

**CONTRACT DRAFTING AND NEGOTIATION:
INDEMNIFICATION AND RELATED ISSUES**

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PURPOSE OF INDEMNITY OBLIGATIONS IN CONTRACTS

Indemnification obligations in contracts are a method for allocating risk and shifting losses and costs to another party. The basic purpose of contractual indemnification is to provide one party (such as a buyer) with a (hopefully) clear contractual remedy for recovering monetary damages arising from:

- Breach of a covenant;
- Breach of representation or warranty;
- Claims by third parties against the indemnitee; and/or
- Other claims provided in the relevant agreement.

INDEMNIFICATION OBLIGATIONS VS. DIRECT CLAIMS FOR BREACH

Indemnification provisions in contracts provide one method through which the parties to the contract can allocate losses, but it may not always be the preferred method of risk allocation. Each fact situation should be analyzed to determine the best method of risk allocation. For example, a seller of real property may be more willing to provide an indemnification to the buyer for losses arising from environmental complications, than to provide a specific representation as to present and/or past environmental conditions.

COMMON LAW OBLIGATION

A duty to indemnify can be imposed by common law. When the claimant/indemnitee pursues a common law claim, there are no buckets, caps, or other limitations as such upon the amount of damages that the claimant/indemnitee can recover. However, contractual indemnification typically provides more (as compared to common law) clarity with respect to what amounts may be recovered, and typically provide that more can be recovered as compared to common law (*e.g.* attorney's fees).

PERSPECTIVE

Indemnitor vs. indemnitee

THEORY VS. REALITY – ABILITY TO PAY

As with any contractual obligation, ability to perform/pay is always an issue and should be considered.

OBLIGOR(S)

In a claim for contractual indemnification, the claimant/indemnitee may not be in privity of contract with the party having the resources to pay the damages sought. For example, the seller might be a subsidiary of a parent, and once all the assets of the subsidiary are sold, the subsidiary has no assets and the cash may have been “upstreamed” to the parent. Absent a “veil piercing” claim (which is a difficult claim on which to be successful), a guarantee or direct obligation from the parent might provide the only mechanism to provide a source of funds.

DUTY TO INDEMNIFY VS. DUTY TO DEFEND

While the terms “hold harmless” and “indemnify” may appear together, generally the terms are duplicative in that “hold harmless” refers to the duty of indemnity, i.e., protecting an indemnitee from a covered loss. However, the duty to defend is the obligation to provide a defense to a covered claim (once initiated). The duty to defend does not depend on the outcome of the claim; the duty to indemnify does not arise unless the outcome of the claim is adverse.

INDEMNIFICATION OBLIGATIONS FOR DIRECT CLAIMS

The New York Court of Appeals has held that in order for an indemnification provision to apply to the claim of a contracting party against another (as opposed to a third party claim against one of the contracting parties), the language of the indemnification provision must be “unmistakably clear” as to such intent. *Hooper Associates Ltd. v. AGS Computers, Inc.*, 74 N.Y.2d, 487; 549 N.Y.S.2d 365 (1989).

INDEMNIFICATION FOR OWN NEGLIGENCE

Absent a statutory provision to the contrary, a party may be indemnified for its own negligence. *Cortes v. Town of Brookhaven*, 78 AD3d 642; 910 NYS2d 171 (2d Dept., 2010).

New York General Obligations Law

5-321 Agreements exempting lessors from liability for negligence void and unenforceable.

5-322 Agreements exempting caterers and catering establishments from liability for negligence void and unenforceable.

5-322.1 Agreements exempting owners and contractors from liability for negligence void and unenforceable; certain cases.

5-323 Agreements exempting building service or maintenance contractors from liability for negligence void and unenforceable.

5-324 Agreements by owners, contractors, subcontractors or suppliers to indemnify architects, engineers and surveyors from liability caused by or arising out of defects in maps, plans, designs, and specifications void and unenforceable.

5-325 Garages and parking places.
5-326 Agreements exempting pools, gymnasiums, places of public amusement or recreation and similar establishments from liability for negligence void and unenforceable.

