendant's claim at the time of *Eurocopy* was presented with a rather high bar to overcome in order to meet these criteria. The House of Lords in *Williams and Humbert* [599] considered that in a case of a striking out application, a judge hearing the application should not proceed where the application involved prolonged and serious argument. This was the case unless the judge doubted the soundness of the defence and striking out would remove the need for a trial or reduce the extent of the trial preparations.[600] Against this

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[593] ibid.
[594] Rule 19(1)(a) of the Rules of the Supreme Court (Revision) 1965/1776. This rule applied between 1 October 1966 and 25 April 1999. *Eurocopy* was heard on 10 April 1991 and judgment given on 1 January 1992.
[595] *Eurocopy* (n 576)4.
[596] ibid 7.
[597] ibid.
[598] [1985] 3 W.L.R. 501, 539.
[599] [1986] AC 368.
[600] ibid 435.

background it is perhaps not surprising that the court in *Eurocopy* was not willing to strike out the defence.

On the relevant points the court concluded, on two occasions, that the defence was not plainly and obviously against the defendants that they should be prevented from relying on it at trial. Furthermore, the Court of Appeal displayed a reluctance to interfere with the High Court's decision [601] and believed great caution should be exercised when considering striking out a defence that a previous judge has said is arguable.[602] In light of the very narrow question for the court of whether the seller's arguments were bound to fail at a full hearing, it is not possible to confidently conclude, like numerous commentators have done, that a buyer cannot bring a claim for breach of warranty where the acquisition agreement contains a knowledge-saving clause and the buyer is aware of a warranty breach.

We turn now to analyse another case which looked at a slightly differently worded knowledge-saving clause.

5.5 Infiniteland v Artisan Contracting – High Court

In *Infiniteland*, the buyer entered into an agreement with the seller in respect of the sale and purchase of shares in three companies. One of the target companies had £1,081,000 injected into it shortly before the share purchase agreement was entered into. The buyer had believed that two of the target companies had, in the previous accounting year, earned ordinary trading profits of over £0.5million, but in reality, there had been a loss of around £0.5million. It was the £1,081,000 cash injection which accounted for the difference between a profit of around £0.5million and a loss of around the same amount. The buyer said the accounting treatment of the £1,081,000 was wrong.[603] The incorrect treatment gave rise to a breach of warranty under the purchase agreement. One aspect of the seller's case was that, although the accounts did not treat the £1,081,000 correctly, the buyer's professional adviser knew about it. The seller argued that knowledge which either they or their advisers had about the £1,081,000 prevented there being any claim for breach of warranty.[604] The buyer claimed that its professional adviser had failed to inform them of the £1,081,000 cash injection issue.

The knowledge-saving clause in *Infiniteland* was worded a little differently to the one in *Eurocopy*:

> "The rights and remedies of the Purchaser in respect of any breach of the Warranties shall not be affected … by any investigation made by it or on its behalf into the affairs of any Group

[601] *Eurocopy* (n 576) 7.
[602] ibid.
[603] Infiniteland *Ltd v Artisan Contracting Ltd* [2004] EWHC 955 (Ch), [5] *Infiniteland* (n 603).
[604] ibid [6].

> Company (except to the extent that such investigation gives the Purchaser actual knowledge of the relevant facts and circumstances) …"[605]

Park J made a few general remarks about a buyer's knowledge of a warranty breach. He said he did not agree that if a buyer knows that a warranty is untrue but still enters into the contract the seller is not liable for the apparent breach of warranty.[606] He thought that *Margetson* was probably obiter [607] and that consideration of the buyer's knowledge needs to be based upon the contract's provisions. He also said, "…there is no room for a more generalised proposition that, if the purchaser knew something and still went ahead with the contract, it cannot say that it was a breach of warranty, whatever the detailed terms of the agreement may have been".[608]

On the subject of knowledge, the buyer had appointed an agent to undertake accounting due diligence on the target company. On the point of actual knowledge, Park J said that where a buyer acts through an agent, the agent's knowledge is also that of the buyer.[609] This view was independent of authority[610] but he said was supported by *Strover v Harrington*.[611] In *Strover*, the buyer's solicitor failed to tell their client that a property had a septic tank rather than mains drainage. In that case, Browne-Wilkinson VC found that the solicitor's knowledge was imputed to the buyer.[612]

The buyer in *Infiniteland* appealed to the Court of Appeal against some of Park J's findings, including that he found the actual knowledge of the accountant was to be treated as actual knowledge of the buyer.

5.6 Infiniteland v Artisan Contracting – Court of Appeal (interlocutory proceedings)

In the Court of Appeal, Chadwick LJ made several observations about the knowledge-saving provision. He said the clause was for the benefit of the buyer.[613] He also said that there was a prior question independent of the clause which was whether there had been a breach of warranty.[614] The court said that if there was disclosure in the disclosure letter that qualified the warranty the knowledge-saving clause would have no application.[615] The premise underlying the knowledge-saving provision was that, without the clause, the rights and remedies of the buyer regarding a breach of warranty would or might be affected by knowledge acquired in the course of due diligence by it or on

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[605] ibid [116].
[606] ibid [113].
[607] ibid [115].
[608] ibid.
[609] ibid [118].
[610] ibid [119].
[611] ibid [119].
[612] ibid 410.
[613] *Infiniteland CA* (n 556), [63].
[614] ibid [63].
[615] ibid [75].

its behalf. As is usual, there was no breach of warranty where a matter had been disclosed in the disclosure letter as that was outside the reach of the clause. The clause cannot have been intended to apply to knowledge of that nature. Further, the qualification to the knowledge saving provision in parentheses – "except to the extent that such investigation gives the buyer actual knowledge" – was not directed to knowledge of disclosed matters.[616] The words 'actual knowledge' in brackets referred to knowledge which has the effect of limiting a breach of warranty claim or remedy.[617] Those bracketed words qualify the words before them – "the buyer's rights and remedies regarding a warranty breach of the warranties not being affected by any investigation made by or on behalf of the buyer".[618]

Having described the structure of the clause, and the matters to which it did and did not apply, the question the court was answering was whether actual knowledge included knowledge of the accountant.[619] The question before the court in *Eurocopy* was different. Chadwick J said that in *Eurocopy* the issue was whether the seller was allowed to say that because the buyer had actual knowledge it could not say it had paid too much for the shares.[620]

Chadwick LJ said that one effect of the knowledge-saving clause before him was that the buyer could not rely on it if it had actual knowledge of the matter on which it seeks to base a warranty claim. He said that does not mean that the warranty claim would necessarily fail. It means only that the buyer could not rely on the clause to counter a defence based on actual knowledge.[621] In relation to constructive knowledge, Chadwick LJ said "It is also possible to say with confidence that constructive knowledge would not prevent the Purchaser from relying on the relevant saving provision… ".[622]

He then went on to say that the more difficult question was "whether, actual knowledge' includes or excludes 'imputed knowledge' — that is to say, knowledge which the buyer does not actually have, but which is to be imputed to it because it is, say, the actual knowledge of its agent".[623] On that point he concluded that "the distinction between 'actual' and 'imputed' knowledge in this field is so well known that if the parties intended to include 'imputed knowledge' in the qualification by which they cut down the scope of the relevant saving provision, they would have said so.[624] Chadwick LJ concluded that "if it were necessary to decide the point (which it is not) I would hold that the judge

[616] ibid [76].
[617] ibid [77].
[618] ibid [76].
[619] ibid [75].
[620] ibid [79].
[621] ibid [81].
[622] ibid [82].
[623] ibid.
[624] ibid.

was wrong to give [the knowledge-saving clause] of the share sale agreement the effect that he did".[625]

However, in *Infiniteland*, Pill LJ disagreed with this view of knowledge of the agent not being knowledge of the buyer. Pill LJ said:

> "If the principal employs an agent to discharge such a duty, the knowledge of the agent will be imputed". In the present case, there was no duty to enquire but the principal took the opportunity provided by the clause to investigate and instructed an accountant to conduct the investigation. In that context, knowledge conveyed to the accountant appears to me to amount to actual knowledge in the purchaser within the meaning of the clause".[626]

> "…is significant is the unlikelihood of the parties intending that the consequences of the accountant failing in his contractual duty to the purchaser should rest with the vendor. In this contractual context, the vendor was, in my view, entitled to assume that information given to the accountant was information given to the purchaser".[627]

Pill LJ was uncomfortable with the accountant's failure to pass information to the buyer and held the view that the accountant's knowledge was actual knowledge. He also said that the situation before him in *Infiniteland* was different to the situations considered by Hoffmann LJ (as he then was) *in El Ajou v Dollar Land Holdings*.[628] In *El Ajou*, Hoffmann LJ set out the three broad circumstances in which knowledge of an agent is imputed to the principal.[629] Firstly, there are cases where the agent is authorised to enter into a transaction.[630] The second is where the principal has a duty to investigate or make a disclosure.[631] Thirdly, where the agent has actual or ostensible authority to receive communications.[632] None of these would appear to be relevant to the *Infiniteland* situation.

Pill LJ believed that if the word 'imputed' in the knowledge-saving clause did appear before the court in *Infiniteland*, the court would have had the debate as to whether the accountant's knowledge was imputed to the buyer. This view seems to be open to challenge. If the clause had included the word 'imputed' then whilst the debate may still have been had it would have been more in depth. As the clause lacked the inclusion of that word it was difficult for the court to conclude the imputed knowledge was actual knowledge. Carnwath LJ[633] succinctly expresses the differences between the different types of knowledge in *Infiniteland*:

> "I also agree with Chadwick LJ's view of [the knowledge-saving clause]. In simple terms, as I understand conventional legal usage, "actual knowledge" connotes a person's own knowledge;

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[625] ibid [83].
[626] ibid [93].
[627] ibid [94].
[628] [1994] 2 All ER 685.
[629] ibid [702].
[630] ibid.
[631] *Infiniteland* CA (n 556) [82].
[632] *El Ajou* [703].
[633] Promoted to the Supreme Court in 2012.

> as distinct from knowledge which the law attributes to him, either because he ought to have it ("constructive knowledge"), or because it is knowledge of his agent ("imputed knowledge"). The distinctions are well-established (see e.g. the judgments in *Al Ajou v Dollar Land Holdings [1994] 2 All ER 685*), even if the precise boundaries and demarcation lines may sometimes become blurred, particularly in the difficult area of corporate knowledge...)[634]

Here, in setting out the different types of knowledge, Carnwath LJ highlights how the knowledge of the agent cannot be the actual knowledge of the buyer. The clause, by not including the word 'imputed' cannot be attributed to the buyer. Pill LJ appears to be saying that actual knowledge is also imputed knowledge, which is against the well-established categories of knowledge and gives the words 'actual knowledge' a broader meaning. As Chadwick LJ says, "had the parties intended to include 'imputed knowledge' in the qualification by which they cut down the scope of the relevant saving provision, they would have said so".[635]

5.7 Infiniteland - observations

Several observations can be made about *Infiniteland*. Chadwick LJ gave the only fully reasoned judgment. Any comments (if, in fact, there were any) on the validity of a knowledge-saving clause were obiter because he had already ruled against the buyer that there was no breach of warranty. Therefore, the validity of the knowledge-saving clause was irrelevant. That said, there may be some argument over whether the judges commented in any way on the validity of these clauses. Their comments appear to only concern the scope of the clauses.

The Court of Appeal judges discuss, and disagree between themselves about, what the category of actual knowledge contains. This is because the knowledge-saving clause excludes from its scope the buyer's actual knowledge. However, it does not say what other types of knowledge are *included* within its scope. So, if the buyer has these other types of knowledge they can still make a claim for breach of warranties, but whether they would be successful in doing so is not commented upon. It does not say that imputed knowledge is included within the scope of the knowledge-saving clause. However, Chadwick LJ and Carnwath LJ say that imputed knowledge is included within the scope of the clause's protection of the buyer. They say that knowledge of an agent, even if actually held by the agent, will nevertheless still only be 'imputed' knowledge of their principal, and therefore, on their construction, will still fall within the saving-protection of the clause. Pill LJ states the opposite. He says that the actual knowledge of the agent should be treated as the actual knowledge of the buyer.

[634] *Infiniteland* CA (n 556), [87].
[635] ibid [82].

None of the three judges suggests that whatever the meaning of actual knowledge, implied or constructive knowledge means, a knowledge-saving clause is either valid or invalid insofar as it seeks to allow the buyer still to claim for a known breach of warranty.

The closest that a view is given as to the validity of these clauses is when Chadwick LJ states it is also "possible to say with confidence that constructive knowledge would not prevent the Purchaser from relying on the relevant saving provision…"[636] There are two ways of interpreting this wording. One, his use of the words "rely on" means 'enforce'. Secondly, "rely on" means 'falling within the wording of'. These are looked at in turn.

5.8 Do the words 'rely on' mean 'enforce'?

Do the words 'rely on' mean enforce? It could be said that that judicial discussion of the types of knowledge was not to the exclusion of the implied acceptance by the Court that such clauses were in themselves enforceable. That could be argued for several reasons.

Chadwick LJ said that he would need to consider the effect to be given to the knowledge-saving clause and the question of imputed knowledge.[637] The effect of the clause was repeated by him some paragraphs later in his judgment.[638] He considered that the knowledge-saving clause was a "..saving provision for the benefit of the Purchaser".[639] He went on to address the prior question, as he called it, which that clause demands in requiring it to be considered which was whether "there has been a breach of warranty on which the Purchaser could otherwise rely".[640] Here, Chadwick LJ was allowing the knowledge-saving clause to determine his approach to what he had described a couple of paragraphs before was the "most substantial issues on this appeal" which was whether or not there was a warranty breach in relation to the accounts.[641]

So, in deciding this "substantial issue", if he did not think the knowledge-saving clause was at least on the face of it valid, he would not have allowed himself to be directed by it and for it to set out the approach to his consideration of the prior question. The same can be said when later, [642] Chadwick LJ is considering whether one type of knowledge includes another, he expressly states he is doing that in the context of the particular knowledge-saving clause. In these circumstances, if he did not think that there was not some acceptance as to the clause's validity Chadwick LJ would have remarked upon it

[636] ibid [82].
[637] ibid [44].
[638] ibid [62].
[639] ibid [63].
[640] ibid.
[641] ibid [61].
[642] ibid [82].

in some way, but he did not do so. Chadwick LJ appears to be assuming the validity of the knowledge saving clause for the purpose of the argument about actual knowledge.

When Chadwick LJ later returns to consider the knowledge-saving clause in detail [643] he does so by stating he would be addressing the point that 'actual knowledge' in the context of the clause does not include the knowledge of a particular person.[644] Immediately before that statement, he also states that the absence of the breach of warranty means that there is no right or remedy which could be affected by the clause. Again, in addressing actual knowledge in the context of the knowledge-saving clause, and stating that the buyer's rights and remedies remain unaffected by it, seems to point to an acceptance of the clause's validity.

Then, to perhaps reinforce this view a little further, Chadwick LJ goes on to repeat the description of what the clause does, he explains its object and its underlying premise and the clause's limits [645] and disagrees with the High Court's restatement of the clause.[646] That process in itself might invite his reflection as to why the effect of a clause is being discussed whilst not believing it is a clause capable of being enforced. It might be asked, what is the likelihood of a detailed judicial discussion about the scope of a clause failing to mention that the clause may not in itself be enforceable.

When Chadwick LJ moves to describe the issues before the Court of Appeal in *Eurocopy*, [647] this is perhaps a good opportunity for him to pass comment on the possibility of a knowledge-saving clause being enforceable or not, but he did not do so. When he first mentioned *Eurocopy*, Chadwick LJ said that the problem to which the knowledge-saving clause in question is directed was illustrated by *Eurocopy*. He then set out the knowledge-saving clause in *Eurocopy* and summarised the claim and the defence in that case. He then said the issue before the Court of Appeal in *Eurocopy* was whether the sellers should be allowed to maintain a defence that, because the buyer had actual knowledge of the matter in question, it could not say it had paid too much for the shares.

Chadwick LJ then extracted Nourse LJ's response in *Eurocopy* which was that the point that the sellers should be prevented from maintaining a defence that the buyer had knowledge was not plainly and obviously against the sellers that they should be prevented from making it. Chadwick LJ ended his discussion of *Eurocopy* by stating that the form of knowledge-saving clause was found in a leading precedent book.

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[643] ibid [75] to [83].
[644] ibid [75].
[645] ibid [76].
[646] ibid [77].
[647] ibid [78].

There might be a revealing aspect of Chadwick LJ's judgment which comes after this when, against this background, he expresses his view of the knowledge-saving clause in question.[648] The clause in *Infiniteland* provided that the buyer's rights in respect of a warranty breach were not affected by its investigation of the target company except where it had actual knowledge of the relevant facts or circumstances. Chadwick LJ states the effect of the knowledge-saving clause puts beyond argument the point raised in *Eurocopy* and that the buyer cannot rely on the clause in question where it had actual knowledge – this may be seen as a statement as to the particular effect of that clause and its exclusion of a buyer making a claim for breach of warranty where it had actual knowledge. Chadwick LJ's use of the words "rely on" in two consecutive sentences in the paragraph in which he expresses his view of the knowledge-saving clause indicates not so much that these two words mean that a particular type of knowledge "falls within the meaning" of the clause, but rather that the buyer cannot use the clause against the seller in circumstances where the seller defends a warranty claim by stating the buyer has such knowledge. This may be what Chadwick LJ is saying in his last sentence of paragraph 81. The same meaning of the words "rely on" applies in his next paragraph [649] where he contrasts actual knowledge and says it is possible to say "with confidence" that constructive knowledge does not prevent the buyer from relying on the clause. In other words, if the seller defends the breach of warranty claim by stating that the buyer had constructive knowledge, the buyer would be able to use the knowledge-saving clause against the seller to allow the buyer to continue with its claim. Chadwick LJ also makes clear the interpretative principle that should be applied to the knowledge-saving clause in that a court should be slow to give the clause a larger meaning than the language requires[650] and concludes that the High Court was wrong to give the clause the effect that it did. This would have been an opportunity for Chadwick LJ to at least question the enforceability of such clauses, but he did not do so.

On the continued point of interpretation, and arguably a clearer demonstration of a knowledge-saving clause being enforceable, is in respect of Carnwath LJ, who, after agreeing with Chadwick LJ's view of the meaning of different types of knowledge, [651] emphasised the importance of legal certainty in relation to types of knowledge both for legal draftspersons and the courts. Perhaps it is unlikely that an expression of the importance of legal certainty ignores the enforceability of such clauses. The process the court has gone through in seeking to interpret the meaning of a clause which the buyer may use against the seller by implication may suggest that the wording in itself is enforceable, rather than the court considering the meaning of a clause that it did not think was enforceable. It might be

[648] ibid [81].
[649] ibid [82].
[650] ibid [82].
[651] ibid [87].

difficult to accept the possibility of the court engaging in a fairly lengthy discussion about the effect of a clause whilst at the same time being indifferent as to the clause's enforceability.

5.9 Do the words 'rely on' mean 'falling within the wording of'?

The above is the view that Chadwick LJ thought that 'rely on' means enforce. The alternative view is that 'rely on' effectively means 'falling within the wording of'. Therefore, a buyer with constructive knowledge would fall within the ambit of the clause's wording and accordingly rely on it. Whether the buyer could rely on the clause is a separate consideration as that concerns validity, not its scope. The second interpretation is probably more convincing.

A buyer with merely constructive knowledge would definitely fall within the protection that the clause is *trying* to confer – and could therefore in that sense rely on it – but whether they could enforce it is a different matter that concerns not its scope, but its validity.

The judges are presupposing that the distinction between these various categories of knowledge does in fact matter or otherwise they would not be discussing knowledge, as knowledge is related to validity. As such, that would presuppose that a knowledge-saving clauses was valid in permitting claims generally. Secondly, also, but perhaps less likely, that a knowledge-saving clause referring to all of the three types of knowledge – actual, constructive or imputed is unenforceable because it fails to distinguish between the types of knowledge. However, it seems unlikely that this alternative view is correct. Certainly, even if it is true that the judges in *Infiniteland* were assuming, in relation to the first point, that the clause in *Infiniteland* was enforceable, they need not have been assuming, as in relation to the second point that the clause in *Eurocopy* was not. They had to distinguish between actual and imputed knowledge because that is what the clause in *Infiniteland* itself did. They could have still been thinking that, if the parties have *chosen* a *Eurocopy* clause, that will be entirely enforceable. The clause in *Infiniteland* simply said that "buyers that have actual knowledge are not protected" cannot be relied on by buyers that have actual knowledge.

Chadwick LJ's next sentence of paragraph 82, and the remaining text of that paragraph, suggests his point concerns defining actual knowledge, not identifying the scope of a valid clause. When Carnwath LJ later agrees with Chadwick LJ's view of the knowledge-saving clause [652] again, it appears to be the case that what he is agreeing with is Chadwick LJ's view of the meaning of and the boundary between actual and imputed knowledge and not the validity of clauses which use those categories. This interpretation is further supported by Chadwick LJ's words in paragraph 81. This is when he says that the effect of a clause worded in the way it is in *Infiniteland* is putting "beyond argument the point

[652] ibid [87].

raised in *Eurocopy*… the purchaser cannot rely on the clause if it had actual knowledge …". It is clear that the buyer's inability to rely on the clause is a consequence of its scope (because of its narrower wording) and has nothing to do with any issue of validity.

But more generally, the judges are not discussing the categorisation of different types of knowledge [653] because it matters to this case (so that we must assume that legal validity turns on it). They have already decided that the legal validity of the clause is irrelevant to the case's outcome. They are discussing the categorisation of different types of knowledge because they think the first instance judge made an error in that regard. They want to correct that error, for its own sake.

Furthermore, it would be surprising given the uncertainty produced by the inconclusive status of the *Eurocopy* decision, and the 'arguable' points raised against validity in that case, three appeal court judges could simply now assume, without offering any reason, that some clauses are definitely valid and, perhaps, others are not.

5.10 The conclusion on both Eurocopy and Infiniteland

In summary, *Eurocopy* leaves almost entirely open the validity of any type of saving clause – apart from noting the 'not clearly unarguable' status of some possible challenges to the validity of at least some such clauses. *Infiniteland* says nothing at all about the validity of any such clauses.

5.11 Opposing views of commentators

Commentators hold opposing views as to the implications of these cases. However, for the reasons given above, the view is that all commentators are wrong. Jastrzebski suggests that the buyer's knowledge prevents it from making a breach of warranty claim against the seller and that a knowledge-saving clause may be unenforceable.[654] Likewise, McNaughton considers that there is a tension between *Eurocopy* and *Infiniteland* and the buyer's awareness may provide the seller with a defence to a breach of warranty claim.[655] Similarly, Phillips interprets *Eurocopy* as casting doubt on a knowledge-saving clause and this doubt was reinforced by *Infiniteland*.[656] Thompson states that it

[653] None of the judges seem to think through the significance, in a situation where the purchaser is itself a *corporate entity*, of the purchaser being able to enforce a warranty notwithstanding the actual knowledge of the purchaser's agent (assuming there is an *Infiniteland* type clause). Where the purchaser is a human, then it makes sense to distinguish between a) the actual knowledge of the human-purchaser; and b) the knowledge of the purchaser's agent (which will, at most, become the merely –imputed knowledge of the human purchaser herself). But if the purchaser is itself a corporate entity, almost all the knowledge it has will be knowledge acquired by the company's agents – whether they be accountants or, say, the directors charged with doing the deal.
[654] J Jastrzebski (n 562) 213.
[655] Ross McNaughton, Matthew Poxon, 'Company acquisitions: representations, warranties and disclosure' (2014). https://www.paulhastings.com/docs/default-source/PDFs/wldoc-14-1-28-12_4-(pm).pdf.
[656] John Phillips, Julian Runnicles and Jeffery Schwartz, 'Navigating Trans-Atlantic Deals: Warranties, Disclosure and Material Adverse Change' (2007) 15(4) JFRC 472, 478.

should not be assumed that if a buyer knows of facts not stated in the disclosure letter that it will have a warranty claim.[657] The buyer cannot ignore the information that it or its advisers have.[658]

By contrast, Adesanya explains that where a buyer has knowledge it can bring a claim.[659] Zakrzewskic considers that knowledge is a question for the meaning of the contract [660] and likewise others debate that knowledge does not prevent a claim [661] and it is implicit in the *Infiniteland* decision that a buyer is not prevented from suing for breach of warranty even if it knows of a breach of warranty claim.[662]

There is a clear lack of consensus between commentators as to what these cases decided which by itself merits further examination.

5.12 Examining some of the High Court's reasons in Eurocopy

In *Eurocopy*, the Court of Appeal stated that its decision was based on some of the reasons specified by the High Court, but did not name which.[663] Those reasons can only be extracted from the Court of Appeal's decision as no transcript of the High Court decision is available. The High Court cited four possible reasons why the buyer might be unable to rely on the agreement excluding its knowledge of warranty claims. These potential justifications preventing the buyer from bringing a claim for a known warranty breach relate to the possibility that doing so is dishonest; the buyer would be estopped from relying on such a provision; or would have affirmed the breach; a knowledge-saving clause amounts to a representation. The Court of Appeal also added a further reason which was that the buyer has not suffered any loss or damage. Each of these is addressed in turn below.

5.12.1 Dishonesty

The first possible reason cited in support was that it was arguable that it would be dishonest to rely on the knowledge-saving clause. This was said in the context of the buyer knowing that the disclosure letter was untrue. The High Court stated that "it is also arguable that the clauses cannot be relied upon by a party who knew that the disclosure letter was incomplete because to do so would be dishonest".[664] In support of that position the court said that "a similar argument was accepted by the House of Lords in *Pearson v Dublin Corporation*".[665] The High Court was not specific in *Eurocopy*

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[657] Thompson (n 179) 1-08.
[658] David P Sellar, 'Commercial law update' [1993] 38 JLSS 309.
[659] Funmi Adesanya, 'Due diligence and the UK and US approach to disclosures' [2018] 29(11) ICCLR 652, 661.
[660] Rafal Zakrzewski, 'Representations and warranties distinguished' [2013] 6 JIBFL 341, 345.
[661] Richard Christou, *Drafting Commercial Agreements* (6th edn, Sweet & Maxwell 2016) para 10-04.
[662] Stilton (n 125) 10-034.
[663] *Eurocopy* (n 576), 6.
[664] ibid 4.
[665] [1907] AC 351.

as to which part of the *Pearson* judgment it was basing its suggestion that reliance on the knowledge-saving clause was dishonest. However, it is submitted that *Pearson* does not support the High Court's view in *Eurocopy* that it is dishonest for the buyer to enter into a contract with the seller which contains a provision that the buyer can claim for a known warranty breach. There are three points to note about *Pearson*.

Firstly, *Pearson* concerned a contractor suing the defendant for representations made by the defendant's agent about a wall. The agreement between them specified that the contractor needed to satisfy itself about the works to be undertaken and the Corporation was not responsible for the accuracy of the information regarding the wall. The House of Lords held that the Corporation was liable for the fraudulent representations of its agents regarding the wall, stating the agreement contemplated honesty by both parties. The point was elaborated by Lord James who said that the party inserting the clause would cause the other party to say: "I assume that those with whom I deal are honest and honourable men. I [reject] the idea of their being guilty of fraud".[666] and further, that "those who designed the fraudulent protection cannot take advantage of it".[667]

In *Pearson*, the Corporation's agent had made fraudulent misrepresentations (for which the Corporation was liable) to a contractor and the agreement contained a provision inserted by the Corporation as to it not being responsible for the representations it had made. The Corporation was therefore attempting to avoid liability for its own representations. There are two elements to this case: the representations and the clause which sought to avoid liability for them.

This is not the same as the provision in *Eurocopy* which provided that anything of which the buyer knows would not prevent it from making a claim against the seller for breach of warranty. The element that is missing, that would be needed for it to bear resemblance to *Pearson*, is a representation from the buyer to the seller. If the buyer had represented to the seller that it did not know of any claims against the seller for breach of warranty, and the buyer had then required the agreement to contain a provision that its knowledge of a breach of warranty would not prevent it from making a claim against the seller, that would then result in *Eurocopy* and *Pearson* being similar. In the absence of such a representation by the buyer, it probably cannot be said that the buyer is being dishonest. It is suggested the type of agreement that was the subject of *Pearson* may have been the reason the court stated that honesty was a requirement. The agreement between the parties concerned building work which required the parties to share information and engage in discussions about the work to be undertaken.[668] This is unlike a share sale.

