

## **REPS, WARRANTIES AND INDEMNITIES IN THE SALE OF A BUSINESS--PART 2**

If you are selling your business, or if you are purchasing a business, the most important sections in any acquisition agreement are those dealing with the representations, warranties and indemnities of the seller. This newsletter is the second part of a two-part newsletter addressing these sections in an acquisition agreement.

***Indemnification by Seller.*** The indemnification section is essentially the heart of the acquisition agreement for the buyer. Although the buyer may have an independent claim for breach of contract if the seller has breached a representation, warranty or covenant, the indemnification section expressly sets forth the buyer's ability to have recourse against the seller. In addition, and more specifically, the indemnification right requires the seller to assume the legal cost of defending any third party claim against the buyer. The buyer will want the shareholders of the seller to be jointly and severally liable for the indemnity, and the buyer should give thought to how creditworthy such shareholders will be post-closing. If the shareholders are not creditworthy, the buyer should consider an escrow agreement or a deferred purchase price with rights of offset.

***Baskets and Deductibles.*** The seller will want to include a limitation on the buyer's right to indemnification known as a "basket" or "deductible." A "deductible" provides that the buyer essentially has to assume any liability up to the amount (like an insurance deductible), and thus a seller prefers it. A "threshold" or "basket" provides that the buyer will not have a claim for indemnification until the value of its claims reaches a certain point, and then the buyer can go against the seller for all amounts from the first dollar (thus, buyers prefer baskets over deductibles). The reasoning behind both baskets and deductibles is so that the seller does not get continually hit with minor claims of the buyer. Generally, a deductible amount is lower than a threshold amount because the buyer is assuming more risk with a deductible. Any basket or deductible needs to exclude the "basic" representations as well as certain others for which logically the seller should be liable for all amounts (such as taxes, accounts receivable, and environmental).

***Time and Dollar Limitations.*** The seller will also want to put a time limit and dollar limit on its indemnification to the buyer. These limitations provide some comfort to the seller so that it will have some sort of "cut-off" from recourse by the buyer. How long the cut-off should be is usually intensely negotiated. The buyer will often argue for at least one full audit period (which may be up to eighteen months after closing), and the buyer will want to exclude the "basic" representations as well as certain others (taxes and environmental).

***Escrows and Holdbacks.*** Regardless of the clarity of the acquisition agreement on the allocation of risk and the buyer's right of indemnification, the buyer may have difficulty enforcing the indemnity – especially against shareholders who are individuals – unless it places a portion of the purchase price in escrow, or holds back a portion of the purchase price (often in the form of a promissory note, an earn-out, or payments under consulting or non-competition agreements) with a right of setoff, in order to secure performance of the seller's and the shareholders' indemnification obligations. These techniques shift bargaining power in post-closing disputes from the seller and the shareholders to the buyer and usually will be resisted by

the seller. An escrow provision may give the buyer the desired security, especially when there are several shareholders and the buyer will have difficulty in obtaining jurisdiction over the shareholders or in collecting on the indemnity without an escrow. Shareholders who are jointly and severally liable may also favor an escrow in order to ensure that other shareholders share in any indemnity payment. The amount and duration of the escrow will be determined by negotiations, based on the parties' analyses of the magnitude and probability of potential claims and the period of time during which they may be brought. The shareholders may insist that the size of the required escrow diminish in stages over time. The buyer should be careful that there is not an implication that the escrow is the exclusive remedy for breaches and nonperformance, although a request for an escrow is often met with a suggestion by the shareholders that claims against the escrow be the buyer's exclusive remedy.

***Indemnification Net of Taxes and Insurance and Sole Remedy of Buyer.*** The seller will want to make sure that the indemnification is net of any tax benefits to the buyer and net of any applicable insurance benefits. In addition, the seller will want a specific provision that buyer's rights to indemnification will be buyer's sole remedies for any causes of action arising from the transaction.

We hope this newsletter has been helpful. If you are thinking about selling your business or buying a business, we can provide the experienced mergers and acquisition assistance you need.