

**Indemnification
in
Mergers and Acquisitions
What's Market?**

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Why is Market Important?

- **Facilitates agreement**
- **Powerful argument against aberrant provisions**
- **Support for position**

Is there such a thing as a market provision?

- **All mergers and acquisitions agreements are highly situational**
- **Is the present transaction in the same market as the data used to establish “market”?**
- **Has the market changed since the data was collected?**
- **How much consensus exists in the legal profession?**

Where do we go for data?

- **The 2007 Private Targets Mergers & Acquisitions Deal Points Study**
- **Market Trends Subcommittee of the Committee on Negotiated Acquisitions (Mergers and Acquisitions) Subcommittee of the Business Law Committee of the American Bar Association**
- **Obtained a survey of 143 acquisitions of private companies by public companies from LiveEdgar**
- **The subcommittee read the agreements and analyzed the results**

Is this data market?

- **Best data we have**
- **Better than the anecdotal experience of practitioners**
- **Bigger survey than the experience of most firms**
- **Is this data a product of its time?**

Why Indemnification?

- **Did we forget about causes of action based on breach of contract?**
- **Breach of contract is a blunt instrument**
- **Breach of contract not consistent with the multiplicity of issues and the complexity of situations encompassed in the typical acquisition agreement**

Advantages of Indemnification

- **Indemnification defines the matters that result in liability**
- **Indemnification may be for matters that are not covered by representations and warranties**
- **Indemnification defines the extent of liability**
- **Indemnification defines the duration of liability**
- **Indemnification defines that mechanisms for determining liability**

Survival: How long does indemnification survive

- **See Section 11.7 of the Model Asset Purchase Agreement – ABA Committee on Negotiated Acquisitions (Mergers and Acquisitions) for a typical time limitation provision**
- **Survival period for 88% of the deals for most representations and warranties was 12-24 months**

Factors in Determining Survival Period

- **Rationale for period is usually one complete audit cycle**
- **Most issues will surface within two years**
- **However, certain areas have their own survival period due to the nature of the potential liability**

Which Representations and Warranties Have Separate Survival Periods

- **Taxes – 67%**
- **Capitalization – 59%**
- **Due Authority – 54%**
- **Ownership of shares – 42%**
- **Employee benefits / ERISA – 39%**
- **Fraud – 37%**
- **Due Organization – 37%**
- **Environmental – 37%**
- **Breach of Target / Seller's Covenants – 36%**

Basket

- **See Section 11.5 of MAPA**
- **Two type of baskets**
 - **The deductible – Seller liable for damages only to the extent that they exceed a given amount**
 - **The first dollar basket – once indemnification liability exceeds a fixed amount, Seller is liable for all indemnification expenses**

Types of Baskets

- **54% were Deductible Baskets**
- **36% were First Dollar Baskets**
- **7% were a combination**
- **3% had no basket at all**
- **If one has a basket, it is a rationale for not having materiality qualifications or exclude the materiality qualifications from the calculation of the basket**

Exclusions from the Basket

- **Certain liabilities such as retained liabilities of the seller, title to assets, labor issues and environmental are excluded from the basket and are first dollar liabilities**

Amount of the Basket

- 2% were greater than 2% of the transaction
- 8% were greater than 1% up to 2% of the transaction
- 28% were greater than 0.5% up to 1% of the transaction
- 62% were 0.5% or less of the amount of the transaction

Caps

- **A cap is the maximum liability of the seller under the indemnification provision**
- **If there is a cap, certain liabilities are excluded from the caps**
- **Sometimes there are different caps on different types of liabilities**
- **Section 11.5 of MAPA**

Amount of Caps

- **1% of deals silent on caps**
- **88% of deals had caps less than purchase price**
- **7% of deals had caps equal to the purchase price**
- **4% were not determinable**

Amount of Caps as a Percentage of Purchase Price

- **26% were less than 10% of purchase price**
- **21% were 10% of purchase price**
- **17% were greater than 10% up to 15%**
- **17% were greater than 15% up to 25%**
- **5% were greater than 25% up to 50%**
- **5% were greater than 50% but less than price**
- **9% were purchase price**

Cap Carveouts

- **64% carved out fraud**
- **46% carved out capitalization**
- **43% carved out due authority**
- **40% carved out taxes**
- **37% carved out intentional breach**
- **29% carved out due organization**
- **29% carved out ownership of shares**

