CA on appeal from TCC (His Honour Judge Bowsher QC) before Lord Woolf MR, Clarke LJ, Mance LJ. 6th July 1999.

JUDGMENT : LORD JUSTICE CLARKE :

Introduction

1. This is an appeal by the defendants from an order from His Honour Judge Bowsher QC dated the 21st December 1998 by which he struck out paragraph 9.1 of the re-amended defence and refused to allow the defendants further to amend paragraph 9.1 to provide further particulars of the allegation contained in it. The appeal is brought by leave of the judge. The order was made in order to reflect the judge's decision that on the true construction of an agreement between the parties dated the 25th February 1993 ("the agreement") the defendants were in breach of warranties 7.2 and 7.6 in schedule 3 of the agreement and that they were not entitled to rely upon clause 7.9.3 to defeat their liability for breach of the warranties or to reduce the damages. As I read the judgment, that was a determination under RSC Order 14A.

Background

2. By the agreement the plaintiffs purchased the majority of the share capital of Vision Technology Group Ltd ("VTG") from the defendants and The Monument Trust Company Ltd. VTG was the parent company of a group of subsidiaries which carried on two businesses, namely a mail order business supplying computer equipment and a chain of retail computer stores trading under the name of "*PC World*".

3. By clause 3.1 of the agreement the consideration for the purchase was the sum of £4.06 million plus an amount equivalent to the value of the net assets, subject to a minimum payment of £900,000 for the net assets. There is no indication in the agreement as to how the price of £4.06 million was arrived at. Mr Michael Briggs QC submitted that we should not speculate on that question. I shall not therefore do so. The net assets were defined by clause 1 and schedule 6 of the agreement as being assets shown in the Completion Balance Sheet, which itself was defined as *"the audited consolidated balance sheet of the company and its subsidiaries forming part of the Completion Accounts. "* Completion Accounts were defined in paragraph 1.2 of schedule 6 as *"the audited consolidated balance sheet as at the date of completion and the audited and consolidated profit and loss account for the period from the last Accounts Date to Completion of the company and the subsidiaries prepared with accordance with this schedule and schedule 7. "*

4. In October 1997 the judge was asked to determine whether the defendants were entitled to have the Completion Accounts re-opened. On the 23rd October 1997 he held that they were not. As a result he ordered some of the paragraphs of the amended defence and counterclaim to be struck out.

The Agreement

5. The issue which gives rise to this appeal depends upon the true construction of particular provisions of the agreement. By clause 6 of the agreement the defendants gave warranties to the plaintiffs as follows:

   6.2 *Each Warranting Vendor jointly and severally warrants to the Purchaser that save as fairly set out in the Disclosure Letter, the Warranties set out in Schedule 3 are true and accurate at the date of this agreement and are not to be affected or limited by any previous or other disclosures, express or implied, to the Purchaser, its officers, representatives or professional advisers.*
   Schedule 3, headed "Warranties", includes the following;

   7.2 ***Net assets***
   An audited consolidated balance sheet of the company and the subsidiaries as at Completion prepared on the same basis and principles as the Completion Balance Sheet would show that the net assets of Company (being the called-up share capital of the Company plus or minus the amounts standing to the credit of or debited to consolidated reserves (including without limitation the share premium account reserve, the capital reserve and the profit and loss account)) would be not less than nil.

   7.6 ***Margin***
   The gross margin on sales achieved by the four retail stores trading as PC World in the period from the Last Accounts Date to Completion was not less than an average of 16%. ... For the purposes of this warranty

gross margins shall mean gross profit expressed as a percentage of turnover (excluding VAT) for such retail stores business...., and gross profit and turnover (excluding Vat) shall be calculated on a basis consistent with the consolidated profit and loss account forming part of the Completion Accounts.

12.1 ***Legal proceedings***

The Company is not and has not since the Last Accounts Date been engaged and so far as the Warranting Vendors are aware there are no circumstances likely to lead to the company becoming engaged in any legal proceedings...

In the course of his judgment the judge concentrated upon warranty 7.6, although his decision related also to warranty 7.2.

6. The consequences of the breach of warranties are limited in certain respects by clause 7 of the agreement, including:

7.9 No liability shall arise to the Warranting Vendors and the Purchaser shall not have any claim whatsoever against the Warranting Vendors in respect of any breach of any of the Warranties or any claim under the Deed of Covenant: ...

7.9.3 to the extent that provision or reserve in respect thereof has been made in the Completion Accounts;

7.9.4 except in relation to a breach of tax warranty or claim under the Deed of Covenant to the extent of the amount as at Completion by which any asset of the Group Companies shall prove to have been understated in the Completion Accounts;

7.9.5 except in relation to a breach of tax warranty or claim under the Deed of Covenant to the extent of the amount as at Completion by which any liabilities of the Group Companies proves to have been overstated in the Completion Accounts.

