

Indemnity Clause and Limitation of Liability in Business Acquisition Transactions

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After an agreement to purchase shares or assets of a business has been reached in principle, the purchaser and seller will negotiate a definitive agreement to document the transaction (“PSA”). While there are a number of provisions that will be subject to negotiation between the parties, one of the most difficult discussions will concern the seller’s indemnity and any limitation of the seller’s liability under its indemnity. The purchaser wants a strong seller indemnity to protect it against damages suffered due to breaches of the seller’s representations, warranties and covenants and the seller will try to limit its indemnity liability to the purchaser under the PSA. These provisions adjust risk between the parties.



Indemnity Clause

Black’s Law Dictionary defines an indemnity clause as a contractual provision in which one party agrees to answer for any specified or unspecified liability or harm that the other party might incur. Most, if not all, PSAs contain a clause similar to the following:

The Seller agrees to indemnify and save harmless the Purchaser from any and all liabilities, claims and demands whatsoever suffered or incurred by the Purchaser as a result of or arising directly or indirectly out of or in connection with:

- (a) any breach by the Seller of or any inaccuracy of any representation or warranty of the Seller contained in this Agreement or in any agreement, certificate or other document delivered pursuant hereto; and*
- (b) any breach or non-performance by the Seller of any covenant to be performed by it that is contained in this Agreement or in any agreement, certificate or other document delivered pursuant hereto.*

A purchaser will often provide a similar indemnity in favour of the seller. If, after closing the transaction, the purchaser is subject to a claim or suffers a loss as a result of a breach of representation or warranty by the seller and/or a breach or non-performance of a covenant,

the purchaser will claim for indemnification from the seller. It must be kept in mind that an indemnity is only as strong as the financial strength of the party that is giving it. When dealing with a corporate seller, it may have no assets after closing if the proceeds of sale are divided to its shareholders. In those circumstances, a purchaser should consider requiring the shareholders of the seller to also provide an indemnity in favour of the purchaser.

Limitations of Liability

There are a number of ways a PSA can be drafted to limit a seller's liability to the purchaser. These include a survival period, use of "knowledge" or "materiality" qualifiers, and monetary limits on indemnification. Each of these terms shift some of the indemnification risk from the seller to the purchaser.

Survival Period

The survival period in a PSA governs the length of time that either party may bring a claim against the other for breach of representation, warranty or covenant. The survival period will typically vary for different representations and warranties. Common ranges of survival periods are as follows:

- 12 to 36 months for general representations and warranties;
- six months following the expiration of the applicable limitation period for tax matters; and
- six months following the expiration of the applicable limitation period for breach of fundamental representations and warranties such as authority to enter into agreement, title to assets, etc.

If a PSA does not contain a survival period clause, the applicable sections of *The Limitation of Actions Act* (Manitoba) will apply to any claim made by either party.

Knowledge or Materiality Qualifiers

A seller will often attempt to limit its liability under certain representations "to the best of its knowledge" or qualify certain representations with "materiality" language. For example, a PSA may contain the following representations by the seller:

(a) To the knowledge of the seller, no part of the premises contains or has ever contained urea formaldehyde foam insulation, asbestos, aluminum wiring, polychlorinated biphenyls or underground storage tanks.

(b) The seller has complied, in all material respects, with applicable laws.

While these qualifiers might be reasonable in certain cases, a purchaser should resist this language as much as possible because it shifts risk to the purchaser. In the case of example

(a), a seller will not be responsible for the cost of removal of an underground storage tank unless it can be shown that he/she knew it was there in the first place. With respect to example (b), the seller will not be responsible for non-compliance with applicable laws that are not material. From the purchaser's perspective, the purchase price it agreed to pay was likely based on it not incurring any such costs and so use of these terms shifts some of the indemnification risk to it.

Monetary Limitations

It is common for a PSA to contain a limit on the amount a seller may have to pay pursuant to its indemnification. For example, the limit might be the amount of the purchase price or a portion of the purchase price. In complex transactions, the limit on indemnification might be specific to certain types of loss (e.g. to a maximum of 30% of the purchase price for breaches of general representations and warranties and to a maximum of 50% of the purchase price for breaches of environmental representations and warranties). There is often not a limit less than the purchase price for damages due to breaches of fundamental matters such as title to the shares or assets.

Where the purchase price is a substantial amount, claims for indemnification may be subject to a "basket" (also sometimes referred to as a "deductible"). If so, the seller will not be responsible to the purchaser for any indemnification payment unless damages reach a certain amount or the aggregate of all such liabilities reach a certain amount. Once the basket amount is reached, the seller will either be responsible for all liabilities from the first dollar or only liabilities in excess of the basket amount, depending on what is negotiated. The purpose of a basket is to prevent the seller from being responsible for non-material matters after closing and/or a recognition that in complex transactions there are going to be some liabilities of this type that the purchaser will accept and factor into the purchase price it agrees to pay. With a basket, the purchaser assumes risk for these items until the basket amount is reached.

Carve Out

A purchaser may require that certain liabilities will not be subject to any limitation of liability and these items be "carved out" from the basket and monetary limitations. An example are matters which the seller agrees to do post-closing and which would cause damages if not done, such as repairs to a building.

In addition, the purchaser might require all "knowledge" or "materiality" qualifiers to be read out for indemnifications purposes. The basis for this is that a seller may want these qualifiers to make its statements factually correct but, as stated above, the purchaser wants the seller to be responsible for any such liabilities whether or not he or she knew about it. Materiality qualifiers are not an appropriate case for limiting the seller's liability where a "basket" is used, as a common purpose for having a "basket" is to allow for liabilities resulting from

immaterial breaches of representations, warranties and covenants.

Procedure for Making Claims for Indemnification

A PSA will often set out the procedure for how claims for indemnification are handled between the parties. A PSA will usually provide for mutual indemnities between the purchaser and the seller. A party seeking indemnification (“Indemnified Party”) will be required to give prompt notice to the indemnifier (“Indemnifying Party”) of any claim, action, suit or proceeding by any third party against the Indemnified Party or against the assets or company that is the subject of the transaction or upon becoming aware of any other facts or events that would reasonably give rise to a right for indemnification by the Indemnifying Party. Upon receipt of the notice of claim for indemnification, the Indemnifying Party will have the right to dispute the claim and, often, to assume defence of a third party claim. The PSA may require the parties to meet and attempt in good faith to resolve the indemnity claim. The time limits within which notices are to be given and/or action taken and allocation of costs of proceedings are often the subject of negotiation.

Representation and Warranty Insurance

In addition to indemnity and limitation of liability clauses, a seller and purchaser can limit their risk under a PSA by purchasing representation and warranty insurance. The insurance would protect a purchaser’s loss resulting from a breach of a representation or warranty by the seller. From the seller’s perspective, any loss incurred by the seller as a result of a claim under the indemnity would be covered. This type of insurance is relatively new and not common practice in Canada, but could be useful in complex transactions as it provides some certainty of recovery to the parties. Of course, matters such as the deductible under such insurance and who pays the premium is also the subject of negotiation.

Conclusion

The negotiation of indemnities and limitation of liability provisions is often a tug of war between the purchaser and the seller. The amount of risk that a seller is able to shift to the purchaser will depend on the specific circumstances and the bargaining power of the parties.

This article was written by Peter S. Toni.

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