Trends in M&A Provisions: Indemnification as an Exclusive Remedy

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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. [2] The scope and detail of these representations and warranties are often heavily negotiated and tailored to reflect not only the nature of the target and its business, financial condition and operations, but also tend to reflect the relative negotiating strength of the buyer and seller. 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. [3] 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. Often the indemnification provisions are agreed to as between the parties as an exclusive remedy for asserting claims (also referred to as an "exclusivity of remedies" or "EOR" provision).

This article examines the use of EOR provisions in private company M&A transactions with reference to the American Bar Association's ("ABA") private target deal point studies. [4]

Indemnification Provisions

As the name suggests, an indemnification as an exclusive remedy provision means that the right to indemnification provided under the M&A agreement is the parties' exclusive remedy for any breach of the representations, warranties, covenants, agreements, and obligations in the M&A agreement. [5] Further, depending upon the scope of the EOR provision, it may also extend to other documents related to the M&A transaction or as to the M&A transaction itself.

M&A indemnification provisions generally specify the rights of the parties regarding how claims are handled (e.g., timing, process, payment of claims, and limitations on liability). An EOR provision

helps prevent plaintiffs from circumventing these carefully negotiated limitations by providing that the right of indemnification constitutes the only post-closing recourse available to either party and precludes the parties from seeking claims outside of the negotiated indemnification terms**.** EOR provisions are common in M&A purchase agreements, although they often include negotiated carve-outs that are usually narrow in scope. [6]

A typical EOR provision may read:

The parties acknowledge and agree that their sole and exclusive remedy with respect to any and all claims (other than claims arising from fraud, criminal activity or willful misconduct on the part of a party hereto in connection with the transactions contemplated by this Agreement) for any breach of any representation, warranty, covenant, agreement or obligation set forth herein or otherwise relating to the subject matter of this Agreement, shall be pursuant to the indemnification provisions set forth in this Article [__]. In furtherance of the foregoing, each party hereby waives, to the fullest extent permitted under Law, any and all rights, claims and causes of action for any breach of any representation, warranty, covenant, agreement or obligation set forth herein or otherwise relating to the subject matter of this Agreement it may have against the other parties hereto and their Affiliates and each of their respective Representatives arising under or based upon any Law, except pursuant to the indemnification provisions set forth in this Article [__]. Nothing in this Section [__] shall limit any Person's right to seek and obtain any equitable relief to which any Person shall be entitled or to seek any remedy on account of any party's fraudulent, criminal or intentional misconduct.

In some circumstances, a buyer may pursue an indemnification as a non-exclusive remedy approach to maintain its ability to pursue other causes of actions. Although, as noted below, non-exclusive remedy provisions are relatively rare in practice, such a provision may read:

The indemnification rights of the parties to indemnification under this Agreement are independent of, and in addition to, such rights and remedies as the parties may have at Law or in equity or otherwise for any misrepresentation, breach of warranty or failure to fulfill any covenant, agreement or obligation hereunder on the part of any party hereto, including the right to seek specific performance, rescission or restitution, none of which rights or remedies shall be affected or diminished hereby.

The Buyer's Position

The Buyer’s arguments for requesting a non-exclusive remedy provision (and resisting an EOR provision) may include:

(1)**EOR Provisions May Not Make the Buyer Whole**. A buyer wants to preserve the flexibility to pursue claims of any type, whether based upon the indemnification provisions in the M&A agreement or otherwise. This is important to the buyer because the remedies afforded to it under the indemnification provisions may be arguably inadequate given the potentially unique and unforeseen nature of harm that may be suffered. Put another way, a buyer may ask why it should waive remedies otherwise available to it under applicable law.

(2) **Fundamental Fairness**. A buyer may also assert that a seller should not be permitted to immunize itself from certain tort or equitable claims premised on false representations of fact contained in the M&A agreement and that the parties acknowledge served as the factual basis on which they entered into the contract.

The Seller's Position

Sellers generally favor EOR provisions and often argue for inclusion because:

(1) **Preserve the Benefit of the Bargain**. In the absence of an EOR provision, a buyer might do an "end-run" around the carefully negotiated indemnification terms and conditions by changing the legal classification of a claim and thereby vitiating (or at least rendering less meaningful) the purpose of the indemnification provisions (particularly the caps, baskets, time limits, and procedural restrictions). In other words, why spend all of the time and effort negotiating detailed indemnification provisions if a buyer can avoid them based on the legal characterization it decides to place on the claim?

(2) Common Market Practices. The 2017 ABA study of private company M&A deal points observed that 9 of 10 M&A purchase agreements included EOR provisions. This result was consistent with the previous ABA studies (2005-2015) in which EOR provisions were included in between 76% and 94% of reviewed deals.

