



EPISODE
174



The Value of Warranties and Due Diligence
For Both Buyers and Sellers

The Deal Room Podcast

Episode 174 – The Value of Warranties and Due Diligence For Both Buyers and Sellers

Note: This has been automatically transcribed so will be full of errors! We are not providing it to you as a word-perfect version of the podcast but just as an easy way to provide you with a different way to be able to scan for information that might be relevant to you.

Transcript

Joanna: Hi, it's Joanna Oakey here and welcome back to The Deal Room podcast, a podcast proudly brought to you by our commercial legal practice Aspect Legal now we have on the show the amazing Claire Bibby once again from our very own Aspect Legal. Claire, I love it when you join me for a bit of a chat. Welcome back.

Claire: Hello, Jo, lovely to see you again today.

Joanna: Oh, it's lovely to see you. Okay, so today we're talking about the crossroads between warranties and due diligence. And I think this is such an important area for us to dive into because I don't think, generally speaking, there's enough sort of comprehension of the fact that due diligence, isn't this thing that sits on its own it is connected to how we deal with warranties and this is really useful, not just for buyers to understand, but for the sellers themselves in terms of how they're dealing with the due diligence process. So why don't you kick it off? Tell us why is it that you thought that this would be such a good topic for us to talk about today?

Claire: So think about it from the perspective of somebody buying a house. So you

wouldn't buy a house, walk in, look around, walk out and write a check for a million bucks. If you're buying in Sydney? Well, that's a very small house in Sydney. But you know, if you're buying an asset, and you wanted to make sure that everything you know, fits together, all the i's are dotted, all the T's are crossed. And so if you bought a house, you'd have a pest inspection report, you'd have a builder's report, you'd go and turn on every single light, you'd go and flush every single toilet, you'd look behind the doors, you know, you check that everything works, you turn the air conditioning on the wall. So when you buy a business, you've got to do exactly the same thing, you've got to go and test that all the light work. And you've got to test that the air conditioning works. And it may not be a physical building that you're buying. But you've got to go and test that everything works. And that's where warranties come into play and warranties are linked, just as you said, to due diligence. So warranties usually appear about halfway through a contract to the end of the contract. So by the time you get up to it, you're tired, and you're probably not very interested in reading it. And then if you get to a really big contract, and there are loads of warranties, they can go for pages and pages and pages,

Joanna: and let's face it, they can be really boring.

Claire: They're awesome, you and I love them. But our clients aren't gonna love them. So warranties and representations are basically assurances or their assertions that are given by one party in a deal to the other. Think of it like promises, so that the promises that something is either true or something has happened or hasn't happened. And it's really important that those things are stated in the contract. Otherwise, we're going back to the very old premise, and this is where I get to quote Latin. *Caveat Emptor*, let the buyer beware because if you've got a caveat emptor contract, no one's telling you anything. So basically, friends, you're buying jack, well, you're not buying jack, but you know jack about what you're buying. So a warranty will tell you about what you're buying. And the follow on from that is you want everything that you're being told to be true. And you want it to be backed up by the due diligence information.

Joanna: So I guess it's like this, isn't it the warranties are the promises by the seller, that the value that is they say is there is actually there, and that there aren't risks that are unknown in the business. So that's how the warranties play out. And of course, we as lawyers are forwards and backwards in the arguments in relation to what is reasonable in this particular transaction to sit in those promises that the seller is giving about the business, whereas the due diligence is this objective investigation by a buyer to test whether the value is there that they think should be there and whether the risks are there and I guess the way maybe the way I feel the people don't fully understand how they work together is when, firstly, when buyers have these massive DDs, and then they end up with a whole heap of information that they can never actually sort through. And then suddenly, you know, they may not realize that the warranties have been given subject to those disclosures. So suddenly, it's up to them to work out whether there's a big gaping hole sitting in all of this due diligence. But on the flip side, from a seller's perspective, it can also be that they don't fully understand the significance perhaps of some of the documents that they're putting across or not keeping track of what they've actually sent across to the buyer. So, you know, what are some of the issues that you see in this world of this mix between the warranties and the due diligence?

