

## Warranties and indemnities: what's the difference?

THE RECESSION HAS SEEN A DRAMATIC increase in litigation. While potential claimants frequently shy away from such action in a more buoyant economy, reasoning that the time and money involved could be better spent on other opportunities, every penny is now fought for tooth and nail. The changed economic climate increases the pressure on lawyers to protect their clients against the common law position of 'let the buyer beware' by negotiating appropriate contractual protection. Depending on the nature of the contract, this protection will often take the form of warranties or indemnities. This article discusses warranties and indemnities, and the key differences between them in relation to the sale of businesses, products and services.

### WARRANTIES

A warranty is a contractual assurance from a seller to a buyer. It is a subsidiary or collateral provision to the main purpose of the agreement: the sale itself. A breach of warranty claim is an action for breach of contract and is subject to the normal legal requirements of proving loss. A party that breaches a warranty is only responsible for the loss and damage that is foreseeable as a result of the breach. The damages for which a seller is liable is the amount necessary to compensate the purchaser for any loss resulting from the breach. For example, where a company is acquired through the purchase of shares, the damages for which a seller is liable is the difference between the amount paid for the shares and the market value of the shares at the time of acquisition. This puts the buyer into the position that it would have enjoyed had the contract been properly executed. Accordingly, where breach of warranty results in a target company incurring liability, but its market value is not affected, the damages for such a breach would be nil. Warranties can take many forms and no one set of warranties can be entirely suitable for every case. The

number of warranties and matters to be covered by warranties will vary considerably depending on the nature of the business and the negotiating strength of the parties. Buyers will seek to include warranties pertinent to the subject of the agreement and the risks associated with it. Depending on the agreement, warranties could provide protection in a wide range of matters, including intellectual property rights, ownership of shares, financial matters, quality and performance of products, and employment issues. In the context of a sale of shares, a typical warranty might read:

'The Seller warrants that the statutory books of the Company are up to date and maintained in accordance with all applicable legal requirements.'

### PURPOSE OF WARRANTIES

One of the main purposes and effects of warranties is to apportion risk and liability between a buyer and a seller. Warranties protect a buyer by providing a possible price adjustment mechanism if a warranty proves to be false and, in the context of a sale of the business, by enabling a buyer to gather information on the business through a disclosure process. However, warranties should not be used as a substitute for due diligence as it is better and usually cheaper for a buyer to know of a problem in advance so that it has the chance to walk away, negotiate a price reduction or seek specific contractual protection (possibly in the form of an indemnity), rather than having to sue for breach of warranty at a later stage. In response to the example warranty above, the seller might disclose:

'The statutory books of the Company are not up to date.'

If the buyer had not found this information out during its due diligence, it has now found it out as a result of disclosure and can decide how to react, including seeking protection in the form of an indemnity.



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## INDEMNITIES

An indemnity is a contract by which the party providing the indemnity undertakes as an original and independent obligation to indemnify (make good) a loss. This means the right to recover one euro for every euro of loss, as distinct from a collateral contract, which gives the innocent party the right to damages. The following is a suggested indemnity to deal with the issue disclosed above:

'In consideration of payment by the Buyer of the Consideration, the Seller shall indemnify, defend and hold harmless the Buyer against any liability, damage, loss or expenses (including legal fees and expenses of litigation) incurred by or imposed on it in connection with any claims, suits, actions, demands or judgments (including, but not limited to, actions in the form of tort, warranty or strict liability) arising directly or indirectly from or in connection with bringing the statutory books up to date and in accordance with all applicable legal requirements.'

It is important that reference is made to there being 'consideration' for the issue of the indemnity and, where there is a concern about the adequacy of the consideration, the agreement should be signed as a deed. Appropriate gross-up provisions should also be applied to ensure that, if any money paid is treated as taxable income, the seller should be obliged to gross up the damages to cover any such liability.