(3)Common EOR Exceptions. Because EOR provisions often include carve-outs for fraud, equitable remedies, and (to a lesser extent) intentional breaches and/or willful misconduct, the seller may claim that the buyer's arguments regarding an EOR provision unfairly capturing claims not properly within a purchase agreement's indemnification provision are misplaced

Trends in Usage of EOR Provisions

Every other year since 2005 the ABA has released its Private Target Mergers and Acquisitions Deal Point Studies (the "ABA studies"). The ABA studies examine purchase agreements of publicly available transactions involving private companies that occurred in the year prior to each study (and in the case of the 2017 study, including the first half of 2017). These transactions range in size but are generally considered as within the "middle market" for M&A transactions; the average transaction value within the 2017 study was $176.3 million.

Over the seven ABA studies (2005-2017), the inclusion of EOR provisions ranged from 76% to 94% of the reported agreements, with the last four studies all observing values in excess of 90%. Thus, not only are parties increasingly including EOR provisions in M&A purchase agreements, but the provision has become commonplace in such agreements. On the other hand, during the same time period, reported agreements including a provision making indemnification a non-exclusive remedy ranged from 2% to 13%, with the last four studies all observing values of 2%. Some agreements reviewed in the ABA studies remained silent on the topic of exclusivity, with silence observed in between 4% and 14% of agreements.

As discussed above, it is common for the parties to agree to carve-out certain exception to EOR provisions. According to the ABA studies, "fraud" is a common carve-out to EOR provisions, present

in over 80% of the reviewed agreements in study (with the exception of the 2009 study). In studies that included a fraud carve-out, there is a steady trend to define fraud with some specificity. According to the ABA studies, commonly used definitions for fraud were "actual fraud," "intentional fraud," "actual knowledge of breach when made," "express intention to deceive," and "common law fraud." [7]

Other common carve-outs are: excluding "intentional misrepresentation," which increased to 43% in the 2017 study, and excluding "equitable remedies," which was present in 80% of the agreements reviewed in the 2017 study and has increased substantially over the past three studies (jumping from 56% in 2011 to 80% in 2017). However, excluding "breaches of covenants," which was present in a relatively small percentage of the agreements reviewed, seems to be on the decline (down from 18% in 2005 to 6% in 2017).

Conclusion

Assuming that the ABA studies reasonably reflect general practice in private company M&A transactions, it appears that EOR provisions have been and continue to be commonly used in M&A purchase agreements. At the same time, carving out fraud and equitable remedies as exceptions to an EOR provision are fairly common. Additionally, the ABA studies show that parties are increasingly defining the term fraud when it is included as a carve-out.

Although the inclusion of an EOR provision can provide certainty to a seller, it may constitute a waiver of claims otherwise available to a buyer. Accordingly, the negotiated exceptions to an EOR provision are critical and counsel on both sides should consider these issues carefully when negotiating an M&A purchase agreement.

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[2] Note that within this article we use the terms "seller" and "target" in the context of a stock purchase transaction—the "seller" would be the selling shareholder(s) making the representations and warranties in the M&A documents, and the "target" would be the company being acquired. In an asset purchase transaction, the "seller" would be the target company itself but, for consistency, we are using "seller" and "target" in a stock purchase setting. In addition, the terms "target" and "Company" are used interchangeably.

[3] There are technical distinctions between a duty to defend, on the one hand, and the duty to indemnify, on the other hand, but we use the reference to indemnity or indemnification as encompassing both concepts within this article.

[4] This article looks at EOR provisions in U.S. private company M&A transactions only; it does not for example examine EOR provisions in other types of transactions or public company M&A transactions. In addition, the enforceability of EOR provisions generally is a matter of state law and is beyond the scope of this article. However, it is worth noting that EOR provisions should not be assumed to be fully enforceable, and practitioners should examine the laws of the relevant jurisdiction—for example, courts may be loathe to enforce EOR provisions in circumstances involving "fraud" or other types of misrepresentations. See, e.g., ABRY Partners V, L.P. v. F&W Acquisition, 891 A. 2d 1032 (Del. Ch. 2006); Livingston Livestock Exch. Inc. v. Hull State Bank, 14 S.W. 3d 849 (Tex. App. 2000); Greenberg Traurig v. Moody, 161 S.W. 3d 56, 77-79 (Tex. App. 2005)(applying New York law).

[5] Indemnification as an exclusive remedy provision more often focuses on representations and warranties, but can cover pre-closing and post-closing covenants as well.

[6] For example, the right to seek injunctive relief is often an exception to an EOR provision, as are claims for fraud, and/or (to a lesser extent) intentional breaches or willful misconduct.

[7] Private Target M&A Deal Points Study, Slide 99, A.B.A. (2017).