M&A Newsletter Series

Part 8: Indemnification clauses

The purpose of this Baker McKenzie M&A Newsletter series is to give an insight to prospective sellers or purchasers into some key legal documents and/or provisions they will most likely be confronted with when entering into any sale or acquisition process concerning a Luxembourg commercial company.

Part 8: Indemnification clauses

This eighth newsletter deals with indemnification clauses in share purchase agreements, typically used in all share deals transactions (except for some intragroup transactions).

PURPOSE OF INDEMNIFICATION CLAUSES IS GLOBALLY TO DEFINE THE TERMS AND CONDITIONS PURSUANT TO WHICH THE SELLER (OR ANOTHER PERSON, AS DISCUSSED BELOW) SHOULD INDEMNIFY AND HOLD HARMLESS THE PURCHASER (OR ANOTHER PERSON, AS DISCUSSED BELOW) IN THE CASE OF INACCURACY OF ANY OF THE SELLER'S REPRESENTATIONS AND WARRANTIES OR SO-CALLED "INDEMNITY"

The purpose of indemnification clauses is globally to define the terms and conditions pursuant to which the seller (or another person, as discussed below) should indemnify and hold harmless the purchaser (or another person, as discussed below) in the case of (a) inaccuracy of any of the seller's representations and warranties, (b) the occurrence of any matter, event or circumstance covered by a specific representation and warranty or so-called "indemnity"[1] or (c) less frequently, a breach of certain other obligations of the seller under the share purchase agreement (collectively, **"Indemnification Event").**

Indemnification clauses are key provisions under any share purchase agreement as, except in the case of fraud (fraude) or willful misconduct (dol), they will very frequently constitute the sole remedy of the purchaser against the seller if an Indemnification Event occurs [2].

Therefore, the parties will usually spend significant time negotiating them, with the purchaser seeking to obtain the broadest indemnification rights and the seller seeking to limit its indemnification obligations toward the purchaser by negotiating various limitations, which will be further discussed below.

[1] For a reminder about the concept of specific representations and warranties or indemnities, please refer to our previous M&A newsletter concerning representations and warranties.

[2] The seller will frequently try to negotiate a so-called "sole remedy" provision pursuant to which the purchaser (a) agrees that its exclusive remedy against the seller in respect of all claims under the share purchase agreement should be the indemnification provision and (b) waives any rights to any other remedies or indemnification it may otherwise have under applicable law.

Due to the contractual nature of the (specific) representations and warranties mechanism, a seller or purchaser could be tempted to believe that indemnification clauses are just a mere repetition of some contractual liability principles under a share purchase agreement.

However, this would be a mistake, as under an indemnification clause, e.g., (a) the concept of fault (faute) is normally absent, (b) there is no obligation that the loss (dommage) in the meaning of the Luxembourg Civil Code suffered by the purchaser must exactly correspond to the amounts to be paid by the indemnifying party to the indemnified party and (c) there is not necessarily a causal link (lien de causalité) between an inaccuracy of the (specific) representations and warranties and the amount to be paid by the indemnifying party in the event of such an inaccuracy [3].

Agreeing on clear and precise contractual terms for indemnification clauses is, therefore, of the utmost importance for all parties involved to avoid any unexpected side effects in the case of triggering thereof.

1. Indemnifying party

When the seller is the sole shareholder of a target, the indemnifying party under the indemnification clause should obviously be such seller.

IN CERTAIN SITUATIONS, THE PURCHASER COULD BE WELL ADVISED TO HAVE A THIRD PARTY AS THE INDEMNIFYING PARTY, OR HAVE A JOINT PRIMARY OBLIGOR

However, in certain situations [4], the purchaser could be well advised to (a) have a third party (such as a parent company, shareholder(s) (being natural person(s)) of the target or, to the extent applicable, an insurance company) as the indemnifying party, or (b) have a joint primary obligor (co-débiteur solidaire) or a guarantor (caution) in addition to the seller as the indemnifying party.

When there are several sellers, the situation becomes even more complex, as the parties will need to agree on the identity of the indemnifying party/ies and the nature of their liability. In this respect, the purchaser will usually insist that all the sellers act jointly and severally (solidairement et indivisiblement) as indemnifying parties. The sellers will usually insist on acting severally (conjointement mais non solidairement) only as indemnifying parties, or some sellers will, from time to time, refuse to give any representations and warranties and incur any indemnification obligations, e.g., because they were minority shareholders that were never involved in the target's management or they are private equity funds.

