CONTRACTUAL LIMITATIONS ON SELLER LIABILITY IN M&A AGREEMENTS

By

BYRON F. EGAN
Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, TX 75202

PATRICIA O. VELLA
Morris, Nichols, Arsht & Tunnell LLP
1201 North Market Street, 18th Floor
P.O. Box 1347
Wilmington, DE 19899-1347

GLENN D. WEST
Weil, Gotshal & Manges LLP
200 Crescent Court, Suite 300
Dallas, TX 75201

THE UNIVERSITY OF TEXAS SCHOOL OF LAW

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I. PERSPECTIVE

Acquisition agreements for closely held businesses frequently incorporate well-defined risk shifting provisions. The buyer seeks to shift risks in the acquisition agreement to the seller through detailed representations, provisions that condition its obligation to close upon the correctness of those representations and provisions that obligate seller to indemnify buyer for losses buyer may suffer as a result of seller breaches and other events.[1] Typically these risk allocation provisions are heavily negotiated.

A contracting party that is dissatisfied with the deal embodied in a written agreement, however, often attempts to circumvent its provisions by premising tort-based fraud and negligent misrepresentation claims on the alleged inaccuracy of both purported pre-contractual representations and express, contractual warranties. The mere threat of a fraud or negligent misrepresentation claim can be used as a bargaining chip by a counterparty attempting to avoid the contractual deal that it made. Indeed, fraud and negligent misrepresentation claims have proven to be tough to define, easy to allege, hard to dismiss on a pre-discovery motion, difficult to disprove without expensive and lengthy litigation, and highly susceptible to the erroneous conclusions of judges and juries.

The seller can endeavor to reduce the risk of post-closing claims by the buyer through provisions in the acquisition agreement to the effect that the acquisition agreement is the exclusive agreement between the parties, that seller is not responsible for any statement not made within the four corners of the agreement[2] and the seller's responsibility for those statements is

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Byron F. Egan, Patricia O. Vella and Glenn D. West are members of the ABA Business Law Section's Mergers & Acquisitions Committee. Mr. Egan serves as Senior Vice Chair of the Committee and Chair of its Executive Council and served as Co-Chair of its Asset Acquisition Agreement Task Force which prepared the ABA Model Asset Purchase Agreement with Commentary. Ms. Vella serves as Co-Chair of the Joint Task Force on Governance Issues in Business Combinations sponsored by the Mergers & Acquisitions Committee and the Corporate Governance Committee of the ABA.

1 *See infra* Section IV. Indemnification Provisions.

2 *See infra* Section V. Entire Agreement.

contractually limited. This paper will endeavor to highlight these issues through a series of hypotheticals and discuss some recent cases that show how the issues are dealt with by some courts.

II. HYPOTHETICAL SITUATIONS

A. Hypothetical 1: Pre-Signing

- Seller conducts competitive auction to sell assets
- After receiving a non-binding indication of interest from Buyer 1, Seller sends an unsigned bid procedures letter to Buyer 1
- The bid procedures letter states that a bid will only be deemed to be accepted upon execution and delivery of the purchase agreement and contains "no legal obligation" language
- Buyer 1 submits a bid pursuant to the bid procedures letter, following which Seller calls Buyer 1 stating the parties have a "deal" and will work to sign a definitive purchase agreement
- Seller continues to market the assets and signs a purchase agreement with Buyer 2
- Buyer 1 sues Seller for fraud and negligent misrepresentation and Buyer 2 for tortious interference with contract

B. Hypothetical 2: Between Sign and Close

- Target conducts a competitive sale process and two buyers are interested
- Buyer 1 and Target sign a merger agreement (or, in a companion case, a letter of intent) with "no-shop" and "prompt notice" provisions
- Target continues to have strategic discussions and share confidential information with Buyer 2
- Buyer 2 makes a topping bid for Target
- Target terminates its signed merger agreement with Buyer 1, pursuant to the negotiated superior proposal termination right in the merger agreement, and signs a merger agreement with Buyer 2
- Buyer 1 sues Target for breach of the merger agreement

C. Hypothetical 3: Post-Closing

- Buyer and Seller sign a purchase agreement and close the acquisition

- The purchase agreement specifies that Buyer's exclusive remedy for any misrepresentation in the purchase agreement is an indemnification claim for damages capped at $20M (there is no fraud exception to the exclusive remedy provision and there is no anti-sandbagging provision)

- The purchase agreement also includes a merger clause that Buyer is not relying upon any representations and warranties not stated in the contract

- Buyer claims that Seller made a false representation in the purchase agreement (i.e., that the Target's financials are accurately stated), which caused Buyer to overpay for Target by $100M

- Buyer sues Seller for fraud and negligent misrepresentation and seeks equitable rescission of the acquisition

III. RECENT CASES FROM WHICH HYPOTHETICALS DEVELOPED

A. Duty to Maximize Value

Under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[3] director fiduciary duties[4] require robust director involvement in sale of control transactions to confirm that the stockholders are getting the best price reasonably available. In *Lyondell Chemical Company v. Ryan*,[5] the Delaware Supreme Court explained *Revlon* as follows:

