2023 Trends in Private Target M&A: Indemnity Caps

Market Trends: What You Need to Know

As shown in the American Bar Association's Private Target Mergers and Acquisitions Deal Points Studies:

- Over the ten ABA studies (2005-2023), indemnity caps have declined as a percentage of transaction value, whether as mean or median, but with two notable “upticks:” the first following the financial recession of 2008, and the second most recently in 2023 (in both cases, one assumes that these upticks are the result of the private company M&A market being more “buyer friendly” during the relevant time period).

- The four most recent ABA studies each show that indemnity caps are almost always lower in reported deals where representations and warranties insurance (RWI) are referenced in the deal documents.

Introduction

In merger and acquisition (M&A) transactions, the definitive purchase agreement whether asset purchase agreement, stock purchase agreement, or merger agreement typically contains representations and warranties made by the seller with respect to the target company. Representations and warranties not only provide information to the buyer, but also operate to allocate risk as between the buyer and seller with respect to the matters covered by the representations and warranties.

In addition to representations and warranties, M&A purchase agreements generally include indemnification provisions, pursuant to which any given party (indemnitor) agrees to defend, hold harmless, and indemnify the other party or parties (indemnitees) from specified claims or damages. These typically include claims arising from a breach of the indemnitor's representations and warranties or covenants set forth in the purchase agreement, or with respect to other specific matters.

These indemnity obligations are generally subject to various limitations, including with respect to the time limit during which the indemnity is applicable, the amount of damages required to be suffered before the indemnity obligation is triggered, referred to as indemnity baskets, and caps on the indemnitor's indemnity liability.

This article examines how buyers and sellers are negotiating indemnity caps in private company M&A transactions, as shown in the American Bar Association's (ABA) private target deal points studies.

Indemnification Provisions

A typical indemnification provision in an M&A purchase agreement may read as follows:

> Indemnification by the Seller. The Seller agrees to and will defend and indemnify the Buyer Parties and save and hold each of them harmless against, and pay on behalf of or reimburse such Buyer Parties for, any Losses which any such Buyer Party may suffer, sustain or become subject to, as a result of, in connection with, relating or incidental to or arising from:
>
> (i) any breach by the Seller of any representation or warranty made by the Seller in this Agreement or any Additional Closing Document;
>
> (ii) any breach of any covenant or agreement by the Seller under this Agreement or any Additional Closing Document;
>
> (iii) any of the matters set forth on Schedule [___];
>
> (iv) any Taxes due or payable by the Company or its Affiliates with respect to any Pre-Closing Tax Periods; or
>
> (v) any Company Indebtedness or Company Expenses to the extent not repaid or paid, respectively, pursuant to Section [___] and not included in the purchase price adjustment pursuant to Section [___].

An indemnity basket and cap may be reflected in language such as the following:

> provided that the Seller will not have any liability under clause (i) above:
>
> I. unless the aggregate of all Losses relating thereto for which the Seller would, but for this clause (I), cumulatively be liable exceeds on a cumulative basis an amount equal to $X (the “Basket”), with the Purchaser remaining liable for such original Basket amount of $X; and
>
> II. to the extent that the aggregate of all Losses for which the Seller would, but for this clause (II), be liable exceeds on a cumulative basis an amount equal to $Y (the “Cap”);
>
> provided, further, however, that the Basket and the Cap shall not apply to: (a) any breach of any representations and warranties set forth in Sections [X]; and (2) any breach of any representations or warranties which constitute, or arise from or relate to, fraud on behalf of the Company or the Seller.

The Parties’ Positions on Indemnity Caps

Because the representations and warranties of the target company, or selling stockholders, as applicable, are likely to be much more extensive than the typically limited representations and warranties of the buyer, the buyer is more likely than the seller to be the indemnitee and beneficiary of indemnity, and thus has an interest in keeping any limitations on indemnity to a minimum. The seller or indemnitor, of course, has the opposite interest: to limit the circumstances in which it will have indemnity liability to the buyer or any other indemnitee.

An indemnity cap is one typical limitation on indemnity liability in private company M&A transactions. While a cap is commonplace in M&A agreements, so are exceptions to the cap. The most common exceptions to an indemnity cap relate to the indemnitor's breaches of its most critical, or fundamental representations or of its covenants or agreements. The former exception recognizes that as to those subject areas which are critical to the overall risk allocation between the buyer and seller, the seller or indemnitor should stand behind its representations and warranties without limitation.

