

Lees Solicitors LLP

Company and business sales – brief guide to warranties and disclosure

The purpose of this note is to provide a brief explanation of the process by which a seller of a business or company will disclose information to the buyer in order to reduce the risk of a claim under the warranties in the sale agreement.

This note is only a general guide to the issues involved. It is not intended to constitute legal advice and you should not rely on it for this purpose in relation to any particular transaction. If you are considering selling or purchasing a business or company you should obtain specific legal advice at an early stage.

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Warranties and the disclosure letter

The draft agreement for the sale of a company or business ("**Agreement**") will usually contain a number of warranties which the seller is required to give in respect of the company or business being sold. These are statements of fact in relation to specific matters at the date of completion (e.g. accuracy of the accounts or that the company is not involved in any litigation).

If a warranted fact is untrue at completion, the buyer may have a claim for breach of contract regardless of whether it placed reliance on the warranty in question when entering into the transaction. The amount of the claim will be based on the reduction in value of the shares in the company or the business acquired as a result of the breach of warranty.

However, no claim will be possible if the fact, matter or circumstance which gives rise to the breach was disclosed to the buyer to the standard required in the Agreement (which will typically require that "fair disclosure, with sufficient detail to identify the nature, scope and effect of the matter disclosed" is needed). It is important that disclosures are made to the standard required in the agreement and are as complete and accurate as possible and not misleading in order to avoid the risk that the disclosures will not be effective to avoid a breach of warranty.

The Agreement will usually provide that only matters, facts or circumstances which are formally disclosed in a disclosure letter delivered by the seller will prevent a claim under the warranties (or "qualify" the warranties) and that no other matters of which the buyer may be aware will be relevant. The current case law suggests that such a provision is likely to be enforceable as a matter of law and the best course of action for a seller is to assume that any information previously given to the buyer will not prevent a breach of warranty unless it is repeated in the disclosure letter.

Claims under the warranties are also likely to be subject to a number of limitations set out in the agreement, including a time limit within which claims can be brought, a provision to disregard small claims, a threshold of total claims which must be reached before a claim can be made and a cap on the overall liability of the seller. However, the seller would be well advised not to rely on these limitations and to make every effort to ensure that the disclosures are as complete and accurate as possible.

From the buyer's perspective the warranties are important because they provide a post-completion price adjustment mechanism if unknown liabilities arise and the buyer suffers loss. However, they also serve the (arguably more important) purpose of eliciting disclosure of important information via the disclosure letter before the sale is concluded, enabling the buyer to consider a price adjustment, an indemnity or even to walk away if they are particularly concerned about certain information disclosed.

As such, a full and detailed disclosure exercise is in the best interests of both parties and it is important that the seller considers the warranties and any potential disclosures carefully.

The disclosure letter and disclosure bundle

The disclosure letter takes the form of a letter from the seller to the buyer. It is divided into two parts: the "general disclosures" and the "specific disclosures". The general disclosures will usually be shorter than the specific disclosures, but can often take a considerable amount of time to negotiate. The final version will also have attached to it copies of the documentation being disclosed or referred to in the disclosures (known as the "disclosure bundle").

General disclosures

The general disclosures cover various matters which appear in public records and/or of which the buyer ought to be aware on the basis of pre-contract enquiries or searches which it has actually made, or which a prudent buyer would normally make.

Where we act for the seller we will draft the general section is based on our standard form. The general practice is for the seller's solicitors to produce a first draft of the general section which is as all-embracing as possible. However, our view is that this approach is not constructive and we will normally seek to avoid any general disclosures which are clearly not relevant or are unreasonably wide and unlikely to be accepted by a competent adviser as a matter of market practice.

Specific disclosures

This section specifically discloses actual matters, facts or circumstances which, if not disclosed, would constitute a breach of warranty.

The specific disclosures are made by reference to the warranties themselves. For example, against a "no litigation" warranty, the seller would need to disclose details of any current litigation affecting the company.

Also, certain warranties may specifically require information to be included in the disclosure letter or documents to be included in the disclosure bundle (for example, a copy of the memorandum and articles of association of the company and/or details of employees of the company).

The disclosure bundle

The final disclosure bundle may contain a large number of documents although this will depend on the complexity and size of the business and the extent of the warranties. The warranties may, for example, require disclosure of all material contracts of the company or business in which case copies of these must be included in the disclosure bundle.

The seller's solicitors will prepare two copies of the disclosure bundle. One of these will be sent to the buyer with the disclosure letter and the other will be retained by the seller. Both copies will be updated as further disclosure material is made available in the run-up to completion.

Immediately before completion of the sale the solicitors acting for the buyer and the seller will arrange for the two bundles to be checked to ensure that they are identical.

Preparation of the Disclosure Letter

The seller's solicitors will generally prepare the first draft of the disclosure letter (comprising the general disclosures) for review by the buyer's solicitors.

Where we act for the seller, we will also prepare an initial draft of the specific disclosures for review by the seller based on the due diligence information and any other information which we may have. This will not be comprehensive, but will save the seller from having to provide information which they have already given to us.

The seller will then need to work through the warranties in the Agreement and identify any other matters of which they are aware which will need to be disclosed. Where we act for the seller we would usually arrange a disclosure meeting with the seller to assist them with this process.

The seller will also need to ensure that the disclosures are kept under review as completion approaches. As the business will continue to operate it is likely that new matters will arise which could require disclosure and the disclosure letter will need to be updated with these.

The buyer's solicitors will review the specific disclosures and comment on them. They may ask for more detail or information in relation to a particular disclosure or if they are particularly concerned about any matter disclosed they may seek to include an indemnity in the Agreement in respect of it.

An "indemnity" in this context is a provision of the Agreement which states that if the buyer or the target company suffers any loss as a result of the relevant matter the seller(s) will compensate them for it on a £1 for £1 basis. Indemnities will not usually be subject to disclosure or the other limitations in the Agreement and will also not be subject to the buyer's usual obligation to do everything reasonably possible to mitigate the loss suffered. Indemnities are usually reserved for key issues of particular concern to the buyer and should not be given lightly.

Knowledge of other relevant individuals

Certain of the warranties may be qualified by the knowledge of the seller(s) (i.e. they will state that "so far as the sellers are aware" there is no litigation against the company).

The Agreement will usually provide that in this context the seller(s) will be deemed to have knowledge not only of matters of which they are actually aware, but also matters of which they would have been aware had they made enquiries of others (for example senior management of the company and/or professional advisers).

The seller(s) will need to ensure that appropriate enquiries are made of all such individuals to ensure that there is nothing of which they are aware which will be relevant to the warranties. They should consider asking these individuals to confirm in writing that they have disclosed all matters of which they are aware (although the provisions of the Agreement will usually prevent the sellers from bringing any claim against them if they have not done so).

What if the seller does not wish to disclose something?

The most obvious issue for a seller who fails to disclose a relevant matter in respect of the warranties is that they run the risk of being sued for a breach of warranty.

However, there are also more serious issues which could arise such as criminal liability under the Financial Services and Markets Act 2000 for concealing information or making misleading statements in connection with a share sale, liability for misrepresentation or even a criminal offence under the Fraud Act 2006.

On this basis we would always advise a seller to ensure that all relevant disclosures are made even if they concern matters which may affect the price or prejudice the transaction.