

Drafting And Enforcing Complex Indemnification Provisions



D. Hull Youngblood, Jr.

is a partner in the Austin, Texas office of K&L Gates LLP. Mr. Youngblood focuses his practice on government contracting, the security industry and complex

financial transactions, and regularly represents clients in a wide array of local, state, and federal contracting transactions and disputes. He can be reached at hull.youngblood@klgates.com.



Peter N. Flocos

is a partner in the New York City office of K&L Gates LLP. Mr. Flocos, who began his legal career as a transactional lawyer and then became a litigator, focuses his practice on “deal

litigation,” insurance coverage litigation, and other complex business and commercial litigation. He can be reached at peter.flocos@klgates.com.

D. Hull Youngblood, Jr. and Peter N. Flocos

Forget about copy and paste. The best indemnification provisions start with the details of the transaction.

THE PURPOSE of this article is to assist transactional and litigation attorneys in the negotiation and drafting of customized, and therefore more effective, indemnification provisions in a wide range of situations, and also to spot certain litigation issues that may arise out of indemnification provisions. This article will identify issues and strategies and suggested language that can act as a starting point to protect the client’s interests in the area of indemnification in complex transactions and litigation. Readers should note that this article is for informational purposes, does not contain or convey legal advice, and may or may not reflect the views of the authors’ firm or any particular client or affiliate of that firm. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Drafters should use this article in conjunction with their own research on the applicable laws of indemnification in the pertinent jurisdiction.

This is not a survey of the substantive law of indemnification in every state and federal jurisdiction. While selected published opinions will be mentioned and occasionally discussed, this article will not focus on case law. Instead, the article is intended to be a practical guide that

illustrates real-world strategies, tactics, and techniques to be used when negotiating and enforcing indemnification provisions.

Because the law allows great flexibility in crafting the terms of an indemnity provision, it is important that the parties to a transaction consider their particular circumstances, issues and needs, and draft accordingly, rather than unthinkingly “copy and paste” an indemnification provision from a prior deal. Indeed, one recent study of “middle market” transactions (below \$1 billion) over the 2002 to 2008 period suggests significant variance in at least certain terms from deal to deal in any given year and over the years as well. *See generally* Houlihan Lokey *Purchase Agreement Study* (May 2009). Similarly, the applicable jurisdiction’s statutory, administrative and common law must always be consulted when drafting, analyzing or enforcing indemnification provisions.

Moreover, the perspectives of litigators and corporate-transactional lawyers often differ regarding the impact and effect of indemnity provisions in transactional documents. Accordingly, it may be productive for the parties to seek a litigator’s review of indemnity language being negotiated, at least when there are or may be particular concerns or sensitivities on certain issues.

Several types of transactions will be discussed in this article including corporate acquisitions, real estate (and the related environmental issues), and confidentiality agreements. Indemnification in the context of litigation (usually relating to settlements) and related insurance issues will also be included.

Many of the examples used relate to the sale of a business, because indemnification provisions are common in the agreements pertaining to such sales. However, the issues discussed in that context are applicable to many types of transactions and agreements — especially those that involve representations, warranties, guaranties, and related issues.

PURPOSE OF INDEMNITY • Indemnification is a method for a legally responsible party to shift a loss to another party. This article will focus on those circumstances in which indemnification, or the transference of a risk, arises from a contract, even though a duty to indemnify can be imposed by law through common law or equitable principles, or through statutes. *See, e.g., American Transstech, Inc. v. U.S. Trust Corp.*, 933 F. Supp. 1193, 1202 (S.D.N.Y. 1996) (indemnity may be found pursuant to an “implied in fact” theory when there is a special contractual relationship supporting such a finding, or pursuant to an “implied in law” theory of indemnity, when one is vicariously liable for the tort of another because one of the tortfeasors was primarily liable for the tort). The true purpose of contractual indemnification is to provide one party (such as a buyer) with a clear contractual remedy for recovering post-closing monetary damages arising from:

- Breach of a covenant;
- Breach of representation or warranty;
- Claims by third parties against the indemnitee; or
- Other claims provided in the relevant agreement.

Indemnification provisions provide just one method through which the parties to the contract can allocate losses, but it may not always be the preferred method of risk allocation. Each fact situation should be analyzed to determine the best method of risk allocation. For example, a seller of property, with more knowledge of the detailed historical use of that property, may be more willing to provide an indemnification to the buyer for losses arising from environmental complications, than to provide a specific representation as to environmental conditions. However, the buyer of that same property might only be willing to accept indemnification from the seller if the indemnification has value based primarily upon ability to pay.

Depending upon how it is drafted, an indemnification provision might afford the indemnitee very different remedies as compared to “regular” contract or tort law remedies. For example, a violation of a specific representation might provide a basis for rescission of the contract under contract or tort law principles; whereas an indemnification for an incurred loss might only subject the seller to repayment of damages.

ALTERNATIVES TO INDEMNITY • A buyer or other indemnitee can limit its risk in many ways other than (or in addition to) a detailed indemnity. For example, under a buy/sell agreement the following actions would also provide the buyer the means to limit its risk:

- The agreement can specify that only certain liabilities are assumed by the buyer;
- Purchase price adjustments can be made contingent on the fulfillment of specific conditions;
- The buyer may defer payment of the purchase price with a right of offset against the deferred amount (typically a note);
- The buyer may escrow part of the consideration with a third party with a right of offset; or
- The buyer may use a subsidiary to purchase the seller or its assets. This generally provides a shield to all of buyer’s assets (from third-party claims) and generally limits the buyer’s risk to the amount invested in the subsidiary.

COMMON LAW REMEDIES • Many agreements in complex transactions permit an aggrieved party to pursue any and all common law remedies, in addition to contractual indemnity remedies. A party should be cautious when choosing to rely upon these remedies rather than negotiating a specific indemnification provision.

As discussed below, one should also be aware that agreements may limit remedies in some fashion, e.g., the contractual indemnity may be the ex-

clusive remedy for all or certain wrongs, specific performance may be waived, and/or certain types of damages may not be recoverable.

