ALLOCATING THE RISK OF FRAUD IN A NO SELLER INDEMNITY TRANSACTION

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I. INTRODUCTION

Lawyers who practice in the area of mergers and acquisitions ("M&A") have two main goals—close the transaction according to the client's expectations and minimize post-closing liability for their client. The introduction of representation and warranty insurance ("RWI") into the M&A landscape provides attorneys with one tool to help them achieve these goals. The parties can also allocate the risk of post-closing liability in the purchase agreement. This includes an allocation of the risk of fraud claims that arise after the transaction's closing. A hypothetical asset purchase transaction helps to illustrate the interaction of RWI and fraud in M&A transactions and the vital role that M&A drafters have in rebalancing transactional risk in the event of fraud.[1]

Imagine representing Sarah Smith, the founder and sole owner of the Delaware corporation, Makeup Tech, Inc., which supplies makeup cartridges for a popular new makeover device. Makeup Tech was recently

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[1] This article focuses on asset purchase transactions involving a state-chartered statutory business entity as both seller and buyer. Similar principles apply to other types of M&A transactions involving business entity sellers and buyers.

granted a patent on a particular feature of its cartridge, which prevents leakage of the makeup between applications. Makeup Tech supplies these cartridges to makeup companies, including Face at the Table, Inc., one of the leading makeup brands for the modern professional. To date, Face at the Table is the most popular brand for these cartridges, and the manufacturer of the makeover device encourages its users to purchase Face at the Table, largely because of the cartridge's anti-leak properties.

Smith has been approached by a private equity firm (the "Buyer") with an offer to buy substantially all of the assets of her business. Smith is well connected with other founders who have sold their businesses with "no strings attached," and she is only willing to sell if the Buyer will agree to a no seller indemnity transaction. Because you are familiar with the workings of her business and you have some experience with M&A, she has asked you to represent her on this asset purchase transaction.

The Buyer is familiar with the concept of no seller indemnity, having utilized this type of transaction itself on the sell side. Knowing that there are several other potential bidders, the Buyer agrees to utilize representation and warranty insurance to cover breaches of representations and warranties. With limited exceptions (for fundamental

representations[2] and fraud), there will be no seller indemnity. The Buyer expressly disclaims reliance on representations and warranties made outside the four corners of the purchase agreement. The parties agree (through an integration clause) that the purchase agreement is the complete agreement between the parties as to the asset purchase. They forego an escrow, and the buyer's exclusive remedy in the event of a breach of the seller's representations and warranties is recovery under the RWI policy. Claims for fraud and for breaches of fundamental representations are excepted from the exclusive remedies provision.

Shortly after closing, another manufacturer of makeup cartridges files a post-grant review request with the USPTO to challenge Makeup Tech's patent. Subsequently, the USPTO determines that the patent is invalid and cancels it. Because Makeup Tech no longer has a monopoly on the no leak technology, Face at the Table begins to seek cartridges from other suppliers, and ultimately stops purchasing from Makeup Tech altogether. This is a devastating loss to the recently acquired business.

[2] Fundamental representations are given special treatment in the purchase agreement and typically relate to the seller's organizational status and legal capacity to complete the transaction. Sean J. Griffith, *Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions*, 104 MINN. L. REV. 1839, 1855 (2020).

Smith represented in the purchase agreement that there was no pending or threatened litigation regarding the validity of the Makeup Tech patent. However, a week before the closing, she had received an important-looking letter in the mail addressed to Smith as the Chief Executive Officer of Makeup Tech, Inc. from PatentTroll Corporation, known by Smith to be a firm that regularly seeks to obtain rights relating to patents for the purpose of benefiting through licensing or litigation. She briefly considered opening the envelope because of the identity of the sender; however, she determined that she needed to stay focused on getting through the closing and was too busy to deal with its contents. As a result, she tossed the letter into a pile on her desk and did not open it until after the closing. If she had opened the letter, she would have learned about the threatened patent challenge. While the RWI policy covered some losses resulting from this breach of a non-fundamental representation, it was not enough to make the Buyer whole.

The Buyer claims that Smith intentionally or, at least recklessly, misrepresented information about the validity of the patent in the purchase agreement. Smith denies that she intended to misrepresent anything, but she does admit to seeing the letter in the mail. Will the Buyer be able to sue Smith for fraudulent misrepresentation, even though the

parties agreed to no seller indemnity? The answer depends, in large part, on how the parties defined fraud in the purchase agreement.

Keeping the hypothetical described above in mind, this article compares (a) the consequences of including a generalized fraud exception ("carve-out") to the indemnity and exclusive remedies provisions of an asset purchase agreement without expressly defining "fraud" with (b) drafting a fraud carve-out that specifically defines fraud according to the parties' intentions. The analysis proceeds in three additional parts, followed by a summary conclusion; the remainder of this Introduction describes each part briefly.

Part II provides background information about representations and warranties in asset purchase agreements and the typical seller's indemnity for breach of those representations and warranties. It then discusses the emergence of RWI and how this insurance product may be used to replace the traditional seller's representation and warranty indemnity in an asset purchase transaction. Part II ends with a brief description of the underwriting and claims processes for RWI.

Part III discusses fraud claims relating to asset purchase agreement representations and warranties. It explains how representations and warranties work together with other contract provisions to allocate the

risk of post-closing fraud claims. These provisions include the integration clause, the anti-reliance provision, the exclusive remedies provision, and the fraud carve-out. Delaware decisional law helps to illuminate these interactions and to emphasize the importance of careful drafting in this area.

Part IV revisits the Makeup Tech hypothetical and discusses two different scenarios that may arise depending on how the parties addressed the fraud carveout in the asset purchase agreement. The treatment of fraud in an asset purchase agreement significantly impacts the rights of both sellers and buyers. From the seller's perspective, an inarticulately drafted fraud definition has the power to undermine carefully drafted integration, anti-reliance, and exclusive remedies provisions, each of which is designed to limit the seller's post-closing liability. From the buyer's perspective, the treatment of fraud may determine whether or to what extent the buyer has recourse in the event of a deal founded on fraudulent information.

The article concludes with an alternative idea about how to address the definition of fraud in the purchase agreement. Wherever and however the parties decide to address fraud in the purchase agreement, it is important to keep in mind that fraud is a business issue that must be

carefully assessed and negotiated.[3] "Structuring to solve business issues—and sorting out business issues resulting from the structure—is what M&A is all about."[4] Lawyers must take care to identify and evaluate fraud risk, and negotiate and draft contract provisions that accurately capture the parties' expectations about the availability of post-closing fraud claims. If an agreement is unclear on the impact of fraud, the discovery of a fraudulent representation will result in difficult enforcement and recovery choices and outcomes for both parties.

II. BACKGROUND

This part provides background information necessary to understand how RWI can be used in place of the typical seller's indemnity in an asset purchase agreement. Beginning with a description of relevant characteristics of a traditional asset purchase agreement, this part discusses the emergence of the "no seller indemnity" transaction. It concludes with an overview of the history, purpose, and mechanics of RWI.