The best example relates to title to the assets or equity being acquired. A buyer will argue, not unreasonably, that if the seller's representations as to ownership of the assets or equity being acquired are untrue, the seller should have full liability for any damages the buyer incurs due to defects in title. The latter exception, as to covenants, is based on the understanding that whether or not a party's covenants are breached is fully within the control of that party. Thus, the breaching party should not be permitted to use the indemnity cap as a shield but, instead, should be required to perform its obligations as stipulated in the agreement.

One common example is the seller's non-competition covenants, whereby the seller agrees not to compete, following the closing, with the business being sold. From the buyer's perspective, the seller should be forced to comply with its agreement not to compete, and should not have an option to compete liability free above an indemnity cap.

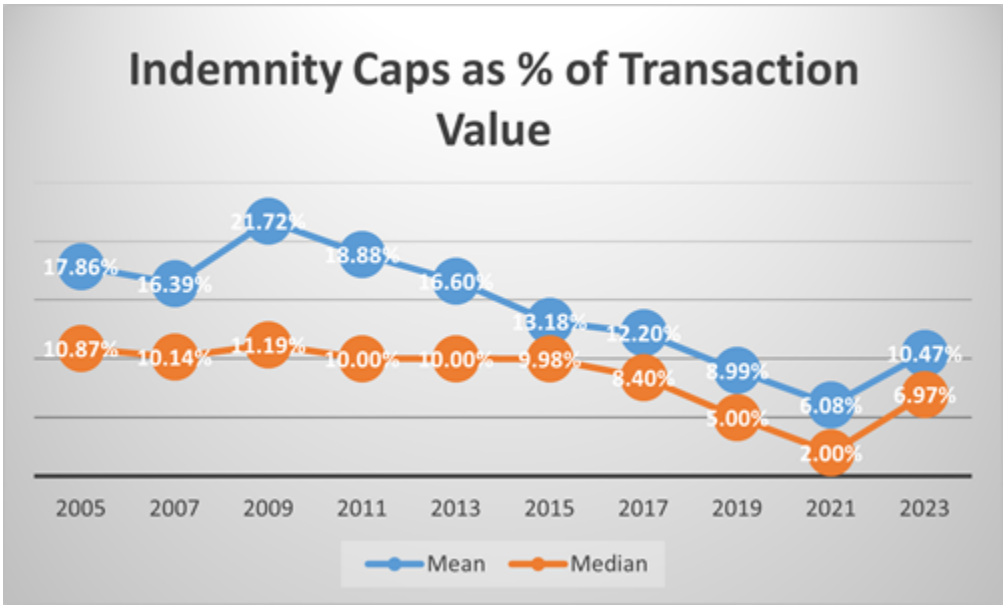
Trends in Indemnity Caps

Every other year since 2005 the ABA has released its Private Target Mergers and Acquisitions Deal Points Studies (ABA studies). The ABA studies examine purchase agreements of publicly available transactions involving private companies. These transactions range in size but are generally considered as within the “middle market” for M&A transactions; the transaction values of the 108 deals within the 2023 study ranged from $30 to $750 million.

Over the ten ABA studies (2005-2023), indemnity caps have declined as a percentage of transaction value, whether as mean or median, but with two notable “upticks:” the first following the financial recession of 2008, and the second most recently in 2023 (in both cases, one assumes that these upticks are the result of the private company M&A market being more “buyer friendly” during the relevant time period).

For reference, the mean represents the average of all of the covered data, and the median represents the data point separating the lower and higher halves of the overall data. Median is often considered a more reliable indicator of what is normal or typical where data distribution is skewed.

The chart below shows the downward trend in indemnity cap amounts as a percentage of transaction values.