Plaintiff’s Perspective

Plaintiffs have a number of issues to consider when choosing to rely exclusively upon common law remedies, rather than creating a contractual right of indemnification.

Recoverability

In a breach of contract claim, the plaintiff might have a solvent defendant to pursue. However, in many situations, the plaintiff may not be in privity of contract with the party having the resources to pay the damages sought. For example, the seller is often a subsidiary of a parent, and once all the assets of the subsidiary are sold, the subsidiary has no assets and the cash may have been “upstreamed” to the parent. Absent a “veil piercing” claim, a guarantee from the parent or a tort theory against the parent, a plaintiff asserting a contractual claim may be able to obtain relief only from those with whom the plaintiff is in privity.

Attorneys’ Fees

Jurisdictions differ as to whether a prevailing plaintiff may recover attorneys’ fees in connection with common law claims. Some states provide for the recovery of attorneys fees in contractual claims, but not in tort actions. *See, e.g., Moody v. EMC Services, Inc.* 828 S.W.2d 237, 246 (Tex. App. 1992) (recovery of attorneys’ fees arises only from contract or statute); *see also Phillips v. Barton*, 24 Cal. Rptr. 527, 532 (Cal. Ct. App. 1962) (same). The practical effect is to require that the plaintiff, absent a contractual indemnification, must suffer and survive a truly substantial injury and related damage before the cost to pursue the remedy exceeds the damages incurred.

Defendant's Perspective

On the other hand, a defendant may have a very different view of common law or statutory remedies.

Unlimited Damages

When the plaintiff pursues a common law claim, there are no buckets, caps, or other limitations as such upon the amount of damages that the plaintiff can recover. The damages that the plaintiff can seek are technically unlimited, subject only to common law legal or equitable doctrines, such as the *Hadley v. Baxendale* rules regarding of recovery of consequential damages.

Longer Statutes Of Limitation

Additionally, a plaintiff can wait until the end of the statute of limitations period to assert a common law claim (which can be up to six years in some jurisdictions). Contractual indemnification provisions may require that claims be asserted within a defined period of time much shorter than the statute of limitations for common law laws — sometimes as short as days after the indemnitee knows of an indemnifiable claim.

Low Barrier To Harassment

Defendants may perceive that only the cost of litigation stands between the defendant and harassment by a plaintiff asserting meritless claims.

ALLOCATION OF RISK • The indemnification provision of an M&A or other agreement could cover almost any subject and is intended at bottom to do two simple things:

- Determine when indemnification “kicks in”; and
- Assign responsibility after the execution of the agreement.

Initially, the parties must determine how a particular problem (e.g., a breach of an agreement rep-

resentation or other provision) will be dealt with. An example involves a determination of the remedy the claimant will be entitled to receive, which could include some or all of the following:

- An automatic reduction in purchase price/post closing adjustment;
- Pursuing a breach of contract claim (which may result in a court-ordered reduction in purchase price); and/or
- Indemnification.

REMEDIES OTHER THAN CONTRACTUAL INDEMNIFICATION

• There are a number of ways to attempt to achieve protections similar to those that indemnification can provide, including:

- Pursuing common law claims under the applicable agreement (e.g. purchase agreement, merger agreement, etc.) for breach of contract or misrepresentation;
- Pursuing common law claims based on fraud and/or fraud in the inducement;
- Anti-fraud provisions of the securities laws; and/or
- Rescission (and partial rescission).

BENEFITS OF INDEMNITY PROVISIONS

• Because parties are generally free to craft their own terms in a contractual indemnity, there are numerous protections that such indemnity provisions can provide:

- Through the use of drafting techniques such as a definitions section, the protected group of “indemnitees” can be much larger than just the parties to the agreement (e.g. non-signatories such as directors, employees, agents, a subsidiary corporation, or a parent corporation, may be included);
- A claimant may be able to recover more under indemnity provisions (including attorneys’ fees and other additional losses) than could be recovered at common law. Indemnity provisions may also limit a claimant to remedies or dam-

ages more narrow than those available under common law claims;

- Parties can resolve uncertainties relating to how a party will be protected as regards notice requirements, tax treatment of losses, selection of defense counsel in case of litigation and other matters;
- Indemnity may cause the indemnitor to be more serious about the representations made, if a breach would trigger a specific and identifiable indemnification obligation.

Another benefit to the indemnitee is that a third party (such as a lender or bonding company) may view the indemnification provisions as part of its security. A number of jurisdictions allow a party to be indemnified for its own negligence, and some jurisdictions even allow a party to be indemnified from its own gross negligence, at least if the indemnification is between “sophisticated parties.” For example, in *Valero Energy Corp. v. M.W. Kellogg Constr. Co.*, 866 S.W.2d 252, 258 (Tex.App.1993), the court held that a “waiver and indemnity provision absolving contractor of all liability sounding in products liability and gross negligence in connection with construction of addition to refinery did not offend public policy” when both the owner and contractor were sophisticated entities.

INDEMNIFICATION DISTINGUISHED FROM GUARANTY, SURETIES, AND CONTRIBUTION

• Indemnity contracts differ from guaranty and surety contracts. While indemnity involves the right of a party to shift a loss to the party who is supposedly responsible or at fault, a guaranty is a promise to answer for the debt, default, or miscarriage of another person. *See, e.g.*, 38 Am. Jur.2d Guaranty §2 (1998). The concept of a surety differs slightly from that of a guaranty in that a surety’s promise gives rise to a direct, primary and immediate duty to pay the debt of another, whereas a guarantor is collaterally liable only upon default of and non-payment by the principal. *See, e.g.*, *Negotiating*

and Drafting Contract Boilerplate, 250 (Tiny Stark ed., ALM Pub. 2003). Contracts of surety and guaranty differ from indemnification agreements, which do not “answer for the debt, default or miscarriage of another,” but instead make good on the loss which results to the indemnitee from the debt, default, or miscarriage. *See, e.g.*, *State ex rel. Copley v. Carey*, 91 S.E.2d 461 (W.Va. 1956).