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[3] Mergers & Acquisitions Comm., A.B.A.: Bus. Law Section, *Fraud Carve-Outs*, HOTSHOT, https://www.hotshotlegal.com/courses/fraud-carve-outs/sections/926https://www.hotshotlegal.com/courses/fraud-carve-outs/sections/926 (last visited Oct. 29, 2022) (interviewing Attorney Glenn West).
[4] CHRISTOPHER S. HARRISON, MAKE THE DEAL: NEGOTIATING MERGERS & ACQUISITIONS 2 (John Wiley & Sons, Inc. 2016).

A. TRADITIONAL TRANSACTION WITH A SELLER'S INDEMNITY

In a typical asset purchase transaction, parties make representations and warranties about themselves and about the business being acquired. This article focuses primarily on representations made by the seller and its willingness (or unwillingness) to indemnify the buyer for breaches of those representations. While the buyer also makes representations, those tend to be less focused on the buyer's business operations and are not as heavily negotiated as the seller's representations.[5]

i. Representations and Warranties

In general, "representations are statements of fact [and] warranties are promises that a stated fact is true."[6] They are sometimes referred to collectively as representations or "reps."[7] In practice, representations should be thought of as "risk allocation devices—not literal statements of truth. A party may—and often does—make several reps believing them to

[5] Lou R. Kling et al., *Summary of Acquisition Agreements*, 51 U. MIA. L. REV. 779, 783, 794 (1997) (noting that "[t]he purpose of the seller's representations is to paint a picture of the business being acquired," whereas "[t]he seller's prime motivation in obtaining representations from the buyer is to know who it is dealing with, to understand exactly what has to happen before the buyer can close the deal and to be as sure as possible that on the day of closing the buyer can actually come up with the purchase price").

[6] Griffith, *supra* note 2, at 1840.

[7] *Id.* at 1841; *see e.g.*, HARRISON, *supra* note 4, at 57 ("Sellers or target businesses use representations and warranties (referred to simply as 'representations' in this book) to confirm important facts.").

be true, but without any way of determining (or any evidence supporting) their actual truth."[8]

Through the representations, the seller is compelled to provide credible information about the business and its risks, which should theoretically lead to an accurate and fair purchase price.[9] The representations are limited by knowledge[10] and materiality qualifiers.[11] The seller often makes representations about corporate authority, corporate structure, existing contracts, compliance with law, absence of litigation, financial statements, environmental liabilities, intellectual property, employee matters, customers or clients and suppliers, and the absence of undisclosed liabilities.[12] Items designated by the parties as fundamental representations are given special treatment in the purchase agreement.[13]

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[8]Mergers & Acquisitions Committee, A.B.A.: Bus. Law Section, *Summary: Fraud Carve-Outs*, HOTSHOT, [hereinafter *Summary: Fraud Carve-Outs*], https://www.hotshotlegal.com/courses/fraud-carve-outs/sections/926 (follow "Summary" hyperlink) (last visited Oct. 29, 2022).

[9] Abraham J.B. Cable, *Comment on Griffith's* Deal Insurance*: The Continuing Scramble Among Professionals*, 104 MINN. L. REV. HEADNOTES 75, 79 (2020).

[10] *See* Kling et al., *supra* note 5, at 793 ("If the representation is qualified by a knowledge limitation, the buyer, in order to recover damages, not only has to show that the underlying representation was false, but also that the seller knew it to be so.").

[11] *See id.* ("[T]he buyer's rights are not triggered unless there is a 'material' problem.").

[12] HARRISON, *supra* note 4, at 89–90 ("The wording of the representations will be quite detailed, and the subject of technical drafting discussions."); *see also* Kling et al., *supra* note 5, at 780 ("Private companies do not have the same reporting requirements as public companies, which creates a greater need for enhanced representations and warranties.").

[13] *See* Griffith, *supra* note 2.

Known exceptions to the representations (as well as important details too voluminous for inclusion in the asset purchase agreement) are referenced in the asset purchase agreement and listed on accompanying disclosure schedules and do not form the basis of a breach.[14] A seller tries to narrow the scope and depth of its representations as much as possible, while a buyer prefers broad representations that allow for expanded pre-closing options and post-closing indemnity claims and adjustments.[15] The buyer's right to sue or recover for a breach is limited by the survival periods set forth in the agreement.[16]

ii. Seller's Indemnity

Representations that are made at the time of signing must be materially accurate and complete at the time of closing as if made at that time.[17] If the parties become aware of a breach of the seller's

[14] HARRISON, *supra* note 4, at 61 ("[A]ny known issues would be disclosed by the target in the disclosure schedules and, thus, would not constitute a breach. The seller may separately indemnify the buyer through a special indemnity for a risk or liability that is known and fully disclosed.").

[15] *Id.* at 90–91 ("If a buyer does not receive a particular representation, the courts may conclude that it assumed that risk that it had adequately diligenced the issue and thus did not need protection through the representations.").

[16] *Id.* at 251–52. The survival period for basic representations is typically one to two years; however, "[f]undamental representations usually have longer survival periods," sometimes up to the applicable statute of limitations. *Id.*; *see also* Kling et al., *supra* note 5, at 805 ("Most representations will generally survive for one to two years, with those relating to taxes, employee benefits, environmental issues and due authorization of the transaction surviving significantly longer.").

[17] *See* HARRISON, *supra* note 4, at 89 ("By covering events as of the closing, the representations can be prospective to that extent rather than merely historical—that is, provide protection for changes that occur and make the representations false between signing and closing."); Kling, et al., *supra* note 5, at 799 ("The condition that the other

representations before closing, the buyer may refuse to close or may demand a re-negotiation of the terms of the transaction.[18] However, if a breach is discovered after closing, the buyer often seeks recovery under an indemnity provided by the seller for that purpose.[19] If the seller makes an inaccurate representation that survives closing and the inaccuracy is discovered during the survival period, the buyer may seek compensation for the resulting losses or damages through the indemnity, subject to agreed-upon limitations.[20] Ultimately, the buyer's ability to recover under an indemnity comes down to the details of both the indemnification provision and the representations and warranties themselves.[21]

party's representations and warranties be true and correct at closing is generally the most significant condition for both buyers and sellers. This 'bringdown' clause protects each party from the other's business changing or additional, unforeseen risks arising before closing.").

18 *See* HARRISON, *supra* note 4, at 62 ("[I]f the target faces a potential liability, the parties may adjust the purchase price for the risk, draft closing conditions or related termination rights tied to successfully fixing those matters, or provide a special indemnity to protect the buyer from losses related to that liability."); Kling et al., *supra* note 5, at 783.

19 HARRISON, *supra* note 4, at 245 ("An indemnity is one mechanism for the buyer to shift liabilities back to the seller."). The parties often enter into an escrow agreement to ensure payment of any indemnification claims. *See id.* at 249.

20 *Id.* at 61 (noting recovery may be limited by deductibles, caps on damages, and restrictions on punitive or speculative damages).

