

# INDEMNIFICATION AGREEMENTS IN COMPLEX BUSINESS TRANSACTIONS

Understanding what your company is agreeing to up front and strategies to strengthen provisions when a claim arises.

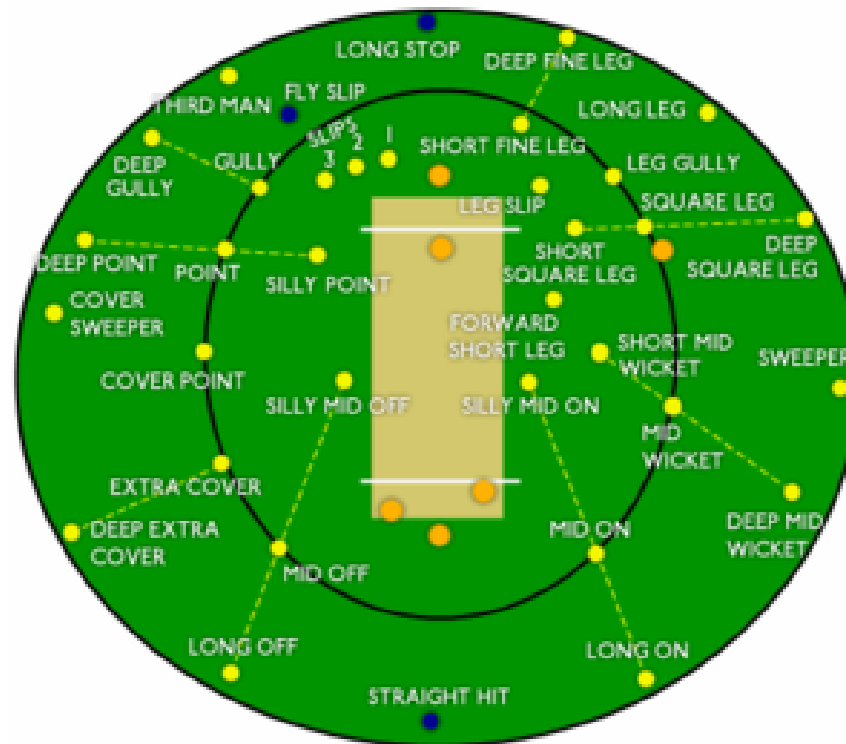
# Indemnity, Contribution, Subrogation - - OH MY

It is hard to imagine another set of legal terms with more sophoric effect than, indemnity, subrogation, contribution, co-obligation and joint tortfeasorship. . . . Even lawyers find words like “indemnity” and “subrogation” ring of an obscure Martian dialect.

*Herrick Corp. v. Canadian Ins. Co.*, 29 Cal. App. 4<sup>th</sup> 753, 34 Cal. Rptr. 2d 844 (4<sup>th</sup> Dist. 1994).

# BUT, LESS COMPLICATED THAN . . .

- The Rules of Cricket



# TODAY'S PROGRAM

- Indemnification, and the interplay between Indemnity, Contribution and Subrogation.
- The impact of power in negotiating terms and conditions.
- Why boilerplate provisions do NOT work.
- Drafting enforceable provisions that reflect the risks being shifted.
- The relationship between indemnification agreements and insurance agreements.
- Alternatives to traditional risk-shifting provisions.

# Indemnification Provisions

- Purpose: to shift a legal responsibility from one party to another, providing a contractual remedy to recovering monetary damages in the event of:
  - Breach of a covenant.
  - Breach of a representation or warranty.
  - Claims by third parties against the Indemnitee (usually lawsuits, requiring defense and settlement payments).
  - Breach of other terms of the particular contract.

# Indemnification Provisions (cont'd)

- Benefits of contractual approach (vs. fraud or breach of contract claims):
  - Eliminate ambiguity about survival/breach of representations (specific indemnity).
  - Make clear that all breaches (even unintentional ones) are indemnifiable.
  - Inclusion of expenses (attorney fees) within the scope of the indemnity – note, however, may still need a “prevailing party” provision.
  - Set out procedures for handling claims (3<sup>rd</sup> party claim defense issues).
  - Include specific/negotiated matters that are not breaches (taxes, disclosed litigation).
  - The ability for the parties to agree to limits on liability (caps, thresholds, survival, etc.).