Indemnification as Exclusive Remedy

- **Indemnification is often explicitly stated to be exclusive remedy**
- **Query whether the baskets, caps and survival periods have any meaning if indemnification is not the exclusive remedy**

Exclusive Remedy Provision

- **77% of transactions state that indemnification is the exclusive remedy**
- **13% state that remedy is not exclusive remedy**
- **10% are silent on relation of indemnification to claims based on breach**

Carveouts from Exclusive Remedy Provision

- **40% exclude intentional misrepresentation**
- **45% exclude equitable remedies**
- **81% exclude fraud**
- **17% exclude breach of covenant**

Mechanisms for Collection

- Escrows
- Holdbacks
- Set-offs against payments on other agreements
- What goes in the escrow?
- Is the escrow the exclusive remedy?

Relationship of Escrow/Holdback to Indemnification

- **13% - no escrow or holdback**
- **32% - escrow/holdback as exclusive remedy**
- **4% - escrow/holdback/earn-out as exclusive remedy**
- **51% - escrow/holdback not exclusive remedy**

Escrow/Holdback as a Percentage of Transaction

- **26% are 5% or less of transaction cost**
- **47% are greater than 5% and up to 10%**
- **22% are greater than 10% up to 25%**

Stand Alone Indemnities

Indemnities outside of Breaches

- **4% ERISA**
- **10% Environmental**
- **31% Taxes**
- **51% Other – such as scheduled items, excluded liabilities, pre-existing liabilities and transaction expenses**

Express Mitigation (Reduction of Buyer Claims)

- **31% have an express setoff for tax benefits**
- **63% have an express setoff for insurance proceeds**
- **22% buyer has an express obligation to mitigate losses**

Type of Damages Covered

- **3% limited to Out of Pocket Damages (and 97% not so limited)**
- **25% includes diminution in value and 10% exclude diminution in value (rest silent on issue)**

Type of Damages Included and Excluded

- **16% exclude incidental damages and 5% include incidental damages**
- **31% exclude consequential damages and 6% include consequential damages**
- **34% exclude punitive damages and 3% include punitive damages**

Liability of Multiple Indemnitors

- **41% were joint and several**
- **35% were joint and not several (“pro rata”)**
- **24% silent on the issue**
- **See Section 11.2 of MAPA**

Sandbagging

- **What is sandbagging?**
- **Closing on a deal knowing that you will have a claim for indemnification that will reduce the effective purchase price**
- **Reason to avoid sandbagging provision is to avoid indemnification claim becoming an inquiry into the buyer's knowledge and state of mind**

Pro-Sandbagging Provision

- **Second part of Section 11.1 of MAPA has a pro-sandbagging provision**
- **“The right to indemnification ... shall not be affected by any investigation ... conducted ... or any Knowledge acquired ... at any time, whether before or after the execution and delivery of this Agreement... .”**

Anti-Sandbagging Provision

- “The Buyer shall have no right to indemnification under this Agreement in respect to an inaccuracy or breach of representation or warranty of the Sellers to the extent that any individual listed in clause (iii) ... has actual knowledge on the date of this Agreement that such representation and warranty is inaccurate as of the date of this Agreement.”

Cases of Buyer Closing With Knowledge of Breach

- *CBS Inc. v. Ziff-Davis Publishing Co.*, 553 N.E.2d 997 (N.Y. 1990), where court upheld indemnification notwithstanding buyer's knowledge of breach
- *Galli v. Metz*, 973 F.2d 145 (2d Cir. 1992), which distinguished *Ziff-Davis* and held that buyer foreclosed from suing on breach disclosed by seller
- *Hendricks v. Callahan*, 972 F.2d 190 (8th Cir. 1992) to similar effect
- Unclear of enforceability of a provision allowing sandbagging in light of the above

Procedural Structuring

- **Procedures for indemnification of third party claims – See Section 11.9 of the MAPA**
- **Procedures for indemnification for issues not involving third party claims – See 11.10 of MAPA**

Conclusion

- **The definition of what constitutes damages in the context of a merger and acquisition agreement is a refined calculation**
- **Indemnification in the mergers and acquisitions constitutes tailoring an agreement to a unique set of facts**

