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CORPORATE LAW

Indemnification Insomnia

Is the negotiation of your client's Stock Purchase Agreement keeping you up at night?

By Henry M. Matri and Jordan A. Fisch

What keeps you up at night? Are you concerned about financial matters, health concerns or family issues, or if you are a transactional attorney, are you tossing and turning over whether you represented your client well in the negotiation of its Stock Purchase Agreement? In particular, did you seek the best possible result for your client when you negotiated and drafted the indemnification clause in the Stock Purchase Agreement? Hopefully this article will help you sleep easier in the nights to come.

Black's Law Dictionary defines the term "Indemnify" to mean "To restore the victim of a loss, in whole or in part, by payment, repair, or replacement. To save harmless; to secure against loss or damage; to give security for the reimbursement of a person in case of an anticipated loss falling upon him. To make good; to compensate; to make reimbursement to one of a loss already incurred by him." *Black's Law Dictionary*, 769 (6th Ed. 1991). The purpose of an indemnification clause is to contractually transfer liability from one contract party to another and to provide for a reimbursement mechanism in the event of a loss suffered by a contract party following the closing of a transaction due to the actions, inactions or conduct of the other contract party. Unfortunately, there is no uniform form of indemnification clause, and attorneys for sellers and buyers spend countless hours drafting and negotiating the provisions of an indemnification clause.

What losses and liabilities should be covered by an indemnification clause, for what period should an indemnification obligation remain open, and what limitations should be imposed on the indemnification obligations are all issues which a buyer and seller discuss as part of their negotiation of a Stock Purchase Agreement. In a buyer's perfect world, the indemnification clause would simply provide that the seller's obligation to indemnify survives closing indefinitely, and that the sellers (if there is more than one seller) are jointly and severally liable for any breach of their representations and warranties, as well as any losses incurred by the buyer as a result of (i) a breach of any covenant, obligation or agreement of the sellers; (ii) any liabilities not assumed by the buyer; (iii) the sellers' prior ownership and operation of their business; and (iv) the enforcement of the agreement against the sellers. Of course, counsel for sellers want to limit the scope of the indemnification and so, as attorneys, we engage in substantial and meaningful negotiations to arrive at the final form of indemnification.

Accordingly, following is an introduction to the indemnification issues and topics to consider in the purchase or sale of the stock of a closely held corporation.

1. Indemnification claims for losses suffered by buyer. This list would include losses as a result of (i) a breach of the representations and warranties of the sellers; (ii) a breach of any covenant, obligation or agreement of the sellers; (iii) liabilities of the sellers and the company not expressly assumed by the buyer; (iv) the sellers' prior ownership and operation of the business; (v) the enforcement of the agreement against the sellers; and (vi) certain enumerated items which might be set forth on an Indemnification Schedule. The Indemnification Schedule would focus on defects discovered during the due diligence period that are to be corrected within a short period of time following closing. The Indemnification Schedule may also include specified matters that shall result in liability to the sellers

Matri and Fisch are members of Cole, Schotz, Meisel, Forman & Leonard of Hackensack. Matri is chairman of the corporate & business transactions department. Fisch is a member of the department, concentrating in business transactions.

without the benefit of materiality or dollar limitation qualifiers contained in the representations and warranties section of the Stock Purchase Agreement or that will not be subject to "caps" and "deductibles" discussed later in this article. Should the buyer's claims for indemnification for breach of the sellers' representations and warranties be mitigated by the buyer's knowledge of an event or condition that results in or is the cause of the sellers' breach of their representations and warranties? If yes, whose knowledge is relevant — buyer's officers, directors, employees, agents, etc.?

2. Survival. Should there be a contractual end date to the sellers' potential liability to buyer for indemnification, or should the sellers' liability continue indefinitely? If the period is to be limited, how long should the period be? Negotiations can include anything from a period of months or years (typically two years) or the statute of limitations with respect to certain claims for indemnification such as tax matters and environmental representations. It can be beneficial to buyers to use the period of the statute of limitations to measure the period during which post-closing environmental indemnification claims can be made. In many cases, the statute of limitations will not start to run until the buyer discovers the environmental problem, which could add years to the open period for claims or even cause the claim to exist without limitation. It is not unusual to have no time limit for claims concerning stock ownership and capitalization. Factors such as deferral of the purchase price, existence of escrows or payment of a royalty or earn-out following closing should be taken into account when negotiating the survival period for indemnification claims. Buyers, in particular, find fault where they discover a defect that is no longer actionable due to limitations in the Stock Purchase Agreement while they are still contractually bound to pay earn-out amounts, deferred purchase price or royalties.