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[666] ibid, 362.
[667] ibid.
[668] In other words, a relational contract – see 1.3.4.2.

Secondly, an honesty requirement for a knowledge-saving clause would defeat its objective. The purpose of such a clause is to allow the buyer to claim if it is aware of a breach of warranty. If being able to rely on such a clause required honesty, then a seller would always assert that the buyer's reliance on the clause was dishonest and so prevent the buyer from ever being able to use it. If a buyer had to first disclose to the seller that it was aware of a breach of warranty that would not be the buyer relying on the clause – instead it would be the buyer informing the seller of the breach. Even if a buyer had to first disclose the breach to the seller, the seller is unlikely to just accept the buyer informing it of a warranty breach before completion. The seller would respond in some way. It would renegotiate the price or add contractual wording to avoid being claimed against after completion, or it would amend the disclosure letter to insert the disclosure that the buyer has communicated to it, and so eliminate the buyer's ability to claim against the seller. Furthermore, an obligation of disclosure on the buyer would contrast with there being no duty on the seller to do so.[669] It is suggested that this cannot be correct.[670]

A third point is that the provision in *Pearson* was a clause in which the Corporation was seeking to exclude its liability for misrepresentation. Such a provision may now be subject to the Misrepresentation Act 1967, s 3 and the test of reasonableness in the Unfair Contract Terms Act 1977, s 11(1). The test of reasonableness in the latter makes no mention of a requirement of honesty on the part of the party who benefits from the clause.[671] By contrast, a knowledge saving clause does not meet the definition of an exclusion clause [672] which generally concerns a party's attempt to limit its duty or liability. Instead, a knowledge-saving clause attempts to preserve the right of the buyer to bring a claim against the seller as such right is seemingly excluded in the absence of such a clause.

5.12.2 Estoppel

The seller in *Eurocopy* also sought to rely on the doctrine of estoppel [673] as a defence to the buyer's claim in two respects. Firstly, it said that if the buyer was aware that material matters were not in the disclosure letter it should be estopped from complaining about them.[674] Secondly, it said that in entering into the agreement there was an implied representation by the buyer that the seller had made full and fair disclosure in the disclosure letter of all material matters and the buyer should be estopped

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[669] See chapter 2.
[670] See chapter 7 for a discussion as to whether a duty to disclose is efficient from a law and economics perspective.
[671] The Unfair Contract Terms Act 1977, s 11(1) states that the requirement of reasonableness is 'that the term shall have been a fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made'.
[672] Beale 33rd (n 206) 5-003 refers to three types of exclusion clauses: (i) clauses which limit or reduce what would be the defendant's duty; (ii) clauses which exclude or restrict the liability which would attach to a breach of contract; (iii) clauses which exclude or restrict the duty of the party in default fully to compensate the other party.
[673] The hallmark of estoppel is that it prevents a party from denying a particular fact - Hodge Malik, *Phipson on Evidence* (19th edn, Sweet & Maxwell 2019)5-07.
[674] *Eurocopy* (n 576), 5.

from stating otherwise.[675] It is submitted that the defences of estoppel by the seller cannot be supported, for the reasons given below.

The seller's first estoppel defence concerns estoppel by convention. The buyer and seller would have needed to have acted on an assumed state of facts or law. For the buyer to be estopped from denying that state it would be unjust to allow it to go back on the assumption [676] and the buyer must have said or done something which had the effect of communicating to the seller that it held the particular assumption in question, and reinforced the seller's belief in that assumption.[677] For the seller to successfully defend the buyer's claim in *Eurocopy* on this basis it would need to have shown that the buyer had communicated an assumption that it was aware of material matters missing from the disclosure letter and that it would not claim in respect of them. The defence put forward in *Eurocopy* does not refer to that assumption having been made. It seems that the defence would not be relevant now, or if made, would not be successful.

This second estoppel defence attempted by the seller concerns the seller claiming that the buyer, by entering into the sale agreement, had made an implied representation that the seller had made full and fair disclosure in the disclosure letter.[678] This seems unlikely to be a successful defence. This estoppel occurs where a representor, by words or conduct, has made a representation which justified the representee in believing that a certain state of fact exists, and in that belief the representee altered his position.[679] If that occurs, the representor is not permitted to state that a different state of fact existed at that time.[680] The essential element is to show that the buyer had made the seller believe that in entering into the agreement the seller had made full disclosure in the disclosure letter. If no such belief had been caused to be held by the seller, the mere fact of entering into an agreement, it is suggested, does not in itself imply such a representation. In any event, it is not clear how a buyer could confidently state (or would want to state) that the seller had made full disclosure against the warranties. To do that the buyer would need to know at least as much about the target company as the seller. If a buyer were to make such a representation it would compromise the buyer's ability to make a claim against the seller for breach of warranty generally.

5.12.3 Affirmation

The third point in *Eurocopy* as a possible justification for concluding that the seller had an arguable claim concerns affirmation. Unfortunately, the *Eurocopy* judgment does not detail the context in

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[675] ibid, 6.
[676] John Cartwright, *Formation and Variation of Contract* (2nd edn, Sweet & Maxwell 2020) 0-05.
[677] Malik (n 671) 5-27.
[678] *Eurocopy* (n 576), 6.
[679] Kenneth Handley, *Estoppel by Conduct and Election* (2nd edn, Sweet & Maxwell 2016) 1-005.
[680] ibid.

which affirmation was used. The seller was perhaps asserting that by the buyer entering into the contract it was affirming the breach of warranty. Affirmation occurs when a party, faced with a repudiatory breach of contract [681] can have a choice to either terminate the contract or treat it as continuing.[682] Affirmation will be implied if the innocent party, knowing of the breach and of its right to choose to affirm or terminate the contract, does something unequivocal.[683] There is, however, a conceptual problem with such a claim and that is one of timing. For there to be an affirmation, there first needs to be a contract, a breach of it and either an affirmation or termination. In *Eurocopy*, if the seller were to allege affirmation in the way suggested, the affirmation would come before the entering into the contract as it does not seem possible that the act of entering into the contract is itself the affirmation.

5.12.4 Representation

The penultimate point for consideration gives hope to a buyer seeking to rely on a knowledge-saving clause that they will be able to bring a claim. In *Eurocopy*, the court suggested that the knowledge-saving clause may be considered to be representations given by the seller to the buyer which would require the buyer to have relied on them.[684] That argument, the court said, was successful in *Lowe v Lombank*. [685] In *Lowe*, the Court of Appeal suggested that a provision which stated that the claimant had examined goods, they were not defective and the goods were fit for purpose cannot be a contractual promise. Instead, it would be a representation needing to be believed by them as true and acted upon by them to their detriment.[686] In *Lowe*, it could not be shown that the defendant believed the representation was true and likewise, in *Eurocopy*, if the buyer knew the representations were untrue, it could not by logic have relied upon them and so could not have acted upon them to their detriment. In *Lowe*, the court held that it is not possible to convert a statement as to past facts, known by both parties to be untrue, into a contractual obligation.[687] The court's objection in *Lowe* was the statement related to past facts and at the time it was made it was known to be untrue.[688] If that is the case, that can be distinguished from a knowledge-saving clause which seeks to allow the buyer to claim if it knows of a warranty breach that the seller has not set out in the disclosure letter.

On the face of it, the objection in *Lowe* may not be supported in the case of a knowledge-saving clause. However, there now appears to be less of a need for the buyer to make that argument as *Lowe*

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[681] A repudiatory breach occurs when 'one party so acts or expresses himself as to show that he does not mean to accept the obligations of the contract any further, then this may, depending on the circumstances, amount to a repudiatory breach of contract' Beale (n 223) 37-218.
[682] ibid 24-002.
[683] ibid 24-003. All of the five cases referred to in Beale (n 223) on this point refer to contracts already entered into.
[684] *Eurocopy* (n 576), 3.
[685] [1960] 1 WLR 196.
[686] ibid, 204.
[687] Ibid.
[688] Kelry CF Loi, 'Contractual Estoppel and Non-Reliance Clauses' [2015] LMCLQ 346, 348.

has since been distinguished in subsequent cases, the effect of which on the buyer would be to shift in their favour the possibility of a knowledge-saving clause being enforceable. This change is the result of two cases.

In *Peekay v Australia and New Zealand Banking Group*, [689] the Court of Appeal did not refer to *Lowe*. However, in respect of terms which stated that a party understood the transaction into which it was entering, was aware of its risks and has determined its suitability, [690] the court stated there was no reason why the parties could not agree that a certain state of affairs should form the basis for the transaction, whether or not it was, in fact, the case. This position was approved by the Court of Appeal in *Springwell Navigation Corp v JP Morgan Chase Bank* [691] where the court stated that such an agreement would not allow the parties to subsequently deny the existence of that state and that there was "commercial utility in such clauses being enforceable so that parties know precisely the basis on which they are entering into their contractual relationship".[692] Such clauses have the effect of being a contractual estoppel [693] and it is unnecessary to show, as suggested in *Lowe*, that the requirements for estoppel by representation [694] need to be satisfied.[695] Despite these direct pronouncements in *Peekay* and *Springwell*, some commentators have concerns about the soundness of the doctrine of contractual estoppel.

If these concerns are justified, the buyer's ability to rely on a knowledge-saving clause may be questioned. McMeel suggests that the series of cases relied upon in *Peekay* and *Springwell* to distinguish the decision in *Lowe* were weak, [696] a view supported by Goh.[697] It has been suggested that the lack of precedential support is not problematic [698] and *Springwell* and *Peekay* treated the discussion about estoppel in *Lowe* as obiter [699] and "the authorities, in conjunction with the analysis of Lowe, and the application of principle…, provide the foundations for the subsequent development of

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[689] [2006] EWCA Civ 386.
[690] ibid [56].
[691] [2010] EWCA Civ 1221 Aikens LJ said, "I respectfully regard the principles stated in *Peekay* as good law. That case has now been followed in a large number of first instance cases which need not be analysed in any detail" [169]
[692] ibid [144].
[693] Beale (n 223) 15-147. A contractual estoppel "arises when contracting parties have, in their contract, agreed that a specified state of affairs is to form the basis on which they are contracting or is to be taken, for the purposes of the contract, to exist. The effect of such "contractual estoppel" is that it precludes a party to the contract from alleging that the actual facts are inconsistent with the state of affairs so specified in the contract" – Beale (n 223) 4 -116.
[694] "Estoppel by representation covers the case where one party makes a representation of present fact (not the future) on which the other relies, thereby barring the representor from leading evidence in any later action to contradict his representation" – Beale (n 223) 5-29.
[695] ibid para 15-147.
[696] Gerard McMeel, 'Documentary Fundamentalism in the Senior Courts: The myth of contractual estoppel' [2011] LMCLQ 185, 206.
[697] Nelson Goh, 'Non-reliance clauses and contractual estoppel: commercially sensible or anomalous' [2015] 7 JBL 511, 518.
[698] ibid, 519.
[699] ibid, 518.

this area of law in *Peekay*".[700] McMeel has suggested that *Springwell* and *Peekay* are per incuriam[701] because they depart from the clear ruling in *Lowe* [702] a line of argument put forward in *Springwell* itself.[703] Despite these complaints, the Court of Appeal in *Springwell* was clear that *Peekay* was "consistent with principle and authority" and was "good law" and had been followed in a large number of first instance cases.[704]

It is over ten years since *Springwell* was decided and the number of first instance decisions in support of it is now even greater [705] and the court was very clear that *Lowe* was not binding authority "that there can never be an agreement… that the parties are conducting their dealings on the basis… that a particular fact was the case, even if it was not the case and both the parties knew it was not".[706] Whilst for some commentators it is unclear that a subsequent decision of the Supreme Court would support the doctrine [707] it has not been considered by them.[708] Whilst McMeel suggest the Supreme Court should destroy the doctrine [709] it is well established as it can be without their decision [710] and should be upheld.[711] Of course, despite the strong opinions in support of the doctrine in *Peekay* and *Springwell* the doctrine is not without its limits. Provided none of these limitations applies to a knowledge-saving clause, it appears a buyer could avoid a repeat of the arguments put forward by the seller in *Eurocopy* and the seller should be prevented from arguing that the buyer's knowledge prevented it from making a claim.

Those limits relate to statute and public policy [712] in the same way that limits apply to other contractual provisions [713]. It is not thought that statutory limitations would apply. Several cases concerning contractual estoppel have centred around non-reliance clauses which involve a limitation of liability for pre-contractual representations [714] and so would be subject to the Misrepresentation Act

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[700] Jo Braithwaite, 'The origins and implications of contractual estoppel' 132 (Jan) LQR 2016, 120, 130.
[701] A decision of the court that is mistaken. A decision of the court is not a binding precedent if given per incuriam; i. e. without the court's attention having been drawn to the relevant authority, or statute. - Mick Woodley, *Osborn's Concise Law* Dictionary (12th edn, Sweet & Maxwell 2013).
[702] McMeel (n 696), 207.
[703] *Springwell* (n 691*)* [168]. An argument that the court rejected.
[704] That court was referring to first instant decisions of *Bottin* (n 445); *Donegal International v Republic of Zambia* [2007] 1 Lloyd's Rep 397*; Trident Turboprop v First Flight Couriers* [2009] 1 All ER (Comm) 16; *Titan Steel Wheels v Royal Bank of Scotland* [2010] EWHC 211 (Comm); *Food Co UK LLP v Henry Boot Developments* [2010] EWHC 358*; Raiffeisen Zentralbank Osterreich v Royal Bank of Scotland* [2010] EWHC 1392. That there is a consistent body of first instance authority where judges have applied contractual estoppel was also noted by after the High Court case of *Springwell* by Catherine Gibaud, 'Contractual estoppel: an old remedy revived or a new remedy forged?' BJIB & FL 2010, 25(6), 336 336, 338. Subsequent to her article Gibaud was junior counsel in the Court of Appeal in *Springwell*.
[705] Braithwaite (n 700) 123.
[706] Springwell (n 691) [155].
[707] Jill Phillips, 'The extent to which an entire agreement clause in a share purchase agreement could give rise to a contractual estoppel' Co Law 38(2) [2017] 39, 47.
[708] Braithwaite (n 700) 123.
[709] McMeel (n 696) 207.
[710] Braithwaite (n 700) 133.
[711] ibid, 130.
[712] *Springwell* (n 691) [144].
[713] *Prime Sight v Lavarello* [2013] UKPC 22 [47].
[714] Goh (n 697) 51.

1967 and Unfair Contract Terms Act 1977. Other cases have concerned parties confirming that a particular state of affairs exists, for example, that one party confirms that it is not relying on the expertise of the other [715] or where a bank prevents a customer relying on a misrepresentation the bank knows it has made.[716] By contrast, knowledge-saving clauses do not attempt to limit the operation of law for the seller or buyer but rather seek to keep open for the buyer the possibility of making a claim that the common law appears to prevent. As such, knowledge-saving clauses should not be considered to only be enforceable subject to meeting the demands of some rule of reasonableness [717] and they are not seeking to evade any statutory terms for the benefit of buyer or seller. Furthermore, even if they were subject to the reasonableness regime in the Unfair Contract Terms Act 1977, they would likely be upheld.[718] Statute does not appear to impact the buyer's reliance on contractual estoppel. Likewise, public policy should also not affect the buyer's reliance on such a clause.

Public policy reasons as to whether a term will be enforced as a contractual estoppel are not clearly defined.[719] Obvious reasons not to enforce it are illegality or fraud, [720] duress, misrepresentation, undue influence and mistake [721] but in itself it is not inherently contrary to public policy for parties to agree that certain facts are established when they are known to be otherwise, [722] but this would not extend to undermining rules designed to protect parties who are in dependent positions, [723] such as employees and beneficiaries. A knowledge-saving clause does not engage these issues. Some may assert that a provision which allows a buyer to claim against a seller where the buyer was aware of the breach could be liable to fall foul of public policy. However, the courts are prepared to uphold provisions under the doctrine of estoppel which state the parties have not relied on any representation by the other party, even if the parties know that is not the case.[724] Whilst the effect of such a non-reliance provision is to remove the ability for the representee to make a claim for misrepresentation, the opposite effect is true in the case of a knowledge-saving clause which serves to leave the door open for a claim that the common law may otherwise close.

As recently as *Wallis Trading v Air Tanzania*, [725] the defendant contended that there could be no estoppel if parties knew of the truth.[726] Butcher J said the effect of contractual estoppel "is that the parties have both accepted that a relevant state of affairs should be assumed to be true, whether it is or

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[715] *Titan Steel v The Royal Bank of Scotland* [2010] EWHC 211 (Comm).
[716] Loi (n 688) 347.
[717] Such as the Unfair Contract Terms Act 1977, s11.
[718] Where the parties are of equal bargaining power – Goh (n 697) 529.
[719] Jo Braithwaite, 'Springwell-watch: New Insights Into the Nature of Contractual Estoppel' LSE Law, Society and Economy Working Papers 12/2017, 28 http://eprints.lse.ac.uk/84438/1/WPS2017_12_Braithwaite.pdf.
[720] Rupert Lewis, 'The development of contractual estoppel [2011] 26(2) JIBLR, 49, 58.
[721] Loi (n 688) 354.
[722] *Prime Sight* (n 713) [47].
[723] Braithwaite (Springwell) (n 719) 29.
[724] John Cartwright, *Misrepresentation, Mistake and Non-Disclosure* (5th edn Sweet & Maxwell 2019) 9-03.
[725] [2020] EWHC 339 (Comm).
[726] ibid [80].

not". If parties contract to accept a certain state of affairs is true the parties cannot establish a case to the contrary.[727] As Butcher J's comments show, what is being honoured is the party's agreement despite the reality being somewhat different. In an acquisition it should be apparent that the buyer could have knowledge of breaches of warranty that the seller has not set out in the disclosure letter. The law has yet to set out clear limitations on the extent to which public policy reasons will limit the enforceability of a contractual estoppel. However, it is suggested that there are no obvious public policy reasons why the courts would refuse to uphold a knowledge-saving clause. So, if this is correct, the limits on contractual estoppel do not apply and contractual estoppel would prevent the seller from arguing the buyer had knowledge of the breach. It could also be said that the law may already be considered to favour the seller.

At the time of *Eurocopy*, *Lowe*, according to the suggestion of the court in *Eurocopy*, may have prevented the buyer from relying on a knowledge-saving clause. This is because the knowledge-saving clause would have been treated as a representation from the seller to the buyer that, to be enforceable against the seller, would have required the buyer to show that it believed that the representation in the terms of the knowledge-saving clause was true and had been relied upon by the buyer to its detriment. Now, under *Springwell*, the knowledge-saving clause is not treated as a representation. Contractual estoppel discards the requirement of reliance, detriment or unconscionability.[728] It is not true estoppel [729], it is of a contractual nature [730] and it is simply the courts enforcing a contractual term.[731] In making this shift, the courts are upholding the contractual freedom of parties[732]. The development of contractual estoppel reflects the court's desire to give parties the freedom to determine the factual basis on which they wish to enter into a contractual relationship [733] and the courts will not disrupt this approach.[734] The courts want to promote commercial certainty and uphold the principle of freedom to contract [735] and contractual estoppel is a celebration of that principle.[736]

The context of a share sale is similar to the banking cases in which the contractual doctrine developed. Braithwaite notes in respect of those banking cases that parties are typically represented by lawyers, the parties are sophisticated, there is equality of bargaining power and there is freedom of choice of the counterparty to the agreement, the documentation is professionally drafted and well-known across

[727] Alexander Trukhtanov, 'Rescission as a Limit to Contractual Estoppel' [2018] LMCLQ 330, 331.
[728] Loi (n 688)357.
[729] ibid, 357.
[730] ibid, 347.
[731] ibid, 34.
[732] Tak Matsuda and Jacqueline Heng, 'Contractual estoppel: Springwell Navigation Corporation v JP Morgan Chase Bank' [2011] 4 JIBFL 227.
[733] Lewis (n 720), 49.
[734] Braithwaite (n 700) 120.
[735] Phillips (n 707), 44.
[736] Goh (n 697) 528.

the market.[737] She further states, "in this context, an emphasis on freedom of contract seems obvious and consistent" [738] but even in the non-banking context involving ordinary individuals, contractual estoppel is valid.[739] It is suggested that the similarity that corporate transactions share with the banking context should further increase the likelihood that a knowledge-saving clause will be enforceable. Commercial parties are free to devise their own "contractual matrix" in order to allocate risk as they see fit.[740] Perhaps it was this that Park J was hinting at in the High Court in *Infiniteland* when, after noting the case of *Margetson*,[741] which held that knowledge of a warranty breach prevents a claim, he said that the matter is a question of construction of the contract. He further noted that the parties' solicitors negotiated the terms of a long and detailed agreement which contained provisions about disclosure and at least one provision dealing with buyer's knowledge. He went on to state that the effect of knowledge on the part of the buyer has to be based upon those provisions, "and that there is no room for a more generalised proposition that, if the purchaser knew something and still went ahead with the contract, it cannot say that it was a breach of warranty, whatever the detailed terms of the agreement may have been".[742] As an aside, it is interesting to note that this approach reflects the position in the United States where the parties can contract around the default rule of the relevant state which, depending on the state in question, either does or does not permit a buyer to bring a claim for a known warranty breach.[743]

The discussion above has concluded that reasons referred to in *Eurocopy* to reject the enforcement of a knowledge-saving clause are not valid in the cases of all reasons other than the case of *Lowe* concerning representation. In respect of that case, it is suggested that the law has since developed, and a subsequent court would apply the principle laid down in *Peekay* and confirmed in *Springwell* to uphold a knowledge-saving provision. However, despite that, there is a further hurdle presented to the buyer relating to value.

5.13 Valuation

It seems the buyer's knowledge of a warranty breach could affect its ability to recover damages. In the case of a breach of warranty in relation to shares, damages are calculated on the basis of the value of the shares as warranted and their actual value.[744] The defendant in *Eurocopy* suggested that the buyer cannot claim that it paid too much for the shares if it knew of the seller's breach of warranty [745]

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[737] Braithwaite (n 700) 131.
[738] ibid.
[739] Braithwaite (Springwell) (n 719) 14.
[740] Braithwaite (n 700) 130.
[741] *Margetson* (n 563).
[742] *Infiniteland* (n 603) [115].
[743] Whitehead (n 569) 1085.
[744] James Edelman, *McGregor on Damages* (20th edn, Sweet & Maxwell 2019) 29-008.
[745] *Eurocopy* (n 576), 7 Nourse LJ and Lloyd LJ.

and their actual knowledge meant that the buyer had not suffered any loss or damage.[746] In response, the court appeared to indicate consensus with this view stating that it is not certain that a valuer would not take into account the buyer's offer, and having done that, must have been influenced by the buyer's knowledge of the material facts and circumstances.[747] This approach seems curious and, it is submitted, wrong.

In addition to the preservation of the ability of the buyer to bring a claim despite actual knowledge of a warranty breach, the clauses in question in *Eurocopy* stated that actual knowledge does not prevent or affect a claim for breach of warranty or reduce the amount recoverable.[748] It may be said that based on the above discussion on contractual estoppel, the seller will be prevented in future from putting forward a defence that the buyer cannot claim that it paid too much for the shares. However, the comments of the court in *Eurocopy* are targeted not at the wording of the agreement, but on the calculation of damages by a valuer. It appears that the court is suggesting that a valuer engaged to determine the difference in the value of the shares between the price paid and their actual value would, or indeed should, discount, perhaps even to zero, the amount of damages that the buyer can recover.

This would appear to place a valuer in a difficult position by requiring them to reduce their calculation of damages despite contractual wording to the contrary and for them to take account of the assumption that the buyer paid a purchase price equal to the value of the breach. For that assumption to be correct, the buyer would have needed to have gone through the same exercise as a valuer by calculating the difference in value. This it would have needed to have been done before completion and in respect of each known breach of warranty. Of course, it may be that a buyer had a nonchalant attitude towards the known warranty breach before completion, but which turned into concern after completion. Some may say that the buyer has not suffered loss because it entered into the transaction knowing of the warranty breach. It may be more acceptable for a valuer to take account of nonchalance and reduce the amount of damages but to increase it where the buyer did not have time, for example, to value to warranty breach? Perhaps these questions are acceptable ones to be put to, and be considered by, a valuer for their determining the amount of damages payable. However, it seems that a valuer should not be put into a situation of having to opine on what the buyer did and did not know and the actions it did and did not take or indeed whether the buyer is expected to be a valuation expert before completion. One thing that must be clear is that the inclusion of a term that

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[746] ibid, 6.
[747] ibid, 7.
[748] Clause 3.3 and 4.1 of the agreement in *Eurocopy* contained wording to this effect. As too was the agreement in *116 Cardamom v Macalister* [2019] EWHC 1200 (Comm) which stated" 'Except for the matters Disclosed, no information of which the Buyer, its agents or advisers has knowledge (in each case whether actual, constructive or imputed) or which could have been discovered (whether by investigation made by the Buyer or on its behalf), shall prejudice or prevent any Claim, or reduce the amount recoverable under any Claim'.

states the known warranty breach should not affect the amount recoverable by the buyer is unlikely to have been intended by the parties to mean that an assessment of damages does the opposite.

5.13 Conclusion

This chapter has demonstrated that the default common law position prevents the buyer from being able to bring a claim for a breach of warranty known to it before completion. In response, buyers have taken to attempting to provide in the contract what the law does not give it and that is the ability to bring a claim for a known breach of warranty not stated in the disclosure letter. However, despite agreements containing knowledge-saving clauses the opposing views of commentators as to the meaning of the two leading cases on this area show that this area is in a state of confusion.

It may well be that a future dispute regarding a knowledge-saving clause will pit *Eurocopy* against *Springwell* with a seller relying on the former, and the buyer the latter. It will be likely that the courts are going to once and for all look at a knowledge-saving clause in the context of a full trial for the uncertainty surrounding this area to be settled. That uncertainty relates not only to the enforceability of knowledge-saving clauses but also to the assessment of damages for breach of warranty in such circumstances. Until then, neither buyer nor seller will know where they stand, but at least, for the buyer, the development of contractual estoppel will give it some hope that the courts will honour a knowledge-saving clause, and perhaps enable full recovery in damages.

Chapter 6

Disclosure

6.1 Introduction

This chapter considers the concept of disclosure by the seller against warranties. It is concerned with the extent that disclosure against a warranty is sufficient to relieve the seller of liability for breach of that warranty. The law's approach to determining whether or not the seller's disclosure has been sufficient for it to avoid liability for a particular disclosed breach of warranty has shifted from favouring the buyer to favouring the seller. This is because the concept of disclosures needing to be 'fair', which existed in cases before 2005, has been substituted with one which places greater emphasis on the terms of the contract. The law appears to no longer impose an overriding sense of fairness into the seller's disclosure of the warranty breach. That disadvantage to the seller was reversed by the Court of Appeal in *Infiniteland v Artisan* [749] and accordingly, the law now appears to favour the seller.[750]

All of the cases discussed in this chapter concern whether the seller has made adequate disclosure.[751]

Section 6.2 looks at what disclosure is and section 6.3 describes what disclosure looks like. Section 6.4 considers cases that favour the buyer as well as, in section 6.5, an anomalous case that appears to have been wrongly decided (section 6.7). Section 6.6 looks at the tension between the buyer-friendly cases. In section 6.8 it is shown that the law has shifted from favouring the buyer to favouring the seller and the consequence of that is shown in section 6.9.

6.2 What is disclosure?

To the extent that a seller describes to the buyer how a warranty is untrue, the seller can escape liability for breach of warranty in relation to that matter. This it does by providing a disclosure letter to the buyer.

As described in Chapter 1, a warranty is a term of a contract which, if breached, may give rise to a claim for damages for the party suffering the breach. If the buyer has been able to negotiate them, warranties tend to be wide-ranging and lengthy in the purchase agreement between buyer and seller.

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[749] *Infiniteland* (n 556).
[750] The practice and mechanism for disclosure in UK are arguably more favourable to the seller than in USA. John Phillips, Julian Runnicles and Jeffery Schwartz, 'Navigating Trans-Atlantic Deals: Warranties, Disclosure and Material Adverse Change' (2007) 15(4) JFRC 472, 476.
[751] It should be noted that UK academic commentary in respected journals on the subject of disclosure is almost non-existent.

