Case Study | Reflection on How to Design Indemnification Clause in a M Agreement

By 王维众 严静安 2019-05-05

When conducting due diligence in an equity acquisition transaction, it is one of commonly found issues that the target company pays the social security and housing provident fund according to a standard which is lower than the national requirement. Especially for those manufacturing enterprises with a relatively long history and a large number of employ the potential amount of indemnification can be relatively high, and the feasibility that the target company makes up for shortage before the equity transfer is relatively low. Therefore, after completion of due diligence by the buyer, normally parties will sign an indemnification clause to leave this issue to be solved after the deal, hoping no claim will be raised the employees.

However, with the employees' increasing awareness of protecting their legal rights in recent years, the probability that employees claim for the supplementary payment of social security and housing provident fund after completion of the transaction has gradually increased. It thus becomes an urgent task to reach more specific agreement regarding the indemnification obligation in a M&A contract.

We recently dealt with a case in which the employees of the target company requested for the supplementary payment housing provident fund around one year after closing of the M&A deal, and the indemnification obligation borne by the toward the buyer was thus triggered. Based on this case, we analyze the points the buyer and the seller shall pay atter to when they draft the post-closing indemnification clause. In fact, these principles apply not only to the supplementar payment of social security and housing provident fund, but also to most other issues which will lead to indemnification (such as environmental protection and tax issues) and worth our attention.

I. Background of the Case

An overseas company A (the "**Seller**") transferred 100% equity that it held in a company in the northwest part of China "**Target Company**") to another overseas company B (the "**Buyer**") in 20XX. During the due diligence process before th equity transfer, the Buyer knew that the Target Company had never paid any housing provident fund to any employees

its establishment; besides, the social security was paid in accordance with the minimum social security base acceptab the local government, which is lower than the national legal standard. After negotiation, the Buyer and the Seller confir that the equity transfer price should be calculated at 10 times of the EBITDA (Earnings Before Interest, Taxes, Deprecia and Amortization). Since the Target Company did not pay the housing provident fund and the social security paid was l than statutory standard, the accountant involved in the transaction adjusted the EBITDA and reduced the equity transfe price accordingly. At the same time, the Buyer and the Seller made agreement in the equity transfer contract regarding potential indemnification liability which may be caused by the housing provident fund and social security issues after th equity transfer.

During the equity transfer process, immediately before and after the closing, the employees did not make any claims o unpaid housing provident fund or underpaid social security. Around one year after the closing, due to the economic downturn, the new management team of the Target Company reduced the salaries and bonus of employees and adjus the overtime payment calculation methods, with a view to cutting down operating costs. The employees were extremel dissatisfied with these measures and, upon the failure of reaching agreement with the company management after negotiation, conducted a strike. As one of the many requests raised during the strike, hundreds of employees went to t local Housing Provident Fund Administration Center to file complaint, requesting the Target Company to pay for all the housing provident fund that had not been paid since its establishment. The potential amount of indemnification arising therefrom may exceed ten million RMB. After receiving notice from the Housing Provident Fund Administration Center, Buyer notified the Seller of the occurrence of such potential indemnification event in accordance with the contract and invited the Seller to participate in the negotiation and communication with the governmental department and employee the negotiation process between the Buyer and the Seller, the provisions of the indemnification clause in the equity tra contract played a crucial role. Below we analyze the key points of the indemnification clause in a merger agreement ba on our experience in this case.

II. Exemption from Indemnification Liabilities

Immediately after the dispute over the payment of the housing provident fund, the Seller raised the following three questions related to possible exemption from its indemnification obligations:

Q&A

Q1: The Seller had fully disclosed its failure to pay the housing provident fund during the due diligence process anc the Buyer, having been explicitly aware of it, still decided to purchase the Target Company. Whether it can be deeme as the Buyer had agreed to bear relevant risks, so that the Seller can be exempted from indemnification obligations the extent that the Seller had disclosed?

A1: According to the principle of contract autonomy, we believe that even if the Buyer was aware of this risk and pa the equity transfer price, the Seller's liability for indemnification cannot be deemed as exempted. We assume that su bewilderment was caused by the confusion between this situation and the Principle of Assumed Risk under tort law system. Therefore, if the Seller wishes to exempt its liability to the extent that it had disclosed, it must negotiate with the Buyer and stipulate it explicitly in the contract. It is also worth mentioning that, according to Chinese judicial practice, if the Seller's disclosure is flawed during the due diligence process or the Buyer fails to perform the obligati of prudent review of the Target Company's relevant situation, the court may allocate the liability for breach of contrac

according to the degree of faults of both parties.

