# Drafting the acquisition agreement – contractual protections for the buyer

This section considers the contractual protections generally required for the buyer.

# Introduction to the buyer’s contractual protections

You have considered certain issues in relation to the preliminary documents and associated matters for the parties to consider at the outset of a corporate transaction. Now, you need to consider **drafting the acquisition agreement** itself.  In this topic we are going to look at the most important aspect of drafting the acquisition agreement: **the contractual protections** required for both the buyer and the seller. In this element you will in particular focus on the buyer’s contractual protections.

Buyer’s contractual protections include:

* Warranties and Indemnities
* Title guarantee
* Restrictive covenants

Additional contractual protections will be needed if there is split signing and completion, which will be dealt with when you look at completion.

# Introduction to warranties and indemnities

The buyer in a corporate transaction generally receives no protection under common law or statute if it subsequently finds that it has not got what it thought it was getting out of the bargain. The buyer is, therefore, likely to want extensive contractual protections - in the form of **warranties** and **indemnities** - in the acquisition agreement. This is particularly so in the case of a share sale, when the buyer will be taking over the whole company including all of its actual and potential liabilities.

**Definitions:** A **warranty** is a statement of fact about the company or the business which the buyer is seeking to acquire which, if untrue, gives rise to a claim for damages against the seller.

An **indemnity** is a promise made by the seller to reimburse the buyer if a particular circumstance arises and, if triggered, seeks to give the buyer £ for £ protection for the relevant matter.

When drafting the acquisition agreement, the buyer’s solicitors must have careful regard to the nature of the target’s business, to ensure that the appropriate warranties and indemnities are included expressly.

One of the principal protections for the seller against a warranty claim is disclosure. If proper disclosure of a matter is made by the seller there will be no claim for the buyer. This is considered in more detail in the next topic.

# Warranties and indemnities

The buyer and its advisers will have already found out as much information as they can about the target through the due diligence process.

It may be that one or more substantial issues have come to light and that the buyer has already sought to **restructure the transaction** or agree a **reduction in price**.

However, even if no substantial issues have emerged which lead to this, it is likely that the buyer’s solicitors will have discovered a number of areas of concern.

From the buyer’s point of view, the acquisition agreement should ideally include (1) **warranties** about all the substantive aspects of the target and (2) **indemnities** covering key areas of possible loss or liability which have been discovered. The provisions might, for example, encompass issues such as doubtful debts, actual or potential litigation, employment and pension liabilities and (on a share sale) tax liabilities. The indemnities will cover specific identified concerns particularly where a warranty claim may be limited due to disclosures made by the seller.

When drafting the acquisition agreement and when analysing the scope of required warranties and/or indemnities, the buyer’s solicitors should consider all relevant information and, in particular, the results of the legal due diligence, the accountants’ report and the results of any commercial due diligence.

**The structure of the transaction**

The level of warranties and indemnities in the acquisition agreement will depend on the **structure of the transaction.**

In the case of a **bilateral sale,** where the buyer generally produces the first draft of the acquisition agreement, the document is likely to contain very extensive and wide-ranging warranties and indemnities.

**Private equity sellers** will generally give very few warranties. You will consider private equity later in this knowledge stream.

In a **sale by auction**, the first draft of the acquisition agreement is generally produced by the seller. It is not, therefore, likely to contain an extensive range of warranties and indemnities.

Nevertheless, it will generally contain some contractual protection for the buyer since the seller will appreciate that, if it refuses to give any warranties and indemnities, this may have an adverse effect on the price a potential buyer will be prepared to pay.

# Tax liabilities

The buyer of all the shares in a company will be acquiring the target with all its tax liabilities. As a result, the buyer will want to ensure that any unexpected tax liabilities relating to the period of ownership before completion are to be paid for by the seller.

Tax is an area where potential liabilities may be difficult to spot. For this reason, it is usual for the buyer to obtain both **tax** **warranties and tax indemnities** to cover any tax liabilities relating to the period up to completion which have not been provided for, or taken into account, as part of the purchase price.