# Alternatives to Indemnity

- Additional insured status.
- Specific remedies stated in the contract (e.g. rescission).
- Escrow accounts/Rep and Warranty insurance
- Contract price adjustments.
- Accelerated or deferred payment provisions.
- Creation of a subsidiary.

# Actions to Recover following a loss

- **Contribution:** A party that pays more than its fair share of a loss can seek recovery from a party bearing the same or greater obligation.
- **Indemnity:** A party agrees to take on the obligations of another party in the event of a loss.
- **Subrogation:** A party (usually an insurer) pays on behalf of one party can recover against the responsible party or another party that is obligated to pay.

# The problem with boilerplate provisions

- No one really understands them. Terms are often outdated, or worse, do not reflect the risks that the contract creates.
- For every type of transaction, consider:
  - Who is being indemnified?
  - What events trigger the duty to indemnify?
  - How much liability is being shifted?
  - Notice and cooperation requirements for recovery.
  - Financial well-being of indemnitor.
  - Interplay with insurance provisions.
  - Bargaining power of Seller/Vendor/Lessor and Purchaser/Customer/Lessee dictates the outcome of the indemnification provisions.

# BARGAINING POWER SCENARIOS

- Supply-Chain Contract, Unequal Bargaining Power
- Lease, Equal Bargaining Power
- Asset Purchase Agreement, Unequal Bargaining Power

# Supply Chain Scenario

- Bridget sells Widget007, a vacuum cleaner that works on solar power.
- Widget manufactures the Widget007, based on specifications and designs provided by Bridget.
- Widget is the only US-based company with the ability to manufacture the Widget007.
- Widget's business, outside of the Widget007, has dropped off dramatically, due to the economy and product liability suits.

# Scenario #1: Unequal Bargaining

- Bridget – The Power player wants:
  - Indemnity for any claim that arises, even if due to Bridget's own fault.
  - Defense for any claim.
  - Additional insured status on Widget's liability policies.

# Bridget's Proposed Indemnity Provision

Widget agrees to indemnify and hold harmless Bridget and its agents from and against any and all claims or suits for:

- i. bodily injury to persons whether employees of Bridget or otherwise, and
- ii. property damage arising out of the Widget007 and all other damage, direct or indirect, of whatsoever nature, resulting from Bridget's use, sale or distribution of the Widget007, however caused, including Bridget's sole or partial negligence. It is expressly understood that this provision shall survive the performance of this Agreement.

# Bridget's Proposed Defense Provision

Widget agrees to defend Bridget for any claim, suit or loss allegedly attributable to bodily injury or damage to property arising out of Bridget's use of the Widget007, even if Bridget is solely at fault for such bodily injury or damage.

# Widget's Negotiation Goals

- Recognizes that Bridget's power in the negotiations will result in the inclusion of a unilateral indemnification provision in Bridget's favor.
- Does not want to take on indemnification for design defects.
- Agrees to indemnify Bridget for any claims that are subject to this Agreement, but does not want to provide defense up front.

# Widget's Proposed Indemnity

Widget proposes to indemnify Bridget for sums that Bridget becomes legally obligated to pay as damages for:

- i. bodily injury to persons whether employees of Bridget or otherwise, and
- ii. property damage arising out of the Widget007 caused by "Widget's fault".

For purposes of this provision, "Widget's fault" shall mean a manufacturing defect, design defect or negligent failure to warn with respect to products manufactured by Widget and supplied to Bridget pursuant to this Agreement. Widget agrees to indemnify Bridget for reasonable legal expenses incurred by Bridget in the defense of any suit seeking such damages. Widget shall have no obligation to indemnify Bridget for any damages caused by Bridget's fault or for any legal expenses incurred by Bridget in defending itself against suits seeking damages caused by Bridget.

# Negotiations

- Bridget wants to have the Widget007 manufactured in the U.S., so agrees to a more limited indemnity provision.
- Widget agrees to provide a defense as well as indemnity to Bridget.

