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M&A Buyers Beware: Who Bears the Cost of Defense of a Third-Party Claim?

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Introduction

Acquiring a business is a significant accomplishment. Your lawyers have worked tirelessly to negotiate a detailed acquisition agreement that includes robust representations and warranties related to the acquired business and comprehensive indemnification clauses providing you with a right to recover some, or all, of the purchase price in the event you discover a breach of those representations and warranties following the closing. But how does this agreement work if the acquired business is subject to a third-party claim? This article examines how the cost of defense of such claims would be treated in an acquisition agreement governed by Delaware law.

Indemnity Generally

Generally, in private target M&A, the acquisition agreement provides the buyer with a right to be indemnified against losses it has incurred in connection with a third-party claim if those losses can be traced to a breach of a representation made by the sellers, subject to the limitations set forth in the agreement. These limitations often include deadlines before which a claim for indemnification must be brought, limitations on what type of "Losses" or "Damages" may be recoverable as part of an indemnity claim or restrictions on a buyer's ability to settle a third-party claim without the consent of the indemnifying parties.

But perhaps the most significant hurdle for a buyer in bringing a claim for indemnity based on a third-party claim is the need to establish that a breach of a representation has actually occurred.[1] If the acquisition agreement states that a buyer is entitled to be indemnified for losses arising from a breach of a representation, then the buyer is not entitled to indemnity unless and until the buyer has demonstrated that there is in fact a breach. A mere allegation by a third party, such as a claim that the target company has infringed a patent, would not be sufficient to demonstrate that the sellers had in fact breached their representation.[2] Without a final determination

[1] *See Lear Corp. v. Johnson Elec. Holdings Ltd.*, 353 F.3d 580, 584 (7th Cir. 2003).

[2] *See Winshall v. Viacom Int'l Inc.*, 76 A.3d 808 (Del. 2013); *see also* Model Asset Purchase Agreement with Commentary: Asset Purchase Agreement 222 (Mergers & Acquisitions ed., ABA Book Publishing 2014) [hereinafter *ABA Model APA*] ("Indemnification generally is not available for claims made that later prove to be groundless. Thus, the buyer could incur substantial expenses in investigating and litigating a claim without being able to obtain indemnification. In this respect, the indemnification

of a breach, the buyer would have no entitlement to indemnification.

Indemnity vs. Obligation to Defend

Demonstrating an actual breach as a necessary step prior to being entitled to indemnity leaves a buyer in an awkward position. In the infringement claim example, the buyer's posture with respect to the third-party claimant is that the business did *not* infringe and the natural corollary of this would be that the representation to this effect made by the sellers was in fact *true*. As a result, the buyer will likely incur substantial legal fees defending the claim regardless of the claim's merit. Those costs of defending the claim may not be recoverable under the indemnity obligation itself unless the breach of the representation has been established by virtue of an unfavorable court decision or perhaps a settlement. Note that while many acquisition agreements define indemnifiable "Losses" to include reasonable attorney's fees, those Losses would not be recoverable in connection with a third-party claim if the indemnity trigger requires a breach and the breach has not yet been demonstrated, unless there is another indemnity or reimbursement trigger that is not dependent on a breach of a representation.

This distinction between the duty to indemnify and the duty to advance expenses to defend a claim is addressed by the Delaware Supreme Court in the *Winshall v. Viacom Int'l Inc.* case.[3]

In *Winshall*, the buyer sought damages from the sellers to cover its costs of defending certain third-party intellectual property claims that arose following the closing, all of which were disposed of either by settlement or court dismissal. The merger agreement contained representations that the target business did not infringe the intellectual property rights of third parties and also contained an obligation of the sellers to indemnify the buyer for breaches of the representations and warranties contained in the agreement. The buyer claimed that the merger agreement imposed an independent duty for the sellers to pay the defense costs of the buyer regardless of whether there was in fact a breach of the infringement representation. The court disagreed:

> Where parties to a merger agreement intend to create separate duties to indemnify and to defend, they employ an "indemnify and defend against claims" clause or similar language to that effect. But where, as here, the contract expressly imposes only a duty to "indemnify," as opposed to "indemnify and defend," the courts generally hold that there is no duty to defend.[4]

The court in *Winshall* made a clear distinction between the duty to indemnify and the duty to defend, drawing an analogy between the duty to defend and the obligation to advance expenses:

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provisions of the Model Agreement, and most acquisition agreements, provide less protection than indemnities given in other situations such as securities underwriting agreements").

