

Indemnification

Indemnification in a Stock Purchase Agreement

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An indemnity is simply protection against loss. Indemnification protects a party from losses due to broken “promises” (i.e., breaches of representations and warranties or covenants), and requires that the breaching party make the other party whole for losses realized.

The representations and warranties describe what must be true and what must remain true, and this article describes what takes place in the event that the representations and warranties are not true, or in the event that a covenant is breached. In other words, this article describes how a party will be compensated in the event that they do not receive what was been negotiated in the purchase agreement.

This allows the parties to define maximum exposure in the event that a party is exposed to loss. Otherwise, damages would be determined by the courts, leaving the parties uncertain about their exposure.

Most concisely, Indemnification in a Stock Purchase Agreement will cover the following:

1. The **scope of the indemnitees**, largely by referencing the representations and warranties and covenants in the stock purchase agreement.
2. The **survival period** of the indemnitees (see below).
3. The **parties covered**.
4. The **procedure to bring a claim** (see below).
5. The **payment of indemnitees** (e.g. in this example, the escrow and the Buyer’s right to clawback the purchase price directly from the Seller), and **limits on exposure** (see below).
6. The indemnitees as **exclusive remedy**.

Indemnification Procedure: This article will also detail the indemnification procedure, which describes the rules that the party seeking indemnity (or protection against loss) must follow to bring a claim. This will be detailed for both third-party claims and for claims made directly by the Buyer or the Seller.

Survival Period: This article will also establish the time horizon over which the parties are indemnified. Survival periods often range anywhere from six months to two years. Within this description you will always certain fundamental representations and warranties that are viewed as so basic and fundamental that the indemnified party is generally protected for an indefinite period.

Liability Limits: As it relates to liability limits, the parties should consider two critical concepts: (1) “Basket” and (2) “Cap.” A Basket is a dollar amount (measured as an aggregate sum of all claims) that must be exceeded before an indemnified party can seek indemnification. Baskets may be structured as a threshold (i.e., a “tipping basket” or “dollar one threshold”) where the indemnifying party is liable for the total amount of losses, or as a deductible (i.e., an “excess liability basket”) where the indemnifying party is only liable for the amount of losses in excess of the agreed amount. The “Cap” is the absolute total dollar sum of exposure for either party in the event of loss. These terms typically would not apply to the fundamental representations or any obligations or representations concerning tax matters.

Representations and Warranties Insurance: Before concluding this introduction, we want to make you aware of an alternative to this approach that has been growing in popularity in the last

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10-15 years. Representation and Warranty Insurance (RWI) policies shift the risk associated with indemnification to an insurer, allowing the parties to protect themselves from breaches while simultaneously facilitating negotiation by eliminating or reducing the post-closing obligations of the Sellers under the stock purchase agreement. A buy-side RWI policy, for example, could potentially eliminate the need for an escrow. At the very least, it should allow for a smaller escrow covering only the exposure not included in the RWI policy. Securing such a policy does not typically eliminate the indemnification obligations of the parties in their entirety, but it can reduce the scope. In the event of a claim, the Buyer will first seek to recover Losses from the RWI policy before seeking to recover losses from the Sellers.

All of the concepts detailed in this article would also be included in a stock purchase agreement where the Buyer secured an RWI policy. The most significant differences in language between the two would be the following:

1. Potentially eliminating or reducing the amount of the escrow.
2. Language stating that the Buyer must first seek to recover damages from the RWI policy before seeking to recover damages from the Sellers directly.
3. Language stating that in no event shall the damages recovered from the RWI policy and Sellers be in excess of the Losses for any particular claim.
4. Including the RWI policy as an exclusive remedy.

Stock Purchase Agreement Language: The pages that follow contain hypothetical language detailing the above sequence as it might appear in a stock purchase agreement. This article references many of the sections relating to representations and warranties and covenants. To make the information easier to digest, these section numbers have been replaced with bracketed descriptions of the sections referenced. Otherwise reading this document would require a lot of cross references.

WHAT FOLLOWS IS A HYPOTHETICAL EXAMPLE PROVIDED SOLEY FOR GENERAL INFORMATION PURPOSES.

STOCK PURCHASE AGREEMENT

**ARTICLE I
DEFINITIONS**

[Only definitions relevant to this post have been included. This is by no means a comprehensive example of the definitions that would otherwise be found in a stock purchase agreement. It is not uncommon to see a purchase agreement with 10+ pages of definitions.]