Schedule 6 to the agreement, headed "Completion Accounts", included the following:

1.2 "Completion Accounts" means the audited consolidated balance sheet as at the date of Completion and the Audited and consolidated profit and loss account for the period from the Last Accounts Date to Completion of the Company and the Subsidiaries prepared with accordance with this Schedule and Schedule 7.

"Draft Documents" means drafts of each of the Completion Accounts, Completion Balance Sheet and Statement to be prepared by Purchaser pursuant to paragraph 2.1;

2.5 Outstanding items, disputed items or the Draft Documents ... shall be referred for final settlement to a firm of chartered accounts ... such firms shall act as experts and not arbitrators and their decision shall be final and binding on all the parties save in the case of manifest error...

Pursuant to those terms draft documents were drawn up and disputed items were referred to an accountant, namely Mr Jackson, of Price Waterhouse, as an expert. He heard submissions from the accountants for the respective parties and he made a determination dated the 20th September 1995 settling the Completion Accounts. It was those Completion Accounts which were the subject of the judge's earlier decision of the 23rd October 1997.

7. Schedule 7 to the agreement included the following:

1. <u>Bases of preparation of the Completion Accounts</u>

1.1 The Completion Accounts shall be prepared on the following basis or presumptions:

1.2 In accordance with generally accepted UK accounting practices and principles including accounting standards and (subject there to) on the basis of the same accounting policies adopted in the Last Accounts (save as provided below):

1.3 For the avoidance of doubt, appropriate provisions shall be included in the audited consolidated and loss account and audited consolidated balance sheet in accordance with generally accepted UK accounting principles (including accounting standards) for:

1.4.3 Stock (including display) (stock to reduce the value of individual items to the lower of (a) average cost price (b) latest cost price and (c) selling price less anticipated direct selling costs to be incurred prior to sale such selling price to take into account age, obsolescence and condition of the stock);

1.4.4 Litigation; ...

The Claim

8. The plaintiff says that the defendants were in breach of warranties 7.2 and 7.6. Both claims are based upon the Completion Accounts. The Completion Accounts show a negative value for net assets, namely £24, 371, which is the sum claimed as damages for breach of warranty 7.2. The claim for damages for breach of warranty 7.6 is very much greater. The plaintiffs' case is that the Completion Accounts show a gross margin of 14.81%, which is less than the 16% warranted, and that it follows that there was a breach of warranty. It is not in dispute that the Completion Accounts do show a gross margin of 14.81% and it is conceded that it follows that there was a breach of warranty. The quantum of the plaintiff's claim is based upon the difference between the value of the business based on the warranted gross margin less the actual value of the business. It claims £0.880 million based on existing business and £3.282 million based on alleged potential business, making £4.162 million in all. I was not surprised to learn that if this appeal fails there is likely to be considerable dispute as to the true quantum of the plaintiffs' claim.

The Defence

9. In response to the plaintiff's claim based on breach of warranty 7.6 (and indeed also to their claim based on breach of warranty 7.2) the defendants wish to rely upon clause 7.9.3 of the contract. Their proposed pleading in its finally amended form is in these terms:

9.1 *By virtue of the provisions of Clause 7.9 of the Agreement set out in paragraph 4 hereof to the extent to which provision or reserve is made ~~for such breaches~~ in respect of the subject matter of any such warranty in the Completion Accounts (as defined in the Agreement) ("the Completion Accounts") such loss is irrecoverable from the defendants.*

PARTICULARS

The provision and reserves made in the Completion Accounts is respect of the subject matter of Warranty 7.6 are set out in a report dated [ ] by Messrs Ernst & Young, copy of which is served herewith.

The provisions of clause 7.9 set out in paragraph 4 of the pleading are clauses 7.9 and 7.9.3 as set out above. The words underlined and the deletion of "for such breaches" show the proposed amendment. The report referred to is appended to a witness statement made by Mr Wilkinson of Ernst & Young in which he described the report as "analysing the proportion of the shortfall of the warranted gross margin [in the Completion Accounts] which is represented by a "provision or reserve"".

10. An important element of the gross margin of 14.81% in the Completion Accounts is gross profit of £2,732,361, which was arrived at by deducting £15,712,525 in respect of "Cost of Sales" from £18,444,886 in respect of "Turnover". Mr Wilkinson's report contain the following:

2. In accounting terminology, the gross profit of a company is generally taken as representing the figure for sales or turnover less the figure for cost of sales. Similarly, gross margin is generally taken as representing the gross profit figure expressed as a percentage of sales. These definitions are consistent with the description of gross margin as set out in clause 7.6 of schedule 3 of the Sale and Purchase Agreement.

3 It therefore follows that in order to assess the impact of any "provision or reserve" on the gross margin, it is necessary to add back all provisions and reserves included in the cost of sales line. Such provisions would generally relate to stock in the opening and closing balance sheet ie provisions for obsolete stock or stock returned by a customer.

