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Limiting Indemnification in Acquisition Agreements

By Ronald Dweck

Among the essential elements in an agreement to purchase a company or its assets are the "indemnification" provisions. The selling company or its owners are generally required to indemnify the buyer against damages that the buyer may sustain because of breaches of the representations, warranties and covenants contained in the acquisition agreement. It is important for the sellers to negotiate meaningful limitations to the indemnification obligations. Those limitations take various forms, and often are the subject of intense negotiations.

In order to bridge whatever gap exists between the parties, it is helpful to recognize that there are certain fundamental representations and issues that typically are not subject to the same limitations as other matters. These may include that the seller owns all of his or her shares free of liens, that the description of the capitalization is accurate, thus making certain the owners and option holders are known, that taxes have been paid, and depending on the type of business, that there are no environmental claims.

Important tools for *limiting* indemnification include (1) the survival period for claims, (2) baskets, (3) eligible claim thresholds and (4) an overall cap on the amount of claims:

1. The “survival period” is the timeframe during which claims for indemnification may be brought. The sellers are responsible only if the claims are made before the end of the survival period. The sellers want to limit claims by the buyer made within a year or two after closing, but should recognize that a longer period is reasonable for the fundamental representations.

2. A “basket” provides that sellers will not indemnify the buyer until the indemnification claims exceed a certain dollar amount. If the sellers are responsible for only the excess, this is a “deductible” basket. Alternatively, there is a “first dollar” basket, in which the sellers are also not responsible to indemnify for losses until a certain threshold is reached. If that total is achieved, the sellers are responsible for the aggregate amount of losses regardless of the threshold. There may be some exceptions from the basket for fundamental representations and taxes.

3. An “eligible claim threshold” excludes individual and unrelated claims under a specific dollar amount (e.g.. $10,000) from an indemnification obligation. Basically, the parties are agreeing not to sweat the small stuff.

4. The ”cap” is the limit on indemnity claims for which the seller can be held responsible . It can be expressed as a dollar amount based on a percentage of the total transaction value. In certain cases, fundamental representations and taxes are also carved out of the overall cap. There can also be special caps for certain types of issues.

Moreover, the amount of dollar thresholds, limits and carve outs are all subject to negotiation and many variables; there is no one shoe that fits all. The nature of the business, the particular concerns of the buyer with respect to particular issues and the willingness of the seller to be subject to some appropriate amount of risk, all come into play. An honest evaluation of the allocation of risk among the buyer and seller is important to reaching an agreement. Creative thinking in negotiating the indemnification provisions can help the parties get to the finish line.

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