LEWIS SILKIN

US/UK M&A: WARRANTIES

In this article we examine the different approaches to giving warranties in US and UK share purchase agreements (**SPA**) including the terms and scope of the warranties, who gives them, the basis of recovery under the warranties, the basis of the sellers' liability and other protections available to buyers.

What are warranties?

Warranties are a common feature of share purchase agreements on both sides of the Atlantic. The warranties are statements of fact in respect of the target company or business which, if untrue, will give the buyer the right to claim for loss. However, the risk allocation under the warranties differs; a US style SPA tends to favour the buyer, whereas a UK style SPA tends to favour the seller.

Does the scope of the warranties vary between the US and UK?

US style SPAs typically contain extensive representations and warranties from the seller; sometimes these include a broad (and sometimes unqualified) warranty as to the absence of undisclosed liabilities; this is less common in UK style SPAs where, although the warranties are broad, they are not usually as detailed or extensive as those in US style SPAs.

Do all sellers give the same warranties?

Customarily in the US each seller provides the same 'business' representations and warranties and the same 'fundamental' representations and warranties with respect to its title (or ownership) of the target shares and its ability to complete the SPA. A similar approach is common in the UK, unless the seller is a private equity or venture capital fund where it has become customary for such sellers to give only the 'fundamental' warranties and for the business warranties to be given by the management team of the target and therefore to be liable for breaches of warranty post-completion. This also has an impact on the transaction documentation, in a trade sale the fundamental and business warranties are set out in the SPA, but where the seller is a private equity or venture capital fund the fundamental warranties are usually set out in the SPA and the business warranties are set out in separate management warranty deed between the target management and the buyer.

Representations - what difference does one word make?

It is also customary for US style SPAs to include language that the "Seller represents and warrants that…"; this language does not affect the remedies available to the buyer for any breach of the warranties – generally both are given on an indemnity basis, with no right of recission arising from breach.

However, in the UK the choice of language matters; using the word "represents" is heavily resisted by sellers – and this usually succeeds. Deleting the word "represents" is considered to minimise the risk of the buyer being able to bring a tortious claim (i.e. non-contractual claim) for damages for misrepresentation under the Misrepresentation Act 1967, and so it removes the possibility that the buyer will attempt to rescind the SPA under the provisions of that Act. In a UK style SPA, a well-advised seller will also seek to exclude the remedies for tortious claims and recission by including an express provision in the SPA to that effect; rather than arguing that those rights are excluded because the warranty statements are characterised only as "warranties" and not "warranties and representations".

It is also worth noting that the measure of damages under English differs for contractual and tortious claims. The contractual measure of damages for breach of warranty in an M&A context equates to the difference between the actual value of the target being purchased and its value had the warranty been true; the aim is to put the buyer in the position as if the contract had been performed. This contrasts with the position in tort, where damages aim to put the buyer in the position that it would have been in had the tort not been committed, and the damages are the difference between the price paid for the target shares and the actual value of the target.

Is the basis of recovery under the warranties the same in the US and UK?

A key difference between US and UK style SPAs is the basis for recovering any loss for a breach of warranty. In the UK, as noted above, the buyer's ability to recover will depend on how the breach of warranty has affected the overall value of the target company's shares, potentially including loss of profits. Therefore, it may be more difficult for a buyer recover all its costs in the event of a breach of warranty. In the UK there is also likely to be a duty on the buyer to mitigate (or minimise) its loss. Any indemnity cover in a UK style SPA will generally be for specific categories of claims or known liabilities such as tax, material litigation or known environmental issues, it is unusual for the warranties to be given on an indemnity basis. This contrasts with the position in the US, where customarily the buyer is indemnified for breach of warranties, meaning that the buyer can recover its losses for breach of warranty on a dollar-for-dollar basis.

Is the sellers' liability limited?

