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MERGER AGREEMENTS

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

By Daniel Avery and Nicholas Perricone

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.[1] The scope and detail of these representations and warranties are often heavily negotiated and tailored to reflect both the nature of the target and its business, financial condition and operations, but also tend to reflect the relative negotiating strength of buyer and seller. Representations and warranties not only provide information to buyer, but also operate to allocate risk as between buyer and seller with respect to the matters covered by the representations and warranties.

In addition, M&A purchase agreements generally include indemnification provisions, pursuant to which any given party will defend, hold harmless and indemnify the other party (or other parties) from specified claims or damages[2]—typically those arising from a breach of the first parties' 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.

As the name suggests, an indemnification as an exclusive remedy provision (also referred to as an ''exclu-

[1] 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.

[2] 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.

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sivity of remedies'' or ''EOR'' provision) in an M&A agreement 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[3] in the M&A agreement and, depending upon the scope of the EOR provision, under other documents related to the M&A transaction or as to the M&A transaction itself.

M&A indemnification provisions generally specify in detail the rights of the parties with respect to how claims are dealt with, including as to timing, process, payment of claims, and limitations on liability. An EOR provision is intended to prevent a plaintiff 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 specifically negotiated indemnification terms**.** EOR provisions are quite common in M&A purchase agreements, though there are also commonly negotiated carve-outs, usually fairly narrow in scope.[4]

A typical EOR provision could read as follows:

> 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.

If a buyer decides to pursue an indemnification as a non-exclusive remedy approach in order to maintain its ability to pursue other causes of actions, a non-exclusive provision - -as noted below, relatively rare in practice—could read as follows:

> 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.

This article examines the use of EOR provisions in private company M&A transactions, and trends in that usage as reported in studies of the American Bar Association (ABA).[5]

The Buyer's Position

Buyers' arguments for requesting a non-exclusive remedy provision (and resisting an EOR provision) may take the form of one or more of the following:

1. EOR Provisions May Not Make the Buyer Whole. A buyer will want to preserve the flexibility to pursue claims of any type, whether based upon the indemnification provisions in the M&A agreement or otherwise, because the remedies afforded a buyer under the indemnification provisions may be arguable inadequate given the potentially unique and unforeseen nature of the harm suffered by a buyer. 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 able to immunize itself from certain tort or equitable claims premised on false representations of fact contained with the M&A agreement and acknowledged by the parties as the factual basis on which they entered into the contract.

The Seller's Position

Sellers typically make the following arguments in favor of an EOR provision:

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 simply 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. As observed below, the most recent ABA report of private company M&A deal points shows that 9 of 10 M&A purchase agreements contain EOR provisions—and this percentage has steadily increased over the four (4) ABA studies.

a. Common EOR Exceptions. A seller may assert that the buyer's arguments about an EOR provision unfairly capturing claims not properly within a purchase agree-

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

[4] 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.

[5] 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).

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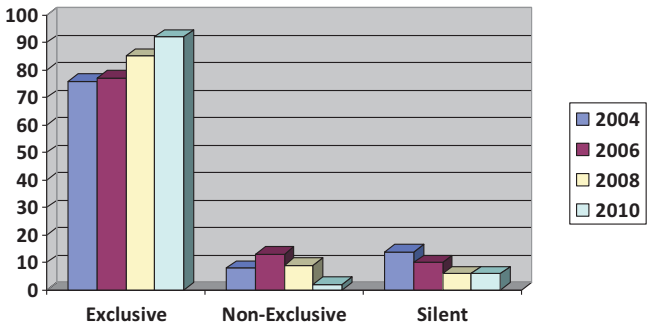
ment's indemnification provisions is misplaced, since (as noted above and also in more detail below), EOR provisions often include carve-outs for fraud, equitable remedies and (to a lesser extent) intentional breaches and/or willful misconduct.

