UNDERSTANDING INDEMNITIES

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A well structured indemnity provision is critical to ensuring both parties are protected in relation to breaches of an asset or stock purchase agreement.

Purpose of Indemnity Provisions
When negotiating an acquisition, the parties carefully allocate the risks between them through the use of warranties, representations, and covenants. Indemnity provisions provide the mechanism by which those obligations are enforced and limit the parties exposure to delayed claims. This article will discuss the key terms of an indemnity provision and the considerations that go into negotiating such provisions.

Survival
Survival provisions serve as a statute of limitations for claims related to the breach of an agreement. Obligations under the agreement are usually divided into two sets, one set which lasts indefinitely and a second set that lapses within one to three years of the closing date.

The indefinite set usually includes obligations related to corporate authority, government authorization, environmental matters, taxes, employee benefits, related party transactions, and similar matters that could have large liability, could completely unwind the deal, or are completely within the seller's control.

The second set of obligations usually lapse within one to three years of the closing date. These obligations generally include all business related representations and warranties, including those related to financial statements, the sufficiency of assets, the condition of assets, any material adverse changes, and litigation. The time lapse provides certainty to the seller, and breaches are generally discoverable before the time period lapses. The time period is generally set to match the term of an escrow, discussed below.

Measuring and Limiting Damages
Almost every party to an acquisition agreement recognizes that there will be small breaches that do not materially impact the operation of the business. Therefore, the parties often create a minimum threshold that must be crossed before the seller will be required to pay damages for a breach. The seller also desires to limit its potential

liability. The primary mechanisms used to manage these risks are a "basket" and/or a "cap."

A "basket" is a threshold amount of damages that must be reached before a party is liable to pay any claims. There are two primary types of baskets, deductible baskets and first-dollar baskets. With a deductible basket, the seller only pays for indemnity claims that exceed the deductible basket threshold. In contrast, a first-dollar basket provides that once the basket threshold is reached, the seller is responsible for all claims, including those used to reach the threshold. Through negotiation, a party can also craft a hybrid of these approaches with different basket thresholds and deductible levels.

A "cap" is a flat dollar limit on the claims that the seller and/or the buyer may be liable for under the agreement. A seller's liability is often limited to at least the purchase price, though it may be negotiated to a lower amount as well. While the cap may be as high as the purchase price, the ability to collect may be functionally limited to the escrow amount, discussed below. Often, cap is inapplicable to the certain obligations due to the magnitude of the liabilities that may be covered, like environmental liability. A buyer may also seek to limit their liability for damages, though the focus is usually on the seller.

The parties should also consider how damages should be measured. While terms like materiality and knowledge are carefully negotiated in various representations and warranties, sellers often seek to ignore such limitations when calculating indemnity claims. This increases the likelihood that a basket threshold will be reached. Both parties should carefully consider whether such a provision is appropriate in their particular deal.

Escrow

All the promises in the world are not worth anything if the seller distributes the purchase price and the buyer has to chase down every shareholder to recover the funds. For this reason, the parties often place a portion of the purchase price into escrow as security for indemnity claims. A common escrow amount is ten percent of the purchase price, though the actual escrowed amount will depend on the risks involved in the transaction and the bargaining power of the parties.

The above summary merely scratches the surface of the complexity related to indemnity provisions. Any party to an acquisition should question their attorney about the risks associated with indemnity provisions and the ways in which indemnity provisions can serve that party's interests.

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