Indemnity differs from the concept of contribution as well. Contribution requires those having joint liability to pay a proportionate share of the loss to a party who has discharged their joint liability and is a cause of action held for example by a joint tortfeasor against all other parties who are liable for the underlying tort. *See, e.g.*, *Rosado v. Proctor & Schwartz, Inc.*, 484 N.E.2d 1354 (N.Y. 1985). Contribution arises by operation of law, so an express contract is not required (although contribution like indemnity may be addressed contractually).

By contrast, in indemnity, the party seeking indemnification has not necessarily committed any wrongdoing, yet faces exposure to liability by virtue of a transaction or other relationship with the supposed wrongdoer. *See, e.g.*, Stark, *supra*, 249. Moreover, an indemnification agreement shifts the entire loss to the alleged wrongdoer (the indemnitor), not merely a portion as in contribution.

Once the parties understand the difference between representations and warranties on the one hand, and indemnification on the other hand, it may be easier to resolve disputes between the seller and the buyer. Understandably, the seller may fear representing something that is not actually known to be absolutely true, while the buyer may believe that the seller is in the position to know and should make clear and direct representations about everything.

It is important to be clear in distinguishing between two different scenarios: direct claims and third-party claims. Under a direct claim, Party A to a contract agrees to indemnify Party B from losses incurred as a result of the conduct of Party A.

These may include Party A's violation of a term, representation or warranty given in the context of the underlying transaction. Under third-party claims, the parties to a contract agree to indemnify each other from various types of claims by that may be brought by third parties, i.e., persons not a party to the agreement. For example, a third party may sue the buyer of a business on a liability that was not intended to be transferred or assumed in the sale.

ENFORCEMENT OF INDEMNITY AGREEMENTS • As an aid to efficiency, the parties can stipulate to the following enforcement-related matters in connection with an indemnity agreement:

- Cover and pursuits of costs of cover;
- Automatic withdrawal from escrow, possession of collateral, or exercise of offset rights;
- Waiver of ability to dispute fees sought;
- Waiver of bond requirements for an injunction;
- Waiver of jury trial;
- Stipulation as to facts so as to facilitate entry of an injunction or other enforcement order; and/or
- Other agreed self-help remedies.

Parties should examine, however, the degree to which the applicable jurisdiction's law allows such provisions to be enforced. For example, there does not appear to be much case law directly addressing the issue of whether in an M&A context a specific performance remedy will be awarded in case of breach merely because the parties have agreed to such a remedy. A court may want to satisfy itself, independent of such an agreement, that the traditional policy criteria for entry of injunctive relief are met, although presumably a stipulation as to factual matters such as the existence of irreparable harm would be given weight by the court.

SPECIFICITY OF INDEMNITY PROVISIONS • A potential problem with the standard short-form indemnification provision is that it may fail adequately to address the key issues that need to be considered on both sides of the table with sufficient specificity. An example of short-form language might be the following or some similar variant:

The Contractor agrees to defend, indemnify, and hold harmless X, from any and all damages, liability, and claims, arising from Contractor's Conduct.

Such a provision (even if many of the key terms are defined and expanded) does not deal with a number of potential questions and issues, including the following:

- Should there be more than one indemnitor (if so, should the liability be joint and several)?
- Who are the indemnitees? Do third parties have the right to enforce the indemnification provisions?
- What losses or expenses are covered by the indemnity? For example, is the indemnitor required to pay the indemnitee's attorneys' fees incurred in enforcing the indemnification provision?
- What is the duration of the indemnity?
- Is there a ceiling or a hurdle on the indemnitor's liability?
- Does the indemnity limit or even eliminate the right to pursue common law remedies?
- Are recoverable "damages, liability and claims" intended to include any loss or damage, even if beyond common law contract or tort measures of damages? Only "direct" damages? Are "consequential" damages intended to be recoverable?
- What are the procedural mechanisms by which the indemnitee is to enforce the indemnity?

It may not be necessary or practical to draft a comprehensive indemnification provision that deals

with all of these issues. However, the issues that have a high probability of occurring should be considered and addressed. If there is a high likelihood of a particular type of claim, the process and issues raised by that claim should be resolved in the indemnity provision.

Definitions

One way to provide significant clarity to indemnity provisions is the creation of proper definitions. Most complex documents now include extensive definition sections. Yet, surprisingly, indemnification provisions may employ important terms that are undefined or insufficiently defined. For example, in an operation and maintenance agreement the following definitions might be created for use solely in the indemnification agreement between the Contractor and Owner:

“Claims” shall mean all claims, requests, accusations, allegations, assertions, complaints, petitions, demands, suits, actions, proceedings, and causes of action of every kind and description.

“Contractor’s Conduct” shall mean any act, failure to act, omission, professional error, fault, mistake, negligence, gross negligence or gross misconduct of any and every kind, of Contractor, its employees, agents, representatives, or subcontractors, or employees, agents, or representatives of such subcontractors, arising out of:

- (i) Any workers’ compensation claims or claims under similar such laws or obligations related to this Agreement;*
- (ii) Performance of this Agreement (or failure to perform);*
- (iii) Breach of this Agreement; or*
- (iv) Violation of any laws.*

“Contractor Defended Claim(s)” shall mean all Claims which allege that Damage was caused by, arises out of, or was contributed to, in whole or in part, Contractor’s Conduct.

“Damages” shall mean each and every injury, wound, wrong, hurt, harm, fee, damage, cost, expense, outlay, expenditure, or loss of any and every nature, including, but not limited to:

- (i) Injury or damage to any property or right;*
- (ii) Injury, damage or death to any person or entity;*
- (iii) Attorneys’ fees, witness fees, expert witness fees and expenses; and*
- (iv) All other costs and expenses litigation.*

“Proven” shall mean that a court of competent jurisdiction has entered a final unappealable judgment on a Claim adjudging an entity or person liable for a monetary judgment.

If customized definitions are used in the context of an indemnification agreement, then the actual terms of the indemnification may be relatively simple rather than the long run-on sentences found in a number of indemnification agreements:

Subject to the terms and conditions of this Article X, Contractor shall provide a defense for the Owner from all Contractor Defended Claims.