# Final Indemnity Provision

Widget agrees to indemnify and hold harmless Bridget and its agents from and against any and all claims or suits for:

- i. bodily injury to persons whether employees of Bridget or otherwise, and
- ii. property damage arising out of the Widget007 and all other damage, direct or indirect, of whatsoever nature, resulting from Bridget's use, sale or distribution of the Widget007, caused in whole or part by Widget. It is expressly understood that this provision shall survive the performance of this Agreement.

# Final Defense Provision

Widget agrees to defend Bridget for any claim, suit or loss allegedly attributable to bodily injury or damage to property arising out of Bridget's use of the Widget007 caused in whole or part by the fault of Widget, even if Bridget is partly at fault for such bodily injury or damage.

# Final Insurance Provision

Widget shall obtain and maintain in full force during the performance of this Contract and six months thereafter: Commercial General Liability insurance endorsed to include products/completed operations; contractual liability (covering Widget's indemnity obligations set forth in the Contract); with a financially sound and reputable insurer having a financial strength rating of at least A- by A.M. Best Company; in the amounts of \$1,000,000 per occurrence and \$2,000,000 in the aggregate. Further, such policy shall name Bridget and its agents as an additional insured.

# Insurance Due Diligence

- Widget provides Bridget with a certificate of insurance that shows limits of liability in the requested amounts.
- Bridget does not ask for a copy of the policy itself, and does not ask to see the endorsement.
- Widget's policy is subject to a \$500,000 self-insured retention, does not provide coverage for products/completed operations and the endorsement adds Bridget to the extent required by contract.

# WIDGET007 Lawsuits

- The Widget007 does not perform as advertised. It destroys carpet, turns on automatically if left in a sunny room and explodes, causing property damage and bodily injury claims.
- Lawsuits are filed across the country, alleging design defect claims only.

# HOW does Bridget fare?

- Bridget submits claims for defense from Widget and Widget's insurer.
- Widget asserts that the indemnification provision does not apply, because Bridget designed the Widget007.
- Widget's insurer asserts there is no coverage because:
  - \$500,000 SIR
  - Insurance is limited to the contract, and Bridget is solely liable.
  - Bridget's own insurance is primary to the insurance issued to Widget.

# Landlord-Tenant Scenario: Equal Bargaining Power

- During the real estate boom, Ben purchased Uptown Office Building. Due to the recent recession, there is less interest in renting Uptown Office Building.
- Jerry is relocating his operations from Vermont. Jerry will receive tax benefits and incentives if he moves his operations to the uptown Charlotte area.
- The Uptown Office Building is the perfect site for Jerry's operations, both in terms of size, build out and price.
- Ben has other potential tenants, but wants the benefit of having Jerry as a corporate tenant.

# Negotiations

- Ben wants Jerry to indemnify him for all claims, even if caused by Ben's fault exclusively and wants defense for claims.
- Jerry rejects that language and seeks indemnification from Ben as well.
- Because neither has more power than the other, they agree to use reciprocal indemnity provisions.

# Reciprocal Indemnity Provisions

- Ben agrees to indemnify Jerry for claims that Jerry becomes legally obligated to pay for bodily injury and property damage caused by Ben's sole negligence.
- Jerry agrees to indemnify Ben for claims that Ben becomes legally obligated to pay for bodily injury and property damage caused by Jerry's sole negligence.
- The indemnity obligations will not be enforceable for any claims that are caused by a change or alteration made by the Indemnitee to Uptown Office Building.

# What happens when suit is filed?

- No upfront duty to defend. Reasonable cost of defense will be reimbursed by the party found wholly liable.
- Depending on language of indemnity agreement, any indemnity obligation could be limited to suits based on the sole negligence of one party.
- Insurance availability depends on whether both parties agreed to name the other as an additional insured.
- Insurance also depends on the insurance provision.

# M&A Scenario

- It is 2011 and it is a buyer's market.
- Widget, a subsidiary of Parent, and a private company, is negotiating the sale of substantially all its assets to Bridget.
- Widget has a pending product liability lawsuits.
- Widget's business, apart from the Widget007, has dropped off dramatically.
- Widget is the only company in the US that manufactures the Widget007 and sales have risen increasingly over the years.
- The purchase price for the assets is discounted.

