Brownstein Trial Victory Emphasizes Limits on Indemnifying Party's Right to Control Litigation in M&A Indemnification Context

A team of trial attorneys from **Brownstein Hyatt Farber Schreck** recently won a significant trial victory stemming from the acquisition of a company by a Brownstein client. The dispute raised questions about the obligations of the seller to the purchaser under the terms of an indemnification provision in the purchase agreement. As detailed below, the trial court's decision underscores the need for both sellers and purchasers to carefully consider the rules governing their relationship if a dispute arises that is subject to an indemnification provision.

Brownstein's client purchased a company from the seller pursuant to a stock purchase agreement. When a customer of the acquired company later filed a lawsuit against our client, the seller assumed the responsibility to defend the claim under the purchase agreement's indemnification provision. Over time, our client expressed concern with how the seller was defending the lawsuit. The seller, however, argued that because he was responsible for paying any verdict or settlement, he had complete discretion to control the litigation and settlement.

Ultimately, our client chose to settle the lawsuit itself and pay the seven-figure settlement amount. Our client then demanded that the seller indemnify it for the settlement payment, but the seller refused, arguing that our client's settlement of the lawsuit absolved him of his indemnification obligation. The seller sued our client for amounts that he claimed were still owed under the purchase agreement and our client counterclaimed for indemnification.

The case was tried over six days to Judge Mullins in the District Court for the City and County of Denver, Colorado. On January 28, 2014, Judge Mullins issued a 28-page opinion, dismissing all claims against our client and ordering the seller to pay our client the entire amount paid in settlement, plus interest, costs and attorneys' fees.

The factual scenario that led to this dispute can arise frequently in the merger and acquisition indemnification context. When one company purchases another, the seller often agrees to indemnify the purchaser for claims or conditions that arose or existed before the closing date. The justification, of course, is that if claims are asserted against the acquired company after the closing that relate to circumstances that existed before closing, the seller should be responsible for those claims. In exchange for the seller retaining the liability for such pre-closing matters, purchasers will sometimes agree to allow the seller to assume the defense of a claim related to the liability.

In ruling in favor of our client and against the seller, the trial court emphasized a number of limitations on the indemnifying party's right to control the resolution of a lawsuit subject to indemnification. As such, Judge Mullins' decision provides useful guidance to sellers and purchasers faced with an indemnification situation:

- *First*, the seller/indemnifying party must not assume that just because it is financially responsible to pay a particular liability under an indemnification clause and has the contractual right to control the defense of the lawsuit, it has complete and unfettered discretion to act as it wishes in that defense, without regard to the interests of the purchaser/indemnified party. Instead, an indemnifying party must act in good faith and give consideration to the business and financial interests of the indemnified party.

- *Second*, the seller/indemnifying party must closely follow all of the terms of the indemnification clause. It must not presume that just because it is obligated to defend an action and pay any settlement or judgment, it may ignore what it considers to be "secondary obligations" in the indemnification provision. For example, if the provision states that the indemnifying party must keep the indemnified party apprised of developments in the litigation, it must do so. If the provision requires the indemnifying party to send the indemnified party copies of pleadings in the lawsuit, it must do so. If the provision prohibits the indemnifying party from taking action that would harm the business of the indemnified party, it must not do so. A breach of these obligations by the indemnifying party may permit the indemnified party to step in and resolve the claim.
- *Third*, the indemnifying party must remember that even though it may hire defense counsel and pay the attorneys' fees, the indemnified party, not the indemnifying party, is the client of those attorneys. As such, the attorneys must act in the best interest of the indemnified party. Moreover, the attorneys have a duty to keep the indemnified party advised of any material events in the litigation. The indemnifying party must not instruct the attorneys to take action that is contrary to the interests of the indemnified party or to keep material information regarding the litigation from the indemnified party.
- *Fourth*, in negotiating an indemnification provision in a purchase agreement, a purchaser should attempt to include express limitations on the seller's right to control the defense of subsequent disputes. For example, a purchaser may include a clause that provides that in defending a claim, an indemnifying party may not take any action that would have an adverse effect on the indemnified party's business unless the indemnified party consents to such action. The inclusion of such a provision may further protect the purchaser if the seller later attempts to take action in the name of the purchaser that could cause it reputational or financial harm.

This document is intended to provide you with general information regarding an indemnifying party's right to control litigation in the M&A indemnification context. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorney listed or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

John V. McDermott
Shareholder
jmcdermott@bhfs.com
Denver
T 303.223.1118

Karl L. Schock
Shareholder
kschock@bhfs.com
Denver
T 303.223.1125

Steven A. Amerikaner
Shareholder
samerikaner@bhfs.com
Santa Barbara
T 805.882.1407