Dealmaking and M&A

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Warranty limitations: 5 essential ingredients

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This month we focus on the limitations on liability typically applied to potential warranty claims under a sale and purchase agreement (SPA). The limitations act as both a safety net for sellers and to provide clarity to buyers as to how, when and against whom a claim can be brought.

> Any negotiation on this topic inevitably revolves around what is "market practice", and we set out below what we have been seeing in five key areas in the last 12 months.

In this article we assume all sellers are providing a full suite of warranties in the SPA.

1. Watching the clock – time limits

Warranties are typically separated into two distinct categories – fundamental warranties (also known as cornerstone or key warranties) and business warranties (also known as commercial warranties). Fundamental warranties go to the heart of the transaction, e.g. confirming that the seller has title to the sale shares and authority to sell them. The business warranties cover the operational aspects of the target company, and for the purposes of limitations are often split between two sub-categories: those relating to tax and those covering other aspects of business operations.

The time limits for breach of fundamental and tax warranties are fairly standard; typically there is no time bar on bringing a claim for a breach of fundamental warranty, and the time limit for bringing tax warranty claims tracks HMRC's longest (non-fraud) review period, seven years.

The time limit applicable to non-tax business warranties (e.g. that the target is not party to any litigation) is more contentious. MJ Hudson's latest deal terms review (to be published later in 2019) revealed a wide range from 6 to 24 months from completion. The average time limit for business warranty claims was 18 months from completion, but a period linked to financial year ends was also popular (e.g. time limit of 6 months after the next financial year end after completion).

2. Caps and hurdles – Financial limits

Sellers will want certainty as to their maximum exposure under the SPA, a concern that is always accommodated but subject to considerable negotiation.

Upper limits

Liability for breach of fundamental warranties is typically capped at the entire purchase price paid to the sellers. Tax warranties may be treated the same way, or liability may be uncapped. Unsurprisingly given their broad subject matter, the caps applicable to non-tax business warranties are the most contentious. The seller-friendly M&A environment that has prevailed (despite the financial crisis) over the last two decades has put liability caps under continuous pressure, and our deal terms review revealed an average cap of just over 50% of purchase price, with 25% and 75% being the lower and upper ranges respectively. However it is worth noting that, on smaller value deals, the total liability cap is likely to be much closer to the entire purchase price, as the buyer will want recourse against a minimum cash amount that is sufficient to remedy problems identified.

Lower limits

Sellers will also want protection against the buyer bringing immaterial, low value "nuisance" claims. In the UK, it is market practice to agree two lower limits; a '*de minimis*' that acts to filter out all potential claims below a certain value, and a 'threshold' (or 'basket') ensuring that claims are only actionable once a number of above 'de minimis' claims have been aggregated. (In the US it is more common to see only the 'threshold'.)

In small to mid-cap deals the *de minimis* limit is typically between 0.1% and 0.5% of the aggregate purchase price, with our review returning an average of 0.25%. The 'threshold' is commonly between 1% and 3% of aggregate purchase price; in our review the average threshold was 1.6%. A separate ingredient to the 'threshold' limitation is whether, once the threshold has been reached, the aggregate of all qualifying (above *de minimis*) claims should be recoverable, or just the excess. In UK deals the entire amount, and not just the excess, is usually recoverable (US practice can differ).

3. Individual caps and liability splits

Individual vs group liability (among the sellers) can also be a hot topic, and a lot rests on whether the sellers are now going to be working together as the management team driving a PE-backed business, close associates who see value in banding together, or unconnected investors who shudder at the thought of sharing any liability of the others.

Individual caps

However the sellers are categorised, each will seek to cap its total liability for all warranty claims (excluding fraud etc.), typically at the total purchase price actually received.

Joint and several liability

A buyer would always prefer the sellers to be "jointly and severally liable", i.e. it can pick and choose which seller(s) to bring a claim against, and can (subject to any individual cap) claim 100% of the value of the claim from those it wishes to pursue. This would, for example, allow a buyer to pursue only a seller with deep pockets. Private equity buyers often insist on joint and several liability as they see the sellers (often being their future management team) as a single block who should be confident in the accuracy of the warranties they are giving in respect of the company they own.

From a seller's perspective, it may be preferable to be severally liable only (i.e. a buyer would have to bring any claim against all sellers, and not target specific individuals). If several liability is agreed, the next question is how they are severally liable, e.g. are certain sellers responsible only for certain warranties, or are all sellers responsible only for a specified percentage of the amount of any claim.

In our review the majority of sellers agreed to joint and several liability.

Musketeer clauses

Sellers (particularly if the sellers form the ongoing management team) have also been known to request a clause providing that a claim is only valid if brought against all sellers. From a seller's/management team's perspective this provides comfort that they will stand together in the event of a claim, and that the prospect of bringing a claim against all sellers/the entire management team could dissuade the buyer from bringing a claim at all.

4. Brakes on recovery

In an SPA, the various caps, hurdles and mechanisms outlined above are often followed by what might appear to be 'boilerplate' clauses. However these typically go beyond regulating mere process – some key provisions to watch out for are summarised below.

Buyer's knowledge

Due diligence, and the disclosure process against warranties, serves to flush out information which shapes the buyer's decision to buy, and on what terms (including price). Therefore the seller will argue that it is unfair for the buyer to be able bring a claim if, at the moment of completion, the buyer is actually aware of circumstances that constitute a breach of warranty. In our experience most sellers will seek to include this clause on their first turn of the SPA.

Conduct of claims

If a third party brings any claim against the target company, the sellers might ultimately become liable if the buyer seeks to recover lost value in a subsequent warranty claim. Sellers will therefore typically want an option to take conduct of such claims (in order to protect themselves, indirectly), or at least to be consulted or informed of the status of those claims. This is often hotly debated, as the buyer will not want to cede control over third party disputes that could impact on relationships and reputation. A typical compromise position might fall short of granting the sellers conduct, but could entail consultation and some restrictions on settling any claim without input from the sellers.

Recovery from third parties and under insurance

If the target company suffers a loss, the sellers would ideally want it to exhaust all options to recover that loss from third parties (including under insurance), before bringing a warranty claim against the sellers. A buyer will understand the sellers' concern, but will want to make good the loss as soon as possible, rather than having to pursue third parties or a complex insurance process for an extended period (and will certainly not want to be 'timed out' of bringing a warranty claim in the meantime). In our experience negotiation typically results in a compromise whereby third party and insurance claims must be prioritised for a specified period only, or pursued in parallel with any warranty claim.

5. Mitigation

The typical remedy for a breach of warranty under English law is an award of damages. However the buyer is also required to mitigate its losses, i.e. take reasonable steps to reduce or avoid the losses. Even though this is a feature of common law, sellers will (in our experience, always) demand an express provision in the SPA, providing a clear reminder a buyer of the duty to mitigate and in effect acting as a limitation to prevent the buyer recovering any losses it could arguably have avoided.

Is this brief too brief? Do you need any help with your upcoming sale process? Expert legal advice is on hand from MJ Hudson's M&A and corporate law team.

Tags: corporate , M&A , SPA , warranty limitations