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Case Law Matters: Drafting Lessons that Every M&A Lawyer Should Learn, But Not the Hard Way

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At the ABA Business Law Section's 2022 spring meeting in Atlanta, the M&A Committee presented a CLE panel discussing case law regarding drafting MAE, indemnification, fraud carve-outs, and other miscellaneous provisions. That CLE panel, which included insightful commentary by Chief Justice Collins J. Seitz, Jr. of the Delaware Supreme Court, is available to view as on-demand CLE, free for Section members. Below is a summary of the decisions and topics discussed.

MAE, Ordinary Course, and Other Lessons Learned from COVID Litigation

COVID-19 has exposed certain structural vulnerabilities in M&A agreements that can be exploited when there is an unexpected event, namely: the Material Adverse Effect definition, the "ordinary course" covenant, and the covenant bring-down condition. Deal points data from 2019–2021 showed Buyers' and Sellers' response to such vulnerabilities:

- *MAE Definition.* Two pro-Buyer developments: Rather than adhering to the standard single-prong definition (i.e., an MAE on the business, subject to carve-outs), there is an increased prominence of the dual prong definition (i.e., that an MAE also includes the ability to consummate/perform the transaction). Second, the "disproportionate effect" override continues (in most instances) to be tied to the industry within which the company operates rather than similar companies within that industry. One pro-Seller development: the exclusions to the MAE definition are more often expressed in relational terms that permit an expansive reading of the exclusions' scope (i.e., language such as "arising under, resulting from or relating thereto" that does not require a direct causal link).

- *"Ordinary Course" Covenant.* One pro-Seller development: Early deal data from 2021 suggest that Sellers have become increasingly successful in negotiating an "efforts" based standard. Nevertheless, a majority of deals continue to impose an absolute obligation on the target to operate in the ordinary course of business, and those that do contain such a flat covenant are also likely to retain a "consistent with past practice" requirement.

- *Closing Condition.* The covenant bring-down condition continues to be tied to a Buyer-friendly "in all material respects" standard of materiality rather than the MAE standard.

There was a string of COVID "broken deal" cases brought in 2020 in the Delaware courts, with the first decided in the Delaware Court of Chancery on April 30, 2021. (1) In December of 2021, the Delaware Supreme Court decided its first COVID "broken deal" case on appeal: *AB Stable VIII LLC v. Maps Hotels and Resorts One LLC.* (2) *AB Stable* offered the following interpretative points regarding these three areas of structural vulnerability:

- *MAE Definition.* The exceptions to the definition of MAE do not need to refer to the root cause of the adverse development to be effective. In other words, there is no requirement that the definition reference "COVID" or a "pandemic" if the effect of the pandemic was itself described by the exception.

- *"Ordinary Course" Covenant.* "Ordinary course" means to operate in accordance with how a business has routinely conducted its business in normal circumstances, not how it or others in its industry operated in the pandemic. "Consistent with past practice" looks only at how such seller operated the business in the past. And a "reasonableness" standard is not implicit in the "ordinary course" obligation.

- *Closing Condition.* The MAE closing condition does not bleed into the covenant bring-down condition's "in all material respects" standard. The court made it clear that the two provisions serve different purposes: (i) the MAE closing condition allocates the risk of changes in a target's valuation, and (ii) the "ordinary course" covenant reassures a buyer that the target has not materially changed its business or practices during the pendency of the transaction. The "in all material respects" covenant bring-down condition does not require a showing equivalent to an MAE or even a showing equivalent to the common law doctrine of material breach, but rather only that a deviation occurred that significantly altered the total mix of information available to Buyer when viewed in the context of the parties' contract, resulting in a meaningful change from Buyer's reasonable expectations about how the business would be operated between signing and closing.

One can expect that the structural vulnerabilities discussed above will become the subject of further attention in M&A agreements as the parties seek to address their impact on closing certainty.

Indemnification, Fraud, and Reliance Lessons

The dense, highly negotiated agreements used in mergers or acquisitions often require courts to decide which party better interprets technical provisions concerning their indemnification obligations or rights, and the ability of parties to assert fraud claims. The variations of nonreliance, integration, exclusive remedies, and indemnification clauses, and the way the clauses interact with each other and the public policies underlying fraud claims, lead to a seemingly endless variety of interpretation questions. Together the decisions guide sellers and buyers as to how to limit (or preserve) their indemnification obligations (or rights) and exposure to (or ability to assert) fraud claims.

