

Warranties, Indemnities and Disclosures

Overview

Share Purchase Agreements (SPA) will almost invariably contain warranties and indemnities by the sellers. They will typically make up more than half the share purchase agreement and much of the negotiation process. A purchaser takes a company with all of its assets and liabilities within it. There are a significant range of risks and possible liabilities which could adversely affect a company and its value. Warranties and indemnities typically deal with these issues.

In an Asset Sale Agreement, warranties will also usually be given, but only in relation to a narrower category of matters. For example, key assumptions such as in relation to accounts, customers and the performance of trading assets would usually be warranted together with employment obligations which will transfer automatically under the so called TUPE Regulations.

A warranty is a statement about a particular state of affairs. In the context of a share or asset purchase agreement, a warranty is a promise or an assurance in the agreement by the seller to the buyer in relation to particular matters concerning the target company, its business or liabilities etc. The purpose is to provide the buyer with a picture of the value of the company or business and allow it to ensure that the position accords with its expectations.

The seller will not wish to give a warranty which he knows is breached. This would give the buyer a claim for compensation for the value of the company thereby reduced. It therefore encourages the seller to disclose known problems. Warranties will usually be watered down or limited by disclosure.

A warranty will only give rise to a claim if actual loss results (i.e. reduction in value) to the buyer, as a consequence of the particular breach. This puts an onus on the buyer to prove this loss in legal proceedings.

Disclosures

A Disclosure letter is a means by which a seller communicates information to the buyer regarding the company and dilutes and limits warranties. If warranty turns out to be untrue the buyer would have a claim for breach of contract. However no claim will usually arise, if the facts given rise to the breach were disclosed in advance of the purchase.

The disclosure letter usually takes the form of a letter containing general and specific disclosures and bundles of attached documents. General disclosures will normally cover broad matters such as matters which appear in public records, of which the buyer should be aware on the basis of normal enquiries. The buyer will generally be cautious about accepting wide disclosure in relation to matters in the public domain.

Specific disclosures will normally be made against the list of warranties. The seller in conjunction with its advisors will consider each warranty and set out matters which are inconsistent with it.

The disclosure bundle will comprise of a list of documentation which are disclosed relative to the warranties. The disclosure letter will be prepared as soon as the warranties are settled. If problems disclosed are significant, the transaction may not happen at all or the price may be re-negotiated.

Indemnities

An indemnity is a promise to reimburse the buyer in relation to a particular liability, if it arises. Reimbursement is usually on a pound for pound basis and does not depend on actual loss. Indemnities are not subject to the common law obligation to mitigate (minimise) loss that would apply in the case of a breach of warranty.

Indemnities are usually given in relation to tax. They will usually indemnify the buyer against all tax liabilities of the target company that are not provided for in the last accounts or do not arise by way of normal trading since that date.

Indemnities are also given for specific problems which are known or arise in the course of due diligence. For example, there may be potential environmental issues, unresolved litigation or other potential risks. Indemnities would often be given in relation to doubtful debts, loan repayments, product liabilities, specific litigation etc.

There would generally be both tax warranties and indemnities. The indemnity will generally be a stronger basis for recovery than the tax warranties.

In the case of asset purchases, tax warranties would be much more limited and relate in principle to matters such as ongoing VAT and PAYE accounting.

Warrantors

The sellers will usually give warranties to the buyer. Possible warranty liability is a significant incentive for the sellers to disclose known or potential problems.

Where there is a single shareholder, such as where the target company is part of a group of companies, there will normally be a single warrantor. This may be more complicated where there is number of sellers and in particular institutional investors who may not wish to give warranties as they may not have been actively involved in the business. Private equity houses will generally refuse to give warranties except as for title to their own shares. At the very least, they would wish to limit their liability to a share of the proceeds.

Where there are multiple sellers, each would ideally wish to limit his liability. A buyer would usually want the obligation to be joint and several so that each person can be pursued for the whole liability, with that person having the right to seek a contribution

from the other seller. In this case, the sellers should agree between themselves the terms on which they will share potential liability.

It is usual for sellers to limit their overall liability to the sale proceeds. The seller will frequently want to qualify or limit his warranties on the basis of his actual knowledge, e.g. to the best of his knowledge. If this is agreed, the seller will be expected to have made proper and careful enquiries. It is preferable from the buyer's perspective that this limitation is not provided.

Common law makes liability for warranties last for six years. However, it is usual for the sale agreement to reduce this period to two to three years other than in the case of tax warranties which are usually "live" for six years. The notion behind limiting warranties for two to three years is that after one or two years of accounts and audits, most significant problems would flush out.

Limits on Warranties

There will usually be a limit on both smaller claims and a maximum cap. A ~~1%~~ minimum limit is usually provided which means that claims below a certain amount, either in total or in aggregate, may not be bought. Once a threshold is crossed, the full amount is recoverable not just the excess. Sellers will usually put an overall limit as to total price received. This will not be acceptable under all circumstances.

Sellers will also seek to put limits in relation to such matters such as the following:-

- preventing double recovery by requiring recovery from third party such as insurers;
- provisions in accounts for the liability concerned to be credited to the seller;
- disregard post completion caused or exacerbated by the buyer's actions;
- limit to matters arising while seller was owner of the company;
- Liabilities arising from changes in law.

The seller may want to have conduct of a dispute with third parties so that the buyer as controller of the company do not simply settle it and rely immediately on the indemnity.

Other Warranty Issues

The general rule is that contracts are made between the parties but special legislation exists in England whereby they may be made for the benefit of a prospective third party. The buyer will generally want to be able to assign the benefit of the warranties to another party if the company or assets are subsequently sold by the buyer within a certain period.

As warranties depend on the solvency and availability within the jurisdiction of the seller, buyers will sometimes seek security to meet claims. The seller may leave the country or may dispose of assets. If the seller is a corporate group it may be wound up.

There are a number of options such as

- obtaining a bank guarantee or a guarantee from a parent company;
- lodgement of part of the purchase price in a joint account for a certain period;
- retention of part of the purchase price until the warranty period has expired;
- set-off whereby the buyer could allow set off of deferred payments against option claims.

It is possible in principle to obtain warranty and indemnity insurance from certain specialist insurers. Cover will be limited to specified amounts and is usually funded by a single premium paid at the conception of the policy. The premium will depend on the level of risk to the insurer.

This Guide is intended as an overview and broad outline of the matters covered in it. Its purpose is to inform and raise awareness. We are happy to offer specific legal advice on particular circumstances.

This Guide should not be relied on as a substitute for comprehensive legal advice with reference to the particular circumstances.

While we have taken due care in the preparation of this publication, we do not accept legal liability as a result of any reliance placed on anything in this Guide. The reader should rely only on specific legal or taxation advice.

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