Mr Wilkinson then carried out an analysis of the basis upon which the Completion Accounts had been prepared and concluded that the figure of £2,732,361 in respect of Cost of Sales included a provision for obsolete and returned stock of £244,453. He then added that the figure back, which had the effect of increasing the gross margin of 14.81% by 1.33% to 16.14%.

11. The defendants submitted to the judge and have submitted to us that in these circumstances the effect of clause 7.9.3 is that the plaintiff's claim for damages for breach of warranty 7.6 is reduced to nil. The judge rejected that submission.

12. The same point arises with regard to warranty 7.2. The Completion Accounts show that as at the 25th February 1993 there was a negative net asset value of £24,371. One of the sums which finally led to

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that figure was £6,532,529 in respect of current assets, which included £244,453, which was the provision for obsolete and returned stock referred to above. It follows that if that provision were removed, the net assets would have had a positive value as at the 25th February 1993. The difference between the two parts of the accounts is of course that the net asset value is taken at a particular date, namely the 25th February 1993, whereas the gross margin is taken over a period of some five months between the date of the last accounts and the date of completion.

The Appeal

13. The question on the appeal is the same as the question which was before the judge. It is whether the defendants are entitled to rely upon clause 7.9.3 to exclude or reduce to nil their liability for breach of warranty 7.6 and 7.2.

Discussion

14. It is common ground that clause 7.9.3 must be construed in the context of the agreement as a whole, which in turn must be set against its surroundings circumstances. One of the relevant considerations is of course the purpose of the clause. For present purposes the clause can be re-written as follows:

No liability shall arise to the defendants and the plaintiffs shall not have any claim whatsoever in respect of any breach of warranty to the extent that provision or reserve in respect thereof has been made in the Completion Accounts.

As I see it the clause is a form of exclusion clause. It applies when there is a breach of warranty and has effect so as to exclude the vendors' liability for that breach to the extent that "provision or reserve in respect thereof has been made in the Completion Accounts".

15. The grammar used might suggest that the expression "*in respect thereof*" in clause 7.9.3 is a reference back to "in respect of any breach of any of the Warranties" in clause 7.9 itself. As to that the judge said this in paragraph 26 of his judgment: *"It was the function of the completed accounts to put a value on the company. It was no part of the task of the Expert to include in the Completion Accounts provision for the liability or potential liability of the defendant shareholders as warranting vendors. Indeed, there is no such provision for such liability in the Completion Accounts. That liability or potential liability is outside the scope of accounts of the companies. The words "in respect thereof" must therefore refer to something other than a provision for liability for breach of warranty. "*

Both parties accept that conclusion. I also accept it, but only on the basis that the judge was pointing to the fact that the Completion Accounts would not expressly refer to a breach of warranty.

16. In their respective skeleton arguments the parties both approach the construction of clause 7.9.3 from substantially the same starting point. Thus in paragraphs 17 and 18 of the defendants' skeleton Mr Michael Briggs QC puts the matter in this way:

17. As a matter of common sense, the phrase "provision or reserve in respect thereof" in clause 7.9.3 must be a reference to a "provision or reserve" which relates to the subject matter of the warranty. The real issue is as to the nature of that relationship.

18. While the plaintiff accepted before the judge that a provision made in respect of the subject matter of a warranty falls within clause 7.9.3 if the language of the warranty and of the provision used the same descriptive word (eg "litigation"), such a construction is purely formalistic and must be too narrow. For example, if there were a warranty as to the value of a company's fixed assets, a provision in respect of depreciation of plant and machinery must be a provision in respect of the subject matter of that warranty.

Mr Briggs' submission on this appeal is that the judge construed the clause too narrowly. In paragraph 9 of the plaintiff's skeleton argument Mr Michael McLaren sets out three possible constructions of the clause and concludes:

(3) Alternatively (ungrammatically but addressing the purpose of the clause), it [ie the word "thereof"] could refer to the subject matter of the warranty; ie here gross margin, or (in the case of warranty 12.1) litigation. The plaintiff contends that this is the correct construction, ie that clause 7.9.3 refers to " a provision ... in

respect of the subject matter of the warranty". By contrast, there is no justification in the wording of clause 7.9.3 or otherwise for the defendants' (wider and looser suggested construction (namely a "provision ... which relates to the subject matter of the warranty")).

Thus both parties start from the position that clause 7.9.3 refers to provisions in respect of the subject matter of the warranty.

17. The judge put the matter in this way in paragraphs 27 to 30 of his judgment:

27 To give meaning to clause 7.9.3, the words "in respect thereof" must have been intended to designate those provisions which were put into the Completion Accounts because they relate to matters bearing on the value of the company where those same matters also have a bearing on a breach of warranty. Read in that way, the value put upon the company is reduced (and the consideration received by the vendors also reduced) by a provision for Circumstance X, but the warranting vendors are not to be made liable for breach of warranty for the same circumstances.

