Indemnification in M&A Deals: The Post-Closing Risk Allocation Tool

In a private M&A deal, closing is not always the end of the story. After the buyer pays the purchase price and takes over the business, it may discover unpaid taxes, inaccurate financial statements, undisclosed litigation, employee benefit problems, environmental issues, customer disputes, or other liabilities that relate to the pre-closing business. Indemnification is the contract mechanism that decides who bears those post-closing losses.

At its core, M&A indemnification allocates risk between buyer and seller. Buyers generally want broad protection because they inherit the economic consequences of what they bought. Sellers generally want certainty and finality because they are exiting the business and do not want open-ended exposure. The indemnification section is where those competing goals get translated into rules: what claims are covered, who can bring them, how long they last, how much can be recovered, how claims are funded, and whether indemnification is the exclusive remedy.

The most common buyer indemnity claims involve breaches of representations and warranties. If the seller represented that the company had no undisclosed liabilities, owned its IP, complied with law, paid taxes, had accurate financials, or disclosed material contracts, and that statement turns out to be false, the buyer may seek indemnification. Indemnity may also cover breaches of covenants, pre-closing taxes, unpaid transaction expenses, debt not accounted for at closing, excluded liabilities, specific known risks, fraud, intentional misrepresentation, or willful misconduct.

Survival periods are critical. Representations and warranties must survive closing to support a post-closing indemnity claim. General representations often survive for a limited period, commonly around 12 to 18 months, while "fundamental" representations—such as organization, authority, capitalization, ownership, brokers' fees, and sometimes taxes—may survive longer. Covenants may survive until performed. If the parties want claims to expire after a certain date, the agreement should say so clearly, because survival language and statutes of limitation do not always interact the way non-lawyers expect.

M&A indemnities also need to identify the right parties. In an asset sale, the seller is usually the indemnifying party. In a stock purchase, the selling stockholders may be responsible. In a merger, the target company disappears into the buyer's structure, so an indemnity from the target itself may be worthless after closing. Buyers therefore often rely on selling stockholders, a stockholder representative, escrow funds, holdbacks, or joinders. This can become especially tricky where some equity holders did not sign the acquisition agreement, so the structure must be designed carefully.

The definition of "losses" is another major battleground. Buyers want broad recovery: damages, settlements, attorneys' fees, investigation costs, diminution in value, multiples, and sometimes consequential or punitive damages if awarded to a third party. Sellers want narrower recovery: actual out-of-pocket losses, no speculative damages, no multiples, no punitive damages except in third-party claims, and no double recovery. If the agreement is vague, the parties may end up litigating not only whether there was a breach, but what kind of damages count.

Caps, baskets, and materiality provisions shape the economics. A basket requires losses to exceed a negotiated amount before indemnity is available. A deductible basket makes the seller pay only amounts above the basket; a tipping basket makes the seller pay from the first dollar once the basket is exceeded. A cap limits the seller's maximum exposure. Fundamental representations, fraud, intentional misconduct, specific indemnities, and sometimes tax claims are often excluded from general caps or baskets. Materiality also matters: if a representation is already qualified by "materiality," and indemnification is also limited to "material" breaches, the buyer may face double materiality. A "materiality scrape" can remove that double filter for indemnity purposes.

Funding is practical leverage. A buyer may negotiate for an escrow, holdback, setoff right against future payments, parent guaranty, or representation and warranty insurance. Escrows are common because they create a known source of recovery and reduce the need to chase multiple sellers after closing. Representation and warranty (R&W) insurance has also become a major deal tool; in some transactions it supplements seller indemnity, and in others it largely replaces traditional indemnification, making the deal closer to a "walk-away" structure.

Procedure matters just as much as substance. The agreement should specify how claims are noticed, what information notices must include, whether late notice defeats recovery or only reduces recovery to the extent the seller was prejudiced, who controls the defense of third-party claims, and when settlements require consent. Buyers often want control where the claim involves customers, suppliers, criminal allegations, injunctive relief, reputational risk, or potential losses above the cap. Sellers want control because they may be paying.

Finally, M&A agreements often address whether indemnification is the exclusive remedy and whether the buyer can "sandbag"—that is, bring a claim for a breach it knew about before closing. Sellers typically want indemnification to be the exclusive remedy, subject to narrow exceptions. Buyers want exceptions for fraud, equitable relief, purchase-price adjustments, and sometimes willful misconduct. Sandbagging rules vary by state, so the agreement should be explicit.

In short, M&A indemnification is the deal's post-closing safety net. It should be drafted with the same care as the price, because it determines whether the buyer has meaningful protection and whether the seller gets the finality it bargained for.

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