> The duty to seek the best available price applies only when a company embarks on a transaction — on its own initiative or in response to an unsolicited offer— that will result in a change of control. * * *
>
> There is only one *Revlon* duty — to "[get] the best price for the stockholders at a sale of the company." No court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control. "[T]here is no single blueprint that a board must follow to fulfill its duties." * * *[6]

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[3] 506 A.2d 173 (Del. 1986). *See* Byron F. Egan, *Recent Fiduciary Duty Cases Affecting Advice to Directors and Officers of Delaware and Texas Corporations*, at pp. 139-221 (Feb. 12, 2010), http://www.jw.com/site/jsp/publicationinfo.jsp?id=1344.

[4] Directors' fiduciary duties are applicable in the case of private corporations as well as corporations whose securities are publicly traded, although the conduct required to satisfy their fiduciary duties will be measured with reference to what is reasonable in the context. *See Optima International of Miami, Inc. v. WCI Steel, Inc.*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (TRANSCRIPT); *Julian v. Eastern States Construction Service, Inc.* (Del. Ch. No. 1892-VCP July 8, 2008).

[5] 970 A.2d 235 (Del. 2009).

[6] The foregoing explanation of *Revlon* was in the contest of the Delaware Supreme Court rejecting post-merger stockholder claims that independent directors failed to act in good faith in selling the company after only a week of negotiations with a single bidder, even accepting plaintiff's allegations that the directors did nothing to prepare for an offer which might be expected from a recent purchaser of an 8% block and did not even consider conducting a market check before entering into a merger agreement containing a no-shop provision (with a fiduciary out) and a 3% break-up fee.

Even in the friendly acquisition, a board's obligations do not cease with the execution of the merger agreement.[7] If a competing acquiror emerges with a serious proposal offering greater value to shareholders (usually a higher price) even after a merger agreement is signed, the board should give it due consideration.[8] Generally, the same principles that guided consideration of an initial proposal (being adequately informed and undertaking an active and orderly deliberation) will also guide consideration of the competing proposal.[9]

During the course of acquisition negotiations, even when there has been active bidding by two or more suitors, it may be difficult to determine whether the bidding is complete. In addition, there can remain the possibility that new bidders may emerge that have not been foreseen. As a result, a board typically seeks to make some provision for further bidders in the merger agreement. Such a provision can also provide the board with additional support for its decision to sell to a particular bidder if the agreement does not forestall competing bidders, permits the fact gathering and discussion sufficient to make an informed decision and provides meaningful flexibility to respond to them. In this sense, the agreement is an extension of, and has implications for, the process of becoming adequately informed.[10]

B. Deal Protection; Fiduciary Outs

The board's interest in retaining flexibility to entertain potentially higher bids for the company must be balanced against the requirements of the buyer in negotiating the merger agreement. During merger negotiations, a board typically seeks to maximize its flexibility in responding to a competing bidder in the merger agreement, while the buyer seeks to require the board to cease negotiating with other bidders and to take the actions needed to promptly close the transaction.

The assurances a buyer seeks often take the form of a "no-shop" clause, a break-up fee, or a combination thereof.[11] The term "*no-shop*" is used generically to describe both provisions

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[7] *See e.g., Emerson Radio Corp. v. Int'l Jensen Inc.*, Nos. 15130, 14992, 1996 WL 483086 (Del. Ch. 1996) (discussing case where bidding and negotiations continued more than six months after merger agreement signed).

[8] *See Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. Nos. 17383, 17398, 17427, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999); *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 107-08 (Del. Ch. 1999).

[9] *See Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1988).

[10] In *Roberts v. General Instrument Corp.*, C.A. No. 11639, 1990 WL 118356, at *8 (Del. Ch. Aug. 13, 1990), the Chancery Court explained that in considering a change of control transaction, a board should consider:

> [W]hether the circumstances afford a disinterested and well-motivated director a basis reasonably to conclude that if the transactions contemplated by the merger agreement close, they will represent the best available alternative for the corporation and its shareholders. This inquiry involves consideration inter alia of the nature of any provisions in the merger agreement tending to impede other offers, the extent of the board's information about market alternatives, the content of announcements accompanying the execution of the merger agreement, the extent of the company's contractual freedom to supply necessary information to competing bidders, and the time made available for better offers to emerge.