28 This construction of the words "in respect thereof" can be illustrated by an example taken in argument. If the Expert included in the Completion Accounts a provision for undisclosed litigation, that would affect the consideration for the sale, but clause 7.9.3 would protect the warranting vendors from a claim for the same amount for breach of warranty (though they might still be liable to pay damages for that breach over and above the amount of the provision). Counsel for both parties are agreed that clause 7.9.3 would achieve that result. But Counsel for the plaintiffs insists that such provision would not <u>also and in addition</u> be effective to set off the provision against a claim for breach of the Gross Margin Warranty, if that were done, there would be double counting against the plaintiffs.

29 In the litigation example, the relationship between the subject matter of the provision and the breach of warranty is clear. One has to move on to consider whether here is a similar relationship between the stock provisions and breaches of the Gross Margin warranty.

30 In considering the Gross Margin warranty, or indeed any other warranty, it must not be assumed either
(a) that every provision must relate to some breach of warranty, or
(b) that every breach of warranty must be capable of being affected by some provision.

For that reason, I see no force in the contention advanced by counsel for the defendants that no provision other than a provision for stock could affect liability for breach of the Gross Margin warranty. It may be so, but it is irrelevant. It is perfectly possible for the parties to have agreed that the Gross Margin warranty is not affected by clause 7.9.3. If the plaintiffs' submissions are correct, that is the effect of what they did agree."

I agree with those conclusions. They do not, however, resolve the question for the decision on this appeal.

18. It is common ground (at least for present purposes) that, as demonstrated in paragraphs 10 and 12 above, since part of the cost of sales includes provision for obsolete or returned stock, variations in the amount of such a provision directly affect the figure calculated for gross profit and therefore for gross margin (and indeed for net assets since any provision in the Completion Accounts will reduce the net assets). Thus the greater the provision for obsolete or returned stock in the cost of sales included in the Completion Accounts the lower the gross profit, the lower the gross margin and the lower the net assets.

19. The defendants submit that it follows that any provision for obsolete or returned stock must be a provision which relates to the subject matter of the gross profit warranty and which thus falls within clause 7.9.3 as being a provision "in respect thereof". They submit that that follows from the paragraphs of the judgment which I have quoted. In particular they say that, having held in paragraph 27 that the words "in respect of" must have been intended to designate those provisions which were put into the Completion Accounts because they relate to matters bearing on the value of the company, where those matters also have a bearing on the value of the warranty logic required the judge to hold that the stock provision has a bearing both on the value of the company and on the breach of warranty.

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20. The judge rejected that approach because he said that it involved (to use the terms of the defendants' submissions before him) writing back the amount of the stock provision. He expressed his conclusions in this way in paragraphs 33 to 39 of his judgment:

33 The defendants argue that it follows that any provision which is in terms concerned with purchases, closing stock or opening stock must be a provision which relates to the subject matter of the gross profit warranty. Therefore, it is said, if there is a breach of the Gross margin warranty, the breach will be increased by a provision against stock and therefore clause 7.9.3 requires the provision to be written back in calculating the amount of the breach. Those words chosen by counsel, that the provision is to be "written back in calculating the amount of the breach", indicate a fundamental flaw in the argument. "Writing back" involves a revision of the account. Indeed, the effect of the defendants' argument is to propose a revision of the Completion Accounts to produce a new figure for gross margin. That is not what is required by clause 7.9.3. The provision identified by clause 7.9.3 is relevant, not in calculating "the amount of the breach", but in calculating the amount of the liability or claim arising from the breach.

34 There is a fundamental flaw in the defendants' argument as it is pressed to a conclusion. The argument is used, not to set the amount of any provision against any liability or claim arising from a breach of warranty, but to misapply the provisions so as to seek to show that there was no breach at all. Mr Wilkinson identified provisions for stock which he says amounted to £244,453. By adding those provisions back into the figure for gross profit determined by the Expert, he produced a gross margin (gross profit expressed as a percentage of turnover) of 16.14%, that is, more than the 14.81% gross margin determined by the expert, and more than the 16% gross margin warranted. The flaw in this process is evident from an examination of the terms of the warranty.

35 The gross margin warranty defined gross margin as gross profit expressed as a percentage of turnover. The warranty also required gross profit and turnover to be calculated on a basis consistent with the consolidated profit and loss account forming part of the Completion Accounts. Those are express provisions to be found in the warranty clause itself. Paragraph 1.7.3 of Schedule 7 required age, obsolescence and condition of the stock to be taken into account in the preparation of the accounts. It follows that the warranty was a warranty as to the gross margin after any stock provisions had been made. Following that contractual process, the Expert determined that the gross margin for the relevant period was 14.81%. That determination was final and binding (see paragraph 2.5 of Schedule 6 to the Agreement and my judgment of 23 October, 1997) and is in no way affected by any application of clause 7.9.3. It is expressly stated in the Completion Accounts that the gross margin was 14.81%, and that figure cannot be altered by any attempt to rewrite, or as the defendants would have it, "explain" the accounts.

