

Don't Get Chomped!

**Mitigating Risk
Through
Indemnification and
Liability Caps**

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What Is an Indemnification Clause?

- A legally binding contractual agreement pursuant to which one party (referred to as the “indemnifying party”) agrees to compensate another party (referred to as the “indemnified party”) with respect to liabilities arising out of certain things.
- While it may be implied by state law, most commercial agreements contain an express indemnification provision so that the parties can customize their indemnification rights and obligations.

Why Is an Indemnification Clause Important?

- Allows the contracting parties to reduce uncertainty and efficiently manage liability risk.
- Without an indemnification clause, the indemnified party may not be able to recover certain types of damages, such as attorney's fees.
- The indemnifying party may not be able to reduce its liability by incorporating a liability cap and a deductible.

Components of an Indemnification Clause

- **Obligation to Indemnify:** Obligation of the indemnifying party to reimburse the indemnified party.
- **Obligation to Defend:** Obligation and right of the indemnifying party to assume and control the defense of a claim.
- **Obligation to Hold Harmless:** In practice, the phrase “indemnify and hold harmless” is generally taken together as a unit to mean indemnity.
 - However, in some states, “hold harmless” language may be construed to require the indemnifying party to: (i) make advance payments for losses; and/or (ii) release the indemnified party from any related direct claims or causes of actions.

Scope of Indemnification

- Common Types of Covered Events
 1. Breach of contract
 2. Negligence of the parties
 3. Bodily injury / death
 4. Non-compliance with laws
 5. Intellectual property infringement
- Common Types of Recoverable Damages
 1. Losses: Any covered judgments, settlements, fees, costs and expenses
 2. Liabilities: Debts and other legal obligations
 3. Claims: Damages resulting from a third-party lawsuit
 4. Causes of action: Damages resulting from a right to seek relief

Example of Indemnification Clause

- "Subject to the terms and conditions of this Agreement, Seller (as "**Indemnifying Party**") shall indemnify, defend and hold harmless Buyer and its officers, directors, employees, agents, affiliates, successors and permitted assigns (collectively, "**Indemnified Parties**") against any and all losses, damages, liabilities, deficiencies, claims, actions, judgments, settlements, interest, awards, penalties, fines, costs or expenses of whatever kind, including reasonable attorneys' fees and the costs of enforcing any right to indemnification under this Agreement, incurred by any Indemnified Party (collectively, "**Losses**"), relating to or arising out of any third-party claim alleging:
 - (a) a breach or non-fulfillment of any of Indemnifying Party's representations, warranties or covenants set forth in this Agreement;
 - (b) any negligent or more culpable act or omission of Indemnifying Party or any of its Representatives (including any recklessness or willful misconduct) in connection with Indemnifying Party's performance under this Agreement;
 - (c) any bodily injury, death of any person or damage to real or tangible personal property caused by the negligent acts or omissions of Indemnifying Party; or
 - (d) any failure by Indemnifying Party to materially comply with any applicable laws."

Negotiating Points for an Indemnification Clause

- Buyer typically seeks broad indemnification from seller.
 1. Buyer will evaluate seller's financial ability to meet seller's indemnification obligations.
 2. Buyer will consider alternatives to indemnification such as:
 - Requiring seller to have insurance.
 - Obtaining a guarantee from seller's parent for seller's indemnification obligations.
- Seller typically seeks to avoid indemnification obligations.
 1. Seller will seek to limit its indemnification obligations by including:
 - A limitation of liability clause that includes seller's indemnification obligations.
 - A deductible.
 2. Seller will seek to make the indemnification obligations mutual.

Why Is a Limitation of Liability Clause Important?

- Limits the potential for damages arising out of the contract.
- Ensures risk for such damages is proportional to the economic benefits received from the contract.
- Without a limitation of liability clause, a contracting party faces:
 1. Potentially unlimited damages.
 2. Risk that is disproportionate to the economic benefits received from the contract.

Components of a Limitation of Liability Clause

- **Consequential Damages Waiver:** Excludes an entire category of damages (indirect damages) and limits liability to direct damages.
 1. Typically includes waiver of damages that are consequential, indirect, incidental, special, exemplary and punitive.
 2. Often in all capital letters and/or bold font, because the waiver can significantly affect a party's rights and statutes may require (and courts may void) the waiver if it is not conspicuous enough for the affected party to notice.
- **Liability Cap:** Limits a party's maximum liability for damages under the contract.
 - Liability can be limited to:
 - A specific dollar amount (“fixed cap”);
 - The total amount of money paid or payable under the contract (“floating cap”); or
 - A combination of a fixed cap and floating cap (“hybrid cap”).