Trends in Usage of EOR Provisions

In 2005, 2007, 2009 and 2011, the ABA released Private Target Mergers and Acquisitions Deal Points Studies. These studies looked at the M&A agreements of transactions that occurred in the year prior to each study. In each year, the studies reviewed 128, 143, 106 and 100 private company transactions, respectively. These transactions ranged in size from $25 million to $960 million, across a broad range of industry sectors.

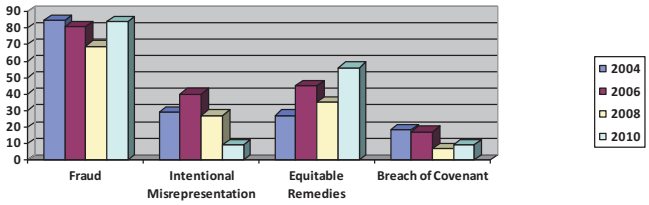
Over the past four studies, EOR provisions were included in 76 percent, 77 percent, 85 percent and 92 percent of the reported agreements, respectively, which reflects a moderate trend to increasingly include the provision and provides clear evidence that the provision is very common in private company M&A agreements. On the other hand, M&A agreements that expressly provide that indemnification is a ***non-exclusive*** remedy were 8 percent, 13 percent, 9 percent and 2 percent; respectively, an indication that such a provision is very rare and has become increasingly so over the ABA study period. Similarly, M&A agreements that are silent on the point are also rare and are becoming rarer as they occurred only 14 percent, 10 percent, 6 percent and 6 percent of the time, respectively. To help elucidate these trends, this information is also provided below in chart form:

Frequency of EOR Provisions



The chart below shows trends in how those M&A agreements that have EOR provisions carved-out certain exceptions to the exclusivity requirement (also by percentage according to the four most recent ABA studies):

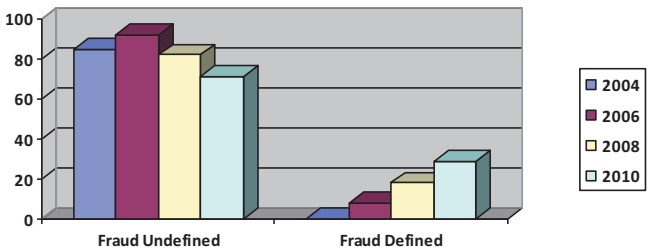
Carve-out to EOR Provisions



As is evident from the chart above, ''fraud'' was consistently a very common carve-out to EOR provisions over the course of the four studies. Excluding ''intentional misrepresentation'' from an EOR provision declined, but this may be explainable—though there is no way to know for sure—by the trend to increasingly define ''fraud'' more specifically (as described in more detail below). Excluding ''equitable remedies'', present in about half of the agreements covered by the most recent study, has seen a moderate increase and the exclusion of ''breaches of covenants'', present in a relatively small percentage of the agreements reviewed, seems to be on the decline.

Lastly, the chart below shows the extent to which the term ''fraud'' was defined if it was included as an exception to an EOR provision. Definitions for fraud commonly used were ''actual fraud'', ''intentional fraud'', ''fraud or intentional misrepresentation'', and, occasionally, ''constructive or negligent fraud''.

Defining Fraud as a Carve-out to EOR Provisions



Although still a minority approach, this chart shows a trend to increasingly define fraud with some specificity when including it as an exception to an EOR provision.

Conclusion

Assuming that the ABA studies reasonably reflect general practice in private company M&A transactions,

it appears that EOR provisions are commonly used in M&A agreements and have become even more ubiquitous over the study period. At the same time, fraud as an exception to an EOR provision is very common, as is a carve-out for equitable remedies. What is somewhat surprising to the authors based on there is experience is an apparent trend to increasingly define the term ''fraud.''

The inclusion of an EOR provision can provide certainty to a seller but at the same time constitute a waiver of claims otherwise available to a buyer. As discussed at length, the specific exceptions to an EOR provision are very important. Counsel on both sides of an M&A transaction should consider these issues carefully when negotiating an M&A agreement.

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