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Indemnification Provisions in Business Acquisition Agreements

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In most acquisitions of privately-held companies, the seller and/or shareholders may be required to indemnify the buyer. The exceptions usually involve financial sellers or situations in which ownership is widely held. The common law definition of "indemnification" generally covered only reimbursement for payments to a third party. In an acquisition context, the term has been interpreted to go beyond reimbursement of third-party claims and to encompass losses or damages from any source.

If a buyer sustains a loss following an acquisition, it might be entitled to indemnification under common law. However, express indemnification provisions will afford a buyer greater certainty with respect to its right to recover and will set out contractually the rights and obligations of the parties. For example, most indemnification provisions are drafted to set out the parties and how the defense will be conducted. For example, in the event that the buyer is served with a lawsuit related to pre-closing or business matters, the agreement may require that notice be given to the seller, with the seller having the right to select counsel to defend the buyer. Express provisions can also expand the scope of indemnification, expand or limit the recoverable losses and add to those liable for indemnification and those entitled to recovery. For the seller, express provisions are crucial because they will specify in detail various limitations on a buyer's right to recover. Therefore, this provision could potentially limit the seller's liability.

Indemnification generally will cover inaccuracies of representations and breaches of warranties and covenants in an acquisition agreement. Often the scope of a seller's indemnification will be expanded to include the disclosure schedules, supplements to the disclosures, and other certificates, documents or writings.

In many instances, indemnification provisions cover certain types of liabilities that may be of particular concern to the buyer, such as taxes, products liability, environmental matters and employee benefit plans. There can be other matters, such as pending litigation, that are to remain the responsibility of the seller even though they are disclosed to the buyer as an exception to the representations and warranties. These matters can be dealt with by adding a separate paragraph to the general indemnification provisions of the agreement. Officers, directors, employees, and affiliates of a buyer often are included as indemnified parties on the theory that they may be subject to litigation or otherwise sustain losses. In a stock transaction, indemnification is provided by the selling shareholders. In an asset transaction, the selling entity will indemnify the buyer.

Sellers usually will insist on a minimum dollar amount for which they will not be liable for indemnification, largely to avoid being subject to recovery for insignificant amounts. This provision would allow recovery for only the excess of the loss over a specified dollar amount after a certain threshold is met. Sellers usually also want a maximum dollar limit (called a "cap" or "ceiling") on the amount of liability. The concern is the seller could be liable under an indemnification paragraph for an amount greater than the purchase price. Additionally, the agreement may require that the buyer indemnify the selling entity for post-closing matters relating to the operations of the business.

This issue of indemnification comes up in many types of agreements including commercial real estate acquisitions, loan documents, employment agreements, property management agreements, etc.

The issue should be carefully reviewed in the contract of any transaction. For further information contact: Harriet B. Alexson, a Professional Law Corporation, One Corporate Plaza, Suite 110, Newport Beach, CA 92660, telephone (949) 219-0442, facsimile (949) 640-9009, e-mail: hbeth@alexsonlaw.com.

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