Likewise, the actual terms that impose an obligation to indemnify may be equally simple:

Subject to the terms and conditions of this Article X, Contractor shall indemnify Owner from any judgment arising from any Contractor Defended Claims, which are Proven against Owner.

Identification Of Indemnitees

When negotiating the parties to be indemnified, the indemnitor’s goal is to limit the universe of the indemnities. On the other hand, the indemnitee may want to expand the class as much as possible. To the extent that an indemnitor indemnifies any affiliate of the indemnitee, the affiliate may satisfy the criteria for being a third-party beneficiary of the indemnity.

In that regard, however, when identifying the indemnitees under an indemnification agreement,

how specific must the identifiers be? As an example, assume that the seller of a business indemnifies the following entities: buyer, subsidiary corporations, parent corporation, shareholders, directors, officers, managers, members, partners (other corporate participants), agents, representatives, attorneys, permitted assigns, affiliates, employees, and lenders. This appears to provide broad coverage but how far can you go? Merely identifying the parties to the indemnification agreement can be quite tricky. How detailed must you be in identifying a party in order for that party to be indemnified? Is “partner” enough? Is “agent or employee” enough?

The term “officers, directors, employees and joint owners” has been held by at least one court to be sufficiently precise, but not to include a consultant to the party to the indemnification agreement. *See, e.g., Melvin Green, Inc. v. Questor Drilling Corp.*, 946 S.W.2d 907, 911 (Tex. App. 1997).

Third-Party Beneficiaries

A signatory to an indemnification provision (such as the buyer of a business) can be indemnified and has the standing to enforce that right to be indemnified. But are non-signatories entitled to make claims under the indemnity? When other parties are not signing the contract, how do these other beneficiaries of the obligation of defense and indemnification get protection and enforce those indemnification provisions? To be a third-party beneficiary of a contract, the contract must express an intention to benefit that party or an identifiable class to which the party belongs; absent express declaration of such intent, it is generally presumed that the third party is not a beneficiary and the parties contracted only to benefit themselves.

If there is a “no third-party beneficiary clause” in the agreement, as may be the case, then generally no entity, other than the signatory parties, would have the standing to enforce the indemnity agreement. Only the signatory parties (such as the buyer

or seller of the business sold) will have the right to force the indemnitor to perform its contractual obligation to indemnify any “non-signatory” indemnity beneficiaries. If that signatory indemnitee party has been merged into the indemnitor, or if the indemnitee and the third-party beneficiaries are no longer on good terms (e.g. terminated employees), the third parties may have a right to indemnity but no practical means of enforcement.

A solution (from the third-party beneficiary’s perspective) is to explicitly make these parties third-party beneficiaries (at least as to the indemnification provisions). However, in doing so, the signatory parties may want to protect their ability to amend all other provisions of the agreement (outside the indemnification provisions) without the consent of the third-party beneficiaries.

Duty To Defend vs. Duty To Indemnify

While the terms “hold harmless” and “indemnify” may appear together, generally the terms are duplicative in that “hold harmless” refers to the duty of indemnity, i.e., protecting an indemnitee from a covered loss corresponding the underlying injury itself, such as loss from breach of a representation.

By contrast, the duty to defend is the obligation to provide a defense to a covered claim. The duty to defend does not depend on the outcome of the claim, whereas the duty to indemnify does not arise unless the outcome of the claim is adverse. Thus, the duty to defend and duty to indemnify are separate and distinct obligations. A party defends against a claim — there is no defense to be provided against a loss, damages, or a judgment — whereas a party can indemnify another entity from a loss, damage, or obligation to pay a judgment.

Because the duty to defend and the duty to indemnify are distinct obligations, the contract may impose a duty to defend the underlying claim even in the absence of a duty to indemnify. *Hollingsworth v. Chrysler Corp.*, 208 A.2d 61 (Del. 1965). In other words, the contractual duty to defend a claim

may be broader than, and arise more often than, the duty to provide indemnity from a loss or judgment.

A number of practical drafting issues arise in connection with providing for a duty to defend apart from the indemnification of litigation expenses, such as:

- The indemnitee's requirement to give the indemnitor notice of a claim by a third party;
- Which party controls the defense;
- Who must consent to settlement and compromise of the third-party claim;
- The treatment of multiple claims when some are indemnified and some are not;
- Remedies when an indemnitor refuses to defend an indemnified claim.

Remedy For Refusal To Defend An Indemnified Claim

The following sample provision addresses the issue of wrongful refusal to provide a defense against or indemnify a claim. Under the sample language, the repercussions for such a wrongful refusal are significant — the indemnitor in essence loses the right to contest the reasonableness of the defense expenses — but the indemnitor also has the right to refuse to defend or indemnify when a legitimate basis for that refusal exists:

Refusal or Failure to Defend. Any Party may refuse to provide a defense hereunder, if such refusing Party, in reliance upon an opinion of qualified counsel, has determined that a valid basis exists for determining that the Claim, for which a defense is sought, is not required to be defended pursuant to the terms of this Agreement, and a refusal to defend under such circumstances shall not be a material breach of this Agreement. However, if the Indemnatee shall be required by a final judgment to pay any amount in respect of any obligation or liability against which the Indemnitor is required to indemnify under this Agreement, the Indemnitor shall promptly reimburse the Indemnatee in an amount equal to the amount of such payment. Further, if such refusal, or any failure, to

provide a defense against a Claim is found not to have been reasonably justified, under the commercially reasonable standards observed in the _____ industry, then the Indemnitor that has refused to so provide a defense: (i) shall be obligated to pay all of the Damages and out-of-pocket expenses incurred by the Indemnatee in defending said Claim, including, but not limited to, the value of the time, including travel time, that all of the employees, agents and representatives of the Indemnatee dedicated to, or expended in furtherance of, the defense of said Claim; (ii) without any further action from any Party, hereby intentionally relinquishes and waives any and all rights of every nature to dispute, defend against or contest, in any manner, (including but not limited to the waiver of every defense of every nature) the claim of the Indemnatee regarding the amount of, reasonableness of, necessity for or the Indemnitor's obligation to pay, the costs, fees and expenses, and other Damages incurred by the Indemnatee in defending the Claim.