Now and then, a compromise may be reached by having certain representations and warranties granted individually, on a several basis but not jointly (conjointement mais non solidairement) or jointly and severally (solidairement), depending on their nature.

[3] For more details about the nature of indemnification clauses and their key differences with the contractual liability regime established by the Luxembourg Civil Code, see notably D. Leclercq, Les Conventions de Cession d'Actions, Larcier, 2009, p. 201 to 215.

[4] E.g., when the seller is a legal entity whose sole assets are the shares in the target and may consequently (a) serve no further purpose after the completion of their sale and (b) distribute all or part of the purchase price to its shareholders immediately after completion, thereby turning into an "empty shell."

2. Indemnified party

When there is one purchaser only, the indemnified party under the indemnification clause should obviously be such purchaser.

IN CERTAIN SITUATIONS, THE PURCHASER COULD BE WELL ADVISED TO HAVE A THIRD PARTY AS THE INDEMNIFYING PARTY, OR HAVE A JOINT PRIMARY OBLIGOR OR A GUARANTOR

However, in certain circumstances, the purchaser could also be well advised to negotiate the option to elect — at its sole discretion — the target and/or, to the extent applicable, any of its subsidiaries (collectively, **"Group Companies"** or **"Group Company"),** as alternative indemnified party/ies [5], essentially to improve its chances to be indemnified in the most efficient manner. In such a situation, the parties will then be careful to properly protect themselves against any adverse potential tax consequences of such an option to elect the indemnified party [6]. Conversely, if the purchaser fails to negotiate such an option, it will most likely try at least to agree with the seller that any loss suffered by any of the Group Companies should be deemed to be incurred by the purchaser in the same amount [7], unless the purchaser demonstrates that it has suffered a greater loss.

Where there are several purchasers, they will pay attention, if they are all designated as indemnified parties, to agree on the manner that any indemnification amounts will be allocated amongst them when applicable [8] and how their payments from the seller will occur accordingly. Finally, the parties will usually discuss whether the purchaser can assign its rights under the indemnification clause to any potential subsequent purchaser of the shares in the target. Failing to agree on such assignability, it will usually be considered that such an assignment requires the seller's prior consent.

3. Definition of loss

Defining the object of the seller's indemnification obligation in case an Indemnification Event occurs will be another aspect that is highly negotiated between the seller and the purchaser with respect to any indemnification clause.

Two main opposite conceptions are globally encountered in this respect. According to the first conception, an indemnification clause (construed as a rebalancing mechanism) should be drafted as an undertaking from the indemnifying party/ies to pay the indemnified party/ies a sum equal to the amount necessary to put the purchaser (and/or the Group Companies) into the position it would have been in if there had been no inaccuracy of the (specific) seller's representations and warranties. According to the second conception, an indemnification clause (construed as a special contractual liability mechanism) should be drafted as an undertaking from the indemnifying party to indemnify (and/or hold harmless) the indemnified party/ies against any loss (dommage) the purchaser (and/or the Group Companies) would suffer in the event of any inaccuracy of the (specific) seller's representations and warranties.

Currently, the second conception largely prevails in the Luxembourg market, forcing the parties to negotiate more or less extensive and comprehensive definitions of the concept of loss/damages (dommage) with (a) the indemnified party/ies willing to seek indemnification for any so-called "direct and indirect loss" (dommages directs et indirects) and (b) the indemnifying party/ies willing to indemnify the indemnified party/ies only for any so-called "direct loss" (dommages directs).

SEASONED PRACTITIONERS WILL USUALLY TRY TO AVOID REFERRING TO CONCEPTS OF "DIRECT AND INDIRECT LOSSES“, "CONSEQUENTIAL LOSSES," "EXEMPLARY DAMAGES" OR "PUNITIVE DAMAGES"

[5] However, in such a case, the purchaser will nevertheless usually remain the sole party entitled to activate the indemnification clause, save for contrary provisions in the share purchase agreement.

[6] Without going into detail, payments made to the purchaser under a properly structured indemnification clause will usually be contractually assimilated to a nontaxable reduction of the purchase price of the shares, where payments made to a Group Company will usually be construed as taxable incomes for the Group Company/ies.