3. Joint and several liability. If there is more than one selling shareholder, are all shareholders jointly and severally liable for all indemnification claims, or are the shareholders jointly and severally liable for all representations concerning the company, but only individually liable for their own representations concerning their respective stock ownership?

4. Damages. The sellers will want to limit damages to out-of-pocket payments and actual losses, while the buyer will seek to expand damages to include incidental and consequential damages, together with the costs of investigation and attorney's fees. The sellers will often request that the indemnification claim be net of any tax benefit received by the buyer as a result of the loss and that the indemnification be net of any insurance proceeds or other third-party payments available to the buyer. A savvy buyer might insist that the amount of premium paid for the insurance should reduce the off-set available to the seller with respect to the insured claim.

5. Limitations on amount, caps, deductibles and baskets. Should there be a limit to the sellers' liability to the buyer (or a "cap")? Generally the cap is the amount of the purchase price paid to the sellers. However, in large transactions, it is not unusual for the seller to request a cap of less than the purchase price, which may be accepted by the buyer if it has had the opportunity to conduct meaningful financial and legal due diligence. The seller will normally negotiate for a minimum amount that must be exceeded before the buyer is entitled to indemnification. This is often referred to as the "basket." The basket can be a real deductible, in which case the amount of the basket is a dollar for dollar reduction in the amount of the indemnification obligation. The basket can also be a "threshold," in which case there is no indemnification until the threshold amount is reached, and then indemnification is owed in the total amount of the loss with no deduction for the basket amount. The buyer's due diligence may disclose certain problem areas which may be excluded from the deductible or cap limitations. For example, claims relating to unpaid taxes, environmental matters and ERISA matters are often excluded from the cap and basket limitations. In addition, claims relating to sellers fraud or willful failure to comply with a covenant or obligation should be excluded from the deductible and cap limitations.

6. Escrows and set-offs. How will the buyer recover from the sellers? In most cases, an escrow should be established at closing to ensure that funds will be available to fund claims against the sellers. The sellers will want funds to be released from the escrow over time, as the likelihood of a claim for indemnification diminishes. The buyer will want to hold the escrow until the survival period has expired. If a portion of the purchase price is deferred to a later date, or if the sellers are entitled to a royalty payment or earn-out, the escrow can be reduced or eliminated if the buyer is provided with a right to set-off losses against the obligation to make those later payments.

7. Procedure for indemnification claims. Who will assume the defense of claims made against the buyer? What will be the procedure for notifying the sellers if they are to assume the defense? At what point in time should the buyer provide the sellers with notice of a potential claim? Should the buyer wait until a claim is made, or should the buyer give the sellers notice of threatened claims? Will the buyer waive its right to indemnification if it does not give timely notice of a claim? Will the buyer have any input in the selection of counsel? If the sellers are to assume the defense, will there be a time limit by which the sellers must do so before the buyer can assume the defense on its own behalf? Will the buyer be entitled to participate in the proceedings that gave rise to the claim for indemnification? If the sellers assume the defense, will the buyer have input in settlement negotiations with third-party claimants, or the right to approve any settlement? If the claim for indemnification involves a claim seeking equitable relief, will the buyer be entitled to retain control of the

defense?

Generally, the party seeking indemnification is required to give written notice to the other party of the claim which should include a reasonably detailed explanation of the facts. The notice must be given within the time limits agreed upon by the parties and should be given within a short period of time following the indemnified party's becoming aware of the claim. If the claim is being brought against the company or the buyer by a third party, the seller is often given the ability to assume the defense of the claim if the seller acknowledges responsibility for the claim. The buyer may participate in the defense assumed by the seller, but only at buyer's own expense.

8. Sole remedy. Often, sophisticated sellers' counsel requests the indemnification clause provide that those provisions are the sole remedy of the parties with respect to the sale transaction. This provision would eliminate the buyer's right of rescission in a case where it could otherwise show that the breaches of the seller are so significant as to negate the entire transaction. This would be particularly irritating to a buyer whose monetary recovery is limited by caps and deductible baskets in the transaction.

Because of the complex nature of indemnification clauses and the myriad of issues presented when drafting and negotiating indemnification clauses, it is strongly recommended that you consider the issues discussed in the preceding paragraphs and review them with your client. For a further discussion of this subject please see, American Bar Association, Section of Business Law, Committee on Negotiated Acquisitions, Model Stock Purchase Agreement with Commentary (1995). As discussed earlier, countless hours have been spent negotiating indemnification clauses due to their complexity and importance, and the sleep patterns of many transactional attorneys have been disrupted. While this article may not be a cure to all of your sleepless nights, hopefully it will help ease some of your concerns. Sleep tight. ■