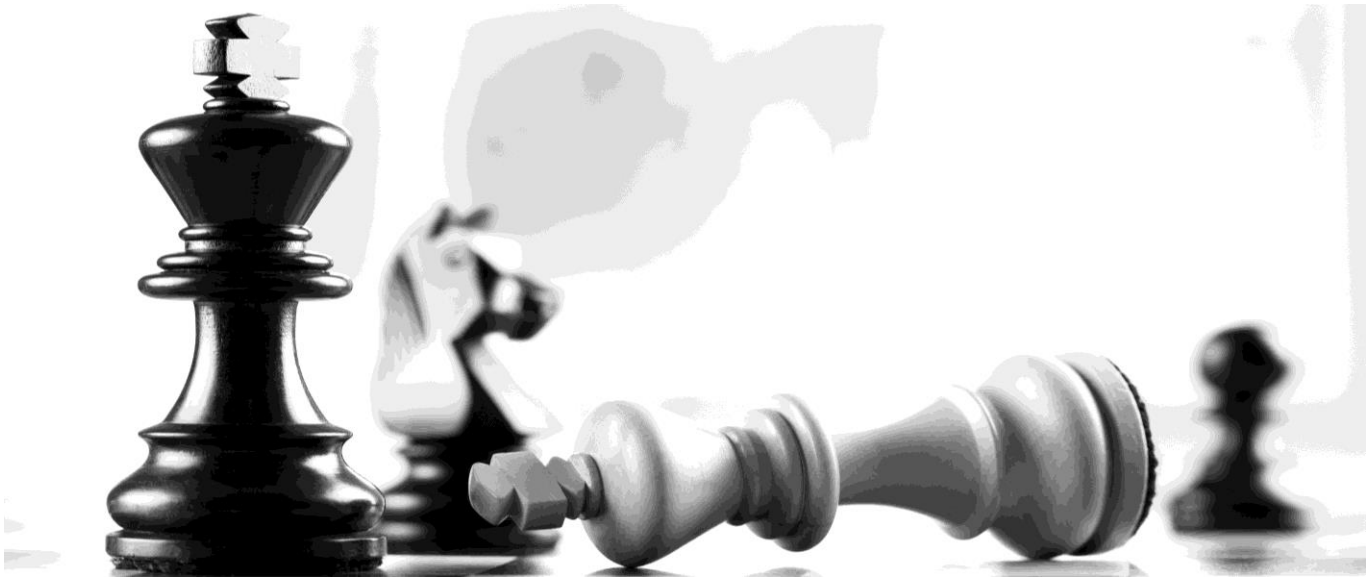
ADDLESHAW GODDARD

PRIVATE EQUITY SPOTLIGHTS

M&A RISK MANAGEMENT

Warranty Claims: Worthwhile or Worthless?



In the high-value, high-stakes world of M&A, risk management is key. Warranties are a vital tool: both parties want a carefully scoped and worded clause, designed to protect and, from the buyer's perspective, appropriately expose to provide remedy if those contractual statements are found to be untrue.

"80% of warranty disputes reached a settlement before proceedings were brought or prior to the hearing"

So what happens when a breach of warranty is uncovered? Are parties prepared to bring a claim? And if so, do those clauses work as they were designed to? In a new study conducted by our litigation team we have assessed a large number of warranty disputes in order to assist our clients in assessing and informing their risk management strategies when they enter into deals.

Here is a summary of just some of the key findings:

- **Types of claimant:** The majority of claims (over 70%) were brought by corporate, rather than PE and other financial acquirers. This will be counter-intuitive to many corporates, who may have an impression of financial investors routinely pursuing any strategy available to recover additional value. Of course, management teams backed by PE are often also vendors, which substantially reduces the likelihood of claims unless there is a case of dishonesty or a more significant and fundamental issue with the acquired business on reputational grounds. In contrast, many corporate acquirers routinely pursue potential claims for incremental value post-deal. Query also whether the more aggressive auction processes often experienced in PE results in a lighter set of warranties making claims more difficult.
- **Amounts claimed:** Private equity buyers typically recovered a far higher percentage of consideration than trade buyers when bringing claims. This again emphasises that some trade buyers will often seek smaller amounts of additional value by bringing claims as a matter of routine (often resulting in a financial recovery), whereas PE buyers may resist bringing a claim in all but the most serious of circumstances. Does this mean that financial acquirers are potentially missing a trick?
- **Litigation from claims:** 80% of disputes resulted in a settlement before hearing, and often before proceedings were brought. Given that there will be other claims which are resolved without specialist litigation input, the percentage of disputes resulting in litigation will actually be far lower than this 20% figure in practice. Alternatives to litigation such as mediation can shorten the claim process significantly – which PE acquirers again might bear in mind if their resistance to bringing claims is motivated by a fear of being drawn into a 2-3 year process to full trial.
- **Focus on diligence:** In 33% of cases inadequate disclosures by the seller formed an underlying cause of claims. Conducting sufficiently detailed due diligence is a balancing act on the buyer's part, involving considerations of time, cost and proportionality. One reason for a lower likelihood of claims from a financial purchaser might be the more extensive due

diligence processes often experienced in a private equity deal, meaning that issues are identified and dealt with via pricing mechanisms or adjustments pre-transaction.

- **Nature of claims:** Over 60% of disputes reviewed involve allegations regarding the accounts, business and trading and financial obligations of the target. Often the accounts warranties will provide a general foundation for warranty claims, alongside the warranties in the relevant specific risk areas. It might be argued that the specific warranties can serve a more useful purpose in provoking disclosure (particularly when knowledge based), whilst the accounts warranties have a primary purpose of allocating risk.
- **Use of retentions:** Trends in our data show that levels of loss in warranty claims typically exceed the amount held in escrow / retention or deferred consideration, often substantially. As such, whilst such mechanisms may provide some comfort to buyers, our data suggests that liability caps are king - both during negotiations and when formulating any later claim.

When warranties are breached, it is worth exploring the merits of a potential warranty claim. As our statistics show, despite the time and effort that may be involved in commencing a dispute, such claims have proven themselves commonly to be an effective approach for successfully making a recovery against your loss. So he who dares (often) wins.

"We have seen the amount of buyer W&I policies increase fourfold since 2010"

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Increasingly parties are using warranty and indemnity (W&I) insurance to manage risk and liabilities in order to facilitate a transaction. Such insurance offers cover for losses arising from the breach of a warranty or an indemnity given in sales documentation and offers an alternative to the traditional approach of a buyer seeking recourse against a seller.

By far the most common form of W&I insurance is buyer-side – to protect the buyer in the event that a warranty is breached. Whilst seller-side cover is also available, where sellers instigate W&I insurance cover as part of a transaction process, this is more usually achieved via "sell side flips" (where sellers offer W&I insurance to the buyer as part of the overall sale package). Data from JLT indicates that whilst 49% of W&I insurance is seller facilitated, only 4% takes the form of a seller rather than buyer policy.

Our fuller report includes additional data from our analysis of claims, as well as more information around trends in W&I insurance cover. If you would like to receive a copy of that report, or to meet with us to discuss how our findings can help improve your policies and processes surrounding warranties on transactions (or a specific claim issue) please do contact any of us, or your usual Addleshaw Goddard contact.

Who to contact and how we can help

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