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Corporate Alert

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What to Expect When You're Selling Your Company – Indemnification

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So you're considering selling your company, or have already decided to do so. You know that it isn't necessarily going to be easy. You have to identify a buyer, settle on a purchase price and the other terms of the deal, and then get through the due diligence process where your buyer "kicks the tires" of your business. All of this can be daunting, especially for a first-time seller. And then you still must document the transaction with a purchase agreement.

When it comes to negotiating a purchase agreement, one of the key components is indemnification, which is a contractual obligation by one party to reimburse another party for its losses. As you might expect, in the purchase agreement you'll likely be required to make a wide variety of factual representations and warranties about your business as of closing, such as reps identifying your company's contracts, disclosing any problems, and the like. You'll then be asked to stand behind these reps through an indemnification provision under which you agree to reimburse the buyer for losses it suffers as a result of your reps being inaccurate or untrue. A key consideration for you as a seller is deciding how far you are willing to go to stand behind those reps. Although the concept of indemnification may not be new to you, it has its own characteristics, rules and implications in the context of selling a business. In particular, you should consider the following:

Survival. How long will you be responsible for your buyer's losses if your reps and warranties turn out to be inaccurate? Typically, you should expect your responsibility for your reps to "survive" for a period of one to three years, although reps about certain fundamental issues such as stock ownership or specialty matters such as tax compliance typically last longer.

Caps. What should the maximum amount be that you must repay to the buyer for its indemnifiable losses resulting from untrue or inaccurate reps? Typically, indemnification for breaches of reps will be capped at some portion of the purchase price, often somewhere between 10% and 30%, although fundamental reps such as stock ownership are often capped at a higher amount or left entirely uncapped.

Baskets. Should the buyer have to suffer some minimum threshold amount ("basket") of losses relating to breaches of reps before it is entitled to any indemnification by you? Almost every deal includes a basket, although the terms are entirely negotiable. For example, the basket may be a "tipping" basket, where the buyer – once the basket amount is met – is entitled to recover the entire amount of its losses including the basket amount (e.g., if the basket is $100,000 and the buyer's losses are $150,000, the buyer can recover $150,000 from the seller). Alternatively, the basket may be a "deductible," in which case the buyer is entitled to recover only the amount of its losses that exceed the basket amount (e.g., if the basket is $100,000 and the buyer's losses are $150,000, the buyer can recover $50,000 from the seller). A basket may also be some combination of the foregoing. Likewise, some losses may not be subject to the basket. Typically, the threshold amount for baskets is ½% to 1% of the total purchase price.

Third Party Claims. What happens if the buyer suffers indemnifiable losses due to an inaccuracy in your reps as a result of third-party claims brought against the buyer? What rights should you as the seller have to control the defense against any such third-party claim, since you'll be indemnifying the buyer for its losses? The purchase agreement should describe the procedures and obligations that govern the process for dealing with any such third-party claim.

Losses. Should you be required to indemnify your buyer for any type of losses it suffers as a result of inaccuracies in your reps and warranties, including unanticipated losses? Special care should be taken in identifying the types of losses you should be responsible for.

Escrows and Holdbacks. Should the buyer be permitted to set aside a portion of the purchase price

otherwise payable to you at closing to be used to fund any indemnifiable losses it suffers? Should these amounts be held by a third-party escrow agent?

Sandbagging. Should you be required to indemnify the buyer if it turns out your reps and warranties were inaccurate at closing, even if the buyer knew about the inaccuracy beforehand? This is called "sandbagging," and it comes in a variety of negotiable shapes and sizes. It is worth mentioning that even if an agreement is silent as to sandbagging – as is often the case – applicable state law may nevertheless impose its own rules regarding whether or not, or in what circumstances, sandbagging is permissible.

Exclusive Remedy. Should the indemnification provision be the *only* remedy available to the buyer if it turns out one of your reps is inaccurate or untrue? The answer to this question, if you're a seller, is a resounding "yes." In fact, the seller *always* wants the indemnification provision to be the buyer's sole remedy for *any* claims relating to the purchase agreement, although it's reasonable to carve out claims relating to restrictive covenants such as non-competes as well as for seller fraud.

Materiality Scrapes. Some of your reps will likely include some sort of "materiality" qualifier, in which case you will not have to disclose immaterial inaccuracies in those reps. However, for purposes of indemnification should those materiality qualifiers be "scraped off" and ignored, in which case you will nevertheless be required to indemnify the buyer for those immaterial inaccuracies? Likewise, should materiality qualifiers be ignored for purposes of determining the dollar amount of indemnification available to a buyer? Does the existence or scope of a basket affect the answer to these questions? Materiality scrapes are negotiable, although it is worth mentioning that they are becoming more common.

Special Indemnities. How should you and the buyer deal with problems that both parties agree exist? Should these matters be excluded from the caps and baskets you've otherwise agreed to? If the problems are substantial, is there a concern about detailing these problems in the purchase agreement in a way that creates a "roadmap" that a third party could then use to bring a claim against the buyer or seller with regards to the problem? Again, care should be taken in dealing with these sorts of issues.

Selling your business can be a complicated process. A seller who is aware of the issues and alternatives involved in a sale of its business – including indemnification issues – is better able to understand and minimize its risks and at the same time maximize its opportunity for a successful sale on terms it can live with. If you have any questions, please contact a member of Venable's **Corporate Practice Group** or one of the authors of this alert.