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THE INFLUENCE OF DUE DILIGENCE ON WARRANTY RIGHTS OF THE BUYER IN THE PURCHASE OF A BUSINESS

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SUMMARY: German law provides statutory warranties, even in the purchase of a business. Entering into a contract knowing of a defect voids the pertinent statutory warranty and waives the related claim. Gross negligence in inspecting the target also waives the claim. While conducting due diligence has become more and more typical in Germany, not to do so does not constitute gross negligence under German law. Likewise, conducting partial due diligence or doing it in a sloppy manner also does not waive the statutory claim. And a seller's simply disclosing the defect in a pile of documents is not sufficient to defeat the warranty. If a defect is found, a specific guaranty (not just a statutory warranty) is required if the buyer is to have a claim.

OBSERVATION: The article emphasizes how strange due diligence seems to German businessmen. It is not part of their business tradition. It also indicates that knowledge of a defect constitutes waiver, but only as to statutory warranties. Specific guarantees survive knowledge of a defect. The article also reflects the fact that Germans are not familiar with American signing-closing procedures.

German buyers today normally engage in a due diligence investigation of the businesses they intend to buy. These investigations stem from Anglo-American practice and are based on the Anglo-American concept of "let the buyer beware." German statutory warranties are not known in Anglo-American practice. But what is the effect of undertaking or not undertaking a due diligence investigation under German law? Or undertaking a very limited investigation? Is doing due diligence so wide-spread that not to do so constitutes gross negligence and rules out claims for breach of statutory warranties?

The purpose of due diligence is to get the most complete picture of the target and to discover defects or risks. The information gap between buyer and seller is reduced. The buyer can better judge the risks and possibly reduce the price. Information also helps customize the contract.

But if no due diligence is carried out, what does that mean for the buyer? What effect is there on the statutory warranty rights of the buyer? We must distinguish between undertaking no due diligence and the incomplete or carelessly conducted due diligence.

Under German law there is no duty to inspect the target. But does the German buyer give up rights by not carrying out due diligence? There are duties of inspection in German law, but only as to the purchase of wares, not businesses. Also this law applies to the

inspection *after* entering into the contract, not before as is typical of due diligence. So if there is a duty, it must be found elsewhere.

Section 442 I BGB [Federal Civil Code] provides that the buyer gives up his statutory warranties as to a defect if the defect is known to the buyer before signing the contract. [Germans are generally unfamiliar with typical American signing and closing.] If the buyer did not see the defect due to gross negligence, then the buyer has rights only if the seller hid the defect or gave a specific guaranty ("Beschaffenhheitsgarantie"). Such gross negligence arises only if the buyer fails in the particular case and to a very large degree to conform to the required minimum amount of information collection and attention.

Gross negligence occurs in the following situations:

1. The buyer does not carry out the investigation
 - i. Even though obvious defects or special reasons for suspicion exist,
Or
 - ii. Buyer possesses special expertise which the seller does not; or
2. Common practice is ignored.

But is due diligence so common as to be a duty under German law? Given the complicated aspects of the purchase of a business and the high costs of inspection, no such duty can be fixed. Even a core inspection duty cannot be found. The situations are simply too complex and vary from case to case. No clear legal decision has been made that requires a due diligence investigation.

Certainly it is true that due diligence is common practice. But there is no official basis for making it a legal requirement. For example, buying a used car without taking a test drive would be gross negligence. Likewise, a good auction house could not purchase a painting by a well known artist from a private person without checking for authenticity. These cases involve objects which, when inspected, are inspected for specific defects. This is different from inspection of a business, which has a great number of possible defects. Plus, the costs of inspection of a business are quite high. There is no core set of due diligence investigation steps which are clearly required. These vary too much from case to case. So the buyer retains the purchase warranties created by the legal system.

But what if the buyer voluntarily conducts a due diligence investigation but it is incomplete or sloppy? What are the effects on warranties created by the legal system?

Buyer gives up its legally created warranties if it learns of defects during due diligence. Only through specific guarantees can the buyer keep these rights. ("...ausbedungene selbststaendige Garantie...")

Less certain is what happens if the buyer carries out an investigation but does not discover the defect. This could be gross negligence. If so, the buyer would give up its implied warranty rights except in case of intentional deception or a specific guarantee. Here are two possibilities: (a) if the due diligence does not include the area where the

defect exists or (b) the seller does not provide the materials necessary to find the defect, then there is no waiver.

But what if the buyer *could* have found the defect, but just did not. There is no obligation to carry out due diligence. Why should a buyer who undertakes an investigation voluntarily but simply is not careful be worse off than the buyer who buys without doing any due diligence at all?

The buyer who does not find the defect despite due diligence would be penalized twice: the buyer (a) does not get the full picture it paid for *and* (b) does not keep its statutorily implied warranties. This result is also not fair given the normal due diligence procedure. Some attorneys of the buyer sit in front of a mountain of documents for a few days under great pressure. The documents cover all aspects of the law. Even with the greatest concentration and care it is impossible that these lawyers, in addition to the summarization of the material peer into every legal aspect. It is certainly possible that one of them simply turns two pages at once and misses material information on the skipped page, such as substantial environmental problems at some plant. This should constitute gross negligence?

A reason for due diligence may be the care a buyer's management owes. But this obligation is to their company, not to third parties. This obligation cannot be used as a basis to create rights for the seller.

Furthermore, due diligence cannot be used to eliminate the obligations of the seller to make disclosure. If the seller wants to fulfill its duty of disclosure, it must do so explicitly. Seller cannot do so merely by presenting a mountain of papers to buyer.

As a result, if a buyer overlooks a defect in the course of due diligence, this does not lead to waiver of statutory warranties by reason of gross negligence. One can at most justify the buyer's loss of warranty protection if the buyer should have seen the defect even without due diligence.

In conclusion, not carrying out due diligence is not gross negligence and does not lead to reduction of statutorily implied warranties. Due diligence has not become as common as to be a legally imposed obligation. Furthermore, if buyer conducts due diligence which is either incomplete or sloppy, this does not result in a waiver of warranties. Only if the buyer *should* have seen the defect even without due diligence can there be a waiver. The seller is liable then only if it intentionally hid the defect or gave a specific guarantee.

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