[11] The fact that a buyer has provided consideration for the assurances provided in a merger agreement does not end the analysis. In *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 48 (Del. 1994), the Delaware Supreme Court took the position that provisions of agreements that would force a board to violate its fiduciary duty of care are unenforceable:

> Such provisions, whether or not they are presumptively valid in the abstract, may not validly define or limit the directors' fiduciary duties under Delaware law or prevent the . . . directors from carrying out their fiduciary duties

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that limit a corporation's ability to actively canvas the market (the "no shop" aspect) or to respond to overtures from the market (more accurately, a "*no talk*" provision). No-shop clauses can take different forms. A strict no-shop allows no solicitation and also prohibits a target from facilitating other offers, all without exception. Because of the limitation that a strict no-shop imposes on the board's ability to become informed, such a provision is of questionable validity.[12] A customary, and limited, no-shop clause contains some type of "*fiduciary out*," which allows a board to take certain actions to the extent necessary for the board to comply with its fiduciary duties to shareholders.[13] Board actions permitted can range from supplying confidential information about the corporation to unsolicited suitors, to negotiating with unsolicited suitors and terminating the existing merger agreement upon payment of a break-up fee, to actively soliciting other offers.[14] In some instances, the "fiduciary out" is only triggered if the target board determines that a competing offer is, or is reasonably likely lead to, a superior proposal to the current negotiated offer. In other instances, certain permitted actions under the agreement are tied to a determination by the board, after advice of counsel, that it is required in the exercise of the board's fiduciary duties. Such "fiduciary outs," even when restrictively drafted, will likely be interpreted by the courts to permit the board to become informed about an unsolicited competing bid. "[E]ven the decision not to negotiate . . . must be an informed one. A target can refuse to negotiate [in a transaction not involving a sale of control] but it should be informed when making such refusal."[15]

C. Merger Agreements Can be Enforced Against the Target and Expose Rival Bidder to Tortious Interference with Contract

The result of the merger negotiations is typically an elaborate set of interrelated provisions intended to allow the board the flexibility it needs to satisfy its fiduciary duties while giving the buyer comfort that the board will take the actions necessary to get the deal closed.[16]

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under Delaware law. To the extent such provisions are inconsistent with those duties, they are invalid and unenforceable.

Although this language provides a basis for directors to resist unduly restrictive provisions, it may be of little comfort to a board that is trying to abide by negotiated restrictive provisions in an agreement and their obligations under Delaware law, especially where the interplay of the two may not be entirely clear.

[12] *See Phelps Dodge Corp. v. Cypress Amax Minerals Co.*, C.A. Nos. 17383, 17398, 17427, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999 (considering prospective competitor's challenge to "no-talk" provision under which target could not talk to prospective acquirors, court stated that clause appeared to impose upon the target board "willful blindness" in violation of the board's fiduciary duty to be informed of all material information reasonably available); *ACE Ltd. v. Capital Re Corp*., 747 A. 2d 95 (Del. Ch. 1999) (expressing view that certain no-talk provisions are "particularly suspect"); *but see In re IXC Commc'ns, Inc. S'holders Litig.*, C.A. Nos. 17324 & 17334, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999) (no talk provisions "are common in merger agreements and do not imply some automatic breach of fiduciary duty").

[13] *See, e.g., Matador Capital Mgmt. Corp. v. BRC Holdings*, 729 A.2d 280, 288-89 (Del Ch. 1998); William T. Allen, *Understanding Fiduciary Outs: The What and Why of an Anomalous Concept*, 55 BUS. LAW. 653 (2000).

[14] *See* Allen, *supra* note 13.

[15] *Phelps Dodge Corp. v. Cypress Amax Minerals Co.*, C.A. Nos. 17383, 17398, 17427, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999).

[16] *See* Byron F. Egan, *Recent Fiduciary Duty Cases Affecting Advice to Directors and Officers of Delaware and Texas Corporations*, pp. 139-221 (Feb. 12, 2010), http://www.jw.com/site/jsp/publicationinfo.jsp?id=1344.

The agreement may contain provisions permitting the corporation not only to provide information to a bidder with a superior proposal, but also to negotiate with the bidder, enter into a definitive agreement with the bidder and terminate the existing merger agreement upon the payment of a break-up fee. Without the ability to terminate the agreement, the board may find, at least under the language of the agreement, that its response must be more limited.[17] Recent cases illustrate that "no-shop" and other deal protection provisions will be enforced by Delaware courts if they are negotiated after a proper process and are not unduly restrictive.

In *NACCO Industries, Inc. v. Applica Incorporated*,[18] NACCO (the acquiror under a merger agreement) brought claims against Applica (the target company) for breach of the merger agreement's "no-shop" and "prompt notice" provisions.[19] NACCO also sued hedge funds

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[17] *See Smith v. Van Gorkom*, 488 A.2d 858, 888 (Del. 1985) ("Clearly the . . . Board was not 'free' to withdraw from its agreement . . . by simply relying on its self-induced failure to have [negotiated a suitable] original agreement.").

[18] 997 A.2d 1 (Del. Ch. 2009).

