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Beware of boilerplate

By Anthony Rospert And Brendan McCarthy Updated 03:05 PM, Sep-24-2012 ET

Boilerplate indemnification provisions may expedite the closing of an acquisition, but can present unforeseen hazards in the defense of third-party claims.

Suppose that your company — perhaps a strategic buyer or a **private equity** firm — has set its sights on acquiring a maker of microprocessors. The manufacturer is the exclusive supplier to a company that produces tablet computers, which is also the manufacturer's biggest customer. You enter into an asset purchase agreement with the seller. You execute an asset purchase agreement with the seller that contains a boilerplate indemnification provision obligating the seller to indemnify you from and against any third-party claims.

Following the closing, the tablet manufacturer files a breach-of-warranty claim against your company — or, more likely, the acquisition subsidiary — for allegedly defective microprocessors that were manufactured and delivered prior to closing. You notify the seller, and it assumes control of the defense based on its clear right or duty to defend specified in the indemnification provision. In an effort to reduce its indemnification exposure, the seller takes a hard-line approach during settlement negotiations with the tablet manufacturer, engages in extensive discovery and forces your best customer to endure a protracted and expensive trial. After this rather unpleasant experience, the tablet manufacturer terminates its relationship with the acquired business and seeks out a new supplier of microprocessors. Having lost this blue-chip customer, the business is now, for all intents and purposes, practically worthless.

This scenario demonstrates the potential hazards a buyer faces when it agrees to a boilerplate indemnification provision, which, unfortunately, is fairly common. This can present unanticipated risks to a buyer and jeopardize its goals in acquiring a business. Regardless of the purpose of the acquisition — strategic or financial — a buyer should not reflexively agree to a boilerplate indemnification provision, but should spend the time to carefully consider, draft and negotiate appropriate limits on a seller's ability to assume and control the defense of third-party claims subject to indemnification.

Perhaps the most obvious situation in which a buyer should be concerned with a seller controlling the defense of a third-party claim is when a customer files suit against the business. The seller, now out of the business and motivated only by limiting exposure to a buyer's indemnification claim, may take an uncompromising approach with the customer, possibly jeopardizing the relationship between the customer and the business. Similar considerations exist where the third party is a major supplier to the acquired business. If third-party claims are not handled with the interests of the ongoing business in mind, the impact can be long lasting and potentially fatal.

One solution available to the buyer is to specify in the purchase agreement certain third-party claims of which

the seller cannot assume and control the defense, even if such matters may be subject to the seller's duty to indemnify. Exceptions might include situations where the third party is a customer or supplier or where it is seeking equitable relief. In terms of the lasting impact on the ongoing business, many of these claims should be handled by the buyer, who has a genuine stake in the business going forward.

If the seller has the right to assume and control the defense of third-party claims, but a particular claim falls under one of the negotiated exceptions, the buyer could have the option to offer the seller the right to assume and control the defense. The seller may reject the offer, but the buyer can proceed in defending against the claim and then seek indemnification from the seller.

Another approach is to allow the buyer to assume and control the defense of a third-party claim at its discretion. The buyer also might elect to "take back" the defense at a strategic point in the litigation, such as at trial or during arbitration or mediation. If the buyer does not choose to do so, the seller would be obligated to continue to control the defense.

A buyer should be careful in crafting exceptions to when a seller can assume and control the defense of a third-party claim that may be subject to indemnification. The solutions mentioned above can assist the buyer in protecting its financial and strategic interests following closing by guarding against the hidden dangers of boilerplate indemnification provisions.

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