The tax warranties are usually contained in the warranty schedule to the acquisition agreement or in the tax covenant. There are usually extensive indemnities in relation to tax which will either be contained in a schedule to the acquisition agreement or they could, instead, be dealt with in a separate document. The tax indemnities, are referred to as the **tax covenant or a tax deed**.

# Tax warranties and tax indemnities

**Example: ‘There are no disputes with any tax authority.’**

If a warranty like this is inserted in the acquisition agreement and the seller knows that there is a dispute with HMRC over some part of the target’s tax affairs, then the seller will be forced to take some action. The seller could ask for the warranty to be struck out (since it is untrue). The buyer will refuse to allow this and, in any event, by asking for the warranty to be struck out, the seller will be putting the buyer on notice that there is a problem. A more realistic and practical solution will be for the seller to allow the warranty to remain and to disclose against it, giving details of the dispute to the buyer.

**Example: ‘The Seller will indemnify the Buyer an amount equal to any liability of the Target to taxation relating to the Seller’s period of ownership, not provided for in the Accounts.’**

In this example, both parties are aware of a specific potential liability (namely that a tax liability of the target may not have been taken into account when the accounts were prepared) and it has been agreed to insert this indemnity in the acquisition agreement so that the seller bears the cost of any such liability should it materialise.

# Liability in relation to warranties

Where the target is being sold by a single seller, that seller will give the warranties and will be liable to the buyer in the event of a breach. Where the company is being sold by a group of individuals, the position is more complicated. A seller’s liability as a warrantor can be:

* **Joint and several** meaning each seller assumes the obligation collectively (on behalf of all those bound) and individually (for himself). The buyer may then sue any one or more of the sellers for the whole or part of the loss.
* **Several** meaning each seller is liable for an agreed specified proportion of the potential damages(as long as the drafting goes on to specify the proportion of liability or a monetary cap on each seller's liability) . Here, the buyer must bring proceedings against individual sellers for their share.
* **Joint** is the same as if the parties were liable jointly and severally. However, the death of a party who is jointly liable will release his estate from liability. A further disadvantage for the buyer is that in order to bring proceedings against joint parties, the buyer must issue proceedings against all of them.

The buyer will therefore want to ensure that the warranties are given by all the sellers on a joint and several basis so that the buyer has a right of action against all or any of the sellers and can choose whom to pursue.

# Protecting individual warrantors

Civil Liability (Contribution) Act 1978

The Civil Liability (Contribution) Act 1978 entitles a joint warrantor who is found liable to pay damages for a breach of warranty, **to seek a contribution from the others liable for the same damage.** The court will evaluate the amount each of the parties should pay to the sued seller based on what the court considers just and equitable having regard to each party’s responsibility for the damage in question.

Express ‘Contribution Agreement’

Often the sellers will not want to leave it to the courts to decide the amount they should each contribute if the buyer is successful in a damages claim. So, it is reasonably common for the sellers to agree between them the **contribution** that each seller would make should a successful warranty claim be made. **The proportion of any liability is often agreed at each seller’s proportion of the consideration received for the shares sold**. However, it might be that a minority shareholder, who does not have much involvement in the running of the company, would seek a lower cap on any contribution they may have to pay.  The agreed terms may be in a separate contribution agreement but are typically found in a schedule to the SPA (to which the buyer will also be a party).

# Title guarantee

**Title guarantee** is a guarantee of the seller’s quality of ownership. In the event of a breach of any of the terms of the title guarantee, the buyer is able to sue the seller for the breach. Under the Law of Property (Miscellaneous Provisions) Act 1994, using the key phrases “full title guarantee” or “ limited title guarantee” imports certain statutory covenants for title into the acquisition agreement.

Selling with **full title** guarantee means that the following covenants are implied:

* the seller has the right to sell the asset; and
* the asset is free from all charges and incumbrances and other rights exercisable by third parties other than those which:
  + are disclosed in the contract; and
  + it did not know, and could not reasonably have known, about.

