INDEMNIFICATION IN M&A TRANSACTIONS FOR STRICT LIABILITY OR INDEMNITEE NEGLIGENCE: THE EXPRESS NEGLIGENCE DOCTRINE

By

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10TH ANNUAL MERGERS AND ACQUISITIONS INSTITUTE

DALLAS, TX • OCTOBER 17, 2014

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Practice: Byron F. Egan is a partner of *Jackson Walker L.L.P.* in Dallas. He is engaged in a corporate, partnership, securities, mergers and acquisitions ("M&A") and financing practice. Mr. Egan has extensive experience in business entity formation and governance matters, M&A and financing transactions in a wide variety of industries including energy, financial and technology. In addition to handling transactions, he advises boards of directors and their audit, compensation and special committees with respect to fiduciary duty and other corporate governance issues, the Sarbanes-Oxley Act, special investigation and other issues.

Involvement: Mr. Egan is Senior Vice Chair and Chair of Executive Council of the M&A Committee of the American Bar Association and served as Co-Chair of its Asset Acquisition Agreement Task Force, which wrote the *Model Asset Purchase Agreement with Commentary*. He is Chair of the Texas Business Law Foundation; is a former Chair of the Business Law Section of the State Bar of Texas and former Chair of that section's Corporation Law Committee; and on behalf of these groups, has been instrumental in the drafting and enactment of many Texas business entity and other statutes. He is also a member of the American Law Institute.

Publications: Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer regarding M&A, governance of corporations, partnerships and limited liability companies, securities laws, and financing techniques. Mr. Egan has written or co-authored the following law journal articles: Corporate Governance: *Fiduciary Duties of Corporate Directors and Officers in Texas*, 43 Texas Journal of Business Law 45 (Spring 2009); *Responsibilities of Officers and Directors under Texas and Delaware Law*, XXVI Corporate Counsel Review 1 (May 2007); Entity Choice and Formation: *Joint Venture Formation*, 44 Texas Journal of Business Law 129 (2012); *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code*, 42 Texas Journal of Business Law 171 (Spring 2007); *Choice of Entity Alternatives*, 39 Texas Journal of Business Law 379 (Winter 2004); *Choice of State of Incorporation – Texas Versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249 (Winter 2001); M & A: *Private Company Acquisitions: A Mock Negotiation*, 116 Penn St. L. Rev. 743 (2012); *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 Penn St. L. Rev. 913 (2012); *Asset Acquisitions: A Colloquy*, X U. Miami Business Law Review 145 (Winter/Spring 2002); Securities Law: *Major Themes of the Sarbanes-Oxley Act*, 42 Texas Journal of Business Law 339 (Winter 2008); *Communicating with Auditors After the Sarbanes-Oxley Act*, 41 Texas Journal of Business Law 131 (Fall 2005); *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 Texas Journal of Business Law 305 (Winter 2005); *Congress Takes Action: The Sarbanes-Oxley Act*, XXII Corporate Counsel Review 1 (May 2003); and Legislation: *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 Texas Journal of Business Law 41 (Spring 2005).

Education: Mr. Egan received his B.A. and J.D. degrees from the University of Texas. After law school, he served as a law clerk for Judge Irving L. Goldberg on the United States Court of Appeals for the Fifth Circuit.

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INDEMNIFICATION IN M&A TRANSACTIONS FOR STRICT LIABILITY OR INDEMNITEE NEGLIGENCE: THE EXPRESS NEGLIGENCE DOCTRINE

BY

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The buyer of a privately-held business usually seeks to impose only on the seller (and often its owners) financial responsibility for breaches of representations and covenants in the acquisition agreement and for other specified matters that may not be the subject of representations. The conflict between the buyer's desire for that protection and the seller's desire not to have continuing responsibility for a business which it no longer owns often results in intense negotiations.