As warranties are drafted in broad, general terms, disclosure against the warranties will be the primary means by which the seller can limit its liability for breach of warranty (as well as the parties separately agreeing to specific limitations on the warranties in the share purchase agreement).[752] Disclosure is a fundamental part of the sale transaction.[753] Therefore, a prudent seller would review the warranties and consider what disclosures it will need to make against each warranty.[754] If the seller's disclosure is inadequate, the seller may be exposing itself to potential breach of warranty claims. If that exercise is properly performed, then the buyer also benefits and disclosure may reveal to the buyer issues with the company which allow it to negotiate and reduce the purchase price.[755] Alternatively, the buyer may wish to seek indemnities from the seller in the share purchase agreement for the specific matter in question. The disclosure may raise concerns for the buyer serious enough that it will want to withdraw from the transaction.[756] Disclosure is made through a 'disclosure letter'. As David Richards LJ said in *Persimmon Homes v Hillier*, [757] the disclosure letter "is an integral part of the suite of documents designed to give effect to the parties' intended transaction". Given its importance, what does disclosure look like in the transaction documentation?

6.3 What does disclosure look like?

Typically, disclosure is made through a disclosure letter which is given by the seller to the buyer. It is divided into two sections. One deals with disclosures of a general nature. Another deals with specific disclosures.[758] Each of these is looked at in turn.

6.3.1 General disclosures

Firstly, general disclosures. This operates to deem disclosure of matters of which the buyer is, or ought to be, aware before entering into the share purchase agreement.[759] Typically, those matters are contained in public records or in documentation previously provided to the buyer. By way of example, an extract of some of the general disclosures from *Sycamore Bidco v Breslin* [760] were:

"By way of general disclosure, the following matters are disclosed or deemed disclosed to the Buyer:

1.1 the contents of the Agreement and all transactions referred to therein;…

[752] Lexis Nexis Disclosure—share and asset purchases (practice note).
[753] ibid.
[754] ibid.
[755] ibid.
[756] ibid.
[757] [2019] EWCA Civ 800 [41].
[758] Rosenberg (n 158) D3-005.
[759] ibid.
[760] *Sycamore* (n 345).

> 1.7 all matters contained in the Information Memorandum prepared by [ ]"[761]

And some further examples in *Liberty Partnership v Tancred* [762]:

> "7. All matters disclosed to the Buyer its accountants and other advisors or which have been revealed in the course of the investigation of the Company by the Buyer and such accountants and other advisors.
>
> 8. All matters which would be revealed by a search of the registers and documents maintained by… the Financial Services Authority in respect of the Company and any employee of the Company at the date of this letter".

And in *Bottin International v Venson* the general disclosures included a number of matters such as:

> "General disclosure was made of (amongst other things) all matters of a factual nature in what was called the Financial Information (being the budget for 2000 and the Outline Strategic Plan for 2000–2004) and all matters disclosed in the management accounts for the period ended 31 October 1999 and "All matters contained in the various documents provided to [Bottin] … a schedule of which is set out in Schedule 1 below"".[763]

It can be seen by these examples that general disclosure provides deemed disclosure to the buyer of certain general information. The purpose is that if there is any information contained within the general disclosures that qualify any of the warranties given by the seller in the purchase agreement the seller's liability for breach of warranty will be limited as revealed by the relevant document or information.

Take an example of the application of general disclosures. Suppose there is a warranty on the following terms which provides that the company was not involved in any litigation:

> "The Company is not at the date of this Agreement, engaged in any litigation, arbitration, mediation, dispute resolution or criminal proceedings and, so far as the Sellers are aware, there are no such proceedings pending, threatened or expected".[764]

Suppose also that the disclosure letter, which is negotiated by the buyer and seller, states that there is general disclosure of all information and matters contained in correspondence that has passed between the seller and its advisers. That correspondence contains a particulars of claim issued in the High Court detailing a claim by a third party against the target company. That particulars of claim may have the effect of qualifying the above 'no litigation' warranty and so relieve the seller of liability for breach of warranty to the extent of the particular claim specified in the particulars of claim. That means that the buyer's breach of warranty claim may fail if it were to bring a claim against the seller for the litigation specified in the particulars of claim. It should be noted that general disclosures do

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[761] *Sycamore* (n 345) Appendix.
[762] [2018] EWHC 2707 (Comm).
[763] *Bottin* (n 445) [19] An example would be a general disclosure of the contents of a data room. See *Triumph Controls v Primus International* [2019] EWHC 565 (TCC) where a general disclosure of a data room was one of the issues.
[764] Lexis Nexis: Share purchase agreement—pro-seller—individual sellers—conditional—long form.

not specify which warranty or warranties the general disclosures may qualify. The buyer has to establish that for itself.

By contrast, in the United States, there is no use of general disclosures. The comparison of the two jurisdictions in respect of general disclosures is to favour the seller in English legal practice in share sales, as general disclosures qualify warranties by way of the provision of, or reference to, general information.[765]

6.3.2 Specific disclosures

Secondly, now to look at specific disclosures. Specific disclosures detail matters which, if not disclosed, would constitute a breach of warranty. The specific disclosures will describe the matters being disclosed and some will refer to separate documents to supply further detail. These documents are typically referred to as the 'disclosure bundle'.[766] The bundle will be indexed for the purposes of cross-reference with the disclosure letter.[767] The specific disclosures work by the seller referring to a warranty in the disclosure letter and specifying how that warranty is untrue.

Using the same example warranty above regarding litigation, the seller may instead have set out a specific disclosure against the relevant warranty in the specific disclosures section of the disclosure letter. It may specify details of the litigation, who the claimant is, the nature of the litigation, the amount claimed, when the defence was filed, what the defence said and what legal advice has been received about the claimant's prospect of success. This, like the above example used for general disclosures, may relieve the seller of liability for breach of warranty to the extent of that specific disclosure. Again, that means that the buyer's breach of warranty claim may fail if it were to bring a claim against the seller for that litigation specified in the specific disclosures. Unlike the general disclosures, the specific disclosure does refer to the specific warranty that is being qualified by the disclosure.

It can be seen that general disclosures and specific disclosures are different means of achieving the qualifying of warranties and so preventing the buyer from making a successful claim for breach of certain warranties. The disclosure letter is a unilateral document [768] and whilst the buyer does not normally accept its terms in the formal sense by applying its signature to the letter, acceptance of its terms is arguably made by the buyer negotiating the general disclosures in the disclosure letter with

[765] There is no separate disclosure letter in US transactions and instead the disclosures are specific disclosures which are attached to the acquisition agreement. Westlaw International - Disclosure Schedules: Mergers and Acquisitions.
[766] Lexis Nexis: Disclosure letters.
[767] ibid.
[768] *Persimmon Homes v Hillier* [2019] EWCA Civ 800 [41].

the seller, [769] those negotiations concluding and the buyer signing the letter to confirm its receipt. In relation to the general disclosures, the buyer is "agreeing" to accept that certain documents provided to it, or to which it has access, qualify the warranties.

The idea of specific disclosure is perhaps somewhat peculiar because the parties agree warranties given by the seller in the agreement and some of those warranties the seller knows are to some extent untrue. In a separate document (the specific part of the disclosure letter), the seller specifies to the buyer how those warranties are untrue. Of course, specific disclosure is a safer option for the seller as it has control over what is communicated to the buyer and brings certainty that the buyer has notice of how a particular warranty is untrue. By contrast, general disclosure may well be uncertain for both buyer and seller. Neither party may necessarily exactly know how any warranty may be qualified by the documentation or information that is generally disclosed.

In addition to the general and specific sections of the disclosure letter, the introductory part of the disclosure letter will usually set out the letter's scope and purpose and typically contain wording along the following lines:

> "This letter is the Disclosure Letter referred to in the Agreement and constitutes formal disclosure to the Buyer for the purposes of the Agreement of the facts and circumstances which are or may be inconsistent with the warranties referred to in… the Agreement (the "Warranties") or which otherwise give or may give rise to a claim under the Agreement by the Buyer in respect of the Warranties. Such facts and circumstances will be deemed to qualify the Warranties accordingly".[770]

Related to the disclosure letter are certain terms contained in the share purchase agreement. The buyer and the seller usually agree a standard of disclosure in the share purchase agreement, often simply using the word "Disclosed" followed by some description. Some examples from cases include:

> "Disclosed" [means] "fairly disclosed in the Disclosure Letter or contained within the Disclosure Documents with sufficient clarity to enable the Buyer to assess with reasonable accuracy the nature of the matter disclosed".[771]

> Disclosed means disclosed, whether generally or specifically in the relevant Disclosure Letter, in such a manner and with sufficient detail so as to enable the Buyer to identify the nature and scope of the matter disclosed and to make an informed assessment of its effect".[772]

> "fairly and clearly disclosed in writing in or under the Disclosure Letter (with sufficient detail to identify the nature of the matter disclosed)".[773]

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[769] As happened, for example, in *Persimmon* – ibid.
[770] *Sycamore* (n 345) appendix.
[771] *BIP Chemical Holdings v Blundell* [2021] EWHC 2590 (Ch) [17].
[772] *Tactus Holdings v Jordan* [2024] EWHC 399 (Comm) [25].
[773] *Triumph* (n 763) [79].

> "Disclosed" [means] "fairly disclosed (with sufficient details to identify the nature and scope of the matter disclosed) in or under the Disclosure Letter".[774]

This means that the defined standard of disclosure will apply at least to the specific disclosures (and perhaps too to the general disclosures, if so stated in the disclosure letter). The purpose of the definition is to provide a standard that the seller's description of how a particular warranty is untrue in the disclosure letter needs to meet. If it meets the standard, the disclosure will be a valid disclosure.

The share purchase agreement will also include a clause which provides that the seller will not be liable for a breach of warranty to the extent that it has disclosed in the disclosure letter:[775]

> "The Sellers are not liable for a Claim … to the extent that the matter the subject of the claim…is Disclosed"[776]

> "No liability shall arise under the Warranties if and to the extent that the matter giving rise to the claim is fairly disclosed in the Disclosure Letter …".[777]

We turn now to consider the cases which concerned matters of disclosure. There appears to be a distinction between buyer-friendly and seller-friendly cases. The former demanded that to constitute fair disclosure the seller needed to refer the buyer to the matter being disclosed against. This requirement of fair disclosure was eroded by the Court of Appeal in *Infiniteland* which concluded that it was permissible in certain situations for the buyer to discover matters for itself. Before considering that case the decisions which established the buyer-friendly position are set out.

6.4 The buyer-friendly cases

Levison v Farin [778] laid the foundation of the buyer-friendly position. The sellers gave a warranty that "save as disclosed" between the period of the balance sheet in the accounts and the date of completion:

> "there will have been no material adverse change in the overall value of the net assets of the company…"[779]

The buyer claimed breach of warranty and the seller claimed she had disclosed against the warranty. The buyer was aware the company was making losses which had the effect of reducing its net assets [780] and the seller argued that such knowledge amounted to disclosure against the warranty. The court

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[774] MDW Holdings [195].
[775] LexisNexis practice note: disclosure.
[776] *Triumph* (n 763) [77].
[777] *Bottin* (n 445) [11].
[778] [1978] 2 All ER 1149.
[779] ibid 1152.
[780] No definition of "net assets" was stated in the judgment in *Levison* but reference to the Companies Act 2006, s 677(2) and 831(2) (which post-dates the case) defines net assets as "the aggregate amount of the company's assets less the aggregate amount of its liabilities".

found the warranty had been breached and all the seller had disclosed was a "possible cause of loss, not an actual drop in net asset value".[781] The court also said there was no disclosure for the purpose of, or with reference to, the warranty. Gibson J described the intention of the warranty and the use of the words "save as disclosed", in the following way:

> "…I have no doubt that a clause in this form is primarily designed and intended to require a party who wishes by disclosure to avoid a breach of warranty to give specific notice for the purpose of the agreement, and a protection by disclosure will not normally be achieved by merely making known the means of knowledge which may or do enable the other party to work out certain facts and conclusions".[782]

Levison conferred a two-stage test to establish whether or not a disclosure was fair. Firstly, the use of the words "save as disclosed" required the seller to provide specific details of the disclosure against the warranty to the buyer. Second, *Levison* required the seller to specify more than from where details of the disclosure can be obtained.

Some may say that *Levison* does not favour the buyer. It might be said that a warranty relating to the value of the company requiring the seller to have "disclosed" would be expected to lead to the two principles specified in *Levison*. However, that view would not appreciate that the court held that it was not considered fair disclosure to make the buyer aware during the course of negotiations that a warranty was not true. Further, the case also showed the court was prepared to protect a rather imprudent buyer who was aware the company was loss-making before completion but who had not taken the obvious step to inquire as to the extent of those losses. In addition, there was no requirement in the agreement for disclosures to be made in writing, but the court considered that was required to make a valid disclosure. Moreover, the details with which the buyer was provided allowed the buyer the possibility of working out certain facts and conclusions for itself. The court interpreted the warranty as requiring the seller not simply to state that there had been a material adverse change, but to state the extent of that change. This is despite the agreement merely requiring the seller to "disclose" without the agreement defining what amounted to disclosure. As will be seen when consideration is given later in this chapter to the decision in *Infiniteland*, these requirements that a seller both notify the buyer formally of the disclosure, and specify from where the buyer can obtain knowledge of the disclosure, were departed from by the Court of Appeal in that case. The following case also considered disclosure, again in the context of omitted information.

Daniel Reeds v EM ESS Chemists [783] reinforced the position that merely putting the buyer on notice was insufficient to amount to valid disclosure. The target company produced and supplied numerous

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[781] *Levison* (n 778).
[782] ibid.
[783] [1995] CLC 1405.

drugs, including paracetamol, the licence for which had expired. The seller had given a warranty to the buyer in the following terms:

> "All necessary licences, consents, permits and authorities… have been obtained by the company to enable the company to carry on its business effectively in the places and in the manner in which such business is now carried on and all such licences, consents, permits and authorities are valid and subsisting…".[784]

Against that warranty the seller had stated the following in the disclosure letter:

> "Schedule 2 [to the disclosure letter] lists all product licences which have been applied for by the company and those which have been approved".[785]

The buyer alleged the seller was in breach of warranty. The seller argued that it had made adequate disclosure against the warranty because there was no licence for paracetamol included in the licences listed in the schedule. Nicholls VC's view of the warranty and the specific disclosure was:

> "In my view there is much force in the defendant's contention that, when the paragraph from the disclosure letter which I have quoted is read with the warranty and the agreement, overall all that is being warranted regarding product licences is the existence of the disclosed applications and licences. The warranty in cl. 9(1) is quite general. The defendants contended that the disclosure letter under this head is a statement by the defendants of what exists in respect of the warranted subject matter. It seems to me that there is force in this argument. In this respect the disclosure letter qualifies the ambit of the general warranty. What it does, in business terms, is to provide a list of the licences the company has, with the intention that it is for the buyer to look at that list and see whether it includes all that the buyer needs for carrying on the business in the way the buyer intends to do. The buyer was being told: that is all we, the company, have.'

The High Court concluded that all that was being warranted was the existence of the licences disclosed in the disclosure letter and it was for the buyer to look at the list and see if it included all the licences the buyer needed to carry on the business.[786] This is despite the warranty stating that the target company has obtained all necessary licences to operate its business, rather than simply listing the licences it does have.

However, the Court of Appeal disagreed with the High Court. It explained what fair disclosure requires and what the concept of specific disclosure requires in order to be fair:

> "…the [disclosure] letter refers to 'specifically disclosed' and this suggests to me that fair disclosure requires some positive statement of the true position and not just a fortuitous omission from which the buyer may be expected to infer matters of significance.[787]

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[784] ibid 1408.
[785] ibid 1409.
[786] ibid 1410.
[787] ibid 1412.

The court did not think it reasonable to infer from the words used in the warranty and the disclosure letter that it was intended that the buyer would look at the list and see whether it included all that the buyer needed for carrying on the business in the way it intended.[788] The High Court's approach would have required the buyer to analyse the 50 or 60 applications contained in schedule 2 [789] to ascertain whether or not all of the licence applications for the continuance of the business were present. Such a task is likely to be considered by some to be excessive and unfair on the buyer. However, as will be seen later in this chapter, such an expectation was placed on the buyer in *Infiniteland* in relation to significantly more documents.

Another case supportive of the buyer was the much-cited Scottish case of *New Hearts v Cosmopolitan Investments*.[790] The agreement contained a warranty that the accounts of the target company showed a true and fair view of the group's assets and liabilities. The buyer claimed breach of warranty, in that a principal asset of the group was significantly overvalued. The seller claimed that it had disclosed against the warranty. The agreement stated the warranties were given "…subject to matters fairly disclosed (with sufficient details to identify the nature and scope of the matter disclosed) in the Disclosure Letter…".[791] The disclosure letter referred to the management accounts and last statutory accounts which the disclosure letter said were deemed disclosed to the buyer. This approach did not meet with the approval of the court which described it as "repetitive and omnibus" where the buyer is invited to make what they can of the documents and simply referring to a source of information in a complex document which a diligent person might find something relevant cannot, in either case, be considered to be fair disclosure with detail sufficient to identify the nature and scope of any matter.[792] This view of the court rejects the idea that an agreement which requires that the nature and scope of a matter is disclosed can be achieved through general disclosures.[793]

6.5 Cypher - the anomalous case

Not all of the reported cases have been so favourable to the buyer and the seller's successful application for summary judgment [794] against the buyer's claim for breach of warranty in *Cypher Holdings v Bertram* [795] may be an anomaly.

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[788] ibid.
[789] ibid 1409.
[790] [1997] 2 BCLC 249.
[791] ibid 258.
[792] ibid and 259.
[793] As a Scottish case, it only has persuasive effect but it has been cited in several English cases and appears to have been accepted by the English courts.
[794] An application for summary judgment is successful if a party can show that the other party's claim or defence has no real prospect of being successful. The application is made under Civil Procedure Rules, part 24.2.
[795] [2001] WL 753375.

In that case, the seller had given a warranty that the target company's management accounts had been prepared consistently throughout their period and in good faith and in all material respects.[796] In addition, the disclosure bundle of documents,[797] attached to the disclosure letter included the management accounts along with a due diligence report on the target company produced by a firm of accountants.[798] This explained how certain figures had been calculated and their provisional nature. The agreement set the standard of disclosure as being "properly and fairly disclosed". The High Court considered, in an application for striking out of the buyer's claim, "that there was fair and proper disclosure of the fact that the Management Accounts did not "… in all respects reflect the assets and liabilities of the company".[799] The accountant's report qualified the management accounts meaning the buyer could not solely rely on those accounts and it needed to look at the report which specified how the accounts were inaccurate.

6.6 The tension between the cases

There is a tension between *Levison, Daniel Reeds* and *New Hearts*, on the one hand, and *Cypher* on the other.

New Hearts was critical of the approach of general disclosures – a seller referring in the disclosure letter to documents that were deemed disclosed to the buyer. Taking the pre-*Cypher* trilogy of cases together it is possible to summarise them that when disclosing against a warranty the seller needs to draw the buyer's attention to the matter in question and the buyer is not to be expected to find out the matter for itself.

In both *New Hearts* and *Cypher* the generally disclosed document in question was the target company's management accounts. In *New Hearts*, the disclosure letter referred to certain accounts, and in *Cypher* the disclosure letter incorporated the disclosure bundle. It is not clear from *Cypher* whether there was express reference in the disclosure letter to the management accounts in the same way as that in *New Hearts*, or if the management accounts were simply listed in an index without special mention of them being made in the disclosure letter. The latter situation, if it were the case, would have meant that neither the management accounts nor the accountant's report would have been specifically drawn to the buyer's attention. Furthermore, the disclosure bundle was likely to have been lengthy in a transaction which, in that case, had a sale price of £36 million, and so the buyer's task to work out matters for itself was significant. In *Cypher*, the court suggested that *New Hearts* and *Levison* were "readily distinguishable" from the facts in *Cypher* and this was on the basis that the

[796] ibid [7].
[797] Referred to in the rest of this chapter as the "disclosure bundle".
[798] *Cypher* (n) [12].
[799] ibid [25].

accountants' report stated that particular figures in the management accounts were not accurate. The management accounts themselves were inaccurate in relation to certain figures but were "corrected" by the report.

6.7 Cypher – wrongly decided?

It is suggested that *Cypher* was wrongly decided. *Cypher* bears similarities to *Daniel Reeds* but it omits the direct reference to the documents which featured in the latter, so in *Cypher* the buyer did not benefit from having any notice of the issue. *Daniel Reeds* contained a requirement for matters to be "fairly disclosed" in the agreement but with an additional reference in the disclosure letter to specific disclosures. Whereas, the disclosure was a general disclosure with a requirement in the agreement for matters to be "properly and fairly disclosed".

Until *Cypher*, there was a reluctance by the courts to accept that fair disclosure could be achieved by the means employed by the seller in *Cypher*. Whilst it could be said that the trilogy of "pro-buyer" cases all turn on their own particular facts, and it is not possible to draw general conclusions about them, such a view would run counter to subsequent cases which cite the prior cases as indicating what amounts to fair disclosure. Take, for example, *Curtis v Lockheed Martin* [800] where Simon J, describing Lord Penrose in *New Hearts* as considering the meaning of "fairly disclosed", summarised that fairness required more than clues to enable a buyer to start a paper chase for matters [801] and later commented on the importance of the context of the disclosure without which it may be unfair, whilst referring to *New Hearts* as an example of unfairness.[802]

In *Cypher*, the buyer was not led to the issues with the management accounts and had to discover the issues for itself, a position inconsistent with the previous cases. Even the wording of the clause in *Levison*, which required the seller only to 'disclose' matters to the buyer, was interpreted by the court as requiring the seller to direct the buyer to the disclosure. That meant the seller providing specific details of the disclosure against the warranty to the buyer and the seller doing more than simply stating from where details of the disclosure can be obtained. That was not achieved in *Cypher*.

A few months before *New Hearts* Lord Penrose had made his thoughts known about what fair disclosure demands in *Prentice v Scottish Power*:

> "…in general there must be fair disclosure of facts and circumstances material to the bargain sufficient in detail to identify the nature and scope of the matter disclosed and to enable the

[800] [2008] EWHC (Comm Ct) 2691.
[801] ibid [70].
[802] ibid [78].

> purchaser or acquirer of the shares to form a view whether to exercise any of the rights conferred on him by the contract".[803]

If the much-cited and forthright view of Lord Penrose in *New Hearts* was not enough, in *Prentice*, not only did Lord Penrose state what fair disclosure required, but went further and stated that it was also designed to assist the buyer, despite the primary purpose of disclosure being, as Lord Penrose later acknowledged in *Prentice*, protection for the seller against a later claim for breach of warranty.[804] It cannot be said that the general disclosure made in *Cypher* met the demands of fair disclosure laid down in *New Hearts* and *Prentice* or, if those cases imposed too high a standard, even the lower standard established in *Levison* was not achieved. Although not a key case in relation to disclosure, because it was an application to strike out the buyer's defence, *Cypher* upsets a line of cases supportive of the buyer and perhaps should be disregarded. However, it is perhaps prescient of the shift from the buyer-friendly trilogy of cases to the one in *Infiniteland* where emphasis on the wording of the document was given greater prominence, and the notion of fairness almost certainly abandoned. Of course, the imposition of the 'fairness' requirement made it more difficult for the disclosure to satisfy the warranty and so disadvantaged the seller.

6.8 The shift to favouring the seller - Infiniteland

There was a shift in the approach of the courts from the buyer-friendly position in the above cases. In *Infiniteland,* the agreement stated that except as provided in the disclosure letter the warranties given by the seller were true and accurate. The disclosure letter contained general disclosures of "all matters from the documents and written information supplied" to the buyer's accountant and of "all matters contained or referred to in" several lever arch folders [805] and of "all matters contained or referred to in the documents contained in the Disclosure Bundle".[806]

The High Court held that disclosure needs to be full, clear and accurate relying on *New Hearts* to reach this view. This approach did not find favour with the Court of Appeal. It criticised the reliance placed on *New Hearts* and concluded that adequate disclosure must be measured against the agreement in question, and not an agreement in another case. This disregarding of previous cases was further elaborated upon, and the buyer was reminded that it needs to stand by the consequences of the terms that it entered into, when the Court of Appeal said:

> "It would have been open to the Purchaser to refuse to accept disclosure made in general terms by reference to what had been supplied to its reporting accountants; and to insist that it

[803] *Prentice v Scottish Power plc* [1997] S.L.T. 107, 1075.
[804] ibid.
[805] *Infiniteland* CA (n 556) [64].
[806] ibid [10].

> would only accept disclosure which was specific to each individual warranty. But the Purchaser did not choose to take that course".[807]

This shifts the risk back onto the buyer.[808] It seems the Court of Appeal was applying the terms of the disclosure letter and not seeking to apply a notion of fairness.

The Court of Appeal set out an objective test for the accountant in respect of the documents that had been supplied to him as:

> "…such matters as might fairly be expected to come to the knowledge of the reporting accountants from an examination (in the ordinary course of carrying out the due diligence exercise for which they were engaged) of the documents and written information supplied to them (including… contents of the Disclosure Bundle)".[809]

As an objective test the accountant's actual knowledge was irrelevant.[810] The court said that the buyer's accountant would become aware of the warranty breach during the course of going through the due diligence process in respect of the documents supplied to him together with the specific disclosures made against certain warranties.

There are some noteworthy points arising from *Infiniteland*.

Firstly, the court remarked that disclosure letters are negotiated documents and the buyer could have insisted on not having deemed disclosure of certain information [811] and the court was prepared to honour the terms of the disclosure letter, a point that was later reiterated by Moore-Bick LJ in *Man Nutzfahrzeuge v Freightliner*.[812] This view of general disclosures demonstrates a change in the attitude of the courts to that in the previous cases. According to Moore-Bick LJ, it would be dangerous to conclude that cases such as *Levison* and *New Hearts* meant that disclosure provisions should be construed in a restrictive manner.[813] No matter what the standard of disclosure in the previous cases, except for *Cypher*, there was a reluctance to accept the idea that general disclosures in themselves were capable of qualifying the warranties. These cases indicate that disclosure is not made by informing of the means of knowledge and letting the buyer work out matters for itself [814], there must be fair disclosure to identify the nature and scope of the matters [815], there is a positive statement of the true position.[816] The Court's interpretation in *Infiniteland* did not impose an

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[807] ibid [70].
[808] Richard Christou, *Drafting Commercial Agreements* (6th edn, Sweet & Maxwell 2016) para 3.
[809] *Infiniteland* CA (n 556) [70].
[810] ibid [72].
[811] ibid [70].
[812] [2005] EWHC 2347 (Comm) [78]. Moore-Bick LJ was sitting as a High Court judge.
[813] ibid [178].
[814] *Levison* (n 778).
[815] *Prentice* (n 803).
[816] *Daniel Reeds* (n 783).

overriding concept of fairness to disclosure irrespective of the terms of the contract and so somewhat eradicated the protection that had existed for the buyer.

Some may argue otherwise, and that the effect of the decision is neutral, favouring neither buyer nor seller as it is up to the parties to agree the terms under which general disclosures are made. So, if the buyer agreed to general disclosures that is its bargain to make. Whilst the buyer may be expected to live with the consequence of its bargain does not eradicate the point that before *Infiniteland* the law intervened and included a concept of fairness. It would also fail to appreciate the previous decisions had the effect of protecting the buyer from general disclosures qualifying the warranties on the basis, in summary, that the buyer was not expected to work out matters for itself. However, in light of *Infiniteland* the buyer is expected to do just that.

Secondly, an objective test for general disclosures may require the buyer's advisers to undertake due diligence with the warranties in mind. However, warranties will typically follow from the due diligence process, [817] so the advisers will not be considering warranties when undertaking due diligence, the purpose of which is to gather information about the target company to help the buyer to decide whether or not to proceed with the proposed purchase.[818] An objective test burdens the advisers to check the general disclosures against the warranties, a process which will also have a cost consequence for the buyer. At best, a reasonable adviser may know that a matter it discovers, such as a drop in the company's profits, could potentially be a breach of warranty, but it would need to check the latest draft of the warranties in the share purchase agreement to discover that.

It is not clear if the objective test would apply absent advisers to whom documents had been supplied – would the buyer have the same objective test applied to it? There seems no reason, in theory, that an objective test would not apply where no professional adviser was advising the buyer. Take the example of the general disclosure of the data room. If the buyer had accepted such a disclosure, which, following the *Infiniteland* decision, the court will hold the buyer to, then some test would need to be applied to the buyer's consideration of documents in the data room. A test of such matters as might fairly be expected to come to the knowledge of the buyer from an examination (in the ordinary course of carrying out the due diligence exercise of the documents), may be a likely one applied by a future court. If that were the case, the same point arises as that above which is the buyer would need to check, using this example, the entire contents of the data room to see if it qualified any of the warranties.

