



Morgan Lewis

M&A ACADEMY INDEMNIFICATION

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November 29, 2016

I. Background

1. What is an indemnity?

- M&A concept is broader than traditional indemnity principles
- Contractual provisions whereby parties agree to allocate liabilities and risk between themselves
- Terms vary widely but there are definitely positions that are “market”
- It is a contract; it is only as good as the contract terms and applicable law, and the credit supporting the indemnity

I. Background

2. What's the purpose of an indemnity?

- Allocation of responsibility for known and unknown liabilities and risks
- Asset vs. stock/merger transaction—the default positions are different
- Enables more specificity than would be possible in a common-law breach of contract or breach of warranty claim
- Protects the party, most importantly the buyer, from breaches of representations and warranties, and covenants and unassumed liabilities
- Also can allocate risks associated with specific issues such as tax, environmental, employee benefits, and known liabilities such as litigation
- For sellers, a well-crafted indemnity provision can set boundaries around future liability for the seller, as well as ensure that liabilities assumed by the buyer will be performed by the buyer

I. Background

3. Who provides indemnity?

- Buyer
- Seller (there are numerous considerations here)
- Public target—generally no indemnity because public disclosure provides some protection and cannot seek recourse from widely dispersed public stockholders
- Bankruptcy auction—generally very limited indemnity but buyer typically takes assets free and clear of claims and liens

II. Specific Issues Addressed in Every Deal

- Who will provide indemnity?
- What is the scope of indemnity?
- What is the recourse?
- How long will the indemnity last?
- Contractual limits—baskets/deductible, thresholds, caps, reductions for insurance, third-party contributions, and/or tax benefits
- Other ancillary issues (such as exclusion of consequential damages and nondirect damages, sandbagging, and exclusive remedy provisions)
- Indemnification procedural issues

II. Specific Issues Addressed in Every Deal

1. Who will provide indemnity?

- Is the deal an asset deal or a stock deal?
- Who is your seller?
 - A company?
 - Seller vs. parent of seller
 - One or more individuals?
 - If there are multiple indemnitors, need to deal with problems raised by several (and not joint) indemnification obligations
 - Use of escrow/holdbacks/sell-side indemnification and contribution agreements
- Consider credit issues both up front and over time (and related guarantee issues)
- Consider issues of obtaining jurisdiction (especially in cross-border transactions)
- Consider setoff and relationship issues if longer-term relationships are also being created among the parties

II. Specific Issues Addressed in Every Deal

2. What is scope of indemnity?

- Everything is negotiable
- Representations and warranties
- Breach of covenants (with possibly different treatment for breaches preclosing vs. postclosing)
- Excluded liabilities and assumed liabilities in an asset deal; preclosing operation of the business versus postclosing operation of the business in an equity deal
- Claims relating to the transaction (for example, appraisal rights or claims of breach of fiduciary duties by directors)
- Specific known items (litigation)
- Specific areas (tax, ERISA, and benefits claims; product liability claims; “group” liabilities)

II. Specific Issues Addressed in Every Deal

3. What is recourse for indemnity?
 - Sue indemnitors personally or any guarantor
 - Escrow or holdback
 - Setoff of deferred consideration
 - Third-party representation and warranty insurance
 - All of the above

II. Specific Issues Addressed in Every Deal

4. Survival – How long does it last?

- No need to lump all reps or covenants together
- Note special carve-outs for tax and employee benefits (sometimes environmental)
- What's common? Think in terms of audit cycle
- Note special treatment of indemnity for “excluded liabilities”—often indemnity survives “indefinitely”
- “Accrual of claims”
- Effect of statute of limitations
 - Delaware Chapter 10, Section 8106(c)—an action based on a written contract involving at least \$100,000 may be brought within a period specified in such written contract, provided it is brought prior to the expiration of 20 years from the accruing of the cause of the action
 - NY Civ. Prac. Rule 201 – six-year statute of limitations on contract claims

