

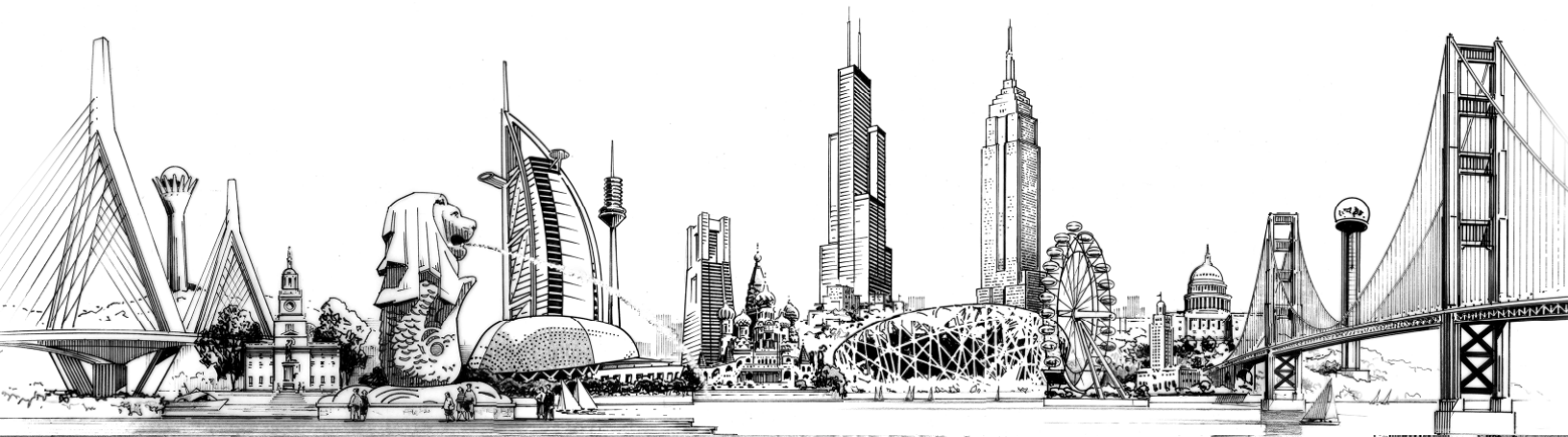
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INDEMNIFICATION ISSUES (NOVEMBER 17, 2015)

Presenters: John Utzschneider, Ben Wills, and Jim Collins

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Indemnification Issues [November 17, 2015]

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Q. What are the implications of including a covenant that all reps and warranties are true and correct as of closing? Does that add a breach of contract claim in addition to an indemnity claim in the event of a breach?

A. I think in theory (without having researched the issue) that this would create the possibility for breach of covenant claims, and the practical difference would depend on how the indemnification provisions treat one type of claim versus the other. In this situation it would not surprise me if the other side resists adding this provision to the contract, arguing that it is a back-door way of trying to get better treatment for representation and warranty claims.

Q. Are M&A contracts typically governed by NY law? Or does it vary with where the parties are located and/or where the target is organized?

A. Many M&A contracts are governed by NY law, but it does vary based on the parties. I think the factors that make NY a popular choice include: (i) a large number of M&A deals are done by NY lawyers, (ii) NY has a user-friendly choice-of-law provision for commercial transaction over a certain size, so there is some comfort that the choice of law will be respected, (iii) the perception that NY courts (Manhattan) are more likely to have dealt with similar complex commercial cases than many other jurisdictions and (iv) it is a safe default provision where the parties are from different parts of the country or are cross-border. For example an Idaho Seller and a Florida Buyer may be unwilling to pick the other party's governing law and/or jurisdiction for disputes, so as a compromise they pick NY law and jurisdiction.

One other point to keep in mind is that merger agreements may be handled a little differently. The merger process is created by state law, so it is more likely in merger deals for the parties to pick as the governing law and jurisdiction the law of the Target's state of organization (Delaware is a popular choice on this basis). Other times the parties will use a hybrid approach -- pick NY as the governing law and jurisdiction generally, but provide that Delaware law (or another state of organization) governs issues relating to the merger mechanics.

Q. Are the insurance carriers able to rely on the contract's indemnity limits to limit their payouts? For example, a buyer may be added as named insured to the seller's \$10 M insurance policy. If the seller's indemnity limit is \$2 M what is available to buyer?

A. I can't tell from your question whether you are referring to representation and warranty insurance or some other type of insurance.

If it is representation and warranty insurance, the policy will have a deductible (often in the amount of approximately 2% of the deal value) and the risk with respect to this deductible will be allocated between the buyer (in the form of the deductible under the acquisition agreement) and the seller (in the form of the actual exposure under the indemnity provisions over and above that deductible). The cap in the policy is negotiated with the insurer and the pricing for the policy is based on that cap.