6.9 The consequences of Infiniteland for the buyer – an example

[817] Rhian Vandrill, 'Legal due diligence in private equity transactions' [2002] ICCLR 13(8), 291.
[818] ibid. See also Christopher Davis, 'New dimensions in due diligence' [1997] ICCLR 1997, 8(7), 243.

The effect of the move to the seller-friendly position can be seen from the decision in *Triumph Controls v Primus International*, [819] where the agreement defined disclosure as "fairly and clearly disclosed in writing in or under the Disclosure Letter (with sufficient detail to identify the nature of the matter disclosed)".[820] The seller gave warranties that the target companies were not engaged in any investigation, inquiry or enforcement proceedings or were likely to be so involved; that supplied goods complied with their terms of sale; and the target companies were not in material breach of contact. The buyer alleged the seller was regularly failing to meet its contractual obligations to make timely delivery to customers of products at the required standard of quality and that put it at risk of claims. It further alleged the seller was also supplying products that did not comply with their terms of sale and held insufficient stock to meet customer orders.[821] In response, the seller said there was fair and proper disclosure in the disclosure letter and through the data room documents made available to the buyer for the due diligence exercise. The data room documents had been generally disclosed or deemed disclosed to the buyers.

O'Farrell J summarised the principles laid down in *Levison*, *Daniel Reeds*, *New Hearts* and *Infiniteland*. She said that adequate disclosure must consider the terms of the disclosure letter along with any references it contains to other sources of information. Specific disclosures made just by referring to other documents will not satisfy a requirement to fairly disclosure with sufficient detail the nature and scope of those matters. However, despite that, she went on to note the point made in *Infiniteland*:

> "…it is open to the parties to agree the form and extent of any disclosure that will be deemed to be adequate against the warranty. That could include an agreement that disclosure may be given by reference to documents other than the disclosure letter, such as by list or in a data room".[822]

But only matters directly discoverable from those documents will be treated as disclosed.[823] It can be seen from this summary of the principles of the previous cases of the distinction in the treatment of specific disclosures and general disclosures. The court decided the seller had fairly and clearly disclosed against the warranties that the buyer alleged the seller had breached.[824]

The disclosure letter provided for general disclosure of the data room. The court said that given the volume of the documentation involved that was a sensible and practical approach.[825] This was despite the information regarding the warranties alleged to have been breached being voluminous.[826] This

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[819] [2019] EWHC 565 (TCC).
[820] ibid [79].
[821] ibid [100].
[822] ibid [335], a summary of a point made in *Man Nutzfahrzeuge v Freightliner* (n 423).
[823] ibid.
[824] ibid [346].
[825] ibid [348].
[826] ibid [317].

approach shows the reality of the *Infiniteland* decision where the general disclosure of information to qualify the warranties, and so relieve the seller of liability, can be achieved through a voluminous data room being deemed disclosed to the buyer, this is the case even where the disclosure letter required disclosures to be fair and clear and disclosed with sufficient detail to identify the nature of the matter disclosed. This also shows the point made earlier in this chapter that the courts, before the decision in *Infiniteland*, did not readily recognise the distinction between general and specific disclosures. *Triumph* is an example of the effect of the loss of the sense of fairness that was generally required in the pre-*Infiniteland* cases and that general disclosures are not subject to the definition of disclosed.[827]

6.10 Conclusion

The purpose of disclosure is to exonerate the seller for a breach of warranty. This extinguishing of the seller's liability occurs to the extent of the disclosure and where the disclosure is sufficient. This chapter considered this latter point from its origins in *Levison* which demanded that even the use of the word "disclose" in an agreement required the seller to do more than simply give the buyer the means of knowledge of the warranty breach to let the buyer work out the extent of the breach itself. This requirement was reinforced in *Daniel Reeds* which decided that the words "specifically disclosed" required the seller to make some form of positive statement about the breach and the buyer is not required to work out matters of significance. In relation to a fair disclosure needing to be of detail sufficient to identify the nature and scope of the matter the Scottish Court of Session, Outer House, rejected the idea that general disclosures could adequately disclose warranty breaches. This chapter argued that the decision in *Cypher*, in which the agreement stated that disclosure needed to be proper and fair, was wrongly decided when a disclosure bundle of documents contained a document which corrected another document contained in the bundle. The effect of these cases was a position in which the law favoured the buyer as it demanded the seller inform the buyer of the breach if the seller wanted to escape liability for the breach.

The Court of Appeal in *Infiniteland* took the step of recognising and respecting the parties' bargain and to hold the buyer to the terms of the general disclosures. The effect of this was to move the law from its position of helping the buyer to helping the seller. In both *Infiniteland* and *Triumph* the courts did not override what the parties had agreed by reference to some sense of what it is fair or reasonable to expect of buyers.

General disclosures serve to benefit the seller and their use burdens the buyer with having to assess whether any of the warranties are qualified by the documents that form part of the general disclosures.

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[827] Unless, of course, the agreement or disclosure letter were to set out a standard of disclosure in relation to general disclosures.

It is a wonder that the cases in this area contain general disclosures at all. There is no advantage to a buyer in accepting them as hidden among the documentation included in the general disclosures may be something which qualifies a warranty and so leaves the buyer without any recourse. Of course, buyers may have little choice in acquisition negotiations to accept some form of general disclosures, but any that they do accept should ideally be limited to as few documents as possible and they should demand that the standard of the disclosures that applies to the specific disclosures also applies to the general ones. Even then, there remains the problem of the buyer having to work out for itself which of the warranties are qualified by the general disclosures.

Chapter 7

Evaluation

This chapter considers the state of the law as described in the previous chapters and evaluates the legal position of share sales and particularly the implications of the caveat emptor doctrine.

Section 7.1 specifies that caveat emptor causes the buyer to demand information and warranties from the seller.

In section 7.2, which briefly refers to implied terms, it is clear that the terms implied by law (only if the parties use the correct words) do not balance information asymmetry.

Warranties are mentioned in section 7.3, and it is noted that their production and negotiation is expensive for both parties.

Section 7.4 recognises there is some debate concerning the efficiency of knowledge saving clauses and transaction costs arise in bargaining around such a provision.

In section 7.6, there is consideration of inequality of bargaining power and whether the seller, as the party in possession of private information that is not required to be disclosed to the buyer, holds illegitimate power over the buyer in the contracting process. It concludes that such a claim cannot be substantiated in a share sale transaction.

Section 7.7 analyses the approach of evaluating share sales from a law and economics perspective. It considers why this perspective is appropriate to do so in section 7.8

The important concept of efficiency is considered in section 7.9 and its meaning set out in section 7.10.

What law and economics says about information asymmetry is looked at in section 7.11, particularly with respect to its effect and if the law should require sellers to disclose information to buyers.

The law's general response to information asymmetry is assessed in section 7.12.

The evaluation of share sales in light of the preceding sections is addressed in section 7.13. The approach that law and economics offers to the informational asymmetry that exists between the buyer

and seller concludes that the seller's entitlement to retain its private information is inefficient from a law and economics perspective. Therefore, on this basis, the continued existence of the caveat emptor doctrine in share sales cannot be justified. The chapter concludes at the end of section 7.13 that the law should introduce penalty default rules into share sales.

7.1 Caveat emptor dictates the parties' approach to share sales and purchases

The foregoing chapters have set out the law in respect of the key areas of share sales and have examined how the law regulates the contractual relationship between seller and buyer. The chapters have looked at caveat emptor, implied terms, warranties and representations and the buyer's knowledge of warranty breaches and disclosure.

Looking at the caveat emptor doctrine from the buyer's perspective, and their ability to obtain information from the seller, they do not have a right to be told anything by a seller. The buyer does not have sufficient information to pass judgment on what it is proposing to buy, as the seller is only required not to mislead it.[828] To some, this silence may be viewed as being morally wrong, but the law will not conclude that the seller has deceived the buyer.[829] Eisenberg has suggested that if a party knows a material fact that is relevant to the transaction, and knows that the other party does not know the fact, non-disclosure is sharp dealing or a kind of moral fraud.[830]

The caveat emptor doctrine is well established in English law. However, the origins of the doctrine do not necessarily justify that it must remain in its present form for a number of reasons. Originally, the rule provided sellers must reveal latent defects to the buyer [831] and responsibility was imposed upon the party to the transaction who knew the product being sold.[832] The doctrine was not borne of corporate transactions but had its roots in a feudal system of buying and selling goods.

The common theme of the discussion in previous chapters is the need for the buyer to obtain information about the company it is proposing to purchase. It uses warranties, and possibly, representations, as a means both to force the provision of information from the seller and to have a remedy in law if what it has been told about the company is untrue.

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[828] FC Sharp and Philip G Fox, 'Caveat Emptor' (1936) 43 Int J Ethics 212.
[829] *Wetherspoon v Van De Berg & Co* [2007] EWHC 1044 (Ch), [17] Although not expressed on efficiency grounds, in 44BC Cicero said "all things ought to be laid open, so that the buyer may be left in ignorance of nothing at all that the seller knows. According to Diogenes, the seller is bound to disclose defects in his goods so far as the law of the land requires…" Cicero, *Ethical Writings of Cicero: De Officiis; De Senectute; De Amicitia and Scipio's Dream* (translated by Andrew P Peabody, Little Brown and Company) http://files.libertyfund.org/files/542/Cicero_0041-01_EBk_v6.0.pdf.
[830] Melvin A Eisenberg, 'Disclosure in Contract Law' (2003) 91 Cal L Rev 1645, 1653.
[831] Walton H Hamilton, 'The Ancient Maxim Caveat Emptor' (1931) 40 Yale LJ 1133, 1157.
[832] ibid.

In failing to require the disclosure of information by the seller to the buyer the law does not work as well as it can for buyer and seller and their respective positions are capable of improvement. Before that is considered in detail, consideration is given to the earlier chapters regarding implied terms, warranties and representations, and the buyer's knowledge of warranty breaches.

References in sections 7.2 to 7.5 below to efficiency and transaction costs are discussed more fully later in this chapter.

7.2 Implied terms

Chapter 3, concerning implied terms, demonstrated that the terms implied by law only concern some limited aspects of the seller's ownership of the shares that there were no third party rights or charges existing over the shares. These terms, which are the minimum the buyer should expect from the seller, [833] are not automatic and are only triggered where certain enabling words (full/limited title guarantee) are used. What is said below regarding warranties and representations can also be said here, which is that whilst an assurance from the seller about what it is selling can balance information asymmetry, the implied terms are too limited in their scope to achieve that purpose.

Setting aside their failure to achieve that balancing function, something can also be said of the parties' awareness of the rule. As Riley notes, the essence of the law and economics approach to default rules is the parties' awareness of an implied term and that it should be discoverable by the parties before they contract.[834] He further notes that the fact that a rule is discoverable does not mean the parties will actually be aware of, or understand, the rule.[835] As was noted in chapter 3, the implied terms are found with legislation regarding property and several words in the LPMPA need to be defined to show that they do not only apply to real property transactions, but also to the sale of shares. Therefore, the implied terms would struggle to meet the requirement of being easily discoverable.

7.3 Warranties and representations

As already stated in chapter 1, the buyer requires warranties from the seller to both give it protection and force information from the seller. This is due to information asymmetry. It is clear that, in general terms, asymmetry can be corrected by the mechanism of voluntary exchange, for example, by the seller's willingness to provide a warranty to guarantee the quality of a product.[836] Where a seller

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[833] Charles GS Smith Company Precedents Sweet & Maxwell 28.6.2.
[834] Riley, C. A. "Designing Default Rules in Contract Law: Consent, Conventionalism, and Efficiency." Oxford Journal of Legal Studies 20, no. 3 (2000): 367, 386.
[835] ibid.
[836] Cooter and Ulen (n 62) 41.

does not provide warranties there is an inefficiently low level of quality provided.[837] Of course, in share sales, it is not that simple. The warranties need to be wide-ranging to balance information asymmetry. Where buyers bargain for extensive warranties, the information asymmetry reduces and buyers enter the transaction in a better informed state.

However, it is not just the information asymmetry that is the problem here. It is the transaction costs that arise from negotiating warranties. The part of the acquisition agreement dealing with warranties is commonly the longest part of a typical acquisition agreement.[838] It is also the part of the agreement that requires the most time for a lawyer to negotiate.[839] Again, the reason is to remedy conditions of asymmetrical information in the least-cost manner.[840] Reducing the cost of acquiring information needed by either party makes both better off.[841] Gilson notes that sellers' lawyers are instructed to negotiate ferociously to keep the warranties short, which has the effect of increased transaction costs.[842]

Whilst warranties are a necessary part of the transaction, their production and negotiation is expensive for both parties. What is clear is that information asymmetry causes the buyer's demand for warranties. How the law should respond to this is dealt with in section 7.12.

7.4 Buyer's knowledge

Knowledge saving clauses were discussed in chapter 5. In the United States, such clauses are known as pro-sandbagging clauses [843] – allowing a buyer to make a claim for a known breach of warranty.[844] Clauses which prevent such a known claim are known as anti-sandbagging clauses.[845] This terminology is adopted here.

Whitehead suggests that an anti-sandbagging rule is optimal. Buyers who desire a pro-sandbagging right will need to establish that the benefits must outweigh the costs, including the transaction costs of bargaining around the rule as well as the seller's interest in modifying contractual terms in response.[846]

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[837] Kenneth Chapman and Michael J Meurer, 'Efficient Remedies for Breach of Warranty' (1989) 52 Law & Contemp Probs 107, 117.
[838] Ronald J Gilson, 'Value Creation by Business Lawyers: Legal Skills and Asset Pricing' (1984) 94(2) Yale LJ 239.
[839] ibid.
[840] ibid.
[841] ibid 272.
[842] ibid 272.
[843] In response to the parties' submission, "What is the current state of "sandbagging" as a defence under Delaware law…?" The answer was "I am satisfied that Delaware law allows a buyer to "sandbag" a seller", Court of Chancery Delaware 2022 *Arwood v AW Site Services* WL 705841, [28] Vice Chancellor Slights.
[844] Chase (n 569).
[845] ibid 1669.
[846] Whitehead (n 569) 1106.

As Chase notes, this conclusion is based on the idea of penalty defaults which give one of the parties an incentive to contract around a default rule (see chapter 8).[847]

Chase suggests that a pro-sandbagging rule is more efficient than an anti-sandbagging rule. He submits that buyers spend significant costs on negotiating for a pro-sandbagging rule and that such a rule is therefore more efficient than an anti-sandbagging rule.[848] There would also be a reduction in costs for the judicial system to in dealing with sandbagging litigation.[849] Chase suggests that Whitehead is implying that the costs of contracting around an anti-sandbagging rule are less than the value the seller obtains as a result of the buyer revealing the possibility that it may bring a post-completion claim for a known breach of warranty.[850] Chase believes that it is costly to negotiate around an anti-sandbagging rule, [851] but does not explain why such costs do not arise in the case of negotiating around a pro-sandbagging rule. He suggests that efficiency can be better obtained by the seller providing fewer warranties.[852] However, this would then have the effect of increasing information asymmetry between buyer and seller.

He also suggests that a pro-sandbagging rule could be refined so as not to include the buyer's constructive knowledge and only allow the buyer to bring a claim for a known warranty breach where it has actual knowledge.[853] However, it is the buyer bringing a claim where it has actual knowledge of a breach that the seller will have a greater issue with and so be more likely to negotiate around a pro-sandbagging rule in that case. Arguably, a pro-sandbagging rule which instead excludes the buyer's actual knowledge of a warranty breach, but includes its constructive knowledge, would be less likely to be negotiated around.

One benefit of a pro-sandbagging rule is that it would encourage the seller to ensure the warranties that it was giving to the buyer were accurate.[854] This may give the buyer some comfort. However, if the seller agrees to a pro-sandbagging rule the seller may also seek to adjust the purchase price and other contractual terms in response.[855] This, then, increases costs as contracting around a rule such as sandbagging rule – whether a pro or anti one – may have a "push" effect on other contractual terms causing the parties to want to make adjustments to other terms.
Therefore, at least when it comes to any sandbagging rule, the rule cannot be considered in isolation. It might be thought that a default pro-sandbagging rule will force the seller to divulge more

[847] Chase (n 569) 1668.
[848] ibid.
[849] ibid 1668.
[850] ibid 1673.
[851] ibid 1673.
[852] ibid 1673.
[853] ibid 1673.
[854] ibid 1679.
[855] Whitehead (n 569) 1106.

information to the buyer especially where there is information asymmetry between the parties.[856] However, this so-called information-forcing effect of a pro-sandbagging rule does not force the production of any coherent information from the seller which is a necessary condition to a rule's efficiency.[857] Identifying the efficiency of either a pro-sandbagging or anti-sandbagging rule is difficult especially as in either case one of the parties will seek to contract around the rule, but there is no useful information signalled to the other party. In both cases, given how significant the issue may be for the parties, costs will be incurred in doing so. Perhaps the only time when negotiation around a pro-sandbagging will not occur is when the seller is giving only very limited warranties to the buyer. The seller's reason to then seek to contract around the rule will be reduced because of the limited circumstances in which the buyer can bring a claim against it.

7.5 Disclosure

If the seller can bargain for a lower standard of disclosure, which may not require the seller to disclose sufficient information for the buyer to understand the nature of the breach, then inefficiency occurs. This is because the parties have bargained for warranties, which in itself incurs transaction costs. In doing so, in part, the buyer wants the seller to specify how any of the warranties are untrue. If the seller does so to an adequate level the buyer is better informed about what it is buying. The buyer can then take appropriate action, such as requiring an indemnity, renegotiating the purchase price or perhaps even abandoning the transaction. If the seller's disclosure lacks detail then the information-forcing value of the warranty is reduced and the buyer is unable to take appropriate action. The effect is wasted transaction costs in negotiating for warranties where the cost of doing so is not balanced by the information that the disclosure should reveal.

7.6 Is there is inequality of bargaining power in share sales?

What has been described above regarding caveat emptor may lead to the conclusion that the caveat emptor doctrine causes an inequality of bargaining power between the seller and buyer, with the seller having an advantage over the buyer. However, this does not appear to be the case where the buyer is advised or sophisticated. The two parties are not duplicates of each other and will be different in numerous ways. In some of the ways in which parties may differ, in ways which harm their bargaining strength, and which in other contexts do raise concerns, do not, it will be seen, apply in any significant way to share sales. Neither party has a monopoly position. Likewise, both parties usually have alternatives to the contract they eventually make. They could sell to others and they do

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[856] Jack Podolsky, 'Sandbagging the Unsophisticated Seller: Arwood v AW Site Services, LLC' (2023) 101 Wash U L Rev Online 71, 82.
[857] Chase (n 569) 1674.

not have to buy. The terms are not standard form contracts offered on a take or leave it basis. The parties usually have good advice and are reasonably sophisticated. However, that said, an inequality of bargaining power may exist in share sales if a material information asymmetry exists at completion of the transaction. That is more likely to happen in cases where the buyer is not sophisticated or does not obtain professional advice. To explain why no bargaining power inequality exists where the buyer is sophisticated or advised, but may exist where it is not, there needs to be consideration of the meaning of inequality of bargaining power.

7.6.1 Defining inequality of bargaining power

It is very difficult to define the scope of the inequality of bargaining power doctrine. In general terms, a bargain is a transaction in which each party attempts, with the other party, to further their aims.[858]

Asymmetry of information may well create an exploitable inequality between the parties.[859] Bargaining power asymmetries can arise from access to information.[860] Atiyah considered that a lack of information may mean that a party has mistakenly overvalued the other party's performance.[861] This, he thought, weakens the persuasive force of holding the party to their consent.[862]

It is possible to easily dismiss some of the usual examples of unequal bargaining power as not applying to share sales. There is no question that some parties are "weak" when compared to the other party in a transaction.[863] Differences in bargaining power are real and can affect the ability of the 'weak' party to obtain its preferred terms in a contract with a 'strong' party.[864] Bargaining weakness may be assigned to consumers, the poor, and the uneducated, for example.[865] In theory, the members of those groups may look to the law to protect them as a result of their lack of bargaining power.[866] Alternatively, a court may employ a process-based approach to assessing bargaining power to conclude that a party had no bargaining power because they "lacked meaningful alternatives" or "had no opportunity to negotiate terms".[867] The question may be to assess whether a party lacked

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[858] Rebecca Stone, 'The Inequality of Bargaining Power' in *Research Handbook on the Philosophy of Contract Law* (Prince Saprai and Mindy Chen-Wihart eds, Edward Elgar Publishing, forthcoming) 1.
[859] Wertheimer (n 69) 487.
[860] Barnhizer Daniel D Barnhizer, 'Inequality of Bargaining Power' (2005) 76(1) U Colo L Rev 139, 171.
[861] PS Atiyah, 'Contract and Fair Exchange' (1985) 35(1) U Toronto LJ, 23.
[862] Atiyah also thought that a lack of information it weakens the argument that the exchange was a Pareto optimal transaction.
[863] Barnhizer (n 860) 150.
[864] ibid 154.
[865] ibid.
[866] ibid.
[867] ibid.

meaningful alternatives to the bargain or had no opportunity to bargain.[868] None of these apply to share sales.

Also, a share sale does not fall into the obvious example of unequal bargaining power which occurs in the case of a monopoly.[869] In that situation, one party would be agreeing to an arrangement because they have no effective choice.[870] Despite giving their consent they would be entitled to attack the result.[871] The buyer, as the weaker party, at least from an information perspective at the outset of the transaction process, does still have the option of effectively altering the power balance by simply abandoning the transaction [872] or using negotiating tactics to shift the bargaining power, [873] in addition to obtaining warranties and performing due diligence.

Also, share purchase contracts are typically negotiated or, at least, capable of being negotiated. They, therefore, are not known as adhesion, or standardised, contracts and in these contracts bargaining power is said to exist. These are contracts drawn by one party provided to the recipient which the recipient either accepts, and so contracts with the providing party, or rejects, and does not contract.[874] In such adhesion contracts the courts assume that the drafter had more power than the recipient because the drafter presented the contract on a take-it-or-leave-it basis and the recipient signed the contract.[875]

7.6.2 Unequal bargaining power and freedom of contract

Even if there were bargaining power inequality in share sales a cautionary approach should be adopted as regards remedying the inequality. There is a conflict between the inequality of bargaining power doctrine and the separate doctrine of the freedom of contract. That is the freedom that a person should be free to make contracts, [876] which is a cherished part of individual liberty.[877] As such, bargaining power asymmetries between the parties may interfere with the consensual nature of the contracting process. This means the law of contract must strike a balance between two seemingly competing, or perhaps complementing, aims.[878] That is, on one hand, to avoid restricting a person's

[868] ibid.
[869] Atiyah (n 861) 23.
[870] ibid.
[871] ibid.
[872] ibid 180.
[873] Albert Choi and George Triantis, 'The Effect of Bargaining Power on Contract Design' (2012) 98(8) Va L Rev 1665, 1676.
[874] Wilson, Nicholas S. "Freedom of Contract and Adhesion Contracts." The International and Comparative Law Quarterly 14, no. 1 (1965): 172, 174.
[875] Barnhizer (n 860) 172.
[876] Thal Spencer Nathan Thal, 'The Inequality of Bargaining Power Doctrine: The Problem of Defining Contractual Unfairness' (1988) 8(1) OJLS 17, 21.
[877] Nicholas S Wilson, 'Freedom of Contract and Adhesion Contracts' (1965) 14(1) ICLQ 172.
[878] Christopher Carr, 'Inequality of Bargaining Power' (1975) 38(4) Mod L Rev 463.

freedom to enter into such agreements as they may choose.[879] However, on the other hand, the law should be alert to ensure that an agreement is the result of a genuine exercise of that freedom.[880] The question then arises whether matters of unequal bargaining power could impact a contract's validity.[881] However, the lack of clarity as to the doctrine's meaning is a threat to the doctrine of freedom of contract.[882] Therefore, any suggestion of interfering with freedom of contract needs to occur in contracting where there is a clear inequality of bargaining power. The concept of freedom of contract might, however, be infringed by unsophisticated/unadvised buyers as some might argue that material information asymmetry by the buyer undermines their autonomy, in that they are not truly consenting to a transaction about which they know little.

7.6.3 Unequal bargaining power and formalism

As well as the interaction between unequal bargaining power and freedom of contract, there is the separate issue of whether inequality of bargaining power should be ignored to give certainty to the contract the parties have entered into.[883] This desire for certainty is typically referred to as formalism. Formalism has been described as the concept of decision-making according to rule.[884] Formalism is how rules achieve their certainty by shielding a decisionmaker from factors that the decisionmaker would otherwise take into account.[885] The argument against formalism is that contractual rights could be enforced as a result of unfair bargaining.[886] The opposite to that approach is that courts should instead be sceptical of legal rules and they can make decisions based on ideas of fairness [887] or, in other words, in consideration of the parties' bargaining power.[888] Like freedom of contract, there needs to be a clear case of inequality before any incursion into formalism takes place and there is no clear case for it in share sales.

7.6.4 At times there may be an inequality of bargaining power in share sales

A broad role of contract law is to shape the exchanges between parties and to devise principles that regulate the contractual relationship.[889]

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[879] ibid.
[880] ibid.
[881] Thal (n 876) 24.
[882] ibid 1.
[883] ibid 24.
[884] Frederick Schauer, 'Formalism' (1988) 97(4) Yale LJ 509.
[885] Frederick Schauer, 'Formalism' (1988) 97(4) Yale LJ 509, 510.
[886] Thal (n 876) 24.
[887] ibid.
[888] "The question of whether our bargain is fair does not require reference to external considerations such as economic efficiency" Marc Ramsay, 'The Buyer/Seller Asymmetry: Corrective Justice and Material Non-Disclosure' (2006) 56(1) UTLJ 115, 133.
[889] Merkin (n 117) 3.

Inequality of bargaining power is concerned that contract law should 'uphold' or promote fairness, and party autonomy (i.e. the parties consenting to the bargains they make).

Any inequality of bargaining power in favour of the seller may be balanced by the buyer including warranties in the purchase agreement. It is correct to state that asymmetry of information regarding the condition of the company exists between the parties and often persists at the time of completion of the transaction, [890] so the buyer never reaches a point of having full information. However, this is less problematic where the buyer is advised. In these cases there is no infringement of the requirement of fairness or autonomy, and so contract law's preference for caveat emptor, and its failure to compel disclosure (or to protect buyers against their ignorance) does not offend the values of fairness or autonomy.

However, a bargain made by a party which is significantly ignorant may be "unfair" or not really be consented to from a fairness or autonomy perspective. Although, typically in "low value" transactions buyers may sometimes fail to protect themselves through either or both of due diligence or warranties, then if contract law is supposed to be about ensuring fairness or party autonomy, its adherence to caveat emptor is inappropriate. Some might argue that it would be problematic and would be considered 'unfair', judged by the 'social norms' of the community in which the deal takes place. This means that in share sales it may be said say that a transaction in which the seller gains at the expense of the ignorant buyer infringes generally accepted commercial norms as between buyers and sellers.

7.6.5 If there is inequality of bargaining power how does the law respond?

Suppose inequality of bargaining power does exist generally, how does the current law respond? The legal regulations designed to equalise bargaining power include mandatory statutory rules on boilerplate clauses (typically in consumer contracts), rights of information and cancellation and mandatory warranties of liability.[891] These legal measures seek to redistribute power to achieve fairer outcomes or even prohibit altogether certain outcomes that typically arise from common situations of unequal bargaining power.[892] These measures also reflect the response that law and economics provides to information asymmetry.

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[890] Choi (Vagueness) (n 59) 861.
[891] Auer Marietta Auer, 'Bargaining with Giants and Immortals: Bargaining Power as the Core of Theorizing Inequality' (2024) 86 Law & Contemp Probs 53, 65.
[892] ibid 56.