Examples of Limitation of Liability Clauses

- Consequential Damages Waiver:
 - “IN NO EVENT SHALL SELLER BE LIABLE UNDER THIS AGREEMENT TO BUYER FOR ANY CONSEQUENTIAL, INDIRECT, INCIDENTAL, SPECIAL, EXEMPLARY, PUNITIVE OR ENHANCED DAMAGES, OR LOST PROFITS OR REVENUES, ARISING OUT OF, RELATING TO, OR IN CONNECTION WITH ANY BREACH OF THIS AGREEMENT.”
- Liability Cap:
 - “IN NO EVENT SHALL SELLER’S AGGREGATE LIABILITY ARISING OUT OF OR RELATED TO THIS AGREEMENT, WHETHER ARISING OUT OF OR RELATED TO BREACH OF CONTRACT, TORT (INCLUDING NEGLIGENCE) OR OTHERWISE, EXCEED THE TOTAL OF THE AMOUNTS PAYABLE TO SELLER PURSUANT TO THIS AGREEMENT OR \$500,000, WHICHEVER IS LESS.”

Negotiating Points for a Limitation of Liability Clause

- Party that bears the most risk in the transaction typically insists on a contractual limitation of liability.
- Is indemnification included in or excluded from the consequential damages waiver?
 1. Indemnifying party (typically the breaching party or the seller) generally negotiates to include indemnification in the waiver.
 2. Indemnified party (typically the non-breaching party or the buyer) generally negotiates to exclude indemnification from the waiver.
- Is indemnification included in or excluded from the liability cap?
 1. Indemnifying party (typically the breaching party or the seller) generally negotiates to include indemnification in the liability cap.
 2. Indemnified party (typically the non-breaching party or the buyer) generally negotiates to either: (i) carve out indemnification from the liability cap; or (ii) increase the liability cap by an amount proportional to the extra risk undertaken by including indemnification in the cap.

Indemnification and Limitation of Liability in the M&A Context

- In contrast to commercial contracts where the parties are attempting to ensure that the appropriate party is bearing the risk, in an M&A contact it is more likely for buyer to seek indemnification from seller.
- Buyer wants indemnification to be as broad as possible, with very few exceptions from indemnification. Seller wants the opposite.
- In an auction situation with multiple bidders, buyer will sometimes use the absence of seller indemnity as a deal sweetener.

Common Types of Covered Claims in the M&A Context

- Breaches of representations and warranties
- Breaches of covenants
- Indemnity for pre-closing taxes
- Specific indemnities
 - These are deal specific.
 - These are generally excluded from coverage under representations and warranties insurance.

Example of Indemnification Clause in M&A Context

- "Subject to the other terms and conditions of this Article VII, Seller shall indemnify and defend each of Buyer and its Affiliates (including the Company) and their respective Representatives (collectively, the "**Buyer Indemnitees**") against, and shall hold each of them harmless from and against, and shall pay and reimburse each of them for, any and all Losses incurred or sustained by, or imposed upon, the Buyer Indemnitees based upon, arising out of, with respect to, or by reason of:
 - (a) any inaccuracy in or breach of any of the representations or warranties of Seller contained in this Agreement or the other Transaction Documents; or
 - (b) any breach or non-fulfillment of any covenant, agreement, or obligation to be performed by Seller pursuant to this Agreement or the other Transaction Documents."

Limitation of Liability in the M&A Context

- Joint and several liability vs. several liability
- Negotiation of the definition of “Losses” or “Damages”
- Scope of fundamental representations
- Survival periods
- Limitations
 - Baskets
 - Caps
- Sources of recovery
 - Holdback
 - Escrow
 - Right to set-off (against earn-out or deferred consideration)
 - Representations and warranties insurance

Overview of Representations and Warranties Insurance

- **Purpose:** Used in M&A transactions to protect against covered losses arising due to seller's breach of certain of its representations and warranties in the purchase and sale agreement
- **Duration of Policy:** Typically, three years for general representations and six years for fundamental and tax representations
- **Cost:** Generally 2.5% - 3.0% of limits purchased
- **Deductible:** Generally 0.5% - 1.0% of equity value
- **Time to Procure:** Assuming all diligence materials are available, generally 1 – 2 weeks

Coverage under Representations and Warranties Insurance

Covered Claims

1. Breaches of representations and warranties, which are not known as of signing and/or closing
2. Pre-closing tax liabilities
3. Fraud (so long as insurer maintains subrogation rights)

Excluded Claims

1. Breaches of representations and warranties, which are known as of signing and/or closing
2. Interim breaches, between signing and closing
3. Covenant breaches
4. Generally, purchase price adjustments, defined benefit and retirement plan underfunding liability, use of NOLs and transfer pricing matters

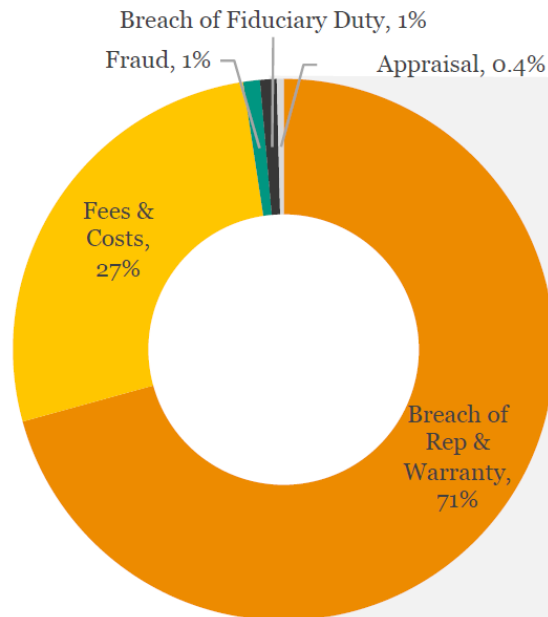
Underwriting Process for Representations and Warranties Insurance

