

### ***Indemnification Provisions: Standard Practice Revisited***

by Stephen I. Glover, a partner in the Washington, D.C. office of Gibson, Dunn & Crutcher LLP. Jane Tucker, a legal assistant at Gibson Dunn, prepared the chart that is part of this article. Published In *The M&A Lawyer*, March 2002, Volume 5, Number 9.

When lawyers negotiate indemnification provisions in acquisition agreements, they often engage in strenuous debates about what is customary. For example, seller's counsel may propose that the seller's indemnification liability should be capped at 10% of the purchase price, arguing that a cap at this level is "market." Buyer's counsel will respond by arguing that his counterpart's view of the "market" is wrong, and that parties customarily agree to a much higher ceiling. The lawyers may have similar arguments about what is customary when they discuss baskets, time limits and a variety of other indemnification issues.

In early 1999, to get a better sense for what constitutes "market" in indemnification provisions, I reviewed a sample of 20 private company acquisition agreements.<sup>1</sup> This article updates the results of my earlier review by considering indemnification provisions in a sample of 22 acquisition agreements, most of which were entered into during the period June through August 2001.

Although the new sample is not very large, the review results are interesting. Like the results of the earlier study, they suggest that there is no such thing as standard market practice. The general structure of the indemnification provisions was similar, but the details of the caps, baskets, time limits and other issues varied greatly from deal to deal. Bargaining power and other deal dynamics seem to have had a larger impact on the outcome than custom.

We pulled the agreements from the SEC's EDGAR database. As a result, the sample includes transactions in which a public company sold a business and the disposition was sufficiently material that the selling company was required to file the agreement with the SEC.<sup>2</sup> It also includes transactions in which a public company acquired a private company or a business operated by a public company, and the acquisition was sufficiently material that the buying company was required to file the agreement. The sample does not include any agreements providing for the acquisition of a public company – since these agreements almost never include

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<sup>1</sup> Stephen Glover, *Indemnification Provisions: Is There Such a Thing As Standard Practice?*, 2 *Merger& Acquisitions Law Report* 460 (April 5, 1999).

<sup>2</sup> See, e.g., Form 8-K, Item 2 (requiring disclosure of significant acquisitions and dispositions other than in the ordinary course of business), Item 7(c) (requiring exhibit filings in accordance with Item 601 of Regulation S-K); Regulation S-K, Item 601(b)(2), 10 (requiring filing of material plans of acquisition and disposition and filing of material contracts); Regulation S-X, Rules 1-02(w), 11-01(b) (defining what constitutes significant acquisition or disposition).

indemnification provisions.<sup>3</sup> The sample also does not include any transactions involving both a private buyer and a private seller – since these agreements do not become part of the EDGAR database.

*Type and Size of Deals.* The agreements included 6 asset acquisitions and 16 stock acquisitions. The stock acquisitions were structured either as stock purchases or merger transactions. The deals ranged greatly in size, from \$200,000 plus assumed liabilities to \$3.25 billion. The average deal size was approximately \$700 million.

*Who Indemnifies Whom.* All but one of the agreements included indemnification provisions. In each of the 21 agreements that included indemnification provisions, the seller agreed to indemnify the buyer. The buyer agreed to indemnify the seller in 58% of the deals. Most of the agreements that provided for indemnification by the buyer involved deals in which the buyer paid cash and made relatively few representations and covenants.

Approximately 64% of the transactions in the sample involved multiple sellers. In most of these deals, the sellers were jointly and severally liable for indemnification – only 15% of the deals involving multiple sellers distinguished among stockholders, providing that some would have more indemnification responsibility than others. This was a fairly surprising result, since sellers' counsel often makes the argument that small stockholders or stockholders who were not directly involved in the operation of the business should bear less indemnification risk than large stockholders or stockholders who operated the business.

The fact that only a small number of deals distinguished among sellers may be a function of the types of agreements that are filed with EDGAR. Most of the multiple seller deals involved corporate sellers who were part of the same corporate group. Relatively few of them involved the sale of a family-owned company or a company owned by a large number of individuals. This makes sense -- the latter deals are less likely to be filed with the SEC, since they are less likely to be material from the buyer's standpoint. But it is deals involving family-owned companies or companies with many individual stockholders in which the arguments for different liability rules are strongest.

*Types of Claims Covered.* All of the 2001 agreements that included indemnification provisions stated that the indemnifying party would indemnify the other party for losses attributable to breaches of representations, warranties and covenants. Approximately 41% of the agreements also contained specific indemnification for tax issues. The same percentage provided specific indemnification for environmental issues. In the earlier sample including 1998 agreements, the corresponding percentages were 50% and 25%.