However, the law at present struggles with the concept of inequality of bargaining power. Lord Denning had suggested that there was a general principle of inequality of bargaining power in the Court of Appeal in *Lloyds Bank v Bundy*.[893] In *Bundy*, Mr Bundy and his son's company banked with Lloyds Bank. The company's account was using an overdraft and Mr Bundy guaranteed the overdraft and charged his house to the bank as security. The company's affairs deteriorated further and the bank said it was not willing to continue to support the company unless Mr Bundy executed a further charge to the bank for an extended overdraft. The company went into receivership and the bank obtained possession of the house from Mr Bundy. Lord Denning said an inequality of bargaining power principle existed in English law:

> "…English law gives relief to one who, without independent advice, enters into a contract upon terms which are very unfair or transfers property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity, coupled with undue influences or pressures brought to bear on him by or for the benefit of the other".[894]

This proposition attracted sympathy from the other judges in *Bundy*, but they did not express an opinion on it.[895] Instead, they based their decision on undue influence.[896] Lord Denning's principle has received little judicial support.[897] A general principle of 'inequality of bargaining power' would give the courts greater freedom to interfere with the parties' contract [898] (freedom of contract). Lord Denning generally favoured allowing judges wide discretion to achieve fair results, but this comes at the expense of certainty and predictability (formalism), both of which are highly prized in the contractual context, so it is unsurprising that this approach of Lord Denning has been rejected.[899] One concern is that it is not clear that the development of a principle of inequality of bargaining power would have advantages which were not outweighed by adverse factors which would threaten the basis of the contract itself.[900] A share purchase is entered into voluntarily. It is not the same as a consumer purchase where limited choice or necessity would allow the seller to take advantage of the buyer. Neither is it a contract of adhesion or a monopoly. The inequality of bargaining power cannot be said to apply in share sales, and as already stated, should not impinge on either freedom of contract or formalism.

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[893] [1975] Q.B. 326.
[894] [1975] Q.B. 326, 339.
[895] ibid per Sir Eric Sachs [347].
[896] "Undue influence is an equitable doctrine. It renders a contract voidable where one party has abused a relationship with another party to influence the latter's assent to a contract" Moore Marcus Moore, 'Why Does Lord Denning's Lead Balloon Intrigue Us Still? The Prospects of Finding a Unifying Principle for Duress, Undue Influence and Unconscionability' (2018) 134(Apr) LQR 257, 260.
[897] Edwin Peel, *Treitel on The Law of Contract* (14th edn, Sweet & Maxwell) 529.
[898] Paul S. Davies, *JC Smith's The Law of Contract* (3rd edn, OUP 2021) 293.
[899] Paul S. Davies, *JC Smith's The Law of Contract* (3rd edn, OUP 2021) 293.
[900] LS Sealy, 'Undue Influence and Inequality of Bargaining Power' (1975) 34(1) CLJ 21, 24.

7.7 Evaluating the law governing share sales from an economic point of view

Law and economics suggests an approach to information asymmetry that is in contrast to caveat emptor. It considers that information asymmetry risks market failure [901] if there is an imbalance of information between parties to a transaction so severe that exchange is impeded.[902] The law should be used to promote incentives for efficient behaviour and disincentives for inefficient behaviour.[903] "A law and economics approach, for example, would structure contract law in a way that maximizes economic efficiency. Good contracts are ones that encourage efficient allocations of resources and the promotion of social wealth.[904]

The justification for evaluating the economic effects of the law builds on - and are strengthened by the conclusion reached in section 7.6. If concerns about autonomy, or fairness, are arguably less pressing in share sale transactions, then the most obvious relevant value is efficiency. If the parties do, by and large, look after their interests reasonably well (but at considerable cost) then the main concern is likely to be that of cost.

Before considering this further, an explanation needs to be given as to why law and economics is appropriate to address this issue.

7.8 Why law and economics?

There are synergies between contract law and law and economics which complement share sales.[905] In general terms, law and economics employs economic methods and tools to identify the human activity contract law attempts to govern.[906] Atiyah was of the view that the classical model of contract is based on an economic model.[907] It appears an appropriate choice as share acquisitions broadly reflect the general nature of contract law. That is contract law has the goal of facilitating exchange between businesses and commercial professionals [908] and economic theory contributes significantly to the function of the law.[909] It is in commerce that value is placed on things in monetary terms and to calculate costs and benefits with economic gain being the motivation for the transaction [910] and that

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[901] Cento Veljanovski, *Economic Principles of Law* (Cambridge University Press 2007), 38..
[902] Cooter and Ulen (n 62) 41.
[903] Stephen A Smith, *Contract Theory* (OUP 2004) 109.
[904] Ramsay (n 888) 123.
[905] John C Coates, 'Why Have M&A Contracts Grown? Evidence from Twenty Years of Deals' (Discussion Paper No 889, Working Paper No 333/2016).
[906] Gregory Klass, George Letsas, and Prince Saprai, *Philosophical Foundations of Contract Law*. Oxford University Press 2014. A Katz Chapter 10 page 171.
[907] Veljanovski (n 901) 109.
[908] Gregory Klass, George Letsas, and Prince Saprai, Philosophical Foundations of Contract Law (OUP 2014) 175.
[909] Wacks (n 35) 265.
[910] Klass (n 906) 176.

also echoes corporate transactions. Further, arguably, it is easier to justify applying efficiency (a central feature of economics)[911]to commercial agreements as one can realistically claim that the parties have agreed to have their affairs governed by economic criteria.[912] It is also probably safe to assume that parties enter into contracts to both risk share and invest in a jointly beneficial project [913] and that seems to replicate the intentions of the parties in share sales. It is due to some shared features between economics and contract law that law and economics appears appropriately equipped to deal with the information problem that buyers face in company acquisitions.[914] More importantly to the central issue in this chapter, law and economics commentators have considered the issue of asymmetrical information and methods to encourage information production by the more informed party, in the present case, the seller, who knows more about what is being sold than the buyer.

Further, and returning briefly to the subject, if it were assumed there was an inequality of bargaining power between the parties, the idea of a concept of fairness to dictate how the law should change may be rejected by the parties. Commercial parties are good judges of what amounts to a good contracting solution and legal rules or terms (commonly also known as 'default rules') should not be chosen on fairness grounds.[915] Parties will replace a legal term that they dislike.[916] If a legal term is unpopular it will raise contracting costs by the parties contracting around the rule. A legal rule is popular if it maximises the parties' joint gains from a transaction.[917] Legal rules will be popular with business parties if they maximize joint surplus and unpopular if they do not.[918] Surplus means a person's willingness to pay for a particular arrangement.[919] There is an error in choosing legal rules just because they are fair. Kaplow and Shavell dismiss the idea of legal rules being based on fairness as they make parties worse off.[920] Parties have the incentive to contract out of even fair rules that do not maximize surplus.[921] Perhaps, if legal rules are designed with fairness in mind then considerations of fairness may struggle to identify and limit the extent of the legal rule and so increase transaction costs which the parties, especially in share sales, are keen to avoid incurring. Any theory of fairness requires a justification for viewing certain acts (but not others) as unfair [922] which is difficult when the subject matter is complex.[923] A legal rule that required, for example, the seller to disclose information to the buyer based on fairness may risk uncertainty as to how far the law should go to resolve the

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[911] Discussed at section 6.9 of this chapter.
[912] Klass (n 906)176.
[913] Posner (n 913) 832.
[914] Other theories that were rejected from consideration were consent, deontology, corrective justice and virtue theory. Each was described in Klass (n 906) chapter 10.
[915] Alan Schwartz and Robert E Scott, 'Contract Theory and the Limits of Contract Law' (2003) 113(3) Yale LJ 541, 596.
[916] ibid.
[917] ibid.
[918] ibid.
[919] Zachary Liscow, 'Is Efficiency Biased?' (2018) 85 U Chi L Rev 1649, 1658.
[920] Louis Kaplow and Steven Shavell, 'Fairness versus Welfare' Harvard L Rev 114, no. 4 (2001) 961, 966.
[921] Schwartz (n 915) 596.
[922] Richard Craswell, 'Kaplow and Shavell on the Substance of Fairness' (2003) 32(1) J Legal Stud 245, 271.
[923] Ibid.

information asymmetry and may result in excessive costs being incurred by either or both of the parties.

If there were substantial issues about fairness or party autonomy, then there might be greater concerns about judging the law economically or focusing on making improvements to the law guided by economic thinking. There would be concerns that on making the pie bigger, when some parties may receive significantly unequal slices of that pie that look unfair, or one party does not have any clear understanding of what slice they will receive. However, section 7.6 has dismissed these concerns. So given that, we can more squarely focus on economic analysis, unconcerned that we are ignoring, or even exacerbating fairness or autonomy concerns.

7.9 The importance of efficiency

Efficiency is a central tenet of default rules in law and economics, although the focus on efficiency to the exclusion of other normative considerations has been the subject of some criticism.[924] There is a broad range of descriptions as to the meaning of efficiency making a clear and succinct definition challenging to state. It is the standard by which rules and laws are measured by economists but does not bear the same meaning as the word in everyday language. Efficiency is achieved when more output is gained from use of the same resources.[925] The normative approach argues that decisions should be made based on efficiency criteria and seeks to justify an economic approach to legal decision-making.[926]

In evaluating efficiency, the actions that a legal rule requires, or does not require, need to be efficient.[927] For example, a term implied in a contract for the sale of goods that delivery must happen within business hours could be justified on the ground that delivery outside of business hours normally involves additional costs and so is inefficient.[928] Another way to look at efficiency is the legal rules reflect what the parties would have specified had they been able to create their contract without incurring costs. So, again, using the delivery in business hours example, that can be justified on the basis that is what the parties would have included in their contract had they negotiated it.[929] It could also be said that the law gives effect to the genuine, unstated intentions of the parties so that is

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[924] See: Avery Wiener Katz, 'Positivism and the Separation of Law and Economics' (1996) 94(7) Mich L Rev 2229.
[925] Ratnapala (n 76) 305.
[926] Symposium on Efficiency as a Legal Concern Introduction, Hofstra Law Review: (1980) Vol. 8: Iss. 3, Article 1, page 1. See a heated exchange on the subject of efficiency between Richard A. Posner. A reply to some recent criticisms of the efficiency theory of the common law Hofstra Law Review, 775 and Richard S. Markovits, 'Legal Analysis and the Economic Analysis of Allocative Efficiency: A Response to Professor Posner's Reply' (1983) 11 Hofstra L Rev 667 in which Markovits refers to Posner's reply as so inadequate that a response is required. His view is that there are good noneconomic reasons for rejecting the hypothesis that efficiency provides a system for the determination of common law duties and rights.
[927] Smith (n 903)114.
[928] ibid.
[929] ibid.

what the law does when the law imposes terms.[930] Parties are more likely to enter contracts if the terms imposed by law satisfy one of these criteria because it is one they would have agreed to themselves.[931] It is already clear that in negotiated share sales, the buyer and seller agree on warranties in the purchase agreement. Any suggested change to the law would in some way need to reflect the way the parties contract.

7.10 The meaning of efficiency

As for its meaning, Posner defines efficiency as: "exploiting economic resources in such a way that value — human satisfaction as measured by aggregate willingness to pay for goods and services — is maximized".[932] Where a particular matter can be avoided by the party at the lowest cost that is considered to be efficient. This is because doing so has the effect of maximising the wealth of the parties.[933] To define the term more fully it can be said that:

> "…economic efficiency is a term of art that follows the definitions of Pareto, Kaldor, and Hicks, who identified an allocation of resources as efficient if and only if there is no way to rearrange resources among the actors in a way that makes at least one of them better off while making none worse off".[934]

7.10.1 Pareto efficiency

To expand upon this, Pareto efficiency [935] occurs when the welfare of an individual cannot be improved without reducing the welfare of others.[936] Wacks provides an example. If X is willing to sell something for £100, but Y thinks it is worth £200 and pays X £150 then that would be considered Pareto efficient as both parties are better off and neither is worse off.[937] However, this is not realistic and in the real world someone will be worse off [938] and Pareto efficiency is somewhat unhelpful as making no one worse off is impossible due to the large number of people involved.[939] There are very few, if indeed any, legal rules which meet the Pareto standard.[940] There will always be those who prefer that a particular rule does not exist.[941]

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[930] ibid.
[931] ibid.
[932] Stephen E Margolis, 'Two Definitions of Efficiency in Law and Economics' (1987) 16(2) J Legal Stud 471 footnote 1 citing Richard A. Posner, *Economic Analysis of Law* (2nd edn).
[933] Antony W Dnes, *Teaching the Essentials of Law and Economics* (Elgar 2020).
[934] "Efficiency does not tell us whether we should wish to pursue material gain, private profit, protection of the environment, social justice, or any other substantive goal. It merely tells us how best to pursue the goals we have, or more precisely, how to pursue them in such a way that performs best on a cost–benefit test." Klass (n 906) 173/174.
[935] It is named after Vilfredo Pareto in his work *Manuel d'Economie Politique* 1909.
[936] Riley (n834) 382.
[937] Wacks (n 35) 267.
[938] ibid.
[939] Liscow (n 919) 1660.
[940] Stephen A Smith, *Contract Theory* (OUP 2004) 111.
[941] ibid.

Therefore, Pareto efficiency is considered restrictive because the welfare of one person cannot be offset by another and, from a default rule design perspective at least, this restriction means that it is unlikely that default rules can be created using it.[942] There is also the concept of Pareto optimality which is the greatest level of efficiency. This occurs when no further improvement can be made without making at least one person worse off. [943] A minor policy change will likely harm the interest of at least one person.[944]

7.10.2 Kaldor-Hicks efficiency

This difficulty is addressed with the concept of Pareto improvement, also known as Kaldor-Hicks efficiency, [945] which is more realistic. It is an attempt to defeat the restriction of the Pareto criterion that only those changes are recommended in which at least one person is made better off and no one is made worse off.[946] The appeal of Kaldor-Hicks efficiency is that it delivers policy recommendations without the very stringent requirement that no one be made worse off. Indeed, Kaldor-Hicks efficiency is also sometimes called "potential Pareto efficiency" because it is viewed as identifying changes that increase overall surplus and thus have the "potential" to be Pareto efficient after transfers from those who gain from the policy change to those who lose from it.[947]

Kaldor-Hicks efficiency is hypothetical.[948] It does not require that every person who is adversely affected must be compensated, but rather the gains made by the winners are sufficient to compensate the losers.[949] The failure to require compensation makes some individuals worse off and so does not satisfy the requirements of Pareto superiority.[950]

Kaldor-Hicks only requires that winners could compensate losers, not that they must do so.[951] This form of efficiency occurs when those who gain can compensate those who have lost and still be better off.[952] Kaldor Hicks efficiency allows changes in which there are both gainers and losers but requires that the gainers gain more than the losers lose.[953] In other words: the cost-benefit test (another name

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[942] Riley (n834) 382.
[943] Ratnapala (n 76) 306.
[944] Veljanovski (n 901) 32 .
[945] Cooter and Ulen (n 62) 42.
[946] ibid.
[947] Liscow (n 919).
[948] Veljanovski (n 901) 39.
[949] Ratnapala (n 76) 306; Jules L Coleman, 'Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law' (1980) 68(2) Cal L Rev 221, 239.
[950] Jules L Coleman, 'Efficiency, Utility, and Wealth Maximization' (1980) 8 Hofstra L Rev 509, 513.
[951] Jules L Coleman, 'The Economic Analysis of Law' (1982) 24 Nomos 83,84.
[952] Veljanovski (n 901) 33.
[953] Cooter and Ulen (n 62) 42.

for Kaldor-Hicks efficiency) of the gains exceed the losses no matter to whom they go.[954] In cost-benefit analysis, a project is undertaken when its benefits exceed its costs, which implies that the gainers could compensate the losers. Cost-benefit analysis tries to take into account both the private and social costs and benefits of the action being contemplated.[955] This maximises welfare [956] which is achieved by default rules providing terms which the parties would themselves choose.[957] In other words, a rule is Kaldor-Hicks efficient if the gains made by those benefitting from the rule are greater than the losses incurred by those the rule may harm.[958] The Kaldor-Hicks test is satisfied when a change in the allocation of resources compensates the losers, [959] in theory.[960] In summary, efficiency definitions range from value maximisation to the "least cost avoider", to making a party better off without making the other party worse off. There is the inability of Pareto efficiency to be workable and the subsequent more realistic Pareto improvement definition.

7.10.3 What does a Pareto efficient and a Kaldor-Hicks efficient change look like?

A Pareto efficient change is normatively desirable because there is no justifiable objection to contract law introducing a rule that benefits someone and harms no one. If it were possible to change the law in such a way that would benefit some parties and harm no one, that would demonstrate disapproval of the current law and clearly show how it could be improved.

To explain the operation of both concepts in a non-contractual scenario. Suppose a factory proposes to move from town A to town B. Those in town B will gain as some may be employed by the new factory and there would be increased local retail activity and opportunity for housebuilders, for example. However, some of the residents of town A may become unemployed and there may be a reduction both in the town's retail activity [961] and property values. Applying Pareto efficiency to this decision, the gainers would have to pay the losers whatever it would take for them to be indifferent between the factory staying in town A and moving to town B. If, instead, the potential Pareto criterion were applied to this decision, the gainers would have to gain more than the losers lose but no compensation would actually occur.[962]

As stated, a Kaldor-Hicks rule may also be a potentially Pareto superior one. In numerous areas of policy making, that potential cannot be realised. Those who lose out as a result, for example, of the

[954] Veljanovski (n 901) 33.
[955] Cooter and Ulen (n 62) 42.
[956] Riley (n 834) 382.
[957] ibid.
[958] Smith (n 903) 110.
[959] Wacks (n 35) 268.
[960] Ratnapala (n 76) 306.
[961] Cooter and Ulen (n 62) 42.
[962] ibid.

introduction of a factory emitting smoke in their town (causing, for example, injury to buildings and vegetation, expenses for washing clothes and cleaning) [963] cannot force the factory, which gains from that situation, to share its gains with the town's residents. However, in contractual relationships the position is different. If the law introduces a Kaldor-Hicks efficient rule that will apply to the parties' relationship, the party that loses out due to the law imposing a rule can refuse to contract unless the party which benefits from the rule compensates them. This can be achieved in numerous ways such as an adjustment to contractual terms, such as the price for the 'burden' that the contract law rule imposes on the affected party. Winners and losers from changes to the law governing smoke-emitting factories cannot engage in this sort of 'private redistribution' of the gains from the Kaldor-Hicks policy, but parties to a voluntary contractual relationship can.

However, even if such private redistribution is not possible in each transaction that takes place there may be deferred gain for the party which is subject to the rule. This would occur if the affected party were, at some point, to be in the opposite position. If a legal rule, say for the disclosure of information were placed on the seller, the seller may 'lose' and the buyer may 'gain'. If the seller is later a buyer then it would gain later from the imposition of the rule. There may therefore be a balancing effect, so that losers may, over time, sometimes gain from the law's adoption of Kaldor-Hicks rules.

Of the types of efficiency concepts, the hypothetical Kaldor-Hicks is the more realistic and achievable and efficiency is attained when the default rule reflects the parties' choice of default. Kaldor-Hicks efficiency need not be Pareto superior or Pareto optimal but it may be either or both.[964] The difference between Pareto superiority and Kaldor-Hicks efficiency is the difference between actual and hypothetical compensation. If compensation were paid to losers, a Kaldor-Hicks efficient move would become a Pareto superior one.[965]

Efficiency maximizes the "welfare" of all participants because each person participates in the process because they think they get more that way than any other way.[966] However, there are limitations, and the efficiency concept is unable to neutralise the existing values of the parties, their respective wealth, capacity, and entitlement.[967]

7.11 What does law and economics say about information asymmetry?

7.11.1 Asymmetry of information risks market failure

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[963] A C Pigou, *The Economics of Welfare* (4th edn, Macmillan 1932) 184.
[964] Coleman (Efficiency, Exchange and Auction) (n 949) 240.
[965] Coleman (Critical Review) (n 94) 651.
[966] Whitehead (n 569) 178.
[967] ibid.

It has already been said that the seller of shares in a company knows more about what is being sold than the buyer. Generally, when a seller knows more about what is being sold than the buyer (or vice versa) information is said to be distributed asymmetrically in the market.[968] Severe asymmetries can disrupt markets so much that a social optimum cannot be achieved.[969] Asymmetries in information can impede the formation of contracts and, in extreme cases, threaten the existence of viable markets.[970] Information imperfections may mean that it is possible to reject the inference that an exchange is welfare enhancing.[971] In real-world settings, contracts are bound to be incomplete, and transactors may have the ability and incentive to behave opportunistically by taking advantage of unspecified elements in a contract.[972] In a share sale, the asymmetry of information is only balanced by the giving of warranties by the seller, which it does voluntarily. It therefore takes a knowing buyer to seek to correct the information asymmetry through warranties. Information asymmetry and uncertainty in share sales strongly affect the wealth generated by both buyer and seller.[973]

7.11.2 Information asymmetry puts buyers at risk of overpaying

As explained in chapter 1 (introduction), the purchase price for the shares is decided upon early by the buyer and seller and the sale process proceeds to due diligence and then the drafting of the share purchase agreement. Then, as the due diligence proceeds, matters may come to light which may impact the agreed price. However, if due diligence is either limited, or not undertaken at all, there is no guarantee that the price will reflect the seller's private information about the state of the company.[974] That private information, as the seller is better informed about the liability than the buyer, may reveal that the agreed purchase price should be less.[975] However, it has been suggested that buyers discount the price in share sales because less information puts the buyer at risk of overpaying.[976] The seller has an incentive not to disclose material negative information to the buyer since disclosure will depress the purchase price.[977] At the same time, the seller is also incentivised to reveal positive information that will increase the price. This creates an imbalance. Generally, when the seller does not disclose, the buyer cannot tell whether such nondisclosure is due to there being no liability or due to the seller's strategic behaviour.[978] The buyer may become reluctant to purchase or

[968] Cooter and Ulen (n 62) 41.
[969] ibid.
[970] ibid.
[971] Michael Trebilcock, *The Limits of Freedom of Contract* (Harvard University Press, 1997), 17.
[972] Janet Kiholm Smith and Richard L Smith, 'Contract Law, Mutual Mistake, and Incentives to Produce and Disclose Information' (1990) 19(2) J Legal Stud 467, 471.
[973] Luypaert (n 60).
[974] Albert H Choi, 'Successor Liability and Asymmetric Information' (2007) 9(2) Am L & Econ Rev 408, 410.
[975] ibid.
[976] Laurence Capron and Jung-Chin Shen, 'Acquisitions of Private vs Public Firms: Private Information, Target Selection, and Acquirer Returns' (2007) 28(9) Strat Mgmt J 891, 896.
[977] Choi (n 923).
[978] ibid.

overly cautious about doing so which will result in increased costs for both parties as the buyer may become excessively diligent. A proposed transaction is likely to be mutually beneficial if the parties agreed to it, voluntarily on good information[979] as the seller will maximise its price and the transaction is less risky for the buyer.

7.11.3 Should the law require sellers to disclose their superior information to buyers?

What needs to be considered is, to paraphrase, Kull, how the law should regard contracts formed between parties who possess different information relating to the subject matter of the transaction.[980] This is the "pervasive problem of asymmetric information" [981] which is "a common factual phenomenon".[982] Kull has succinctly expressed how law and economics has responded to this "pervasive problem":

> "Law-and-economics commentators have attempted to identify the circumstances in which a legal rule compelling the disclosure of information would induce more efficient behaviour by contracting parties".[983]

Law and economics literature involving non-disclosure is stimulated by a concern for economic efficiency.[984] Certain information conditions need to be met before a particular exchange has Pareto superior qualities.[985] Pareto efficiency assumes both parties to a transaction are made better off by it. Trebilcock also believes that if an objective of efficiency is to implement legal rules which enable assets to move to their most productive uses with minimal transaction costs then material information should be disclosed by the party in possession of it.[986] The question that arises from this is whether a disclosure requirement reduces the incentive for a party to create the information. Information might be worth acquiring for the seller regardless of their intention to sell.[987] Scheppele believes that a certain amount of information is required so that a party can understand the implications and establish if that party's aims are met.[988] In other words, there needs to be a minimum amount of information which would be required to achieve that aim.

However, if there is an inaccurate evaluation of what that party will obtain from the transaction then there is less certainty that both parties will be better off.[989] Information asymmetry is one factor that

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[979] Smith (n 903) 113.
[980] Andrew Kull, 'Unilateral Mistake: The Baseball Card Case' (1992) 70(1) Wash U LQ 57, 57..
[981] ibid 58.
[982] Christopher T Wonnell, 'The Structure of a General Theory of Nondisclosure' (1991) 41(2) Case W Res L Rev 329, 329.
[983] Kull (n 929) 60.
[984] Wonnell (n 982).
[985] Trebilcock (n 971) 102.
[986] ibid 112.
[987] ibid.
[988] Kim Lane Scheppele, *Legal Secrets: Equality and Efficiency in the Common Law* (University of Chicago Press) 25.
[989] Trebilcock (n 920) 103.

could cause such an inaccurate evaluation. Buyers may make incorrect decisions based on incomplete information whilst the seller could have taken corrective action if still in possession of the property.[990]

However, making an informed choice is very difficult to define and no choices are made with perfect information.[991] The question, therefore, is how much information is sufficient to make a sensible choice. It is true to say that if a seller is required to disclose information it would be wasteful to require sellers to disclose every minor issue that exists.[992] Trebilcock believes that if an objective of efficiency is to implement legal rules which enable assets to move to their most productive uses with minimal transaction costs then material information should be disclosed by the party in possession of it.[993] The question that arises from this is whether a disclosure requirement reduces the incentive for a party to create the information. Even if the answer is in the affirmative, much of the information relating to companies will have been generated to either meet legal obligations which require its generation or concern information accumulated over the course of the company's trading. Even if that were not the case, then the information might be worth acquiring for the seller regardless of their intention to sell.[994]

If the law is to require disclosure, imposing a duty upon the party in possession of the information deprives them of a private advantage which the information provides to them.[995] Kull suggests that legal rules based on law and economics seek to reverse the ordinary bargaining situation which is for a party to retain the privilege of disclosing or withholding information as their assessment of self-interest might dictate.[996] Others argue that if a party is required to disclose there is a risk of the loss of the anticipated bargain.[997] Therefore, a duty to disclose may be requiring that person to make public their property.[998] The ability for a party to profit from their superior information is lost if the information must be shared.[999] If the better informed party is not permitted to enjoy their informational advantage the incentive to create private information will be lost.[1000] This is less relevant in share sales as the seller already has the information. When the information would be produced in any event, efficiency requires the knowledge is provided to those who may, without it, make disastrous decisions.[1001] It is virtually costless for a party who possesses the information to

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[990] Wonnell (n 982)383.
[991] Trebilcock (n 971) 20.
[992] Trebilcock (n 971) 107.
[993] ibid.
[994] ibid 112.
[995] Anthony T Kronman, 'Mistake, Disclosure, Information, and the Law of Contracts' (1978) 7 J Legal Stud 1, 13, 15.
[996] Kull (n 980) 61.
[997] Wonnell (n 982) 336.
[998] Kronman(n 995) 15.
[999] Kull (n 980) 78.
[1000] ibid.
[1001] Scheppele (n 988) 41.

disclose it to other party,[1002] although a seller in share sales will bear some cost due to the volume of information that exists.

Kull's concern is that a requirement to disclose interferes with an intensely personal form of property.[1003] Even if that is true, a law that instead of imposing a blanket requirement of disclosure imposes specific rules which the parties can contract around gives the opportunity for the party on whom the rule is imposed the freedom to decline to contract on those terms, therefore preserving the property right if that is important to them. In the share sale context, that would be property, that is both confidential and which, if the recipient has ulterior motives, could exploit for some other purpose than the intention for which it was provided. For example, a competitor pretending to be interested in purchasing shares may really instead be going on a "fishing expedition" for information about the seller's business.[1004]

Kull rejects the idea of requiring the seller to make disclosure as it would be expensive to administer.[1005] He believes that there is a cost to the legal system of determining when material information has been improperly withheld and that cost is likely to be excessive.[1006] However, in making this rejection on these grounds, Kull fails to address the inefficiency of the buyer's search for information, and his suggestion is that there would be costs for the courts to determine disputes over whether information that should have been disclosed has not in fact been disclosed. This implies that many cases of a failure by a party to disclose would result in dispute. Kull does not consider the effect of a broad rule requiring disclosure would perhaps result in over-disclosure which could then reduce the likelihood of disputes. It also ignores the point that the existence of the right legal rule would limit the possibility of disputes. As Trebilcock says more broadly as to Kull's rejection of disclosure on Kull's suggested administration grounds, "administrative costs cannot be absolutely determinative of contract rules, or we would simply ban all actions for breach of contract" [1007] does somewhat overstate the issue. Clearly, a ban on such actions would not likely be the result, but it is right to state that administrative costs should not be the basis of rejection of the imposition of a disclosure rule.

