

Competition Alert

09 April 2010

Caveat emptor? Competition conditions in sale and purchase agreements

A recent decision of the Scottish Court of Session, *BSA International SA Ltd v Hugh Irvine and Others*¹ ("**BSA v Hugh Irvine**"), provides a rare insight into the likely interpretation of competition warranties in sale and purchase agreements. This Alert examines the judgment and comments on the key things to be aware of when agreeing to a competition warranty, noting the pros and cons from the perspective of both vendors and purchasers.

What is a Competition Warranty?

A competition warranty ("**CW**") is a term inserted into a sale and purchase agreement ("**SPA**") designed to indemnify the purchaser against the risk that, prior to the sale, the company has engaged in a breach of competition law that has not yet come to light.² To mitigate against such risks, it seems that purchasers are requiring vendors to sign a warranty stating that they are not aware of any present investigation into the conduct of the company by competition authorities, nor any reason for a potential investigation in the future. In the event of a breach coming to light, the vendor would be responsible for meeting any competition damages and potentially also any litigation costs.

The risk of a regulator's investigation is a real risk, not only in terms of the potential for a penalty but also the amount of time and money that can be spent complying with a regulator's investigatory process. In the UK, WM Morrison Supermarkets plc ("**Morrisons**") became aware of the unfortunate realities of accepting this risk without the protection of a competition warranty: Morrisons acquired rival supermarket chain Safeway Stores Ltd ("**Safeway**") in 2004 and is now facing liability for a

fine of over £11 million for Safeway's alleged involvement in a cartel with other UK supermarkets and dairy processors during 2002 and 2003.³

"A well drafted competition warranty enables a purchaser to align the incentives of the vendor with its own. It is in the purchaser's interests to find out as much as possible about the company that it is buying. Their knowledge is often the only "control mechanism" through which they can accurately price any competition law risk they may be exposed to in purchasing a company."

A well drafted CW enables a purchaser to align the incentives of the vendor with its own. It is in the purchaser's interests to find out as much as possible about the company that it is buying. Their knowledge is often the only "control mechanism"⁴ through which they can accurately price any competition law risk they may be exposed to in purchasing a company. However, in the absence of a CW, it may be in the interests of a vendor to conceal – or not explicitly identify – any potential competition risk, in the hope of receiving a more favourable price for the company.

While there may be remedies available for misrepresentations under tort, contract law and the Fair Trading Act, none of these provide the certainty possible under a well-drafted CW. A CW is useful in clearly establishing a positive duty to disclose competition risk. This may explain the growing popularity of such warranties overseas. Due to their relative novelty, judicial consideration of such clauses is very limited and *BSA v Hugh Irvine* provides valuable insight into how the courts would seek to apply them.

Background

On 29 September 2004 the defendants sold their shareholdings in A McLelland & Son Ltd ("**McLelland**") to the plaintiffs, BSA International ("**BSA**"). The SPA between the parties included a CW. Clause 13 of the SPA provided:

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No Group Company has received any process, notice or communication, formal or informal, by or on behalf of the Office of Fair Trading or the European Commission or any other authority of any country ... having jurisdiction in anti-competitive matters in relation to any aspect of the business of that Group Company or any agreement of arrangement to which that Group Company is, or is alleged to be, a party, **and so far as the Warrantors are aware, there are no subsisting circumstances that may give rise to any such process, notice or communication being received by any Group Company.**

[Emphasis added].

Unbeknownst to BSA, McClelland had engaged in anti-competitive conduct prior to the sale. As a result, on 5 May 2005 the Office of Fair Trading ("**OFT**") required McClelland to provide documents and information for the purpose of an investigation. Subsequent to this, on 20 September 2007, the OFT issued a Statement of Objections ("**SO**"), alleging that over a two year period (2002 to 2003) McClelland had, along with other competitors, engaged in fixing the retail prices for milk, butter and cheese, in breach of the Competition Act 1998 (UK) ("**Competition Act**"), by sharing highly commercially sensitive information, including details of the level of price increases.

Following the service of the SO, McClelland admitted involvement in breaches of the Competition Act. A penalty has yet to be imposed. In *BSA v Hugh Irvine*, BSA invoked the CW and sought damages in the amount of the potential penalty as well as legal expenses incurred by the company in responding to the OFT's claim. A second alternative cause of action sought damages for negligent misrepresentation.

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Of principal interest in *BSA v Hugh Irvine* was the application of the knowledge component contained in the SPA's CW. The primary issue for debate was whether the warrantors were in fact aware of any 'subsisting circumstances', and had therefore breached the CW by failing to inform BSA of those circumstances. A further issue was whether this requirement was satisfied simply by proof of knowledge of the circumstances that led to the initiation of the OFT's proceedings, or whether the CW required a higher standard of proof, namely that the warrantors possessed an awareness that those circumstances might lead to a communication from the OFT?