**Limited title guarantee** may be given by sellers who have little relevant knowledge of the asset, or have a limited interest in the asset, such as:

* trustees; and
* personal representatives.

Limited title guarantee is similar to full title guarantee but there is no guarantee by the seller that the property is free from all third-party rights, charges and incumbrances. Instead, this is replaced by a guarantee that the seller has not since the last sale created any incumbrances over the asset and is not aware that anyone else has done so since the last sale.

# Restrictive covenants

You considered restrictive covenants in the Due Diligence topic in the context of an employment contract. You will now consider restrictive covenants as a form of contractual protection for the buyer. The seller will usually be expected to give undertakings, in the form of restrictive covenants, to refrain from competing in a business similar to that which is being sold.

Restrictive covenants are also an effective way of protecting know-how and confidential information so it is important to understand how they work before looking at the steps the buyer should take to protect know-how and confidential information of  the target.

**Trego v Hunt [1896] AC 7:** the courts will not imply covenants by the seller to the effect that it will not set up in competition with the business once it has been sold. At common law the buyer will only be awarded minimum protections, namely that the seller may not: (1) **represent** itself as the owner of the same business; or (2) solicit persons who were customers of the business prior to the sale by **direct** means; or (3) **disclose** confidential information relating to the business. This will not, however, provide adequate protection for a buyer. So, a buyer will usually require a seller to enter into restrictive covenants in the **acquisition agreement**.

# Drafting restrictive covenants

When drafting restrictive covenants, there are three issues to bear in mind:

1. The covenants will be unenforceable unless they are reasonable for the protection of a legitimate interest of the buyer (such as the protection of trade secrets);
2. The covenants must be reasonable in (a) geographical scope; (b) business scope; and (c) duration. There are no general guidelines as to what would be considered reasonable and which can be followed. Each covenant must be considered by reference to the particular facts of the individual case; and
3. If the agreement is found to be anti-competitive, it might give rise to fines under applicable Competition Law.

The following covenants are usually given by the seller in the acquisition agreement to protect the buyer’s interests:

1. not to compete with the target business for a specified period and within a specified geographical location;
2. not to solicit existing customers for a specified period and within a specified geographical location;
3. not to solicit employees for a specified period and within a specified geographical location;
4. not to solicit existing suppliers for a specified period and within a specified geographical location;
5. not to disclose confidential information/know-how relating to the business; and
6. not to use the name of the business or any similar name.

# Protection of know-how

The term ‘**know-how’** is used here to describe confidential commercial information and trade secrets. The directors and employees of the target will possess know-how by virtue of the knowledge and expertise they have acquired from doing their jobs.

A number of parties could also be in possession of know-how relating to the target. These might include (**1) the seller (2) other group companies of the seller and (3) individuals working for the seller.** In addition, there may be one or more individuals who have been involved in running the target but who are leaving their employment for one reason or another (possibly retirement) at the time of completion.

If there are persons in possession of knowledge and expertise relating to the target and they are in a position to exploit this knowledge and expertise to the **detriment of the target** after completion, then the buyer will need to take additional precautions - by way of restrictive covenants - in relation to all relevant parties.

It is unlikely these parties will all be parties to the agreement so the buyer may try to include an obligation on the seller to procure that these parties do not breach the restrictive covenants. The extent of any such liability will be a point of negotiation between the parties.

# Summary

* Having carried out its due diligence early on in the transaction, the buyer has already found out a great deal of information about the target company or business. If specific problems are discovered at that stage, the buyer might request indemnities as a means of pushing those risks back onto the seller. The buyer will also ask the seller for a set of warranties, confirming much of the due diligence information as well as a title guarantee and restrictive covenants.
* Title guarantee is a guarantee of the seller’s quality of ownership.
* The seller will be expected to enter into restrictive covenants in the acquisition agreement not to compete with the target or the target’s business.
* Other persons or the seller’s group companies may possess know-how about the target’s business. The buyer will therefore need to take precautions to prevent this know-how being used to the detriment of the target after completion.