PE Investments — Lookout for Representations and Warranties

Representations and warranties pertain to statements of facts pertaining to the investee company and the promoters, including solvency, the state and validity of the business of the investee companies, their business permits, licences, contracts, customers, etc.

The recent cancellation of the 2G telecom licenses has led Telenor to sue Unitech for breach of warranties and Etisalat to sue Swan Telecom for fraud and misrepresentation. These developments merit a closer look at the legal concepts of representations and warranties and the remedies available for their failure or breach.

What are Representations and Warranties?

In common parlance, the terminologies 'representations' and 'warranties' are used interchangeably though in reality they are conceptually quite different.

The Indian Contract Act, 1872 (Contract Act), does not define either 'representation' or 'warranty'. The meaning of the terms 'representation' and 'warranty' has evolved over a period of time through various case laws. A representation is an assertion of a past or existing fact, made by one party to a contract to the other, before or at the time of the contract, relating to the subject matter of the contract. A statement by a company that it used appropriate means to obtain its business licences and that such licences are in effect is an example of a representation regarding past and existing facts or state of affairs. A statement that such licenses will not be cancelled or affected in the future may be more in the nature of a promise (depending on the intention of the parties). A representation that something will be done

1. http://www.deccanherald.com/content/227602/telenor-drop-partner-unitech-2g.html
in the future may result in a contract (unless the law requires otherwise) if the person to whom it is addressed acts on the basis of such a representation.4

Warranties are terms of a contract and breach of a warranty can give rise to a claim for damages. Representations which are made on the basis of a contract or on the terms of a contract are warranties. In the example above, the existence and continuance of a valid business license may be considered to be an essential term of the contract between a company/promoter and a potential investor, and if this is the case, such a statement could be a warranty. Whether a statement of fact is a representation or warranty needs to be construed from the intention of the parties and will depend upon the facts of the case.

What Amounts to Misrepresentation?

Sections 18 and 19 of the Contract Act define the term 'misrepresentation' and the remedies available to a party who has suffered on account of a misrepresentation. Misrepresentation means the following:

i. Positive assertion of a fact, not supported by the information of the person making it, though he believes it to be true.

For example, X makes an investment in a company on the basis of the representation of the promoter of the company that Y will also invest in this company. Y does not in fact make the investment. The promoter genuinely believed that Y would do so. This could constitute a misrepresentation by the promoter if he did not have sufficient basis to say that Y would in fact invest. These kinds of representations, though innocently made, would constitute misrepresentation under law if made without sufficient basis or information.

In the case of Governor of Orissa State V/s Shivaprasad Sahu,7 where a forest contractor had marked certain trees as sound (based on external appearance) for felling, the court held that there was no misrepresentation at all as the forest contractor had made statement of facts after verifying the external appearance of the trees, which was a reasonable ground, as per the facts of the case. The court observed that "that innocent misrepresentation does not cause avoiding a contract unless the representation is made without reasonable ground".

Breach of duty by a party, without intent to deceive, as a result of which the breaching party gains an advantage over the other party, by misleading the other party to his prejudice.

For example, a company knows that some of its key employees

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4 Century Spinning & Manufacturing Co. Ltd. V/s Ulhasnagar Municipal Council 1970 SCR (2) 854. Where there is no concluded contract, it may also be possible to apply the doctrine of promissory estoppel, an equitable doctrine – this doctrine is applied where one party has made a promise with the knowledge that the other will act on it, such other party actually acts on the basis of this promise, and it is inequitable to allow the party making the promise to go back upon it. See M.P. Sugar Mills Co. Ltd. V/s State of Uttar Pradesh AIR 1979 SC 621.

5 The Sale of Goods Act, 1930 defines a warranty as “a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not to a right to reject the goods and treat the contract as repudiated.” This definition is quite different from the meaning of the term warranty as commonly understood. The Sale of Goods Act, 1930 applies to a sale of shares.

6 All India General Insurance Co. V/s S.P. Maheswari AIR 1960 Mad 484.

7 Governor of Orissa V/s Shivaprasad Sahu AIR 1963 Ori 217
intend to resign from their employment, but has not received any formal letters of resignation from any of them. It does not inform a potential investor of this fact because it believes that until a letter of resignation is received it is not necessary to communicate this to the investor. The investor is misled into believing that the key employees will be retained by the company, and this is one of the assumptions of a potential investment in the company. Such non-disclosure, though made without any intent to deceive, is a misrepresentation, since the investor considers the retention of the key employees material to the investment and requires the company to disclose all material facts regarding the key employees.

iii. Innocently (i.e. without the intent to deceive) causing the other party to make a mistake as to the substance of the thing which is the subject of the agreement.