“Action” means any claim, action, cause of action, demand, lawsuit, arbitration, inquiry, audit, notice of violation, proceeding, litigation, citation, summons, subpoena or investigation of any nature, civil, criminal, administrative, regulatory or otherwise, whether at law or in equity.

“Escrow Agent” means [insert name of firm serving as Escrow Agent].

“Escrow Agreement” means the Escrow Agreement to be entered into at the closing by Buyer, the Sellers’ Representative and the Escrow Agent.

“General Escrow Amount” means [\$XX,000,000].

“General Indemnification Cap” means [\$XX,000,000].

“Losses” means losses, damages, liabilities, deficiencies, Actions, judgements, interest, awards, penalties, fines, costs, or expenses of whatever kind, including reasonable attorney’s fees and the cost of enforcing any right to indemnification hereunder and the cost of pursuing any insurance providers; provided, however, that “Losses” shall not include punitive damages to the extent actually awarded to a third party.

“Material Adverse Effect” means any event, occurrence, fact, condition or change that is, individually or in the aggregate, materially adverse to (a) the business, financial condition or assets of the Company, or (b) the ability of Sellers to consummate the transaction contemplated hereby; provided, however, that Material Adverse Effect shall not include any event, occurrence, fact, condition or change attributable to: (i) general economic or political conditions; (ii) conditions generally affecting the industry in which the Company operates; (iii) any changes in securities markets; (iv) acts of war; (v) any natural or man-made disaster or acts of God; (vi) any changes in applicable laws or accounting rules; or (vii) any failure by the Company to meet any forecasts for revenue or earnings.

“Person” means an individual, corporation, partnership, joint venture, limited liability company, unincorporated organization, trust, association, governmental authority or other entity.

“Pro Rata Share” means [this will reference each Seller’s percentage ownership of the securities sold prior to the closing].

“**Representative**” means, with respect to any Person, any and all directors, officers, employees, consultants, financial advisors, counsel, accountants and other agents of such Person.

“**Taxes**” means all federal, state, local, foreign and other income, gross receipts, sales, use, production, ad valorem, transfer, franchise, registration, profits, license, lease, service, service use, withholding, payroll, employment, unemployment, estimated, excise, severance, environmental, stamp, occupation, premium, property (real or personal), real property gains, windfall profits, customs, duties or other taxes, fees, assessments or charges of any kind whatsoever, together with any interest, additions or penalties with respect thereto and any interest in respect of such additions or penalties.

ARTICLE VII INDEMNIFICATION

Section 7.1 Survival. Subject to the limitations and other provisions of this Agreement, the representations and warranties contained herein (other than any representations or warranties contained in [*the section that references taxes in Representations and Warranties of the Sellers*] which are subject to [*the Tax Matters Article*]) shall survive the closing and shall remain in full force and effect until the date that is twenty-four (24) months from the closing date; provided, that the [*limited representations and warranties detailed below**] shall survive indefinitely and the representations and warranties in [*the section that references employee benefit matters in Representations and Warranties of the Sellers*] shall survive for the full period of all applicable statutes of limitations. All covenants and agreements of the parties contained herein (other than [*covenants contained in the Tax Matters Article*]) shall survive the closing for the period explicitly specified therein or if no period is specified then twenty-four (24) months following the closing date. Notwithstanding the foregoing, any claims asserted in good faith with reasonable specificity and in writing by notice from the non-breaching party prior to the expiration date of the applicable survival period shall not thereafter be barred by the expiration of the relevant representation or warranty and such claims shall survive until finally resolved.

[*Note: R&W of Seller references sections on (i) Organization and Authority of the Company, (ii) Capitalization and (iii) Brokers. R&W of Buyer references sections on (i) Organization and Authority of Buyer and (ii) Brokers. In the stock purchase agreement these would be listed by section number, which can make the document difficult to follow without context.]

Section 7.2 Indemnification By Sellers. Subject to the other terms and conditions of this Article VII, Sellers shall severally and not jointly, based on their respective Pro Rata Share indemnify and defend each of Buyer and its affiliates (including the Company after the closing) and their respective Representatives (collectively, the “**Buyer Indemnitees**”) against, and shall hold each of them harmless from and against, and shall pay and reimburse each of them for, any and all Losses incurred or sustained by, or imposed upon, the Buyer Indemnitees based upon, arising out of, with respect to or by reason of:

[*Note: More concisely, Seller shall make Buyer whole for any Losses due to what follows in the lettered bullets.*]