Good information, Eisenberg considers, is a strong efficiency reason for requiring disclosure.[1008] The principle that bargains should be enforced according to their terms rests most securely on a foundation

[1002] Wonnell (n 982) 337.
[1003] Kull (n 980) 79.
[1004] Stilton (n 125) part 1, chapter 2, 2-06.
[1005] Kull (n 980) 80.
[1006] ibid.
[1007] Trebilcock (n 971) 115.
[1008] Eisenberg (n 830) 1654.

of complete information.[1009] In other words, transactions concluding where the buyer has been provided with quality information do not threaten formalism. If a party is required to disclose, it may remove the need for a party to search for information that the other party already possesses and avoids duplicate searches to generate the same information.[1010] If the buyer withdraws from a transaction after having undertaken due diligence, a subsequent potential buyer is going to go through the same exercise as the initial buyer. It is wasteful for a subsequent party to invest in generating information about an asset where information is already possessed by the initial party and can be transmitted at a trivial marginal social cost.[1011] The same must also be said where, instead of there being a subsequent buyer, there is the initial prospective buyer and the seller. There too it is wasteful for the buyer to go through the process of asking for information already possessed by the seller. If the buyer can obtain good quality information from the seller, then there is value to it because the buyer feels confident no "material adverse event" hazardous to the value of the company has occurred.[1012]

One way of looking at a party's information is to consider it as being private information in need of converting into public information. That private information impedes bargaining. This is because much of it must be converted into public information before being able to provide reasonable terms for cooperation between the parties.[1013] In general, bargaining is costly when it requires converting a lot of private information into public information.[1014] For example, negotiations for the sale of a house involve issues of finance, timing, quality, and price. The seller knows a lot more about the house's hidden defects than the buyer.[1015] The buyer knows a lot more about their own ability to obtain financing than the seller.[1016] During negotiations, each party attempts to extract these facts from the other. To a degree, the parties may want to divulge some information.[1017] However, they may be reluctant to divulge all of the information.[1018] Each party's share of the surplus that a transaction generates depends, in part, on their keeping some information private, but finalising the transaction requires making some information public. The balancing of these conflicting pulls is difficult and potentially costly.[1019]

7.11.4 Casually acquired and deliberately acquired information

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[1009] ibid.
[1010] ibid.
[1011] ibid.
[1012] Ephraim Kwashie Thompson and Changki Kim, 'Information Asymmetry, Time Until Deal Completion and Post-M&A Performance' (2020) Journal of Derivatives and Quantitative Studies 123, 125.
[1013] ibid 89.
[1014] ibid.
[1015] ibid.
[1016] ibid.
[1017] ibid.
[1018] ibid.
[1019] ibid.

It has been suggested that the law should require disclosure of material facts except in cases where disclosure would involve significant efficiency costs.[1020] One concern, however, is that a disclosure requirement might reduce the incentive to produce information. This means that a seller would not seek to obtain information if it was required to disclose information to the buyer. However, this appears less relevant in share sales when the information is already likely to exist. Kronman suggests information should be required to be disclosed only if it was acquired causally.[1021]

Kronman notes that those who supply information may have obtained it as result of a deliberate search. In other cases, their information was acquired casually. Use of the term 'deliberately acquired information' means the acquisition of information which involves costs which would not have been incurred except that for the purposes of its production.[1022] These include direct search costs.[1023] If the costs would have been incurred anyway the information will have been casually acquired.[1024] In this context, the suggestion is that "information is acquired casually if the costs that were incurred to engage in the activity that produced the information were not incurred for the purpose of acquiring information".[1025] In other words, information is acquired casually if it is acquired in the course of an activity engaged in for purposes other than acquiring the information.[1026] A party who acquires information casually does not incur costs in acquiring the information. Therefore, requiring a party to disclose the information is not likely to reduce the production of information.[1027] However, disclosure should not be required if the relevant information was acquired as the result of a party's deliberate and costly search for information.[1028] The crux of Kronman's theory is that exchanging without a requirement to disclose incentivises persons to acquire valuable information.[1029] A person will not incur the cost of obtaining information if they are required to disclose, without payment, that information to the other party to an exchange.[1030]

Trebilcock takes a different view to Kronman. He considers that sellers should disclose material facts whether deliberately or casually acquired.[1031] 'Material', in this context Trebilcock defines as facts the ignorance of which is likely to substantially impair the expected valuation of the transaction to the buyer.[1032] This definition appears acceptable, but without the law specifying default rules which set

[1020] Eisenberg (n 830) 1655.
[1021] Kronman(n 995) 370.
[1022] Kronman(n 995) 13.
[1023] ibid.
[1024] ibid.
[1025] Eisenberg (n 830) 1656.
[1026] ibid.
[1027] ibid.
[1028] ibid.
[1029] Wonnell (n 982) 340.
[1030] ibid.
[1031] Trebilcock (n 971) 114.
[1032] ibid.

out what this means for particular transactions, a buyer will still be uncertain what information has not been provided to it. He does, however, consider that disclosure can be achieved through the use of implied warranties.[1033] The subjective nature of Trebilcock's definition risks the seller omitting to disclose something of importance. On the other hand, if the undisclosed matter is fairly insignificant the exchange may still be beneficial to both parties, or only slightly detrimental to one of the parties [1034] which means it will be efficient from a Kaldor-Hicks perspective in that the transaction provides benefits to one party that are greater than the loss incurred by the other party.[1035]

Problematically, Trebilcock also qualifies the disclosure obligation where the requirement to disclose discourages the acquisition of information.[1036] This qualification is vague. What information, if required to be disclosed, discourages sellers generally from acquiring the information in the first place because they know there will be a requirement to disclose it? Further, a qualification such as this would leave buyers wondering whether the seller has invoked it. In other words, the buyer will not know if the qualification has been applied. A requirement to disclose material information with a qualification of this nature also means that the information not disclosed could be material and so this approach undermines a duty to disclose. The buyer may be confident that the seller has disclosed all material information, but it does not know if material information falling within the qualification has not been disclosed.

When it comes to buyers, should Trebilcock's questionable qualification apply to them too? On this point, his qualification is more justifiable. Where a buyer has incurred costs to acquire information and where the information, if required to be disclosed to the seller, would generally discourage future buyers from acquiring information, the buyer would simply be providing the seller with information that the seller could use and for which the buyer gains no benefit.

Returning to Kronman, he suggests that where the information in question is market information a rule permitting nondisclosure of market information is sensible whether the party possessing the information is a buyer or seller.[1037] This is because a disclosure requirement, in his view, reduces the usefulness of the information.[1038] Conversely, where the subject matter is not market information but, instead, the sale of goods, Kronman argues that a duty to disclose latent defects concerning those goods is unlikely to cause the seller to avoid investing in obtaining knowledge of what is being sold.[1039] Kronman gives an example of a party that knows a company is suffering losses and sells

[1033] ibid.
[1034] Wonnell (n 982) 336.
[1035] ibid fn 41.
[1036] Trebilcock (n 971) 114.
[1037] Kronman (n 995) 26.
[1038] ibid 28.
[1039] ibid.

shares in the company to a buyer ignorant of the losses.[1040] This, claims Kronman, is a form of market information where non-disclosure is permitted.[1041] However, it is difficult to accept Kronman's distinction where information concerning goods has a disclosure requirement but information about the market does not. If Kronman is arguing for disclosure in one case, but not the other, it is hard to see the justification as to why the buyer of shares is not in the same place as the buyer of goods, or arguably, in far worse position given the complexity of share sales. In both cases, there is information concerning the state of what is being acquired (in the case of shares the state of the company as the underlying asset) that has a value to the buyer. The effect, of course, on the buyer of shares is the risk of paying more than the true value of the shares.

Posner makes a similar argument to Kronman. Posner, believes Scheppele, assumes that companies want to conceal information that is the result of substantial investment,[1042] which means that where that is not the case the case for its protection is weakened.[1043] Scheppele suggests that Posner would claim that there is more economic rationale in companies being able to keep their information private. He believes, notes Scheppele, that companies invest in the production of information though research and development and improved ways of performing tasks.[1044] However, this justification for the withholding of information does not relate to information produced in contemplation of a transaction, but rather as a result of the typical operations of running a company. Arguably, therefore, the justification in keeping the information secret in that context is less persuasive.

7.11.5 Information asymmetry – different approaches for buyer and seller

If Kronman's view is correct, then it results in different approaches for buyer and seller. A seller is likely to already be in possession of information about the company either as part of running a business or as required to do so by law. It will, for example, hold contracts with third-party suppliers and customers and those with its employees as part of running a business and will be required to produce annual accounts and maintain a register of the company's members by law. There should be little that the seller would be required to incur costs to produce for the sole purpose of providing to the buyer for the transaction itself. By contrast, the buyer will have to incur the costs of acquiring the information itself *solely* for the purpose of the transaction. Therefore, the seller's information will be casually acquired, and required to be disclosed for efficiency reasons, and the buyer's information is deliberately acquired, and so not required to be disclosed. However, what about information that the buyer knows and the seller does not? For example, what happens if the buyer has information that a

[1040] ibid.
[1041] ibid.
[1042] Scheppele (n 988) 39.
[1043] ibid.
[1044] ibid 40.

forthcoming change in the law is likely to significantly increase the value of the company. Should the buyer be required to disclose that information to the seller? Kronman and Posner believe that sellers acquire information casually, but buyers acquire information deliberately, [1045] so, on their reasoning, the answer is no.

The buyer wants to avoid making an acquisition that does not meet the expectations that made the purchase price acceptable to it in the first place.[1046] Instead, for the seller, it can sell its property and acquire its market value from the buyer. However, if the buyer does not disclose information to the seller the seller does not obtain a benefit it might otherwise have acquired, [1047] but did not expect to acquire. A buyer who cannot use its "secrets" will be unlikely to offer the information for the benefit of the seller.[1048] There is no incentive for buyers to acquire information and disclose it as they "will not be able to capture any increase in value due to information because sellers, being the holders of property rights, naturally enjoy the option of not selling and instead using valuable information themselves".[1049] Trebilcock considers that buyers would have no duty to disclose because, if there is a desire for buyers to move resources to more productive uses then there is a desire to for them to both acquire information and utilise it in transactions.[1050] The same cannot be said of buyers who fall victim to the secrets of sellers. A buyer will suffer costs. Buyers do not receive the assets they expect to gain from the contract.[1051] A seller, if they sell, fails to get more.[1052] Therefore, a seller, in a situation where a buyer is required to disclose, gets more than the seller expected. In a situation where the seller is required to disclose, the buyer gets information that may, or may not, meet its expectations. The difference between buyers and sellers is their respective expectations. Shavell believes that sellers may also have an incentive to acquire information even if they are required to disclose it because they will be able to capture an increase in value due to information.[1053] However, the buyer will be primarily interested in information that may reduce the company's value.

However, it is important to note that the buyer also sometimes acts like a seller, such as when the buyer has an obligation to pay when the obligation to do so becomes due.[1054] If a buyer, for example, fails to disclose their creditworthiness before completion they are comparable to the seller who does not disclose material defects about what they are selling.[1055] In a share sale, the buyer may have a pre-contractual knowledge that the deferred payment it is to make to the seller it cannot afford, in fact, to

[1045] Wonnell (n 982) 346.
[1046] Ramsay (n 888) 129.
[1047] Ramsay (n 888) 129.
[1048] ibid 128.
[1049] Steven Shavell, 'Acquisition and Disclosure of Information Prior to Sale' (1994) 25(1) RAND J Econ 20, 21.
[1050] Trebilcock (n 971) 114.
[1051] Ramsay (n 888) 129.
[1052] ibid 129.
[1053] Shavell (n 1049) 21.
[1054] Wonnell (n 982) 343.
[1055] ibid 344.

make. This they would not be required to disclose. The more material the buyer's non-disclosure, the greater the inefficiency that arises due to the failure to merge the information with the resource.[1056] However, buyer non-disclosure helps to assist the process of moving the resource to its highest and best use.[1057]

It is also important that information which changes circumstances is made available as soon as possible by those who have control over it.[1058] This is a relevant point in share sales where costs can rise quickly in the information-seeking and analysis process that due diligence entails. Knowing of a significant change as soon as it occurs limits the incurrence of further costs if the buyer wishes to halt the due diligence process due to the new information provided.

The above discussion regarding information asymmetry and whether the seller should disclose information to the buyer has shown that efficiency demands the seller disclose material information about the company to the buyer.

7.12 Generally, how can the law respond to correct asymmetry of information?

In cases of asymmetry of information the asymmetry "can be corrected by a seller's willingness to provide a warranty to guarantee the quality of a product".[1059] Whilst that applies to goods, the same applies to the sale of shares and, as already known, warranties are widely used in share sales. The use of warranties given by the seller to the buyer – is one of the solutions to the problem described by Akerlof [1060] that buyers who cannot properly assess what they propose to purchase will pay less for it.[1061] Whilst some possible means of response to asymmetry of information require the adoption of specific contractual terms, some do not.[1062] However, all responses have a common economic rationale which is to provide information to facilitate exchange by reducing informational asymmetry.[1063] Government intervention can correct informational asymmetries and induce more nearly optimal exchange.[1064] For example, the buyer of a house is likely to know less than its owner about latent defects, such as a cracked foundation.[1065] As a result, the market for the sale of houses

[1056] Wonnell (n 982) 344.
[1057] ibid 345.
[1058] Kronman (n 995) 13.
[1059] Cooter and Ulen (n 62) 41. If there was equality of bargaining power the response is the same: "If we are serious about helping weaker parties secure better deals through contract law, we probably need to get our hands dirty and engage in more aggressive forms of market regulation including mandatory quality rules and regulation of the bargaining process - Omri Ben-Shahar, 'A Bargaining Power Theory of Default Rules' (2009) 109(2) Columbia L Rev 396, 430.
[1060] Kiholm Smith (n 972) 471.
[1061] Akerlof (n 146).
[1062] Kiholm Smith (n 972) 471.
[1063] ibid.
[1064] Cooter and Ulen (n 62) 42.
[1065] Cooter and Ulen (n 62) 42.

may not function efficiently as buyers may be paying too much for a house.[1066] In the United States, some states have responded to this issue by requiring sellers to disclose knowledge of any latent defects to prospective buyers and if the sellers do not disclose they may be responsible for correcting those defects.[1067] The buyer's concerns about information asymmetry will likely be more extensive for the buyer purchasing a company due to the wealth of information that a company will hold and the broad range of issues that such information may reveal.

7.13 What is the evaluation of share sale transactions – are they efficient, how should the law respond and by what means?

7.13.1 Share sale transactions are mutually advantageous to both buyer and seller and so are Pareto efficient

Normative economics asks if a rule makes a person better off.[1068] One function of contract law is to permit efficient exchanges but discourage inefficient ones.[1069] Exchanges can be evaluated from a Pareto efficiency perspective if it is possible to infer that the exchange is welfare enhancing in that it makes a person better off without making another worse off.[1070]

Share sale transactions are, from an economic point of view, mutually advantageous and as such are Pareto improvements in that both parties are left better off by the transaction. If two persons enter into an exchange there is a presumption that they will be better off and therefore Pareto superior.[1071] In simple terms, say a party values their own car at £5,000 and another party values that car at £5,100. If the parties agree a sale at £5,050, the transaction is Pareto superior as each party £50 better off. If share sales are efficient in this sense, contract law is itself promoting efficiency by enforcing such transactions. This would satisfy Friedman's view that parties benefit from an economic transaction if it is bilaterally voluntary and informed.[1072]

7.13.2 The law needs to deal with the problem of transaction costs in share sales

However contract law can do more to promote efficiency than just enforcing the contract that has been made. Most obviously, making contracts is expensive due to transaction costs. It is unrealistic to assume that there are no costs in carrying out a transaction.[1073] Transaction costs are the costs of

[1066] ibid.
[1067] ibid.
[1068] Trebilcock (n 971) 7.
[1069] ibid 17.
[1070] Ibid.
[1071] ibid 7.
[1072] Milton Friedman, *Capitalism and Freedom* (40th anniversary edn, University of Chicago Press) https://ctheory.sitehost.iu.edu/resources/fall2020/Friedman_Capitalism_and_Freedom.pdf 13.
[1073] Coase, R. H. "The Problem of Social Cost." *The Journal of Law & Economics* 3 (1960): 1, 15.

making an exchange and an exchange has three steps.[1074] First, an exchange partner has to be located which involves finding a buyer or seller, as the case may be. Secondly, a bargain must be struck between the exchange partners.[1075] A bargain is reached by successful negotiation, which may include the drafting of an agreement.[1076] Third, after a bargain has been reached, it must be enforced.[1077] Enforcement involves monitoring the performance of the parties and punishing breaches of the agreement. These three steps can be labelled information costs;[1078] bargaining costs; and enforcement costs.[1079] Transaction costs include all of those costs which are involved in completing a transaction.[1080] Coase described these three factors as "extremely costly" [1081] and that they are "sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost".[1082]

Transaction costs are high for unique goods but low for standard ones.[1083] Where the matter concerns uncertain, complex rights, unfamiliar parties, unreasonable behaviour, delayed exchange, numerous contingencies, high monitoring costs and costly punishments, transaction costs are likely to be high.[1084] All of these characteristics apply to share sales. If transaction costs were zero, there would be no need to be concerned about specifying legal rules to achieve efficiency.[1085] The current problem for share sales is that transaction costs are high even before the point when the parties reach agreement on the terms of the purchase agreement.

Transaction costs may prevent the parties from making an agreement. In the above example of the car, if, say, the transaction costs in entering into the transaction were £300, those transaction costs would eliminate the gains from trade. By taking account of the transaction costs it is likely that both parties would be made worse off by the transaction.

Alternatively, transaction costs may not prevent the transaction deal, but they may result in a suboptimal transaction being made, in that the parties cannot exploit all the gains from trade. This may occur if the parties, for example, agree that a broad range of matters are dealt with by a single contractual term, as this is cheaper to draft, but may be unsatisfactory. Perhaps, instead, the parties could have provided for different terms to different matters which might result in efficiency (in that

[1074] Cooter and Ulen (n 62) 88.
[1075] ibid.
[1076] ibid.
[1077] ibid.
[1078] Ratnapala (n 76) 307.
[1079] Cooter and Ulen (n 62) 88.
[1080] Ratnapala (n 76) 307.
[1081] Coase (n 1073) 15.
[1082] ibid.
[1083] Cooter and Ulen (n 62) 88.
[1084] ibid 91.
[1085] ibid 85.

both parties feel better off), but agreeing these multiple bespoke rules would have created more transaction costs which the parties decline to incur. This means they end up with a simpler, cheaper, but sub-optimal agreement (from an efficiency point of view). So, an efficient contract law, besides enforcing the agreement that has been made, may also want to address the problem of transaction costs and by doing so it would generate either more transaction, or more efficient transactions.

7.13.3 Contract law could provide default rules for share sales

Default rules exist for several reasons. The law of contract generally contains many default rules [1086] and as a separate discipline, there is the concept of default rules with origins in law and economics.[1087] The judiciary and law and economics commentators describe the benefits of default rules. They fill gaps[1088]in incomplete contracts.[1089] A gap is when a contract is silent about an issue it could have stated.[1090] Contracts will always have gaps. The idea that a contract can anticipate and articulate every contingency that might arise before, during or after performance is fantasy and therefore contracts will be silent on an untold number of items.[1091] Lord Leggatt suggests default rules reduce costs, [1092] inconvenience and unfairness "where parties, whether through inertia, lack of opportunity or foresight, or deliberate choice, have not negotiated express terms to cover certain significant contingencies" [1093] and extrajudicially Lord Sales has likewise remarked on the time-saving benefits and reduced expense for the parties that default rules offer.[1094] Even fully negotiated contracts are incomplete [1095] and the primary reason is transaction costs.[1096] These costs include those for drafting contracts, their negotiation as well as legal fees. As Ayres observes, the parties weigh costs against the benefit of the contract dealing with a contingency [1097] but there is more to default rules than just gap-filling, time reduction and decreased financial expenditure.

[1086] *Barton v Morris* [2023] UKSC 3, [129].
[1087] Riley (n 834) 368.
[1088] Whilst defaults operate to fill gaps in a contract the question arises as to whether a contract does contain a gap and that is a matter of interpretation - Eric A. Posner, There Are No Penalty Default Rules in Contract Law, 33 Fla. St. U. L. Rev. (2006) 568.
[1089] Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 Yale LJ 87.
[1090] Curtis Bridgeman, 'Default Rules, Penalty Default Rules, and New Formalism' (2006) 33 Fla St U L Rev 683, 694.
[1091] Randy E Barnett and Nathan B Oman, *Contracts: Cases and Doctrine* (6th edn, Wolters Kluwer 2017) 1065.
[1092] As too do Cooter and Ulen (n 62) 34.1
[1093] *Barton v Morris* (n 1086) [128].
[1094] Lord Sales, Default Rules in the Common Law: Substantive Rules and Precedent, Presentation at International Workshop on Default Rules in Private Law, Oxford, 24 March 2023 https://www.supremecourt.uk/docs/Default%20Rules%20in%20Common%20Law%20-%20Lord%20Sales.pdf.
[1095] Veljanovski (n 901) 121.
[1096] Ayres and Gertner (n 1089) 93. See also *Walford v Miles* [1992] 2 AC 128 where a buyer incurred significant costs pursuing a transaction.
[1097] ibid.

Whilst the principal function of contract law is to apply a framework of rules, certain default rules also allow the parties to opt out of their application.[1098] Default rules can also be modified by the parties [1099] and they can operate to improve the parties' bargain.[1100] They have a benefit even if there is a low contingency of a particular matter occurring. In such a case, the parties are unlikely to include a particular provision in the contract addressing the matter even if to do so would have no cost attached to it.[1101] If an appropriate default rule exists it can address that contingency. Ayres notes that Easterbrook and Fischel have suggested that default rules should reflect what the parties would have wanted were the costs low, [1102] although whether that is a sound concept is open to debate.[1103] However, other commentators criticise the idea of default rules. Working from the premise of contracts enhancing liberty, [1104] the mere fact that contractual parties bind themselves to each other does not mean they have consented to their mutual obligations being enforced by the state.[1105] Whilst default rules may be disliked by some, they are an inherent part of contract law giving the parties the ability to accept, modify or reject the default rule, facilitate easier contracting, provide cost savings and remove the need for parties to consider all contingencies. Notably, default rules are absent in share sales from an asymmetry of information perspective, in that there are no rules which seek to balance the asymmetry.

In share sales, the law could provide default rules that mimic what the parties would themselves have agreed. This would save them the transaction costs of providing their own rules.[1106] However, the law would be trying to second guess what the parties themselves would have agreed. The issue might be whether contract law, when producing defaults, would be more efficient in having more disclosure. It is concerned more with whether parties are, in fact, incurring transaction costs in the contracting process and whether the law could reduce these. If parties do incur substantial transaction costs to produce warranties then the law might help reduce such transaction costs by setting as a default the warranties that buyers and sellers typically end up drafting. However, if, in fact, buyers rarely insist on such warranties, then the law should not do so.

7.13.4 The law could provide penalty default rules for share sale transactions

[1098] *Barton v Morris* (n 1086) [126].
[1099] Alan Schwartz, 'The Default Rule Paradigm and the Limits of Contract Law' (1993-1994) 3 S Cal Interdisc LJ 389, 390.
[1100] Riley (n 834) 370.
[1101] Ayres and Gertner (n 1089) 93.
[1102] ibid 90.
[1103] ibid See Goetz & Scott, 'The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms'(1985) 73 (1) Calif L Rev 261.
[1104] Jules Coleman, Douglas Heckathorn, Steven Maser, 'A Bargaining Theory Approach to Default and Disclosure Provisions in Contract Law' (1989) 12 Harv JL & Pub Pol'y 639.
[1105] Ibid.
[1106] The question would also be is how such default rules should be provided legislatively ('ex ante') or judicially ('ex post').

The problem only of providing default rules is that by doing so contract law does not develop its own economic analysis of what sort of terms would be more efficient in the sense of generating optimal contracting. It would be only looking at it from one dimension which is just reducing one cost of contracting – transaction costs. Achieving greater efficiency by reducing transaction costs is a start, but it is insufficient.

Instead, the law should also work out what sort of contracting process would generate greater overall wealth. A default rule might be appropriate that, perversely, generates greater transaction costs if, in the process, it produces 'better' transactions that generate even greater overall wealth. This is where the increase in wealth outweighs the higher transaction costs. This can be achieved through penalty defaults.

Penalty defaults have particular merit in cases of information asymmetry. They are information-forcing. Posner defines penalty defaults as:

> "… a rule that fills a gap in a contract with a term that would not be chosen by a majority of parties similarly situated".[1107]

The penalty default model was devised by Ayres and Gertner [1108] "in which… a penalty default is to induce one contracting party to reveal socially valuable information that, with transaction costs, it would supposedly keep to itself under a "non-penalty" default rule.[1109] Whilst the general approach is the law should minimize the costs of contracting around default rules, Ayres and Gertner suggest that efficiency-minded lawmakers may want to increase transaction costs to discourage parties from contracting around certain defaults.[1110] The main purpose of their article in which the concept was introduced was to establish a normative claim that circumstances exist when penalty defaults should be used.[1111] Penalty defaults give at least one party to the contract an incentive to contract around the default. However, Mitchell suggests that it cannot be assumed that contracting around will occur.[1112] Penalty defaults "[place] the burden of change on the party most likely to seek change, if change is desired".[1113] If a party changes a rule their doing so communicates information to the other party.[1114] Penalty defaults may be justified as either giving both contracting parties incentives to reveal

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[1107] Eric A. Posner (n 1088).
[1108] Ayres and Gertner (n 1089).
[1109] Eric Maskin, 'On the Rationale for Penalty Default Rules' (2006) 33 Fla St U L Rev 557 though the general idea of contract law being designed either to reflect reasonable expectations or to induce parties clarify them arguably belonged not to Ayres and Gertner but instead to Lon Fuller & Robert Braucher, Basic Contract Law 557-58 (1964) cited in Einer Elhauge, Preference-Estimating Statutory Default Rules, Columbia Law Review, Dec 2002 Vol 102 No. 8 (Dec 2002) 2027 footnote 11 but arguably before that to King Solomon bible reference Kings 3:16-28, suggests Whitehead (n 569).
[1110] Ayres and Gertner (n 1089) 95.
[1111] Ian Ayres, Ya-Huh: There Are and Should Be Penalty Defaults, 33 FLA. ST. U. L. REV. 589 (2006), 596.
[1112] Catherine Mitchell, *Contract Law and Contract Practice* (Hart 2013) 157.
[1113] Cass R. Sunstein 'Deciding by Default' University of Pennsylvania Law Review , December 2013, Vol. 162, No. 1 (December 2013), 1-57, 35.
[1114] Footnote 136 Alan Schwartz, Robert E. Scott, The Common Law of Contract and the Default Rule Project, Virginia Law Review, Vol. 102, No. 6 (October 2016), 1523, 1566.

information or giving the more informed contracting party an incentive to reveal information to the less informed party.[1115]

Riley helpfully expands upon this. He summarises the purpose of penalty defaults, what they seek to achieve and how an informed party signals to the other party when an appropriate penalty default applies:

> "The thinking… is to promote efficient contracting precisely by supplying default rules which the parties almost certainly do not want, and which they are likely to exclude by providing an express term of their own choosing. The point of encouraging them so to do is to overcome problems of 'asymmetric information'. One party knows more than the other does, say about the quality of goods the better informed party is offering for sale. If the law provides a rule which the better informed party does not want (say that her goods are of a high standard), that party is likely to attempt to exclude the rule".[1116]

A penalty default, in contrast to a "general default" (or majoritarian default, as it is sometimes known) is therefore a term potentially unwanted by one of the parties and if that party seeks to delete or modify the penalty default in a contract doing so will inform the other party accordingly. For example, concerning the sale of goods, the law implies that the "goods supplied under the contract are of satisfactory quality". [1117]The buyer will be put on notice that what it is seeking to buy may not be of satisfactory quality if the seller seeks to contract around this rule.