MATTERS TO CONSIDER WHEN DRAFTING AND NEGOTIATING INDEMNIFICATION PROVISIONS

- Indemnitor(s)
- Indemnitee(s) / Third Party Beneficiaries
- Losses and Damages – What is Covered – Definitions of “Costs” and “Losses”
- Inclusion or Waiver of Consequential or Indirect Damages, Lost Profits, Etc.
- Baskets – Issues with “Double Dipping” (*i.e.* “material” qualifiers for representations and warranties)
- Caps
- Exclusivity
- Source of Payment
- Knowledge of Buyer/Anti-Sand Bagging
- Effects of Availability of Other Sources of Payment (*e.g.* insurance proceeds)
- Effects of Tax Law
- Mechanics – Notice, Selection of Counsel, *etc.*
- Term of Indemnification Obligations

SAMPLE CONTRACTUAL INDEMNIFICATION PROVISIONS

ASSET PURCHASE AGREEMENT

Article VIII. Indemnification

8.01 Survival. Subject to the limitations and other provisions of this Agreement, the representations and warranties contained herein shall survive the Closing and shall remain in full force and effect until the date that is the eighteen (18) months after the Closing Date; *provided, that* (i) the Fundamental Representations shall survive indefinitely; (ii) the representations and warranties in **Section 4.18** and **Section 4.23** shall survive until the date that is three (3) years from the Closing Date, and (iii) the representations and warranties in **Section 4.21** shall survive for the full period of all applicable statutes of limitations (giving effect to any waiver, mitigation or extension thereof) plus sixty (60) days. All covenants and agreements of the parties contained herein shall survive the Closing indefinitely or for the period explicitly specified therein. Notwithstanding the foregoing, any claims asserted in good faith with reasonable specificity (to the extent known at such time) and in writing by notice from the non-breaching party to the breaching party in accordance with **Section 8.05** prior to the expiration date of the applicable survival period shall not thereafter be barred by the expiration of the relevant representation or warranty and such claims shall survive until finally resolved.

8.02 Indemnification By Seller and Shareholder. Subject to the other terms and conditions of this **Article VIII**, Seller and Shareholder, jointly and severally, shall indemnify and defend each of Buyer and its Affiliates and their respective Representatives (collectively, the “**Buyer Indemnitees**”) against, and shall hold each of them harmless from and against, and shall pay and reimburse each of them for, any and all Losses incurred or sustained by, or imposed upon, the Buyer Indemnitees based upon, arising out of, with respect to or by reason of, and including any Direct Claim (as hereinafter defined) related to:

(a) any inaccuracy in or breach of any of the representations or warranties of Seller and Shareholder contained in this Agreement or any Closing Certificate delivered by or any behalf of Seller or Shareholder pursuant to this Agreement;

(b) any breach or non-fulfillment of any covenant, agreement or obligation to be performed by Seller or Shareholder pursuant to this Agreement, the other Transaction Documents or any certificate or instrument delivered by or on behalf of Seller or Shareholder pursuant to this Agreement;

(c) any Excluded Asset or any Excluded Liability; and/or

(d) any Third Party Claim based upon, resulting from or arising out of the business, operations, properties, assets or obligations of Seller or any of its Affiliates (other than the Purchased Assets or Assumed Liabilities) conducted, existing or arising on or prior to the Closing Date.

8.03 Indemnification By Buyer. Subject to the other terms and conditions of this **Article VIII**, Buyer shall indemnify and defend Seller and its Affiliates and Representatives (collectively, the “**Seller Indemnitees**”) against, and shall hold each of them harmless from and against, and shall pay and reimburse each of them for, any and all Losses incurred or sustained by, or imposed upon, the Seller Indemnitees based upon, arising out of, with respect to or by reason of:

(a) any inaccuracy in or breach of any of the representations or warranties of Buyer contained in this Agreement or in any Closing Certificate delivered by or on behalf of Buyer pursuant to this Agreement;

(b) any breach or non-fulfillment of any covenant, agreement or obligation to be performed by Buyer pursuant to this Agreement or any certificate or instrument delivered by or on behalf of Buyer pursuant to this Agreement;

(c) any Assumed Liability; or

(d) any Third Party Claim based upon, resulting from or arising out of the business, operations, properties, assets or obligations of Buyer or any of its Affiliates (other than any Excluded Asset or Excluded Liability) conducted, existing or arising on or after the Closing Date.