In 50% of the deals in the 2001 sample, the seller agreed to indemnify the buyer for specific retained liabilities, e.g., certain pre-closing litigation or liabilities associated with businesses not

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<sup>3</sup> In a public company deal, where the sellers consist of a very large number of public stockholders, collecting indemnification would be very difficult.

being sold. In 32% of the deals, the buyer agreed to indemnify the seller for the liabilities it was assuming. This agreement can be viewed as a simple corollary to the buyer's assumption of liabilities – if the buyer is willing to assume liabilities, it should also be willing to hold the seller harmless from those liabilities.

In a smaller percentage of the deals – 18% -- seller's counsel persuaded the buyer to indemnify the seller for any claims that arise out of the operation of the acquired business post-closing. Buyer's counsel often takes the position that this indemnification is unnecessary, since the seller should have an airtight defense to post-closing claims if the claims do not have any connection to the pre-closing operation of the business. In effect, buyer's counsel argues, the seller's request for indemnification is really just a request that the buyer defray the minimal legal and other costs of mounting what should be an unassailable defense.

*Special Carve-Outs.* The agreements in the sample used a variety of different carve-outs. Approximately 9% of the agreements provided that the indemnifying party would not be responsible for consequential damages. Negotiators who are considering a consequential damages carve-out should recognize that debates may arise after closing about exactly what consequential damages are.

Approximately 9% of the agreements also provided that the indemnifying party would not be responsible for punitive damages. This carve-out may be relatively easy to justify where the indemnified party's misconduct led to the punitive damages award. But it is much harder to defend where the punitive damages are attributable to someone else's misconduct.

Almost half of the agreements – approximately 46% -- included language to the effect that the indemnified person would not be entitled to indemnification to the extent that a loss was attributable to its own gross negligence or willful misconduct. At first glance, this exclusion may seem entirely sensible and consistent with general principles of contributory negligence. Negotiators should recognize, however, that determining what portion of a loss is attributable to the indemnified party's misconduct may be very difficult.

*Impact of Knowledge of Breach.* Sellers often seek to limit their responsibility for breaches of representations and warranties by arguing that if the buyer knew of the breach at the time of closing, it cannot make an indemnification claim. Buyers resist this request vigorously because the limitation substantially reduces the value of their indemnification rights. If they accept a knowledge qualifier, buyers can expect to fight with the seller about whether they knew that a problem existed every time they make an indemnification claim based on a breach of a representation.

The seller succeeded in obtaining the knowledge qualifier in 18% of the agreements in our sample. Each of these agreements included a provision to the effect that the indemnified party's knowledge of a breach would be a defense to an indemnification claim. The agreements did not define what constituted knowledge. For example, they did not specify whether certain specified individuals must have had actual knowledge of the breach, or whether the fact that the a reasonable indemnified party should have known about the breach would be sufficient.

*Indemnification as Sole Remedy.* When an agreement includes indemnification provisions, but does not expressly state that indemnification is the sole remedy, the question arises whether a party that suffers losses may make contract or tort claims outside the indemnification provision. In some cases, this may be advantageous – the injured party may be able to avoid caps, baskets, time limits and procedural restrictions set forth in the indemnity. Even when the agreement is silent, however, the indemnifying party should have a good argument that the indemnified party should be forced to rely on the indemnification provisions when it asserts damage claims — otherwise what was the point of negotiating a complex set of rights and remedies?

To avoid doubt on this issue, parties sometimes include language to the effect that indemnification is the sole remedy for damage claims. These provisions often also provide that the indemnified party will continue to have a right to pursue claims for equitable relief. Approximately 27% of the agreements in the sample contained language to this effect.

*Time Limits.* The typical indemnification deal establishes a time limit for indemnification claims based on breaches of representations and warranties – all but one of the agreements in the sample established a limitations period. The general period ranged from 12 months to two years – none was longer than two. In the 1998 sample, by contrast, only 75% of the agreements established time limits. Moreover, the time limits were somewhat longer on average – only 40% of the 1998 sample set the general time limit at three years or less.

Approximately 90% of the deals in the 2001 sample established longer periods for specified claim categories, such as environmental, tax and ERISA claims and claims alleging defects in title, than for general breach of representation claims. These agreements took one of three approaches – they stated either that the special indemnification obligations would survive for a time period longer than the general period, that they would survive indefinitely or that they would survive until the applicable statute of limitations expired.

