

Let the Seller Beware

SOUND DECISIONS // Fraud Carve-outs in M&A Deals Can Spell Trouble



Andrew Lucano
Partner,
Seyfarth Shaw
LLP

Buyers frequently insert fraud carve-outs into M&A agreements; they stipulate that in case of fraud, all bets are off and any limitations on recovery under the agreement's provisions should not apply. While this sounds fair, sellers should not liberally accept fraud carve-outs. A May 2017 Delaware court decision, *EMSI Acquisition, Inc. v. Contrarian Funds, LLC*, offers a cautionary tale.

What Happened?

The buyer asserted post-closing indemnification claims against the selling shareholders related to manipulation of the target company's financial statements by employees. Sellers moved to dismiss, saying the stock purchase agreement limited recourse for indemnification claims regarding breaches of representations and warranties to the amount in an escrow fund. Conversely, the buyer argued its indemnification claim was not capped by the fund—which was then depleted—due to the broad, undefined fraud carve-out in the stock purchase agreement. Citing, among other things, “inelegant drafting” and conflicting provisions, the court denied the motion to dismiss, finding that extrinsic evidence was needed to interpret the ambiguous indemnification provisions.

Points of Interest

The stock purchase agreement contained a non-reliance clause that “specifically disclaimed any reliance on extra-contractual representations”; the court reiterated its validity and the protection it provides against fraud claims for statements made outside the purchase agreement. However, the court noted the broad nature of the fraud carve-out “may be read to allow extra-contractual claims for fraud notwithstanding the non-reliance clause.”

Despite certain permissible limitations on fraud claims, the court made clear that Delaware's

public policy against intentional fraud does not allow a seller to insulate itself by contract from claims that it made “a knowingly false contractual representation,” including claims that it knew the target company made a false representation in the purchase agreement.

The case raised issues regarding pleading standards for fraud under Delaware law and the type of fraud, as well as who knew about it, who committed it, and who made the fraudulent contractual representations at issue.

Limiting Fraud Carve-outs

The *EMSI* decision shows why sellers should avoid agreeing to undefined, broad fraud carve-outs in purchase agreements. Sellers should:

1. Specifically define “fraud,” limiting it to fraud intentionally and knowingly committed by the seller regarding the specific representations and warranties expressly made in the agreement.
2. Avoid a carve-out for fraud committed by others where the selling shareholder was not a knowing participant (the exception should only apply where the representations and warranties made in the agreement by the company or the shareholder were known by the shareholder to be false).
3. Avoid fraud carve-outs that might trump or cloud non-reliance clauses or allow buyers to pursue “extra-contractual” claims. Sellers should provide the carve-out as a specific exception to the indemnity cap and basket, while otherwise staying within the agreement's indemnity regime, not as an exception to the exclusive remedies provision. //

Andrew Lucano is a partner with Seyfarth Shaw, vice chairman of its M&A practice, and editor of its *M&A Surveybook*. He can be reached at alucano@seyfarth.com.