[3] *See Winshall*, 76 A.3d at 822.

[4] *Id.* at 820. Note that the result may be different in other jurisdictions. Some states, such as California, have found an implied duty to defend within the indemnity obligation unless the contract expressly states otherwise. *See* Cal. Civ. Code § 2778(4) (2024) ("The person indemnifying is bound, on request of the person indemnified, to defend actions or proceedings brought against the latter in respect to the matters embraced by the indemnity, but the person indemnified has the right to conduct such defenses, if he chooses to do so"); *see also Crawford v. Weather Shield Mfg., Inc.*, 187 P.3d 424, 434 (Cal. 2008) (interpreting subdivision 4 of the California Civil Code Section 2778: "… an indemnitor's duty 'to defend' the indemnitee upon the latter's request, places in every indemnity contract, unless the agreement provides otherwise, a duty to assume the indemnitee's defense, if tendered, against all claims 'embraced by the indemnity'").

> Finally, the Defendants' interpretation of § 8.2(d)(i) improperly conflates the legally distinct concepts of advancement and indemnification. Under Delaware law, an "indemnify and hold harmless" clause does not confer a right of advancement, *i.e.*, the right to payment of "litigation expenses as they are incurred regardless of whether [the party] will ultimately be entitled to indemnification."[5]

This obligation to defend was not present in the merger agreement at issue in the *Winshall* case.[6] Is this obligation contained in your agreement?

Luckily, many agreements do include the words "indemnify, ***defend*** and hold harmless" in describing the obligations of sellers. If your agreement has this language, then the sellers in your deal probably do have the obligation to pay your defense costs related to such a third-party claim in advance of a settlement or decision by a court, subject to the other terms and limitations contained in your agreement. This obligation would exist even if you prevail in court against the third-party claimant, meaning the breach of the underlying representation has not previously been, and may never be, established.[7]

Despite the importance of the duty to defend as a feature in acquisition agreements, it receives very little attention in legal scholarship in the M&A context. Whether or not practitioners appreciate the practical import of the duty to defend in this context, it is present in many but not nearly all private target acquisition agreements. Though the ABA 2023 Private Target Mergers & Acquisitions Deal Points Study does not provide data on this topic, an independent examination of a portion of the agreements analyzed in the sample group revealed that half of the examined agreements included a duty to defend against, in addition to the duty to indemnify for, breaches of representations and warranties.[8]

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[5] *Winshall*, 76 A.3d at 822 (citing *Majkowski v. Am. Imaging Mgmt. Servs., LLC*, 913 A.2d 572, 586 (Del. Ch. 2006)). Note, despite the court's association of the duty to defend with the obligation of advancement there are important differences between the two concepts. The concept of advancement is a subset of the broader duty to indemnify and still relies on an ultimate indemnification claim. The obligation of advancement requires payment, on an ongoing basis, of the litigation expenses of a potential indemnitee regardless of ultimate entitlement to indemnification. However, this obligation of advancement is merely an advance credit of the indemnification proceeds, and because an indemnification claim requires an established breach, the advancement must be repaid if an indemnification obligation is not eventually established. *Majkowski v. Am. Imaging Mgmt. Servs., Ltd. Liab. Co.*, 913 A.2d 572, 586 (Del. Del. Ch. 2006) (finding the obligation of advancement requires the repayment of "all sums advanced to him if it is later determined that he is not entitled to be indemnified."). In contrast, the court in *Winshall* suggests that the duty to defend is not a subset of the duty to indemnify; it is a distinct obligation. *See Fillip v. Centerstone Linen Servs., LLC*, No. CIV.A. 8712-ML, 2013 WL 6671663, at *6 (Del. Ch. Dec. 3, 2013) (finding "*Winshall* strongly suggests a contract's reference to a duty to defend means something other than an indemnity obligation and creates a duty to 'pay for the outlays of defense on a current basis'"). The *Winshall* court does not state that a person with an obligation of defense requires repayment of expenses absent a later determination of a breach.