21 HARRISON, *supra* note 4, at 95–96 ("[A]n indemnity renders every detail of the representations and warranties critical, because it can mean the difference between the seller having, or not having, to make post-closing indemnity payments to the buyer.").

B. NO SELLER INDEMNITY TRANSACTION WITH RWI

Some transactions deviate from the standard seller's indemnity by limiting or even replacing the seller's liability for breaches of representations and warranties with a RWI policy purchased by the buyer. This is commonly referred to as a no seller indemnity RWI transaction.[22] No seller indemnity transactions are also known as "public style" transactions.[23] In a no seller indemnity transaction, the representations and warranties do not survive the closing.[24] Aside from carve-outs for breaches of fundamental representations and for fraud, the buyer's exclusive remedy in the case of a breach of representations and warranties is the RWI policy.[25] The history of RWI and its appeal to both buyers and sellers,

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[22] "No seller indemnity" is not the only way to refer to this type of deal. For example, it is sometimes referred to as a "no-recourse deal." Mergers & Acquisitions, A.B.A.: Bus. Law Section, *supra* note 3.

[23] *See* Griffith, *supra* note 2, at 1851 ("[I]n public company deals there is no indemnity, and the reps do not survive the closing. Breaches of reps in public company deals thus only matter if they are discovered prior to the closing and are sufficiently large to enable the buyer at least to threaten not to close."); Kling, et al., *supra* note 5, at 780 (noting that in a public company acquisition, "unless an escrow or similar holdback device is established, there is no way for the purchaser to obtain indemnification from public shareholders.").

[24] Andrew J. Noreuil & Brian J. Massengill, *Delaware Supreme Court Adopts* ABRY Partners *Framework Permitting Limitations of Liability for Fraud Except for Intentional Fraud*, MAYER BROWN (March 1, 2021), https://www.mayerbrown.com/en/perspectives-events/publications/2021/03/delaware-supreme-court-adopts-abry-partners-framework-permitting-limitations-of-liability-for-fraud-except-for-intentional-fraud ("In effect, a no indemnity deal provides that the representations and warranties expire at the closing of the transaction, and the buyer has no claim against the seller for breaches of representations and warranties.").

[25] *Id.* ("The buyer often negotiates for the seller to be liable for breaches of fundamental representations and for fraud, but otherwise agrees to have its representations and warranties insurance policy be its exclusive remedy for breaches of representations and warranties.").

together with information about the RWI underwriting and claims processes, aid in understanding RWI and no seller indemnity transactions.

i. History of RWI

RWI has become more popular in recent years due to the rise in private equity transactions, lower RWI policy premiums, and expanded RWI coverage.[26] The RWI underwriting process formerly caused significant delays in a transaction but a policy can now be finalized in as little as two weeks.[27] RWI is most commonly used in private company M&A transactions worth at least $50 million, including transactions worth over $1 billion.[28] While RWI started out as a way to supplement the seller's indemnity,[29] it is now sometimes used to significantly reduce or entirely replace the seller's indemnity.[30]

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[26] Cable, *supra* note 9, at 83–84.

[27] *Id.* at 85, 87.

[28] Griffith, *supra* note 2, at 1864–65.

[29] *See* Stephen Leitzell, *Representations and Warranties Insurance: No Longer Optional for Strategic Buyers*, DEAL LAWS., May–June 2021, at 1, 1, https://www.dechert.com/content/dam/dechert%20files/people/bios/ l/stephen-leitzell/Representations-And-Warranties-Insurance-Stephen-Leitzell.pdf. RWI is still more commonly used *in conjunction* with the traditional seller's indemnity. *See* Griffith, *supra* note 2, at 1866. However, this article focuses on the less common "no seller indemnity" variety of RWI.

[30] Griffith, *supra* note 2, at 1866 ("Survey respondents reported that roughly one third of recent RWI policies were written to cover deals in which there was no seller indemnity."); *see also* Brian Keeler, Morgan Lewis & Bockius LLP, *Representations and Warranties Insurance in M&A Transactions*, BLOOMBERG LAW (Mar. 2020), https://www.morganlewis.com/-/media/files/news/2020/representationsandwarrantiesin.pdf.

ii. Purpose for using RWI

RWI has become a staple in the M&A industry. The seller likes RWI because it provides a way to reduce its post-closing liability.[31] RWI is attractive to the buyer because of its capacity to make the buyer a more competitive bidder in a seller's market. [32] RWI is especially popular when the buyer is a private equity firm and the seller or the seller's management intend to have a managerial role or some other business relationship with the acquired business after the closing.[33]

iii. Obtaining a RWI policy

Typically, RWI is purchased as a "buy-side" policy with the parties allocating the premium as part of the transaction costs.[34] The buyer

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31 Leitzell, *supra* note 29, at 3–4 ("Sellers of businesses, familiar with the product through their own buy-side activity, whether as strategic sellers or private equity owners themselves, have increasingly taken the view that they will only sell to a buyer willing to use RWI in order to eliminate or at least minimize their post-closing exposure."); Griffith, *supra* note 2, at 1920 ("As a substitute for standard indemnity and escrow obligations, RWI allows sellers to minimize risk at exit. RWI may also provide value to private equity buyers by preventing managerial risk aversion in the selection of portfolio company investments.").

32 *See* Leitzell, *supra* note 29 at 1, 4 ("[T]he closer the relative bargaining power between the buyer and the seller in any deal, the more likely that the seller will require RWI in order to limit its post-closing exposure, and the more likely that the buyer will have to agree."). The usage of RWI has become so commonplace that sellers sometimes pre-qualify the target company and provide coverage options to potential buyers. Keeler, *supra* note 30.

33 Leitzell, *supra* note 29, at 5 (explaining that a no seller indemnity is the easiest way to provide a seller with a clean break); Cable, *supra* note 9, at 95 ("Often, a buyer, especially in the private-equity context, expects the seller to continue in a management capacity. It can be awkward to assert a claim in that circumstance, and it may be easier to bring a claim against an insurance company."); Keeler, *supra* note 30, at 4 ("RWI can help avoid putting the buyer to a choice between suing its management team or forgoing a portion of the buyer's losses.").

