# Drafting the acquisition agreement – funds to meet a claim

This section considers the methods of ensuring that funds will be available should a successful claim be made - and the tax consequences for the parties if a claim is successful.

# Introduction

Clearly, having the grounds to bring a breach of warranty claim is of no value to the buyer if funds are not available to meet any such claim.

Depending on the nature and financial standing of the seller, the parties may agree on one of several different methods of ensuring funds will be available should a successful claim be made.

In addition, if a buyer successfully brings a claim, there may be tax consequences for the seller.

# Ensuring funds are available to meet a claim

There are a number of different ways to seek to manage the risk that funds are not available to meet any claim.

* Retention or Escrow Account
* Guarantee
* Deferred Consideration
* Warranty and Indemnity Insurance

These will each be considered in turn.

**Retention/escrow account:** The buyer pays into a separate account a proportion of the consideration, which may be refunded to it (in whole or in part) if it later makes a successful warranty claim. The separate account is usually an escrow account administered by a bank governed by a separate escrow agreement. Occasionally this may be in the joint names of the parties’ solicitors but this presents regulatory issues and is not permitted by many firms risk policies. The consideration remaining in the account after a certain period of time has expired (often the warranty limitation period) is then paid to the seller. The interest accrued in the account will usually be paid to the parties in proportion to the amount they received from the retention account.

**Deferred Consideration:** The buyer agrees to pay part of the consideration on a given future date or when agreed criteria are met. The cost of a breach of warranty in the intervening period may then be offset against such deferred consideration payable.

**Guarantee:** If the seller is a subsidiary, the parent company may guarantee any obligations undertaken by that subsidiary.

# Warranty and indemnity insurance

The **seller** may take out insurance cover against possible warranty and/or indemnity claims (although this has become less common over the years).

More typically, **buyers** purchase warranty and indemnity insurance to cover breach of warranty claims that they would have been able to bring against the seller if the financial and/or time limitations in the sale and purchase agreement did not apply.

Warranty and indemnity insurance products have become more established over the years and are now a reasonably common feature of corporate transactions.  A detailed disclosure exercise and disclosure letter will still be required even where this insurance cover is put in place not least because the insurers will want to be confident that a thorough process has taken place.

# Subsequent adjustments to the consideration

1. If the buyer makes a **successful claim against the seller under the warranties** then this will be treated as an adjustment to the purchase price (and wording should be included in the SPA to confirm that this is the intention). The effect of this is that the seller will be regarded as having received **less consideration**. This reduces the gain the seller made on the sale, and the seller's tax liability (if any, i.e. assuming no reliefs apply) will be reduced accordingly.  The buyer’s base cost for the acquired company or business will also be reduced potentially increasing the gain and the buyers tax liability on a future sale.
2. Where part of the consideration is held in a **retention account** instead of being paid to the seller, HMRC will still treat the seller as having received the total amount of the consideration (including the amount in the retention account) on the **date of completion** and will tax the seller accordingly. If the seller does not ultimately receive the whole of the consideration because the buyer does make a successful claim against the seller which is paid out from monies from the retention account, this is treated as a subsequent adjustment to the consideration in the same way as a payment under a warranty.

# Indemnity claims

When drafting indemnities, it is important to bear in mind the case **of Zim Properties Ltd v Proctor (Inspector of Taxes)** [1985] STC 90.  It used to be common practice for indemnities to be given in favour of the target, rather than the buyer, as it was the target that would suffer the loss if the potential liability addressed by the indemnity crystallised. However, as a result of **Zim Properties** this is no longer seen as tax efficient.  It is therefore very important for indemnities to be given in favour of the buyer rather than to the target.

In **Zim Properties** a firm of solicitors was negligent when acting on a conveyancing transaction and subsequently paid £69,000 compensation to its client in settlement following an action in negligence.  Warner J held that the right of action against the solicitors was an asset for CGT purposes (a chose in action- a thing that can be sued for).  When the client received the £69,000 it was deemed to have disposed of the chose in action and made a capital gain.  Furthermore, the case established that the base cost of such a chose in action would usually be nil so that the chargeable gain would be equal to the whole of the proceeds arising on the disposal of the chose in action, and so this whole amount would be chargeable to tax.

Following Zim Properties, the risk with an indemnity given in favour of the target is that any payment made under it by the seller may be treated as a disposal by the target of a chose in action, with the target accordingly charged to tax on the whole of the proceeds.

Where an indemnity payment is paid by the seller to the buyer however HMRC have confirmed in Extra-Statutory Concession D33 that the payment will be treated as an **adjustment to the consideration in** the same way as a payment under a warranty – therefore avoiding the tax charge.

**Summary**

* It is important that the buyer’s solicitors include provisions in the acquisition agreement ensuring sufficient funds are available should the buyer bring a successful claim for breach of contract.
* There are several ways in which this can be done, including:
  + Paying part of the consideration into a retention / escrow account;
  + Deferring payment of part of the consideration;
  + Obtaining a parent company guarantee; or
  + Taking out warranty and indemnity insurance.
* If the seller has to make a payment in respect of a successful claim by the buyer, then this should be characterised as a reduction in the consideration.