Q2: During the transaction, the EBITDA and the equity transfer price had been reduced because of the Target Company's failure to pay the housing provident fund. Whether the Seller can be exempted from the liability for indemnification to the extent of the adjusted amount of EBITDA?

A2: Let's first explain the reason for the adjustment of EBITDA. Briefly speaking, the long-term underpayment of soc security and housing provident fund affects the valuation of the Target Company, because the Target Company's profits generated during the past years are based on the fact that it reduced its mandatory costs. If the Target Company begins to pay the social security and housing provident fund in accordance with laws after the equity acquisition, its profit will be reduced accordingly. That is the reason that the accountant adjusted the figures in the then-existing account book of the Target Company. Because the purchase price in this case was calculated at 10 times of the EBITDA, the purchase price was reduced by 10 times of the underpaid amount (which is more than 10 million RMB in our case). From the Seller's perspective, it had paid the "cost" for the underpayment of social security and housing provident fund in the process of the transaction. However, from a neutral third-party's perspective, it is a fair deal, because the adjusted EBITDA reflects the Target Company's true profitability and true value in the future, a such adjustment is irrelevant to the indemnification for the previous events. Therefore, unless the contract expressly stipulates that the Seller's liability can be exempted to the extent of EBITDA's adjustment, such exemption claim car hardly get recognized and supported in the lawsuit.

Q3: If the claim for indemnification is raised or the claimed amount is enlarged due to the Buyer's fault after closing the M&A deal, can the Seller thus claim to exempt its liability for indemnification accordingly?

A3: The indemnification clause normally stipulates that the premise for indemnification claim against the seller is tha such claim is caused by the seller's act or omission before the equity transfer. In this case, there is a dispute betwee both parties on this point. The Buyer held that employees' claim for supplementary payment results from the failure o the Seller to pay such amount before the equity transfer and thus the Seller shall assume 100% of liabilities. In contrast, the Seller held that the employees never claimed for supplementary payment before equity transfer, and it i the Buyer's poor management and illegal labor treatment after the acquisition that irritated the employees and thus l to the claim for supplementary payment of housing provident fund, as one of their many claims. As a consequence, the Buyer shall at least bear part of liabilities. We think that, although the Seller's failure to pay the housing provident fund is the main reason, the Seller's argument is also reasonable to some extent. If this case comes into litigation stage, it is uncertain whether the Buyer needs to bear a portion of liabilities for its mismanagement, especially under the circumstance that the Buyer had deducted employees' statutory salaries or had conducted other unlawful acts during its operation.

In addition, the indemnification clause under the contract expressly stipulates that after the occurrence of the indemnification claim, the Buyer shall be obliged to make best efforts to coordinate and negotiate, with a view to reduc the amount of indemnification that the Seller needs to pay. Back in this case, there is also a big gap of understanding between both parties. The Buyer held that the payment of the arrears of the housing provident fund is a statutory oblig that is not subject to any derogation. Therefore, as long as the cost borne by the Seller is not higher than the statutory

standard, it can be regarded that the Buyer has fulfilled its contractual obligations, even if the Buyer has not conductec active communication or negotiation.

However, the Seller held that there is room for negotiation in terms of the amount of the housing provident fund to be n up. In accordance with the local practice, some other companies, facing same claims from the employees, have compensated the employees according to a standard lower than the legal requirement and compensated for less years Therefore, the Buyer is still obliged to actively negotiate with the government and employees to minimize the amount o indemnification.

We believe that the interpretation of the terms of the contract may have some flexibility and be subject to the specific circumstances of the case, whereas the Seller shall bear a relatively high standard of burden of proof to get its claim recognized and supported by the court. For instance, how to prove that the internal policy of local government allows f back pay of the housing provident fund that is lower than statutory standard; how to prove the payment standards of o companies; and how to prove the Buyer's negative response and its failure to mitigate losses, etc. It is difficult to obtai above evidence, and whether the claim can be finally recognized and supported by the court depends on the court's discretion. In addition, the time and monetary cost in this case would be quite considerable because of overseas dispu resolution method agreed upon by both parties. Thus, it will be more beneficial to the Seller if such dispute can be resc through negotiation.