## DIFFERENCES BETWEEN WARRANTIES AND INDEMNITIES

A warranty is a statement by the seller about a particular aspect of the target company's business. 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 was to reduce the value of the asset acquired. The onus is therefore on the buyer to show breach of contract and quantifiable loss. An indemnity is a promise to reimburse the buyer in respect of a particular type of liability, should it arise. The purpose of an indemnity is to provide guaranteed compensation to a buyer on a euro-for-euro basis in circumstances in which a breach of warranty would not

necessarily give rise to a claim for damages or to provide a specific remedy that might not otherwise be legally available. In the adjacent example warranty, and assuming that no disclosure had been made, the buyer claiming under the warranties would have to show that the statutory books not being up to date is a breach of the warranty

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and that the value of the company has been reduced as a result of the breach of the warranty. This could prove difficult. In the case of the example indemnity, the buyer would simply demand repayment of its costs in updating statutory books. Other key differences between a warranty and an indemnity are detailed below.

### Mitigation

Under common law, a buyer is clearly obliged to mitigate any loss for a breach of warranty. There is no such clear obligation for a buyer to mitigate its loss under an indemnity.

### Disclosure

Disclosures might be made against warranties in certain transactions, such as share or asset sales, thereby limiting liability, but should not be made against indemnities. A buyer might initially seek an indemnity because of information disclosed either during due diligence or in a disclosure letter. In the case of the adjacent example warranty, assuming the disclosure had been made, the buyer could not bring a claim under the warranties. However, they are not prevented from claiming under an indemnity, such as the one in the example above, regardless of disclosure. Disclosures transfer the commercial risk for information disclosed to a buyer, which cannot sue for a matter that has been properly disclosed. The level of disclosure that qualifies as proper disclosure will often be a matter of serious negotiation.

### Proof of loss

It is necessary for a buyer to prove that losses arise as a result of a breach of warranty – that share value has fallen as a result of the breach – and all issues relating to matters such as remoteness of damages apply. With an indemnity, however, a buyer can recover any losses sustained without

having to prove that there has been a diminution in share value.

### Buyer's knowledge of a breach

Depending on the terms of a contract, a buyer that is aware of a breach of warranty might be precluded from bringing a claim on the basis that they were aware of a breach and decided to enter into a contract regardless. However, knowledge of a breach of contract will not prevent a buyer from making a claim under an indemnity. Indeed, buyers often negotiate an indemnity as contractual protection from a specific problem that they have discovered.

### Limitations

Warranties are commonly subject to a series of negotiated limitations on liability that would not usually apply to indemnities. Like warranties, the number and form of the limitations varies depending on the nature of the business and the negotiating strength of the contracting parties. The kind of disclosure discussed above is a commonly sought form of limitation, as is limiting the period during which a claim can be brought and defining the amount that may be claimed under a warranty. However, in large-scale transactions in particular, as with warranties, warranty limitations can run to many pages in a contract. It is standard practice in the US to seek indemnification of warranties but this is not the case in Ireland or the UK, where, apart from negotiating tax indemnity on share sales, indemnities are negotiated on

a case-by-case basis. The provision of any indemnity – let alone general indemnities – is often strongly resisted because of the relative ease of recovery under such an

deal. The attitude of many sellers to the provision of indemnities again highlights the importance of due diligence as way of allowing a buyer to make an informed

these agreements. If there is doubt about a seller's credit rating, circumstances might require some form of security, such as a staggered payment of consideration, a bank guarantee or warranty and indemnity insurance.

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agreement in comparison to warranties. In many cases, a seller will take the position that 'we don't do indemnities'. This means that, if this position stands up to pressure under negotiation, a buyer's options to deal with a specific issue are reduced and it can take the risk of possibly relying on a warranty, if it is able to do so, seeking a price reduction or refusing to complete the

decision. In acting for a seller, it is important to be conscious of the distinction between warranties and indemnities, and to be aware of catch-all indemnity clauses in any contract. Lawyers should also be aware that, while it is all well and good negotiating warranties and indemnities on behalf of a client, such contracts will be worthless if the seller is not able to fulfil

**COMMENT**

The salient commercial points of a contract are often thrashed out by clients, while lawyers focus on negotiating the terms of such security. Frequently, however, it is left to lawyers to negotiate the body of warranties, indemnities and warranty limitations, under instructions from clients to ensure that they are protected. Given the impact that the difference between warranties and indemnities can have on clients, it is crucial that lawyers remember the distinctions between the two while negotiating.

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