Concerning fraud claims, the Delaware Court of Chancery decision in *Online Healthnow, Inc. and Bertelsmann, Inc., v. CIP OCL Investments, LLC et al.,* [3] analyzed how sellers can contractually seek to modify their exposure to post-closing fraud claims. Vice Chancellor Slights noted that they can do so in four ways: "(1) 'what' information the buyer is relying on, (2) 'when' the buyer may bring a claim, (3) 'who' among the sellers may be held liable, and (4) 'how much' the buyer may recover if it proves its claim." [4] The Vice Chancellor relied on what he described as the seminal decision in this area, *Abry Partners V., L.P. v. F&W Acquisition LLC,* [5] to answer the "what" and "how much" questions, reiterating that parties may contractually disclaim reliance on extra-contractual statements, but may not contractually limit their liability for knowingly making false statements within the contract itself given Delaware's "distaste for immunizing fraud." [6]

Vice Chancellor Slights then focused on the "when" and "who" questions in the case, analyzing an agreement that contained "remarkably robust survival, anti-reliance and non-recourse provisions that appear to atomize Plaintiffs' claims across all of the recognized planes of contractual limitations." [7] *Abry* and its progeny make clear that "contractual limitations on liability are effective when used in measured doses," but it would be "too much dynamite" to "invoke a clause in a contract allegedly procured by fraud to eviscerate a claim that the contract itself is an instrument of fraud." [8] That meant the survival provision could not cut off a claim for contractual fraud, and the non-recourse provision could not insulate a third party from liability if that party knew of and facilitated the fraudulent misrepresentations made in the acquisition agreement. [9] On the specifics alleged, the plaintiff in *Online Healthnow* had adequately pled the parties knew of and facilitated the fraudulent misrepresentations through their participation in the sale process and drafting of the agreement. [10]

Regarding indemnification and reliance cases, the number of cases discussing these points is such that a full discussion is beyond the scope of the CLE presentation or this summary. A number of those cases were thus discussed briefly, [11] before using the recent Chancery decision in *Spay Inc. v. Stack Media Inc.*, [12] as a case study. There, the court largely denied a motion to dismiss because the purchase agreement did not bar the asserted claims. First, the court determined that the limitation on survival applicable to non-fundamental representations and warranties did not by its terms apply to covenants. [13] Because the purchase agreement failed to specify a survival period applicable to covenants, the covenants survived until expiration of the applicable statute of limitations. [14] Further, the survival period applicable to non-fundamental representations and warranties was not applicable where the claim for breach was based on fraud (which was not defined in the agreement). [15] The exclusive remedy provision specifically stated that such fraud was not exclusively governed by the indemnification regime in the purchase agreement, meaning claims for breaches based on such fraud could still be brought after expiration of the contractual survival period. [16] The court did not address, but referenced in dicta that the survival period for representations may not apply to the closing certificate unless expressly stated. [17]

Beware the Boilerplate

Sample, model, or previously used agreements commonly serve as the starting point for drafting transactional documents. Using those provisions and treating them as boilerplate that does not require customization, however, may result in outcomes not considered by the parties. Recent decisions construing boilerplate provisions, and particularly those relating to governing law, exclusive forum, and jury trial waivers, should make practitioners consider whether to modify those provisions to better reflect the interests of their clients.

As Professor John Coyle of the University of North Carolina School of Law has observed, there is a secret language of choice-of-law and forum selection clauses. [18] As a result, to ensure that the law chosen by the parties applies to not only resolution of any *interpretive* questions arising under the contract (i.e., ambiguities) but also determination of their substantive rights and obligations, parties should expressly state that the contract shall be "governed" (as opposed to interpreted or construed) by the laws of the specified jurisdiction. [19] Similarly, if the parties' intent is to have the specified "governing" law apply not just to contract claims but also to tort or statutory claims relating to the contract, then many jurisdictions (among them New York [20]) require that they expressly say so; inclusion of the phrase "and claims relating to this agreement" should eliminate any doubt as to the parties' intent (most courts view "arising out of" as too narrow in scope). And a majority of U.S. courts (New York and Delaware—but not California—among them) distinguish between substantive law and procedural law when interpreting choice of law provisions. Since statutes of limitation are generally considered *procedural* in nature, a clause that provides the contract is to be governed by the law of a specified state, without more, runs the risk of selecting only such state's substantive, not its procedural, law, resulting in the statutes of limitation of the forum jurisdiction, not those of the specified governing jurisdiction, being applied. [21] To avoid that result, parties' governing law provision should contain the phrase "including those laws applicable to statute of limitations."

Finally, a word or two about exclusive forum selection clauses. What if the parties desire all claims relating to an agreement to be litigated exclusively in a specified jurisdiction? Would the following accomplish that goal: "The sole and exclusive jurisdiction for any litigation for enforcement of this Agreement shall be in the courts of [X]"? The answer is no—"enforcement" merely applies to the obligations set forth in the contract. [22] As is true with respect to governing law, if parties want to ensure that all claims are adjudicated in a specific jurisdiction,

they should replace "litigation for enforcement" with "litigation related to this Agreement." And parties need to recognize that courts will refuse to enforce forum selection clauses if they believe the chosen forum would not apply a constitutional or statutory right, or the benefit of a fundamental public policy to which a party is entitled. [23]

Endnotes

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