[19] The Agreement and Plan of Merger dated as of July 23, 2006, by and between HB-PS Holding Company, Inc., a Delaware corporation ("Hampton") and a wholly owned, indirect subsidiary of NACCO Industries, Inc., a Delaware corporation ("Parent"), and Applica Incorporated, a Florida corporation ("Apple"), provided in relevant part:

> 6.12 *No Solicitation*.
>
> (a) Apple [the acquired company] will immediately cease, terminate and discontinue any discussions or negotiations with any Person conducted before the date of this Agreement with respect to any Apple Competing Transaction, and will promptly, following the execution of this Agreement, request the return or destruction (as provided in the applicable agreement) of all confidential information provided by or on behalf of Apple to all Persons who have had such discussions or negotiations or who have entered into confidentiality agreements with Apple pertaining to an Apple Competing Transaction.
>
> (b) Prior to the Effective Time, Apple will not, and will cause its Affiliates and representatives not to, directly or indirectly solicit, initiate or encourage any inquiries or proposals from, discuss or negotiate with, or provide any non-public information to, any Person (other than Parent, Hampton and their respective representatives) relating to any merger, consolidation, share exchange, business combination or other transaction or series of transactions involving Apple that is conditioned on the termination of this Agreement or could reasonably be expected to preclude or materially delay the completion of the Merger (an "Apple Competing Transaction").
>
> (c) Apple will promptly (and in any event within 24 hours) notify Parent of its or any of its officers', directors' or representatives' receipt of any inquiry or proposal relating to, an Apple Competing Transaction, including the identity of the Person submitting such inquiry or proposal and the terms thereof.
>
> (d) Notwithstanding anything in this Agreement to the contrary, Apple or its board of directors will be permitted to engage in any discussions or negotiations with, or provide any information to, any Person in response to an unsolicited bona fide written offer regarding an Apple Competing Transaction by any such Person (which has not been withdrawn), if and only to the extent that, (i) the Apple Shareholder Approval has not been given, (ii) Apple has received an unsolicited bona fide written offer regarding an Apple Competing Transaction from a third party (which has not been withdrawn) and its board of directors has determined in good faith that there is a reasonable likelihood that such Apple Competing Transaction would constitute a Apple Superior Proposal, (iii) its board of directors, after consultation with its outside counsel, determines in good faith that such action is required by its fiduciary duties, (iv) prior to providing any information or data to any Person in connection with an Apple Competing Transaction by any such Person, it receives from such Person an executed confidentiality agreement containing terms Apple determines to be substantially the same as the Confidentiality Agreement (but permitting the disclosures to Parent described in this Section 6.12(d) to be made to Parent), and (iv) prior to providing any information or data to any Person or entering into discussions or negotiations with any Person, it complies with Section 6.12(c). Apple will use its commercially reasonable efforts to keep Parent informed promptly of the status and terms of any such proposal or offer and the status and terms of any such discussions or negotiations and will promptly provide Parent with any such written proposal or offer. Apple will promptly inform its directors, officers, key employees, agents and representatives of the obligations undertaken by Apple in this Section 6.12. Nothing in this Section 6.12(d), (x) permits Apple to terminate this Agreement (except as specifically provided in Article VIII) or (y) affects any other obligation of Apple or Parent under this Agreement.

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(e) For purposes of this Agreement, "Apple Superior Proposal" means a bona fide written offer regarding an Apple Competing Transaction made by a Person other than a party hereto or its controlled Affiliates which is on terms which the board of directors of Apple concludes, after consultation with its financial advisors and following receipt of the advice of its outside counsel, would, if consummated, result in a transaction that is more favorable to the Apple Shareholders than the Transactions.

(f) No provision of this Agreement will be deemed to prohibit (i) Apple from publicly disclosing any information which its board of directors determines, after consultation with outside counsel, is required to be disclosed by Law, whether pursuant to the federal securities laws, state law fiduciary requirements or otherwise, or (ii) the Apple board of directors from changing its recommendation in respect of the Merger if it determines, after consultation with outside counsel, that such action is required by its fiduciary duties; provided, however, that nothing in the preceding clause (ii) will relieve Apple of its obligations with respect to the Apple Shareholders Meeting under Sections 6.10 or 8.3.

* * *

8.1 *Termination*. Except as otherwise provided in this Section 8.1, this Agreement may be terminated at any time prior to the Effective Time, whether before or after the Apple Shareholder Approval:

(a) by mutual written consent of Parent and Apple;

(b) by Apple (provided that Apple is not then in material breach of any covenant or in breach of any representation or warranty or other agreement contained herein), if (i) there has been a breach by Parent or Hampton of any of their respective representations, warranties, covenants or agreements contained in this Agreement or any such representation and warranty has become untrue, in either case such that Section 7.2(a), Section 7.2(b) or Section 7.2(d) would be incapable of being satisfied, and such breach or condition either by its terms cannot be cured or if reasonably capable of being cured has not been cured within 30 calendar days following receipt by Parent of notice of such breach or (ii) the condition contained in Section 7.1(g) will be incapable of being satisfied;