Losses / Damages; Waivers Or Limitations On Types Of Damages

When drafting indemnification provisions, losses and damages that are intended to be recoverable or not recoverable should be carefully defined. Without sufficient specificity, as can be provided by a clear definition section, a court may have difficulty determining whether or not the following types of items are intended to be recoverable under the indemnity:

- **Fees and expenses** (accountant, attorney, experts, etc). In some jurisdictions, an indemnitee is entitled to recover attorneys' fees and expenses in connection with an indemnifiable loss unless expressly prohibited under the contract;
- **Consequential or indirect damages; "lost profits."** Recovery of "consequential damages," and/or indirect damages, may be waived or limited in the transaction agreement. Subject to provisions in the transaction agreement, the standard of *Hadley v. Baxendale* must be met to recover consequential damages under a contractual theory. Indemnitors may at-

tempt to limit or eliminate recovery of consequential damages because the amount of the recovery is too unpredictable. Damage waiver or limitation provisions also may refer to lost profits, losses based on multiples of earnings, diminution in value losses (i.e., the indemnitee may not suffer an out-of-pocket loss yet its assets or business may decrease in value), or similar types of losses. A court may have difficulty categorizing certain types of damages as “consequential” or “direct” under the common law definitions of those terms. Accordingly, parties should consider whether their intention is to exclude recovery only for lost profits, losses based on multiples of earnings, diminution in value losses, etc. that are consequential damages, or whether their intention is to exclude recovery for any such types of losses, whether they are direct or consequential. Indeed, parties may wish to draft their own definition as to what does and does not count as a “consequential damage”;

- **Fines;**
- **Costs.** “Costs” may be interpreted simply as “costs of court,” e.g., as administrative expenses such as filing fees and transcript fees. That interpretation is much narrower than the full “expenses of litigation,” which would include any costs, fees, and expenses related to the litigation, such as expert witness fees, travel time, travel expenses, etc. An example of a broader form of provision is set out below:

“Losses” means all Liabilities, losses, damages, injuries, harm, diminution in value, expense, expenditure and disbursement of every nature (including, without limitation, costs of investigation, travel expenses, value of time expended by personnel), fines, fees and expenses of litigation (including without limitation reasonable attorneys’ fees incident to any of the foregoing), costs and costs of court.

Amount Of Indemnity — Financial Limits

Financial limits on the amount of indemnity can take several forms, as discussed below.

Baskets

A basket is a type of limit on the total amount of the indemnification obligation. For example, a deductible basket provides that the indemnitor is responsible only for those damages exceeding the basket amount. Indemnitees may seek to have the basket be inapplicable in cases of fraud by the indemnitor. Buyers and sellers of businesses may argue about the applicability of the basket to post-closing claims for warranty work to be performed by the seller. Buyers may want the basket to apply to this work, in order to eliminate dealing with any sort of small post-closing claim by the seller for warranty work. Sellers may try to make the distinction that reimbursing them for warranty work is completely different than indemnifying them from claims asserted by an unrelated third party.

Hurdles And Caps

A hurdle is the threshold amount of damage that the indemnitee must suffer before a claim for indemnification can be made. When drafting this type of provision, consideration should be given to whether the parties intend a separate hurdle to apply to each claim or instead that a single hurdle apply to all claims such that once fulfilled the hurdle no longer acts as a limitation upon the indemnitor’s obligation. The parties also should consider whether the indemnitor is liable for the entire loss, from the first dollar, once the threshold is hit (referred to as “first dollar” hurdle clauses), or whether instead the hurdle is to act more like a deductible basket. Depending upon how basket and hurdle issues are handled, the parties may also wish to consider providing for a “cap” on the indemnity, which is a maximum amount that the indemnitee can recover under the indemnity under any set of circumstances or defined set of circumstances. A sample pro-

vision containing both a \$50,000 hurdle (not first dollar) and a cap of \$2 million is set out below:

Dollar Limitations. The Contractor shall not be liable to indemnify and hold harmless Owner for any Damages arising from the Claims, until Owner has first suffered, sustained or incurred aggregate losses relating to such matters in excess of \$50,000, at which point the Contractor will be liable to indemnify Owner and hold it harmless from and against all such Damages in excess of the \$50,000 deductible amount. In addition, the Contractor shall not be liable to indemnify Owner for any Damages in excess of \$2,000,000.

Double Dipping Basket

If the agreement in question contains materiality qualifiers, then the indemnitor may argue for a “double dip” limit on liability. For example, in a stock purchase agreement, a representation or warranty may be subject to a materiality qualifier such that the representation is breached only if it is untrue in a “material” respect. In that case, the materiality qualifier may act as an implicit limit on the amount of any indemnification obligation pertaining to breaches of the representation. If the indemnification obligation in addition provides an express limit, then the indemnitor will contend its obligation is in effect is “doubly” limited. Accordingly, the parties should consider the effect of materiality qualifiers upon indemnity claims. Sample language addressing the interplay of materiality qualifiers and damages recoverable under an indemnity clause is set out below:

Materiality. With respect to any claim for indemnification relating to a breach (or alleged breach) of a representation or warranty that may only be considered breached if the defect, inaccuracy, mistake or misrepresentation is material, the materiality of such defect, inaccuracy, mistake or misrepresentation will be considered for purposes of determining whether a breach of such representation and warranty has occurred, but will not be considered in determining the amount of the Damages arising out of such breach.

A recent study of middle-market transactions (less than \$1 billion) over the 2002 to 2008 time period provides interesting data regarding the frequency of, and terms and sizes of, baskets, hurdles and caps. See *Houlihan Lokey Purchase Agreement Study*, at pp. 9-18 (May 2009).

