What's Market: Indemnification Caps and Baskets in M&A Transactions

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In private M&A transactions, indemnification serves as a contractual remedy within the acquisition agreement where one party (usually the seller) agrees to compensate the other party (usually the buyer) post-closing for specific claims or damages. These claims or damages often arise from breaches of the seller's representations and warranties or covenants outlined in the acquisition agreement, or other specific matters. Indemnification obligations are typically subject to certain limitations, such as caps and baskets, which set limits on the seller's indemnification liability. This article provides an overview of indemnification caps and baskets, along with the latest market trends related to these provisions.

What is an Indemnification "Cap"?

An indemnification "cap" is the maximum amount the seller is obligated to pay to the buyer for post-closing indemnification claims. Caps can be expressed as a fixed dollar amount or a percentage of the purchase price. For example, a cap may be set at $5 million or 10% of the purchase price. If the buyer's losses exceed the cap amount, the seller is generally not liable for any additional amounts beyond the cap.

Buyers and sellers can also negotiate different caps to apply to different types of claims or losses. A "general cap" is a maximum total amount the seller can be liable for all indemnification claims. Certain claims may be excluded from the general cap, such as those related to fraud, willful misconduct, or breaches of "fundamental" representations. For these excluded claims, the seller's indemnification liability is typically uncapped or there is a separate, higher cap (such as an amount equal to the purchase price). Whereas, a "specific cap" is a total amount the seller can be liable for indemnification claims related to a particular category of indemnifiable issues, such as tax issues, environmental claims, or legal disputes, rather than the total amount of all claims combined. For example, there may be a specific cap of $2 million for tax-related claims, separate from a general cap covering other types of claims.

The seller should try to expand the coverage of the cap so that it applies to all indemnification claims and remove any carve-out for fundamental representations. If the seller cannot remove the carve-out for fundamental representations, it should try to cap its liability for losses resulting from breaches of fundamental representations, even if the amount has to be higher than the general cap for breaches of other representations and warranties. In contrast, if the buyer has concerns about potential losses, it should try to either exclude the cap or set a higher amount for the cap, exclude particular matters with potentially significant liabilities from being subject to the cap, or exclude liabilities that the seller has agreed to assume. If the buyer cannot exclude particular matters with potentially significant liabilities from the cap, the buyer can try to negotiate a specific cap for such liabilities.

What is Market for Caps?

Frequency and Size of Caps. According to the ABA Private Target M&A Deal Points Study, which covers transactions from the full year of 2022 and the first quarter of 2023, nearly all deals featuring survival provisions included a cap. A substantial portion (86%) of these deals had caps set below the purchase price. The ABA Private Target M&A Deal Points Study also reported that almost 40% of the deals had caps ranging from 1% to 10% of the purchase price. For deals with

representations and warranties (R&W) insurance, most deals had caps of less than 1% of the purchase price.

Coverage of Caps. The ABA Private Target M&A Deal Points Study reported that 90% of the deals had indemnification caps that covered losses due to breaches of the seller's representations and warranties. In contrast, indemnification caps applied to losses due to breaches of the seller's covenants and other indemnification issues in only 9% and 11% of the deals, respectively.

Cap Carve-Outs. The ABA Private Target M&A Deal Points Study stated that deals with indemnification caps included a carve-out for:

- Representations relating to, among others:
  - broker's/finder's fees (67%);
  - capitalization (59%);
  - due authority (73%);
  - due organization (74%);
  - subsidiaries (43%); and
  - taxes (54%).
- Fraud (including deals with a fraud carve-out in an exclusive remedy provision that has general applicability to all indemnification limitations) (90%).
- Breach of seller's covenants (37%).

What is an Indemnification "Basket"?

An indemnification "basket" is a minimum amount of losses (the basket) that must be exceeded before the seller is required to indemnify the buyer. Baskets are typically structured in one of three ways:

- ***Tipping Basket***. A "tipping basket" (also called a "first dollar" or "dollar one" basket) is a type of basket where the seller is only required to indemnify the buyer for losses once the losses exceed the basket threshold, but once that basket threshold is reached, the seller is liable for the total amount of the losses, from the first dollar of such losses. For example, with a tipping basket of $2 million, if losses total $4 million, the seller is required to indemnify the buyer for the entire $4 million. The buyer usually prefers this type of basket because it is made whole for the losses once the basket threshold has been met.
- ***Deductible***. A "deductible" is another type of basket where the seller is only required to indemnify the buyer for the amount of losses in excess of the basket threshold. For example, if the deductible is $1 million and losses total $1.5 million, the seller is required to indemnify the buyer for $500,000 (the amount above the basket threshold). This type of basket is usually preferred by the seller.
- ***Partial Tipping Basket***. A "partial tipping basket," which is the least common of the types of baskets, is a combination of a tipping basket and a deductible where the seller is only required to indemnify the buyer for a proportion of the losses exceeding the basket threshold. For example, with a $2 million partial tipping basket and 50% liability on excess losses, if the total losses are $4 million, the seller is required to indemnify the buyer for $1 million (50% of the $2 million excess). A partial tipping basket provides a compromise between a full tipping basket and a deductible.

What is Market for Baskets?

Frequency and Size of Baskets. According to the ABA Private Target M&A Deal Points Study, most deals with survival provisions included a basket, a majority of which were structured as a deductible (67%). All deals that referenced R&W insurance had baskets structured as deductibles. The size of most indemnification baskets was equal to 1% or less of the transaction value, with a larger percentage (56%) being 0.5% or less of the transaction value. For deals with R&W insurance, most deals had baskets equal to 0.5% or less of the transaction value.

Coverage of Baskets. The ABA Private Target M&A Deal Points Study reported that indemnification baskets almost always applied to losses for breaches of the seller's representations and warranties, but only applied to losses for breaches of the seller's covenants and other indemnification matters in a small percentage of deals (6% for each).

Basket Carve-Outs. Based on the ABA Private Target M&A Deal Points Study, deals with baskets also have similar carve-outs as indemnification caps, such as carve-outs for:

- Representations relating to, among others:
  - broker's/finder's fees (71%);
  - capitalization (61%);
  - due authority (79%);
  - due organization (74%);
  - subsidiaries (48%); and
  - taxes (63%).
- Fraud (including deals with a fraud carve-out in an exclusive remedy provision that has general applicability to all indemnification limitations) (90%).
- Breach of seller's covenants (39%).

For more information on indemnification caps and baskets, please contact a member of Morse's M&A team.