34 *See* Keeler, *supra* note 30, at 3.

commonly uses a broker to solicit bids for the RWI policy.[35] The buyer and the insurer, through their respective legal counsel, negotiate the terms of the policy.[36] The insurance broker may also assist with the negotiation.[37] The insurer charges an underwriting fee of $25,000 to $50,000 to pay for the legal counsel retained for this negotiation process.[38]

The underwriting process relies heavily on the diligence conducted by the buyer.[39] The underwriter may review documents provided in response to due diligence requests as well as reports prepared by the buyer's various advisors.[40] Finally, the underwriter conducts a diligence call with the buyer to discuss any identified areas of risk.[41] The policy may contain exclusions based on this diligence.[42]

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[35] Cable, *supra* note 9, at 85 ("Several insurance brokerage firms maintain teams primarily dedicated to RWI. These brokers are often former M&A lawyers.").
[36] *Id.* at 86–87 (commenting that while the terms of any individual policy are subject to negotiation, "market conventions are emerging" with respect to certain policy features).
[37] *Id.* at 88 ("Brokers maintain relationships with insurers and so may have influence with them.").
[38] *Id.* at 98 (noting that underwriters keep a small staff and typically hire outside counsel to help review diligence and draft exclusions to the policy).
[39] *See id.* at 94 ("Underwriters themselves do not necessarily have the personnel to effectively diligence a large M&A transaction in the time provided.").
[40] *Id.* at 91 ("[U]nderwriters sign a letter acknowledging that the reports cannot be the legal basis for a claim by the underwriter against the advisor.").
[41] *Id.* at 92 ("Underwriters are looking for a disconnect between a seller's operations and risk profile and the buyer's diligence.").
[42] *Id.* ("If the insurer cannot get comfortable with the scope and quality of the buyer's diligence on a particular matter, the insurer might limit the scope of coverage through writing out language in a representation or creating a new policy exclusion.").

A RWI policy is commonly limited to 10% of the transaction's value.[43] A typical premium is around 3% of the policy limit.[44] Claims are subject to a retention (or deductible) of approximately 1% of the transaction value.[45] Of course, the terms of any given policy may vary. A 2016 transaction between Bobcat North America, LLC and Inland Waste Holdings, LLC worth $64.9 million offers a good example.[46] The RWI policy at issue had a $10 million limit (15% of transaction value) subject to a $649,000 deductible (1% of transaction value).[47] The cost of the premium was $400,000 (4% of the policy limit).[48]

iv. Filing a Claim under the RWI policy

The claims process under a RWI policy is similar to the indemnification procedure under a purchase agreement.[49] The policyholder provides notice of a claim to the insurer, who either issues payment or disputes the claim.[50] Claims are paid out subject to the

43 Griffith, *supra* note 2, at 1868 ("Limits anchor around 10%, one insurer remarked, because the purpose was 'to replace the seller escrow that used to predominate 5–10 years ago.'").
44 *Id.* at 1867; *see also* Cable, *supra* note 9, at 84 (noting premiums typically "equal [] 2.5-3% of the coverage amount").
45 Griffith, *supra* note 2, at 1867–68.
46 Bobcat N. Am., LLC v. Inland Waste Holdings, LLC, No. N17C-06-170 PRW CCLD, 2020 WL 55876883 at *2 (Del. Super. Ct. Sept. 18, 2020) (involving the sale of several waste-management companies).
47 *Id.* at *3.
48 *Id.*
49 Griffith, *supra* note 2, at 1895.
50 *Id.*

retention (i.e., deductible) and the policy limits.[51] In many cases, the buyer and seller allocate the cost of the retention through an escrow agreement.[52] However, in a no seller indemnity deal, only the buyer is responsible for paying the retention amount.[53]

Insurers use coverage defenses to mitigate the risk of fraud and misinformation provided by either the buyer or the seller.[54] If the buyer provided false information during the underwriting process, the insurer may seek to rescind the policy to avoid coverage.[55] If the insurer pays out claims related to the fraud of the seller, it might assert its subrogation rights.[56] While claims for rescission and subrogation are not common, the existence of these rights are tools that may be used by an insurer to bargain for a discounted claim settlement.[57]

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[51] *See* Cable, *supra* note 9, at 84; *see also* Griffith, *supra* note 2, at 1909–10 (stating that "most claims settle within the retention[,]" making this a very profitable industry for insurers)

[52] Leitzell, *supra* note 29, at 2.

[53] *Id.*

[54] Griffith, *supra* note 2, at 1915–16.

[55] *Id.* at 1916.

[56] *Id.*; *see also* Louis Matthews & Steve Wright, *Impact of a Buy-Side Representations and Warranties Insurance Policy on the Acquisition Agreement*, 1 M & A PRACTICE GUIDE § 18.07 (Jonathan Whalen ed., 2022) (noting that the treatment of fraud in the agreement will also govern the insurer's subrogation claim); Keeler, *supra* note 30, at 6 ("[F]or purposes of the RWI policy [fraud] will have the same meaning as it does in the underlying acquisition agreement.").

[57] Griffith, *supra* note 2, at 1917 ("An insurer that can credibly threaten to exclude, rescind, or subrogate may be able to settle RWI claims at a substantial discount.").

III. FRAUD CLAIMS WHEN THERE IS NO SELLER INDEMNITY

While post-closing fraud claims are not unique to no seller indemnity transactions, they are increasingly asserted by buyers in this context to recover damages in excess of the limits of the RWI policy.[58] A buyer experiencing unusually large damages or losses in connection with a breach will look for other means to make itself whole. Even if the buyer's sole remedy is the RWI policy, it still may be able to assert a fraud claim, depending on how the parties have defined fraud in the purchase agreement.

While the buyer would like to preserve as much post-closing fraud liability as possible, the seller, of course, would prefer to complete the transaction with few or no strings attached.[59] After all, the purchase price was likely computed, in part, based on the post-closing liability scheme agreed to by the parties.[60] Moreover, defending even an unfounded

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[58] Noreuil & Massengill, *supra* note 24 ("Once the representations and warranties insurance policy limits are exhausted, buyers are increasingly bringing fraud claims against sellers to seek to recover the remaining alleged damages because fraud claims are the only remaining claims permitted under the typical purchase agreement.").

[59] Express Scripts, Inc. v. Bracket Holdings Corp., 248 A.3d 824, 831 (Del. 2021) ("The seller wants to limit its liability for post-closing disputes over representations and warranties.").

[60] Abry Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1035 (Del. Ch. 2006) (arguing that the buyer, a sophisticated party, should be held to the deal and a "voluntarily-accepted limitation on its remedial options"); *Id.* at 1052 ("The Seller contends that a deal between sophisticated parties with the free right to walk away is a deal, and the law of this State should honor it.").

allegation of fraud poses significant costs to the seller, both financially and reputationally.[61]

While the parties cannot eliminate post-closing fraud claims entirely, they may draft provisions in the asset purchase agreement to address these concerns. The parties may negotiate for and include various contract provisions to allocate the risk of post-closing fraud claims. Delaware decisional law illustrates the acceptable bounds within which the parties may allocate this risk without running afoul of public policy.

A. POST-CLOSING FRAUD CLAIMS

There are two competing policies when it comes to fraud claims stemming from contractual relations. On the one hand, Delaware law favors freedom of contract.[62] On the other hand, the law disfavors fraud,[63]

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[61] *Id.* at 1061 ("If the Seller, a private equity firm, gets a rap as a fraudster who tries to sell portfolio companies based on false representations, that Seller will pay a price."); Fridrikh V. Shrayber & Morgan J. Hanson, *Anti-Reliance Clauses and Other Contractual Fraud Limitations Under Delaware Law*, 25 WIDENER L. REV. 23, 26 (2019) ("Even if a fraud claim is ultimately dismissed or otherwise resolved before trial, a [seller] may nevertheless feel the negative reputational effects stemming from contemporaneous publicity about the lawsuit and its allegations."); *see also Abry Partners V, L.P.*, 891 A.2d at 1058. ("[C]ourts are not perfect in distinguishing meritorious from non-meritorious claims of fraud.").