II. Specific Issues Addressed in Every Deal

5. Contractual limits on indemnity?

- Limits generally apply only to “nonfundamental” reps
 - Per incident/*de minimis* threshold
 - Basket (often called a “deductible” or “tipping basket”)
 - Cap on liability for representations and warranties
- Interplay with knowledge and materiality qualifiers in representations and warranties and covenants, and use of “materiality scrapes”
 - Use of basket/*de minimis* threshold sets materiality threshold and justifies inclusion of “materiality scrape”
 - If materiality is not “scraped” for purposes of determining a breach and/or losses, then need to consider impact of materiality qualifiers on indemnity claims
 - Knowledge is not typically “scraped” and will limit ability to seek indemnification
- Cap on liability for all claims for indemnification
- Practical impact of escrow

II. Specific Issues Addressed in Every Deal

6. Related Issues

- Insurance issues
 - Net of insurance
 - Access to seller insurance
 - Obligation of buyer to maintain insurance
 - Subrogation rights
 - Deal-specific representation and warranty insurance
- Net of taxes?
- Anti-sandbagging/effect of knowledge
 - Knowledge at time of signing
 - Knowledge at time of closing
- Seller's ability to update disclosure schedules and effect on indemnification

II. Specific Issues Addressed in Every Deal

6. Related Issues (continued)

- Fraud/liability of parent of seller
- Exclusive remedy clauses; use of “fraud” as an exception to exclusive remedy provisions and unintended consequences of undefined “fraud”
- Importance of “no reliance” clauses and “no other representation” clauses
- Consequential damages/diminution in value
- Duty to mitigate—specify in contract or rely on common law?
- Interplay with purchase price adjustment provisions—make sure there is no right to double recovery

II. Specific Issues Addressed in Every Deal

7. What are the indemnification procedures?

- Language to the effect that failure to give prompt notice does not affect indemnity unless indemnifying party is materially prejudiced by such failure
- Assumption of defense/acknowledgment of obligation/exceptions to right to assume defense
- Ability to settle
- Consequences of not agreeing to a settlement
- Ability to participate
- Arbitration vs. litigation
- Venue and governing law

III. Practice Pointers

1. Context is everything

- Stock deal vs. asset deal
- Financial buyer vs. strategic buyer
- Financial seller vs. strategic seller
- Multiple stockholders
- High price vs. “bargain basement”
- “Market” practices
- Specific context of deal—multiparty auction or exclusive negotiations?
- Merger—consider *Cigna v. Audax* case from Delaware
 - Merger agreement with private company target
 - Court invalidated indemnification obligation because it violated DGCL 251(b) requirement that merger consideration be firm and determinable
 - Consider temporal and value limitations on indemnification to increase likelihood of enforceability
 - Use an escrow and describe it as contingent rights to additional purchase price; include description of indemnification obligations in merger consideration section of merger agreement; give consideration for release

III. Practice Pointers

2. Find precedents for these parties or similar deals
3. Make sure client understands as a business issue—everything ties back to business issues such as allocation of risk
4. Keep it comprehensible—only works if judge/arbitrator/jury can understand it
5. Need to address “boilerplate” issues—jury trial waiver, consequential and punitive damages waiver, assignment restrictions and merger clause; don’t pick a governing law unless someone knowledgeable in the law of that jurisdiction reviews the contract
6. Don’t leave contract silent on a point (for example, effect of knowledge of Buyer or the duty to mitigate) unless you know what the applicable law is
7. Duty of “forthright negotiator”

IV. Resources for Market Statistics

1. Houlihan Lokey purchase agreement study
2. SRS/Acquiom study
3. Practical Law Company
4. ABA

V. QUESTIONS?

Biography



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Benjamin R. Wills advises public and private companies on corporate and securities matters. Among the areas he covers are mergers and acquisitions (M&A), joint ventures, securities disclosures and compliance, public and private debt and equity offerings, and corporate governance issues. Ben represents clients in a variety of industries, including energy, telecommunications, technology, banking, and manufacturing. His oil and gas work includes representation of master limited partnerships and negotiating complex, long-term tolling, storage, terminalling and throughput agreements.

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Biography



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James (Jim) Francis Collins' practice includes broad-based general corporate and securities matters. He has experience representing public and private corporations, investment management firms, and private equity sponsors and their portfolio companies in mergers and acquisitions, stock and asset purchases and sales, private and public equity and debt financings, securities offerings, and other general corporate matters. Jim also counsels clients on Securities and Exchange Commission reporting and disclosure, corporate governance matters, and stock exchange listing requirements.

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