THE DIFFERENCE BETWEEN A WARRANTY, AN INDEMNITY AND A CONDITION

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Introduction

Warranties and indemnities are forms of contractual protection provided by a seller in a sale and purchase agreement. In agreeing to make the acquisition and in agreeing to the purchase price, the buyer will inevitably have relied upon information provided to him by or on behalf of the seller and on various assumptions. In most transactions, the buyer will insist upon the sale and purchase agreement containing warranties and/or indemnities regarding the shares and the underlying business and its assets and liabilities, in order to compensate him if the information or the assumptions on which he is relying prove to be incorrect.

Conditions, on the other hand, are the terms of a contract that are so important that if not performed or if breached, entitle a party to terminate the contract. Conditions may be precedent, concurrent, or subsequent. The most common example of a condition precedent is, where required and in the context of a sale and purchase of shares, the obtaining of the relevant regulatory approvals.

The distinction between warranties and indemnities and conditions is critical as the remedies to which innocent parties are entitled differ depending on whether the term breached was a warranty, an indemnity, or a condition. This article discusses the key differences between conditions, warranties, and indemnities in relation to the sale and purchase of shares.

What is a warranty?

In substance, a warranty is an assurance of the condition of the business or company or other matters relevant to the sale such as title to the shares. Warranties can be express, or they can be implied, including by statute. In the context of a sale and purchase of shares, if a warranty proves to be false resulting in a reduction in the value of the shares and the buyer suffers a loss, the seller is liable to pay compensatory damages in order to put the buyer in the position it would have been had the warranty been true, subject to contractual rules of foreseeability and remoteness. The onus is on the buyer to show a breach of contract and quantifiable loss.

What is an indemnity?

An indemnity is a promise by the seller to reimburse the buyer for any loss which that party suffers as a result of a particular event or a set of circumstances in question. It is a contract by which the seller undertakes an original and independent obligation to indemnify (make good) a loss. The buyer is generally able to recover all the losses covered by the indemnity since contractual principles of remoteness and foreseeability will not apply, provided that the indemnity is sufficiently widely drawn.For example, it is possible to draft an indemnity against losses not caused by the trigger event but only connected with it. Express words could require payment of losses that would be too remote to recover as damages for breach of contract. An indemnity may, therefore, have a number of advantages over a warranty and a claim under an indemnity is likely to be easier to establish than a claim for breach of warranty.

What is a condition?

The most common form of a condition is a condition precedent, which is a term of the contract that prescribes a set of circumstances that must be fulfilled before the remaining terms of the contract become binding on the parties. Conditions precedent typically prescribe circumstances that are not within the full control of any one party and which if not obtained may render it impossible to complete the contract– for example, the obtaining of the requisite regulatory approvals or waivers or consents from existing shareholders. Conditions can also be promissory, contingent, concurrent, or subsequent, but common to all types of conditions is that the breach of a condition entitles the innocent party to terminate the contract without having to prove that the innocent party has suffered any prejudice as a result of that breach. It should be noted that much like warranties, conditions can be implied by the law. It should also be noted that whether a term is a condition does not depend solely on whether it is described as such in the contract – the key is whether the substance of the term that is purported to be a condition is so important so as to go to the "root" of the contract. In the absence of an express right to terminate, the non-defaulting party may seek to terminate the agreement at common law if the defaulting party has breached a condition or a sufficiently serious breach of an intermediate term (*RDC Concrete Pte Ltd v Sato Kogyo (S) Pte Ltd* 4 SLR(R) 413). The parties are also free to classify a term of a contract as not amounting to a condition under general

law, but clear and unambiguous words must be used as it would otherwise be possible to construe the term as a condition.

