

Last month, the High Court at Christchurch released its decision on a case briefly addressing the measure of damages for breach of a turnover warranty in a business sale and purchase agreement (*Cunningham v European Interiors Limited* [2024] NZHC 618).

Turnover warranties are a common feature of business sale and purchase transactions and are one of the main warranties in the ADLS standard form agreement. In most cases, the warranted turnover is the *historic* turnover of the business, rather than future turnover. Of note in this case is that the Court awarded damages for breach of the turnover warranty based on loss of expected profits from the business post-completion.

The case provides useful context for considering the broader implications of financial warranties and remedies for breach claims, and highlights the importance of robust financial due diligence and consideration of the financial strength of parties from whom recourse might be sought.

## The High Court decision

*Cunningham* concerned the purchase of part of a kitchens and appliances business by Ms Cunningham and her nominee company (Cunningham) from European Interiors Limited (European). Amongst other things, European had warranted the turnover of the business in the nine-month period prior to Cunningham's entry into the sale and purchase agreement. The shareholder and director of European (as covenantor) also covenanted the warranties in the sale and purchase agreement.

Cunningham sued European and the covenantor for breach of the turnover warranty. A claim was also made against European under the Fair Trading Act 1986.<sup>1</sup> The sale and purchase agreement warranted that the turnover in the relevant period had been some \$2.2 million. After completion Cunningham discovered that the actual turnover had been less than half of that – closer to \$1.05 million.

European had been placed into liquidation during the proceeding and had not filed any defence. The covenantor had also been adjudicated bankrupt and had not advanced any active defence. The matter was therefore dealt with by formal proof, accounting for the brevity of the decision.

The Judge was satisfied on the evidence that the turnover warranty had been breached. His Honour therefore turned to consideration of the appropriate measure of damages.

Cunningham claimed loss on two alternative bases:

- for loss of profits, on the basis that if the turnover warranty had been correct the purchaser would have earned additional profits of approximately \$2.3 million; and
- in the alternative for loss of capital value, on the basis that the true value of the business was \$1 million less than the purchase price of \$1.2 million paid for it.

The Judge held that, where a turnover warranty is breached, it is common to approach the calculation of the plaintiff's loss by reference to its loss of profits. The innocent party has an expectation interest which the law requires to be fulfilled, by financially restoring that party to the position they would have occupied if the contract had been performed.

The Judge had the benefit of extensive evidence from Cunningham's forensic accountant and was satisfied that Cunningham was entitled to damages calculated by reference to loss of profits over the three-year period from completion. Judgment in the sum of \$2.3 million was accordingly entered against European and the covenantor on a joint and several basis, together with interest and costs.

1. Cunningham had also brought claims in negligence and for breach of contract against the accounting firm advising Cunningham, but these claims had been resolved prior to trial.

## Discussion

The decision departs from the usual starting point that a claim for breach of warranty in a sale and purchase context typically sounds in damages assessed by reference to the difference between the “as warranted” value of the business and the actual value of the business at the point of sale. That was the approach adopted in *Dangerous Goods Compliance Ltd v Farquhar Lelean Holdings Ltd (in liquidation)* [2022] NZHC 3041 where Muir J proceeded on the basis that the proper measure of damages for a breach of a turnover warranty is the difference between the value of the business if the turnover was as warranted (warranty true) and its value given its actual turnover (warranty false).

In the authors’ view it is less common, in the absence of a forward-looking warranty, for the Courts to award expectation losses as if the warranty were a term of the contract requiring performance. A warranty as to the historic turnover of a business would typically be characterised as a contractual “promise” (or representation) of a past fact, not any promise as to how the business will perform in future. In *Superior Vending Ltd v Superior Vending Company (New Zealand) Ltd* (High Court Auckland, CP704/98, 18 August 2000) Williams J did not allow a claim for annual losses following settlement, finding that the business was the purchasers’ to run from settlement and noting that there had been no warranty as to future profitability.

Of course, an expert valuing the business would be expected to have regard to the future earning capacity of the business based on its past turnover performance and an assessment about the sustainability of those earnings in the future. That analysis would fall squarely within the traditional bounds of assessing the value of the business “as warranted”, applying an appropriate (market) risk discount to the prospect of future earnings as at the date the warranties are breached.

In a similar case of *AAM Ltd v Exotica Enterprise Limited* [2019] NZHC 1482 which concerned the purchase of part of a business, Lang J considered the appropriate measure of damages for breach of a warranty as to historic turnover. There were several features of the case – primarily relating to the way in which the purchaser operated the business post-completion – that meant that the “only realistic approach” the Court could take to the assessment of damages was to determine the price that the purchaser would have been prepared to pay had she been aware of the true position regarding the turnover. While that is a slightly different assessment to the market value of the business “as warranted” as compared to its true position, that approach bears a much greater similarity to the usual approach to damages for breach of warranty as applied in the other authorities referred to above. The subjective approach appears to have been necessary because the purchaser appeared to have had little regard for market value in entering the transaction in the first place.

### Broader observations:

- The turnover warranty is one of several financial warranties that may be given by a vendor in a sale and purchase agreement. They are readily relied on by purchasers and their advisers in valuing a business. It should come as no surprise that claims for breach of financial warranties are among the most common.
- Most warranties given in a sale and purchase context relate to historical matters, including financial accounts. However, businesses and companies are commonly valued based on future financial forecasts, which may be made available by a vendor but not warranted. When the purchase price has assumed a big uptick in future earnings, it can be challenging to establish losses based on breach of warranties as to historic matters that do not prove up those assumptions. Vendors are unwilling to give warranties as to future performance so purchasers are often better to protect themselves with other mechanisms in those scenarios – particularly earnouts.
- These factors make a robust financial due diligence critical. Even more so when a warranty insurance policy is sought as underwriters increasingly require comfort that due diligence has been carefully carried out on the warranted subject matter.
- The financial strength of parties from whom recourse might be sought is also critical. While Cunningham and her nominee succeeded in this case, they appear to rank as unsecured creditors in the liquidation and bankruptcy of European and the covenantor. In a more distressed business environment, holdbacks and secured escrow retentions can be important.

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