8.04 Certain Limitations. The indemnification provided for in **0** and **0** shall be subject to the following limitations:

(a) Except as provided in **Section 8.04(c)**, Seller and Shareholder shall not be liable to the Buyer Indemnitees for indemnification under **Article VIII(a)** until the aggregate amount of all Losses subject to indemnification under **Article VIII(a)** exceeds \$_____ (the “**Basket**”), in which event Seller and Shareholder shall be required to pay or be liable for only such Losses in excess of the Basket. The aggregate amount of all Losses for which Seller and Shareholder shall be liable pursuant to **Article VIII(a)** shall not exceed \$_____ (the “**Cap**”).

(b) Except as provided in **Section 8.04(c)**, Buyer shall not be liable to the Seller Indemnitees for indemnification under **Article VIII(a)** until the aggregate amount of all Losses subject to indemnification under **Article VIII(a)** exceeds the Basket, in which event Buyer shall be required to pay or be liable for only such Losses in excess of the Basket. The aggregate amount of all Losses for which Buyer shall be liable pursuant to **Article VIII(a)** shall not exceed the Cap.

(c) The limitations set forth in **Article VIII(a)** and **Article VIII(b)** shall not apply to Losses based upon, arising out of, with respect to or by reason of any inaccuracy in or breach of any of the Fundamental Representations or resulting from fraud, criminal activity or willful misconduct on the part of a party hereto.

(d) The Buyer Indemnitees and the Seller Indemnitees shall not be entitled to indemnification under this Agreement: (i) to the extent the Indemnitee has actually received payment or reimbursement from another source for the same loss, liability or claim giving rise to the indemnification claim in question; or (ii) to the extent of any insurance proceeds actually

received by the Indemnity for the same loss, liability or claim giving rise to the indemnification claim in question. Notwithstanding the foregoing, each Indemnitee shall use its commercially reasonable efforts to recover under insurance policies and agreements providing for indemnity, contribution and other similar payments. Notwithstanding the foregoing, the agreement of the Indemnitee to use commercially reasonable efforts to recover under insurance policies and agreements providing for indemnity, contribution and other similar payments shall not preclude the making of an indemnification claim against the Indemnitee prior to resolution of any attempt by the Indemnitee to recover under any such insurance policies and agreements providing for indemnity and shall not be deemed to require the Indemnitee to commence any action to recover any insurance proceeds or payments made under agreements providing for indemnity, contribution and other similar payments.

(e) For purposes of this **Article VIII**, any inaccuracy in or breach of any representation or warranty shall be determined without regard to any materiality, Material Adverse Effect or other similar qualification contained in or otherwise applicable to such representation or warranty.

8.05 Indemnification Procedures. The party making a claim under this **Article VIII** is referred to as the “**Indemnified Party**”, and the party against whom such claims are asserted under this **Article VIII** is referred to as the “**Indemnifying Party**”.

