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Practical Issues Regarding Breaches of Balance Sheet Guarantees

M&A sale and purchase agreements contain as a standard a balance sheet guarantee, which often results in lengthy negotiations. The question arises whether a "subjectively soft" or "objectively hard" guarantee is to be given. Especially in "locked box" sale and purchase agreements, the purchaser will insist on an "objectively hard" balance sheet guarantee, as the purchase price will, in such case, have been calculated mainly on the basis of the latest balance sheet, and no purchase price adjustment will be made as of the closing on the basis of "closing accounts". The interpretation and, in particular, the legal consequences of breaches of balance sheet guarantees have been disputed for years. This is problematic, in particular, against the background of the tendency that it is tried more and more often to use balance sheet guarantees as a "rescue guarantee".

A current decision by the Higher Regional Court of Frankfurt (judgement of 7 May 2015, court file no. 26 U 35/12, published in GmbHR 2016, p. 116) had to deal with exactly these issues. This is a welcomed opportunity to examine considerations of practical relevance which should be observed as early as at the drafting of M&A sale and purchase agreements.

Elements of balance sheet guarantees

Quite often, the wording is used that the balance sheet "(i) was prepared with the due care of a prudent businessman in compliance with the statutory provisions *and* (ii) accurately reflects the company's actual asset, financial and earnings position". The reference under (ii) is understood as a "hard" balance sheet guarantee; this means that the guarantee will also be breached if, for example, debts and contingent liabilities for which no provisions were made already existed at the

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preparation while they were actually not apparent, even when applying duty of care required by accounting law. Any such facts and circumstances which become apparent only later are also referred to as "value-brightening facts" *(bilanzaufhellende Tatsachen)*, which were not required to be shown in the balance sheet at all in accordance with the principles of proper accounting. Ultimately, such a "hard" balance sheet guarantee focuses on the fiction of an omniscient preparer of the balance sheet.

If a seller wishes to avert a "hard" balance sheet guarantee, the seller must, therefore, insist on a subjective element. As a general rule, this can be achieved in two different ways:

Knowledge qualifier

The seller can accept a wording which limits the guarantee to the seller's knowledge. The wording will then be "(ii) to the seller's knowledge, accurately reflects the company's actual asset, financial and earnings position." The comprehensiveness of that limitation will then, of course depend on the definition of the seller's knowledge. Such limitation will – however – not be of help in relation to facts and circumstances which were not recognisable at the time of the preparation of the balance sheet, regardless of the character of the definition of "knowledge".

First sentence of section 264, subsection 2 German Commercial Code

A more subtle possibility to include a subjective element is the reference to the wording of the first sentence of section 264, subsection 2 German Commercial Code. The wording will then be: "(ii) *in compliance with the principles of proper accounting,* accurately reflects the company's actual asset, financial and earnings position. Such a reference to the principles of proper accounting, likewise, excludes facts and circumstances which were not apparent, as proper accounting will also be observed if, when applying the care required by accounting law,

unknown facts were not included in the accounting. The above clearly shows that the wording is essential in the drafting of, and negotiations on, balance sheet guarantees. Even minor changes can trigger a completely different scope of the guarantee.

Legal consequences

The legal consequences of a balance sheet guarantee are even more difficult to handle than its elements, even though the reference to sections 249 et seq. German Civil Code with all its usual restrictions (often in relation to lost profit, consequential damage, frustrated expenses etc.) in sale and purchase agreements appears to be unsuspicious at first glance. The almost philosophical discussions regarding the difference between positive and negative interests are deliberately not dealt with here.

- **Balance sheet replenishment *(Bilanzauffüllung)***

For practical purposes, it is sufficient to know that the claim to balance sheet replenishment has not been accepted from a dogmatic point of view. Applying that approach, in the event of a breach of a balance sheet guarantee, the balance sheet item would have to be replenished by a payment of the amount by which the relevant item was understated in the balance sheet. If, for example, provisions would have had to be made in knowledge of contingent liabilities, those provisions would have adversely affected the annual profit, and the difference would have to be compensated. That result, however, conflicts with the principles of German indemnity law, as no damage to be compensated will exist if the risk (e.g. provisions for warranty duties or lawsuits) does not materialise.