[6] *Winshall*, 76 A.3d at 820.

[7] The *Winshall* court favorably cites decisions holding that insurers with a duty to defend must provide such a defense "even if any of the allegations of the Claim are groundless, false or fraudulent." *See Winshall*, 76 A.3d at 820 (citing *United Westlabs, Inc. v. Greenwich Ins. Co.*, 2011 WL 2623932, at *3 (Del. Super. Ct. June 13, 2011), *aff'd*, 38 A.3d 1255 (Del. 2012); *DynCorp v. Certain Underwriters at Lloyd's,* London, 2009 WL 3764971, at *4 (Del. Super. Ct. Nov. 9, 2009) (finding the policy required insurer to defend claims "even if groundless, false, [or] fraudulent"); *Pac. Ins. Co. v. Liberty Mut. Ins. Co.*, 956 A.2d 1246, 1250 (Del. 2008) (providing that insurer has a "duty to defend any 'suit'")).

[8] *See* Jessica C. Pearlman et al., Private Target Mergers & Acquisitions Deal Points Study (American Bar Association, 2023) [hereinafter *ABA Report*]. The ABA 2023 Private Target Merger & Acquisitions Deal Points Study examined 108 publicly available definitive agreements. *See* Jessica C. Pearlman & Tatjana Paterno, *Announcing the ABA's 2023 Private Target Mergers &*

Costs of Settlement

So, we have established that legal fees incurred by a buyer defending a third-party claim would likely not be covered by an indemnification obligation unless and until the trigger for indemnity (*i.e.*, the breach of the representation) has been demonstrated, absent a separate duty on behalf of sellers to defend such claims. What about amounts paid by a buyer to a third party to settle such a claim? The cost of the settlement itself may not be covered by the duty to defend. While the agreement by the buyer to settle the claim would suggest that there is at least some merit to the allegations of the third party making the claim, it may not be sufficient to establish that the underlying breach has occurred and thus may not be covered by the indemnification obligation either. Of course, the specific terms of your agreement may affect this analysis. For example, if the agreement permits the seller to assume the defense of a third-party claim, and the seller elects to do so, then the costs of any resultant settlement would likely be the obligation of the seller. In addition, some agreements state that if the seller is given notice of a third-party claim and chooses to not assume the defense of such claim, then the seller is bound by any judgment or settlement of such claim.[9] However, even if such language is included, the seller would likely retain its ability to argue that the claim was not indemnifiable at all because there was no breach of representation to trigger it.

"If True" Clauses

In some acquisition agreements, buyers include language expanding the trigger for indemnity to include not only actual breaches of the representations and warranties, but also alleged breaches. Stated another way, these clauses expressly state that the indemnification obligation is triggered the moment a third-party claim alleges facts that, if true, would constitute a breach of a representation or warranty. There are several different ways to draft an if true provision, such as "… [sellers] will … hold the [buyer] harmless against all damages, losses, out-of-pocket expense, … and reasonable and documented attorneys' fees that the [buyer has] incurred arising out of: (a) the inaccuracy or breach of any representations and warranties set forth in … this Agreement or any Ancillary Agreement ***including any Third-Party Claim alleging facts that, if true, would constitute a breach of any such representation or warranty.***"[10]

Acquisitions Deal Points Study, Am. Bar Assoc. (Dec. 22, 2023), https://www.americanbar.org/groups/business_law/resources/business-law-today/2023-december/announcing-aba-2023-private-target-ma-deal-points-study/. Of the 108 definitive agreements examined in the ABA study, an independent study examined 51 of those agreements, a representative sample. Eleven of the 51 agreements examined did not contain an indemnification package. Out of the remaining 40 agreements, 20 contained "defend" language, such as "indemnify, ***defend*** and hold harmless," and 20 did not include an obligation to "defend" as a part of the indemnification package.

[9] *See ABA Model APA*, *supra* note 1, at 233 ("If notice is given to an Indemnifying Person of the assertion of any Third-Party Claim and the Indemnifying Person does not, within ten (10) days after the Indemnified Person's notice is given, give notice to the Indemnified Person of its election to assume the defense of such Third-Party Claim, the Indemnifying Person will be bound by any determination made in such Third-Party Claim or any compromise or settlement effected by the Indemnified Person").