(c) by Parent (provided that neither Parent nor Hampton is then in material breach of any covenant, or in breach of any, representation or warranty or other agreement contained herein), if (i) there has been a breach by Apple of any of its representations, warranties, covenants or agreements contained in this Agreement, or any such representation and warranty has become untrue, in either case such that Section 7.3(a), Section 7.3(b) or Section 7.3(d) would be incapable of being satisfied, and such breach or condition either by its terms cannot be cured or if reasonably capable of being cured has not been cured within 30 calendar days following receipt by Apple of notice of such breach or (ii) the condition contained in Section 7.1 (g) will be incapable of being satisfied;

(d) by either Parent or Apple if any Order preventing or prohibiting consummation of the Transactions has become final and nonappealable;

(e) by either Parent or Apple if the Merger shall not have occurred prior to March 31, 2007, unless the failure of the Merger to have occurred by such date is due to the failure of the party seeking to terminate this Agreement to perform or observe in all material respects the covenants and agreements of such party set forth herein;

(f) by either Parent or Apple if the Apple Shareholder Approval is not obtained at the Apple Shareholders Meeting ;

(g) by Parent if the board of directors of Apple shall have modified or withdrawn the Apple Board Recommendation or failed to confirm the Apple Board Recommendation within four Business Days after Parent's request to do so (it being understood, however, that for all purposes of this Agreement, and without limitation, the fact that Apple, in compliance with this Agreement, has supplied any Person with information regarding Apple or has entered into discussions or negotiations with such Person as permitted by this Agreement, or the disclosure of such facts, shall not be deemed a withdrawal or modification of the Apple Board Recommendation); or

(h) by Apple, if the board of directors of Apple authorizes Apple, subject to complying with the terms of this Agreement, to enter into a written agreement with respect to an Apple Superior Proposal; provided, however, that (i) Apple shall have complied with the provisions of Section 6.12, (ii) Apple shall have given Parent and Hampton at least four Business Days prior written notice of its intention to terminate this Agreement, attaching a description of all material terms and conditions of such Apple Superior Proposal, (iii) during such four Business Day period, Apple engages in good faith negotiations with Parent and Hampton with respect to such changes as Parent and Hampton may propose to the terms of the Merger and this Agreement, (iv) Parent and Hampton do not make prior to such termination of this Agreement, a definitive, binding offer which the Board of Directors of Apple determines in good faith, after consultation with its legal and financial advisors, is at least as favorable to Apple Shareholders as such Apple Superior Proposal and (v) prior to such termination pursuant to this Section 8.1(h), Apple pays to Parent in immediately available funds, the fee required to be paid pursuant to Section 8.3. Apple agrees to notify Parent and Hampton

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managed by Herbert Management Corporation (collectively "*Harbinger*"), which made a topping bid after the merger agreement with NACCO was executed, for common law fraud and tortious interference with contract.

NACCO's complaint alleged that while NACCO and Applica were negotiating a merger agreement, Applica insiders provided confidential information to principals at the Harbinger hedge funds, which were then considering their own bid for Applica. During this period, Harbinger amassed a substantial stake in Applica (which ultimately reached 40%), but reported on its Schedule 13D filings that its purchases were for "investment," thereby disclaiming any intent to control the company. After NACCO signed the merger agreement, communications between Harbinger and Applica management about a topping bid continued. Eventually, Harbinger amended its Schedule 13D disclosures and made a topping bid for Applica, which then terminated the NACCO merger agreement. After a bidding contest with NACCO, Harbinger succeeded in acquiring the company.

In refusing to dismiss damages claims by NACCO arising out of its failed attempt to acquire Applica, Vice Chancellor Laster largely denied defendants' motion to dismiss. As to the contract claims, the court reaffirmed the utility of "no-shop" and other deal protection provisions, holding that "[i]t is critical to [Delaware] law that those bargained-for rights be enforced," including by a post-closing damages remedy in an appropriate case. Good faith compliance with such provisions may require a party to "regularly pick up the phone" to communicate with a merger partner about a potential overbid, particularly because "in the context of a topping bid, days matter." Noting that the no-shop clause was not limited to merely

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promptly if its intention to enter into a written agreement referred to in its notification given pursuant to this Section 8.1(h) shall change at any time after giving such notification.

8.2 *Effect of Termination*. In the event of termination of this Agreement by either Parent or Apple pursuant to Section 8.1, this Agreement will forthwith become void and there will be no liability under this Agreement on the part of Parent, Hampton or Apple, except (i) to the extent that such termination results from the willful and material breach by a party of any of its representations, warranties or covenants in this Agreement and (ii) as provided in Section 8.3; provided, however, that the provisions of Sections 6.5, 6.16, 8.3, 9.5 and this Section 8.2 will each remain in full force and effect and will survive any termination of this Agreement.

8.3 *Fees and Expenses*.

(a) Notwithstanding Section 6.16, if this Agreement is terminated by (i) Parent pursuant to Section 8.1(e) or Section 8.1(f) and prior to the time of such termination an Apple Competing Transaction has been communicated to the Apple board of directors and not withdrawn, and within nine months Apple enters into an agreement to complete or completes Apple Competing Transaction, (ii) Parent pursuant to Section 8.1(g), or (iii) Apple pursuant to 8.1(h), then Apple will pay to Parent a termination fee equal to $4.0 million plus up to $2.0 million of reasonable documented, third party, out-of-pocket Expenses (the "Termination Fee").