If you are referring to some other policy (for example a CGL or employer liability policy), there are a few issues to address including (i) whether that policy permits the Buyer to be covered as a named insured, (ii) whether the indemnity provision provides that the Buyer's indemnity claim is net of any available insurance proceeds and (iii) whether the insurer has subrogation rights if it pays out on a claim, and whether the insurer could assert those subrogated rights against the Seller or affiliated companies and

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assert the Buyer's indemnity claim under the indemnification provisions, or assert other rights of the Buyer against other third parties. Before agreeing to maintain insurance for a Buyer or the Target post-closing, a Seller should carefully review these issues with a knowledgeable insurance professional

Q. Please talk a little more about the interplay between the 'no reliance' clause and waiver of the 'fraud' exception.

A. In many states, one of the elements that must be proved for a fraud claim is that the claimant relied on the allegedly fraudulent statement. So, if the acquisition agreement has the Buyer stating that it has not relied on any statement or information provided by the Seller other than the representations and warranties in the acquisition agreement, that may preclude (or at least make it more difficult for) the Buyer from later asserting in a fraud claim that it relied on a statement made by the Seller outside the agreement.

Q. Do either New York or Delaware prohibit indemnity claims by Buyer in the event they know about the liability prior to sign/close?

A. With respect to New York, there is case law on the matter. If the contract is silent (i.e., the Buyer does not include a provision that allows it to recover on an indemnity claim even if it had knowledge of the breach), in New York the issue hinges on whether or not the Buyer believed it was "purchasing the promise as to the truth" of the relevant warranties. The question, therefore, goes not only to what the Buyer knew or thought but also whether the Buyer believed it was making its purchase based on the Seller's representation that the reps and warranties were true. The implication of this is that if a Buyer has knowledge from facts disclosed by the Seller that the Seller is in breach of a representation and warranty then the Buyer may be precluded from recovering on an indemnification claim (because, in that case, the Buyer cannot claim that it was purchasing based on the Seller's representation that the representations and warranties were true). If a Buyer merely questions the accuracy or correctness of a representation, or has knowledge from a source other than the Seller, the Buyer may still be able to recover.

Delaware case law also generally supports the notion that the representations and warranties made by a Seller are a binding contractual promise and, therefore, a Buyer may bring an indemnification claim even if it had pre-closing knowledge of a breach. Delaware courts have found (such as in *Universal Entertainment Group, L.P. v. Duncan Petroleum Corp.*) that a Buyer need not show reliance on the representations.

Q. Do either New York or Delaware have fraud statutes other than that for intentional fraud that would be carved out of an exclusive remedy provision?

A. In the M&A context, we are typically not dealing with statutory fraud provisions (such as those relating to consumer protection laws). When considering a fraud carve-out, we think in terms of the common law for fraud and contract claims. In both Delaware and New York, there is the concept of fraud which is rooted in the intent to deceive (this is the "fraud" that everyone is probably intending when using the word "fraud"). There are also other types of fraud recognized under the common law. For example, in Delaware there is a concept of equitable fraud where a plaintiff is seeking an equitable remedy (such as rescission). In general terms, equitable fraud requires that the defendant have made untrue statements, but does not require an intent on the part of the defendant to deceive.

In New York case law, there is also the concept of negligent misrepresentation. A claim for negligent misrepresentation is similar to fraud in that the plaintiff must show reliance on the misstatement but there is no requirement of an intent to deceive. Instead, the defendant must have expressed the words

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directly, with knowledge they would be acted on, to the plaintiff and the defendant must have had some special relation or duty of care to the plaintiff. Given that this concept is recognized in the New York courts by the term “negligent misrepresentation,” the Seller would likely have an argument that it is not included within an undefined “fraud” term even though the two concepts overlap to some extent.

In New York, there is also the concept of promissory fraud, which is based upon an allegation that the Buyer or the Seller made a promise of future performance that it never intended to perform. In New York case law, there are examples where courts have recognized the concept of promissory fraud and there are other cases where the concept was rejected. Therefore, it is unclear whether a claim of promissory fraud would be recognized by a New York court. The presence of these other theories in New York show that parties must be careful with the wording in any exception from any exclusive remedy provision for “fraud” claims to make sure that the provision is not unintentionally under inclusive or over inclusive.

If your transaction involves a stock sale, you could also be dealing with federal and state securities laws. You should consider the carve-out in both the context of the transaction and the applicable law.

Q. Based on market trends, do you see notable differences in indemnity amount and duration in an asset vs. a stock deal?

A. I don’t see significant differences in indemnity caps or time limits, except in asset deals it is more likely that there is a general cross-indemnity for “assumed liabilities” and “retained liabilities” and these are often uncapped or have large caps, and long time limits or no specific time limit.