[10] Shutterstock, Inc. & Pond5, Inc., Agreement and Plan of Merger § 9.1 (May 2022), EDGAR Form 8-K, https://www.sec.gov/ix?doc=/Archives/edgar/data/0001549346/000114036122018607/brhc10037452_8k.htm. Another common formulation makes reference to "alleged" breaches, such as in the following example:

> Sellers shall indemnify the buyer for Losses suffered or incurred by or imposed on such Buyer Indemnitee to the extent resulting from or arising out of any breach of any representation or warranty, including any breach of any such representation or warranty alleged by a third party.

An "if true" clause is very favorable to buyers because it removes the condition to indemnity that the underlying breach be established, clearly and expressly entitling the buyer to the costs of its defense of any third-party claim alleging facts that if true would demonstrate a breach of representation. And subject to the terms and limitations elsewhere in the agreement, the "if true" clause may also entitle a buyer to its costs incurred in settlement of such a claim, which may not be covered by the duty to defend. But if true clauses are not routinely included in private target acquisition agreements. According to the ABA 2023 Private Target Mergers & Acquisitions Deal Points Study, only 17% of deals in 2022-23 included a buyer's right to indemnity based on alleged (as opposed to actual) breaches.[11]

Other Ways to Cover Defense of Third-Party Claims

In addition to the "defend" obligation and "if true" trigger for indemnity, there are several other ways buyers may be compensated for the costs of third-party claims without the need to demonstrate a breach.

First, many acquisition agreements contain bullet indemnities covering specific matters such as claims by equity holders of the target company, taxes and other risks that are discovered in the diligence process. These targeted indemnities are often drafted to pick up potential liabilities, including third-party claims themselves, unrelated to whether there is a breach of a representation or warranty contained in the agreement. Because these indemnities are tailored to specified risks, they can be a good mechanism to allow the parties to allocate risk of some third-party claims to the sellers, regardless of their merit, while allocating the risk of others to the buyer.[12]

Second, in many asset deals, some or all potential liabilities of the acquired business are excluded from the purchase and left with the target company. This excluded liability concept, together with indemnity coverage of such excluded liabilities, can provide buyers with protection against third-party claims related to the pre-closing operation of the business, without the need to establish a breach of representation.

Lastly, in many private target acquisition agreements, the seller (or a representative of multiple sellers) is permitted to assume the defense of third-party claims that may be subject to an indemnification claim by the buyer. In those agreements, if the seller assumes the defense of the claim, the seller is then responsible for the losses ensuing therefrom, including the costs of defense, whether or not the outcome of the claim establishes a breach of the representations and warranties. However, since this concept is typically drafted as a permissive right of the seller to assume and control the defense and not as an obligation to do so, the inclusion of such a feature does not by itself require the seller to pay the costs to defend a claim in advance of a determination of liability if the seller does not choose to exercise this right.[13]

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[11] *ABA Report*, *supra* note 8, at 92.

[12] For example, in the *ABA Model APA* indemnification provisions in favor of the buyer, there is no duty by the indemnifying parties to defend claims generally and no "if true" provision applicable to the breach of representation indemnity trigger, but there are bullet indemnities for broker fees and environmental liabilities, both of which expressly include claims alleging responsibility of the indemnifying parties. *See ABA Model APA*, *supra* note 1, at 218-25.

[13] The *Winshall* Court found that the "obligation to pay defense costs" included within the notice of third-party claims provisions in that agreement still depends on the "existence of a duty to indemnify …" *Winshall*, 76 A.3d at 821.

Representation and Warranty Insurance

Over the past decade, representation and warranty insurance has significantly expanded as a means to facilitate deal-making and offset the risk and burden of indemnification obligations. According to the ABA 2023 Private Target Mergers & Acquisitions Deal Points Study, 55% of the examined deals in 2022-23 expressly referenced the use of representation and warranty insurance, a notable increase from just 29% of the deals examined in 2016-17.[14] It is important to note that the actual usage may be even higher as the study data does not take into account insurance that may have been required or obtained outside of the express terms of the agreement, further underscoring its growing role in private target M&A.