[7] Or, the purchaser does not acquire all the shares in the target in proportion to the percentage of the target's capital, which was represented by the acquired shares on the completion date.

[8] Which will usually be pro rata shares in the target, unless the target is directly indemnified in such a situation.

Seasoned practitioners will usually try to avoid referring to these concepts of "direct and indirect losses" as they are particularly unclear under Luxembourg law. They will usually further refrain from using any references to "consequential losses," "exemplary damages" or "punitive damages," as these legal concepts (stemming from common law jurisdictions) do not exist under Luxembourg law. After fierce discussions, seasoned practitioners will then very likely end up agreeing on a balanced definition of indemnifiable "loss" by referring to some key provisions of the Luxembourg Civil Code, according to which a loss (dommage) is only indemnifiable if it is actual (certain, né et actuel), foreseeable (prévisible) and an immediate and direct consequence (suite immédiate et directe) of the occurrence of the Indemnification Event. However, the seller should keep in mind in this respect that both the loss incurred (damnus emergens) and loss of profit (lucrum cessans) constitutes a loss (dommage), pursuant to the provisions of the Luxembourg Civil Code.

4. Time limitations for claims

In accordance with market practice, the seller will negotiate provisions for fixing one or several maximum time period(s) after which the purchaser will no longer have the right to make a claim for losses, and ask for indemnification thereof, in the case of inaccuracy of the seller's representations and warranties. These time limitations during which a claim will give rise to an indemnification obligation by the seller under the share purchase agreement will usually depend on the nature of the relevant (specific) representations and warranties. Indeed, market practice currently tends to split the seller's representations and warranties into "fundamental representations and warranties" on the one hand [9] and "business representations and warranties" [10] on the other hand.

With indemnification for any claim based on (a) any inaccuracy of "fundamental representations and warranties" or occurrence of any event triggering a specific indemnity being usually available up to three months after the date upon which the underlying fact of such claim is barred by the applicable statutes of […] limitation and (b) any inaccuracy of another seller's representations and warranties being usually available up to 12 to 36 months after the completion date.

5. Financial limitations for claims

In accordance with market practice, the seller will usually further negotiate provisions for fixing one or several financial limitations to its obligation to indemnify the purchaser if an Indemnification Event occurs. In accordance with current market practice, these financial limitations will usually be threefold, with the seller negotiating with the purchaser (a) a so-called "de minimis," [11] (b) a so-called "basket" or "deductible" [12] and (c) a so-called "liability cap" [13]. However, these financial limitations will most frequently not apply to "fundamental representations and warranties" and specific indemnities. Finally, they will of course never apply in the case of fraud (fraude) or willful misconduct (dol) of the seller.

[9] Generally consisting of the representations and warranties concerning the capacity of the seller, the validity and enforceability of the seller's obligations under the share purchase agreement, the existence of the company and its share capital, the ownership of the sold shares, tax and social security matters…

[10] Generally consisting of all other representations and warranties that are not qualified as "fundamental representations and warranties."

[11] Pursuant to which the seller will not be liable in respect of any claim, the amount of which is less than a certain low individual materiality threshold.

[12] Pursuant to which the purchaser will not be entitled to recover any loss in respect of any claims unless the aggregate amount of these claims ends up exceeding a certain higher aggregate materiality threshold, with the seller then indemnifying the purchaser either for the full losses incurred (so-called "basket") or the exceeding losses only (so-called "deductible").

[13] Pursuant to which the maximum aggregate liability of the seller in respect of all claims will usually not exceed a certain percentage of the purchase price.

6. Other customary limitations

IN ADDITION TO TIME AND FINANCIAL LIMITATIONS, THE SELLER WILL ALSO VERY FREQUENTLY TRY TO NEGOTIATE, WITH MORE OR LESS SUCCESS DEPENDING ON THE BARGAINING POSITION OF THE PARTIES ADDITIONAL LIMITATIONS TO ITS INDEMNIFICATION OBLIGATIONS

In addition to time and financial limitations, the seller will also very frequently try to negotiate, with more or less success depending on the bargaining position of the parties, all or part of the following additional limitations (which are not intended to be exhaustive) to its indemnification obligations toward the purchaser:

First, the seller will try to negotiate that it should not have to indemnify the purchaser for any liability that is contingent (dette éventuelle), unless and until such contingent liability becomes an actual liability and is due and payable (dette liquide et exigible) (so-called "contingent liability clause"). Such a limitation will generally be accepted by the purchaser, provided it is agreed that it will not prevent the purchaser from making a claim in respect of a contingent liability, if made within the agreed time limitations.