(a) **Third Party Claims.** If any Indemnified Party receives notice of the assertion or commencement of any Action made or brought by any Person who is not a party to this Agreement or an Affiliate of a party to this Agreement or a Representative of the foregoing (a “**Third Party Claim**”) against such Indemnified Party with respect to which the Indemnifying Party is obligated to provide indemnification under this Agreement, the Indemnified Party shall give the Indemnifying Party reasonably prompt written notice thereof, but in any event not later than thirty (30) calendar days after receipt of such notice of such Third Party Claim. The failure to give such prompt written notice shall not, however, relieve the Indemnifying Party of its indemnification obligations, except and only to the extent that the Indemnifying Party is actually prejudiced by reason of such failure. Such notice by the Indemnified Party shall describe the Third Party Claim in reasonable detail and shall include copies of all material pleadings and correspondence by or with the party asserting such Third Party Claim. The Indemnifying Party shall have the right to participate in, or by giving written notice to the Indemnified Party within fifteen (15) days following receipt of the Indemnified Party’s notice of such Third Party Claim, to assume the defense of any Third Party Claim at the Indemnifying Party’s expense and by the Indemnifying Party’s own counsel reasonably acceptable to the Indemnified Party so long as the Litigation Conditions have been satisfied and continue to be satisfied, and the Indemnified Party shall cooperate in good faith in such defense. In the event that the Indemnifying Party assumes the defense of any Third Party Claim, subject to **Article VIII(b)**, it shall have the right to take such action as it deems necessary to avoid, dispute, defend, appeal or make counterclaims pertaining to any such Third Party Claim in the name and on behalf of the Indemnified Party. The Indemnified Party shall have the right to participate in the defense of any Third Party Claim with counsel selected by it subject to the Indemnifying Party’s right to control the defense thereof. The fees and disbursements of such counsel shall be at the expense of the Indemnified Party. If the Indemnifying Party elects not to compromise or defend such Third Party Claim, fails to timely notify the Indemnified Party in writing of its election to defend as provided in this

Agreement, fails to diligently prosecute the defense of such Third Party Claim, or if the Litigation Conditions do not exist or cease to exist, the Indemnified Party may, subject to **Article VIII(b)**, pay, compromise, defend such Third Party Claim and seek indemnification for any and all Losses based upon, arising from or relating to such Third Party Claim. Seller, Shareholder and Buyer shall cooperate with each other in all reasonable respects in connection with the defense of any Third Party Claim, including making available records relating to such Third Party Claim and furnishing, without expense (other than reimbursement of actual out-of-pocket expenses) to the defending party, management employees of the non-defending party as may be reasonably necessary for the preparation of the defense of such Third Party Claim.

(b) **Settlement of Third Party Claims.** Notwithstanding any other provision of this Agreement, the Indemnifying Party shall not enter into settlement of any Third Party Claim without the prior written consent of the Indemnified Party, except as provided in this **Article VIII(b)**. If a firm offer is made to settle a Third Party Claim without leading to liability or the creation of a financial or other obligation on the part of the Indemnified Party and provides, in customary form, for the unconditional release of each Indemnified Party from all liabilities and obligations in connection with such Third Party Claim and the Indemnifying Party desires to accept and agree to such offer, the Indemnifying Party shall give written notice to that effect to the Indemnified Party. If the Indemnified Party fails to consent to such firm offer within ten (10) days after its receipt of such notice, the Indemnified Party may continue to contest or defend such Third Party Claim and in such event, the maximum liability of the Indemnifying Party as to such Third Party Claim shall not exceed the amount of such settlement offer. If the Indemnified Party fails to consent to such firm offer and also fails to assume defense of such Third Party Claim, the Indemnifying Party may settle the Third Party Claim upon the terms set forth in such firm offer to settle such Third Party Claim.

(c) **Direct Claims.** Any Action by an Indemnified Party on account of a Loss which does not result from a Third Party Claim (a “**Direct Claim**”) shall be asserted by the Indemnified Party giving the Indemnifying Party reasonably prompt written notice thereof, but in any event not later than thirty (30) days after the Indemnified Party becomes aware of such Direct Claim. The failure to give such prompt written notice shall not, however, relieve the Indemnifying Party of its indemnification obligations, except and only to the extent that the Indemnifying Party forfeits rights or defenses by reason of such failure. Such notice by the Indemnified Party shall describe the Direct Claim in reasonable detail, shall include copies of all material written evidence thereof and shall indicate the estimated amount, if reasonably practicable, of the Loss that has been or may be sustained by the Indemnified Party. The Indemnifying Party shall have thirty (30) days after its receipt of such notice to respond in writing to such Direct Claim. The Indemnified Party shall allow the Indemnifying Party and its professional advisors to investigate the matter or circumstance alleged to give rise to the Direct Claim, and whether and to what extent any amount is payable in respect of the Direct Claim and the Indemnified Party shall assist the Indemnifying Party’s investigation by giving such information and assistance (including access to the Indemnified Party’s premises and personnel and the right to examine and copy any accounts, documents or records) as the Indemnifying Party or any of its professional advisors may reasonably request. If the Indemnifying Party does not so respond within such thirty (30) day period, the Indemnifying Party shall be deemed to have rejected such claim, in which case the Indemnified Party shall be free to pursue such

remedies as may be available to the Indemnified Party on the terms and subject to the provisions of this Agreement.

