fact sheet

Selling a Company: Warranties, Representations and Indemnities

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There are many possible risks which could arise when the owner of a company sells, or attempts to sell, his or her shares to a third party. There is the risk that the sale does not go ahead and the company's business is badly affected by the disruption and the diversion of the owner's attentions. If the deal includes an element of deferred consideration, then there is the risk that the buyer becomes unwilling or unable to pay that additional consideration. However, one risk that will be relevant for most sellers is the risk that the buyer will seek to recover some or all of the purchase price from the seller by making a claim against the seller after completion of the sale. In most cases, such a claim will be based on the warranties, representations and indemnities included in the share purchase agreement.

The General Law

It is, of course, possible to transfer shares to a third party simply by using a stock transfer form and without entering into a formal share purchase agreement. However, this is unlikely to be acceptable to a buyer as the principle of *caveat emptor* (buyer beware) applies to such a transfer. In other words, the buyer has no protection under statute or common law as to the nature or extent of the assets or liabilities he is acquiring.

Although there may be no recourse available to the buyer, the seller should be aware of section 89 of the Financial Services Act 2012 (which replaced section 397 of the Financial Services and Markets Act 2000). Under section 89, it is a criminal offence for someone to:

- make a statement that he knows to be false or misleading in a material respect;
- recklessly make a statement that is false or misleading in a material respect; or
- dishonestly conceal any material facts whether in connection with a statement made by that person or otherwise

if he does so with the intention of inducing another person to enter into a relevant agreement. A "relevant agreement" includes an agreement to purchase shares in a company.

The Financial Conduct Authority ("FCA") has the power to bring a prosecution for this offence and the offence is punishable by imprisonment or a fine. Whilst it may seem unlikely that the FCA would bring a prosecution against a seller of shares in a private company, the fact that the offence exists should give a seller pause for thought if he is considering withholding information from a buyer.

Warranties and Representations

Because the general law offers so little protection to a buyer of shares, most company sales involve the parties entering into a share purchase agreement which will usually include warranties given by the seller in favour of the buyer. Warranties are contractual statements about the company and its business and serve two purposes. Firstly, they provide the buyer with a remedy if the warranties prove to be untrue and the value of the company is reduced – namely to claim damages from the buyer for breach of warranty. Secondly, they encourage the seller to disclose any problems he knows about by way of a disclosure letter. The agreement will stipulate that matters which are properly disclosed in the disclosure letter may not form the basis of a warranty claim. The seller should therefore be diligent in undertaking the disclosure letter to ensure that all relevant matters are disclosed. There may be a reluctance on the part of the seller to disclose some matters in case they lead to the buyer renegotiating the price for the shares, or even walking away. However, even those situations are likely to be preferable to being embroiled in a warranty claim after completion.

The buyer will sometimes ask that the warranties are also given as representations by the seller. A seller should try to resist this as a claim for a misrepresentation may result in a different level of damages to a warranty claim. If there is a successful claim for breach of a warranty, then the damages will be the difference between the value of the shares had the warranty been true and their actual value. If the warranty was also given as a representation, the damages will be the difference between the amount the buyer paid for the shares and their actual value. The difference between these two methods of calculating damages could be significant if the buyer has paid more than the company was worth, even with a clean bill of health.

Indemnities

Indemnities differ from warranties in that an indemnity is a promise to reimburse the other party if a particular type of liability arises. Under a claim for breach of a warranty, the buyer could only claim damages if he can show that the breach reduced the value of the shares. Under an indemnity, the buyer could claim for whatever costs he incurred due to the breach of the indemnity, even if the breach had no effect on the value of the company. The first draft of a share purchase agreement will often include a clause stating that the seller will compensate the buyer for any breach of warranty on a pound for pound basis. This is known as an indemnity basis of warranties and effectively turns each warranty into an indemnity. For obvious reasons, the seller should refuse to accept this clause and insist that the buyer prove his loss on any breach of warranty.

Although wholesale indemnities are resisted, some limited matters are often dealt with by indemnities. It is common for the seller to indemnify the buyer in relation to the tax affairs of the company, often in a separate tax covenant. This allows the buyer to be reimbursed by the seller if the company has not paid all tax due in the period it was owned by the seller. Also, if specific problems are identified during the due diligence or disclosure processes, these can sometimes be dealt with by way of a limited indemnity.

Misrepresentation

Although a seller may have ensured that the warranties given in the share purchase agreement are not also representations, and also resisted entering into onerous indemnities, he may still be tripped up by statements made before the agreement is signed. This is because such statements may be misrepresentations – untrue statements of fact or law which induce the other party to enter into a contract.

Misrepresentations may be fraudulent, negligent or innocent and the remedies available to the other party will depend on the type of misrepresentation committed. However, one remedy which is available for all forms of misrepresentation is rescission of the contract. Rescission means that the contract is set aside and the parties are put back into the position they were in before the contract was made. In the context of a share purchase agreement, this would mean the buyer handing back the shares and the seller returning the purchase price. The right to rescind the contract may be lost in various circumstances, for example if the innocent party affirms the contract by doing something inconsistent with an intention to rescind it, or if it is no longer possible to return the parties to their pre-contract positions.

To avoid the potential uncertainty of pre-contract statements becoming actionable misrepresentations, agreements such as a share purchase agreement usually include an "entire agreement clause". Such clauses seek to achieve two main aims – firstly to record that the terms contained in the agreement (and any ancillary documents referred to) are all the terms agreed between the parties, and secondly to exclude liability for misrepresentation. The latter is usually done by the parties confirming that they have not relied on any statements not set out in the agreement and/or specifically excluding rescission as a remedy. Such clauses will not be upheld by the courts if they are deemed to be unreasonable, so for this reason the clause will state that liability for fraudulent misrepresentation is not excluded.

For anyone needing any corporate or technical support, there is no-one better to work with.

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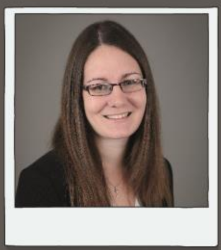

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