The Decision

In his decision, Lord Glennie found in favour of the latter requirement- ie the higher standard. In respect of the claim

for a breach of the CW, Lord Glennie found that the word 'aware' required more than mere knowledge of facts, instead suggesting a measure of understanding of the potential for those facts to lead to an OFT communication.

It seems to me to point to awareness on the part of the Warrantors of something more than the bare facts which, albeit unknown to them, might interest the competition authorities.⁵

Lord Glennie held that liability was dependent on the purchaser establishing that:

- » the Warrantors (the vendors) were aware of the facts which in the event did give rise to communication from the OFT; and
- » the Warrantors (the vendors) were or ought reasonably to have been aware that those circumstances might lead to such communication.⁶

In Lord Glennie's view, this finding was said to be a 'commercially sensible construction' of the clause, and took into account considerations of where the risks ought to lie as between vendor and purchaser in a SPA. Having made these findings on the correct interpretation of the competition warranty, Lord Glennie suspended the case for counsel to make further submissions regarding breach.

While acknowledging that the purpose of the CW was to ensure that the purchasers were made aware of any known regulatory risk, Lord Glennie stated that the above construction made the most commercial sense as it would be untenable "to make vendors liable for the existence of circumstances where they could not possibly have been aware of their importance."⁷ Lord Glennie was of the view that such a construction would not appeal to commercial parties entering into a SPA.

"Knowledge of facts or circumstances that would lead a reasonable businessperson in the shoes of the vendors to be aware of the potential for investigation by competition authorities will be sufficient to meet the requirement of 'awareness' under the CW. Essentially, vendors cannot feign ignorance if circumstances exist which would, from an objective point of view, create awareness of the risk of future investigation."

The phrases "ought reasonably to have been aware"⁸ and "could not possibly have been aware"⁹ impart an objective test for the degree of awareness required by the wording of the CW. Knowledge of facts or circumstances that would lead a reasonable businessperson in the shoes of the vendors to be aware of the potential for investigation by competition authorities will be sufficient to meet the requirement of 'awareness' under the CW. Essentially, vendors cannot feign ignorance if circumstances exist which would, from an objective point of view, create awareness of the risk of future investigation.

Relevance to the New Zealand market

In light of a predicted increase in merger and acquisition activity in 2010, parties should be cognisant of the effect a CW might have in a SPA. If international trends and the possible impact that criminalisation of cartel activity might have on risk allocation in commercial transactions are an indication, purchasers are likely to continue to require warranties against 'regulatory investigations' and potentially to push for the inclusion of a specific CW in SPA's. However, unless drafted with sufficient clarity, it is questionable whether CWs will add much beyond the existing protections available under contract, tort law and the Fair Trading Act, particularly in light of the difficulties associated with establishing the existence of sufficient knowledge to engage the clause. Given the costs of enforcement when a knowledge element is required, more simple and transparent CWs may prove the best method of allocating risk between the parties, a fact noted by Lord Glennie in *BSA v Hugh Irvine*:

Had it been intended, however, that the Warrantors should warrant that no circumstances existed which **might** give rise to any such process, notice or communication from the competition authorities, it would have been easy to say so.

[Emphasis in original].

Due to the lack of case law on CWs, and risk of greater penalties if criminalisation proceeds, it will be interesting to

observe the extent to which CW wording becomes more of a focus in commercial negotiations. Vendors may increasingly need to weigh the extent to which a reluctance to provide a CW may raise question marks for prospective purchasers against the difficulty in valuing competition law risks.

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Regardless, in our experience, while regulatory risk warranties are common, specific CWs are less so. Nevertheless, BSA's action in *BSA v Hugh Irvine* reflects a wider trend, as increased enforcement activity on the part of competition authorities and a general upward trend in penalties has led many firms to seek more innovative means of defraying potential competition law liabilities.¹⁰

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1. [2010] CSOH 12.
2. In New Zealand, a competition warranty would seek to indemnify breaches of the Commerce Act 1986.
3. This settlement between Safeway and the Office of Fair Trading was the subject of a February 2010 Competition Alert. See Russell McVeagh Competition Alert, *Safeway turns on its price fixing employees*, 19 October 2009 available at http://www.russellmcveagh.com/docs/CompetitionAlertFeb2010_277.pdf
4. A phrase used by Counsel for the purchasers in *BSA International SA Ltd v Hugh Irvine and Others* [2010] CSOH 12, quoted by Lord Glennie at [35].
5. *BSA International SA Ltd v Hugh Irvine and Others* [2010] CSOH 12 at [39].
6. *Ibid.*
7. *BSA International SA Ltd v Hugh Irvine and Others* [2010] CSOH 12 at [39].
8. *Ibid* [39].
9. *Ibid* [39].
10. For example the *Safeway* case (referred to above) in the United Kingdom, in which ex-employees and directors were pursued for indemnity against fines for breaches of the Competition Act and compensation for legal costs.

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