Q. 1 of 3: In a situation where both parties in a deal are sued by a THIRD party (e.g., some potential joint liability issue) (i) when is the indemnity triggered and (ii) what are the logistics?

A. I think that these situations are rare, but they could come up for example where a claim is asserted by a third party that the Target breached a contract or violated a law both before and after the closing. If the acquisition were structured as a stock sale or a merger, the claim may be asserted only against the Target (because only the Target is the entity party to the contract or the entity violating the law), and in this case I expect the Buyer would assert an indemnity claim against the Seller for all or some of the liability.

If it were an asset deal, then the claim could be asserted against both the Seller (owner of the business pre-closing) and the Buyer (owner of the business post-closing). In this situation I would expect both Buyer and Seller would review the claim and the facts and look for ways to assert indemnity claims against each other for all or part of the potential liability. Where the allocation of liability comes out and who can control the defense will depend on the wording of the indemnity.

Q. 2 of 3: For example, does indemnity kick in only after some judgment is issued on absolute liability of one party (or contribution of each party to the overall liability) and related legal fees?

A. Generally, I would expect the indemnified party is permitted to assert the claim for indemnification when the third party claim is asserted, but the indemnifying party does not have to pay the ultimate liability until there is a judgment or settlement. Until that time, the indemnifying party may have to assume the defense, pay legal costs etc. of the indemnified party, depending on the wording of the indemnity.

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Q. 3 of 3: How is the actual indemnity effected? Do the parties offset their indemnity amount and just pay the net difference? How often are the indemnity payments made, if ongoing?

A. If both parties acknowledge their respective allocations of liability, they could agree to make adjusting payments along the way. However, it would not surprise me if one or the other side disputes the allocation of liability, in which case I expect that no one would make payments to each other until a court arbitrator decides the issue or there is a settlement. In a situation where both the Seller and the Buyer have been sued on the same third party claim, my advice would include advice that while the Seller and Buyer may have disputes on who is ultimately responsible, it is in their collective best interest to make sure that the third party claim is adequately defended, insurance carriers are notified where appropriate etc., so that the overall exposure is handled and mitigated. While that is going on they can decide (or litigate) how to handle the exposure between them.

Q. Question about "materiality scrapes." Why would you "include" this in the agreement as opposed to just simply striking the materiality qualifier language on the reps you are concerned about?

A. Good question. Keeping the materiality qualifiers in the representations and warranties may serve several other purposes. First, it may eliminate some of the burden in preparing disclosure schedules – for example, preparing a schedule that lists all the Target's "material intellectual property" is easier than trying to prepare a schedule that lists rather than "all intellectual property". On this point, even if intellectually you get to the same point in the indemnity, I have found that people preparing schedules are diligent and conscientious, and don't like the idea of preparing schedules that aren't 100% correct. Second, the materiality qualifiers may provide some cushion on either the closing condition based on the representations and warranties or the termination provisions allowing for termination in the event of certain uncured breaches of representations and warranties, although this will depend on how those conditions and termination provisions are worded.

Q. I thought the statute of limitations for breach of contract in DE was 3 years? Does the reference just limit the time set out in a contract to no longer than 20 years?

A. You are correct that the statute of limitations for a breach of contract claim in Delaware is generally 3 years from the accruing of the cause of action. 10 Del. C. §8106(c) allows the parties to an agreement to contractually agree to a longer statute of limitations, subject to a maximum of 20 years after the accruing of the cause of action.

Q. How frequently do you find a Delaware-governed M&A contract containing provisions to reduce the 20 year statute of limitations, even for the 'indefinite' indemnities such as for fundamental reps?

A. Effective August 1, 2014, Delaware amended 10 Del. C. § 8106 to include the following subsection (c): "Notwithstanding anything to the contrary in this chapter (other than subsection (b) of this section) or in § 2-725 of Title 6, an action based on a written contract, agreement or undertaking involving at least \$100,000 may be brought within a period specified in such written contract, agreement or undertaking provided it is brought prior to the expiration of 20 years from the accruing of the cause of such action." The language does not create a 20 year statute of limitations, but rather allows parties to elect to include in an agreement a 20 year statute of limitations on claims. The law is relatively new (a little over a year old) and, therefore, the market practice is still evolving. However, in our experience, we are seeing purchase agreements that include an express reference that the survival periods in the agreement were negotiated and, therefore, the parties do not intend to apply 10 Del. C. §8106(c).

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Q. Would you see something in lieu of indemnity in a public deal?

A. Deals with public targets rarely have structures (for example escrows) that address risks that are usually covered in indemnification provisions in deals with private targets. Buyers of public companies instead have to rely on their due diligence, and pricing the bid to take into account risks that have been publicly disclosed in the Target's SEC filings or uncovered during due diligence.

We hope that you find the foregoing Q&A to be helpful. If you have any other questions on indemnification please contact:

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