Differences between a warranty, an indemnity, and a condition

Purpose

Warranties protect a buyer by providing a possible price adjustment mechanism if a warranty proves to be false and, in the context of a sale of shares of a company, by enabling a buyer to gather information on the business through a disclosure process. The purpose of an indemnity is to provide guaranteed compensation to a buyer on a dollar for dollar basis in circumstances in which a breach of warranty would not necessarily give rise to a claim for damages or to provide a specific remedy that might not otherwise be legally available. A condition, on the other hand, can protect both a buyer and a seller by ensuring that the parties are not obligated nor liable to one another under the contract unless and until the condition has been fulfilled. If a term is explicitly drafted as a condition, termination of the agreement will be permitted when it is breached.

Mitigation

A warranty is subjected to contractual rules of mitigation, meaning that the buyer has the responsibility to mitigate losses incurred due to breach of warranty. In contrast there is no clear obligation for a buyer to mitigate its loss under an indemnity. However (in the absence of express words) it may well be concluded that the parties to an indemnity against breach of contract must have intended to require a payment equivalent to damages for breach of contract. That is what the English Court of Appeal concluded in the case of *Total Transport Corp v Arcadia Petroleum Ltd (The Eurus)* 2 Lloyd's Rep 408. Their decision was based on their interpretation of the contract, not on the nature of an indemnity claim.
Therefore, contracting parties can create an indemnity that expressly applies or excludes the rules on mitigation, remoteness and causation. Whether they have done so is a question of interpretation. In the absence of express wording, the courts are likely to interpret an indemnity against breach of contract as giving rise to a claim equivalent to damages for that breach.

Disclosure

The purpose of a warranty is to encourage disclosures from the seller and therefore obtain from the seller material information which may not otherwise come to light. The process of putting forward warranties and obtaining disclosures should, therefore, complement the due diligence work for a transaction. Assume that the buyer wants the seller to provide a warranty that there is no current or threatened litigation, but in practice, there may be claims or disputes that are likely to lead to litigation. The seller can make disclosures against the warranty to limit liability. Once proper disclosure has been made, the buyer can no longer make

a claim for a breach of warranty due to that matter. However, the buyer can seek indemnities after disclosure has been made so that the buyer can be indemnified against any loss that might arise from the circumstances made in the disclosure. Buyers are not prevented from claiming under an indemnity regardless of disclosure.

Conditions can also be used to encourage disclosures and confirmations. It is common for conditions to be inserted to state that the entire transaction is conditioned upon the buyer receiving written confirmations from the seller or from third parties of certain facts by a certain date. However, as noted above, a key difference between a condition and warranty is that the breach of a condition entitles the innocent party to terminate the contract. As such, where the matter being disclosed is one of utmost importance to the contract, the disclosure or confirmation should be made a condition rather than a warranty.

Where conditions are concerned, the innocent party's conduct after having knowledge of the breach affects their entitlement to treat the contract as having been terminated. If the innocent party performs their obligations under the contract even though those obligations were subjected to conditions precedent and despite knowing that those conditions have been breached or not fulfilled, the innocent party would have waived their right to treat the contract as having been terminated. This may also impact the amount of damages that the innocent party may be able to claim.

Proof of loss

It is necessary for a buyer to prove that losses arise as a result in order to claim damages for a breach of warranty or or of a condition – such as a fall in the value of the shares being acquired – and other contractual law issues relating to matters such as remoteness of damages apply. An action for breach of the warranty or condition will leave it to the court to assess the extent of the loss which can be recovered, especially when there is a dispute as to the impact of the breach on the actual market value of the shares.

With an appropriately worded indemnity, however, a buyer can recover any losses of the underlying assets of the business sustained without having to prove that there is any corresponding loss in value of the shares being acquired, and is generally not subject to contractual issues relating to remoteness and foreseeability. An appropriately worded indemnity also assists a buyer to recover the expense of bringing a claim. Buyer protection also often includes a tax indemnity, which will allocate to the seller risk of liability for tax in the company outside the ordinary course of business up to the completion of the acquisition.