Both UK and US style SPAs include detailed limitations on the

LEWIS SILKIN

sellers' liability for breach of warranty. UK deals often feature a higher overall cap than the US. In the US, liability for warranty claims is often capped at 100% of the purchase price for a breach of 'fundamental' warranty (those relating to title and capacity) and between 10% and 20% of the purchase price for a breach of the other business warranties. The approach in the UK has traditionally been more generous to the buyer and for this cap to be set between 50% and 100% of the consideration, with 100% common on smaller transactions. It is also common practice to include a 'basket'; this is the level of damages that must be reached before the buyer is able to bring a claim for breach of warranty. The 'basket' may be a deductible basket where only a claim for the amount exceeding the level of the basket can be brought; or more commonly it may be a 'tipping basket' where once the threshold has been reached, the full amount of the claim can be brought. UK SPAs also typically include a 'de minimis' or 'mini basket' level; any claims below this level will be disregarded and will not count towards the basket

Recourse for warranty claims:

Warranty and indemnity insurance ("W&I") (or representation and warranty insurance in the US) has become increasingly popular in both the UK and the US, primarily driven by private equity houses looking for as clean a break as possible on exit. W&I insurance provides cover for losses discovered post-completion and aims to provide cover for any liability arising from a breach of warranty or liability under the tax covenant (or both) in each case where the matter giving rise to the claim has not been fairly disclosed or was not known to the insured. Both buy side and sell side policies are available; although buy side policies are the most common and means that the buyer can sue the insurer directly. In the US W&I cover is often more comprehensive with fewer general exclusions and usually provides the ability to recover for breach of any warranty on an indemnity basis – this also means that US W&I cover is more expensive than UK policies (although this will depend on the risk profile and specifics of the transaction). The precise nature of the exclusions in a W&I policy will also depend on the transaction, but it is relatively common in both markets for policies to exclude matters including unfunded pension liabilities, forward-looking statements, and non-financial relief. Historically, policies have typically excluded known tax liabilities; however, in the UK tax liability insurance may now be available – this is a relatively new product.

Finally, it is worth noting that it in the US it remains common for a portion of the consideration to deposited into an escrow account; arguably, this provides better protection for a buyer, as it has a source of accessible funds if there is a breach of warranty which are not subject to the exclusions imposed under W&I policies. Administratively an escrow is also an easier process to manage as the buyer must only seek release of funds from the escrow agent rather than bring a claim under a W&I insurance policy where the buyer's recoverable loss is likely to be less than the actual loss. Escrow accounts are not uncommon in UK transactions, but they are not used as frequently as the US, and as such it is advisable to agree them at the outset of the transaction in the letter of intent. Additionally, in the UK escrow accounts are most commonly used to address specific risks that have been identified, this contrasts with the position in the US where escrows/retentions are commonly used as a source to fund warranty claims.

What are the key issues for US buyers?

Scope of the warranties: extensive warranties will be included in both UK and US style SPAs (although they may be more extensive and detailed in US style SPAs). It is also unusual in the UK style SPA to find a warranty that none of the representations, warranties and disclosures contain any untrue or misleading statements and do not omit any material fact; in the UK a well-advised seller would consider such a warranty to too broad and subjective.

Risk allocation: risk allocation under the warranties tends to be more seller friendly under a UK-style SPA. For example, where the seller is a financial seller there is a tendency for fundamental warranties to be given by the seller.

Basis of recovery for breach of warranty differs: In the US warranties are given on an indemnity basis, this is unusual in the UK. In a UK SPA warranties usually protect against the unknown and indemnities allocate risk in respect of a known liability such as tax.

Escrow/retention: are not used as routinely as in the US; where they are used in UK style SPAs the seller's potential liability will often extend beyond the escrow terms and amount.

Lewis Silkin regularly works with US financial and corporate buyers on M&A deals across a wide range of sectors on UK domestic and cross-border transactions. We'd be delighted to discuss any questions you may have regarding UK deal practice at an early stage in any discussions you may be having in relation to possible UK acquisitions.

For more information please contact:

Geraint Tilsley
Partner

+44 (0)20 7074 8034
geraint.tilsley@lewissilkin.com

Find out more

twitter.com/LewisSilkin

linkedin.com/company/lewis-silkin

lewissilkin.com