8.06 Payments. Once a Loss is agreed to by the Indemnifying Party or adjudicated to be payable pursuant to this **Article VIII**, the Indemnifying Party shall satisfy its obligations within fifteen (15) Business Days of such adjudication by wire transfer of immediately available funds. The parties hereto agree that should an Indemnifying Party not make full payment of any such obligations within such fifteen (15) Business Day period, any amount payable shall accrue simple interest from the date such payment was due at a rate per annum equal to five percent (5%) plus the prime rate on the date such amount first became payable, as reported by the Wall Street Journal or an equivalent successor publication.

8.07 Tax Treatment of Indemnification Payments. All indemnification payments made under this Agreement shall be treated by the parties as an adjustment to the Purchase Price for Tax purposes, unless otherwise required by Law.

8.08 Effect of Investigation. The representations, warranties and covenants of the Indemnifying Party, and the Indemnified Party's right to indemnification with respect thereto, shall not be affected or deemed waived by reason of any investigation made by or on behalf of the Indemnified Party (including by any of its Representatives) or by reason of the fact that the Indemnified Party or any of its Representatives knew or should have known that any such representation or warranty is, was or might be inaccurate or by reason of the Indemnified Party's waiver of any condition set forth in **Section 7.02** or **Section 7.03**, as the case may be.

8.09 Exclusive Remedies. The parties acknowledge and agree that their sole and exclusive remedy with respect to any and all claims (other than claims arising from fraud, criminal activity or willful misconduct on the part of a party hereto in connection with the transactions contemplated by this Agreement) for any breach of any representation, warranty, covenant, agreement or obligation set forth herein, shall be pursuant to the indemnification provisions set forth in this **Article VIII**. In furtherance of the foregoing, each party hereby waives, to the fullest extent permitted under Law, any and all rights, claims and causes of action for any breach of any representation, warranty, covenant, agreement or obligation set forth herein it may have against the other parties hereto and their Affiliates and each of their respective Representatives arising under or based upon any Law, except pursuant to the indemnification provisions set forth in this **Article VIII**. Nothing in this **0** shall limit any Person's right to seek and obtain any equitable relief to which any Person shall be entitled or to seek any remedy on account of any party's fraudulent, criminal or intentional misconduct.

SUPPLY AGREEMENT

19.01 Indemnification by Seller

Seller shall indemnify, defend and hold harmless Buyer (and its Affiliates) from and against any and all third party Damages (including, without limitation, reasonable attorney's fees) (collectively "**Third Party Damages**") that may be sustained, suffered or incurred by Buyer (or its Affiliates), arising directly from or by reason of or otherwise relating to (a) the breach by Seller of any warranty, representation, covenant or agreement made by Seller in this Agreement or any Affiliate Agreement; (b) Products which are non-conforming to the Product warranty under Section 11.02; (c) any actual or alleged infringement or violation of any patent, trade secret or other proprietary rights of any third party and relating to Seller's Background Intellectual Property; or (d) Seller's negligence or willful misconduct; provided that the foregoing shall not apply to the extent arising from Buyer's negligence or willful misconduct.

19.02 Indemnification by Buyer

Buyer shall indemnify, defend and hold harmless Seller (and its Affiliates) from and against any and all Third Party Damages, that may be sustained, suffered or incurred by Seller (or its Affiliates) arising directly from or by reason of or otherwise relating to (a) the breach by Buyer of any warranty, representation, covenant or agreement made by Buyer in this Agreement; (b) Buyer's negligence or willful misconduct; provided that the foregoing shall not apply to the extent arising from Seller's negligence or willful misconduct or from Product which are non-conforming to the Product warranty under Section 11.02; (c) the handling, storage, promotion, testing, use, marketing, distribution or sale of any Products subsequent to delivery to Buyer and to the extent not caused by Products which are non-conforming to the Product warranty under Section 11.02, (d) any of Buyer's designs or Specifications of the Products, or (e) any Buyer Directed Material and/or Buyer Supplied Material.

