

Risk of liability: Account warranties in German M&A deals - German Court decides on warranty claims

Sellers' liability under accounts warranty in German M&A deals may be extensive and include unknown liabilities

It rarely happens that German courts deal with M&A litigation. The parties commonly prefer to defer their dispute to (confidential) arbitration. On one of these rare occasions, the Higher Regional Court of Frankfurt am Main had to decide on a warranty claim based on an accounts warranty. The case confirmed that both buyer and seller cannot pay too much attention to the accounts warranty and its particular wording.

Accounts warranty serves as "catch-all" warranty

A warranty on the accuracy of certain annual accounts of the target company granted by the seller is usually a key warranty for the buyer, as the annual accounts commonly serve as a basis for the purchase price calculation. In the case at hand, the buyer brought a claim for breach of the accounts warranty against the seller on the basis of several issues that in total led to a substantial overstatement of profits. The court was convinced that the buyer had based its purchase price calculation on the annual accounts presented to him by the seller and which turned out to be incorrect. In the court ruling the buyer was awarded damages in connection with customer guarantee claims, IT-maintenance costs, attorney expenses, personnel costs, insufficient deferred tax and VAT accruals and other reasons. It is unlikely that the seller had granted specific warranties dealing directly with these topics and yet the buyer was able to successfully establish his claims in court, effectively using the accounts warranty as a "catch-all" warranty.

Warranty held to cover both known and unknown liabilities

The parties had agreed on an objective accounts warranty, i.e. the warranty was not limited by the seller's knowledge. The court made clear that such objective accounts warranty can be triggered even if the seller has acted with all due care when setting up the accounts and although the seller was absolutely unaware of the risk prior to signing. It has to be noted that the wording of the clause did not refer to unknown liabilities in any way. Even though the specific clause largely resembled the German equivalent of the "true and fair view" principle set out in the German Commercial Code, the court did not give much weight to the question on how careful the seller has to be when accruing for risks under the applicable accounting standards. The court emphasized that the parties have agreed on an objective standard. The seller was thus denied a defence based on the seller's knowledge or standard of care at the time the accounts were set up.

Conclusions for M&A practice

Several legal practitioners criticized the decision, in particular for the strict approach taken on the objectiveness of the account warranty. However, the decision is unappealable and will remain part of the very limited case law on accounts warranties under German law. From a practitioner's perspective, it is therefore crucial – in particular for sellers – to fully understand the impact of the accounts warranty. If such warranty is drafted without necessary care, the seller may face extensive liability even if the annual accounts were set up in accordance with all applicable accounting standards and the underlying facts were unknown to the seller. An accounts warranty may be interpreted in a way that it effectively has the effect of a "catch-all" warranty, exposing the seller to extensive liability for topics (which are reflected in the annual accounts), for which the seller denied to grant a specific warranty.

Crucial facts are often revealed for the first time when setting up first annual accounts under buyer's control.

In the case discussed here, the buyer gathered all facts needed to establish the case during the preparation of the first annual accounts after closing. This again shows the need for the buyer to ensure while negotiating that the agreed time limitation allows the buyer to (i) set up annual accounts of all target companies under his own control, (ii) have these accounts

audited and (iii) prepare a claim based on any findings resulting from this exercise.

(The case discussed was decided by the Higher Regional Court (OLG) Frankfurt a.M. on May 7, 2015, case reference 26 U 35/12)

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