Posner helps explain the similarities and differences between the two types of default:

> "…what distinguishes a penalty default rule and a majoritarian default rule is not that only penalty default rules are information-forcing. Both types of rule are information-forcing…The only difference between the two rules is that more parties opt out of or would prefer to opt out of a penalty default rule than out of a majoritarian default rule, everything else held equal".[1118]

It can be seen therefore that the information-forcing effect can arise under both default rule types but is more likely to occur under a penalty default. Notably, the asymmetric information problem is not limited to just differences between what the parties know. It goes further and it affects the terms of the contract between the parties because it "can lead to distortions in the resulting contract as compared to the contract that would have been negotiated under symmetric information, with such distortion resulting in a loss of welfare"[1119] for the less informed party.

[1115] Ayres and Gertner (n 1089) 97.
[1116] Riley (n 834) 384.
[1117] Sale of Goods Act 1979 s 14 if the seller seeks to specify in the contract that it wants to exclude such a term this will be subject to the test of reasonableness in of Unfair Contract Terms Act 1977 ss 6 (1A) and 11. There would be debate whether this example is a default rule or a penalty default rule.
[1118] Eric A. Posner (n 1088) 573.
[1119] Benjamin E Hermalin, Avery W Katz, and Richard Craswell, 'The Law & Economics of Contracts' in *The Handbook of Law & Economics* (final draft 5 June 2006) 28.

Ayers and Gertner have argued that when parties are asymmetrically informed about the subject of their transaction, the law should induce fuller disclosure by prescribing a penalty default which fills in contractual gaps and resolves ambiguities with terms the informed party least prefers.[1120] Therefore, penalty defaults stand as somewhat glaring counter-examples to the proposition that courts should simply choose defaults that the parties would have wanted.[1121] Ayres characterises the informed party as being instructive when remarking that penalty defaults "…are a feasible way of inducing the contractor who has better information to educate the less informed".[1122] As asymmetrical information is the issue that exists between buyer and seller in share sales, penalty defaults have the potential to force the disclosure of information by the seller to the buyer. The better a certain theory explains particular circumstances the more confidence there can be about the outcome being correct.[1123] Penalty defaults can be explained by their ability to force information and there is certainty that their use can bring about the desired result.

As a concept, penalty defaults are not considered a "strict" term, despite their name perhaps suggesting otherwise. Ayres describes different types of defaults on a horizontal scale with penalty defaults at one end and mandatory default rules at the other – mandatory rules being rules the parties cannot contract around. On that scale, he describes penalty defaults as the "most desirable" and mandatory rules as the "least desirable" perhaps reaching that conclusion because if a rule cannot be contracted around it provides no informational effects to the other party.[1124] The desirability or otherwise of a default rule is based on the extent to which the law seeks to impede the contractual parties, although mandatory rules should perhaps not be so easily dismissed as being undesirable as there will be situations when they are of value. Unsurprisingly, a mandatory rule attempts to "impede all parties from achieving particular contractual results".[1125] As such, then, a penalty default is a 'soft' form of default at least insofar as it relates to the revelation of information. Issacharoff paints a similar picture by inviting consideration of default rules on a continuum but offers a warning that a default rule does not provide any benefit when it is different to what the parties would typically bargain for and in that case adds to the bargaining process with further transaction costs[1126] presumably because of the need for both parties to reject the default for not reflecting either of their needs and the necessity to in turn bargain for something more appropriate and the costs implications of their doing so.

[1120] Klass (n 906) 183.
[1121] Ayres and Gertner (n 1089) 106.
[1122] Ayres (n 1111) 597.
[1123] Barnett (n 75) 270.
[1124] Ayres (n 1111) 593.
[1125] Ian Ayres, 'Regulating Opt-Out: An Economic Theory of Altering Rules' (2012) 121 Yale LJ 2032, 2087.
[1126] Issacharoff , 'Contracting for Employment: The Limited Return of the Common Law ' (1996) 74 Tex L Rev 1783, 1793.

Judged from an efficiency perspective, it is a criticism of contract law that it fails to provide default rules that compel disclosure by sellers in share sale transactions. This is not simply because most buyers and sellers currently incur high transaction costs to force such disclosure. The law could reduce these transaction costs. Seller disclosure would generate, from an economic point of view, a more efficient market for the sale and purchase of companies. Economically, it is more efficient for sellers to be required to disclose information than for sellers to take advantage of their superior information. This would promote efficiency.

In considering the information asymmetry issue, this chapter has suggested modification of existing contract laws. It has done so by asking the conventional normative question: what contract law should the state provide [1127] for the asymmetry and caveat emptor problem in share sales? In answering the question it has primarily utilised one of the three distinct but overlapping types of argument that exist within law and economics.[1128] One type explains and justifies legal principles in economic terms. This type is conservative with a desire to avoid change to the common law by way of legislation.[1129] By contrast, another more radical approach focuses on the limitations of state-created laws.[1130] The emphasis in that type is not on how the state creates laws but rather on how the contractual parties who are subject to those rules conduct their affairs and create their own contractual enforcement.[1131] However, this chapter did not consider either of the above two seemingly opposing types of argument. Instead, it has taken a more 'centrist' approach using a third type. It has followed the reformist and progressive approach primarily of Ayres and Gertner and to a lesser extent Shavell.[1132] These authors do not look at justifying legal principles but rather seek to find superior alternatives and consider which legal rules are more efficient.[1133] These authors seek to "displace traditional legal practices only where they are economically dysfunctional and to retain them otherwise".[1134] Their broad objective fits well with the asymmetry/caveat emptor problem this chapter has identified and was an appropriate approach to seek to resolve it.

7.14 Conclusion

This chapter has considered the current state of the law in share sales as inefficient from a law and economics perspective due to information asymmetry. It has rejected the idea that there is inequality

[1127] Schwartz (n 915) 618.
[1128] Klass (n 906) 178..
[1129] ibid.
[1130] ibid.
[1131] ibid.
[1132] ibid 178.
[1133] ibid 177.
[1134] ibid 178.

of bargaining power between buyer and seller to the extent that the law needs to regulate the relationship between the parties from that perspective.

This chapter has questioned whether the seller should be required by the law to disclose any information to the buyer and if so, what information. In answering that question it has employed certain theories from law and economics. Whilst law and economics broadly reflects the nature of the contracting parties in share sales, most importantly it has considered the issue of asymmetry of information between the parties which is particularly prevalent in share sales and which is not addressed by the current law requiring the seller to disclose information to the buyer because caveat emptor dominates the share sale arena.

To address the imbalance between buyer and seller as regards the revelation of information to the buyer penalty defaults seem perfectly suited to the task of forcing the seller to share pertinent information.

Inefficiency arises in share transactions from two angles and affects both parties. In respect of the seller, it incurs costs in having to deal with the buyer's request to provide information that the seller already possesses. The buyer incurs costs in formulating questions for the seller and drafting warranties to force the provision of information to it from the seller. If the buyer discovers negative information about the company which causes it to want to reduce the price, introduce terms to address the information it has discovered or withdraw from the transaction then both parties have needlessly incurred wasted costs. This process only occurs after the parties have incurred costs negotiating the price and other main deal terms. It would be more efficient if the parties knew, at the very outset of their negotiations, that the seller was required to at least provide certain material information to the buyer. If the buyer then wished to modify the price, propose contractual terms to address the issue or simply not undertake the transaction then this would be discovered early and the parties will have reduced their respective costs.

There is perhaps a more significant benefit which arises in cases of low-value transactions. In these cases the parties are less willing or able to pay for, legal advice. In those cases, a legal rule which requires the disclosure of certain material information will benefit both the buyer and seller in price maximisation for the seller and the provision of information at an early stage to the buyer and, for both parties, a reduction in time and costs negotiating and documenting the transaction.

Chapter 8

Penalty Defaults

8.1 Introduction

It is proposed the law introduces a new form of what is known as a penalty default rule which is to apply to share sales, derived from law and economics theory. This type of default is appropriate to deal with informational asymmetry between the parties and specifically the revealing of material information.

This chapter will give more detailed consideration to penalty defaults.

Section 8.2 will consider the criticisms of penalty defaults. Penalty defaults may not be efficient all of the time but will certainly be so when it is virtually costless for the party with more information to provide it to the party with little or no information.

Consideration will then be given to the general principles of penalty defaults in section 8.3. It will put forward a suggested penalty default and provide an explanation for each element of the suggested default in 8.5, having used, as a starting point, a precedent (section 8.4). This default will confer a dual benefit on the buyer which is to require the seller to provide certain information to the buyer and for the seller to be liable for that information being incorrect.

The expected application of the suggested penalty default is in section 8.7, with its limitations having been considered in section 7.7, which is that in higher-value transactions the parties would typically seek to supplement the suggested penalty default with additional terms. This leaves the penalty default more likely operating in lower-value transactions where either no or limited legal advice is typically obtained by the parties due to disproportionate costs to the transaction's value.

8.2 Criticisms of penalty default rules

When considering penalty defaults it would be remiss not to consider whether any criticisms have been levelled at the concept of penalty defaults impacting the problem this chapter is discussing. Separately, Posner and Maskin have attacked penalty defaults.

Posner has criticised the central example that Ayres and Gertner used as their basis for penalty defaults. They refer to the rule in *Hadley v Baxendale* [1135] that the claimant cannot recover unforeseeable losses unless those losses were communicated to the other party at the time the contract was entered into. This denial of damages for unforeseeable losses, say Ayres and Gertner, is likely to be inconsistent with what fully informed parties would have wanted [1136] and the limitation on recoverable damages increases efficiency by stimulating information communication between the parties [1137] and so is a 'penalty' or 'information-forcing' default rule.[1138]

In *Hadley*, the claimants were owners of a flour mill and provided a broken mill shaft to the defendant for them to deliver to a manufacturer so that a copy shaft could be made. However, delivery was significantly delayed resulting in lost profits for the miller. In *Hadley*, the miller was the more informed party and so the rule acts as an inducement for it to reveal its potential losses to the carrier.[1139] Informing the carrier of the losses creates value by allowing the carrier to know of the loss so it can prevent the loss more efficiently.[1140]

However, Posner takes issue with the view that the rule in *Hadley* is a penalty default [1141] arguing that it is not clear that it is one.[1142] Instead, Posner argues that the *Hadley* rule is a majoritarian or 'general' rule [1143] and more extremely concludes that US law contains no penalty defaults. However, to reach that conclusion Posner provides a narrow definition of what amounts to a penalty default. In response, Ayres rejects Posner's definition and provides a long list of examples where various other commentators have specified a law as being a default rule.[1144] Posner's criticism relies on a distinction between default rules and contract formalities and a distinction between default rules and rules of contract interpretation [1145] and both distinctions fail.[1146] One may ask, why does Posner's criticism matter? In one sense, arguably little if the major example used by those who conceived the idea of penalty defaults may not meet the definition of a penalty default. It is not necessary to prove the existence of penalty defaults to show they should exist [1147] but if Stigler is right when he argues that "all durable social institutions, including common and statute laws, must be efficient" [1148] or in

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[1135] 156 E.R. 145 [1854].
[1136] Ayres and Gertner (n 1089) 101.
[1137] Robert E Scott, 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19(2) J Legal Stud 597.
[1138] Ian Ayres and Robert Gertner, 'Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules' (1992) 101 Yale LJ 729, 735.
[1139] Ayres and Gertner (n 1089) 101.
[1140] ibid.
[1141] Eric A. Posner (n 1088) 565.
[1142] ibid.
[1143] ibid.
[1144] Ayres (n 1111) 601.
[1145] Bridgeman (n 1090) 695.
[1146] ibid 694.
[1147] Ayres (n 1111) 591.
[1148] George J Stigler "Law or Economics?" (1992) JLE, vol 35 no 2 1992, 455, 459.

other words, if there are longstanding existing penalty defaults, that at least lends supports to the feasibility of penalty defaults generally.[1149] Whether or not *Hadley* is a penalty default does not upset the call for the establishment of a penalty default in share sales. Posner criticises the existence of penalty defaults, and he and Maskin (discussed below) both, unconvincingly, question their efficiency.

Generally, it has already been said that default rules can be efficient but inefficiencies occur when parties seek to contract around a default rule.[1150] Before considering these criticisms it is worth being reminded of what Ayres and Gertner together or separately say about the efficiency of penalty defaults. They believe penalty rules show that efficient rules are not just those that the majority of parties would want.[1151] Ayres and Gertner maintain that inducing the revealing of information results in an efficient contract [1152] and "from an efficiency perspective, penalty default rules can be justified as a way to encourage the production of information".[1153] They remind us of the central idea that contracting around can have informational effects [1154] and different defaults have different effects.[1155] Their view is that penalty defaults should be considered by those lawmakers who are efficiency-minded as they could choose penalty defaults as it may cause knowledgeable parties to reveal information by contracting around the default rule.[1156] Ayres and Gertner are confident of the efficiency of penalty defaults. However, even they have said outside of their principal article on penalty defaults that only at times are penalty defaults efficient.[1157] The decision turns now to Maskin's questioning the possible inefficiency of penalty rules.[1158]

Ayres interprets Maskin's article as being a claim that penalty defaults are not efficient [1159] although whether or not that really is Maskin's conclusion is not clear.[1160] Ayres considers Maskin's criticism to be unconvincing. Maskin suggests penalty defaults are not efficient when the transaction cost is the cost of contracting around the default, but reaches the opposite view when the transaction cost is the cost of communicating between the parties.[1161] Ayres seeks to undermine this argument by explaining

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[1149] Ayres (n 1111) 597.
[1150] It has been said that all there is a strong indication that if there is a default option it can be expected that a large number of people will end up with that option, whether or not it is good for them Richard H Thaler and Cass R Sunstein, *Nudge* (Penguin Books 2009) 93.
[1151] Ian Ayres, Robert Gertner Majoritarian vs. Minoritarian Defaults page Stanford Law Review, Vol. 51, No. 6 (Jul 1999), 1591.
[1152] Ayres and Gertner (n 1089) 99.
[1153] Ayres and Gertner (n 1089) 97.
[1154] Ayres (n 1111).
[1155] ibid.
[1156] Ayres and Gertner (n 1089) 94.
[1157] Ayres and Gertner (1151)1593.
[1158] Maskin (n 1109).
[1159] Ayres (n 1111) Despite Ayres' interpretation, Maskin seeks to argue that Ayres and Gertner's analysis of penalty defaults is flawed and suggests that a party will disclose information under a 'non-penalty default' - Maskin (n 1109).
[1160] Ayres (n 1111) 615.
[1161] ibid.

that by setting the default rule in favour of the uninformed party the informed party reveals information, and, consequently, the efficient contract results. However, this does not quite address the point, as contracting around is likely to incur a cost, but these are merely "out-of-pocket costs" [1162] in Ayres' and Gertner's view, though even if no contracting around occurs the provision of information itself too bears a cost, but arguably that too is likely to be small. The parties communicating with each other also results in cost so Maskin's opposing conclusions on contracting around costs versus communicating costs are difficult to comprehend – the former being inefficient, the latter not, in his view. That said, and despite Maskin's unconvincing attack on the efficiency of penalty defaults he, at the very least, does question the efficiency of penalty defaults and in doing so requires lawmakers to take note of the costs of contracting around penalty defaults when designing default rules. Ultimately, Maskin's main argument relates to showing that a party has an incentive to contract around a non-penalty default, [1163] rather than making a direct and meaningful attempt to question the efficiency or otherwise of penalty defaults. Posner, perhaps rather too simplistically, notes that a provision that is rarely contracted around is probably efficient and a rule that is frequently contracted around is probably inefficient.[1164]

Maskin's apparent criticism differs from Posner's on the point of efficiency. Posner believes penalty defaults can be efficient as against majoritarian defaults but qualifies this view that efficiency only occurs if implausible assumptions are made [1165] but may not be particularly committed to such a view when he adds the words "but others may disagree".[1166] This broad statement that penalty defaults may be inefficient, despite having acknowledged that majoritarian and penalty defaults both have the same information-forcing effect, is difficult to reconcile especially as there is little to differentiate between these default types. Much, surely, must depend on the penalty default itself. Posner, separately, has suggested that there is no way of measuring the variables that determine the relative efficiency of either majoritarian or penalty defaults [1167] in any event, which perhaps indicates the challenge for lawmakers in determining default rule efficiency. Whilst Posner attacks penalty default efficiency, Whitehead, on the other hand, explains when each of a default rule and penalty default will be efficient:

> "If aggregate costs exceed benefits, then a traditional default rule reflecting the consensus standard may be more efficient. If, however, the net benefits of disclosure are positive, a penalty default may be more valuable".[1168]

[1162] Ayres and Gertner (1151) 1592.
[1163] Maskin (n 1109) 557.
[1164] Richard A Posner, *Economic Analysis of Law* (9th edn, Wolters Kluwer) 99.
[1165] Eric A. Posner (n 1088) 570. Posner says these assumptions are: "that individuals have preferences over outcomes, that these preferences obey basic consistency conditions, and that individuals satisfy these preferences subject to an exogenous budget constraint. Contracts scholars usually assume that individuals do not have preferences regarding the consumption or well-being of other individuals, nor regarding contract doctrine itself there is no preference for expectation damages" - Posner (n 913) 832.
[1166] Eric A. Posner (n 1088) 570.
[1167] Posner (n 913) 841.
[1168] Whitehead (n 569) 1105.

Whitehead's slightly more technical explanation of how efficiency occurs emphasises the need for the revelation of information to have a net benefit. Riley offers a somewhat clearer explanation of how efficiency can arise when contracting around a penalty default:

> "If the law provides a rule which the better informed party does not want (say that her goods are of a high standard), that party is likely to attempt to exclude the rule. But in so doing, she is thereby forced to reveal her privately held information (that her goods are of a lower standard). If this increased disclosure of information will increase aggregate welfare, then the penalty default will enhance efficiency, even though it raises transaction costs in the process (by encouraging express contracting around the rule)".[1169]

Taking these views together, whilst transaction costs are increased by the act of contracting around the penalty default, the disclosure of information to the buyer in that process is efficient. As such, it must be taken to be correct for its obviousness. It is therefore possible, at least concerning asymmetry of information, to reject Posner's elaborate assumptions argument which is a wider criticism of law and economics generally. Positively, there is also an additional, and perhaps less obvious, benefit of penalty defaults concerning the increased value to the more informed party:

> "changes in legal rules or contract terms that benefit one side of the transaction at the expense of the other (for example, providing an implied warranty in a sale of goods), will increase the amount the benefited party is willing to pay to enter into the deal, as well as the exchange value that the burdened party will insist on receiving".[1170]

It may be thought that the requirement to disclose information in light of a penalty default is burdensome on the seller despite being efficient, but there is an upside for the seller. Shavell focuses on the benefit of disclosure for the informed party:

> "Sellers will have the correct, positive incentive to acquire information even when required to disclose it because they will be able to capture an increase in value due to information.[1171]

Of course, a value increase assumes that the information obtained does not reveal material issues with the shares being sold or the company which would cause the buyer to want to renegotiate or terminate negotiations. Maskin suggests that majoritarian defaults can also force parties to divulge information. He does show that penalty defaults can be inefficient but only some of the time. Other commentators have specified that penalty defaults can be efficient but much is dependent on the terms of the penalty default, which is discussed next.

8.3 Suggested penalty defaults in share sales – general principles

The problem facing the buyer is a combination of information asymmetry and there being no duty on the seller to disclose information to the buyer. The purpose of the penalty default is to have the seller

[1169] Riley (n 834) 384.
[1170] Klass (n 906) 176.
[1171] Shavell (n 1053) 21.

reveal information that it would otherwise keep to itself. If there are intended ends, such as information-forcing, the means of producing that end is a penalty default.[1172] When the rationale is to inform the relatively uninformed contracting party, the penalty default should be against the relatively informed party.[1173] If the drafter knows what the efficient terms of the default are the better informed party can be identified.[1174] It is clear from these, and earlier points in this and the preceding chapter, that the penalty default should be set against the seller in order to encourage the seller to reveal information about the company to the buyer.

In addition to efficiency, which has the potential of being difficult to achieve in default rule design,[1175] there are a number of principles that need to be considered before a potentially appropriate default or defaults can be produced. These include having a targeted default, the benefits and costs of the default, the seller's likely response to a suggested default, the need for a default to be simple and not focus exclusively on problems and how the parties can contract around the penalty default and that a penalty default is not to apply to a buyer. Each of these is expanded upon next.

The penalty default needs to be targeted. An information "dump" on the buyer would not assist the buyer in working through the information and it may jeopardise the sale from an information overload perspective. The buyer would not know the value of the information until information has been acquired by which point it is too late to establish if the expense was worthwhile.[1176] Whilst that has been said in the context of searching for information, the same must be true in the search through it. Being given too much information is problematic because the buyer still has the costs of working out if the information is of value to it. Another problem is that information that the seller may think is important for the buyer to know may not be valued by the buyer. What point would there be in providing significant amounts of information if some it was irrelevant? The targeted approach is supported by the perhaps obvious point that one cannot seek to be perfectly informed about something as doing so may be too costly.[1177] It can be said that there is an optimal level of ignorance where the costs of more information outweigh the expected benefits.[1178] Providing targeted information is more difficult and expensive for the seller than handing over all information it possesses but targeted information reduces the buyer's costs of searching through it, but requires the buyer to appreciate that it is impossible to have absolutely perfect and fully informed knowledge of the company.

[1172] Ian Ayres (n 1125) 2044.
[1173] Ayres and Gertner (n 1089) 98.
[1174] Alan Schwartz and Robert E Scott, 'The Common Law of Contract and the Default Rule Project' (2016) 102 Va L Rev 1523, 1561.
[1175] Schwartz (n 915) 598.
[1176] Veljanovski (n 901) 144.
[1177] ibid.
[1178] ibid.

The selection of an appropriate default rule should be based on two further points: an analysis of benefits and costs with the selected default rule being one that maximizes net benefits.[1179]

Firstly, as regards benefits, the broad benefits to both the seller and buyer of the seller providing relevant information to the buyer concern a number of points. These include the increased chance of the transaction completing, a quicker transaction, less negotiation and pressure, and specifically for the seller, a reduced chance of the price being renegotiated. As for the buyer, the benefit includes it being informed of the state of the company it proposes to buy. Of course, this is on the assumption that the information provided does not indicate problems with the company which would result in the buyer wanting to withdraw from the proposed purchase.

Secondly, concerning costs, the production of information is going to have a cost for the seller in both obtaining the information and compiling it into a presentable format. There may also be the need to request information from the seller's advisers such as their accountant or legal advisers. Typically, the information that a company possesses will be that which it has built up through the course of its operation. Some, of course, is information that it would have incurred costs to acquire such as health and safety reports, surveys, inspections etc. There is therefore a distinction between information the seller has acquired as part of operating the business and the seller having to incur costs to acquire information primarily to provide to the buyer. The former information type is low cost and so would be expected to fall into the disclosure requirement, whereas the latter would not. Of course, there will be internal costs for the seller in compiling and presenting information perhaps contributed to by having to request the information from employees who may accordingly be diverted from their normal role and function. As for the buyer, there is going to be a cost in assessing and analysing the information provided. The extent of that cost in some part will be dictated by the form of the information. Poorly collated information which has no logical order will take more time and expense to assess.

If the seller is not running the company the provision of information may be more difficult. The seller will not be aware of the extent and location of the information. It can be assumed that it remains easier and cheaper for the seller to obtain credible information from the company than it would be for the buyer.[1180] It is likely to be efficient for the knowledge possessed by the company's directors and relevant personnel to be allocated to the seller.[1181]

[1179] Cass R. Sunstein 'Deciding by Default' University of Pennsylvania Law Review , December 2013, Vol. 162, No. 1 (December 2013) 1, 36.
[1180] Jastrzebski (n 562) 295.
[1181] ibid.

Schwartz and Scott suggest a good default rule should be simple.[1182] No doubt a complicated default is going to increase the possibility of contracting around and the costs of doing so. As well as being simple it should not concentrate solely on problems and issues. Whilst the buyer will want to know such matters the provision of information solely addressing problems may affect the likely success of the transaction reaching completion. Whilst it has been said in the context of property transactions that "sales are best achieved by accentuating the positive, not by zeroing in on an exhaustive description of all the home's major hidden flaws – at least not until the buyer is emotionally committed to the transaction", [1183] the same must also be true of the purchase of a company. The seller should not be required only to provide a list of problems to the buyer.

The informed party's likely response to the suggested penalty default will also need to be established.[1184] This is because different penalty defaults would cause the informed party to communicate different information to the uninformed party.[1185] The elements of the penalty default must include more than simply the information-forcing terms. Allied to the seller's response to the penalty default is how the parties can contract around the default rule. This is essential.[1186] Ayres suggests that "penalty defaults should naturally be combined with error-reducing altering rules to assure that attempts to displace the default actually communicate the relevant information".[1187] So, if the parties do not contract out correctly the penalty default remains.[1188]

The penalty default should only fall on the seller. The duty to disclose is one-sided. Shavell usefully summarises the situation of buyers acquiring information if they were to have a disclosure requirement. The conclusion regarding its disclosure to the seller is different to that of the seller disclosing to the buyer:

> "Buyers will then have no incentive to acquire information, for they will not be able to capture any increase in value due to information because sellers, being the holders of property rights, naturally enjoy the option of not selling and instead using valuable information themselves. Thus, for buyers to have an incentive to acquire information, they must have the right not to disclose it".[1189]

Shavell continues that the buyer's bargaining position worsens if the buyer is required to disclose information to the seller:

[1182] Schwartz (n 915) 598 .
[1183] George Lefcoe, 'Real Property, Probate and Trust Journal' (2004) 39 RPP&TJ 193, 214.
[1184] Alan Schwartz & Robert E. Scott, The Common Law of Contract and the Default Rule Project, 102 VA. L. REV. 1523 (2016), 1561.
[1185] Although this, suggests Schwartz and Scott, is all rather difficult - Alan Schwartz and Robert E Scott, 'The Common Law of Contract and the Default Rule Project' (2016) 102 Va L Rev 1523, 1561.
[1186] Ian Ayres (n 1125) 2034.
[1187] Ian Ayres (n 1125) 2098.
[1188] So to bargain around this default, the promisor must convey information which is generally directly contrary to his strategic interest in bargaining with the default Jason Scott Johnston, 'Strategic Bargaining and the Economic Theory of Contract Default Rules' (1990) 100 Yale LJ 615, 617.
[1189] Shavell (n 1053) 21.

> "… [as] a buyer ... does not possess property rights in the good he is seeking, his revealing information that can raise the value of the good will not improve his bargaining position. By telling the seller what he knows, the buyer confers an advantage on the seller, allows the seller to charge more for the good because the good is now worth more to the seller. In contrast, when the seller discloses information that can raise the value of his good, the seller is able to collect more for the good because he does enjoy property rights in the good when he is bargaining".[1190]

In both of these similar statements there is a range of both good and bad information that the buyer could acquire, not all of which has the effect of raising the value of the shares. The buyer could equally acquire information to show the seller why, for example, the price needs to be reduced.

Finally, although it has been argued that when the parties do not have the same information identifying what terms they would have chosen is not well-defined [1191] it is possible to confidently say what a typical buyer and seller would agree in a negotiated contract which is that the seller would give extensive warranties to it. In the absence of those negotiations what will be suggested here is a broad, but not comprehensive, rule to encourage some information revelation.

In summary, a penalty default will need to apply solely to the seller and not also to the buyer and there are clear benefits to both buyer and seller of the seller providing information. That information needs to be targeted and requires the giving of both positive and negative information about the company in a logical format. It does not extend to information the seller has to pay third parties to produce primarily to provide to the buyer as that would not amount to information held by the seller in any event. The seller's likely response to the penalty default, and how the parties can contract around the default rule, needs also to be stated.

8.4 Suggested penalty defaults in share sales – use of precedents as a starting point

In turning now to devise a potential default the discussion will not start with a "blank page". Instead, reference will be made to legal practice and the consideration of certain warranties in precedent share purchase agreements that are said to be of value to a buyer when little or no due diligence has been undertaken and so the hypothetical buyer has little knowledge of what it proposes to buy. The reason for this approach is that it mirrors the starting position of a typical buyer. The suggested wording from these precedents and their accompanying drafting notes, [1192] will then be tested using the above principles of penalty default rules.

[1190] ibid 33.
[1191] Lucian Arye Bebchuk, Steven Shavell, 'Reconsidering Contractual Liability and the Incentive to Reveal Information', Stanford L Rev Vol. 51, No. 6 (1999) 1615, 1626.
[1192] Drafting notes to greater or lesser extent explain the contractual wording specifying what is problematic and whether particular parties should accept or reject the text.