III. Time Limit for Indemnification Liabilities

This case involves the statute of limitation applicable for the supplementary payment of housing provident fund. In con with social security, there are no laws and regulations that set a statute of limitation which bar the employees' claim for supplementary payment against an employer. That is to say, in principle employees are entitled to raise such claim at a time, and once it is raised, the relevant Housing Provident Fund Administration Center is entitled to order the employer make the supplementary payment for all the past years. This is special among all indemnification matters. In general, tl Seller's obligation for indemnification regarding the potential risks before equity transfer should not exist indefinitely. Instead, a survival period shall be set. For general matters, the survival period may be 1-3 years after equity transfer; fc special matters, the survival period may be determined with reference to the statute of limitation applicable under PRC For instance:

1.With regard to the liability for unpaid/underpaid taxes, according to Article 52[1] of the Law of the People's Republic China on the Administration of Tax Collection, in general the seller shall bear the compensation obligation within 3 year 5 years after closing. In the event that the seller evades tax, refuses to pay or conducts fraud in tax payment, as the ta authorities can recover the unpaid tax and impose penalty indefinitely, the buyer may therefore request for indemnificat with no time limit.

2.With regard to unpaid or underpaid social security, Article 20[2] of the Regulation on Labor Security Supervision stipu that the governing authority may pursue illegal acts within a two-year period. If the company has paid social security in compliance with the national statutory requirements before or immediately after the equity transfer, the parties concern may set a two-year survival period for the indemnification obligation. However, if the illegal activity continues, namely, t target company continues to contribute social insurance at a standard lower than the national requirement after the eq transfer, the competent authority can order the company to make up for all historical payments. Of course, considering the above is a national regulation and that the local practice may be different, we recommend the parties to confirm the local practice in advance. It is noteworthy that, on September 21, 2018, the General Office of the Ministry of Human

Resources and Social Security issued the Emergency Circular on Stabilizing the Work of Social Security Fee Collection Accordance with the Spirit of the Standing Meeting of the State Council (the "**Circular**"). The Circular prohibits human resources and social security departments at all levels from organizing any centralized collection campaign, in their ow initiative, against all historical unpaid social securities by the companies.

IV. Limitation of Indemnification Liability

With regard to the scope of indemnification, if you are the buyer in a M&A transaction, you can simply require the seller bear all contingent or potential liabilities, especially for those mandatorily required liabilities, such as the payment oblig of social security, housing provident fund and taxes. In order to ensure that such indemnification obligations can be effectively fulfilled, the buyer may also require the seller to deposit the contingent or potential amount of indemnificatio an escrow account within the agreed time period, so that such amount can be deducted from the escrow account whe indemnification obligation is actually triggered.

If you are the seller of a M&A transaction and have certain bargaining power, you need to consider in a more complex w regarding your liability for indemnification. Usually, the seller has the following methods to narrow down the amount an scope of its indemnification liabilities:

1. Liability Cap: The seller may require a ceiling on all its total liabilities under an equity transfer contract, beyond which compensation shall be paid. This ceiling can usually be a certain percentage of the equity transfer price (e.g., 20% to 100%). It should be noted that, where the potential amount of certain liabilities can hardly be estimated (for example, damages caused by environmental pollution), the buyer may require excluding such event from the application scope c Liability Cap.

2. Seller Deductible: in addition to the Liability Cap, the seller can request for buyer's waiver of some small-amount cla such as the claim in which the losses suffered by the buyer are less than RMB500,000. Such arrangement can avoid unnecessary negotiations and transaction costs caused by small-amount claims.

3. How to determine the specific amount and scope of indemnification can easily trigger disputes between the parties thus should be clearly defined to the extent possible. For instance, as agreed in this case, the indemnification amount the housing provident fund issue shall be determined in accordance with the written payment notice issued by the government department. This is a relative objective standard which can avoid excessive claims of the employees and i easy for the Buyer to prove. It is also agreed in this case that both the Buyer and the Seller are entitled to engage lawye and the cost of which shall be borne by one of the parties. However, some specific issues may not be agreed upon, fo instance, whether the legal fees should be reasonable, how to determine the rationality of such fees, whether there is a ceiling for such fees. In practice, the absence of such specific agreement often triggers disputes.

4. The indemnification scope of the seller shall be restricted to those claims that are legally valid and enforceable. Takir unpaid social security as an example, in principle, if an employee has left the company for more than two years, even i he/she goes to the government department to claim for supplementary payment of his/her previously underpaid social security, the government department will no longer provide remedy. Therefore, the seller may claim that it will not bear indemnification obligation for any employee's claim that exceeds the 2-year time limit. If the buyer or the target compa voluntarily repays such amount for any reasons, it is irrelevant to the seller.

