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M&A Indemnification: Who Should Control 3rd-Party Claims?

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Indemnification. The devil is in the details, and it is all about control. When a third-party claim arises following the sale of a private company, indemnification may cover the related economic losses, but the party controlling its defense may influence the claim's ultimate effect on the noncontrolling party, both economically and otherwise. Some indemnitors may want a contractual right to assume control over the defense of third-party claims, but certain situations may call for an alternative regime in which the indemnitee maintains control.

The standard reasoning provides that the party paying for the losses should have the right to control the defense, because it has the greater incentive to be efficient and financially judicious with the defense. Therefore, a commonly agreed-upon indemnification procedure following the sale of a private company allows the indemnitor the right to assume control of the defense. Certain conditions and exceptions typically apply. For example, the indemnitee may require evidence of the indemnitor's financial capability to defend a claim and fulfill its indemnification obligations. In extreme situations, the indemnitee may even require the posting of a bond or escrow of funds for additional comfort. Similarly, indemnitor control provisions often include other conditions without which the indemnitor may not assume control (or must relinquish control). The conditions for an indemnitor to assume and maintain control may include (1) confirming that no conflict of interest exists, (2) agreeing to use satisfactory counsel, (3) providing evidence of financial capability, and (4) agreeing to provide indemnification for all resultant losses (including beyond any indemnification cap).

Even if an indemnitor satisfies the conditions above, conflicting incentives may naturally arise between indemnitors and indemnitees. Indemnitors have the incentive to resolve third-party claims quickly and inexpensively until the liabilities reach the applicable indemnification cap. This generally aligns with the indemnitee's incentive to preserve the maximum indemnitor's indemnification obligation available for future claims. However, the indemnitee may have additional incentives as well. For example, an indemnitee may want to defend a beachhead claim vigorously, with limited regard for cost, to discourage future claims.

The indemnitee may not want the indemnitor to control the defense of third-party claims when the parties have misaligned interests. For example, if a claim seeks injunctive relief, the indemnitor may have no incentive to defend against the injunction, and the indemnitee cannot rely on the indemnitor to adequately protect its interests.

In consideration of these concerns, the ABA Model Stock Purchase Agreement, Second Edition, includes an exception from the indemnitor's right to assume control if an indemnitee "determines in good faith that there is a reasonable probability that a Third-Party Claim may adversely affect it or any Related Party other than as a result of monetary damages for which it would be entitled to relief under this Agreement."

This broad exception gives an indemnitee great flexibility to maintain control over third-party claims. However, many parties have moved away from general exceptions in favor of specific, enumerated exceptions in which the indemnitor may not assume control. Determining an exhaustive list may prove challenging, because the exceptions will depend on the business, the industry, and a variety of other circumstance-specific factors, but may include: (1) conflicts of interest, (2) claims involving criminal charges, trade secrets, confidential information or material intellectual property, (3) claims from key customers or suppliers, governmental bodies, regulators, financing sources, or partners, or (4) claims seeking injunctive or noneconomic relief, admissions, waivers or nonindemnifiable losses.

Even if the preceding conditions are satisfied and no exceptions apply, the manner in which the indemnitor defends a claim may

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still adversely affect the indemnitee. Admissions, waivers, missed deadlines or certain positions taken by the indemnitor may undermine other ongoing claims or limit the defenses, positions or other options that the indemnitee has available in future claims. To mitigate these risks, the indemnitee may want to monitor the defense of the claim to ensure that the indemnitor manages the defense diligently and responsibly. Receiving prompt updates and copies of all filings, notices, communications and other material information will allow the indemnitee to stay abreast of the status of the defense. In addition to information rights, the indemnitee may require participation rights, including an opportunity to review or approve the indemnitor's strategies, filings, communications and positions before its counsel implements or delivers them. Due to the importance of this monitoring, the indemnitee may require that the indemnitor pay the fees and expenses of the indemnitee's separate counsel to assist in the monitoring.

Monitoring also extends to settlement discussions. The indemnitor controlling the defense of a third-party claim may want to settle the claim if the expected cost of defense exceeds the cost of settlement. However, the indemnitee has additional interests. In a typical indemnitor control regime, the indemnitor may settle controlled claims if and only if (1) the sole relief under the settlement is monetary damages, (2) the indemnitor indemnifies the indemnitee for the full amount of the settlement, (3) the settlement involves no admission by the indemnitee or finding of guilt, and (4) the indemnitee receives a full release from the claimant.

However, even if a settlement meets these requirements, an indemnitee may nevertheless want to reject the settlement and continue to vigorously defend the claim. For example, the indemnitee may want to make an example out of a patent troll, relating to a frivolous claim, in order to deter future claims. If the claimant makes a settlement offer that satisfies the requirements described above, and the indemnitee rejects the settlement offer, the parties may agree that the indemnitor need not indemnify the indemnitee for any losses exceeding the monetary damages under the settlement offer and the defense costs incurred through that point.

Even with all of the conditions, exceptions, monitoring rights and settlement limitations, third-party claims may adversely affect an indemnitee in unforeseeable ways. The mere existence of a third-party claim may include intrinsic or unquantifiable harm, such as reputational harm, that an indemnitor may not internalize. In addition, if midway through the defense of a claim the indemnitor becomes financially unstable or fails to satisfy any other condition to control, the indemnitee may want to reassume control. However, shifting control back to the indemnitee may raise additional circumstance-specific issues, concerns and inefficiencies.

Upon considering the issues described above, some circumstances may dictate a departure from the traditional mindset altogether. Under an indemnitee control regime, an indemnitee would maintain control of the defense of all third-party claims, and the indemnitor may only assume control with the consent of the indemnitee. From the perspective of the indemnitee, even the strongest indemnitee-favorable safeguards in an indemnitor control regime do not give the indemnitee the same protection as direct control. This proposition may seem extreme at first, but it is not that extraordinary.

Under the example described above, from the ABA Model Stock Purchase Agreement, Second Edition, the indemnitee would merely need to determine that there is a reasonable probability that a claim may adversely affect it beyond monetary damages. Modern insurance provides another helpful data point (after all, indemnitors act like insurers for third-party claims). In common representations and warranties insurance policies, the insured party controls the defense of all third-party claims, and the insurer does not have a right to assume control. Instead, insurers rely on familiar protections: consent rights on counsel, consent rights on settlements, information rights and participation rights. The insurer may also require the insured to mitigate its losses.

In reality, even in an indemnitor control regime, an indemnitee will likely have the right to control the defense of some subset of third-party claims. However, as long as this balancing act creates a gray area, and the right to assume control can shift from one party to another, inefficiencies will exist. By moving to a bright-line rule, the parties will have clear expectations and may adjust other contractual levers to align incentives, such as those used by insurers.

An indemnitee control regime may also introduce new contractual levers. For example, the indemnitor may require that the indemnitee invite settlement offers. Or, if a settlement offer is received and rejected by the indemnitee, the indemnitor may argue that it should not be responsible for indemnification in excess of the monetary damages set forth in the rejected settlement offer. Because the indemnitee control regime does not take into account the indemnitor's interest in minimizing losses below an indemnification cap, such a regime may put downward pressure on indemnification caps. Alternatively, an indemnitee control regime may lead to a shared defense costs scheme, where the indemnitee controlling the defense of a third-party claim must pay a percentage of all resultant losses or defense costs.

When third-party claims arise, control can make all the difference. An understanding of the interests of the parties involved, their respective businesses and the dynamics expected from potential third-party claims is critical to negotiating appropriate third-party claim control provisions for each situation.