Negotiators should recognize that references to the statute of limitations may not always provide clear guidance on when the representation will expire. Parties interpreting the agreement after the fact must decide which jurisdiction's statute of limitations apply. They must then decide which limitations period within that jurisdiction applies. Does the statutory period applicable to contract disputes apply? If there are allegations of fraud, does the period applicable to tort claims apply? Determining the answers to these questions is not always easy.

Several agreements provided that obligations to perform post-closing covenants would extend indefinitely, or that they would extend for a specified period after the obligation to perform matured. This type of exception makes perfect sense – ongoing obligations should not be subject to cut-offs.

*Caps.* The cap on indemnification liability almost always receives careful attention. Approximately 73% in the 2001 sample established caps on liability. In the 1998 sample, the comparable percentage was 50%.

The details of how the cap applied varied greatly from transaction to transaction in the 2001 sample. All of the deals that established maximum liability limits provided for a general cap,

and then different caps that applied to different types of claims. The general cap ranged between 3% and 100% of the transaction price, with the average at approximately 35%. The comparable percentages for the 1999 sample were 5%, 75% and 40%.

The percentage that the cap bears to the purchase price was not tightly distributed around the mean – there was a high degree of variation among the percentages. Thus, it would be a mistake to argue too aggressively that most parties settle on a cap in the neighborhood of 35%.

Approximately 23% of the 2001 sample established different caps for tax liabilities, or stated that no cap at all would apply to taxes. The same percentage also established different caps or no cap for environmental liabilities. Several of the environmental indemnification provisions used a sharing or layering approach. For example, the buyer might bear 100% of the risk up to a specified dollar level, but only 50% of the risk between that level and a second specified amount, and then only 10% of the risk above the second amount.

*Baskets.* Approximately 77% of the agreements in the 2001 sample established an indemnification basket requiring that aggregate claims must exceed a specified level before recovery would be available. The smallest basket was 0.1% of the purchase price, the largest basket was 2.9% of the purchase price and the average basket was 1.0%. By comparison, the smallest basket in the 1998 sample was lower than 1.0% of the purchase price, and the highest basket was 10%. In both the 2001 sample and the 1998 sample, the basket percentages were more tightly distributed around the mean than was the case with the baskets.

Seventy-five percent of the deals that used a basket provided that the basket established a deductible amount. In other words, recovery would be available only to the extent damages exceeded the basket – there would be no recovery for damages up to the basket amount. Only 25% of the deals provided for indemnification coverage from the first dollar of loss once the basket was full. The comparable percentages in the 1998 sample were approximately 50% and 50%. This shift may reflect a trend toward using the deductible approach, but the sample sizes probably are not large enough to support a firm conclusion.

Approximately 32% of the deals in the 2001 sample established not only an aggregate basket but also a threshold for individual claims. These agreements provided that individual claims would not be considered at all unless they exceeded a specific amount. The individual amounts ranged from \$25,000 (used in more than 50% of the deals that established minimum claim sizes) to \$250,000.

*Insurance and Tax Benefits.* Approximately 46% of the deals in the 2001 sample included language to the effect that the indemnifying party's indemnification responsibility should be net of any insurance recoveries made by the indemnified party. The comparable percentage in 1998 was 25%. Counsel sometimes chooses not to ask for an insurance benefits qualifier on the theory that the indemnified party's claim must be limited to its actual damages, which will take into account any insurance recovery. Negotiators should recognize that if the qualifier is included, interpretive difficulties may arise if the indemnified party self-insures or decides to cancel an insurance policy.

Approximately 27% of the deals in the 2001 sample stated that the indemnifying party's indemnification responsibility should be net of any tax benefits received by the indemnified party in connection with a recovery. The comparable percentage in 1998 was 20%. In this context, negotiators should recognize that measuring the tax benefits associated with a loss can be very difficult.

*Escrow Provisions and Other Security Arrangements.* Only three of the agreements (14% of the sample) we reviewed provided for the creation of an escrow account to secure indemnification obligations. In all cases, the account was created by the seller for the benefit of the buyer. The amount placed in escrow ranged from 3.3% to 14.0% of the overall deal price. In one case, the buyer's only recourse was to the account; in the other deals, the buyer had recourse to assets other than those deposited in the account.

The relatively low number of escrow arrangements may be attributable to the fact that the sample was drawn from the EDGAR database. Most of the transactions involved relatively large, creditworthy buyers and sellers. As a result, establishing escrow accounts or security arrangements may have been less important than in smaller deals involving groups of individual selling stockholders or family owned businesses.

*Conclusion.* Once again, the survey results suggest that there is no such thing as standard practice when it comes to the negotiation of indemnification provisions. Buyer's and seller's counsel cannot resolve indemnification debates simply by chanting the mantra, "it's market."