36 It follows that the defendants cannot escape from the conclusion that they are in breach of the gross margin warranty.

*37 The claim made by the plaintiffs arising out of that breach of the gross margin warranty is £1.985m. Clause 7.9.3 provides that the plaintiffs shall not have any claim arising out of the breach of warranty "**to the extent that provision has been made in the Completion Accounts**". If one were to assume in the defendants' favour that there was a contractual relationship between stock provisions and the gross margin warranty, it would be facile to say that the effect of clause 7.9.3 is therefore that the plaintiffs' claim for breach of gross margin warranty is (subject to proof of the figures on both sides) £4.186 million less £244,453. But that would be wrong.*

38 The plaintiffs' claim for breach of the gross margin warranty is for damages representing the difference between the value of the business as warranted and the value of the business in fact. Since the value of the business as warranted was the value after provisions had been made, the provisions for stock should not be set against that side of the calculation. It is equally inappropriate to set those provisions against the calculation of the business in fact. No provision has been made in the Completion Accounts which has a bearing on the claim which arises out of the breach of the gross margin warranty and clause 7.9.3 has no bearing upon it.

39 That analysis of the defendants' argument has been made on the assumption that the defendants are right in their contention that there is a contractual relationship between provisions for stock and the gross margin

warranty and its breach. Even on the assumption, the defendants' contentions fail. That analysis confirms my view that, taken on a broad commonsense reading of the words of clause 7.9 in the context of the Agreement as a whole, a provision for stock is not a provision in respect of a breach of the gross margin warranty. To demonstrate that relationship, it is not enough to show that the existence of a provision affected the computation of the gross margin. The words used by Clause 7.9.3 are "in respect thereof", and those words do not refer to some other item which affects the item under consideration. In the context of this Agreement, a provision for litigation is a provision in respect of the warranty concerning litigation. A provision for stock would be a provision in respect of a warranty as to the value of the stock if there were such a warranty in the Agreement, but there is so such warranty in the Agreement. There is no such thing as a provision for gross margin. The argument presented on behalf of the defendants relies on a strained and unusual construction of the words of the Agreement, which is no doubt why it was not spelt out in the original pleading of the Defence and Counterclaim in 1994 nor in the two amendments made in 1996 and 1997.

Mr Briggs emphasised before us that it is not and was not the defendants' submission that there was no breach of warranty. Their submission was and is (as put in their skeleton argument) that where some part of or the whole of the breach of warranty is seen to be attributable to something in respect of which there is also a provision in the Completion Accounts, then to avoid double counting the liability for the breach must be reduced or eliminated by subtracting from the financial measure of the breach the financial amount of the provision.

21. Mr Briggs submits that the judge wrongly treated his submission as if it were that there was no breach of warranty. He submits that clause 7.9 is an exclusion clause which does not simply have the effect of reducing the damages recoverable for a breach of warranty, as it were, by way of set off, but, depending upon the figures, may have the effect of excluding or limiting liability for the breach, not because the defendants are not in principle liable for the breach, but because "no liability shall arise to the Warranting Vendors and the Purchaser shall not have any claim whatsoever in respect of any breach ... to the extent that provision ... has been made in respect thereof in the Completion Accounts". Mr Briggs' argument is, in my judgment, correct in principle. Thus the clause is indeed an exclusion or limitation of liability clause which either excludes or limits the defendants' liability for a breach of warranty depending upon the extent to which provision has been made "in respect thereof" in the Completion Accounts.

22. However, that conclusion does not help to identify what is meant by "provision .. in respect thereof" in clause 7.9.3. Nor does it help to decide whether the defendants' liability is excluded or limited by the clause, save perhaps in one respect. The question is to what extent (if at all) the defendants are relieved from liability for an established breach of warranty. It is thus for them to bring themselves within the clause and if there is any doubt as to whether or not they can do so the issue must be resolved against them (as it used to be said contra proferentes) and in favour of the plaintiff.

23. The judge accepted Mr McLaren's submission that the purpose of the clause was simply to exclude items, such as litigation, in respect of which the defendants had given a warranty and in respect of which the Completion Accounts made a provision. Thus a provision in the Completion Accounts of £x in respect of litigation or anticipated litigation would exclude or limit the defendants liability for breach of warranty 12.1. It is common ground that clause 7.9.3 would have that effect,. The question is whether it also has the effect of excluding or limiting their liability where the provision is not in respect of the whole subject matter of the warranty but only in respect of one of the items which made up the calculation which led to the conclusion that there was a breach of the warranty. That is whether clause 7.9.3 has the effect of depriving the plaintiffs of their right to claim damages for breach of warranty 7.6 in respect of gross margin where the gross margin the subject of the warranty was expressly to be calculated inclusive of any relevant provision.