- Engage broker for representations and warranties insurance.
- Broker solicits bids from insurers with proposed pricing and expected scope of coverage.
- Diligence materials are provided to insurer, and insurer conducts underwriting conference call to probe.
- Insurer conducts follow-up due diligence and negotiates exclusions to coverage based on risks identified.
- Broker and legal counsel review policy and negotiate provisions with insurer.
- Policy is bound, generally upon the signing of the transaction.
- If there is a bifurcated signing and closing, then prior to closing there is a “bring-down” conference call where buyer reaffirms no knowledge of any breaches of the representations and warranties.

Post-Closing Indemnification Claims*

- Claims for breaches of representations and warranties comprise the largest percentage of indemnification claims

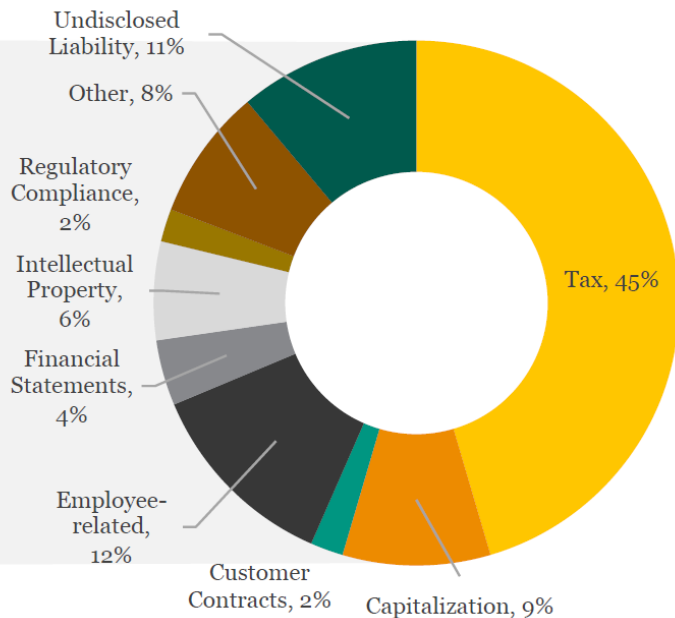
Subject matter as % of all indemnification claims (500+ claims)



Post-Closing Indemnification Claims*

- Of claims for breaches of representations and warranties, claims for breaches of tax representations comprise the largest percentage of indemnification claims

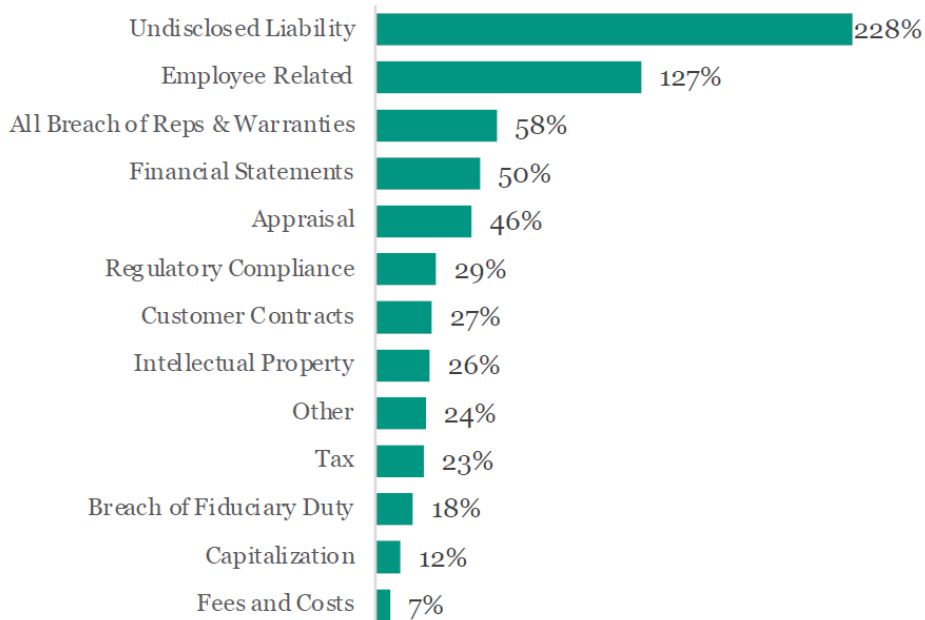
Subset: breaches of R&W (350+claims)



Post-Closing Indemnification Claims*

- Fraud claims tend to have the largest claim amounts (above the escrow amount) and take the longest to resolve

Average claim size as % of the escrow, by type



*SRS Acquiom Inc. 2022 M&A Claims Insights Report

Questions?



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