

### **What Is an Indemnification Provision?**

If a seller breaches its obligations to the buyer in an M&A deal, the buyer has the right to bring a breach of contract or other legal claim against the seller. However, broad legal claims do not give buyers or sellers much certainty as to what their risk and exposure will be. As a result acquisition agreements typically include indemnification provisions: the seller agrees to compensate the buyer, and agrees to a specific procedure for doing so, and in exchange receives some limitation on its legal exposure.

Generally speaking, indemnification provisions provide that the “Indemnitor” (the party providing indemnification) will reimburse the “Indemnitee” (the party receiving indemnification) for losses incurred by the Indemnitee as a result of the Indemnitor’s conduct in connection with the transaction. Both the buyer and seller will often have indemnification obligations, but it is the buyer that faces greater risk exposure and, consequently, will be more focused on obtaining indemnification protection.

### **What Is the Scope of Indemnification?**

It is common for the seller to indemnify the buyer for losses arising from some or all of the following occurrences:

- Breaches or inaccuracies in the seller’s representations or warranties;
- Failures by the seller to perform any covenant;
- Pre-closing taxes of the acquired company;
- Excluded liabilities (i.e., liabilities of the target company specifically not assumed by the buyer);
- Employee benefits for employees that did not transfer to the buyer;
- Environmental liabilities;
- Pre-closing product liability claims, etc.

The buyer may indemnify the seller for losses arising from the following:

- Breaches or inaccuracies in the buyer’s representations or warranties;
- Failures by the buyer to perform any covenant;
- Liabilities assumed by the buyer; and
- The operation of the acquired business following the closing.

The seller will seek to minimize its exposure by having its representations and warranties terminate soon after the closing. The buyer, on the other hand, will want the seller’s representations and warranties to last as long as possible. The usual compromise is for certain representations and warranties to survive for a full accounting cycle after closing plus additional time to identify a claim (e.g., 18 months). It is also common for indemnification for certain matters that cannot be identified quickly—such as environmental contamination or tax matters—to survive for a longer period or until the expiration of the applicable statute of limitations for such matters.

## **Who Is Indemnified?**

The Indemnitee, whether it is the buyer or seller, should ensure that the indemnification also covers its affiliates, employees and representatives. On the other hand, the Indemnitor will want to clarify that the obligation to indemnify is limited to the party, or parties, executing the purchase agreement.

In an asset deal, following the closing, the seller may end up as a shell entity with no resources. The buyer in this situation will therefore want to make the seller's parent entity or controlling stockholder joint and severally liable for indemnification.

In a stock deal, the stockholders of the target company will indemnify the buyer. Public company deals generally do not provide for indemnification because it would be impractical to impose the indemnification obligation on a large number of public stockholders.

## **Limitations on Indemnification**

There are several ways that an Indemnitor may seek to limit the extent of its indemnification obligations. Most important is to have both parties agree that the indemnification rights are the only rights of compensation for the buyer, unless the seller committed fraud or acted in bad faith.

Indemnification obligations are typically limited to a maximum amount, or "cap." The size of the cap will depend on the size of the deal, the bargaining power of the parties, and whether any outstanding concerns were raised during the due diligence process. Caps in large deals can often be 10% of the purchase price, but in smaller deals it is not uncommon to cap liability at 50% or more of the purchase price.

Another common means of limiting indemnification is by setting threshold amounts that must be met before the indemnification obligation is triggered. For example, the indemnification clause may provide that the Indemnitor is not obligated to indemnify for any single claim with a value of less than \$10,000. In addition to the foregoing "de minimis" limitation, there is often a requirement that the Indemnitor's obligation does not kick in unless the Indemnitee has aggregate claims totaling at least a certain amount, say \$50,000. This is known as a "basket" if the Indemnitor is obligated to pay the full \$50,000 plus any additional losses, or a "deductible" if the Indemnitor's liability only covers amounts in excess of the \$50,000. The amount of the basket/deductible is often around 1% of the purchase price.

Finally, the Indemnitor may also try to exclude all incidental, consequential, punitive, indirect and other damages.

## **Making a Claim**

When drafting an indemnification provision, it is important to be clear regarding the process to be followed when making a claim. A typical indemnification clause will set forth requirements for giving notice of a claim or electing to assume the defense of a claim. Be aware of the required timing for such notices, as missing a notice deadline may impact your party's rights or obligations.

### **Third-Party Claims**

If the claim for indemnity is based on a third-party lawsuit, the seller may have more motive than the buyer to ensure the lawsuit is managed effectively. Moreover, indemnification provisions usually include that the Indemnitor will “defend” and “hold harmless” the Indemnitee against such third-party claims.

As a result, in most indemnification provisions the Indemnitor agrees to take over the litigation defense of a third-party claim brought against the Indemnitee. This is typically a permissive right on the part of the Indemnitor, meaning that the Indemnitor may choose to take over the defense but is not required to do so. Such provisions usually state that if the Indemnitor does not assume the defense, the Indemnitee may proceed with defending the claim in good faith and the Indemnitor will be obligated to reimburse the amount of any judgment plus the costs of the litigation. In the event that the Indemnitor assumes the defense, the parties should consider whether the Indemnitee will retain approval rights over the selection of counsel and the decision to settle, and whether the Indemnitee will have the option to take back control of the litigation at a later point in time.

### **Escrow Accounts**

In some deals, the buyer does not have sufficient comfort that the seller will be able to meet its indemnification obligations. This is particularly the case when buying from a single purpose company, as in the case of private equity sellers, or when buying from individual shareholders. In such cases, buyers often demand that a portion of the purchase price be paid into a separate account which can be used to indemnify the buyer after closing. These escrow accounts expire at some time after closing, and the escrowed amount is paid to the seller. However, if the buyer makes a claim against the seller, the buyer can be paid from the escrow account.

### **Conclusion**

A well-drafted indemnification provision can be a very helpful component of a purchase agreement. The indemnification provision should work in conjunction with the other parts of the agreement, such as the representations and warranties section and the disclosure schedules. However, making a successful claim under an indemnification provision can be difficult and time consuming. For this reason, it is important to conduct a thorough due diligence review before entering into an agreement to disclose as many issues as possible.