24. The judge concluded that it does not and, on balance, I agree, although I have found the matter much less clear than the judge did. For my part, I would not characterise the defendants' arguments as facile as the judge did in paragraph 37 of his judgment. Indeed I was at one time attracted by them. For example, I see the force of Mr Briggs' submission that the defendants are not seeking to rewrite the

Completion Accounts. They are simply making use of the information in the Completion Accounts in order to identify the extent to which they are relieved of liability for the breach of warranty which is identified in the accounts.

25. As I see it, clause 7.9.3 is capable of having the meaning ascribed to it by the defendants. Thus it could be said that where gross margin depends in part upon the cost of sales and the cost of sales depends in part upon the extent of a provision as to the value of obsolete or returned stock, the provision in respect of such stock could be described both as a provision in respect of the cost of sales and a provision in respect of gross profit and thus of gross margin. However, that seems to me to be a strained construction of the clause. It would be much more apt to describe the provision as simply in respect of stock.

26. The phrase "in respect of" is a somewhat colourless expression. Its meaning depends very much upon its context. Thus there is no doubt that a provision as to litigation is a provision in respect of the subject matter of the litigation warranty, or indeed (as I see it) a provision in respect of the breach of the litigation warranty. There is no conflict between the terms of the litigation warranty and the application of clause 7.9.3 in that context. The same would be true if there had been a stock warranty, as the judge pointed out in paragraph 39 of his judgment. However, the same cannot in my opinion be said in the case of the gross margin warranty or the net assets warranty.

27. In October 1997 the judge held that the parties intended the Completion Accounts to be final. The gross margin warranty is expressly defined in the agreement as meaning gross profit as a percentage of turnover and by the express terms of the warranty "gross profit and turnover ... shall be calculated on a basis consistent with the consolidated profit and loss account forming part of the Completion Accounts". Warranty 7.2 contains a similar provision. Thus whether the gross margin was or was not less than the 16% provided by warranty 7.6 depends upon the gross margin calculated as set out in the Completion Accounts. It must of course have been apparent to the parties when they agreed the terms of the warranty that gross profit would depend upon the cost of sales, which would in turn be either bound or at least very likely to include a provision for obsolete and returned stock, especially in the light of paragraph 1.4.3 of schedule 7 to the agreement set out above.

28. The effect of the defendants' argument is that, in order to establish whether their liability for breach of the gross margin (or indeed net asset) warranty calculated on the express basis set out in the warranties is excluded or limited by clause 7.9, it is necessary to recalculate the gross profit and cost of sales by adding or excluding that part of the cost of sales referable to the provision made for obsolete and returned stock. If the parties intended that result they chose a very obscure way in which to achieve it. In these circumstances I do not think that clause 7.9.3 is apt to require the extent of the defendants' liability for breach of warranties 7.2 and 7.6 to depend not upon the calculation expressly defined in the warranties themselves, but upon a recalculation excluding obsolete or returned stock.

29. In this regard I accept Mr McLaren's submission that in accounting terms it does not make sense to refer to a provision in respect of gross margin. As paragraph 88 of schedule 4 to the Companies Act 1985 shows, a provision will ordinarily relate to liabilities or charges (ie amounts retained for the purpose of providing for a liability or loss) or to depreciation or diminution in the value of assets. Thus a provision might be made in respect of a potential liability or indeed in respect of the value of stock. Indeed the provision in respect of obsolete or returned stock contemplated by paragraph 1.4.3 of schedule 7 to the agreement is such a provision, but, as I see it, such a provision would not ordinarily be described as a provision in respect of gross margin or gross profit. The provision is simply one of many factors which goes to make up the cost of sales, and indeed the net value of the assets. I accept Mr McLaren's submission that the position might have been different if the agreement had contained a stock warranty.

30. If the question is asked whether the Completion Accounts contain a provision in respect of gross margin the natural answer is in my opinion no. As Mance LJ pointed out during the course of the argument, the provision is to be found within or as part of the calculation of gross margin and not external to it, and thus not (in ordinary parlance) in respect either of gross margin or of the breach of the gross margin warranty. For the reasons which I have tried to give it is my view that the provision

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was in respect of stock and not of gross profit. The same is in my opinion true of the submission that provision was made in respect of the net assets warranty. In this regard Mr McLaren put his submission in this way:

1. The defendants warranted that the net assets would not be less than nil, and agreed that net assets would be calculated after taking into account any provisions required to be made in the Completion Accounts (which included a provision as to stock).

2. Suppose that after completion much of the stock was found to be obsolete, leading to the expert inserting a substantial provision (say £1 million) in the Completion Accounts for such obsolete stock.

3. Suppose that such provision depressed the net assets from what would otherwise have been plus £100,000 to minus £900,000, thus showing net liabilities of £900,000.