Claire: Well, back when I first started practising about 100 years ago, you actually go

over to someone, I'm older than you. So I can say this, you actually had to go over to someone's office, right, and you had to sit in a room, and you will be surrounded by files, and you know, some of your audience is going to go, Oh, I remember this microfinish. And we had to look up things and add dusty boxes, and all of that sort of stuff. These days, it's all electronically. It's all electronic, I should say, and it's data rooms. A lesson for the uninitiated, you want to make sure that people aren't removing just that. This is just a basic principle that so many people forget, what if they removed something from the data room, and it's no longer there when you have to sue Three years later, or five years later, or something like this. But let's just take a step back, it doesn't only apply for buying and selling assets or shares, it also applies in you know, service agreements. So if you're going to hire an architect, you want the architect to give you warranties and representations that you know, their services are going to be of a sufficient standard, they're going to do certain things by certain days. So warranties go a lot further in the legal world than just buying and selling assets. But that's, of course, what we're talking about today. And then you want a lawyer who knows what they're doing in this space because of the legal consequences of whether something is a warranty, or whether it's a representation. If everything then goes pear-shaped the consequences that then flow from that drafting. So does an incorrect warranty or representation give you a right to damages? So you've still got to own the thing, but you'll get some money back? Or does it give you the right to pull out of the contract completely? So there are lots of little tricks like that in the drafting that we as lawyers live and breathe by, but our clients are going to look at it and go "that sounds pretty good." We're going to tell you whether that's pretty good, or whether it's not pretty good because we do this stuff for a living. So we love warranties, but our clients do not.

Joanna: Haha and sometimes clients understand, I think the seriousness, but they can sort of being two modes of reaction, I think, to this area. One is on the extreme is the lack of interest. Sometimes the clients have, you know, they lack understanding the beginning of the importance of getting this area, right, on the flip side, those clients that can be ultra-cautious, and concerned about giving any warranties at all, when of course, this is where it becomes important from a commercial perspective as a lawyer, you know, to be able to give them some comfort about the usual of granted. You know this is just part of the game of buying and selling businesses. These are normal things, but it's about working out what's commercial, and what's appropriate for each transaction.

Claire: Absolutely. I've just done the last few transactions I did. One was north of \$5 million. One was south of 500,000. The one that was north of \$5 million. You know, we had reams and reams of warranties and disclosures. And I sat with the director and we individually went through every single line every single word we did disclosures thereafter if anything had changed, whereas the transaction that was sub 500. I'm not 100% convinced at the person on the other side even read them because unless my drafting is so awesome that no one would ever want to change it. But the other person on the other side, signed it and sent it straight back and I thought, oh, okay, should I be concerned about this, but it's also the attitude that the clients come to the transaction with as well that's really important and as you say how much energy they want to put into the transaction and what the risk is for them. So in that smaller deal, my client was the buyer and it worked in my favour because I did quite extensive representations and warranties from the seller and the sellers sell just signed it. In the other transaction, I'm acting for the seller and the risk is so much greater for them in this transaction. So that's why we had to cross as we do in every deal anyway, but we had to go through

every single measure word by word. And one of my overarching concerns in that deal, Jo, was whilst we work the seller, the transaction had been set up before we had got involved and the buyer had control of the due diligence room. And that did not sit well with me, because my client was the one selling the company and I wanted the buyer to be able to obviously go into the DD room, but I wanted my seller to be in control and my seller wasn't in control.

Joanna: So let's dig into that a bit. Because I think that's a really good point. Because many in many times transactions will come to us where they're already underway. And that, you know, quite often commercial terms already have been signed. And then they might suddenly realize it's time to get the lawyer on board. But they're already you know, the buyers already into DD. So the data rooms may already have been set up, which is what happened in this instance. So let's talk about that downside, what is the downside of not controlling the data rooms?