# M&A Negotiation Positions: Identifying Indemnitors and Indemnities

- Who Is Indemnified?
  - Whether the Indemnitee is the Buyer/Seller, both will want to ensure the indemnification covers at least the following
    - Affiliates
    - Employees
    - Representatives
- APA vs. SPA:
  - In an asset deal, the Seller may end up as a shell with no resources. Buyer in this scenario would want to make Seller's parent or controlling stockholder joint and severally liable for indemnification.
  - In a stock deal, the stockholders of the target company will indemnify the Buyer.

# M&A Negotiation Provisions: Categories of Indemnified Liabilities

## Buyer:

### Most Common

- Breaches of Representations (during the applicable survival period – i.e. power and authority)
- Breaches of Covenants

Faces the greatest risk exposure and will be more focused on obtaining indemnification protection

## Seller:

### Most Common

- Breaches of Representations and Warranties (during the applicable survival period)
- Breaches of Covenants

### Other Indemnities commonly covered:

- Pre-Closing Taxes
- ERISA Issues
- Transaction Expenses
- Indebtedness

### Specific Items:

- Known Litigation
- Known Environmental Liability

# M&A Negotiation Positions: Survivability

- Representations and Warranties; Survival:
  - Seller: Wants representations and warranties to terminate soon after Closing.
  - Buyer: Wants representations and warranties to last as long as possible.
- Final Survival Provision:
  - Representations and Warranties have finite survival period (median 12-18 months)
  - Exceptions for fundamentals representations (capitalization, ownership, power and authority) (some have specific survival periods, but not all)
  - Special survival periods – tax, environment, ERISA
  - Covenants and specific indemnities typically survive

# M&A Negotiating Positions: Monetary Thresholds

## Limitations on Indemnification:

- Basket (\$ amount of losses that must be suffered by Buyer before Buyer can seek recovery from Seller)
    - True deductible (Buyer bears cost of deductible) vs. threshold that tips back to dollar one or combination (once basket limit met, Seller pays all losses, including losses for items in the basket) (95% of deals have basket; of those, slightly more than half have deductible formulation; size – few > 1%; carve outs here, too)
  - Cap (86% of deals have one that is less than Purchase Price; median is between 10 and 20%, but number really is higher because often many reps are carved out)
  - De minimus - (only about one quarter of deals include this)
  - Applicability – to reps and warranties only or to any other indemnified matters
- Exceptions
- Retained liabilities
  - Fraud
  - Hot button issues (i.e. environmental)

# M&A Negotiation Positions: Materiality Scrape

- Materiality Scrape
  - Buyers often try to say that indemnification for breaches of reps and warranties is “without regard to materiality, in all material respects, MAE or other such qualifiers” (24% of deals have this)
    - Without regard to materiality for determining damages (32% of subset)
    - Without regard to materiality for determining whether an underlying breach occurred

# M&A Negotiation Positions: Updated Disclosure Schedules

- Updated Disclosure Schedules
  - Intersection of closing conditions and indemnification
  - If the Seller updates Disclosure Schedules, do indemnification obligations flow from the initial Disclosure Schedule, or from the Schedules as supplemented?
  - A Seller may want to limit a Buyer's right to walk away from the deal to only significant items in the updated Schedules (conditions)
  - A Buyer may want to carve-out items in updated Schedules from the basket, cap and other monetary limitations (indemnification)

# M&A Negotiation Positions: Exclusive Remedy

- Exclusive Remedy
  - Indemnification provisions often purport to be exclusive:  
“...the remedies provided in this Section will be the parties’ exclusive remedies for claims arising out of or resulting from any misrepresentation, breach of warranty, breach of covenant, or nonperformance of any obligation to be performed on the part of either party under this Agreement...”
  - Carve-out for fraud

# M&A Negotiation Positions: Damage Exclusions

- Buyer will often push to exclude the following (often these are boilerplate):
  - Incidental Damages
  - Special or Exemplary Damages
  - Consequential Damages
  - Punitive Damages
  - Lost Profits
  - Damages based upon diminution in value of the Business or any multiple thereof
  - Multiples of Revenue or EBITDA
  - Lost Profits