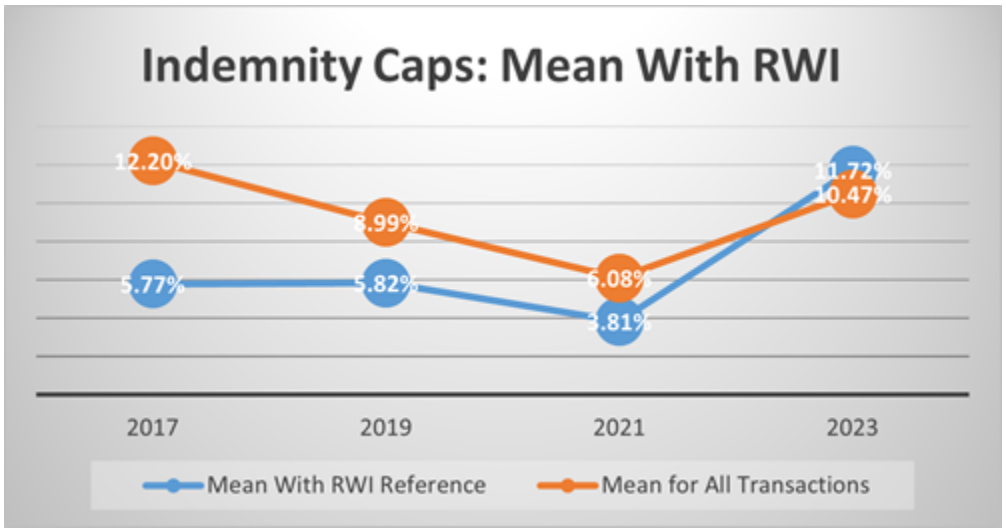


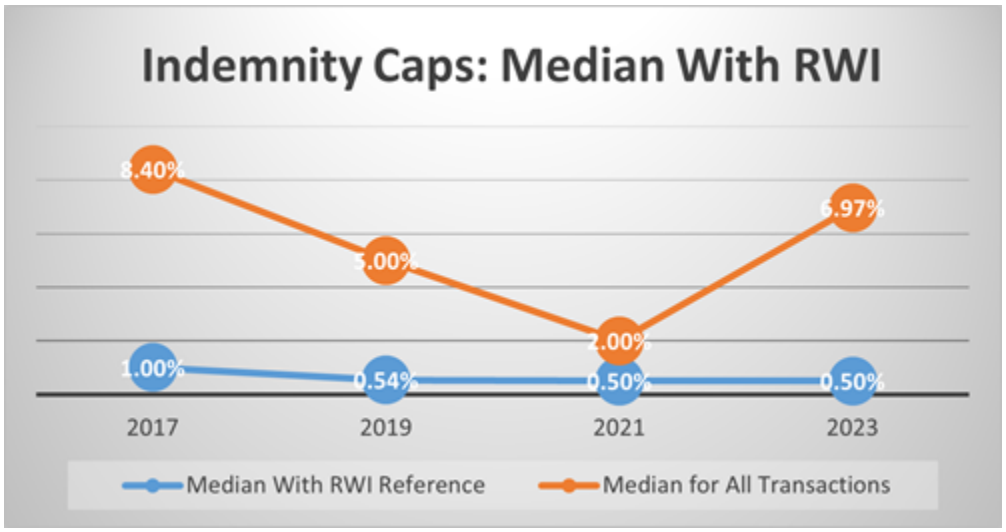
The Role of Representation and Warranty Insurance (RWI) in Indemnity Caps

One of the biggest changes in private company M&A during the past decade has been the growth in the use of RWI. With RWI, buyers and sellers are able to allocate some of the post-closing M&A indemnity risk to third party insurers. RWI has gone from being a differentiator that aggressive buyers offered to a much more common feature of private M&A deals. As indemnity risk has been shifted through RWI from sellers to third party insurers, avenues for a buyer's indemnity recourse against sellers have narrowed. This narrowing includes the lowering of indemnity caps and even the elimination of post-closing seller indemnity for representations and warranties, subject to narrow exceptions, such as in the event of fraud.

The ABA Study in 2017 was the first to review the use of RWI in private M&A transactions, and to consider the relationship between indemnity caps and deals that referenced RWI in the transaction documents.

As shown in the two charts below, the 2017, 2019, 2021 and 2023 ABA studies each showed that indemnity caps were usually lower in reported deals where RWI was referenced in the deal documents, as compared with transactions without any such reference (the one exception being most recently in 2023, when the mean in RWI transactions was actually higher (11.72%) than the overall mean (10.47%)).





Conclusion

Indemnity caps are often one of the most intensely negotiated provisions of an M&A purchase agreement. The market amount for indemnity caps has historically been a direct reflection of the relative strength of buyers and sellers in the private company M&A market. Most recently, however, the growth of RWI has had a material impact in lowering indemnity caps, and this trend is expected to continue and stabilize.

General Information

Date Filed	Thu May 02 00:00:00 EDT 2024
Citation	bn:blawpg_1700_pp_216821