The resulting acquisition agreement typically begins with sections relating to the determination of the amount, form (cash, securities or other property) and time of payment of the purchase price. These sections are followed by representations and covenants of both seller and buyer and finally provisions for indemnification for breach of the representations and covenants.[1] Since transaction structures and the bargaining position of the parties vary widely, there is no such thing as a "standard" indemnification section.[2] There are, however, common structures for the indemnification provisions which appear toward the back of the purchase agreement: (1) provide that the parties' representations survive the closing and thus are available as the basis for post-closing monetary remedies and perhaps to negate defenses based on knowledge and implied waiver; (2) define the matters for which the seller (and perhaps its owners) and the buyer have post-closing monetary liability, including from inaccuracies in representations and breaches of covenants; (3) sometimes require seller to indemnify for specific matters such as environmental liabilities, intellectual property matters and contingencies that may not be adequately covered by the more general indemnification provisions; (4) set forth levels of damage below which post-closing monetary remedies are not available (i.e., "baskets") and maximum levels for contractual post-closing monetary remedies (i.e., "caps"); (5) the time periods during which post-closing monetary remedies may be sought; (6) set-off rights against any promissory note or other deferred consideration to be paid as part of the purchase price; (7) procedures to be followed for, and in the defense of, third party claims; (8) procedures for matters not involving third party claims; and (9) finally a provision that the indemnification

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1 Byron F. Egan, *Acquisition Structure Decision Tree*, TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course, San Antonio, May 23, 2014 http://www.jw.com/publications/article/1980. A purchase agreement also typically contains sections containing definitions of terms used in the agreement and miscellaneous provisions.

2 *Id.* at 224.

provided for in the indemnification section is applicable notwithstanding the negligence of the indemnitee or the strict liability imposed on the indemnitee.[3]

Such a provision, which is intended to comply with the "express negligence doctrine" discussed in the Comment below following the provision, could read as follows:

INDEMNIFICATION FOR STRICT LIABILITY OR INDEMNITEE NEGLIGENCE

THE INDEMNIFICATION PROVISIONS IN THIS ARTICLE SHALL BE ENFORCEABLE REGARDLESS OF WHETHER THE LIABILITY IS BASED ON PAST, PRESENT OR FUTURE ACTS, CLAIMS OR LEGAL REQUIREMENTS (INCLUDING ANY PAST, PRESENT OR FUTURE BULK SALES LAW, ENVIRONMENTAL LAW, FRAUDULENT TRANSFER ACT, OCCUPATIONAL SAFETY AND HEALTH LAW, OR PRODUCTS LIABILITY, SECURITIES OR OTHER LEGAL REQUIREMENT), AND REGARDLESS OF WHETHER ANY PERSON (INCLUDING THE PERSON FROM WHOM INDEMNIFICATION IS SOUGHT) ALLEGES OR PROVES THE SOLE, CONCURRENT, CONTRIBUTORY OR COMPARATIVE NEGLIGENCE OF THE PERSON SEEKING INDEMNIFICATION, OR THE SOLE OR CONCURRENT STRICT LIABILITY IMPOSED ON THE PERSON SEEKING INDEMNIFICATION.

COMMENT

Purpose of Section. The need for this section is illustrated by *Fina, Inc. v. ARCO*, 200 F.3d 266, 267 (5th Cir. 2000) in which the U.S. Court of Appeals for the Fifth Circuit invalidated an asset purchase agreement indemnification provision in the context of environmental liabilities. In the *Fina* case, the liabilities arose from actions of three different owners over a thirty-year period during which both seller and buyer owned and operated the business and contributed to the environmental condition. The purchase agreement indemnification provision provided that the indemnitor "shall indemnify, defend and hold harmless [the indemnitee] . . . against all claims, actions, demands, losses or liabilities arising from the use or operation of the Assets . . . and accruing from and after closing." The Fifth Circuit, applying Delaware law pursuant to the agreement's choice of law provision, held that the indemnification provision did not satisfy the Delaware requirement that indemnification provisions that require payment for liabilities imposed on the indemnitee for the indemnitee's own negligence or pursuant to strict liability statutes such as CERCLA must be clear and unequivocal. The Court explained that the risk shifting in such a situation is so extraordinary that to be enforceable the provision must state with specificity the types of risks that the purchase agreement is transferring to the indemnitor.

There are other situations where the acquisition agreement may allocate the liability to the seller while the buyer's action or failure to act (perhaps negligently) may contribute to the loss. For example, a defective product may be shipped prior to closing but the buyer may fail to effect a timely recall which could have prevented the liability, or an account receivable may prove uncollectible because of the buyer's failure to diligently pursue its collection or otherwise satisfy the customer's requirements.

