

Indemnification provisions: Buyer's protection in the purchase agreement

Today's market presents increased opportunities to purchase a business. But what happens if the seller doesn't disclose important details or provides inaccurate representations in the purchase agreement? Buyers can ensure they are protected through the indemnification provisions of their purchase agreement.

Indemnification

Indemnification provisions are an agreement by sellers to compensate buyers for agreed-upon costs and expenses related to sellers' representation and warranties. Indemnities are used to allocate risk between buyers and sellers, minimize the uncertainty of future potential liabilities, potentially reduce litigation on the issue of liability allocation, and compensate buyers for risks they did not assume. Buyers and sellers desire respectively different outcomes regarding indemnification, so the following highlight some of the

areas where buyers and sellers can expect to spend time in negotiation.

Time

Most purchase agreements provide a time period for which representations and warranties survive closing; common survival periods range from 12 to 24 months or more. Most issues can be discovered in this period and buyers can complete at least one full fiscal year as owners/operators. To be valid, claims must be brought within the survival period. In addition to expanding the general survival period as long as possible, buyers can negotiate to have specific survival periods for unique representations and warranties. Known as carve-outs, representations and warranties for essential components of the deal may need increased protection.

Thresholds

Many sellers want a contractual

limit for misrepresentations or warranty breaches, so buyers should expect to negotiate "indemnity basket" provisions. These provisions create thresholds that potential claims must reach before buyers receive indemnity payments. A deductible means only the amount above the defined threshold must be paid to buyers. Buyers should aim for a "first dollar" basket, which means when the indemnification claims exceed the threshold, buyers receive payment on all losses. A hybrid approach makes sellers liable for a proportion that is less than 100% of the basket amount once the threshold is met. Most agreed-upon thresholds are based on a proportion of the transaction value, so buyers should aim for as low a value as possible (0.5% to 1% is not uncommon). Buyers can also look to have essential representations and warranties as well as specific

covenants carved out so they are not captured by thresholds and buyers will receive indemnification for any claim made against the carve-outs.

Caps

Indemnification caps are similar to thresholds and are often based on a percentage of the transaction value. Buyers aim to avoid any contractual limit on the amount that can be claimed under indemnification. Since caps are common market practice, that is difficult to achieve; therefore, buyers aim to (a) keep the cap as high as 50% to 80% (versus sellers targeting closer to 25%) of the transaction value, and (b) negotiate specific carve-outs for covenants and essential representations and warranties that are exempt from the cap.

Escrows and holdbacks

Buyers and sellers can set aside part of the purchase price to ensure sufficient

funds are available to cover indemnification claims. If the held-back funds remain with buyers, this is a holdback; if funds are paid to a third party, this is an escrow. Buyers understandably want to retain control and establish a holdback, but escrows are much more common. The amount held back is usually less than 15% of the transaction value, but buyers aim to ensure the amount is high to cover all possible claims. A time period is established for the holdback/escrow so buyers aim for a duration that aligns with the survival period.

Conclusion

Indemnification provisions offer buyers protection against any bumpy roads encountered post-closing and help smooth things out. Experienced legal counsel can help you navigate the purchase agreement and ensure you obtain levels of risk and protection that you are comfortable with.

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