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Guide to warranties and indemnities

On the acquisition of the shares or assets of a company, the principle of caveat emptor (buyer beware) applies. The law provides no statutory or common law protection for the buyer regarding the nature or extent of the assets and liabilities it is acquiring. Hence the need for extensive contractual statements in the form of warranties and indemnities.

Warranties and indemnities are forms of contractual protection a seller provides in a sale and purchase agreement. They are effectively statements that the buyer will rely on when entering into the agreement and represent some of the assumptions made when acquiring the shares or assets.

Negotiation will usually revolve around the nature and extent of the warranties or indemnities. However, common areas include, but are not limited to:

- The capacity/authority to sell;
- The ownership and title;
- The accounts;
- The contracts;
- The licences/consents;
- Litigation;
- Intellectual property rights;
- Employment;
- Taxation.

If a statement is discovered to be untrue or inaccurate at the date of the agreement, then the buyer can pursue the seller for damages. It is important to note that the statements relate to matters both past and present and do not normally relate to future events or performance of the company/business.

<u>What is the difference?</u>

The distinction between warranties and indemnities is critical as the remedies to which innocent parties are entitled differ.

A breach of warranty will only give rise to a successful claim in damages if the buyer can show that the warranty was breached and that the effect of the breach is to reduce the value of the company or business acquired. The onus is, therefore, on the buyer to show breach and quantifiable loss.

An indemnity is a promise to reimburse the buyer for a particular type of liability. It is therefore used for more specific matters that become apparent through due diligence, should they arise (for example, tax or ongoing litigation). The purpose of an indemnity in an acquisition context is, broadly speaking, to shift the risk of a particular event or matter to the indemnifying party and to allow the indemnified party to recover on a pound-for-pound basis in respect of that matter or event.

Another key distinction is that, unlike warranties, indemnities may not be subject to the obligation of the buyer to mitigate its loss. It is, therefore, in the seller's interest to limit warranties offered and, where possible, reject giving indemnities.

Remedies for a breach – what can I do?

As mentioned above, there are key differences between warranties and indemnities. The general procedure, however, is governed by contract law, and the buyer will have to show that there was a breach of a warranty or indemnity, showing that the statement was untrue and, in the case of a warranty, resulted in a loss.

There is no guarantee that a buyer's claim will be successful and will often be determined by the court. In our experience, a claim for a breach of warranty or indemnity is rare, largely due to the limitations highlighted below. It may also be the case that the cost and time required to enforce or bring a claim against the seller may outweigh the damages sought.

If you require more information about claiming or defending a breach of warranty or indemnity, please do not hesitate to contact our experienced litigation department.

Are there any limitations?

Yes. It is only natural for the seller to seek to limit the extent of their liability under the warranties and indemnities, not only by cutting back the wording of the statements themselves but by specifying certain financial or time constraints. These limitations commonly fall into four categories:

1. Awareness;
2. Disclosure;
3. Time limits; and
4. Financial limits.

Awareness

Although the party giving the warranty or indemnity may be involved in every aspect of the target business, they may not be aware of all the facts or circumstances that may give to a breach (sometimes it is outside their control). Therefore, the seller will seek to qualify the statement as to their awareness, specifying that the statement is true and accurate "as far as they are aware". Although this does not absolve the seller from having to make 'reasonable enquiries', it may help to limit the seller's liability under that specific warranty/indemnity. A buyer often rejects these statements, arguing that the seller ought to know.

Disclosure

During the sale and purchase of the target's shares or assets, the buyer will undertake an information-gathering task commonly known as due diligence. The buyer will raise various enquiries about the commercial, financial and legal aspects of the target and, through this process, hope to gain a complete picture of the company and its strengths and weaknesses. If the buyer is made aware of any fact or circumstance in which a warranty or indemnity is untrue or inaccurate, and such information is deemed 'disclosed' (often in the form of a disclosure letter), then a claim for breach of warranty/indemnity will fail. Disclosure is a key element of any share or asset sale and purchase, and we have other material available addressing this in more detail.

Time limits

In the absence of a contractual term, the normal period for which a breach of warranty or indemnity is actionable is six years, 12 years, when the contract is executed as a deed. A seller will often try to reduce this period between two and three years for matters not relating to tax. For tax warranties and indemnities, a seller may be expected to give the buyer up to six or seven years, as HMRC has the power to reopen the tax affairs of a company up to six years after the end of the accounting period in which the tax event occurs.

Financial limits

It is market practice to include financial limits, which will often be subject to and depend upon the consideration paid to the seller. Common financial limits are 1) a minimum limit for individual claims, so a buyer cannot claim for a breach unless the claim exceeds a certain amount. 2) a minimum limit for aggregate claims – so a buyer cannot claim for a breach unless the aggregate limit of multiple claims exceeds a certain amount. 3) an overall limit – this is commonly the 'purchase price' so the buyer cannot claim an amount exceeding the total consideration paid. The minimum limit for individual claims is typically between 1% and 3% of the overall purchase price, whereas the minimum limit for aggregate claims is commonly between 3% and 10%. Although these percentages can appear small, they can often represent tens of thousands of pounds and are subject to fierce negotiation.

Enforcement

Warranties and indemnities are often subject to fierce negotiation, as the seller will want a clean break from the sale with no overriding responsibility/liability. In contrast, the buyer will want to keep the seller 'on the hook' for as long as possible.

Like most promises, warranties and indemnities are only as good as the seller giving them. If a buyer has doubts about enforcing a warranty or indemnity, they may want some security. For example:

- If the buyer doubts the creditworthiness of the seller;
- Whether the seller plans to leave the country, making enforcement difficult or impossible; or
- When the seller is a corporate entity, which may distribute the sale proceeds and seek to wind up after the sale.

In this event, the buyer may want to obtain a bank guarantee or request retention (being part of the purchase price retained until the warranty limitation period has expired).

Conclusion

In conclusion, warranties and indemnities form a significant part of an acquisition and the negotiation of the shares or assets of a company. Buyers and sellers must negotiate a good balance of warranties and indemnities depending on the circumstances and any particular concerns the buyer may have.