WARRANTY AND INDEMNITY INSURANCE ON FRENCH PE EXITS:

MANAGEMENT TEAM RISK, AN ISSUE FOR SPONSORS?

Introduction

Driven by the quest for "clean break" deal terms, the practice on financial sponsor-led portfolio company sale transactions of offering the buyer warranties and indemnities given by the portfolio company's management team, has been developing in France and is already well established in the UK (the largest market for warranty and indemnity insurance in Europe), northern Europe and the US.

The management's warranties are the subject of a buy-side warranty and indemnity insurance policy, with their liability for breach of the warranties typically capped at a nominal amount of one euro. The liability caps under the insurance policy are a separate matter for the buyer to decide and agree with the insurer.

The residual risk of *dol*

It has generally come to be understood by market participants and their advisors that in committing to give warranties and indemnities on this basis, the management are not placing themselves at risk of incurring personal liability, except in the event that the claim against them is based on fraud (*dol* under French law).

In order for the buyer to successfully make a claim based on *dol* and thereby open the door to the possibility of an award of damages against the management for an amount which exceeds the agreed liability cap, it is necessary for the buyer to prove that the obligor's breach of its contractual obligation was intentional[1].

When the hurdles to the making of a successful claim based on *dol* are explained to management teams, sponsors and their advisors have been accustomed to securing the management's acceptance that the residual risk of a claim on that basis is a theoretical one which it is reasonable for them to assume. The management are typically incentivized to cooperate, by means of transaction bonuses or through the terms of management incentive equity plans (MIPs), although no financial consideration for their warranties and indemnities is paid to them by the buyer to whom they are given.

Assuming the risk of a claim based on *dol* is a rational choice. A different potential source of risk for the management which deserves attention is article 1170 of the Civil code.

A recent judgment of the Court of Appeal of Limoges which focuses on article 1170 concerned a liability cap contained in a business solutions software licensing contract. It serves as a reminder that the potential for article 1170 to provide a basis for the buyer with a warranty claim in an M&A transaction to persuade the court to ignore a EUR 1 liability cap on management warranties should not be overlooked.

[1] Note that wilful misconduct (*faute lourde*) has been assimilated with *dol* by article 1231-3 of the Civil code, the effect of which is that the obligor is required only to pay the damages [for breach] provided for in the contract…except where the breach results from wilful misconduct or fraud. The Cour de Cassation has determined (Chronopost, Cass., ch. mixte, 22 April 2005, n0. 03-14.112) that « *seule une faute lourde caractérisée par une négligence d'une extrême gravité confinant au dol et dénotant l'inaptitude du débiteur à l'accomplissement de sa mission contractuelle peut mettre en échec la limitation de l'indemnisation* » and in a later case (Faurecia/Oracle, Cass. Com. 29 June 2010 n° 09-11.841) that « *la faute lourde ne peut résulter du seul manquement à une obligation contractuelle, fût-elle essentielle, mais doit se déduire de la gravité du comportement du débiteur* ».

Article 1170 of the Civil code

Over a period of several years preceding its 2016 codification of earlier appellate court jurisprudence, legal commentators and advisors took a close interest in earlier appellate court jurisprudence which eventually established that *"est réputée non-écrite la clause limitative de réparation qui contredit la portée de l'obligation essentielle souscrite par le débiteur*" ["a liability limitation clause which contradicts the essential substance of the obligor's obligation is deemed to be of no effect"].[2]

This principle is now enshrined in article 1170 of the Civil code, which states that *"Toute clause qui prive de sa substance l'obligation essentielle du débiteur est reputée non écrite*". ["A clause which empties of its substance the essential obligation of the obligor is deemed to be of no effect"].

It's worth noting that article 1170 applies to any clause which has the proscribed effect, not just liability caps. It's also worth noting that whilst the jurisprudence prior to the adoption of article was founded on a "clean hands" principle, to the effect that a party may not escape the consequences of its intentional breach or fraudulent actions by reliance on a limitation or exclusion of liability clause, article 1170 on its terms is not limited to intentional breach or fraud.[3]

In the context of insured management team warranties and indemnities, the questions which this article invites us to consider are (a) what is the "essential obligation" of the management team and (b) whether the one euro liability cap has the effect of "emptying of its substance" that obligation.

The precise wording will of course vary from one transaction to another, but in essence the management will typically agree to indemnify the buyer in respect of losses suffered as a result of their warranties being untrue.

That the courts will view a contractual obligation to indemnify for breach of warranty as being the essential obligation resulting from the warranties is illustrated by a 2014 Paris Court of Appeal case, concerning an M&A transaction involving a company called Sindaur SA.[4]

[2] The Faurecia/Oracle case: Cass.com, 29 June 2010, n° 09-11.841.

[3] See the commentary on Cass. Com. 20 January 2009, n° 07-18136 in Dondero, "*L'annulation de la clause de « cap » d'une garantie de passif*" JBS-2011-0018, p.76.

[4] CA Paris, 5,8, 28-10-2014, n° 12/08589.

The focus of that case was a failure by the sellers to comply with an obligation to make a payment into escrow as security for the warranties, an obligation which, in deciding against the buyer, the Court of Appeal determined to be a mere *"modalité d'exécution*" [method of execution] of the sellers' payment obligation. However the court noted that *"l'obligation essentielle du contrat [était] en l'espèce la garantie d'indemnisation stipulée en faveur des acquéreurs à hauteur d'un plafond convenue entre les parties"* ["the essential obligation of the contract was in fact the indemnification obligation provided in favour of the purchasers within the limit of a cap agreed between the parties"].

In the absence of the insurance policy, to which the management are not a party, it is tempting to conclude that the essential obligation resulting from the management's warranties is to indemnify the buyer if they prove to be untrue, or at the very least to compensate the buyer financially and that a liability cap of one euro empties that obligation of its substance.