How does this all work in the case of an insured deal? As between the buyer and the insurer, it should not matter whether the agreement contains the duty to defend and/or an if true clause — the policy should provide that the insurer will cover costs of defense against alleged breaches without obligation to repay in the event the breach is not proven.

Most policies cover losses based on claims by third parties without the necessity of establishing that a breach has actually occurred. A common formulation provides that "Losses" as defined in the policy will include the cost of defending "Third-Party Claims," which include "… any claim … which, if successful, would reasonably be expected to result in a Loss arising out of, resulting from or with respect to a Breach." If a policy does not have this or similar language, you should negotiate with the insurer to have it included. Note that as between the buyer and the sellers, in the case of exclusions or claims in excess of the policy limits, the issues discussed elsewhere in this article remain important.

Takeaways for Buyers

It is critical for the buyer of a business to understand its risk of loss in the event of a third-party claim and to recognize that it may incur substantial costs in defending such a claim regardless of its ultimate disposition. As described in this article, the seller's mere duty to indemnify the buyer for breaches of representations and warranties may not obligate the seller to assume and be responsible for these costs. Buyers should consider the following takeaways to address this issue in the acquisition agreement:

- **Carefully define the trigger for indemnity.** Buyers should seek protection for third-party claims alleging facts that if true would demonstrate a breach. This approach would most clearly require the indemnifying seller to cover the costs of defense of a claim as well as the costs of settlement, regardless of the ultimate disposition of the claim. Note, however, that "if true" indemnity triggers are still not found in many private target deals, so sellers may resist this language as "not market."
- **Include the separate duty to defend.** Regardless of the indemnity triggers, buyers should seek to impose a separate obligation on sellers to bear the cost of defending third-party claims. While this duty may not cover the cost of settlement, it would cover legal fees of the buyer in defending the claim, which in some cases could represent a majority or even all of the financial burden resulting from the claim. Since the duty to defend is commonly

[14] *See ABA Report*, *supra* note 8, at 121.

found in acquisition agreements, sellers will have more difficulty pushing back on the language.

- **Be aware of potential compromises.** If unable to secure an "if true" indemnity trigger and a duty to defend, consider bullet indemnities that cover specific areas of risk, which are not tied to breaches of representations and warranties, to allocate those risks to the sellers. Another approach would be to include an obligation of sellers to advance defense costs but employ higher deductibles, lower caps or other cost sharing mechanisms to allocate the risk absent a determination that the claim is indemnifiable as a result of an actual breach.
- **Acquire representation and warranty insurance.** Insurance is being utilized in an increasing number of deals, including smaller deals that were previously not insurable. Most policies will cover cost of defense of third-party claims alleging a breach regardless of the ultimate disposition of the claim, though the language of the policy should be carefully reviewed to confirm this.
- **Focus on shared incentives.** While the inclusion of the duty to defend is generally favorable to buyers, it may offer a more efficient way to allocate the risks of third-party claims for both parties. The absence of a duty to defend may create an incentive for buyers to "roll over and play dead" in the defense of the claim. A buyer, who is on the hook for the defense expenses unless and until the breach has been established, would likely prefer to establish a breach instead of vigorously defending the claim over an extended period of time, since a vigorous and successful defense of such a claim may leave the buyer with a large legal bill that is not indemnifiable. Conversely, if the buyer does "roll over and play dead," or otherwise seeks expedited closure, the seller may end up indemnifying for a larger judgment. By focusing on shared incentives, sellers may determine that an agreement to fund an effective defense of third-party claims regardless of the disposition may encourage a more efficient outcome for both parties.

Conclusion

Acquiring a business can be a very rewarding but also very risky exercise. For some businesses, the single greatest potential liability facing the buyer relating to the pre-closing operation of the business will be the costs of defending third-party claims. If those claims are resolved through a settlement or dismissed by a court, the legal fees incurred by the buyer may be no less significant, but the buyer's rights against the seller of the business may be very limited, notwithstanding typical indemnification obligations in respect of breaches of representations and warranties. Buyers should discuss this risk with counsel, including the types of claims that are likely to be significant and how the risk of loss from those claims is addressed by the specific terms of the acquisition agreement. There are several ways to handle the risk of third-party claims, but failure to address them specifically is likely to leave the buyer with more than it bargained for.

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