Claire: The biggest downside is the risk that somebody will remove something. And then you are asked to give a warranty or representation as to what is in the data room. And the red flags for me start when I see words like the disclosure materials contain all information that is material to a buyer of the shares. May you say that to any lawyer who's acting for a seller, and we will freak out because you're basically saying to the purchaser, everything that you need to know so let's say I'm selling him a chicken shop. And I give you a call as it says basically Joe everything you as Joanna Oakey needs to know about running my chicken shop in French's forest on the corner of such as such street, I promise, I've told you absolutely everything. No seller is going to want to give away something like that. And it's then linked to the information that you've put in the due diligence room. But sometimes we see those sorts of clauses. And if you see a clause like that, and your client has agreed to it, or the negotiation is such that the other side won't buy the asset. Without that sort of warranty being given, then we really have to hone into what an Earth is in the disclosure materials. And Have I told Joanna Okay, absolutely everything she needs to know about buying my chicken shop on the corner on such and such a road and such and such, street? I mean, could there be street works that are coming up in the next six months, and there's gonna be no access to that shop, and I have a drive-thru chicken window, and nobody's gonna be able to come by my chicken because they're not gonna be able to drive up to my shop. And do I need to tell you that? Or should you go to the council and look it up and find out what's going on? So whilst it starts off thinking, Oh, yeah, I just have to tell him this, that the other and they'll go and work it out for themselves. You can't assume that the contract is going to say well yeah, you're going to have to go work it out for yourselves because that's when we get involved and look at the drafting. And we look at what's in the due diligence room. As a lawyer, you know, sometimes can be a two-edged sword. Do I want to go into a due diligence room that's got hundreds, if not 1000s of pieces of paper? And does my client want to pay for that? Because if they don't, and there's, say, a change of control clause, and one of the most important contracts, and I don't know about that, and my client doesn't want to pay me to go and find that out. But then we do the deal. We exchange and then we go and approach whoever it is that we have to approach for consent. And they say no. And then the counterparty who's buying it says, Well, I don't want to buy the business anymore. You've got to find a balance between what's going into the due diligence room, what the warranties are, and how much you want your lawyers to get involved. And there's ways and means around this. I mean, lawyers can do due diligence reports, accountants can do due diligence reports, tax advisors can do due diligence report. So they go into the DD room, and they read

everything for the client, and then they give you a report, then you go to read the fine print, because does the fine print say? Well, I've looked at everything, and I'm giving you this report, lots of care, but no responsibility. And if a client is getting something like that, again, they're going to have to ask themselves the question, what is in that room? You know, what is going to mean? What has possibly come out that I don't know about if I don't have control of the report? And if everything goes to pot in three years time, and I find out that my lawyer missed a contract or missed a clause in a contract, who am I going to sue because there's this really small print here that says the lawyers disclaimed all their responsibility. So it can be a minefield unless of course you're using someone like Aspect Legal and we will advise you that it's not a minefield, or we're here to help you. But you know, there's a lot of things to think about, and we do this day in, day out, so we can ebb and flow with what the client wants and explain to them the risk. And also, me, I like to keep control of a due diligence room. If I am the seller, if I'm the buyer, I have a much more relaxed attitude about it. But if I'm the buyer, then I'm going to get really excited about what the warranty say. And I'm going to try and get you as a seller on the other side to work as much as possible. But when I'm the seller, I put a different hat on, and I want to work on behalf of my client as little as possible. So you need to know where the balances both from a legal perspective, and of course, from a commercial perspective, because you don't spend, you know, months or 10s of 1000s of dollars negotiating a deal if the risk isn't warranting that amount of money or that amount of time.