[62] *Express Scripts, Inc.*, 248 A.3d at 830. ("There is also 'a strong American tradition of freedom of contract, and that tradition is especially strong in [Delaware], which prides itself on having commercial laws that are efficient.'") (alteration in original); ChyronHego Corp. v. Wight, No. CV 2017-0548-SG, 2018 WL 3642132 at *1 (Del. Ch. July 31, 2018) ("Our law supports freedom of contract, holding parties to their bargains, good and bad.").

[63] *ChyronHego Corp.*, 2018 WL 3642132 at *1. ("[O]ur law abhors fraud, which is inimical to free exchange, properly understood."); Aveanna Healthcare, LLC v. Epic/Freedom, LLC, No. N20C-08-055 AML CCLD, 2021 WL 3235739, at *12 (Del. Super. Ct. July

as "[t]he public policy against fraud is a strong and venerable one that is largely founded on the societal consensus that lying is wrong."[64] Delaware's compromise is to allow parties to contract away liability for fraud based on extra-contractual representations—statements and information not contained in the asset purchase agreement itself—and for contractual misrepresentations that are not intentionally made.[65]

i. Elements of Common Law Fraud

While there are different types of fraud, this article primarily refers to common law fraud involving contractual representations and warranties in an asset purchase agreement.[66] To state a claim for fraud under Delaware common law:

> [T]he plaintiff must plead facts supporting an inference that: (1) the defendant falsely represented or omitted facts that the defendant had a duty to disclose; (2) the defendant knew or believed that the representation was false or made the representation with a reckless indifference to the truth; (3) the defendant intended to induce the plaintiff to act or refrain from acting; (4) the plaintiff acted in justifiable

29, 2021) ("In Delaware, contractual freedom ends where attempts to 'immunize' contractual fraud begin.").

64 *Abry Partners V, L.P.*, 891 A.2d at 1035.

65 *Id.*

66 See, e.g., Glenn D. West, That Pesky Little Thing Called Fraud: An Examination of Buyers' Insistence Upon (and Sellers' Too Ready Acceptance of) Undefined "Fraud Carve-Outs" in Acquisition Agreements, 69 BUS. LAW. 1049, 1066–67 (2014) (differentiating equitable fraud, promissory fraud, and unfair dealings-based fraud from common law fraud).

> reliance on the representation; and (5) the plaintiff was injured by its reliance.[67]

In sum, the plaintiff must prove that the defendant made a false representation, either knowingly or with reckless indifference as to its truthfulness, with the intention of inducing the plaintiff to act, and that the plaintiff was injured when it justifiably relied upon that representation.[68]

One instance in which a buyer might assert a fraud claim is when the seller knowingly conceals the loss of a major customer so the buyer will not pull out of the transaction.[69] For example, in *Swipe Acquisition Corporation v. Krauss*, the parties entered into an agreement in which Swipe Acquisition Corporation would purchase PLI Holdings, Inc., a company that makes and distributes gift cards.[70] One of PLI's most important customers was First Data Corp.[71] Through this relationship with First Data Corp., PLI became the gift card supplier for Amazon.com.[72] This indirect relationship with Amazon was discussed at length during the

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[67] *Abry Partners V, L.P.*, 891 A.2d at 1050 (citing DCV Holdings, Inc. v. Conagra, Inc., 889 A.2d 954, 958 (Del. 2005)).
[68] *Id.*
[69] Swipe Acquisition Corp. v. Krauss, No. CV 2019–0509–PAF, 2020 WL 5015863, at *1 (Del. Ch. Aug. 25, 2020).
[70] *Id.* at *1, 3.
[71] *Id.* at *2 .
[72] *Id.*

purchase negotiations, and the seller gave assurances that Amazon would be a longstanding customer.[73]

While the parties were still negotiating the terms of the purchase agreement, the seller learned that the company would be losing Amazon's business.[74] Fearful that the transaction would fall through if the buyers learned of the loss, the seller purposefully and actively concealed this bad news during the diligence process and failed to update its financial projections to reflect the impending loss of business.[75] The seller never informed the buyer of this critical information, and the transaction proceeded to closing.[76]

Shortly after closing, the buyer learned of the loss of Amazon's business and filed claims for breach of contract and for common law fraud, premising its fraud claim on the following false representation:

> No PLI Company has received any notice or has any knowledge that . . . any entity identified in Schedule 3.21 (each, a "Major Indirect Customer") has ceased or substantially reduced, or will or intends to cease or substantially reduce, use of, demand for, or the price it will pay for, any products or services of the Company or its Subsidiaries that are indirectly provided to

[73] Id.
[74] Id.
[75] *Id.* at *3.
[76] *Id.*

> such Major Indirect Customer, including by any Major Customer.[77]

The buyer presented evidence that the seller knew this representation was false three weeks prior to signing the purchase agreement.[78] Because the seller had knowingly made a false representation in the purchase agreement to induce the buyer to close the transaction, the buyer was able to state a proper claim for fraud.[79]

ii. Fraud Based on Extra-Contractual Representations

Delaware law allows parties to contract away liability for false representations made outside the four corners of an asset purchase agreement.[80] One of the elements of common law fraud is that the claimant justifiably relied on the representation.[81] When parties utilize an anti-reliance provision, they declare that they are not relying on information outside the four corners of the agreement.[82] Therefore, even if one party knowingly makes false statements, if those statements are not part of the agreement, "the complaining party cannot, in light of the

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[77] *Id.* at *5.
[78] *Id.*
[79] *Id.* at *10.
[80] Aveanna Healthcare, LLC v. Epic/Freedom, LLC, No. N20C-08-055 AML CCLD, 2021 WL 3235739, at *13 (Del. Super. Ct. July 29, 2021).
[81] Abry Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1050 (Del. Ch. 2006) (citing DCV Holdings, Inc. v. Conagra, Inc., 889 A.2d 954, 958 (Del. 2005)).
[82] ChyronHego Corp. v. Wight, No. CV 2017–0548–SG, 2018 WL 3642132 at *1 (Del. Ch. July 31, 2018).

contractual provision, have reasonably relied on the prior false statements."[83]

iii. Fraud Based on Representations and Warranties in the Purchase Agreement

Delaware treats fraud based on contractual representations differently from fraud based on extra-contractual representations. "Contractually binding, written representations of fact ought to be the most reliable of representations, and a law intolerant of fraud should abhor parties that make such representations knowing they are false."[84] However, Delaware does allow parties to contract away liability for contractual misrepresentations that are made unintentionally,[85] as the law distinguishes between lies and unintentional misrepresentations.[86] In other words, while the parties may not contract away liability for intentional fraud, they may place limits on liability for misrepresentations that are made recklessly or negligently.[87]

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[83] *Id.*

[84] *Abry Partners V, L.P.*, 891 A.2d at 1057.

