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Reducing M&A Risks With Caps And Baskets

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Most buyers and sellers of businesses believe the purchase price is the most important term of the agreement. Many lawyers think the representations and warranties are the most important terms in the agreement. In reality, indemnification is where the action is. Furthermore, the cap and basket provisions within the "indemnity package" can give indemnification within an agreement real bite or leave it toothless.

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In private acquisition agreements, the indemnification cap and basket are frequently two of the most heavily negotiated items in the entire transaction. The indemnification terms are primarily responsible for allocating any risk in the transaction between the parties. Caps and baskets can be structured many different ways, so it is important to understand those structures in order to identify what risk you are taking on.

Indemnity Caps

Indemnification caps limit a party's maximum total recovery to a stated dollar amount. The cap amount is often equal to a percentage of the purchase price. These seller-friendly provisions are common in seller-friendly markets like the current one. Last year, over 90 percent of middle-market deals had an indemnity cap, with the median indemnity cap at around 10 percent of the purchase price. Smaller transactions generally have higher caps than larger transactions, with some smaller transactions having a cap of 100 percent of the purchase price. Indemnity caps typically are subject to certain exceptions for specified types of claims, such as the seller's fraud, willful misconduct, or breaches of certain representations and warranties.

If the buyer has particular concerns about potential losses, it should either try to exclude them from the cap or try to:

1. Set a high cap amount.

2. Exclude areas with potentially significant liabilities (such as environmental matters) from the cap or have these subject to a separate or higher cap.

3. Exclude liabilities that the seller has agreed to assume.

Second-Level Indemnity Caps

Over 80 percent of middle-market deals have a separate cap for other specifically identified types of indemnity claims. Common carveouts for separate caps include those for breaches of fraud, “fundamental” representations (e.g., due organization, authorization, capitalization, noncontravention, etc.), tax and intellectual property. These caps, especially those for fraud, fundamental representations and tax, tend to be much higher than the general cap. Breaches of fundamental representations and taxes frequently are capped at 100 percent of the purchase price. Breaches resulting from fraud are generally capped at the purchase price or are not subject to the cap at all. Furthermore, buyers of technology companies holding significant intellectual property will often try to negotiate a separate cap for the reps and warranties related to the tech target’s intellectual property.

Indemnity Baskets

Just as no two deals are alike, it is true that no two baskets are alike. The basket varies in form and size, so it is important to understand and define this term carefully in the purchase agreement. A basket limits indemnification obligations so that an indemnifying party is not liable for inaccuracies in or breaches of certain representations until losses exceed a specified minimum dollar amount.

Baskets can be structured as either a:

1. True deductible basket (also known as an excess-liability basket), where the indemnifying party does not pay a single dollar unless and until the eligible indemnity claims exceed the specified threshold amount, and then, is only liable for the amount over that specified threshold.” A deductible also prevents the buyer from bringing "immaterial" claims, but also acts as a risk allocation mechanism. By incorporating a deductible, the sellers are requiring the buyer to bear the burden of the first tranche of their losses. This type of basket is preferred by the seller and is generally more common.

2. Tipping basket (also known as a dollar-one or threshold basket), where the indemnifying party is liable for the total amount of losses once the minimum amount is exceeded. Here, the indemnifying party also does not pay a single dollar unless and until the other party’s losses exceed the specified threshold amount, but unlike the deductible basket, once losses surpass that threshold amount, the indemnifying party is liable for the full amount of any and all loss, starting from $0 (instead of just the amount over the threshold amount). This type of basket is obviously preferred by the buyer because it is made whole for the losses once the threshold has been met.

3. Hybrid basket, where the indemnifying party is only liable for losses once a threshold amount is exceeded, but once that amount is reached, the indemnifying party is liable for losses that exceed an amount that is less than the threshold amount but greater than zero.

Almost 90 percent of all middle-market deals last year contained both a cap and basket indemnity provision. In a seller-friendly market like we are in now, sellers are more likely to be able to require a true deductible basket rather than a tipping basket. Of the middle-market deals that had an indemnification basket in 2016, roughly 75 percent of them had true deductible baskets, although that data has been trending lower since 2014. The basket size for a middle-market deal is typically between 0.5 percent and 1 percent of the purchase price with the median around 0.75 percent.

Basket Carveouts

While the exceptions may be specific to each deal, "fundamental" representations (e.g., due organization, authorization, capitalization, noncontravention, etc.), tax matters and environmental representations generally are excluded from the limitations of basket. Other important carveouts to consider are breaches caused by fraud or intentional misrepresentation.

Baskets may also contain a "minibasket," which requires the losses from a particular claim to exceed a certain amount before those losses can be counted toward the basket. The purpose of this is to prevent the buyer from searching for any minor breach in order to reach the basket amount. Sellers don't want to be bothered with every claim that arises after the closing. A minibasket is generally subject to the same carveouts as the basket in which it is included. Only about a quarter of middle-market deals have this minibasket provision.

Negotiating Caps and Baskets

As the current M&A environment continues to favor sellers, key deal terms such as the indemnity caps and baskets tend to be driven by sellers. Meanwhile, buyers continue their attempt to differentiate themselves and present a more compelling bid for targets by taking on more risk through lower caps and higher baskets in their letters of intent and purchase agreements. Buyers are also increasingly purchasing representation and warranty insurance in an effort to make their acquisition proposal even more attractive to a seller by limiting potential post-closing liability of the seller.

Each deal has unique facts and circumstances that impact the negotiation of the acquisition agreement, including, importantly, the relative leverage of the buyer and seller. It is nonetheless helpful when negotiating to have a strong understanding of where the terms of your "indemnity package" fall in the current market spectrum.

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