The following two warranties of a similar nature appear in two separate precedent share purchase agreements. Each is a wide-ranging warranty sitting alongside a large number of more specific warranties concerning a target company. The first states:

> "There is no information that has not been Disclosed which, if Disclosed, might reasonably be expected to affect the willingness of the Buyer to enter into the Transaction on the terms of this agreement".[1193]

And the second:

> "So far as the [Seller is] aware [1194] there are no material facts or circumstances in relation to the assets, business or financial condition of the Company which have not been Disclosed [1195] and which, if Disclosed, might reasonably have been expected to affect the decision of the Purchaser to enter into this Agreement on the terms set out herein".[1196]

There are drafting notes accompanying each of these warranties. The notes for the first warranty above states:

> "A buyer may find it easier to justify a warranty in these terms where the circumstances of the transaction have not allowed it to conduct a thorough due diligence exercise".[1197]

According to the drafting note, not undertaking due diligence might give grounds for the inclusion of such a warranty. Assessing and verifying facts is expensive, [1198] and so too is the cost of requesting the information, and taking the time to formulate the right questions, particularly as different types of target companies will require the buyer to ask different questions.

In the second example warranty, the drafting note says:

> "This is the infamous sweeping-up warranty that is intended to cover any matters not specifically dealt with by the detailed warranties. "… carefully consider whether it is more appropriate to refer to the decision of "the Purchaser" or "a purchaser" to provide for either a subjective or objective view. By use of the defined term "Disclosed", an objective standard is used to determine the fairness of such a disclosure.

[1193] Share purchase agreement: multiple individual sellers: simultaneous exchange and completion Practical Law Company, Thomson Reuters.
[1194] It is assumed the seller is an individual. If the seller was a legal entity the question would arise as to whose awareness is to apply. The immediate answer in the case of a company selling its shares is the directors but awareness could extend to others outside of the board of directors such as senior employees.
[1195] Reference to "Disclosed" is to the standard of disclosure that a statement of how a warranty is untrue needs to meet as explained in the disclosure letter. The word is defined in a share purchase agreement.
[1196] Thompson (n 179) 20.
[1197] Share purchase agreement: multiple individual sellers: simultaneous exchange and completion Practical Law Company, Thomson Reuters.
[1198] Veljanovski (n 901) 143.

> "In most cases where there are full warranties dealing specifically with all areas of importance to a purchaser, this warranty, even in amended form, will not be given by the vendors and it is difficult in such circumstances for the purchaser to justify its inclusion".[1199]

So, at least from the perspective of practitioner-focussed publications, a broadly worded warranty in a share purchase agreement where only limited or no other warranties are given may be justified. That is premised on the buyer having undertaken little or no due diligence so has limited knowledge of what it is proposing to purchase. Both of the example warranties from these precedents require the provision of information relating to the state of the target company, but the requested information is broad and requires the seller to determine what information it is required to provide. For that reason alone a seller is likely to be unwilling to provide such a warranty. It appears less than clear what the seller "signals" to the buyer if it were to seek to contract around such terms if there were a penalty default. On first consideration, it appears too wide to have any real value because the seller will be seeking to avoid the default on the basis of uncertainty and the buyer learns nothing from that exercise.

Furthermore, these examples make no mention of both positive and negative information about the company, the format of that information or how the parties can contract around the default rule. However, the first part of the second warranty up to "and" may have some use. It refers to the seller's specific knowledge by using the word "aware" and there is a degree of specificity concerning what information is required: " assets, business or financial condition of the Company" and a threshold has been applied in the use of the word "material" meaning that minor information is ignored. Despite that, clearly, in its current form, it is not suitable and rewording is required, but it remains a starting point. As the first example is too broad and subjective, as it requires the seller to consider what is important to the buyer, it is ignored from further consideration. The same can be said with respect to the second part of the first warranty. Therefore, the remaining part of the second warranty requiring to be refined reads:

> "So far as the [Seller is] aware there are no material facts or circumstances in relation to the assets, business or financial condition of the Company which have not been Disclosed".

8.5 The suggested penalty default

To meet the principles of penalty defaults set above, the wording could be amended to state:

> Unless any of all of the matters listed below have been excluded by the parties in writing,[1200] the following information concerning the Company was provided in writing by the seller to

[1199] Thompson (n 179) 7-31.
[1200] Writing for these purposes may include or exclude email.

the buyer in a listed and indexed format prior to the date the parties entered into a contract for the sale of the Company. Each of the following is true at the date of completion of the sale and purchase except to the extent that the seller has fairly disclosed in writing to the buyer how each is not true:

a) the shares are sold with "full title guarantee" under the Law of Property (Miscellaneous Provisions) Act 1989 and represents all of the Company's issued share capital;
b) the list of the Company's main assets which it requires to run its business including, intellectual property, all of which the Company owns;
c) up to date accounting and financial information of the Company showing its profits and losses for the last 12 months and its debts;
d) the Company has paid all of its tax or retained sufficient sums to pay it;
e) the Company is not involved in any litigation and none has been threatened; and
f) details of the Company's main customers and suppliers.

The opening term and each of the above sub-terms will be explained. The terms together concern the seller being able to sell the shares, the shares not being incumbered or subject to third-party rights and some terms concerning the company in which the shares are being sold. This generally reflects the overall structure of warranties in precedent share purchase agreements which, as was shown in chapter 1 contain extensive warranties.

The introductory language covers several points. It specifies how the parties can contract round, which is one of the essential elements that Ayres suggests is needed in a penalty default. The requested information in sub-terms (a) to (e) inclusive is required to be provided in writing to reduce the risk of dispute and to provide an evidential trail. The term also includes the information to be given to the buyer in a listed and indexed format which is cost-saving for the buyer as it will not have to work through what otherwise could be disorganised information. However, this will probably increase the seller's cost but it would be expected that the seller would keep information concerning the company in some sort of ordered fashion in any event. Therefore, extracting that information is not expected to be expensive. The information is to be provided before the sale and completion of the shares to give the buyer time to assess it but is expressed to be true at completion. This gives the buyer assurance that when entering the transaction, and up to the date it acquires the company, the seller is confirming the truth of the information provided. Giving assurances at completion also reflects the practice of share sales. This term also acts as a "penalty default within a penalty default" because if the seller is prepared to give an assurance that previously provided information is true, and some of that information changes before completion, the seller will need to reveal the extent of that change.

Finally, there is a potential increase in efficiency. This is due to the seller having to "fairly disclose" to the necessary extent any terms that it cannot say are true. Efficiency is possibly increased because disclosure is cheaper for the seller than contracting around. In a fully negotiated share sale there is

less of a process of contracting around a term the seller dislikes (unless its scope is too broad), the buyer being put on notice and the buyer needing to ask why the term is unacceptable, and then parties spending time and incurring costs negotiating for a different term. Instead, and as the seller knows why the term is untrue, disclosure against it is easier than its deletion and hence costs are saved. The idea of disclosure was discussed in chapter 6 and reflects market practice where, unless the term is too onerous, the seller does not amend it, but rather discloses against it when the warranty is to some extent untrue. In addition, this is in line with Maskin's (debatable) above conclusion that communicating between the parties is efficient[1201] because there is no cost of contracting around. As for the meaning of "fairly disclosed" in the example penalty default, either these words can be defined in the penalty default or the common law meaning of them can apply. We turn now to each of the sub-terms.

The first sub-term in (a) covers what is being sold. This means the shares in the Company that the buyer is buying. In chapter 3 full title guarantee was discussed. Use of the term "full title guarantee" invokes Law of Property (Miscellaneous Provisions) Act 1994, s 2 which provides that the person selling has the right to sell what she is selling and further and will at her own cost do all that she reasonably can to give the buyer the title she purports to give. In addition, LPMPA, s 3 provides that the seller is selling free from all charges and incumbrances and from all rights exercisable by third parties in respect of what is being sold. This means that the use of "full title guarantee" in the example penalty default triggers the inclusion of existing legislation that, it will be recalled from chapter 3, does not apply to share sales unless the term "full title guarantee" is used. It will also be recalled that the state-issued document required to transfer shares — the stock transfer form in Stock Transfer Act 1963, Schedule 1 — has not been amended in light of the LPMPA, s 2 coming into force to add words providing that shares are transferred with full title guarantee. The example wording penalty default therefore provides the buyer with a confirmation that the seller owns the shares and they are not incumbered without the buyer having to have the knowledge that it needs to use the words "full title guarantee" in order to have the seller make those promises. As such, this point alone would amount to a change in the law.

The second term in (b) requires the seller to list the main assets of the company. This resembles the use of the word "material" in the example precedent wording above but has been substituted with "main" because its use is colloquial and "material" is not typical of everyday language. The buyer will want to know that the company owns all of the assets which it uses or needs to use in order to enable it to carry on its business and where it does not then there is a lease, hire, rental or licence agreement

[1201] See (n 1161).

which enables it to use the assets.[1202] Therefore, perhaps more than term (a), there is the possibility that a seller would seek to either contract round this provision or alternatively, and probably more likely, specify how the term is untrue by way of disclosure.

As publicly available accounting information is not up to date as companies file information for past financial years, it is useful for a buyer for the seller to provide accounting information that is up to date. This sort of information should be readily available to a seller and so not problematic for it to provide. This concerns (c).

Taking both (d) and (e) in the example together, these are designed to capture the potential significance of unpaid taxes and litigation and the cost to the company of such matters.

In respect of (f), the buyer will want to review all contracts and agreements which are likely to matter in the business. The buyer will typically want details of all major customers and suppliers of the business.[1203]

Overall, the example penalty default is designed not to overburden the seller and to provide basic information to the buyer.[1204] The costs of information gathering for the seller are lower than for the buyer.[1205] It also is designed to act as a prompt for the parties to consider further matters and to "get the conversation going" between the parties. Further, the buyer avoids the need to incur the costs of formulating appropriate questions itself and the provision of information by the seller in the way suggested allows the buyer to be able to determine at low cost, and at an early stage, whether or not the company is a potentially sound purchase. It also avoids the seller having to format answers to the buyer's questions in the format the buyer wants. In seeking to achieve all of these matters it clearly has some shortcomings.

8.6 Limitations of the suggested penalty default

The example penalty does not cover a broad range of matters that the company does, for example, that there is no arrangement for the company to allot shares to another person. If it had then the buyer would find itself having to split the shares it has bought with whoever is to have shares allotted to them and so the buyer would not hold one hundred per cent of the company's issued share capital.

[1202] Stilton (n 125) 7.17.
[1203] ibid.
[1204] On a related note, the question arises as to where liability lies in relation to matters not covered by the suggested penalty default. Which party should bear the risk in relation to matters about which no information has been provided? This point is not addressed in this thesis but the current position in law and practice is that the risk remains with the buyer as regards 'information gaps'.
[1205] Jastrzebski (n 562) 293.

None of the example penalty defaults cover the seller owing money to or being owed money by the company. The financial information of the company that is to be provided under the example penalty default should reveal such potential mutual indebtedness. There is also no mention of the company having in place sufficient insurance cover or having all licences and any other consents in order to operate, no details of the company's employees, the key members of staff, salaries etc or their contracts of employment and no pension details are provided for. This is to name a few. As chapter 4 showed, contractual assurances in terms of warranties are extremely extensive and need to be tailored to specific transactions. As such, a penalty default cannot be expected to address every such aspect of a company and its business. In light of these limitations, who will the example penalty default realistically apply to?

8.7 Expected application of the suggested penalty default

The answer is the penalty default will likely apply to low-value transactions. In low-value transactions, let us assume typically those with a purchase price of up to a few hundred thousand pounds, the seller and buyer face difficult questions of costs. Those are costs associated with legal due diligence, financial due diligence and tax due diligence on the target company, transactional advice from relevant respective professional advisers throughout the transaction process and the required input into negotiating a lengthy share purchase agreement. These costs for the seller will represent a high percentage of the amount of consideration they will receive from the sale of the shares. The buyer's costs will be similar and will constitute a large amount relative to the amount being paid. Like many people buying something of low value they will seek to make savings and adopt a selective, limited or "light touch" approach to the transaction. This usually means limited or no involvement of professional advisers and a "do-it-yourself" approach.[1206]

As for higher-value transactions, it is expected that they will supplement the rule [1207] with more extensive warranties.

[1206] A reader may rightly initially wonder that what is being said is true of many contracting situations. However, buying a company involves wide-ranging considerations and risk for a buyer from employment, data protection, real estate, taxation, intellectual property to name but a few and numerous potential liabilities, obligations, costs and expenses associated with each aspect. It is easy to imagine a company with an unpaid tax bill. If the buyer has no legally enforceable assurance from the seller that the company has paid all of its tax then the buyer may find itself having to pay a tax bill that there may be insufficient money to meet. If we look to property transactions there are standard form contracts and low professional costs even in higher value sales and purchases. No such regime exists for corporate transactions.

[1207] Separately, it is suggested the example penalty default rule would not be appropriate to apply to transfers between connected persons such as the definition in Taxation of Chargeable Gains Act 1992, s 286 concerning transfers between spouses or intra-group transfers.

Finally, it is suggested that the example penalty default is expressed as being a warranty. As explained in chapter 1, warranties encourage "pre-contract disclosure" [1208] and they provide the buyer with a remedy against the seller if the warranty is untrue.[1209] They have a value-creating function in the context of acquisition agreements concerning overcoming asymmetry of information and minimising costs of information gathering and verification.[1210] The use of warranties is an inherent part of acquisitions and so labelling the suggested penalty default as one is not a departure from any expectations that the parties may have, reflects existing market practice, encourages information production and gives the buyer a legal remedy.

8.8 Conclusion

One issue is the challenge penalty defaults make to the concept of efficiency which is not necessarily shared to the same extent by majoritarian default rules. However, the extent of the efficiency, or inefficiency, of a penalty default is largely dependent on the default rule itself and the degree to which the parties will need to contract around it because that process potentially incurs costs which then undermines efficiency. However, it is clearly the case that if the cost of provision of information will be negligible for the seller, then efficiency is accordingly increased.

The suggested penalty default that has been devised in this chapter is based on principles from various law and economics sources. It has, in its sights, buyers and sellers in low value transactions and is designed to bring about the revelation of some specific types of information by the seller about the company whilst also making some basic promises about ownership of what it is selling, namely the shares. This is done by invoking the full title guarantee concept from existing legislation and requiring the law to set the suggested penalty default as a warranty.

Of course, no default rule is going to be able to replace the current significant set of warranties that are required in a typical negotiated share sale, even low value ones. However, it will make some inroads into the seller-friendly existence of information imbalance and caveat emptor with the effect of reduced costs for both parties in negotiating a transaction, reduced likelihood of dispute post-completion, protection for the buyer and a potential value increase for the seller who provides useful information to the buyer. As such, the suggested penalty default benefits both parties more than the current law.

[1208] Tedjani (n 134) 40.
[1209] ibid.
[1210] Jastrzebski (n 562) 293.

Chapter 9

Conclusion

This thesis has sought to demonstrate that the law fails to address the information asymmetry that exists between buyers and sellers in share sale transactions. This creates inefficiency, and in cases where the buyer remains uninformed at completion of the transaction, there is also a potential inequality of bargaining power. It has been suggested that the law needs to establish default rules, and in particular, penalty default rules to address this.

Share sale transactions are lengthy. They are complex. Despite that, caveat emptor remains in share sale transactions which means that the seller can remain silent about material issues with the company proposing to be purchased. As a result, the buyer undertakes an expensive and time-consuming exercise to understand what it is proposing to purchase. The caveat emptor doctrine is not undermined by either the law of misrepresentation or the criminal law. Whilst it was shown that the point is less clear under the Financial Services Act 2012, it appears unlikely that particular legislation imposes an obligation on a seller to disclose information where that obligation is not reflected in the civil law. However, the law has sought to erode caveat emptor in the public company setting as regards the obligation on such a company to share material information with a proposed investor. The only time the law imposes a duty on a seller generally is to require a party to disclose information to the other party if information that a party has already given to the other has subsequently changed. That, however, does not extend to a party being required to disclose information generally, but rather correcting or withdrawing a statement it has already made.

Some purchase contracts may include the implied term of full title guarantee under the LPMPA 1994 but this implied term only applies when the parties use certain words. Even if used, the benefit of the implied term does make much inroad into caveat emptor or balance asymmetry of information. It was identified that in the cases of asset sales there are some automatic, though limited, implied terms from which the buyer benefits.

Costs arise for both buyer and seller as regards the buyer seeking protection, particularly in the form of warranties, from the seller. Whilst a number of situations concerning warranties were discussed, it was clear that, at a basic level, the law assists buyers in their efforts at self-protection, by enforcing whatever warranties they secure, or by allowing them to claim for misrepresentation (provided the seller has not excluded liability for misrepresentation in the contract). However, in other respects, the law seems to be unwilling to give effect to the representations or warranties that buyers have obtained from the seller in certain situations. In having claims for breach of contract and misrepresentation the

buyer seeks to have two claims that it may bring and can choose the one which will give it greatest recovery. However, warranties will not be given 'double protection' by being treated as also representations. Contractual limitations for warranty claims will be treated as also extending to misrepresentation claims that are brought in respect of the subject matter of the warranty. The law around contractual representations is far from clear, and if a buyer wants to establish some certainty around the court's treatment of them, then buyers will need to change the way in which contractual representations are expressed in contracts.

The default common law position, absent a knowledge-saving clause, prevents the buyer from being able to bring a claim for a breach of warranty known to it before completion. In response, buyers attempt to provide in the contract that the buyer can a claim for a known breach of warranty not stated in the disclosure letter. Knowledge of breach of a warranty may prevent an action for breach. Much uncertainty remains on the subject of knowledge-saving clauses, not only as to their enforceability, but also as to the assessment of damages for breach of warranty in such circumstances. It seems, as it was shown, that the development of contractual estoppel will assist the buyer in that the courts may now more likely honour a knowledge-saving clause.

Moving to the subject of disclosure, the law has moved to take a formalist approach to the terms of the agreement and does not seek to override the terms of the contract with a sense of fairness. A contrast can therefore be seen towards the approach to the courts of keeping parties to their terms in cases of disclosure, but the courts are less strict in doing so in cases of enforcing contractual representations. We see buyers, therefore, being treated less favourably by the courts in both of these situations.

Despite the issues raised by caveat emptor, this thesis has rejected the proposition that there is inequality of bargaining power between buyer and seller to the extent that the law needs to regulate the relationship between the parties from that perspective. This is because the parties enter into the transaction voluntarily and the transaction is not one which is part of a monopoly nor is it an adhesion contract. However, there may be an inequality of bargaining power if the buyer enters into the transaction in situations where information asymmetry remains at the time of completion.

This thesis has suggested that the law fails to deal with share sale transactions and the challenges they raise in an effective manner. Where information asymmetry does persist, the law does not deal with it. Even where the buyer is informed, the process is expensive and inefficient from a law and economics perspective. Inefficiency affects both parties. The seller incurs costs in having to deal with the buyer's request to provide information that the seller already possesses. The buyer incurs costs in formulating questions for the seller, requesting information, analysing information and drafting

warranties to force the provision of information to it by the seller. If the buyer discovers negative information about the company which causes it to want to reduce the price, introduce terms to address the information it has discovered or withdraw from the transaction then both parties have needlessly incurred wasted costs.

In looking at asymmetry of information, this thesis questioned whether the seller should be required to disclose any information to the buyer and if so, what information. This question is answered in the affirmative. To address the imbalance between buyer and seller as regards the revelation of information to the buyer penalty defaults offer the means to force the seller to share material information with the buyer.

The suggested penalty defaults are likely to offer the greatest value to those parties who are less able to pay for legal and other professional advice. In those cases, a legal rule which requires the disclosure of certain material information will benefit both the buyer and seller. It helps to maximise the price for the seller and provides the early release of information to the buyer. This results in a reduction in time and costs negotiating and documenting the transaction.

One of the challenges of penalty defaults is their adherence to the concept of efficiency, which is more difficult to satisfy than default rules that may not be contracted around. The contracting around increases transaction costs but, if properly formulated, will have generally beneficial effect on wealth maximisation. However, the extent of the efficiency or inefficiency of a penalty default is largely dependent on the default rule itself and the degree to which the parties will need to contract around it. However, it is clearly the case that if the cost of provision of information will be negligible for the seller, as it is suggested it will be, then efficiency is accordingly increased. In any event, the concept of disclosure by the seller, rather than contracting around penalty defaults, is likely to be how parties respond to the suggested penalty defaults. This will have lower costs associated with it than the parties seeking to delete or modify the penalty default.

Of course, it is accepted that no default rule will be able to replace the significant set of warranties that an informed buyer will require in a typical share sale. However, the suggested penalty defaults do offer some basic protection that it is expected would be demanded by any buyer. The suggested penalty default that has been devised in this chapter is based on principles from various law and economics sources. It has, in its sights, buyers and sellers in low value transactions and is designed to bring about the revelation of some specific types of information by the seller about the company and the shares it is selling.

This thesis does not consider from where any suggested penalty default rules should be promulgated. Default rules can be produced by the courts or by legislation. One issue that may be considered as part of this is how adequate default rules could be set by the courts in a reasonable time which reflects what share sale transactions require. This is especially the case when the courts deal with cases of breached warranties and if adequate disclosure has been made, rather than which warranties would be appropriate for a buyer to demand in a share transaction.

There has been no empirical research undertaken as part of this thesis. There is an opportunity for empirical research to be undertaken in respect of the findings made in this thesis.

Nor does this thesis consider matters from a comparative perspective. There are different approaches to share sales in other jurisdictions. The law and practice of the United States is compared to the law and practice in England and it is said that the law favours the buyer in the former and the seller in the latter. The reasons for this, and how these differences present, may be worthy of additional study.

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Appendix

Terms implied in shares sales in other jurisdictions

Are there any terms implied by law as to the seller's title to the shares in a share sale?

No implied terms: Japan, Belgium, Singapore, Ireland, BVI, Finland, Thailand, United Arab Emirates, Turkey, Poland, Cyprus, Australia, Spain, Netherlands, Malta.

India

Shares are considered goods under the Sale of Goods Act 1930 (Sale of Goods Act). The following terms are implied by law as to the seller's title to the shares (unless the circumstances of the contract show a different intention):

- An implied condition that the seller has the right to sell the goods.
- An implied warranty that the buyer has quiet possession of the goods.
- An implied warranty that the goods are free from any undisclosed charge or encumbrance in favour of any third party.

(Section 14, Sale of Goods Act.)

South Africa

The case law implies into the contract a warranty by the seller that there is no one with better title to the sale shares who will "evict" the buyer from the sale shares. No specific wording is needed for this implied warranty to apply, provided that the agreement meets the usual requirements (naturalia) of a sale transaction.

Canada

Certain provincial corporate statutes provide that a person transferring a security makes certain limited warranties relating to the securities (for example, the transfer is effective and rightful, no knowledge of impairments to the validity of the security, and no adverse claim).

Switzerland

The Swiss Code of Obligations provides that the seller is liable if there are deficiencies in the title to the shares.

France

French civil law provides for certain implied guarantees:

- Fraud: if the seller intentionally fails to disclose material information, the buyer can apply to court to have the sale declared void or to claim damages.
- Legal guarantee against hidden defects (*Garantie légale des vices cachés*) (Article 1641, Civil Code): This protects the buyer against any hidden defects (*vices cachés*) of the shares/assets that make them unfit for the use for which they were intended at

the time of the purchase or impair their use to such an extent that the buyer would not have acquired them, or would have paid a lower price, had they been aware of the defects. If the seller is in breach of this warranty, the buyer can obtain rescission of the contract and damages. The buyer must start a legal action rapidly after discovering the defect, failing which the claim will be barred.

The warranty against hidden defects does not, however, include an implied warranty as to the value of the shares, which means that it does not cover the underlying assets of the company being purchased.

- Legal guarantee against dispossession (*Garantie légale d'éviction*) (Article 1626, Civil Code). The seller must warrant the buyer against dispossession, in whole or in part, of the object sold (shares/assets), or against encumbrances over the object that were not declared at the time of the sale.

This guarantee applies to shares but not to the underlying assets (that is, the company and its business).

The buyer may also benefit from statutory protections under the general principles of the Civil Code, including:

- Duty of disclosure (Article 1112-1, Civil Code): This requires the seller to inform the buyer of any information that has a decisive influence on the buyer's decision to conclude the contract. This duty only applies if the buyer is legitimately unaware of the information or relies on the seller's knowledge. This obligation is more generally related to the parties' duty to negotiate, conclude, and perform contracts in good faith (Article 1104, Civil Code).

Luxembourg

Share transactions fall within the Civil Code's provisions on sales. The seller's title to the shares is implied by law on the following terms:

- Proper delivery of the shares (Article 1604, Civil Code). The seller must properly deliver the agreed shares to the buyer.

- Guarantee for hidden defects (Article 1641, Civil Code). The seller guarantees the buyer against any hidden defects in the shares which either:

    - make them unfit for the use for which they were intended at the time of the purchase; or
    - impair their use to such an extent that the buyer would not have acquired them or would only have paid a lower price.

The guarantee relates to the rights granted by the shares (that is, dividend or interest rights and voting rights).

- Guarantee of buyer's "quiet possession" (Article 1626, Civil Code). The seller must protect the buyer against third party acts in relation to the shares (for example, if the shares are subject to an encumbrance before the transfer).

No specific wording is required for these statutory guarantees to apply.

Hungary

The Civil Code generally requires and implies a warranty that a transfer of shares or quotas gives full and unrestricted ownership of the shares or quotas.

If the ownership title to the transferred shares or quotas is restricted, or if the transfer is hindered by third-party rights or claims, the buyer can rescind the sale and can claim damages. This claim for breach of the warranty implied by the Civil Code is limited by any buyer's knowledge of the limitation of transfer or ownership, unless the seller provides an explicit guarantee to unrestricted title.

China

There is an implied representation and warranty that the seller must own and have the right to dispose of the equity interests or shares in the target company. This is the default rule.

South Korea

Under the Commercial Code, the holder of a share certificate is presumed to be the owner of the shares represented by the certificate. However, the seller's ownership of the shares is not completely guaranteed by law.

Serbia

There is a statutory implied contractual term that the seller has good title to the shares without legal defects.

Czech republic

If not specified otherwise, the law implies that the:

- Seller has full title to the shares.
- Shares have been properly and validly issued.
- Shares are not encumbered in any way (except for encumbrances registered in the business register).

Italy

A warranty implied by law (Article 1483 and following, Civil Code) about the seller's title to the shares provides that there are no third-party ownership rights or other claims which may prevent or limit the buyer from exercising its proprietary rights over the shares (including an absence of liens).

If a third party's right or claim is confirmed or upheld by a judgment, the buyer can recover from the seller the purchase price and damages suffered in connection with the purchase provided that, among others, the buyer had no knowledge of the third-party claim and has joined the seller into the third-party proceedings.

Taiwan

The provisions of the Civil Code on sale contracts apply to a share sale. A seller must deliver the goods sold and transfer title to the goods to the buyer (Article 348, Civil Code). In addition, the seller must ensure that the goods are free from any third-party rights or claims against the buyer (Article 349, Civil Code). In a transfer of rights, the rights must be validly existing (Article 350, Civil Code).

Bangladesh

Under the Sales of Goods Act 1930, shares are considered to be goods. Therefore, unless the circumstances of the contract demonstrate a different intention, the following terms are implied by law as to the seller's title to the shares:

- An implied condition on the seller that it has a right to sell the shares.
- An implied warranty that the buyer has and enjoys quiet possession of the shares.
- An implied warranty that the shares are free from any undisclosed charge or encumbrance in favour of any third party.

Romania

There is a general legal warranty against eviction. This establishes the liability of the seller to the buyer in relation to the validity of the title to the transferred shares/assets. Therefore, the seller has a legal obligation to defend the buyer against third party claims to the shares/assets and to protect the buyer against the total or partial loss of the shares/asset due to causes existing before the transaction.

There is also a general legal warranty against latent (hidden) defects. This triggers liability of the seller to the buyer if the defects either:

- Make the sold assets/shares improper for use.
- Reduce the value of the assets/shares to the extent where, if known at the date of the transfer, the buyer would not have acquired the assets/shares or would have paid a lower price.

The seller and the buyer can agree in the sale agreement to limit or exclude the warranty against latent (hidden) defects. However, the seller will remain liable to the buyer for the latent (hidden) defects if it was aware of or should have been aware of at the execution date of the sale agreement.

Nepal

The law implies that the seller has good title to the shares and power and authority to sell the shares (section 535, Civil Code).

Source: Westlaw International