[85] *Id.* at 1035 ("In other words, parties may allocate the risk of factual error freely as to any error where the speaking party did not consciously convey an untruth.").

[86] *Id.* at 1062 ("[T]here is a moral difference between a lie and an unintentional misrepresentation of fact. . . . There is also a practical difference between lies and unintentional misrepresentations. A seller can make a misrepresentation of fact because it was misinformed by someone else, was negligent, or even was reckless.").

[87] Express Scripts, Inc. v. Bracket Holdings Corp., 248 A.3d 824, 830 (Del. 2021) (acknowledging that while a party may not limit exposure for conscious lies to the buyer, it may place limits on liability for reckless, grossly negligent, or negligent behavior).

For example, in *Express Scripts, Inc. v. Bracket Holdings Corp.*, the sellers engaged in fraud by recklessly inflating revenue and working capital.[88] The buyer recovered $13 million under the RWI policy (its sole recourse under the exclusive remedies clause in the purchase agreement) and then prevailed on a fraud claim in the Superior Court.[89] The jury awarded over $82 million.[90] The award was reversed on appeal because the jury had been instructed about recklessness when the purchase agreement limited the seller's liability to "deliberate" fraud.[91] The court stated that "[a] deliberate state of mind is a different kettle of fish than a reckless one."[92]

B. CONTRACT PROVISIONS USED TO ALLOCATE THE RISK OF POST-CLOSING FRAUD CLAIMS

Parties to asset purchase agreements use various contract provisions to allocate the risk of post-closing fraud claims. Delaware "respect[s] the ability of sophisticated businesses . . . to make their own judgments about the risk they should bear and the due diligence they undertake, recognizing that such parties are able to price factors such as

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88 *Id.* at 826.
89 *Id.*
90 Id.
91 *Id.* at 834.
92 *Id.* at 826.

limits on liability."[93] The integration and anti-reliance clauses in an asset purchase agreement are used to contract away liability for extra-contractual misrepresentations, while the exclusive remedies clause and the fraud carve-out are used to allocate liability for contractual misrepresentations.[94]

i. Integration Clause

One important way the parties allocate risk is through an integration clause.[95] An integration clause provides that the asset purchase agreement is the entire agreement between the parties as to the asset purchase and that it supersedes any prior representations, warranties, and agreements relating to the asset purchase.[96] Side agreements, oral statements, or due diligence not incorporated into the agreement cannot constitute contractual representations when there is an integration clause.[97]

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93 Abry Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1061 (Del. Ch. 2006).

94 *Id.* at 1058–59.

95 *Id.* at 1058 ("This sort of definition minimizes the risk of erroneous litigation outcomes by reducing doubts about what was promised and said, especially because the contracting parties have defined that in writing in their contract.").

96 HARRISON, *supra* note 4, at 109–10.

97 *Id.* at 109.

ii. Anti-Reliance Clause

An integration clause alone, however, will not relieve a party of extra-contractual fraudulent representations.[98] The contract must also contain clear anti-reliance language.[99] An anti-reliance clause is an affirmative declaration made by the buyer that it did not rely on extra-contractual representations in its decision to sign the agreement.[100] This clause, in effect, "prohibits the promising party from reneging on its promise by premising a fraudulent inducement claim on statements of fact it had previously said were neither made to it nor had any effect on it."[101] An anti-reliance clause is a way to disclaim potential fraud claims for inaccurate or incomplete statements made outside the contract.[102]

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98 *Abry Partners V, L.P.*, 891 A.2d at 1059 ("[M]urky integration clauses, or standard integration clauses without explicit anti-reliance representations, will not relieve a party of its oral and extra-contractual fraudulent representations.").

99 *Id.* ("If parties fail to include unambiguous anti-reliance language, they will not be able to escape responsibility for their own fraudulent representations made outside of the agreement's four corners."); *see also* Anschutz Corp. v. Brown Robin Cap., LLC, No. CV 2019-0710-JRS, 2020 WL 3096744 at *13 (Del. Ch. June 11, 2020) ("A standard integration clause, without more, is insufficient to disclaim all reliance on extra-contractual statements.").

100 Aveanna Healthcare, LLC v. Epic/Freedom, LLC, No. N20C-08-055 AML CCLD, 2021 WL 3235739, at *13 (Del. Super. Ct. July 29, 2021) ("[P]arties eliminate 'extra-contractual' fraud claims while preserving 'intra-contractual' fraud claims."); *see, e.g.*, *Abry Partners V, L.P.*, 891 A.2d at 1035 ("[T]he Buyer has accepted that it had promised that the only representations of fact it was relying upon and the only representations of fact made to it were contained within the Agreement itself, and that this court's jurisprudence will hold it to that promise.").

101 *Abry Partners V, L.P.*, 891 A.2d at 1056.

102 Mergers & Acquisitions, A.B.A.: Bus. Law Section, *supra* note 3 (interviewing Tali Sealman).

On the other hand, if the agreement does not "actually include a specific acknowledgement by a party that it is only relying on information contained within the four corners of the agreement, that party is not shirking its bargain when it later alleges that it did, in fact, rely on extra-contractual representations."[103] For example, in *Anschutz Corporation v. Brown Robin Capital, LLC*,[104] the buyer brought a claim for fraudulent inducement based on representations made outside the four corners of the purchase agreement.[105] The Chancery Court denied the seller's motion to dismiss because the purchase agreement did not contain an adequate anti-reliance clause.[106] In fact, the purported anti-reliance language actually served to bolster the buyer's claim. The relevant portion of the agreement read as follows:

> Buyer acknowledges and agrees that it has made its own inquiry and investigation into, and, based thereon, has formed an independent judgment concerning, the Company and its business operations, and that it has been provided with such information about the Company and its business and operations as it has requested.[107]

[103] *Anschutz Corp.*, 2020 WL 3096744 at *14.
[104] *Id.* at *1.
[105] *Id.* at *13.
[106] *Id.* at *15.
[107] *Id.* at *14.