V. Procedural Battles on Who to Control the Negotiation

Last but not least, in addition to the above-mentioned substantive issues, the agreement on the procedures is critical. A was expressly stipulated in the equity transfer contract in this case, the whole negotiation process shall be led and controlled by the Buyer when the claims are related to social security and housing provident fund issues, and the Selle only entitled to participate the negotiation and bears the obligation to cooperate with the Buyer.

The advantage of such arrangement is that the Buyer, as the actual controller of the Target Company after equity transf can cope with the crisis more efficiently. On the external side, the Buyer faces the government directly, and can communicate with the government more smoothly. On the internal side, the Buyer faces employees directly and has a better understanding of the situation of the employees (such as the employees' current salary, length of service, causes main purposes of the claim, etc.). The Buyer also holds more bargaining power because it has the management author over the employees.

However, such arrangement can be quite unfavorable to the Seller. The negotiation process is controlled by the Buyer, whereas the outcome of the negotiation is at the expense of the Seller. As the consequence of negotiation will not be b by the Buyer, there is hardly any incentive for the Buyer to conduct negotiation proactively and diligently to reduce the potential cost. In addition, the Seller, who has lost control of the company, does not have the channel to communicate directly with the government and employees. Rather, all such communication will be solely arranged by the Buyer. In ou case, this is even worse because all the middle and senior management originally appointed by the Seller have been dismissed by the Buyer. So the Seller can hardly mitigate the losses by itself.

In view of this experience, if the buyer dominates the negotiation process, we suggest that the seller may require the followings in terms of procedure as a check and balance: (1) the seller has the right to participate in the full communica process, including but not limited to the access to written information relating to the claim for indemnification and to ev meeting with governmental departments and employees, etc.; (2) the seller has the right to hire lawyers separately; (3) a negotiation plan to be provided to the employees shall get the prior consent from the seller (of course the seller shall no unreasonably delay in giving such consent); and (4) if the buyer fails to communicate and negotiate with the governmen and employees actively and timely, the seller shall not bear any indemnification liabilities for the extended losses or the losses that should have been mitigated.

In conclusion, with regard to the post-transaction indemnification clause, there is abundant room for the buyer and the seller to negotiate from both substantive and procedural perspectives. Both parties can reasonably assess and allocate risks by analyzing the specific details of each M&A project and resorting to experienced and sophisticated lawyers.

注：

---

[1] Article 52 of the Law of the People's Republic of China on the Administration of Tax Collection stipulates that:

Where a taxpayer or withholding agent fails to pay or underpays taxes for reasons attributable to the taxation authorities, the taxation authorities may, within three years, require the taxpayer or withholding agent to pay the tax in arrears without, however, the imposition of penalty for late payment.

Where a taxpayer or withholding agent fails to pay or underpays taxes owing to its own miscalculation or other faults, the taxation author may, within three years, recover the taxes in arrears and impose the penalties for late payment; under special circumstances, the time lim recovering the taxes in arrears may be extended to five years.

Where a taxpayer evades, refuses to pay or conducts fraud in tax payment, and the taxation authorities shall not be restricted by the time prescribed in the preceding paragraph when recovering the unpaid or underpaid tax amount, the amount of penalties for late payment, o

tax payment defrauded on.

[2] Article 20 of Regulation on Labor Security Supervision stipulates that:

Where an act in violation of labor security laws, regulations or rules is neither found by the labor security administration nor reported or complained by others within 2 years, the labor security administration shall no longer conduct investigation and punish against it.

The period prescribed in the preceding paragraph shall begin from the date when the act in violation of labor security laws, regulations or occurred; or begin from the date when the act in violation of labor security laws, regulations or rules ends if such act continues or is in a continuing state.

特别声明：

以上所刊登的文章仅代表作者本人观点，不代表北京市中伦律师事务所或其律师出具的任何形式之法律意见或建议。

如需转载或引用该等文章的任何内容，请私信沟通授权事宜，并于转载时在文章开头处注明来源于公众号“中伦视界”及作者姓名。未经本所授权，不得转载或使用该等文章中的任何内容，含图片、影像等视听资料。如您有意就相关议题进一步交流或探讨，欢迎与本所联系。

Print article

Relevant personnel

David Wang Shanghai
Equity Partner

Practice Areas：
Corporate/Foreign Direct Investment, Mergers & Acquisitions, Litigation & Arbitration

Jingan (April) Yan Shanghai
Non-equity Partner

Practice Areas：
Corporate/Foreign Direct Investment, Mergers & Acquisitions, Labor & Employment

Copyright © Zhong Lun Law Firm All rights Reserved ICP No. 05006255-1

Disclaimer |