19.03 Claims

Each indemnified party agrees to give the indemnifying party prompt written notice of any matter upon which such indemnified party intends to base a claim for indemnification (an "**Indemnity Claim**") under this Article 19. The indemnifying party shall have the right to participate jointly with the indemnified party in the indemnified party's defense, settlement or other disposition of any Indemnity Claim. With respect to any Indemnity Claim relating solely to the payment of money damages and which could not result in the indemnified party's becoming subject to injunctive or other equitable relief or otherwise adversely affect the business of the indemnified party in any manner, and as to which the indemnifying party shall have acknowledged in writing the obligation to indemnify the indemnified party hereunder, the indemnifying party shall have the sole right to defend, settle or otherwise dispose of such Indemnity Claim, on such terms as the indemnifying party, in its sole discretion, shall deem appropriate; provided that the indemnifying party shall provide reasonable evidence of its ability to pay any damages claimed and with respect to any such settlement shall obtain the written release of the indemnified party from the Indemnity Claim. The indemnifying party shall obtain

the written consent of the indemnified party prior to ceasing to defend, settling or otherwise disposing of any Indemnity Claim if as a result thereof the indemnified party would become subject to injunctive or other equitable relief or the business of the indemnified party would be adversely affected in any manner.

20.01 Limitations

EXCEPT WITH RESPECT TO (A) A BREACH OF ARTICLE 15 (CONFIDENTIALITY) OR (B) SUCH DAMAGES WHICH ARE A PART OF THIRD PARTY DAMAGES DUE IN CONNECTION WITH ANY INDEMNIFICATION OBLIGATIONS UNDER ARTICLE 19, TO THE FULLEST EXTENT PERMITTED BY LAW IN NO EVENT SHALL SELLER, BUYER OR ANY AFFILIATE BE LIABLE TO THE OTHER OR ANY THIRD PARTY SEEKING DAMAGES UNDER THIS AGREEMENT (INCLUDING, WITHOUT LIMITATION, IN CONNECTION WITH ANY BREACH BY SUPPLIER OF ANY WARRANTY UNDER SECTION 11.02) OR ANY AFFILIATE AGREEMENT FOR PUNITIVE, EXEMPLARY, INDIRECT, INCIDENTAL, SPECIAL, OR CONSEQUENTIAL DAMAGES ARISING OUT OF THIS AGREEMENT OR ANY AFFILIATE AGREEMENT, INCLUDING WITHOUT LIMITATION, LOSS OF PRODUCTION, REVENUE OR PROFITS, EVEN IF IT HAS BEEN ADVISED OF THE POSSIBLE EXISTENCE OF SUCH LIABILITY. EACH PARTY HEREBY IRREVOCABLY WAIVES ANY RIGHT TO SEEK ANY SUCH DAMAGES.

EXCEPT WITH RESPECT TO (A) A BREACH OF ARTICLE 15 (CONFIDENTIALITY) OR (B) SUCH DAMAGES WHICH ARE A PART OF THIRD PARTY DAMAGES DUE IN CONNECTION WITH ANY INDEMNIFICATION OBLIGATIONS UNDER ARTICLE 19, IN NO EVENT SHALL SELLER'S LIABILITY FOR LOSSES OR DAMAGES OF ANY KIND UNDER THIS AGREEMENT EXCEED THE GREATER OF (I) \$1,000,000 OR (II) THE AGGREGATE AMOUNT PAID BY BUYER TO SELLER DURING THE TWO (2) FULL CALENDAR YEARS IMMEDIATELY PRECEDING THE DATE OF THE EVENT GIVING RISE TO SELLER'S LIABILITY FOR LOSSES OR DAMAGES.