4. On the defendants' case, the plaintiffs would have no claim against the defendants for the breach of the net asset warranty because the shortfall was due to a provision caught by clause 7.9.3. But that is clearly not what the parties intended, since there is no warranty as to stock and the warranty as to assets related to the net asset position after any necessary provisions had been made.

31. That is really another way of putting the point which I have already discussed. It seems to me to be convincing. In short I agree with the judge that the defendants' approach to clause 7.9.3 is inconsistent with the contractual definition of both warranties and should not be accepted. In any event clause 7.9.3 does not clearly exclude or limit the defendants' liabilities for breach of warranties 7.2 and 7.6. It is at best ambiguous from the defendants' point of view and should not be construed so as to limit or exclude the defendants' liability for breaches of the warranties.

32. Mr Briggs submits that this construction is inconsistent with the commercial purpose of the clause. He submits that the purpose of the clause was to avoid the defendants being prejudiced by double counting and that the effect of this construction is to cause double counting and not to eliminate it. However, as Mance LJ has demonstrated in his judgment (of which I have seen a draft and with which I agree), all depends upon the circumstances. To my mind the approach adopted by the judge is consistent with the commercial purpose of the agreement. Thus the effect of the agreement as he construed it is that it can readily be seen from that Completion Accounts, both whether there is a breach of warranties 7.2 and 7.6 and whether any provision has been made in respect of them or the breach of them. It seems to me to be likely that that what was intended by the parties.

33. For these reasons, which are I think essentially those given by the judge, and for those given by Mance LJ, I would dismiss the appeal.

LORD JUSTICE MANCE :

34. I have had the benefit of reading in draft the judgment given by Clarke L.J. and agree with the reasons he gives for dismissing the appeal. I add a few words, with particular reference to Mr Briggs' arguments about the commercial purpose and supposed consequences of the plaintiffs' construction of clause 7.9.3 of the share sale agreement. Clause 7.9.3 is a provision limiting (or excluding) sellers' liability for breach of warranty in circumstances where the Completion Accounts make provision or reserve *in respect thereof* . Both parties agree that the word "thereof" involves commonality of subject-matter. The phrase could be re-expressed as: in respect of the same subject-matter as the subject-matter of the warranty (or, perhaps, as the subject-matter of the liability for breach of warranty). Thus, both parties agree that a provision for outstanding or anticipated litigation would be in respect of the same subject-matter as the warranty, and as any claim for breach of the warranty, given by clause 12.1 of schedule 3 that the company was not engaged or likely to become engaged in legal proceedings. The subject-matter would in each case be exposure to legal proceedings.

35. Here, the subject-matters of the relevant warranties are, respectively, net assets and gross profit margin (clauses 7.2 and 7.6 of schedule 2). Mr Briggs submits that, if a provision in the Completion Accounts plays a causal role in bringing about a breach of warranty in the share sale agreement, then it has and is "in respect of" the same subject-matter as the warranty or as the liability for its breach. In my opinion, that is a strained use of language. A provision or reserve which is one element in a set of figures leading up to a conclusion as to net assets and gross margin is not "in respect of" that

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conclusion. The phrase "in respect of" implies the pre-existence of the subject-matter to which the provision relates. The causal connection required by clause 7.9.3 is the reverse of that which Mr Briggs advocates. The accounting provision must be made in the light of and because of the subject-matter in respect of which it is made. It is not sufficient that the subject-matter only comes into existence because of the provision.

36. Another oddity about the defendants' construction is apparent from the scheme of the agreement. The conclusions as to net asset value and gross margin, which determine whether there has been any breach of the warranties in clauses 7.2 and 7.6 of schedule 2, derive from the Completion Accounts to be drawn up in accordance with the detailed provisions of schedule 7. If clause 7.9.3 also requires, for the practical operation of the warranties, a comparison based on the drawing up of revised completion accounts nowhere expressly provided for in the agreement, the parties have, as Clarke L.J. has said, chosen a very obscure way of expressing themselves.

37. Mr Briggs suggests that commercial considerations point in an opposite direction. He relies on the fact that the consideration payable is potentially variable according to the company's net asset value. A provision in the Completion Accounts could thus, he points out, lower the price and (on the plaintiffs' case) lead to the recovery of damages for breach of the gross margin and/or net asset value warranty; and that, he says, would be unfair.

38. The relationship between the consideration payable and net asset value is however qualified. Firstly, the bulk of the price consists of the flat sum of £4,060,000. Second, although a sum is to be added thereto equivalent to the net assets, the agreement continues "in respect of which the Purchaser shall pay a minimum amount of £900,000". The £900,000 must be paid, although net assets fall well short of that sum in value. Indeed, the warranty in clause 7.2 of appendix 2 makes clear that the purchasers have no complaint on that score unless the net assets are less than nil. In fact, net assets were negative - they were minus £24,371, so that the plaintiffs have on the face of it a small claim on that account, although that claim (like the gross profit margin claim) is one which the defendants's construction would eliminate.