A recent appelate case

A recent Court of Appeal judgment[5], relating to a dispute between the building materials company Rubis Matériaux and its IT services supplier Quadria, suggests that whilst that conclusion would be excessively pessimistic, article 1170 embodies potential risk for managers.

Again, the case concerned software contracts, this time in relation to the migration of the client's data to the Cloud and the maintenance of its systems. The contracts contained clauses limiting the service provider's liability to an amount equal to the value of six months' fees payable under them. The customer's losses largely exceeded the amount to which the clauses limited recovery.

The Court of Appeal decided that the contractual liability caps should be deemed to be of no effect, on the basis of article 1170.

In doing so, it observed that the damages to which the customer would be entitled if the liability caps were respected would be "derisory", having regard to the extent of the losses suffered by the customer as a result of the supplier's failures.

It also noted that the clauses in question were contained in general terms of service, which the customer did not have the opportunity to negotiate, the contracts being its standard forms (*"contrats d'adhésion"*).

The court took into account what it characterized as the "significant imbalance" in the respective rights and obligations of the parties (i.e. resulting from the liability caps).

Finally, it's interesting to note that the court also took account of the customer's right of recovery under an insurance policy it had contracted with Allianz. The cumulative amount of the insurance recovery and the contractual damages, if subject to the cap, would have been insufficient to cover the customer's entire loss.

Arguing a case based on article 1170 in an insured warranty context

An attempt to transpose the reasoning in the Rubis Matériaux/Quadria case to a management-backed W&I insurance policy prompts the following observations and questions:

- The court will consider the extent of the buyer's loss resulting from the breach of warranty. We should perhaps expect that the larger the loss, proportionate to the amount the buyer could recover if the cap were to apply, the greater the temptation of the court to disapply the cap. In a sense, this evaluation is a proxy for the determination of whether the obligation that has been breached is of the "essence" of the contract.

- This may be particularly true if the court concludes that the warrantors' breach resulted from particularly egregious behaviour. Article 1170 on its terms is not limited to cases of fraud or wilful misconduct (*dol* or *faute lourde),* but the case report suggests that Quadria did a particularly bad job and that in doing so caused Rubis grave problems for Rubis's business. An equivalent scenario might be one in which the warranty breach is particularly serious (for example a product liability issue comes to light, with a severe and enduring impact on the profitability of the acquired company's business, putting compliance with laws, fitness for purpose and compliance with customer specifications warranties in play). But there was no suggestion that Quadria engaged in fraud (*dol*) or that its breaches were intentional.

- The contract containing management backed warranties and indemnities is not a standard form contract ("*contrat d'adhésion*"), so this argument wouldn't be available to the buyer of a company in the way it was deployed by Rubis.

- The court can be expected to take account of the recovery available under the insurance policy. But what if the insurer fails to pay (perhaps on a technicality), or if the cover purchased by the buyer is insufficient to compensate the full loss (as was the case for Ruby Matériaux)? If combined with other factors, this one may add weight to a buyer's argument that the cap should be disapplied.

- Finally, there is the question of "significant imbalance". In most cases, this factor would, we assume operate in favour of the management. After all, they receive no direct economic benefit (apart form one euro, which they would presumably have to share amongst themselves…) for giving the warranties. But what about cases where the company becomes insolvent with significant job losses and public criticism of management conduct, or where the management receive significant amounts of money as a result of their participation in a MIP?

It can be seen that whilst article 1170 does not provide a buyer with a loaded gun to aim at an unarmed adversary, it might in some cases provide it with ammunition.

[5] Court of Appeal of Limoges, Chambre Economique et Sociale, 15 June 2022 n°21/00432.

The insurer's subrogation rights

Except in the most extreme cases (for example if it incurs uninsurable losses or losses of an amount which exceed the buyer’s rights of recovery under its insurance policy, or cases of insolvency) the management team can reasonably take the view that the buyer is unlikely ever to be motivated to bring a claim against them which deploys arguments based on article 1170. Moreover, if the buyer is itself a financial sponsor who has incentivized the management with a MIP, its interests and those of the management will be aligned, in the absence of “bad leaver” events.

However, the insurer’s interests and rights also have to be considered.

Policies invariably provide for a right of subrogation in favor of the insurer, exercisable if it is required to make payments pursuant to claims made under the policy. Typically, the policy will contain limitations on the exercise of the insurer’s rights. The insurer will waive its rights of subrogation against the seller and its related parties (who should be defined to include the management team giving the warranties), except in the case of fraud (under a French law policy, *dol*). Since the one euro contractual liability cap with respect to the warranties and indemnities would in any event not protect the management if they were proven to have committed fraud, the insurer would not need to have recourse to arguments based on article 1170 in order to exercise its rights of subrogation in such a case.

Conclusion

Article 1170 of the Civil code should not, it is submitted, be considered to be a “red flag” whose existence should prevent the use of management-backed W&I policies in France. However, market participants should take it into account when considering the use of these solutions.

The managers are not parties to the insurance policy. They may, if well advised, seek a commitment (from the buyer alone or possibly by way of a third party beneficiary clause in the policy), that the buyer will not agree to an amendment to the policy whose effect is to broaden the insurer’s exercisable right of subrogation without their consent. The selling fund should support the management in this request.

Other markets, in which W&I policies are more widely used, have in recent years seen the development of totally “synthetic” policies, where the warranty schedule is appended to the policy itself and neither the seller nor the management give warranties. For the moment this type of policy is understood to be encountered in certain real estate and distressed deals only. The reticence of the insurance market suggests that a wider use of such policies, providing a solution to the advantage of both financial sponsors and management teams, is an unlikely development.

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