- **Purchase price reduction**

By contrast, any damage in the event of a breach of a balance sheet guarantee must – by way of principle – be calculated on the basis of the excess amount paid by the purchaser as the purchase price because the purchaser had relied on compliance with the guarantee, and thus the accuracy of the balance sheet.

As plausible as this may initially seem, this will be difficult to prove by the purchaser in practice, as the Higher Regional Court of Frankfurt sets high thresholds in relation to conclusiveness by stating that the annual profit stated in the balance sheet is only one of various indications for the assessment of the hypothetically appropriate purchase price. Any damage can, however, only be substantiated in practice if the breach of the balance sheet guarantee negatively affected the economic profitability, and thus the enterprise value, in the first place.

Therefore, in the event of a dispute, a court will have to review the details of the company valuation (DCF, capitalised earnings method, multiples etc.). It is rather unlikely that the parties would wish to turn to the court for such a complex task. Moreover, M&A sale and purchase agreements often provide that a calculation of damage on the basis of a hypothetical purchase price is excluded. Now, the judgement by the Higher Regional Court of Frankfurt provides purchasers with new arguments that such exclusion is not justified. What can now, at least, definitely be argued with more emphasis is a differentiation between recurring and non-recurring items which has a sustainable effect on the EBIT(DA) and will, therefore, affect the purchase price determination within the scope of the usual multiplication.

In the case at hand, the purchaser had not cleared the hurdle for a conclusive substantiation of the hypothetical purchase price. The court helped the purchaser in that respect by referring to the difference between the annual profit stated in the balance sheet and the annual loss which would arise in the case of "accurate accounting" and made a deduction of 20% within the scope of an estimated minimum damage in accordance with section 287 German Code of Civil Procedure.

In so doing, the court accepted the estimated amount to be lower than the actual damage. Effectively, the court granted a balance sheet replenishment with a 20% deduction. If the accounting errors affect the annual profit, one cannot invoke the main argument against the balance sheet replenishment that a claim for damages exists, although no damage was incurred at all, as damage of some kind will certainly exist in such case.

If a purchaser is, however, not willing to accept such a blanket approach, the hypothetical purchase price must be substantiated on the basis of all circumstances which are relevant for the purchase price determination. One question remains, however: How would a court calculate the damage if the sale and purchase agreement contained an exclusion of the calculation of damage on the basis of a hypothetical purchase price? Could the court then assume the existence of any damage at all as a result of the dogmatic classification of the calculation of damage? Would a court then switch to a claim of balance sheet replenishment (including a deduction, if applicable) in order to award to the purchaser at least some claim for damages as set forth herein? In view of the dogmatic position regarding the calculation of damage in the case of a breach of a balance sheet guarantee, the latter appears to be difficult.

Unfortunately, an appeal on points of law was not allowed, so that uncertainty is likely to continue to exist in practice, especially if the calculation of damage on the basis of a hypothetical purchase price is contractually excluded. The purchaser's legal advisors can hardly accept such a blanket exclusion.

Auditors' liability for damages

If a breach of a balance sheet guarantee results from the fact that the balance sheet was not prepared in compliance with the principles of proper accounting and/or the statutory provisions (i.e. the asset position was inaccurately stated not as a result of unknown facts but, rather, as a result of inaccurate accounting given knowledge of all facts), the company might have a claim for damages against the auditors. One should, however, exercise caution here, as the damage incurred by the company will in no way be the damage incurred by the purchaser as a result of an excessive purchase price payment.

Outlook

In conclusion, the parties would be well-advised to reach a specific understanding in connection with the contract negotiations on the legal consequences of the breach of the balance sheet guarantee (if necessary, by using exemplary

damage calculations) in order to avoid any subsequent unclear post-M&A disputes before a court of law (or an arbitral tribunal in the case of an arbitration clause in the M&A sale and purchase agreement). There is, however, a tendency to shift such complicated issues into the future more or less "with open eyes".

Therefore, it would not be surprising if blanket references to the calculation of damage in accordance with sections 249 et seq. German Civil Code will still be found in practice. A similar approach is adopted if the parties are unable to agree on specific duties. In such case, "best efforts" language is often applied, although it is most unclear to which set of duties is specifically referred therewith. If the parties would like to be sure which damage is to be compensated in the end, the parties cannot do without a detailed regulation on the legal consequences of a breach of a balance sheet guarantee. To avoid unpleasant subsequent disputes, one must clearly advocate specific arrangements regarding the damage calculation.

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