Contractual provisions may entitle a party to terminate where the breach in question does not amount to a repudiatory breach at common law (a declaration of non-performance either by an express refusal to perform or that can be inferred from the party's conduct which would lead a reasonable person to conclude that it has no intention of fulfilling its obligations). However, in this situation it may not be possible to recover common law "loss of bargain" damages (which means that the innocent party is, as far as possible, put in the position in which it would have been if the contract had been properly performed, subject to the usual rules on causation, forseeability and mitigation). Where the breach is not also repudiatory at common

law, damages will usually be limited to loss suffered up to the date of termination unless the contract expressly provides otherwise. An innocent party who instead decides to affirm the contract, rather than terminating, can claim damages in the normal way for loss suffered as a result of the breach or breaches.

Buyer's knowledge of the breach

Depending on the terms of a contract, a buyer that is aware of a breach of a condition or warranty might be precluded from bringing a claim on the basis that they were aware of a breach and decided to enter into or continue with the contract regardless. However, knowledge of a breach of contract will not prevent a buyer from making a claim under an indemnity. Indeed, buyers often negotiate an indemnity as contractual protection from a specific problem that they have discovered.

Other Limitations

Warranties are commonly subject to a series of negotiated limitations on liability that would not usually apply to indemnities although many sellers resist indemnities. Common limitations that may be sought include limiting the period during which a claim can be brought and defining the amount that may be claimed under a warranty. The limitation period in respect of indemnities starts to run from the date on which the loss is suffered, whereas in the case of warranties the limitation period starts to run from the date of the breach of the warranty. Theoretically, therefore, the limitation period is longer under an indemnity. However, in practice, the time period for claims under a share purchase agreement is usually contractually agreed and the statutory limitation period is not of much significance.

Other practical points

Delay between exchange and completion

Warranties are only true at the moment they are given, so the buyer will have an interest in having them repeated to ensure effectiveness where there is a delay between exchange and completion. However, the buyer may have to accept that there may be late or even last-minute disclosures as circumstances change. The buyer is, however, entitled to object if the seller attempts to swamp him with last-minute disclosure of matters which ought to reasonably be disclosed earlier. The seller may be attempting to sneak through disclosure of material issues at such a late stage such that the buyer is unlikely to be able to properly consider all the implications of the disclosure.

Set-off and security for warranty and indemnity claims

The buyer should take care to ensure the seller will be able and around to pay out indemnities or for breach of warranty. This can be done by requiring the seller's bank, shareholders or parent company to provide

guarantees; retention of part of the purchase price for an agreed period in order to satisfy any warranty or indemnity claims which may arise during that period; or set-off any warranty or indemnity claims against deferred consideration.

Multiple sellers

Where the warranties or indemnities are given by more than one person, there should be clarity over who is liable. The buyer will normally request that they will be liable on a joint and several bases as this gives the buyer the maximum possible flexibility to make claims. It is also common for sellers to enter into a contribution agreement under which they agree, as between themselves, to share any liability in specified proportions.

Undertakings in support of conditions

Conditions may often relate to matters not under the direct or complete control of the parties. However, parties may nevertheless be able to influence the procurement or fulfilment of the condition, whether precedent, concurrent, subsequent, or otherwise. Supporting undertakings should therefore be inserted to oblige the relevant parties to procure or to exert their best or reasonable endeavours to procure the fulfilment of those conditions. These undertakings should be appropriately worded as not being contingent on any other term of the contract.

Conclusion

Warranties, indemnities, and conditions offer different forms of contractual protection and it is crucial for buyers to negotiate a good balance of warranties, indemnities, and conditions, including in a share purchase agreement depending on the circumstances and particular concerns that the buyer has. If a term is explicitly drafted as a condition, termination of the agreement will be permitted when it is breached. Warranties are used to “flush out” information by encouraging sellers to make disclosures. Specific indemnities, on the other hand, are used to protect the buyer against specific concerns that arise after disclosure and a general indemnity may be drafted to make it easier to claim for losses impacting the underlying assets or business and expenses of bringing claims. In general, an indemnity may have a number of advantages over a warranty and a claim under an indemnity is likely to be easier to establish than a claim for breach of warranty. However, sellers are also more resistant to providing indemnities.