Exclusivity Of The Contractual Indemnification Remedy

As indicated previously, to the extent the agreement does not provide that the contractual indemnification provision is the exclusive remedy available to the indemnitee, the indemnitee may be able to pursue common law claims against the indemnitor and thereby “sidestep” the contractual indemnity, including sidestepping any baskets, hurdles, caps, etc. For this reason, indemnitors may demand that the indemnification agreement between the parties be the sole and exclusive remedy for a breach of a representation or warranty, and even for other types claims such as tort claims arising out of the transaction.

Method Of Payment

Generally, one party to a transaction is paying for something, and the other party is getting paid. What therefore is the method of payment to be used by the receiving party when an obligation of indemnification arises? For example, if the seller of a business is getting all cash for the sale, the buyer may request that an indemnification obligation owed to the buyer be paid in cash. Where more complex consideration is received by the seller, the issue of how the seller will pay an indemnification obligation to the buyer may be similarly complex.

If the seller is being paid with cash, a promissory note and stock in the buyer, the seller may request that any indemnity obligation be satisfied by an offset of the then owing principal balance of the promissory note, and/or the return of shares of the buyer’s stock. The more restricted the stock

is with respect to transfer to third-parties, the more important this right is to the seller.

If the offset of a deferred payment obligation is the method of payment, the description of the offset is may be straightforward. The amount of the indemnity obligation is deducted from the deferred payment obligation. This may be handled in a manner similar to a pre-payment of a note, with the credit first applied to accrued but unpaid interest, and then to unpaid principal. However, if stock is to be used as a method of payment to satisfy an indemnity obligation, then the parties should consider:

- Whether only shares acquired by the seller in the transaction can be used for payment (not shares purchased otherwise);
- Whether fractional shares can be returned (any balance to be paid in cash); and
- How to determine the value of the shares returned (e.g., agreed upon floor per share, verifiable price determination, average market price over the preceding 20 days, or other formula).

Actual Knowledge Of Buyer;

Anti-Sandbagging

An “anti-sandbagging” provision is intended to protect the buyer of a business from knowledge that it may gain during a due diligence investigation. Basically, the provision is intended to preserve a buyer’s remedies, at least in some fashion, even though the buyer actually knew that a representation or warranty was untrue at the time the transaction closed. Sellers may object to such provisions, citing theories of waiver and fairness. Buyers on the other hand may demand this type of provision because they believe that the seller will as a result be put to the task of clearly updating disclosure schedules before the closing.

As an alternative, sellers may propose a provision that establishes “no prior disclosure” by seller of a representation or warranty issue as a condition precedent to buyer’s assertion of a claim. Buyers

may want to clarify that “prior disclosures” are only acceptable if contained in the disclosure schedules, on the grounds that without such clarity, the seller will argue that informal disclosures, such as verbal disclosures, are sufficient.

Another potential alternative is a buyer representation stating that, as of the closing, the buyer has no knowledge of any violation of any of the seller’s representations or warranties. If the buyer is found to have had such knowledge, the buyer may be subject to a claim by the seller that the buyer breached that representation to the seller.

A sample anti-sandbagging provision could provide the following:

Anti-Sandbagging. No information or knowledge of Buyer, nor the results of any due diligence or investigation by Buyer of the Company, shall affect, waive, modify, limit, or diminish: (i) any representation or warranty of Seller contained in this Agreement or the Related Documents; or (ii) Buyer’s right to rely upon such representations and warranties of Seller.

Other formulations might provide more specifically that the buyer’s remedies themselves (as opposed to the representations or the ability to rely) are unaffected by the buyer’s knowledge (*see, e.g.*, the ABA Model Stock Purchase Agreement and Model Asset Purchase Agreement). The reported case law appears to deal mostly with a “right to indemnification or other remedy not affected” type of formulation. No case law appears to address directly the “representations and warranties not affected” formulation versus the “right to indemnification not affected” formulation. An anti-sandbagging provision may also contain language that the purpose of the due diligence investigation is to confirm the accuracy of representations and warranties.

In any case, without an anti-sandbagging provision, the seller may argue that the buyer’s actual knowledge at closing of the seller’s breach of a representation or warranty precludes the buyer from seeking a remedy in connection with that breach.

See Galli v. Metz, 973 F.2d 145 (2d Cir. 1992); *Hendricks v. Callahan*, 972 F.2d 190 (8th Cir. 1992).

The Effects Of Tax Law And Other Recoveries Received By The Indemnitee

A common issue to resolve is a party's claim that an indemnitee should not incur a windfall, or suffer an unreimbursed loss, as a result of indemnification, in light of tax benefits or losses that the indemnitee may realize on the indemnification payments. A similar issue is presented by the fact that the indemnitee may recover monies from sources other than the indemnitor for the loss at issue. Depending upon the jurisdiction, litigation may resolve such issues, even if the parties do not include a provision for such tax consideration, in light of doctrines such as the "one recovery" rule and the "collateral source" doctrine.

In any case, the parties may wish contractually to address the effect of tax law and recoveries by the indemnitee from other sources on the indemnification right. For example, "Net Tax" and similar provisions take into consideration that amounts paid by the indemnitor to the indemnitee will be reduced by:

- All insurance proceeds received by the indemnitee as compensation for the damages at issue under the indemnity obligation;
- All tax benefits recognized by the indemnitee as a result of the damages at issue under the indemnity obligation; and/or
- All amounts received by the indemnitee from any source (other than the indemnitor) as payment of the damages at issue under the indemnity obligation.

A Net Tax provision might also address the following issues:

- Whether indemnity payments are to be first calculated and paid as though none of the foregoing adjustments were to be made. If so, thereafter, through additional payments, repayment,

or offset of other obligations, the payment to the indemnitee would be increased or reduced (or refunded as the case may be) after the indemnitee has actually incurred the tax or received a recovery from another source. It may be a benefit to one or more of the parties for the adjustment in the amount of an indemnity payment to be treated as an adjustment in the purchase price;

- The determination of the precise amount of tax owed may take longer than the life of the indemnification. Parties accordingly sometimes make the adjustment subject to further adjustment upon the final and unappealable determination of the amount of tax owed.

