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PROTECTING ACQUISITIONS FROM HIDING GREMLINS:

Warranties & Indemnities - Why and What is the Difference?*

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The starting point for a buyer in most transactions is the maxim ‘caveat emptor’. Even with the precaution of a thorough due diligence though, it is possible undiscovered gremlins will surface after pen has been put to paper.

It is accordingly reasonable for a buyer to seek protection by negotiating appropriate warranties and indemnities.

Without warranties or indemnities, unless the seller has made misrepresentations, the buyer is at risk of having no or limited legal recourse in the event problems come out of hiding post closing. As a result, it is common to structure sale agreements so that they include:

- a schedule setting out a comprehensive list of warranties;
- a schedule in which the seller has an opportunity to make any disclosures against warranties provided; and
- indemnities.

WARRANTIES

A warranty is a contractual assurance given (normally) by the seller to the buyer that a certain state of affairs exists. Warranties allocate risk between the seller and the buyer. They also:

- allow the buyer to elicit information about the target through disclosure;
- encourage the seller to make disclosure against the warranties;
- provide a mechanism to adjust the purchase price after closing; and
- enable the buyer to seek protection by way of:
    - indemnities for liabilities disclosed; and/or
    - the option to cancel in extreme circumstances.

A breach of a warranty is ordinarily not as serious as a breach of other terms in an agreement (at least not as serious as one which goes to the root of a contract and permits the buyer to cancel as well as claim damages).

The buyer’s remedy for a breach of warranty will likely be in damages, unless the agreement specifically allows the buyer to terminate (e.g. for breach of warranty concerning the seller’s ownership of shares to be purchased).

For a discussion on the importation of the term ‘warranty’ from English Law to South African Law and the related interpretive issues see Christie, Law of Contract in South Africa, 6th Edition, page 162.

Warranties in an agreement should cover most areas of the target company and/or the underlying business.

The following will be negotiated:

- the scope of what is warranted;
- the minimum amount of loss which can trigger a claim for breach of warranty;
- the maximum possible claim arising from a breach of warranty;
- procedures on the submission of claims;
- the period in which the warranties will apply; and
- the interpretation of disclosures.

Warranties and disclosures in a disclosure schedule (or a disclosure letter) serve separate but interdependent purposes. Warranties protect the buyer while the disclosures work so as to limit the seller's liability under the warranties.

For example, a seller might give a warranty to the effect that the target company it is not involved in any litigation, arbitration, mediation or dispute resolution proceedings and there are no such proceedings pending, threatened or expected either by or against the target company. If the company is in fact engaged in litigation, the seller will then (or at least should) disclose this against the warranty in the disclosure schedule in sufficient detail to qualify its liability under the warranty.

REMEDY FOR A BREACH OF WARRANTY

If the seller fails to disclose against a particular warranty or the disclosure against a warranty is inadequate, the buyer will have a contractual claim for breach of warranty which will likely involve a claim for damages (assuming the warranty does not go to the root of the agreement and entitle the buyer to also cancel).

The following points are worth noting:

- The giver of a warranty does not promise to do anything other than make good any loss suffered arising from the warranted fact not existing. This means that impossibility of performance is not a defence to a claim for breach of warranty - See LAWSA, Volume 9 at 373.
- The function of damages is compensatory and intended to recover actual loss rather than serve a punitive purpose.
- Under contract, damages for a breach of warranty should, in principle, place the buyer in the position it would have been if the warranty had been true - subject to limitations. The general rule is that damages which flow naturally from the breach (i.e are reasonably foreseeable) are recoverable.

The English case of Hadley v Baxendale [1843-60] AA ER Rep 461 sets out principles for the amount of damages recoverable following a breach of contract (principles around the 'remoteness of damage'). See also: Holmdene Brickworks (Pty) Ltd v Roberts Construction Co Ltd [1977] 4 All SA 94 (A) and Transnet Ltd t/a National Ports Authority v The Owner of mv Snow Crystal [2008] 3 All SA 255 (SCA)[35].

In the Transnet case Scott JA set out the inquiry as follows:

"to answer the question whether damages flow naturally and generally from the breach one must inquire whether, having regard to the subject matter and terms of the contract, the harm that was suffered can be said to have been reasonably foreseeable [at the time the agreement was concluded] as a realistic possibility".

In the Law of Contract, the liability depends on the presumed contemplation of the parties at the time when the agreement was concluded. It is presumed that, unless agreed otherwise, the parties would have only contemplated liability for what is usual, normal or likely to happen.

Of course, the buyer will be obligated to mitigate any loss arising from a breach of warranty.

INDEMNITIES

An indemnity (in the context under consideration) is an agreement by the seller to reimburse the buyer for losses arising from a specified event.

The operation of the indemnity will depend on the type of loss it is seeking to recover. The seller might agree to give the following indemnity:

> ***"Without limiting any other rights that the Buyer may have, including its rights to claim damages for breach of warranty, the Seller shall indemnify and keep indemnified the Buyer from and against all liabilities, costs, expenses (including legal expenses), claims, actions, proceedings, damages, fines, penalties, loss of profits arising out of or in connection with [insert description where liability could arise from....]"***

A buyer will often seek indemnities where liabilities are known or anticipated (e.g. current litigation or environmental liabilities) if the buyer considers, once a liability is disclosed, that the warranties will not provide sufficient protection.

ADVANTAGES OF AN INDEMNITY OVER A CONTRACTUAL WARRANTY

The advantages of an indemnity over a warranty include the following:

- there is scope, subject to the wording of the indemnity, for the amount which can be claimed to include broader categories of losses than those arising from an ordinary breach of a warranty;

- the buyer does not have to prove a breach of the agreement, only that the event covered by the indemnity has taken place and that its losses are covered by the indemnity. This can help with the avoidance of interpretive issues around the impact of disclosures which could be material to whether a warranty has been breached but which are unlikely to dilute the effect if an indemnity; and

- the prescription period for an indemnity will run from the date the loss is suffered, rather than from when the event which causes the loss occurs. On this point relating to prescription See Botha v Iveco South Africa (Pty) Ltd 2012 JDR 0863 (SCA), [2012] ZASCA 78.

Often a buyer will require the seller to give warranties on an indemnity basis. What is the reason for this? Presumably it is to allow the buyer to claim from the seller the amount necessary to put the buyer into the position it literally would have been had there been no breach of warranty. This is arguably broader than a claim for damages arising only from the ordinary foreseeable consequences of a breach of warranty. Whether not this purpose would be achieved is questionable.

Although what is agreed will ultimately be a matter of negotiation between the parties, where the buyer is concerned about the seller's solvency or foreseeable practical difficulties in enforcing warranties and indemnities, it will need to consider additional options to provide comfort. It may take security in the form of a bank guarantee (or parent company/related party guarantee) or part of the sale proceeds may be deposited into a retention fund, only to be released on the expiry of warranty periods.

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Merger and Acquisition services included:

- Legal due diligence.
- Co-ordinating sale and acquisition of businesses including drafting and advice.
- Advising on the Broad Based Black Economic Empowerment Act and its Codes.
- Regulatory approvals including takeover regulation panel, competition commission and exchange control.
- Advice on the Companies Act 71 of 2008 and its implications for directors and shareholders.
- Assisting with the resolution of shareholder disputes.