Deal trends: Warranties and indemnities in the sale of financial advice portfolios

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The sale of financial advice portfolios is on the rise and both buyers and sellers are finding new ways to allocate risk. In this post, we put the current deal trends under the microscope.

Following the Royal Commission, and as we move towards the deadlines for new FASEA requirements to be implemented, it's become a buyers' market. Buyers are keen and empowered to limit their exposure and risk to changes to remuneration and poor advice. One way they're doing this is by imposing more stringent warranties and indemnities in their portfolio transfer agreement.

Buyers are asking for deeper warranties

A warranty is a promise by one party that a particular statement is true and may be relied upon by the other party. For example, a seller may warrant that certain compliance requirements have been met (for example, opt-in and Fee Disclosure Statements), or warrant the levels of recurring revenue to support the purchase price/value of the sale.
Following the Royal Commission, buyers are more vigilant than ever about the quality of the portfolios they acquire. They are conducting a more extensive due diligence process and asking for better warranties than they have for similar transactions in the past.
Buyers also want more certainty around the payment of any PI claims, especially with so many advisers leaving dealer groups who are shutting down their FP operations entirely.
Buyers now expect warranties to cover things like:

- **Conduct in servicing clients:** This may include the type of services provided, what advice was given, the products issued, compliance issues and even the 'client to advisor' ratio.
- **Remuneration:** They often want confirmation that fees were not charged where no services were provided, no grandfathered remuneration is included and no clawbacks for overcharging fees.
- **Records:** Warranties that electronic records are complete and in a satisfactory state to service the clients and deal with client complaints/claims.

To mitigate their risks, buyers are also asking sellers to give personal (owner/director) guarantees for these types of warranties.
The rationale behind these requests is to push the risk exposure back onto the seller as much as possible for poor advisory and compliance practices, allowing the buyer to reduce the purchase price for any adverse impact on recurring revenue and retention of

the acquired client base. This isn't entirely unreasonable given the seller is the one who 'knows' the clients, the business and its risks.

Sellers can still limit their exposure and risk

Sellers can counter warranty extensions requested by buyers to limit their exposure and risk. My recommendations for this include:

- **Cap the amount the buyer can seek for breach of warranty:** Determining the amount of the cap is almost always the subject of much negotiation. My view is that a seller shouldn't accept a higher exposure, and a buyer shouldn't accept less protection, than the purchase price paid.
- **Cap the time period to make a warranty claim:** This gives the seller certainty around their exposure. How long this period should be is usually dictated by any period of deferred payments of purchase price. If it is in instalments over 2 years for example, then a 2 year time period is probably a good compromise, but the exposure for indemnity claims (i.e. 6 years) may be longer, so this needs to be considered carefully.
- **Set a minimum loss threshold:** This can be drafted so that the buyer must suffer an individual loss or an aggregate amount of $X before they can make a warranty claim. What $X is will be contingent on the purchase price and subject to negotiation between the parties. I suggest 3-5% of the purchase price is fair and reasonable in most transactions. Noting that sometimes the parties will set it as the amount of the excess/deductible under the Seller's PI insurance.
- **Set the process:** Sellers may want to impose a formal process for how buyers can make a warranty claim. This should be in the agreement and include what notice and information the buyer must give to the seller before they can make a claim and during the process. This is particularly important if the warranties are extensive, the warranty period is long, or the monetary warranty cap is high.

Indemnities are also gaining favour with buyers

Indemnities are a contractual obligation by one party to reimburse the other when an agreed event happens. In the current risk-averse landscape, buyers are seeking to impose catchall general indemnities for any liability arising from the seller's activities. A better compromise is for the indemnity to cover any breaches of the law, legal negligence, or claims involving clients. Arguably, some of these indemnities are excessive and go beyond what is really needed to protect the buyer, so sellers should resist these and only agree to specific indemnities.

Specific indemnities are items identified or disclosed in the due diligence process that can't be resolved because the issue is ongoing where the potential loss is not quantifiable at that time. If the issue can be finalised before completion or dealt with by adjusting the purchase price then it should be done through a reduction to purchase price, rather than relying on indemnities.

In every sale transaction, counterparties obviously have competing interests. The key is understanding these interests and appropriately addressing them in the sale agreement. As a buyer, you want to have certainty about your rights to claim against the seller and the seller’s financial resources to meet indemnity and warranty liability. It is essential that the buyer has confidence in the PI insurance arrangement for the seller’s exposure in the period after the sale. Without this, the indemnities are worthless because there will be no safety net for these risk exposures. Equally, as a seller you want to know what your liabilities and obligations to the buyer are and when they will end.

If you’re negotiating or preparing to sign a portfolio transfer agreement, you should seek legal advice to make sure you’re mitigating your risk and exposure under the agreement.

By Katie Johnston