(b) Each of the parties acknowledges that the agreements contained in this Section 8.3 are an integral part of the Transactions and that, without these agreements, the other party would not enter into this Agreement or the Ancillary Agreements. In the event that Apple fails to pay the amounts due pursuant to Section 8.1(h) and this Section 8.3 when due, and, in order to obtain such payment, the non-breaching party commences a suit that results in a judgment against the breaching party for the amounts set forth in this Section 8.3, the breaching party will pay to the non-breaching party interest on the amounts set forth in this Section 8.3, commencing on the date that such amounts become due, at a rate equal to the rate of interest publicly announced by Citibank, N.A., from time to time, in The City of New York, as such bank's base rate plus 2.00%.

soliciting a competing bid, and that the "prompt notice" clause required Applica to use "commercially reasonable efforts" to inform NACCO of any alternative bids and negotiations, the Vice Chancellor had "no difficulty inferring" that Applica's alleged "radio silen[ce]" about the Harbinger initiative may have failed to meet the contractual standard.

The Vice Chancellor also upheld NACCO's common law fraud claims against Harbinger based on the alleged inaccuracy of Harbinger's Schedule 13D disclosures about its plans regarding Applica. The Vice Chancellor dismissed Harbinger's contention that all claims related to Schedule 13D filings belong in federal court, holding instead that a "Delaware entity engaged in fraud"—even if in an SEC filing required by the 1934 Act—"should expect that it can be held to account in the Delaware courts." The Vice Chancellor noted that while the federal courts have exclusive jurisdiction over violations of the 1934 Act, the Delaware Supreme Court has held that statutory remedies under the 1934 Act are "intended to coexist with claims based on state law and not preempt them." The Vice Chancellor emphasized that NACCO was not seeking state law enforcement of federal disclosure requirements, but rather had alleged that Harbinger's statements in its Schedule 13D and 13G filings were fraudulent under state law without regard to whether those statements complied with federal law. The court then ruled that NACCO had adequately pleaded that Harbinger's disclosure of a mere "investment" intent was false or misleading, squarely rejecting the argument that "one need not disclose any intent other than an investment intent until one actually makes a bid." In this respect, the NACCO decision highlights the importance of accurate Schedule 13D disclosures by greater-than-5% beneficial owners that are seeking or may seek to acquire a public company and raises the possibility of monetary liability to a competing bidder if faulty Schedule 13D disclosures are seen as providing an unfair advantage in the competition to acquire the company.

In declining to dismiss NACCO's claim that Harbinger tortiously interfered with NACCO's merger agreement with Applica, the court commented that "The tort of interference with contractual relations is intended to protect a promisee's economic interest in the performance of a contract by making actionable 'improper' intentional interference with the promisor's performance," and that a claim for tortious interference with contract requires proof of "(1) a contract, (2) about which defendant knew and (3) an intentional act that is a significant factor in causing the breach of such contract (4) without justification (5) which causes injury." In this case, there was no meaningful dispute about the existence of the merger agreement or Harbinger's knowledge of it.

The complaint adequately alleged that Harbinger knew about the no-shop and prompt notice clauses in the merger agreement, but nevertheless engaged in contacts and communications that violated those clauses. The detailed allegations of fraudulent statements made in Harbinger's SEC filings provided a sufficient basis for a claim of tortious interference. The court commented that Harbinger "made false statements to hide its intent and get the drop on NACCO." The court took into account Harbinger's success in acquiring a nearly 40% stock position, facilitated at least in part through its false disclosures, and wrote that "Vice Chancellor Strine held a defendant liable for tortious interference where the defendant obtained an unfair advantage by using confidential information it had obtained from other defendants in violation of contractual agreements with the plaintiff."

While *NACCO* was a fact-specific decision on motion to dismiss, the case shows the risks inherent in attempting to top an existing merger agreement with typical deal protection provisions. *NACCO* emphasizes that parties to merger agreements must respect no-shop and notification provisions in good faith or risk after-the-fact litigation, with uncertain damages exposure, from the acquiring party under an existing merger agreement.

In a subsequent case addressing liability of a seller for breach of an asset purchase agreement, the Delaware Court of Chancery, in *WaveDivision Holdings, LLC v. Millennium Digital Media Systems, L.L.C.*,[20] in a post-trial opinion, found that a company that had agreed to sell certain assets breached the non-solicitation and best efforts clauses of the asset purchase agreement. From the moment the asset purchase agreement was signed, the seller had focused on pursuing an alternative transaction that was inconsistent with the consummation of the asset sale. The court awarded the spurned buyer $15 million in expectancy damages which represented the profits the buyer had expected to make on the purchase.