Joanna: Yeah, I totally, love it. Claire. I think perhaps little people listening in today, to a large extent may not realize how much strategy there is, in thinking about how you run due diligence, because that's ultimately what we're talking about, isn't it? It's not just don't just assume that due diligence is just a thing. And everyone knows how to do the end that there's one way to run it, there's not there's a strategy to it, it depends if you're looking at it from the buy-side or the sell-side in terms of what it is that you're providing, and how you're providing it. And what you do with that with the warranties.

Claire: Correct. There's another aspect, which you see, rarely, but I do see it, and I mainly see it in the really big, you know, sub \$100 million claims, which you know, we don't do an awful lot of, but sometimes a client will think, oh, shoot, I'm giving all these warranties. What if something goes pear-shaped, and I have to then payout on one of these warranties if they're wrong. There's a whole body of insurance, good warranty and indemnity insurance that doesn't have a massive following in Australia. It's used a lot more in the States. But as your lawyers, you know, if you've got a transaction that's going down a certain pathway, and the risk is huge, we may say to you, Hey, have you ever thought about getting warranty and indemnity insurance. Now again, you only do that for certain levels of transactions, because that takes time and that costs money. But it's an important enough area that our colleagues in the insurance industry have written a policy to deal with this risk. So that's telling you that this is a pretty important area, I think that there can be pretty high-risk exposures. So you want to get DD right or due diligence. I said DD to a client the other day, they looked at me blankly and said, "Yeah, Claire you're not being a good lawyer. If you're saying DD to somebody and they don't know what you're talking about, you have to actually use the full word." So yeah, you got to know what you're doing in the due diligence space, and you need to understand the warranties or have a lawyer who's explaining to you what the warranties mean.

Joanna: Claire, this has been an absolute pleasure if you've got any last parting

thoughts, although I've got to say that's the quote for today. But if you've got any parting thoughts for us.

Claire: My parting thoughts are to remember that you don't have to give away the kitchen sink when you're giving warranties and indemnities you can have caps on liability, you can exclude certain things, you can have time limits like there are lots of tricks and tools that we can bolt on to the drafting to make sure that if you are accepting risk, we are bringing that risk back as much as we possibly can to allow you to get the deal over the line and also allow you to then either exit the business and hopefully not have anything more to do with it if you're the seller and that's your end result. Or as a buyer, we're giving you protection so that if something happens in the future we're still there or the contract is still there to work in your favour.

Joanna: Absolutely love it. Clear it's been an absolute pleasure. Thank you so much for coming to The Deal Room today.

Joanna: You are welcome Jo, See you. Bye.

Joanna: Well, that's it for this episode of The Deal Room podcast. Just a quick recap. Of course in this episode, we were talking about the crossroads between warranties and due diligence. And of course, due diligence is a really important topic, not just for buyers, certainly for buyers, but also for sellers in relation to how you can manage the due diligence process, while also preserving your rights and minimizing your risk in the process as well. Now look, if you'd like more information about this topic, then head over to our website at thedealroompodcast.com, where you'll be able to download a transcript of this podcast episode if you'd like to read it in more detail. Now bear in mind, we have an automatic transcription of this podcast. So don't expect it to be word perfect, but we do our best in providing you with an efficient transcript albeit not perfect. You'll also be able to find on our website how to contact Claire Bibby and our other legal Eagles at Aspect Legal if you or your clients would like to discuss any legal aspects of sales, or acquisitions, or of course due diligence whether or not you're looking at due diligence on the buy side, or the sell side we've got a number of great services to help businesses navigate this process. We've also got a number of great services to help guide businesses through the wholesale and acquisition process. And we work with clients both big and small. So don't hesitate to book an appointment if you'd like to find out how we might be able to assist. And finally, one last thing if you enjoyed what you heard today, please pop over to your favourite podcast player. Hit subscribe and maybe leave us a review and we'd be ever so grateful. Well, that's it thanks again for listening in. You've been listening to Joanna Oakey and The Deal Room podcast, a podcast proudly brought to you by our commercial legal practice Aspect Legal. See you next time.