Keep in mind that the *seller* had disclaimed any express or implied representations or warranties other than those within the agreement, and that the agreement also contained a standard integration clause.[108] However, because the *buyer* had not made an express acknowledgment of anti-reliance, it was not barred from bringing an extra-contractual fraud claim.[109]

Well-drafted anti-reliance clauses work together with carefully written integration clauses to preclude liability for extra-contractual fraud. It is, therefore, essential that a buyer obtain appropriately tailored representations and warranties in the purchase agreement. The drafting of a purchase agreement could be compared to the working of a puzzle in the shape of the business being acquired.[110] The seller supplies various puzzle pieces pursuant to the buyer's request.[111] Once the buyer is satisfied with the picture, it stops requesting pieces, and the transaction closes.[112] The buyer cannot then "construct a fraud claim upon the notion that it

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[108] *Id.*
[109] *Id.* at *14–15.
[110] Pilot Air Freight, LLC v. Manna Freight Sys., Inc., No. CV 2019-0992-JRS, 2020 WL 5588671, at *23 (Del. Ch. Sept. 18, 2020).
[111] *Id.*
[112] *Id.*

needed more, or different, pieces in the [asset purchase agreement] to see the full picture. Aggressive bargaining is not fraud."[113]

The buyer can protect itself from reliance upon important information obtained outside the agreement by weaving that information into the representations and warranties by express reference in the agreement, or through its inclusion in the related disclosure schedules.[114] For example, in *Aveanna Healthcare v. Epic*, the buyer relied heavily on financial performance analyses and documentation prepared by various advisors of the seller.[115] Those reports survived closing as part of "the contractually-defined and incorporated 'Financial Statements.'"[116] As such, false statements in the reports were incorporated by express reference into the agreement itself, and fraud claims based on those statements would not be barred by anti-reliance language.[117]

iii. Exclusive Remedies Provision and the Fraud Carveout

The exclusive remedies provision provides that a buyer must pursue damages according to the agreed upon indemnification provisions instead of pursuing other contract or tort-based claims that may be

113 *Id.*

114 Mergers & Acquisitions Comm., A.B.A., *Fraud Carve-Outs: Drafting*, HOTSHOT, www.hotshotlegal.com/courses/fraud-carve-outs-drafting/sections/932 (interviewing Tali Sealman) (last visited Oct. 29, 2022).

115 Aveanna Healthcare, LLC v. Epic/Freedom, LLC, No. N20C-08-055 AML CCLD, 2021 WL 3235739, at *2 (Del. Super. Ct. July 29, 2021).

116 *Id.*

117 *Id.* at *12.

available for the same issue.[118] In a transaction that utilizes RWI, the insurance is often the exclusive remedy, except in a case of fraud or with regard to fundamental representations. For example, in *Express Scripts v. Bracket Holdings Corp.*, the purchase agreement contained the following language in its indemnification section:

> THE BUYER AND PARENT EACH ACKNOWLEDGES AND AGREES THAT EXCEPT IN THE CASE OF ANY DELIBERANT [sic] FRAUDULENT (I) ACT, (II) STATEMENT, OR (III) OMISSION (1) *THE SOLE AND EXCLUSIVE REMEDY* OF WITH RESPECT TO ANY BREACH BY PARENT OR ANY REPRESENTATION OR WARRANTY (OTHER THAN THE FUNDAMENTAL REPRESENTATIONS) CONTAINED IN THIS AGREEMENT *SHALL BE SATISFIED FROM THE R & W INSURANCE POLICY* . . . .[119]

Most transactions utilize some type of fraud carve-out to the exclusive remedies provision.[120] Nevertheless, even when the parties omit a fraud carveout, the court may read in a common law fraud carve-out.[121]

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118 HARRISON, *supra* note 4, at 268.

119 Express Scripts, Inc. v. Bracket Holdings Corp., 248 A.3d 824, 830 (Del. 2021) (emphasis added).

120 *Summary: Fraud Carve-Outs, supra* note 8, at 1.

121 *Id.* at 5. ("[U]nder Delaware law, even if the parties don't include a fraud carve-out in the exclusive remedies provision, a buyer could still bring a tort-based claim if they believe the seller knowingly lied in the written reps.").

a. The Danger of an Undefined Fraud Carveout

An undefined fraud carve-out is often found within the exclusive remedies provision and consists of the following sparce language modifying the parties' acknowledgement of the exclusive remedy: "except in the case of fraud."[122] This type of carve-out is buyer-friendly and may be more broad than the parties intended.[123] For example, a court might determine that the parties intended the exclusion to apply to both contractual and extra-contractual representations, essentially voiding the integration and anti-reliance clauses.[124] Under this result, the seller would be subject to more liability than if the court simply enforced the public policy carveout.[125]

b. Limiting the Scope of the Fraud Carveout by Defining Fraud

In most cases, the parties intend for a fraud carve-out to apply when a seller knowingly makes a material false representation that the

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[122] Mergers & Acquisitions Comm., A.B.A.: Bus. Law Section, *Summary: Fraud Carve-Outs: Drafting*, HOTSHOT, [hereinafter *Summary: Fraud Carve-Outs: Drafting*], https://www.hotshotlegal.com/courses/fraud-carve-outs-drafting/sections/932 (follow "Summary" hyperlink) (last visited Oct. 29, 2022).

[123] West, *supra* note 66, at 1054 ("[A] fraud carve-out that does not qualify the term 'fraud' with the specific type of fraud to which one is intending to refer may well be a carve-out that captures more than the egregious conduct intended to be captured."); *Summary: Fraud Carve-Outs*, *supra* note 8, at 1–2 ("Buyers prefer either no definition at all or a broader definition that includes misstatements made both in and outside of the agreement . . . .").

[124] *See Summary: Fraud Carve-Outs, supra* note 8, at 4 ("When fraud is left undefined in the carve-out, there could be a conflict between the No-Reliance clause and the carve-out. This can raise questions about whether both contractual and extra-contractual representations should be allowed as the basis of a fraud claim.").

[125] *Id.* at 5.

buyer relies upon.[126] Sellers should, therefore, insist on "limit[ing] the scope of the fraud carve-out to a defined set of circumstances where the sellers deliberately included a representation in the agreement knowing it was false."[127] The parties may define fraud within the carveout itself or in a defined term.[128] An example of a more seller-friendly provision is as follows:

> Except in the case of claims of *intentional common law fraud* respecting the *express representations and warranties set forth in this Agreement* and asserted against the Person who *knowingly* committed such intentional common law fraud, claims for indemnification brought in accordance with and subject to this Article [ ] shall be the *sole and exclusive remedy* of any Indemnitee for Losses from and after the Closing Date with respect to any claim arising from, based upon, or related to this Agreement (whether in contract or tort).[129]

Along similar lines, the exclusive remedies provision litigated in the *Express Scripts* case, mentioned above, provides a carve-out that excepts any deliberate fraudulent acts, statements, or omissions from the

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126 *See id.* at 3.

127 *Id.* at 1.

128 *Summary: Fraud Carve-Outs: Drafting*, *supra* note 124, at 1

129 *Id.* at 1−2 (emphasis added).

exclusive remedies provision.[130] In that case, the buyer could recover damages above the amount of the representations and warranties insurance policy if the seller committed deliberate fraud, but it was limited to the remedy provided by the insurance policy if the fraud had been committed with a lesser state of mind.[131]

IV. DEFINING FRAUD TO CAPTURE THE PARTIES' INTENT

The analysis and observations provided in Part III indicate that transactional lawyers advising on, negotiating, and drafting asset purchase agreements should be familiar with and pay attention to decisional law when determining contents of the agreement, including the words used to define fraud as the term is used in any fraud carve-out from the exclusive remedies clause. As noted above, undefined fraud carveouts carry a bigger risk of post-closing liability for the seller because they may be construed to include reckless or negligent fraud.[132] Narrowing fraud to only intentional acts, however, may preclude a buyer from instigating a cause

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[130] Express Scripts, Inc. v. Bracket Holdings Corp., 248 A.3d 824, 830 (Del. 2021) (emphasis added). The reader will note that there are at least two typographical errors in this provision, which is quoted in full at *supra* note 122. First, the word "deliberate" is misspelled as "deliberant." Then, in the final sentence, the first "of" is out of place. While the latter error appears to be insignificant, no doubt the misspelling of "deliberate" caused the drafting attorneys significant embarrassment during the court proceedings. Let this be a warning that careless drafting errors are sometimes put on display for the world (and other lawyers) to see.