Mechanics Of Indemnity

Indemnity provisions may require some type of notice to be given by the indemnitee to the indemnitor. If the notice clause is drafted as a covenant, then the indemnitor will argue that failure to deliver notice is a breach of the indemnity agreement. The indemnitor would contend that it is entitled to damages based on the lack of notice and that, if delivery of notice is a condition precedent to the indemnitor's obligation to indemnify, the failure to satisfy the condition precedent relieves the indemnitor of its obligation to defend or indemnify. The delivery of notice may be a particularly significant issue when indemnification is being sought because of a claim by a third party.

Indemnity provisions may be drafted to state that defective notice does not excuse the indemnification obligation unless or except to the extent that as a result, the damages to be indemnified are increased or the indemnitor is otherwise prejudiced, e.g., the indemnitor's ability to provide a defense is somehow prejudiced. The following is an example of such a provision.

Notice. Each Indemnitee must provide written notice to the Indemnitor within 10 days after obtaining knowledge of any

claim that it may have pursuant to Section X (whether for its own Losses or in connection with a Third Party Claim); provided that the failure to provide such notice will not limit the rights of an Indemnitee to indemnification hereunder except to the extent that such failure materially increases the dollar amount of any such claim for indemnification or materially prejudices the ability of the Indemnifying Party to defend such claim. Such notice will set forth in reasonable detail the claim and the basis for indemnification.

Joint Claims

In some situations, both the indemnitor and the indemnitee will be targets of a claim by a third party and neither party will be responsible for all the damage sought. The contract may require one party to provide a defense for both of the target parties, but that does not necessarily mean that the indemnitor must ultimately bear the full cost of that defense. One method of distributing the cost of defense to the various parties is to provide that defense counsel will allocate its fees and expenses between the defendant parties, if in fact such an allocation is possible. An example of that language (assuming allocation is possible) is set out below:

Division of Fees. Counsel retained hereunder for the defense of a party hereunder shall be instructed by the party retaining them to regularly estimate in good faith the portions of all costs, fees, and expenses of such defense which relate directly to Contractor Defended Claims and Owner Defended Claims. All fees of such defense counsel shall be allocated between Contractor Defended Claims and Owner Defended Claims. The division of fees (which shall not disclose any information other than the amounts of fees, and costs) shall be provided to Contractor, Owner and all defended parties, and such accounting shall be irrevocably binding on the Owner, Contractor and the defended party. Owner shall promptly pay Contractor for the costs, fees, and expenses paid by Contractor to such defense counsel relating directly to the defense of Owner Defended Claims. Contractor shall reimburse Owner for the costs, fees, and expenses paid by Owner to such defense counsel that are directly related to the defense of Contractor

Defended Claims. The Owner and Contractor agree to complete such reimbursements within 30 days after receipt of any such accounting by defense counsel described herein.

Transfer Of Relationship

When an ongoing customer (or other) relationship is being transferred from the indemnitor to the indemnitee, e.g., the transfer of customer relationships in connection with the sale of a business, the indemnitee may want to defend all claims that arise with the newly acquired customers, even if the seller-indemnitor is obligated to defend the claim and may ultimately be responsible for the loss. Depending on the circumstances, the buyer-indemnitee may not want the claims defended vigorously, and instead may want the claims simply paid off, so as to protect its relationship with the customers, whereas the seller-indemnitor may want to defend the claim vigorously, and never pay any portion of the claims, with little regard to the impact that such a posture may have on the buyer-indemnitee's relationship with the customers. Possible compromises include:

- The buyer-indemnitee is allowed to control the defense but must also assume responsibility for all or a specified portion of the litigation expenses and any adverse judgment; or
- The seller-indemnitor retains control of the defense, but cannot settle without the buyer-indemnitee's consent.

See John Seegal, Allocation of Post-Closing Risk in Private Company Acquisitions, in Acquiring or Selling the Privately Held Company (Practicing Law Institute 2006).

Selection Of Counsel

An indemnitor may expressly be given the right to select counsel to provide the required defense. The indemnitee may also be given a "right of reasonable refusal." An example of such a formulation is as follows:

Selection of Counsel. Any party obligated to provide a defense hereunder shall do so with qualified counsel that is selected by the party providing the defense, where such counsel is approved by the other party; but such approval shall not be unreasonably withheld.

Such a provision may lead to future complications if the indemnitor and indemnitee end up as adversaries in litigation related to the defense of the underlying third-party claim (e.g., from contribution disputes). For example, the counsel selected by the indemnitor may become privy to confidential information about the indemnitee that might be helpful to the indemnitor in a direct action between the two, and that counsel may also be the regular counsel for the indemnitor and therefore also involved in making demands on the indemnitor's behalf for contribution or indemnification from the indemnitee. Although applicable rules of ethics may prevent counsel from becoming involved in such a scenario, the parties may wish to avoid the situation entirely by agreeing in advance upon a law firm that will provide the defense, so long as no conflict of interest would preclude the representation.

The “shall not be unreasonably withheld” standard may also present complications. For example, if an indemnitee refuses counsel proposed by the indemnitor, and the underlying case is lost, the indemnitor may claim that the indemnitee's refusal to approve the proposed counsel caused the loss and therefore excuses the indemnitor's obligation to indemnify. The indemnitee would argue that its approval was not “unreasonably withheld.” On the other hand, the seller-indemnitee may believe that the benefits of the consent requirement outweigh the costs. If the seller does wish to compromise the issue, it might do so with the following type of provision, that at least preserves certain protections for it:

Selection of Counsel. Any party obligated to provide a defense hereunder shall do so with qualified counsel with demonstrable experience defending claims of the type to be defended,

who is selected by the party providing the defense, and such counsel shall be deemed to have been approved by the party to be defended, without further action by said party, unless the party to be defended establishes: (i) a substantive conflict of interest with such counsel; or (ii) a substantial cause or reason to withhold such approval.

