Taking the Sting out of Warranties

Expert knowledge means success

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Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

A warranty claim is something that every vendor dreads. Having already endured the highly stressful experience of selling a business and having possibly already re-invested the sale proceeds, the last thing the vendor wants is to have to lock horns with the purchaser again in a protracted and expensive legal dispute over warranties. The problem is that if a vendor is not prepared or cannot, for whatever reason, give warranties he will have to accept a significant diminution in the purchase price. Putting warranty insurance in place, to cover against possible future claims, may provide vendors with a solution to this problem.

Warranty insurance is a relatively recent phenomenon. Indeed, there are only a few brokers who specialise in this area, and advisers tend to dismiss the concept as either "too expensive" or "too complicated." In certain circumstances, this conclusion may be correct. However, from our experience, whilst many professional advisors have heard of the concept, few have investigated it in any detail, and even fewer have had direct experience of applying it in practice.

This publication[1] looks at the main reasons for considering warranty insurance, provides an outline of the mechanics involved, and discusses some of the problem areas.

Warranty Insurance for Institutions

It is virtually axiomatic now that financial institutions and, in particular, venture capital funds, do not give warranties. It is not that, in refusing to give warranties, institutions are just being difficult. In most cases, there are perfectly legitimate reasons which make them either unable or unwilling to do so. For most institutions, the perennial problem is that the funds they manage are typically "closed end," and have to be distributed to their external investors, in their entirety, usually between 5 and 10 years after inception. Accordingly, it is not possible for such funds to give warranties that could result in a claim being made following the final distribution to investors. Retentions or, even worse, claw-backs from final distributions to cover claims are also unacceptable.

Another problem for institutions in giving warranties is that many take a very "hands-off" approach to managing their investments. In some instances, they may be completely passive investors holding minority stakes as a result of syndication exercises. In such circumstances their knowledge of the investments may be so limited that they cannot give meaningful warranties.

One might conclude that the impediments which institutions face in giving warranties work in their favour, as they have a ready-made excuse whenever the issue arises. However, the problem is that most purchasers, being risk averse, will pay considerably less for a business if it does not have the protection afforded by a full set of warranties. Indeed, many purchasers will simply not make an acquisition without the benefit of warranty protection.

An institution which is not prepared to give warranties is therefore faced with three main choices:

- It can try to persuade the buyer to accept that the institution's shareholding will not be covered by warranties and accept a reduction in the purchase consideration.
- It can try to persuade the "management shareholders" to cover 100% of the warranties, including the institution's proportion. This route is only practical if the institution holds less than 50% of the equity. Any more, and the management are unlikely to accept the risk.
- It can agree a retention with the buyer against claims arising during a period following the sale. However, the buyer may demand an unacceptably high level of retention. Furthermore, given that tax warranties often remain for up to 7 years, this route may not solve the fund distribution issue.

If these routes are not open to the institution, warranty insurance may provide a solution. The institution should then ask itself whether giving warranties on the disposal, backed by insurance, will realise greater sale proceeds than a disposal without warranties.

The answer will typically be "yes", as experience with two recent disposal exercises demonstrates.

In one case, the vendors of a venture capital investment were offered two alternate bids from the same prospective purchaser - one of £14 million for a deal which included warranties, the other of £12 million for a deal which did not. In that case, the price differential of £2 million was more than ten times the likely cost of warranty insurance.

In the other case, the vendors received a number of competing bids, but the highest bidder would only proceed on the basis of a full set of vendor warranties. The management, who held less than 10% of the shares, were understandably reluctant to bear more than their share of the risk. This presented obvious problems for the institutions, who held the balance of the shares in the company.

However, they appreciated that the only way to secure the highest bid was to accede to the purchaser's demands and provide warranties. The impasse was settled by the institutional investors taking out warranty insurance. In this instance, the insurance cost was £65,000 and the consideration differential was over £1.5 million.

Warranty Insurance for Individual Vendors

Whereas a financial institution may take out warranty insurance to increase the proceeds of sale, for the individual vendor, the attractions of warranty insurance often relate more to peace of mind and financial security. An individual who sells his business will often be relying on the proceeds of sale for his retirement. Alternatively, he may be intending to reinvest the proceeds in another business venture.

However, if the vendor has given warranties in the sale agreement, there is always the possibility that his carefully made plans could be thwarted by an unexpected warranty claim, which could consume a large part, if not all, of the sale proceeds. To remove this uncertainty, the cost of warranty insurance may, for some vendors, be a small price to pay.

Furthermore, the fact that a vendor has the backing of a large insurance company will deter purchasers from entering into spurious warranty claims in an attempt to recoup some of the purchase consideration.

