WARRANTY WOES

AN EVOLUTION CBS WHITE PAPER

Special points of interest:

- *Warranties & Indemnities—the difference*
- *Limiting Liabilities*
- *Insuring against claims*

Author: Maung Aye, Mackrell Turner Garrett

Having experienced the roller coaster of emotions that can be involved in successfully selling a company or a business, a seller may be forgiven for taking some time out after completion to relax and enjoy the fruits of his labour.

This sense of relief can quickly disappear however, if a seller is faced with a potential warranty or indemnity claim after completion.

During the course of a sale, whether of shares in a company or of assets, a seller would usually be expected to give certain warranties to the buyer.

These are contractual statements about the business or company being sold. For example, a warranty might state that the company has not sold any defective products or that no employee has given notice to terminate his employment.

Other common areas of warranty protection include tax affairs, commercial contracts, environment and intellectual property.

Whilst a buyer would be expected to conduct due diligence on the target company or business, this would be primarily aimed at ascertaining whether the target company or business is worth what he is paying for it.

Warranties and Liabilities—the difference

Warranties are intended to give the buyer some additional comfort regarding certain areas of the business and also give the buyer a remedy against the seller if any warranty given by the seller proves to be untrue.

A breach of warranty would generally give the buyer the right to sue the seller for breach of contract although the buyer would also usually be under a duty to mitigate his loss and more importantly, would need to show that the effect of the breach of warranty is to reduce the value of the acquired company or business.

This may be difficult to prove, particularly if the loss is solely down to management time (by tidying up a company's statutory books for example), which may not actually reduce the value of the company or business.

An indemnity on the other hand, is a promise by the buyer to compensate the seller for a particular, identifiable liability. For example, there will usually be a tax indemnity given by the seller for any tax liabilities of the target company which were not disclosed to the buyer in the accounts of the target company. A buyer may also require an indemnity in relation to certain environmental liabilities or any litigation that the company is involved in.

Limiting Liabilities

Given the extent of the warranties in the acquisition agreement, a seller will usually seek to limit his liability in a number of different ways.

A seller will review the warranties in the acquisition agreement and make a list of any matters that conflict with any warranty in a disclosure letter. For example, if a warranty states that no employee has given notice to terminate his employment but two employees had given such notice, the seller would disclose this fact in the disclosure letter.

Generally, a buyer will not be able to claim against a seller for a breach of a warranty if the disclosure letter contains details of the particular fact or matter which conflict with that warranty.

Other ways for a seller to limit his liability under the warranties include:

- making the warranties subject to his awareness;
- putting time limits on warranty claims. This is usually anywhere between 18 and 36 months for non-tax warranties and 6 or 7 years for tax warranties since HM Revenue & Customs can re-open the tax affairs of companies up to six years after the end of the accounting period in which the tax event occurs; and
- putting financial limits on warranty claims, which would include the seller limiting his total liability under the warranties to the consideration he has received.

Insuring against claims

Finally, it may even be possible to obtain warranty and indemnity insurance to cover any warranty claims. The premiums will usually depend on a number of factors including the value of the transaction, how complex it is and the nature of the warranties and indemnities. The insurers and their professional advisers will want to review the transaction documentation so it is important that sellers make contact with an insurance broker early enough so that all formalities can be dealt with.

If a potential claim comes to light, it is important for the parties and their professional to review the acquisition agreement and disclosure letter carefully to see whether any disclosures have been made by the seller against the warranty concerned and whether the seller's liability is limited in any way.

Following this, if the buyer still wishes to proceed with a claim, often full and frank communication with the seller and his professional advisers can result in any claim being settled out of court, saving both parties considerable costs.

About the Author

Maung joined Mackrell Turner Garrett as a corporate solicitor in 2011 and deals with all aspects of corporate and commercial law, specialising in company acquisitions and disposals, joint ventures, corporate finance transactions and commercial agreements.

Maung also advises business owners on shareholder and partnership agreements, company reorganisations and general corporate governance.

Mackrell Turner Garrett

www.mackrell.com