[3] *Id.* at 265.

This section is intended to prevent the allocation of risks elsewhere in the indemnification section from being frustrated by court holdings, such as the *Fina* case, that indemnification provisions are ambiguous and unenforceable because they do not contain specific words that certain kinds of risks are intended to be shifted by the Agreement. As discussed below, the majority rule appears to be that agreements that have the effect of shifting liability for a person's own negligence, or for strict liability imposed upon the person, must at a minimum be clear and unequivocal, and in some jurisdictions must be expressly stated in so many words. The section is in bold faced type because a minority of jurisdictions (including Texas) require that the risk shifting provision be conspicuously presented.

Indemnification for Indemnitee's Own Negligence. Indemnities, releases and other exculpatory provisions are generally enforceable as between the parties absent statutory exceptions for certain kinds of liabilities (*e.g.*, Section 14 of the Securities Act of 1933, as amended, and Section 29 of the Securities Exchange Act of 1934, as amended) and judicially created exceptions (e.g. some courts as a matter of public policy will not allow a party to shift responsibility for its own gross negligence or intentional misconduct). *See* RESTATEMENT (SECOND) OF CONTRACTS § 195 cmt.b (1981) ("Language inserted by a party in an agreement for the purpose of exempting [it] from liability for negligent conduct is scrutinized with particular care and a court may require specific and conspicuous reference to negligence . . . . Furthermore, a party's attempt to exempt [itself] from liability for negligent conduct may fail as unconscionable.") As a result of these public policy concerns or seller's negotiations, some counsel add an exception for liabilities arising from an indemnitee's gross negligence or willful misconduct.

Assuming none of these exceptions is applicable, the judicial focus turns to whether the words of the contract are sufficient to shift responsibility for the particular liability. A minority of courts have adopted the "literal enforcement approach" under which a broadly worded indemnity for any and all claims is held to encompass claims from unforeseen events including the indemnitee's own negligence. The majority of courts closely scrutinize, and are reluctant to enforce, indemnification or other exculpatory arrangements that shift liability away from the culpable party and require that provisions having such an effect be "clear and unequivocal" in stating the risks that are being transferred to the indemnitor. *See* Conwell, *Recent Decisions: The Maryland Court of Appeals*, 57 MD. L. REV. 706 (1998). If an indemnity provision is not sufficiently specific, a court may refuse to enforce the purported imposition on the indemnitor of liability for the indemnitee's own negligence or strict liability. *Fina, Inc. v. ARCO*, 200 F.3d 266, 270 (5th Cir. 2000).

The actual application of the "clear and unequivocal" standard varies from state to state and from situation to situation. Jurisdictions such as Florida, New Hampshire, Wyoming and Illinois do not mandate that any specific wording or magic language be used in order for an indemnity to be enforceable to transfer responsibility for the indemnitee's negligence. *See Hardage Enterprises v. Fidesys Corp.*, 570 So.2d 436, 437 (Fla. App. 1990); *Audley v. Melton*, 640 A.2d 777, 778 (N.H. 1994); *Boehm v. Cody Country Chamber of Commerce*, 748 P.2d 704, 706 (Wyo.1987); *Neumann v. Gloria Marshall Figure Salon*, 500 N.E. 2d 1011, 1014 (Ill. 1986). Jurisdictions such as New York, Minnesota, Missouri, Maine, North Dakota, and Delaware require that reference to the negligence or fault of the indemnitee be set forth within the contract. *See Gross v. Sweet*, 400 N.E.2d 306, 308 (1979) and *Geise v. County of Niagra*, 458 N.Y.S.2d 162,

163 (1983)(both holding that the language of the indemnity must plainly and precisely indicate that the limitation of liability extends to negligence or fault of the indemnitee); *Schlobohn v. Spa Petite, Inc.*, 326 N.W.2d 920, 923 (Minn. 1982)(holding that indemnity is enforceable where "negligence" is expressly stated); *Alack v. Vic Tanny Int'l*, 923 S.W.2d 330, 332 (Mo. 1996)(holding that a bright-line test is established requiring that the words "negligence" or "fault" be used conspicuously); *Doyle v. Bowdoin College*, 403 A.2d 1206, 1208 (Me. 1979); (holding that there must be an express reference to liability for negligence); *Blum v. Kauffman*, 297 A.2d 48, 49 (Del. 1972)(holding that a release did not "clearly and unequivocally" express the intent of the parties without the word "negligence"); *Fina v. Arco*, 200 F.3d 266, 270 (5th Cir. 2000)(applying Delaware law and explaining that no Delaware case has allowed indemnification of a party for its own negligence without making specific reference to the negligence of the indemnified party and requiring at a minimum that indemnity provisions demonstrate that "the subject of negligence of the indemnitee was expressly considered by the parties drafting the agreement").