For example, the promoter of a company represents to an investor that the company has received a business license XYZ. The investor assumes, by mistake, that such a license permits the company to engage in a certain activity (for which a similar but separate license is usually issued). Such a representation would be misrepresentation, even though the promoter made it innocently and the investor made a mistake.

To constitute a misrepresentation, the assertion, breach of duty, or action in question should have been committed without an intent to deceive. If an intent to deceive exists, the same assertion, breach of duty or action, would constitute 'fraud'.

**Consequences of Misrepresentation and Breach of Warranty**

Section 19 of the Contract Act provides that if consent to an agreement is induced through fraud or misrepresentation, then the party whose consent has been obtained in such manner can either:

i. Avoid the agreement by rescinding the contract. When an aggrieved party chooses to avoid a voidable contract and rescind it, he will not be required to perform his obligations under the agreement. Further, each of the parties to the agreement must also return any benefits or advantages they have received from the other. The aggrieved party may also claim restoration in the form of damages. However, a contract cannot be rescinded if the party rescinding it cannot be restored to the same position in which he was before entering the contract.

**Or**

ii. Continue with the contract, claim performance of the contract and restoration to the same position he would have been in had the representation been true. Such restoration may be in the form of damages.

**There are a couple of exceptions/qualifiers to Section 19. An agreement is not voidable if:**

i. The fraud or misrepresentation in question was not an inducement for the consent to the agreement;

ii. The consent was caused by innocent misrepresentation or by fraudulent silence and the consenting party could have discovered the truth with ordinary diligence.

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8 Section 65 of the Contract Act
9 Section 65 of the Contract Act. Also, see Sorabshah Pestonji V/s Secretary of State for India (1927) 29 Bom LR 1535 where it was held that compensation can be awarded in lieu of performance of contract.
10 RC Thakkar V/s Gujarat Housing Board AIR 1973 Guj 34
11 There are different categories of fraud under section 17 of the Contract Act. The exception, refers to the active concealment of a fact, where there was a duty to disclose such fact.
12 Other kinds of fraud under section 17 of the Contract Act will not be covered by this exception, and the aggrieved party can either avoid the contract or claim damages, whether or not he could have discovered the truth with ordinary diligence.
set out in the Specific Relief Act, 1963 are relevant. Courts may refuse rescission if the party entitled to rescission had ratified the contract or due to change in circumstances the parties cannot be substantially restored to their original position. Also, specific performance is granted if damages are not an adequate relief.

Difference Between the Consequence of Misrepresentation and Breach of Warranty

The difference between the consequence of misrepresentation and breach of warranty has been explained by the Madras High Court as follows in the case of All India General Insurance Co.

"In the case of a warranty, materiality or immateriality of the fact warranted signifies nothing. Its incorrectness constitutes a defence to an action on the policy, even though it be not material and be made in perfect good faith. But, in the case of a representation, the insurer can avoid the policy only by proving that the statement is false and fraudulent or that it was false and material to the risk. In other words, it is only a material misrepresentation that can avoid a policy if the truth of the facts contained in the representations be not warranted by the policy."

Does a Due Diligence of a Company or Disclosures Made by It, Dilute Its Representations and Warranties?

During the course of a due diligence exercise, an investor obtains access to volumes of information about the investee company. If the investor had knowledge of the truth of a certain matter, that is the subject of a misrepresentation, then it may be difficult to seek any remedy under law. Also, another common method of qualification is through a disclosure schedule accompanying the representations and warranties, where the party making the representations and warranties discloses specific liabilities and issues, for which it may not be subsequently prosecuted for misrepresentation. Therefore, prior knowledge of an investor weakens its remedies against the promoter/company, and it may lose its right to avoid the contract and claim damages. An indemnity contract may be useful in such scenarios where the investor has knowledge of certain issues and does not want to bear the risk of any losses on account of them. Under an indemnity contract, the promoter and company could be required to reimburse the investor for any specific losses, despite the investor's prior knowledge regarding the events that caused those losses.

Conclusion

From an investor's perspective it is important that

(i) the company and its promoters rectify all statutory and contractual non-compliances etc. as a condition precedent to the investor investing in the company and to the extent possible resolve issues that may result in a material liability to the company or the investor before the investment takes place;

(ii) the documentation specifies what should be considered as a material representation or a warranty, or a condition to the contract and which of the representations and warranties are material and are inducement to the contract; and,

(iii) the investor be entitled to claim indemnity.

From a promoter's perspective it is important

(i) to make true and complete disclosure of all material facts regarding the business of the company, and

(ii) not make any representations/warranties regarding the future business or operations of the company.

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