

Retentions – can the cash be unlocked?

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Please note: the information contained in our legal updates are correct as of the original date of publication

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Businesses (and indeed individuals) who have sold companies or businesses over recent years may have, as part of the terms of the deal, agreed to a “withholding”, “retention” or “escrow” (for the purpose of this article we will use the term “retention”). Such retentions provide a buyer with some security for any future warranty and indemnity claims (“Claims”). Some retentions are general – there to secure all Claims – and others relate to specific Claims or risks.

These arrangements will often result in cash being deposited in a blocked bank account at closing (either with lawyers or escrow agents). Sometimes, if the buyer’s credit worthiness is good enough, the retention is actually just withheld by the buyer and becomes a debt owed at a later date (subject to any rights of set off for Claims in the interim).

For sellers, there are options available to accelerate the release of this cash. In the current climate, sellers may want to access this cash (1) to help fund other business interests of the seller, (2) more generally, to improve their cash position in these uncertain times or (3) if they are concerned about the future financial position of the buyer as a result of the coronavirus.

There may be a cost to a seller of releasing early, as explored below, but this may still be attractive and quicker to achieve than going through a credit or other capital raising process needed for other forms of financing.

How does a retention/escrow work?

Retentions are released to a seller on the agreed release date, which depending on the risks being secured is commonly between 12 and 36 months from completion (“Release Date”). Of course, the parties can agree to an earlier release. Any release/payment would be subject to set off/deduction for settled/determined Claims or prolonged withholding/retention for reasonable Claims which have yet to be settled/determined. Contractually, a buyer would need to agree to an early release/payment of a retention.

Whether a buyer agrees to it will likely depend on a number of factors, including:

- For a general retention, whether Claims have been notified (or are likely to be notified). The more comfortable a buyer can be through its original due diligence or post-closing trading and audits, the more likely early release will be. The future claims risk can be mitigated through insurance solutions (see below).
- How long remains of the retention period. The closer one is to the end of the period, the more amenable a buyer is likely to be to releasing early.
- Whether there is an ongoing relationship between buyer and seller. Does an individual seller still work at a senior level in the business? Does the seller or his/her pension fund have an ongoing landlord/tenant relationship with the business? Does a corporate seller still have a commercial relationship with the business or the wider buyer business?
- How much discount the seller is willing to concede for early release (the buyer will most likely want something).

Negotiating the early release with insurance

Warranty and indemnity (“W&I”) insurers are working with buyers and sellers to facilitate early release of retentions. In reality, insurance is likely to be used for larger retentions given the cost of the insurance premium and legal costs in implementing the policy or where there was W&I insurance on the original transaction and insurance to facilitate the early release of a retention can act as a “top up”.

For a buyer, a policy (whether standalone or top up) would replace the retention as security in respect of a Claim, making it more likely they will allow early release. For a seller, it will help to facilitate the early release of a retention and will shelter a seller (wholly or partly) from any Claims which arise between the date of the insurance policy and the date on which the seller’s liability for Claims expires in the sale and purchase agreement (SPA).

As part of the negotiation, the parties will need to agree what the seller’s revised cap on liability will be if insurance is obtained – a seller is likely to want a £nil cap on liability to ensure that there is no recourse against them in the event of a Claim (particularly if they are paying a “discount” and covering the cost of the insurance) but the buyer may want the seller to retain some “skin in the game” and have a de-minimis cap on liability or a cap equal to the excess under the policy of insurance.

As the buyer is unlikely to be worse off where insurance is used to facilitate the early release (save in respect of any costs associated with it which may be borne by a seller), a seller is likely to have a stronger argument that the discount for early release should be minimal (perhaps limited to the costs that the buyer will incur to effect the early release).

Negotiating the early release without insurance

Negotiating the early release of a retention is possible without insurance to support it provided that the parties can agree the terms associated with the early release.

Given that the buyer would not be replacing its security for Claims in this instance, we would expect any discount to be higher. Effectively the discount would be the buyer’s way of “hedging” the early release against the risk of being unable to recover its losses in respect of a Claim. The buyer may also ask for some kind of guarantee from a party connected to the seller to give the buyer extra comfort in the event that there is a Claim.

It should also be noted that a seller’s exposure in relation to a Claim will remain the same if the retention is released early without insurance. However, any discount agreed for early release should reduce a seller’s overall cap on liability.

If insurance is not an option, it is worth considering whether an early release of only part of the retention would work for a seller. A partial release (subject to the size of the retention) could be more palatable to a buyer if it will leave them with a reasonable buffer for Claims.

Consequential issues to address on early release

If there is a “discount” conceded by a seller for early release (which would ultimately be a reduction in the purchase price) you should consider with your advisers all the consequential implications to the original deal including:

- the extent to which there need to be any consequential changes to the SPA (particularly with regards to the seller’s overall cap on liability); and
- whether or not a tax reduction or rebate can be claimed reflecting the amount of any discount.

Multiple sellers

Where there is more than one seller contributing to a retention, they may be in different positions and some may be keener than others to obtain an early release of funds. There is no reason why one seller cannot negotiate a release (perhaps paying a discount) and another not – but it does complicate matters. Sellers who have not obtained a release clearly will be in a position where their retention will be a first port of call for Claims (liability for which is usually joint and several). Insurance will help to solve these issues to a degree but a seller who is not releasing may require a payment to compensate him/her/it for the additional risk. Amendments may also be needed to any contribution agreements between shareholders.

The terms of the SPA will dictate whether all sellers need to agree to an early retention release for some but not all of them. Often such consents can be given by a particular seller on behalf of all (where that seller has been appointed as the “sellers’ representative”).

Conclusion

If you do have cash locked up in a retention account or which has been withheld by a buyer, it may be worth considering making an approach to a buyer to agree an early release. This may be both an efficient and cost-effective way of securing positive cash flow in these uncertain times.

We would be delighted to talk to any sellers who are in this position (or indeed any buyers who have been approached by sellers with a view to early release). We would be happy to help deal with the negotiation and documenting of terms and if necessary, the procurement of insurance.

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