Under the "express negligence" doctrine followed by Texas courts, an indemnification agreement is not enforceable to indemnify a party from the consequences of its own negligence unless such intent is specifically stated within the four corners of the agreement. *See Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987) ("The express negligence doctrine provides that parties seeking to indemnify the indemnitee from the consequences of its own negligence must express that intent in specific terms."); *Atlantic Richfield Co. v. Petroleum Personnel, Inc.*, 768 S.W.2d 724, 724 (Tex. 1989); *American Eurocopter Corporation v. CJ Systems Aviation*, 407 S.W.3d 274 (Tex. App.—Dallas 2013, pet. den.) (following *Ethyl*, express negligence doctrine applied to concurrent negligence); *Fisk Elec. Co. v. Constructors & Assocs., Inc.*, 888 S.W.2d 813, 814 (Tex. 1994) ("We hold that no obligation to indemnify an indemnitee for the costs or expenses resulting from a claim made against it for its own negligence arises unless the indemnification agreement complies with the express negligence test.").

Indemnification for Strict Liability. Concluding that the transfer of a liability based on strict liability involves an extraordinary shifting of risk analogous to the shifting of responsibility for an indemnitee's own negligence, some courts have held that the clear and unequivocal rule is equally applicable to indemnification for strict liability claims. *See, e.g., Fina, Inc. v. ARCO*, 200 F.2d 266, 300 (5th Cir. 2000); *Purolator Products v. Allied Signal, Inc.*, 772 F. Supp. 124, 131 n.3 (W.D.N.Y. 1991; and *Houston Lighting & Power Co. v. Atchison, Topeka & Santa Fe R.R.*, 890 S.W.2d 455, 458 (Tex. 1994); *see also* Parker and Savich, *Contractual Efforts to Allocate the Risk of Environmental Liability: Is There a Way to Make Indemnities Worth More Than the Paper They Are Written On?*, 44 Sw. L.J. 1349 (1991). The Court concluded that this broad clause in the *Fina* asset purchase agreement did not satisfy the clear and unequivocal test in respect of strict liability claims since there was no specific reference to claims based on strict liability.

In view of the judicial hostility to the contractual shifting of liability for strict liability risks, counsel may wish to include in the asset purchase agreement references to additional kinds of strict liability claims for which indemnification is intended.

Conspicuousness. In addition to requiring that the exculpatory provision be explicit, some courts require that its presentation be conspicuous. *See Dresser Industries v. Page Petroleum, Inc.*, 853 S.W.2d 505, 508 (Tex. 1993) ("Because indemnification of

> a party for its own negligence is an extraordinary shifting of risk, this Court has developed fair notice requirements which . . . include the express negligence doctrine and the conspicuousness requirements. The express negligence doctrine states that a party seeking indemnity from the consequences of that party's own negligence must express that intent in specific terms within the four corners of the contract. The conspicuous requirement mandates that something must appear on the face of the [contract] to attract the attention of a reasonable person when he looks at it."); *Alack v. Vic Tanny Int'l of Missouri, Inc.*, 923 S.W.2d 330, 337 (Mo. banc 1996). Although most courts appear not to have imposed a comparable "conspicuousness" requirement to date, some lawyers feel it prudent to put their express negligence and strict liability words in bold face or other conspicuous type, even in jurisdictions which to date have not imposed a conspicuousness requirement.

For the reasons discussed, a provision such as the "Indemnification For Strict Liability or Indemnitee Negligence" provision set forth above is intended to reduce the risk that a court would decline to enforce carefully negotiated indemnification provisions set forth elsewhere in the purchase agreement on the basis that they involve such an extraordinary risk shifting that they are not enforceable under the Express Negligence Doctrine.