- (a) any inaccuracy in or breach of any of the representations and warranties of Sellers contained in this Agreement (other than any breach of [*the section that references taxes in Representations and Warranties of the Sellers*], it being understood that the sole remedy for any such inaccuracy in or breach thereof shall be pursuant to [*the Tax Matters Article*]), as of the date such representation or warranty was made or as if such representation or warranty was made on and as of the closing date;
- (b) any breach of non-fulfillment of any covenant, agreement or obligation to be performed by Sellers pursuant to this Agreement (other than any breach of any covenant agreement or obligation in [*the Tax Matters Article*], it being understood that the sole remedy for any such inaccuracy in or breach thereof shall be pursuant to [*the Tax Matters Article*]);
- (c) with respect solely to claims made by Buyer that are to be satisfied from the General Escrow Amount, such claims shall be considered a joint and several obligation of Sellers, but not in any other instance.

Section 7.3 Indemnification By Buyer. Subject to the other terms and conditions of this Article VII, Buyer shall indemnify and defend each of the Sellers and their respective affiliates and Representatives (collectively, the “**Sellers Indemnitees**”) against, and shall hold each of them harmless from and against, and shall pay and reimburse each of them for, any and all Losses incurred or sustained by, or imposed upon, the Sellers Indemnitees based upon, arising out of, with respect to or by reason of:

- (a) any inaccuracy in or breach of any of the representations and warranties of Buyer contained in this Agreement, as of the date such representation or warranty was made or as if such representation or warranty was made on and as of the closing date; or
- (b) any breach or non-fulfillment of any covenant, agreement or obligation to be performed by Buyer pursuant to this Agreement (other than [*the Tax Matters Article*], it being understood that the sole remedy for any such breach thereof shall be pursuant to [*the Tax Matters Article*]).

Section 7.4 Certain Limitations. The indemnification provided for in Section 7.2 and Section 7.3 shall be subject to the following limitations:

- (a) Notwithstanding anything in this Agreement to the contrary, (i) no Seller shall have any obligation to indemnify the Buyer Indemnitees under Section 7.2(a) for any individual item, or group of items arising out of the same event, where the Loss relating thereto is less than [\$XX,000], and (ii) no Seller shall have any obligation to indemnify the Buyer Indemnitees under Section 7.2(a) other than with respect to a claim for indemnification based upon, arising out of, with respect to or by reason of any inaccuracy in or breach of any representation or warranty in [R&W for Buyer Basket Exclusions] (the “**Buyer Basket Exclusions**”), until the aggregate amount of all Losses in respect of indemnification under Section 7.2(a) exceeds [\$XXX,000] (the “**Threshold Amount**”), and thereafter Buyer Indemnitees will be entitled to recover all Losses back to the first dollar.
- (b) Buyer shall not be liable to the Sellers Indemnitees for indemnification under section 7.3(a) (other than with respect to a claim for indemnification based upon, arising out of, with respect to or by reason of any inaccuracy in or breach of any representation or warranty in

[R&W for Seller Basket Exclusions] (the “**Sellers Basket Exclusions**”)) until the aggregate amount of all Losses in respect of indemnification under section 7.3(a) exceeds the Threshold Amount, and thereafter Sellers Indemnitees will be entitled to recover all Losses back to the first dollar.

- (c) Notwithstanding anything in this Agreement to the contrary, the maximum obligation of each Seller to indemnify Buyer under Section 7.2 (other than Buyer Basket Exclusions) shall not exceed such Seller’s Pro Rata Share of the “General Indemnification Cap” and each Seller’s obligation to indemnify for claims arising out of or in connection with the Buyer Basket Exclusions, shall be capped at the amount of the Purchase Price received by such Seller, but in each case limited to such Seller’s Pro Rata Share of the Loss.
- (d) For purposes of this Article VII, any inaccuracy in or breach of any representation or warranty shall be determined without regard to any materiality, Material Adverse Effect or other similar qualification contained in or otherwise applicable to such representation or warranty.

Section 7.5 Indemnification Procedures. The party making the claim under this Article VII is referred to as the “**Indemnified Party**,” and the party against whom such claims are asserted under this Article VII is referred to as the “**Indemnifying Party**.”