In *WaveDivision,* the seller, Millennium Digital Media Systems, L.L.C. ('Millennium') had two main classes of debt: (i) the IRN Holders and (ii) the Senior Lenders. Millennium was managed by a management committee, whose members included representatives of several IRN Holders. In 2005, the Senior Lenders pressed Millennium to sell assets in order to meet its repayment obligations. The IRN Holders approved Millennium's plan to pursue an asset sale. To proceed with any asset sale, Millennium was required to obtain the consent of the Senior Lenders and the IRN Holders. In January 2006, Millennium agreed to sell two of its three cable systems (the 'Systems') to WaveDivision ('Wave') for $157 million in an asset purchase agreement (the 'APA') and the Millennium management committee unanimously consented to that sale.

The APA contained two clauses that were the focus of the litigation. In the 'no shop' clause, Millennium covenanted not to 'initiate, solicit or encourage, directly or indirectly, any inquiries' relating to the Systems and not to provide information to another person related to the Systems, which could 'reasonably be expected to lead to, any effort' by another person to acquire the Systems. In the 'best efforts' clause, Millennium agreed to use commercially reasonable efforts 'to obtain all Seller Required Approvals in form and substance reasonably satisfactory to' Wave.

During the negotiation of the APA and following the signing of it, Millennium pursued parallel—but mutually exclusive—paths of the Wave asset sale and an alternative refinancing arrangement. Millennium pursued this refinancing alternative in communication with certain IRN Holders who favored a refinancing over an asset sale. One of the IRN Holders, Highland, eventually agreed to provide Millennium $30 million via a refinancing. After Millennium obtained this refinancing, it terminated the APA. Millennium told Wave nothing of its pursuit of an alternative transaction. Millennium devoted nearly all of its energies from the time the parties signed the APA to the time Millennium terminated it to securing refinancing from the IRN

[20] C.A. No. 2993-VCS (Del. Ch. Sept. 17, 2010).

Holders, rather than upon obtaining their consent to the asset sale as it was obligated to do under the APA.

The court found that Millennium breached the 'no shop' and 'best efforts' clauses of the APA, by consciously facilitating an alternative transaction that was inconsistent with the APA with the same lenders whose consent Millennium was supposed to be working to obtain. The fact that Millennium's management was pessimistic that their alternative transaction would be consummated did not excuse Millennium's repeated choices to violate the APA.

The court also noted that Millennium's lenders' failure to consent to the asset sale did not excuse its non-performance because Millennium's conduct was the proximate cause of the lenders' failure to consent. Moreover, Millennium's failure to notify Wave that it was aware that Highland was buying senior debt from the Senior Lenders to secure the ability to block the asset sale by virtue of the senior debt's consent rights underscored Millennium's failure to make reasonable efforts to obtain the required consents.

The court held that Millennium breached the APA by generating new cash-flow projections for the IRN Holders in connection with the asset sale. The IRN Holders had rights to examine certain company documents, but those rights did not include having Millennium generate new analyses based on confidential information. This was particularly so because the IRN Holders were aware of the "no shop" clause through their representation on the management committee.

The court also found that Millennium's retention of an investment banker to help analyze the asset sale and the refinancing was a breach of the APA. The court rejected Millennium's argument that the progression of the investment banker's work from evaluating the asset sale to helping develop an alternative transaction was not foreseeable and, therefore, not a breach of the APA. The court explained that the proper course of action would have been for Millennium to "play[] it straight . . . from the get-go," i.e., honor its contractual obligations, not hire a banker for the IRN Holders, not help develop alternative transactions and not develop projections related to a refinancing alternative.

Notably, in addressing the ability of a corporation to enter into a binding contract without a fiduciary out, the court wrote: "As important, despite the existence of some admittedly odd authority on the subject, it remains the case that Delaware entities are free to enter into binding contracts without a fiduciary out so long as there was no breach of fiduciary duty involved when entering into the contract in the first place."

Ultimately, Wave was entitled to recover "the value it expected to realize from the [APA] minus any cost avoided by not having to perform . . . and minus any mitigation." Wave was entitled to damages that equaled the profits it reasonably expected to make through improving and reselling the Systems, or running the Systems profitably. Wave's damages were not limited to the immediate resale value of the Systems, because, if that were the measure of damages, then, in a market-based transaction, there would by definition be no injury to a jilted buyer. This case further illustrates the need for sellers to act in accordance with the terms of the transaction agreements they negotiate. Otherwise, they face possibly significant liability for breach.

Most recently, in *Ventas, Inc. v. HCP, Inc.*, the United States Court of Appeals for the Sixth Circuit upheld a jury award of $100 million after finding a rival bidder that had breached its standstill agreement with the target liable for tortious interference to a winning bidder in an auction. *Ventas* involved the auction of Sunrise Senior Living Real Estate Trust, a Canadian real estate investment trust ("Sunrise"). Ventas, Inc., the plaintiff, was the winning bidder in the auction. The defendant, HCP, Inc., was the interloper. To participate in the auction, Ventas and HCP each signed a confidentiality agreement which included a standstill provision that would, among other things, prohibit the participant from making or announcing any bid outside the auction process for a period of 18 months following the conclusion of the auction.

