Limitations on Warranty Claims

In venture capital transactions, investors will commonly expect management teams and the investee company (collectively named "warrantors") to give warranties, which are a set of contractual assurances as to the operational and financial condition, and tax position of the investee company in the period up to and including completion.

The two main purposes of warranty provisions are to enable warrantors to disclose to investors any matters factually inconsistent with the warranties, and to provide a contractual remedy for investors in the event of a breach of warranty (indicating the condition of the investee company is not as it was purported to be).

Where a claim for breach of warranty is concerned, warrantors will want to ensure this is restricted to circumstances of genuine factual inaccuracy against the warranties at the time they were given. Moreover, they will seek to limit their liability so that claims brought against them are not open-ended.

The scope of such restrictions and limitations will be agreed during negotiation of the investment agreement. This article sets out those limitations commonly seen in growth capital investments.

No limitation on liability

The limitation provisions will not apply in certain narrowly defined circumstances.

This includes where a claim arises as a result of fraud, dishonesty, wilful concealment or wilful misrepresentation on the part of the warrantors. Although one should consider instances where only one of a group of warrantors has caused a breach of warranty. In such circumstances, it may be appropriate for the innocent warrantors to have the benefit of limitation provisions where their conduct cannot reasonably be linked to the breach in question.

Furthermore, certain warranties will be considered so fundamental to the value of an investor's investment, and within the knowledge of all warrantors, that they should not be subject to any contractual, financial, or temporal limits.

Such fundamental warranties may include:

(a) the issued share capital of the investee company at completion, and that all issued shares are fully paid up
(b) any management shareholders are the legal and beneficial owners of any shares held by them
(c) no person has any right to acquire shares in the investee company
(d) the responses given by warrantors to any management questionnaires

As a result, warrantors should carefully consider the accuracy of historical statutory records, particularly an investee company's register of members, and in respect of item (c), disclose details of any share options granted, or share warrants issued, conferring rights on employees, investors, or other persons, to acquire shares in the investee company at a future date.

Time limits for notification of warranty claims

The parties should endeavour to negotiate a reasonable period within which warranty claims can be notified. Often, for general non-tax related warranties, the period ranges between 18 to 24 months from completion of the investment, or a period which ends a few months after two sets of statutory accounts have been filed following completion. In each case, it is likely any major problems giving rise to a potential claim should by then have come to light.

Tax-related warranties tend to be subject to a different claim period to align with HMRC's statutory periods. HMRC is permitted to make a discovery assessment for loss of corporation tax within four years after the relevant accounting period, which is then increased to six years where the loss of tax is brought about by careless inaccuracy, and 20 years if brought about deliberately. To accommodate these varying timescales, investors will often seek a limitation period of up to seven years for tax warranty claims.

Depending on the nature of the business of the investee company, there may be certain categories of warranty where it is appropriate to agree a longer limitation period in relation to claims under those warranties, recognising a proportionate period of time for relevant issues to come to light (such categories may include environmental, health and safety, and property).

Finally, alongside the foregoing limitation periods, investors should be required to notify warrantors of a claim within a specified period of their becoming aware of it; moreover, it may be appropriate for investors to lose a right to pursue a claim if proceedings are not commenced within a specified period.

Financial ceilings on claims and settlement

The limitation provisions should set the maximum aggregate monetary amount that investors may recover for all claims under the warranties and also set de minimis and basket levels which if not met will prevent investors from bringing a claim.

The investee company's maximum liability is usually set at a sum equal to the gross sums invested by the investors (who have the benefit of the warranties). The cap placed on each management warrantor's personal liability will be set at a much lower amount, often by reference to a multiple of salary (whether this is gross salary or includes the value of any bonus and other contractual entitlements is a matter for negotiation). Investors will usually want to establish a sufficiently material maximum liability cap so that each individual warrantor is incentivised to give proper attention to the warranties and conduct a thorough disclosure exercise.

There is a question over whether the financial liability caps should include the sum of costs incurred by investors for bring a claim. If these sums are not included, for larger scale warranty claims this could result in warrantors becoming liable for a sum in excess of the total funds invested by investors. Also, it could mean a warrantor's actual liability might significantly exceed the limits set by the financial caps. Conversely, investors will argue that contractual damages aim to place a party in the position they would have been in had the breach not occurred. If the liability cap includes the costs of bringing a claim, it follows a claimant will never be able to recover 100% of sums invested. Whether or not costs are included will be a matter for negotiation between the parties.

A de minimis level will also be agreed, whereby if the value of a claim is below a specified level that claim will not count towards any claim even if there has been a technical breach of warranty. In conjunction with the de minimis threshold, a basket level will be set, whereby investors can only bring a claim in the event an aggregate threshold for all claims reaches the basket amount. As an example, with a de minimis of £5,000 and a basket of £25,000 – investors may claim for all and any claims with an aggregate value in excess of £25,000, but any claim with a value of less than £5,000 will be discounted. Notwithstanding the de minimis and basket amounts, warrantors stand to be liable for full amount of any claim rather than simply the excess.

Overall, the guiding rationale for financial ceilings should be to ensure the warrantors' minds are sufficiently focussed to communicate to investors any matters that are materially inconsistent with the warranties.

Notwithstanding the financial limits, if a warrantor is found liable for claims up to their agreed cap amount, it is possible they will not have adequate financial resources to meet that liability. Therefore a mechanism can be included under which warrantors may choose to settle all or part of such a liability by transferring shares registered in his name to the claimants. The ability to do so will be subject to consent of investors (or a majority thereof) as, in certain circumstances, a further acquisition of shares by investors may have an undesirable outcome on the company's capital structure (for example if it changes the voting power within the investor base). For the purposes of settling claims via this route, each share will have a deemed value, which may be equal to an amount linked either to the fair market value of the shares at the time of the transfer or the subscription price paid for the shares at the outset. It should be noted, as shares in a private company can be difficult to sell, investors accepting shares in settlement of a claim are unlikely to be able to convert those shares into cash straight away. As a result, the value of those shares may rise or fall over time, changing the amount the investors will eventually receive in respect of the claim.

Exceptions from liability

Circumstances may arise after completion of an investment that give rise to a technical liability under the warranties (such as changes in legislation or HMRC practice, or changes to comply with amended accounting standards). As the warranties are given at completion they are not movable beyond the timeframes set by the limitation provisions and appropriate carve outs for should be included.

There will also be an exception for matters provided in the latest set of statutory accounts filed before completion or a set of management accounts for an agreed financial period. It is common practice for these matters to be deemed disclosed to investors (and as such particular attention should be given to the accounts to ensure they give a true and accurate portrayal of the investee company's financial position), who should therefore be aware and have already been taken into account for negotiating the investment.

Where a claim is capable of remedy, the warrantors should not be liable if the breach is remedied to the reasonable satisfaction of the investors within a given time period of the warrantors receiving the notice of the claim, and no investor suffers any loss in connection with the breach.

The precise nature and scope of limitations will of course vary between transactions and will be a matter for negotiation between the parties. Any agreed form set of warranties and limitations should always be underpinned by a focussed and thorough disclosure exercise, which is the first line of protection for warrantors against potential claims.

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3 April 2024