SURVIVABILITY OF INDEMNIFICATION

- Transaction agreements may provide that representations and warranties, and the rights to indemnification for breaches thereof, remain in effect (or “survive”) only for some specified period of time. In theory, the time specified should be intended to give sufficient time, post-closing, to determine the veracity of the representations and warranties. This is, however, a general guideline and moreover, different types of representations or indemnity rights may be treated differently as far as survival periods. For example, the following types of representations or warranties may be given indefinite survival:

- **Taxes.** While taxes may be defined as “excluded” from an asset sale transaction, unpaid personal property taxes may follow the assets, and the buyer of the assets may be subjected to liability for such taxes. Accordingly, indemnification from any liability for the seller's pre-closing taxes may be demanded by the buyer in asset purchase transactions. Some parties use statutes of limitation as the limit of survivability for representations regarding taxes. However, considering that those limitation periods may be tolled or extended, many parties request that representations and warranties relating to taxes, and the right to seek indemnification for their breach, be indefinite;
- **Environmental.** The fear of the unknown, and the potential for very significant costs of environmental remediation, may motivate parties to seek indefinite duration for environmental representations and warranties and the related right of indemnity for breach thereof;
- **Title.** When acquiring realty or personal prop-

erty (including stock or other assets), a buyer may demand indefinite duration for the representations and warranties relating to the seller's ownership of and title to the items and related right of indemnity for breach thereof. The buyer may take a similar approach to representations regarding liens and rights of others to the property in question;

- **Corporate Authority.** When an entity makes a representation that it has the authority to enter into a transaction, such that the agreements are binding and enforceable upon that party, the other party may seek to make those representations and warranties, and the related rights of indemnity, unlimited in duration.

The following types of representations or warranties may be given long, although not indefinite, survival:

- **Third-party claims.** Many buyers argue that the duration of indemnification from claims by third parties against the buyer should extend for a significantly longer period of time than the right to indemnification for claims between the buyer and seller. Third parties do not have any obligation to commence a lawsuit earlier than the statute of limitations, and "discovery" or other tolling doctrines may extend the limitations period for a significant period of time. Accordingly, with respect to third-party claims, the buyer may request that the survival period be stated not in terms of a period of specified years, but instead in terms of the "applicable statutes of limitation, as they may be tolled or extended by agreement or by operation of law."
- **Securities claims.** If a sale of securities is involved in the transaction, buyers may request that the duration of indemnity for Section 10(b)/Rule 10b-5 violations be as long as possible.

PUBLIC POLICY • Although a number of jurisdictions permit indemnification against the consequences of one's own negligence, a provision indemnifying the indemnitee for its negligence may be void as against public policy in some jurisdictions. Depending upon the jurisdiction, indemnification for gross negligence may be enforceable. Even when indemnification for negligent or even grossly negligent conduct is valid, indemnification contracts have been held invalid in certain jurisdictions where the indemnity covers the indemnitee's intentional or malicious conduct. In determining how severe the indemnitee's mental state may be consistent with permitting indemnification, a court may consider the sophistication of the parties and may allow more leeway for indemnification the more sophisticated are the parties. For example, in *Valero*, supra, 866 S.W.2d at 258, the court held that a "waiver and indemnity provision absolving contractor of all liability sounding in products liability and gross negligence" in connection with construction of a refinery did not offend public policy where both owner and contractor were sophisticated entities.

REPRESENTATION AND WARRANTY INSURANCE • Certain insurers are now offering "representation and warranty insurance" as a potential supplement to or substitute for a private contractual indemnity. The target market appears to be middle market transactions and/or repeat M&A buyers, e.g., private equity firms.

Although insuring language and other provisions, including exclusions, may vary from policy to policy, in general terms the concept of the insurance is to cover losses resulting from breach of a representation or warranty. The policy may be structured to correspond to (and may even attach) the transaction agreement in question. The policy period may simply match the representation and warranty survival period in the transactional agreement, although if so, the policyholder may be able

to purchase an extension. Policy exclusions may include such items as:

- Loss arising out of any breach of which the insured’s “deal team members” had “actual knowledge”;
- Loss payable under any purchase price adjustment provisions in the transaction agreement;
- Loss payable under any indemnification provision in the transaction agreement;
- Loss arising out of consequential, special, indirect, multiplied, punitive, exemplary damages;
- Loss arising out of injunctive, equitable or non-monetary relief;
- Loss arising out of any “estimate, projection or forward looking statement”; and
- Other transaction specific exclusions added by the insurer.

Certain information suggests that limits of up to \$150 million are available per transaction, with the premium being two to four percent of the amount of the limit and the deductible being one to two percent of transaction value, and that over 500 representation and warranty policies have been issued worldwide over the past 10 years or so.

Insurers claim that the insurance has various benefits for buyers in an M&A transaction, such as enhancement of the indemnity in the transaction agreement (including possible extension of survival periods for reps and warranties); alleviation of concerns about collecting on the transaction agreement indemnity (e.g., concerns about the financial condition of the seller and the difficulty and expense of suing the seller); and a potential competitive advantage in bidding because the buyer can accept less indemnity protection from seller and then supplement with the insurance.

Insurers also claim that the insurance has various benefits for sellers in an M&A transaction, such as facilitating a “clean exit” in which worries about future claims are eliminated, hold-backs, or escrows are eliminated or satisfied, and sale proceeds quickly distributed to the seller or its owners; protection for “passive sellers”; and increase in the sale price.

The authors express no opinion regarding these claims by insurers or on the advisability of representation and warranty insurance in general. Parties should, however, consider various issues in evaluating whether to employ such insurance products instead or in addition to negotiating a private indemnity in the transaction agreement. For example, parties should consider these questions:

- Is the insurer more financially creditworthy than the transaction counterparty?
- Can the insurer offer broader indemnity compared to what could be negotiated with the transaction counterparty? Even if so, is the premium worth it?
- Can the insurer offer enough in limits as compared to the transaction counterparty? Even if so, is the premium worth it?
- Will the insurer pay its coverage obligations more quickly and reliably, and with less dispute or need for litigation, as compared to the transaction counterparty? Even if so, is the premium worth it?

CONCLUSION • Indemnity provisions are inherently flexible and should be built to suit the transaction. When they are, they can do much to mitigate the risks undertaken and provide a considerable degree of security.

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