Advantages for Purchasers

Warranty insurance can however be beneficial to purchasers. Quite apart from enabling them to obtain warranties which perhaps might not have otherwise been available, in the case of a distress sale, or if there is any doubt as to the long-term financial viability of the vendor, purchasers will be in a much more secure position if they have received warranties which are backed by warranty insurance. This is particularly the case if the purchaser is named as co-insured on the policy.

How does Warranty Insurance work?

If a vendor takes out warranty insurance, he will only be insured against any claims made by the purchaser under the warranties and indemnities which fall within the terms of the insurance cover and (if he chooses) the legal costs associated with fighting such claims.

Typically, there are a number of areas which warranty insurance is not likely to cover. The main exclusions are:

- claims where the insured knowingly withheld information of which he had actual knowledge at the date of the agreement;
- claims where there has been fraud or dishonesty on the part of the insured;
- claims for bad debts;
- claims relating to the inadequacy of pension funding; and
- claims relating to certain environmental issues.

In some instances, these exclusions completely undermine the benefit of taking out the insurance in the first place. However, a number of the exclusions cover areas which are in the direct control of the insured or could be covered by the judicious use of short-term retentions.

It is therefore advisable to consult with insurers at an early stage to establish the terms of the policy and the list of exclusions. At this point, the insurer can also give a preliminary indication of the likely premium levels.

Ultimately, of course, the insurer will also need to review the final legal documentation (at the very least, the Sale Agreement, the Deed of Tax Indemnity and the Disclosure Letter), to determine the scope of the warranties and the extent of the possible exposure.

This review is carried out when all of the documentation has been agreed between vendor and purchaser and is conducted by the insurers' solicitors for a fee normally around £2,500, which is often offset against the final insurance premium. Vendors should allow up to 5 working days for this process to be carried.

Based on their solicitors' report, the insurer will detail any changes that they require to the documentation and quote a final price for the policy. This typically works out at between 1% and 1.5% of the purchase consideration but decreases on a sliding scale as the size of the purchase consideration increases.

The cost of warranty insurance is deductible against any taxable gain made on the disposal of the business.

Points to Consider

As noted above, warranty insurance has small print containing exclusions from the scope of the coverage. These exclusions will almost certainly mean that the warrantor is not insured against the full spectrum of warranties and indemnities typically found in a sale agreement. It is therefore prudent to warn the purchaser that warranty insurance is being considered, and to discuss with him in advance the likely exclusion areas.

In some instances, it is possible to persuade the purchaser to accept that he will only obtain warranties to the extent that they are covered by the insurance policy. However, in order to achieve this "seamless" approach, a high level of co-operation will be needed from the purchaser. It is therefore more likely to succeed if the purchaser has been given plenty of warning, so as to allow an opportunity of a more detailed due diligence review of the excluded areas.

The insurance brokers should be brought in at the initial drafting of the legal documentation to pre-empt major problems arising later. Although the brokers normally state that they will only get involved once everything is in final form, experience shows that it is possible to persuade them to comment informally on the shape and content of the draft documentation at a much earlier stage.

Finally, it should be borne in mind that putting insurance in place will add to the complexity and level of contention in negotiating and documenting a sale agreement. This adds to the costs, both in terms of increased professional fees and the emotional pressures.

Conclusions

Warranty insurance is not a universal panacea for overcoming the problems associated with warranties. In many cases, it is either inappropriate or simply impossible to put in place. However, in certain circumstances, warranty insurance can be a very effective solution for vendors who, for whatever reason, cannot, or do not wish to, expose themselves to ongoing warranty exposure. It therefore merits consideration by advisors as part of any disposal planning process.

Further Information

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

Reference:

[1] Hugo Haddon-Grant FCA kindly wrote the text for this publication. In early 1988 he formed Cavendish Corporate Finance Limited with Howard Leigh and has since then advised on a large number of company sales. In the course of this work he has built up a particular expertise in the distribution, retail and service sectors. Cavendish Corporate Finance Limited specialises in selling businesses. Their clients range from private companies to fully listed public companies with values broadly from £5m to £100m. Cavendish only ever acts for vendors of businesses and so does not have the conflicts of interest faced by firms who advise purchasers as well as vendors. Cavendish has developed considerable expertise in sales, to both trade buyers and financial institutions, having advised on over 100 successfully completed company sales since its formation in 1988. They can be contacted at 12 Cavendish Place London W1M ONT Tel + 44 (0) 207 436 2391 Fax + 44 (0) 207 323 2145 or by e-mail to: cscales@cavendish.ltd.uk

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