39. So, on the scenario which occurred, the plaintiffs have had to pay the full £900,000, without any deduction on account of the shortfall in net asset value contributed to by the provision for obsolescence. Yet, on the defendants' case, the plaintiffs are unable to recover either under the net asset value warranty (in respect of the £24,371 shortfall below nil) or under the gross margin warranty (in respect of the shortfall below the warranted 16%). Commercial considerations, far from favouring the defendants' case, here point in the opposite direction.

40. The defendants direct attention to different factual scenarios. If, apart from the provision for obsolescence, net assets had been at least £1,144,453, the provision of £244,453 would then have reduced the consideration payable pound for pound, and the question could squarely arise whether the plaintiffs should, in fairness, also recover damages for any breach of the gross profit margin. But, first of all, it is far from clear that this would have been more than a remote hypothesis when the agreement was made. It is, in particular, unclear whether, when the agreement was made, there would have been much prospect that the company's net asset value company would amount to much - if anything - in excess of £900,000. We do not even have the last accounts, as at 30th August 1992, which might have shed some light on that. Further, assuming that there was a real prospect that the net asset value would be in that order, it is unclear that there could then have been any likelihood of a breach of gross profit margin. A higher net asset value may very well derive from high profitability. The scenario is, in short, speculative - in contrast with the scenario considered in the previous two paragraphs, which has at least the merit of having occurred.

41. Secondly, the fact that the consideration payable had two elements - the sum of £4,060,000 and, in effect, the higher of net asset value and £900,000 - demonstrates that the parties attached substantial value to the company deriving from aspects other than its net asset value. Mr Briggs urges us not to speculate about the basis on which they did so, but his suggestion that the £4,060,000 could be viewed as being for the acquisition of a "concept", rather than an existing profit stream, is itself speculation. Either rationale or a combination of both may represent the true position. The existence of the gross

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margin warranty gives at least some credence to a view that the company's profitability was of significance. If, as may be, it was, then the fact that the plaintiffs might (in a hypothetical scenario like that considered in the preceding paragraph) both pay a reduced price *and* claim damages for any shortfall in gross profit margin would not necessarily involve any double benefit at all.

42. Thirdly, and however that may be, breach of the gross margin warranty could, at least in some circumstances, yield a claim calculated by reference to loss of profitability extending for several years beyond the particular period to which the breach related. We cannot in any way pre-judge the issues (no doubt likely to be contentious) which will arise in that connection on the facts of this case. But, in a case where the loss resulting from the breach of the warranty did extend over a matter of years, the defendants' construction of clause 7.9.3 would appear capable of leading to further anomaly. The defendants do not contend for a single deduction of the accounting provision from the loss. They invite recalculation of the gross margin as it would be but for the provision, followed by a comparison of the gross margin so recalculated with the actual gross margin in the six-month accounting period covered by the Completion Accounts. In this way, a single provision of £244,453 in one accounting period could eliminate a larger, perhaps many times larger, claim for damages calculated over several accounting periods. That would be the actual effect of clause 7.9.3, as the defendants interpret it, on the claim as presented by the plaintiffs in this case. But this means that clause 7.9.3 has, on the defendants' interpretation, an effect potentially far more disproportionate than any involved on the plaintiffs' construction.

43. Commercial considerations, so far as one can judge them at all, do not therefore point one way. If anything, they favour the plaintiffs' construction - which at least leads to what appears to be a reasonable result on the actual facts. At the very lowest, what happens depends on the circumstances, and it is a matter of swings and roundabouts who may benefit or lose. On that basis, we must gauge the parties' intention from the general scheme which they adopted and the way and words in which they formulated this in their agreement. This leads to the conclusion which Clarke L.J. has expressed, and to the dismissal of the appeal.

LORD WOOLF, MR :

44. I agree this appeal should be dismissed for the reasons given in the judgments of Clarke and Mance LJJ.

45. The fact that this appeal has resolved the issues as to the construction of the contract should enable the parties to now resolve the remaining issues by agreement.

46. If there are difficulties in achieving this, they should try mediation. Although the appeal is now determined, the ADR Scheme of the Court of Appeal, which provides experienced mediators without charge, would still be prepared to assist the parties. I urge the parties, if this is necessary, to take advantage of this scheme.

Order: Appeal dismissed with costs. Leave to appeal to the House of Lords refused.

MR MICHAEL BRIGGS QC with MR S MOVERLEY SMITH (Instructed by Messrs Berwin Leighton, London, EC4R 9HA) appeared on behalf of the Appellant
MR MICHAEL MCLAREN (Instructed by Messrs Titmuss Sainer Dechert, London, EC4Y 1LT) appeared on behalf of the Respondent