Indemnification Escrow Accounts – What Are They and How Should They Be Used?

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By Katherine Hampel on September 18, 2024

Parties to business acquisitions use indemnification clauses to provide security for harm that may result following the closing of the transaction. Indemnification obligations require one party to compensate the other for costs that arise relating to the performance (or lack thereof) of the terms the parties agreed to in the transaction documents.

The sources of indemnification funds can come from multiple outlets: an indemnification escrow account, a holdback or deferred payment of the purchase price, or the right to set off future payments a party is entitled to receive pursuant to the terms of the purchase agreement, such as an earnout.

Indemnification escrow accounts are often used to provide security that the selling party in a transaction has sufficient funds to meet its indemnification obligations. Because a buying party is more likely to bring indemnification claims after a closing, it typically has the greater interest in ensuring these funds exist prior to closing.

The parties will agree on the amount to be put in the escrow account, usually as a percentage of the transaction purchase price (a highly negotiated issue), and the duration of time that the escrow account will remain open to satisfy future indemnification claims. The decisions on these items will depend on varying factors, including the level of concern the parties have that liability claims will be made following the closing, the selling party's willingness to forgo receipt of the entire purchase price at closing, and if representation and warranty insurance is being obtained as part of the closing.

The parties may choose to create one escrow account that will hold all of the funds needed for all potential indemnification claims or multiple accounts, each of which holds funds to serve an individual category of claims.

The period of time that the escrow account remains open is usually tied to the survival period of the representations and warranties contained in the purchase agreement. The release of indemnity escrow funds can also be separated into different stages so that portions of the funds are released at different durations or upon the occurrence of negotiated post-closing transaction milestones.

The parties may agree to include restrictions on the types of claims that are covered by the indemnity escrow amount, as well as the amount of indemnity funds available to satisfy a claim. In some instances, all potential indemnification claims will be subject to a dollar cap. However, certain categories of claims are not subject to these types of caps and the entire purchase price may be at risk to satisfy the claims. This is typical for claims brought based on fraud or intentional misrepresentation by a party. The parties may also opt to have certain claims be uncapped, such as breaches of certain "fundamental" representations and warranties (i.e., claims deemed to be the most important to the transaction). Fundamental representations and warranties usually relate to the ownership of the purchased assets and the capitalization of the selling party, the authority of the parties to enter into the contract, and the good standing status of the parties to the transaction.

Overall, indemnification escrows are a highly negotiated tool to apportion risk. A good indemnification escrow is aligned to the rights identified by the parties and enables post-closing issues to be handled efficiently and, hopefully, without litigation. Practitioners should take great care to make sure indemnification provisions align with the priorities of their client.