- (a) **Third Party Claims.** If any Indemnified Party receives notice of the assertion or commencement of any Action made or brought by any Person who is not a party to this Agreement or an affiliate of a party to this Agreement or a Representative of the foregoing (a “**Third Party Claim**”) against such Indemnified Party with respect to which the Indemnifying Party is obligated to provide indemnification under this Agreement, the Indemnified Party shall give the Indemnifying Party reasonably prompt written notice thereof, but in any event not later than thirty (30) calendar days after receipt of such notice of Third Party Claim. [The remainder of this section explains that a failure to communicate a Third Party Claim does not relieve the Indemnifying Party of its indemnification obligations, describes the procedure for communicating the claim, explains how the parties can respond to the Third Party Claim and how the associated fees and expenses will be paid.]
- (b) **Settlement of Third Party Claims.** Notwithstanding any other provision of this Agreement, the Indemnifying Party shall not enter into settlement of any Third Party Claim without the prior written consent of the Indemnified Party, except as provided in this Section 7.5(b). If a firm offer is made to settle a Third Party Claim without leading to liability or the creation of a financial or other obligation on the part of the Indemnified Party and provides, in customary form, for the unconditional release of each Indemnified Party from all liabilities and obligations in connection with such Third Party Claim and the Indemnifying Party desires to accept and agree to such offer, the Indemnifying Party shall give written notice to that effect to the Indemnified Party. If the Indemnified Party fails to consent to such firm offer within [X] days after its receipt of such notice, the Indemnified Party may continue to contest or defend such Third Party Claim and in such event, the maximum liability of the Indemnifying Party as to such Third Party Claim shall not exceed the amount of such settlement offer. If the Indemnified Party fails to consent to such firm

offer and also fails to assume defense of such Third Party Claim, the Indemnifying Party may settle the Third Party Claim upon the terms set forth in such firm offer to settle such Third Party Claim. If the Indemnified Party has assumed the defense pursuant to Section 7.5(a), it shall not agree to any settlement without the written consent of the Indemnifying Party (which consent shall not be unreasonably withheld or delayed).

- (c) **Direct Claims.** Any Action by an Indemnified Party on account of a Loss which does not result in a Third Party Claim (a “**Direct Claim**”) shall be asserted by the Indemnified Party giving the Indemnifying Party reasonably prompt written notice thereof, but in any event not later than [X] days after the Indemnified Party becomes aware of such Direct Claim and in any event subject to the limitations set forth in Section 7.1. The failure to give such prompt written notice shall not, however, relieve the Indemnifying Party of its indemnification obligations, except and only to the extent that the Indemnifying Party forfeits rights or defenses by reason of such failure. Such notice by the Indemnified Party shall describe the Direct Claim in reasonable detail, shall include copies of all material written evidence thereof and shall indicate the estimated amount, if reasonably practicable, of the Loss that has been or may be sustained by the Indemnified Party. The Indemnifying Party shall have [X] days after its receipt of such notice to respond in writing to such Direct Claim. The Indemnified Party shall allow the Indemnifying Party and its professional advisors to investigate the matter or circumstance alleged to give rise to the Direct Claim, and whether and to what extent any amount is payable in respect of the Direct Claim and the Indemnified Party shall assist the Indemnifying Party’s investigation by giving such information and assistance (including access to the Company’s premises and personnel and the right to examine and copy any accounts, documents or records) as the Indemnifying Party or any of its professional advisors may reasonably request. If the Indemnifying Party does not so respond within such 30 day period, the Indemnifying Party shall be deemed to have rejected such claim, in which case the Indemnified Party shall be free to pursue such remedies as may be available to the Indemnified Party on the terms and subject to the provisions of this Agreement.
- (d) **Tax Claims.** Notwithstanding any other provision of this Agreement, the control of any claim in respect of Taxes of the Company shall be governed exclusively by [Article titled Tax Matters] hereof.
- (e) **Escrow.** Any indemnification to which Buyer is entitled under this Agreement shall first be made as a payment to Buyer from the General Escrow Amount in accordance with the terms of the Escrow Agreement.

Section 7.6 Payments. Once a Loss is agreed to by the Indemnifying Party or finally adjudicated to be payable pursuant to this Article VII, the Indemnifying Party shall satisfy its obligations within [X] business days of such final, non-appealable adjudication by wire transfer of immediately available funds. [The remainder of this Section 7.6 will outline the penalty for the Indemnifying Party in the event that the full payment is not made. This is generally expressed as an interest rate applied to the unpaid sum.]

Section 7.7 Tax Treatment of Indemnification Payments. All indemnification payments made under this Agreement shall be treated by the parties as an adjustment to the Purchase Price for Tax purposes, unless otherwise required by law.

Section 7.8 Exclusive Remedies. 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 [*the Tax Matters Article*] and this Article VII. Nothing in this Section 7.8 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 Person's fraudulent, criminal or intentional misconduct.