Gaby Hardwicke SOLICITORS

Briefing Note: Warranties and Tax Indemnities in Share Sales

Introduction

In agreeing to acquire a business or shares of a private company ("the **Company**"), a Buyer will usually have relied upon various representations and assumptions originating with the Seller. To compensate for the lack of statutory protection available to a Buyer and to ensure the Buyer can recover its loss if the basis of the purchase subsequently proves to be incorrect, the main representations and assumptions being relied on are usually included in the Sale & Purchase Agreement as express representations and are known as warranties. This guide should not be relied upon as legal advice and you should contact us for advice on your specific circumstances.

Briefing Note
Reviewed September 2025

Summary:
An introduction to the use of warranties, limitations on warranties and the tax covenants in the context of the sale of a company's shares.

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1. Purpose of Warranties

In the acquisition of the Company, warranties serve a dual purpose; (i) they provide a mechanism for retrospective price adjustment and (ii) are a means of obtaining information regarding the Company.

In the context of a private company or business acquisition it is generally accepted that the Buyer will seek and the Seller will give warranties. Warranties take the form of assurances or guarantees from the Seller as to the condition and state of the target Company and in particular, any existing liabilities, at the time of completion. No matter how thorough the Buyer's due diligence, he cannot expect to find out everything about the Company before completing the acquisition. If the Buyer subsequently finds he has not bought what he thought he was getting, he may be able to bring a claim for damages for breach of warranty.

Negotiation will usually revolve around the nature and extent of the warranties, the liability arising on breach and limitations on liability to protect the Seller.

2. Matters to be covered by Warranties

The number of warranties and the matters to be covered by warranties will vary considerably depending upon the nature of the business carried on by the Company, whether shares or assets are being acquired and the identity of the Warrantor. The most common areas covered by warranties are:-

- Capacity/Authority to sell
- Ownership of shares
- Group structure
- Insolvency
- Accounts
- Accuracy of information
- Contracts Licences Product liability
- Litigation
- Ownership of assets
- Employment
- Property Tax

3. Remedies for Breach of Warranty

Warranties given on these areas tend to relate to matters in the past or the *present* but will not normally relate to the *future* performance of the Company.

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If a warranty is incorrect, contractual damages are the appropriate remedy and fundamental Contract Law concepts will apply:-

- The Buyer will have to show (1) a breach of the warranty, ie that it is untrue and (2) it has suffered a "loss" as a result of the breach in order to sustain a claim for damages.
- The measure of recovery will be governed by reference to the "loss", ie damages sufficient to put the Buyer in the position it would have been in if the relevant warranty had been true.
- The Buyer has a duty to mitigate its loss.

Where however a specific liability has been identified a pure indemnity may be sought by the Buyer rather than a warranty. A breach of warranty will usually only give rise to a successful claim in damages if the Buyer can show the warranty was untrue, breached and that the effect of the breach was to reduce the value of the Company or business acquired. The purpose of an indemnity is to provide a guaranteed remedy for the Buyer in circumstances where a breach of warranty does not necessarily give rise to a claim in damages. With an indemnity the Buyer does not have to show he has suffered loss which flowed from the liability.

4. Covenant for Taxation

It is normal practice for the Seller to give an indemnity in respect of taxation suffered or incurred by the Company which is referable to the period prior to completion.

The basic principle, which will be enshrined in any covenant/tax deed, is the Seller's obligation to compensate the Buyer for:

- any tax liability of the Company which exceeds the provision in the Company's accounts for the period up to the last accounts date; and
- any tax liability arising after the last accounts date but pre-completion to the extent that it is *outside* the ordinary course either of the Company's business or of its trade. Tax arising from the ordinary course of business since the accounts date will not usually be caught by the covenant because if the Buyer is to get the benefit of trading since that date, it should also bear the tax.

However, where completion accounts are being prepared to take a 'snap shot' of the company at completion, the tax liability will be ascertained and therefore the covenant will not exclude tax in the ordinary course of business since the last accounts date as the liability will be known once the completion accounts have been agreed; and a price adjustment will occur at that point.

5. Limitations on Warranty Liability

As mentioned above warranties have two purposes; to impose legal liability on the Warrantors in relation to undisclosed liabilities or obligations and to flush out information regarding the Company. To the extent that the warranties are given, the Seller accepts the liability flowing from breach of them but in doing so the Seller will normally seek to restrict that liability in various ways including:-

- Imposing a ceiling on liability (usually no more than the total consideration being paid) and a threshold before claims can be made, to avoid trivial nuisance claims.
- Limiting the time during which claims for breach of warranty may be made (anything between one to three years is normal and seven years for breach of tax warranties and the tax covenant).
- By disclosure. Having disclosed the information to the Buyer the seller will wish to avoid liability under the warranties for claims relating to the matters disclosed. To avoid redrafting warranties to reflect matters identified by the seller, the Disclosure Letter is used to identify exceptions to the warranties.

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Copies of all documentation provided to the Buyer or its advisors (including accountants) must be retained by a Seller in order that the lawyers can prepare the Disclosure Letter and the bundle of documents which will be annexed to that letter. If the Seller makes a disclosure either verbally or in writing then he should provide his lawyer with a copy of the letter or note which he can add to the disclosure bundle.

If you would like to know more about this topic or our legal services, please contact Mark Williams on 01323 435900 or mark.williams@gabyhardwicke.co.uk

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