# M&A Negotiation Positions: Seller Friendly (Anti-Sandbagging)

- Seller-Friendly (Anti-Sandbagging)
  - Limits the Buyer's remedies for an inaccuracy of a Seller's representation or warranty or breach by the Seller by prohibiting indemnification in respect of any matter as to which the Buyer had knowledge prior to Closing

*"No claim for indemnity for a breach of a particular representation, warranty or covenant shall be made after the Closing if the Buyer had Knowledge (including by virtue of any Disclosure Schedule) of such breach as of the Closing."*

# M&A Negotiation Positions: Buyer-Friendly (Pro-Sandbagging)

- Buyer-Friendly (Pro-Sandbagging)
  - Reinforce the Buyer’s bargained-for recourse against a Seller’s breach of representation, warranty or covenant notwithstanding any knowledge or awareness the Buyer may have obtained
  - The ABA Model Asset Purchase Agreement contains the following pro-sandbagging provision:

*“The right to indemnification, reimbursement or other remedy based upon such representations, warranties, covenants and obligations shall not be affected by an investigation (including any environmental investigation or assessment) conducted with respect to, or any Knowledge acquired (or capable of being acquired) at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of or compliance with any such representation, warranty, covenant or obligation.”*

# M&A Negotiation Positions: Sandbagging (Other)

- Silent – Dependent on governing law and case law
- 50% of deals are silent; 40% have pro-sandbagging (Buyer favorable) and only about 10% have anti-sandbagging provisions

# M&A Negotiation Positions: Reductions

- Reductions
  - To the extent taking into account in the working capital adjustment (double counting)
  - Insurance recoveries
  - Tax benefits

# M&A Negotiation Positions: Collection – Is funding the indemnity obligation necessary?

- Indemnity
- Holdback
- Set-offs
- Guaranty

# M&A Negotiation Positions: Duty to defend separate from duty to indemnify

- The non-defending party should have the right to defend a claim if the other party fails to defend or chooses not to so.
- The non-defending party should have the right, at its sole option and expense, to be represented by counsel of its choice, if the counsel is reasonably acceptable to the defending party.

# Tips and strategies: USE DEFINING TERMS

- Define with specificity the losses and damages that are intended to included AND excluded in the indemnity agreement.
  - Consequential damages, economic losses
  - Fees and expenses
  - Fines and penalties
  - Costs
- Define “claims” that will be indemnified.
- Define “acts” that give rise to indemnification

# Tips and Strategies: Scope of Indemnification provision

- Survival of provision after Contract is terminated
- Exclusive right of recovery
- Notice provision and other rules to protect the Indemnitor or Indemnatee
- Address third party beneficiaries in agreement
- Who controls the defense, selects counsel if a defense is provided
- Consent to settlements
- Remedies for refusal to indemnify

# Public Policy Considerations

- Anti-indemnification provisions.
  - Typically limited to construction contracts
  - Some states apply it to certain landlord-tenant situations
- Use separate clauses for indemnity and insurance.

# Who pays first? Indemnitor or Insurer?

- No uniformity of case law.
- Insurance provision should specifically state that it is the express intent of the parties that insurance will be applied first, and that indemnification obligation is available only if there is no insurance available.
- Reciprocal indemnity provisions, and mutual obligation to add each party as an additional insured will end up in a nullity if both parties are sued.

# Waiver of Subrogation

- Endorsement to a policy whereby an insurer gives up the right to take action against a third party for a loss suffered by an insured. Typically, under terms of the “Right of Recovery” clause, the insurer, having paid an insured for a loss, takes over any rights possessed by the insured who has suffered the loss.
- This should be part of the Additional Insured endorsement.
- If there is no waiver, after paying the loss, the insurer who pays can seek indemnification from the other party.

# Tips and Strategies: Insurance Provisions

- Understand additional insured status.
- If specific insurance (i.e. products) is required, confirm through review of policy.
- Certificates v. endorsements.
- Limits are capped, know who else is an additional insured.
- Best's ratings

# Representation and Warranty Insurance

- Relatively new product.
- Buyer/Seller.
- Alternative to escrow/indemnity.
- Will track the reps and warranties, including any caps, sub-limits and time periods.
- Not available for ERISA.
- Lenders Loss Payee/Additional Insured status

# Questions or Comments?

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