[131] *Id.* at 834 (finding that "deliberate" had the same meaning as "intentional" and did not mean "reckless").

[132] *Supra* notes 129—34 and accompanying text.

of action against the seller for misrepresentations or omissions, however egregious, made with lesser states of mind. This tension is one that must be dealt with openly when the parties are negotiating the terms of the purchase agreement. Fraud is not something that should be left up to interpretation—unless the parties expressly agree that they will leave it up to interpretation.

A. REVISITING THE MAKEUP TECH HYPOTHETICAL

This part applies the fraud concepts discussed in Part III to the Makeup Tech hypothetical presented in the Introduction. In the hypothetical, Smith and the Buyer agreed to a no seller indemnity transaction. Smith desired to utilize this type of transaction in order to reduce her post-closing liability so she could complete the transaction "with no strings attached." The Buyer agreed in order to make itself a more competitive bidder, and it was likely able to make a slightly lower bid in return. The intent of the parties was to substitute a RWI policy for the typical seller's indemnity.

The purchase agreement included integration and anti-reliance clauses thereby precluding a fraud claim based on extra-contractual misrepresentations. It also provided that the RWI policy would be the exclusive remedy in the event of a breach of the seller's contractual

representations and warranties. However, the agreement included a fraud carve-out to the exclusive remedies provision allowing the buyer to seek additional recourse in the event of fraud. Does Smith's failure to investigate the contents of the letter amount to the type of fraud that can be recovered under the fraud carve-out? That depends on how the parties failed to define or defined fraud. This part compares two possible scenarios—one in which the parties left fraud undefined, and one in which they limited the carveout to intentional fraud.

i. Carveout that Leaves Fraud Undefined

Suppose that the parties included an undefined fraud carveout to the exclusive remedies provision that reads as follows:

> The buyer acknowledges and agrees that *except in the case of fraud*, the sole and exclusive remedy with respect to any breach of any representation or warranty (other than the fundamental representations) contained in this agreement shall be satisfied from the representations and warranties insurance policy.[133]

Because fraud is left undefined, this carveout is not necessarily limited to contractual misrepresentations that are intentionally made.[134] It leaves up

[133] This language is a modification of the *Express Scripts* language found at *supra* note 122.

[134] In fact, the buyer might be able to assert other types of fraud claims than the type of fraud discussed in this article.

to a judge or jury the question of whether Smith's conduct amounts to fraud. Her conduct could reasonably be considered grossly negligent, possibly reckless, and arguably even intentional if the buyer could present the right facts. An undefined fraud carve-out leads to a lot of uncertainty, which is something that the contracting parties to an asset purchase agreement wish to reduce.

ii. Carveout that Defines Fraud

Now, suppose that the parties included the following fraud carveout which narrows fraud to only intentional conduct:

> The buyer acknowledges and agrees that *except in the case of intentional fraud* with respect to any *representation or warranty expressly contained in this agreement*, the sole and exclusive remedy with respect to any breach of any representation or warranty (other than the fundamental representations) contained in this agreement shall be satisfied from the representations and warranties insurance policy.[135]

Under this scenario, the buyer would have a more difficult time proving that Smith intentionally misrepresented that there were no pending or threatened claims regarding the patent. It is certainly possible that the

[135] This language is a modification of the *Express Scripts* language found at *supra* note 122 and the sample language found at *supra* note 132.

buyer would still prevail. However, this drafting captures the intent of the parties better and reduces the likelihood of Smith facing liability for fraudulent misrepresentation. The buyer will prevail only if they can prove that Smith's conduct was intentional.

B. DRAFTING TECHNIQUES USED TO DEFINE FRAUD

As the hypothetical indicates, the outcome of a fraud claim may be determined, in part, by whether the parties utilized careful contract drafting principles. There are two main ways to limit the scope of a fraud carveout in a purchase agreement—by defining fraud in the carveout itself or in a defined term. This part discusses those two options and provides additional ideas for how to deal with fraud in the purchase agreement.

i. Defining Fraud as a Defined Term

Fraud could be defined in the defined terms section of the purchase agreement. However, this may have unintended consequences when fraud has multiple meanings throughout a document. Perhaps the definition could be stated broadly at first, but then qualified to indicate that with regard to the exclusive remedies provision, fraud means intentional common law fraud.

ii. Drafting a Descriptive Fraud Carve-Out

The parties could specify in the fraud carve-out whether it applies only to intentional conduct or to lesser states of mind. This seems to be

the most straightforward method of dealing with fraud, and it allows the parties to limit any ripple effects throughout the purchase agreement. For example, if the parties wish to use a broader definition of fraud in other parts of the agreement, they could do so while specifying that for purposes of the fraud carve-out in the exclusive remedies provision, only intentional fraud will trigger the carve-out.

iii. Addressing Fraud in the Recitals

The parties could include a recital indicating that it is the intention of the parties to enter into a no seller indemnity transaction in which the exclusive remedy is a policy of RWI. The recital would go on to clarify the parties' intentions with respect to contractual fraudulent misrepresentations. If the parties intend to create an undefined fraud carve-out, they could make this explicit in the recital. A recital would be used in addition to one of the above options in order to clarify the parties' intentions. However, the parties run the risk of creating an ambiguity between the recital and the agreement if there are differences between the two.

iv. Creating a Special Section of the Agreement to Address Fraud

Finally, the parties could create a special section in the agreement to deal with fraud. Each part of the agreement that typically contains a

reference to fraud would cross-reference the special fraud section. That section would outline all the different ways that fraud could be implicated, and it would specify whether the conduct must be intentional or whether the common law definition would apply. This would require the parties to think through and be intentional about how they treat fraud in every aspect of their agreement, and it would help to eliminate any ambiguity or inconsistencies between sections of the agreement.

V. CONCLUSION

When parties intend to complete a no seller indemnity transaction, it is important that they negotiate and come to an agreement about how to handle post-closing fraud claims. If the purchase agreement is silent or unclear about what constitutes the type of fraud that will trigger a remedy outside of the RWI policy, the court may read in a meaning that the parties did not intend to create. A lawyer's job is to capture the intent and wishes of her client. In the context of a purchase agreement, this intent is best captured through careful drafting. In the event of a post-closing fraud claim, a lawyer wants to make sure her client faces no more liability than the client bargained for during the negotiation process.