Second, the seller will try to negotiate that, in calculating the amount of any loss to be indemnified to the purchaser, the amount of any reserve or provision booked in the accounts of the Group Companies in connection with the fact, matter or circumstance giving rise to such loss or of a similar or comparable nature should be deducted (so-called "provision clause").

Third, the seller will try to negotiate that any amount for which it would become liable under the indemnification clause should be reduced by the amount, if any, by which any tax which would otherwise be payable by the purchaser or any Group Company, is reduced or extinguished as a result of the fact or circumstance giving rise to the claim (so-called "tax savings clause").

Conversely, the purchaser should then usually try to negotiate that any loss to be indemnified should include any tax arising from the payment of the indemnification (if any) (so-called "grossing up clause").

Fourth, the seller will try to negotiate that it should not be liable for any claim, and no loss should be indemnified by the seller, in respect of any loss with respect to the purchaser or any Group Company if, and to the extent that, the relevant company has an enforceable right of recovery in respect to such loss from any third party, including, e.g., under an insurance coverage (so-called "third party recovery clause").

Fifth, the seller will try to negotiate that it should not be liable for any claim, and no loss should be indemnified by the seller, to the extent that such loss or any part thereof results from (a) any inaccuracy of the seller's representations and warranties (or other covenants as applicable) that were (actually) known by the purchaser prior to signing or closing, (b) any act or omission of the purchaser or the Group Companies at the express request of the Group Companies, (c) the passing of or any change in an applicable law after the signing or closing date, d) any change of any generally accepted interpretation or application of any law or regulation after the signing or closing date, or (e) any change in the accounting or tax policy of the purchaser or the Group Companies introduced after the closing date (so-called "post completion matters clause").

Sixth, the seller will try to negotiate that if the same facts, matters or circumstances give rise to a claim under several provisions of the share purchase agreement, such facts, matters or circumstances will give rise to a full single indemnification but not give rise to indemnification more than once (so-called "double claims clause" or "single recovery clause").

Seventh, the seller will try to negotiate that the purchaser procure and cause the Group Companies to procure that all reasonable steps are taken and all reasonable assistance is given to avoid or mitigate the seller's liability under the indemnification clause (so-called "mitigation clause").

Eighth, the seller will try to negotiate to be afforded by the purchaser a reasonable opportunity to remedy the subject matter of a claim.

7. Indemnification procedure

SEASONED PRACTITIONERS WILL USUALLY TRY TO AVOID REFERRING TO CONCEPTS OF "DIRECT AND INDIRECT LOSSES“, "CONSEQUENTIAL LOSSES," "EXEMPLARY DAMAGES" OR "PUNITIVE DAMAGES"

In addition to discussing the previous time, financial and other limitations, the seller and the purchaser will also be well-advised to agree on a clear procedure to follow to raise any claim for indemnification under the share purchase agreement. Such claim procedure will usually include certain deadlines, notification methods and other requirements (e.g., in terms of minimal content of the claim notice) to be observed for validly making a claim, with each of the parties respectively trying to sanction any violation of such procedure rules by depriving the breaching party of its right to, respectively, be indemnified or defend the relevant claim.

However, reasonable parties will usually only agree to apply such sanctions if, and only to the extent that, such violation actually prejudices the other party's position in respect of such claim. Finally, the seller will be well-advised to negotiate specific provisions with respect to any claim made against it as a result or in connection with a so-called third-party claim if it wants to associate, more or less extensively, with the conduct of such a third-party claim.

8. Security to secure the performance of the indemnification obligation of the seller

Finally, the purchaser will often request that the seller provide it with a certain form of guarantee for securing the proper performance of its indemnification obligations. Customary forms of security include escrow accounts, holdback amounts, bank guarantees, a pledge on certain assets, a setoff mechanism and a parent company guarantee. The most used forms of guarantee will be discussed in more detail in our next newsletter.

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