Neither Ventas nor HCP were party to the other's standstill agreement. HCP's standstill agreement permitted HCP to make only one final bid while Ventas's standstill agreement permitted Ventas to make a second final bid if Sunrise accepted a competing offer after Ventas made its initial final bid. Ventas and HCP each made it to the second round of bidding, after making bids of $13.25 and $16.25 per unit, respectively, in the first round, and were the only two parties left. The requirement of a binding bid in the second round had the effect of forcing a bidding party to reach out to a third party ("SSL") that managed Sunrise's properties under long-term management contracts. Ventas reached an agreement with SSL, but HCP did not. After HCP was unable to reach an agreement with SSL, it withdrew from the auction process.

Ventas subsequently reached an agreement with Sunrise to acquire Sunrise for $15.00 per unit, subject to approval by Sunrise's unitholders. The purchase agreement required Sunrise to use best efforts to secure the unitholders' approval, contained a customary no shop and required Sunrise to enforce any existing standstill agreements. In the weeks following the public announcement of the purchase agreement with Ventas, the CEO of Sunrise suggested to the CEO of HCP that HCP make a bid for Sunrise. HCP entered into negotiations with SSL and ultimately advised Sunrise's investment banker that HCP would make an offer of $18.00 per unit and sent Sunrise a letter explaining the details of its offer and an unsigned and unconditional purchase agreement. HCP did not disclose that its offer was conditional on reaching an agreement with SSL. Sunrise requested that HCP refrain from publicly announcing its offer, but HCP nonetheless issued a press release including the $18.00 offer price and noting that the offer was not subject to any due diligence or financing contingencies. The press release also included a copy of the offer letter from the HCP CEO to Sunrise which stated that HCP was confident that it could enter into arrangements with SSL comparable to those entered into by Ventas. After HCP issued the press release, Sunrise became concerned about whether HCP's bid contained an undisclosed condition because HCP had not signed the proposed purchase agreement. That evening, HCP finally disclosed to Sunrise that its bid was conditioned upon reaching an agreement with SSL. Sunrise ultimately issued a press release stating that it would not consider HCP's offer until HCP had confirmed that its offer was not conditioned on HCP reaching an agreement with SSL.

Sunrise and Ventas each filed actions in the Ontario Superior Court of Justice in Canada seeking declarations regarding the continued validity of the standstill agreement between HCP and Sunrise. The Canada Court ruled, *inter alia*, that Sunrise must enforce its standstill agreement with HCP. As a result, HCP withdrew its offer.

When the vote was taken on Ventas's $15.00 offer, a sufficient number of proxies had been entered against the purchase agreement to prevent its approval. To salvage the deal, Ventas increased its bid from $15.00 to $16.50, and the Sunrise unitholders ultimately approved the deal.

Ventas then filed an action in the United States District Court for the Western District of Kentucky asserting Kentucky state law claims of tortious interference with contract and tortious interference with a prospective advantage. Ventas alleged that HCP improperly interfered with its valid expectancy that the Sunrise unitholders would approve its $15.00 per unit offer to purchase Sunrise causing Ventas to raise its offer to $16.50 per unit. The district court granted summary judgment on Ventas's claim of tortious interference with contract, but permitted Ventas's claim of tortious interference with a prospective advantage to proceed to trial. After a jury trial, the district court granted judgment as a matter of law for HCP on the issue of punitive damages, concluding that Ventas had not presented sufficient evidence to present the issue to the jury. However, the jury ultimately awarded $100 million on Ventas's claim of tortious interference with prospective advantage.

On appeal, HCP attacked the jury instructions on several grounds, including whether the instructions properly set forth the elements of a tortious interference with prospective advantage claim and whether the jury could consider HCP's breach of its contract with Sunrise as improper conduct. With respect to the elements of the underlying tortious interference claim, the appellate court noted that Kentucky law generally follows the Restatement (Second) of Torts. Under Section 766B of the Restatement, intentional interference arises when one "intentionally and improperly interferes with another's prospective contractual relation." Under Section 767 of the Restatement, to determine whether that interference is improper, consideration is given to the "actor's motive," among other things. The court noted that the Kentucky Supreme Court had summarized the test for improper interference as requiring a showing of "malice or some significantly wrongful conduct."

The court also noted that under the Restatement, claims between competitors hold plaintiffs to a "more exacting standard." Section 768 of the Restatement provides that competition alone does not constitute improper interference, and that improper interference between competitors will not be found where, among other things, "the actor does not employ wrongful means." The appellate court thus approved the district court's instruction to the jury that in order to find "improper interference" it must find that HCP employed "significantly wrongful means," which includes "conduct such as fraudulent misrepresentation, deceit and coercion," and that the jury could consider 'the parties' conduct, motive and the circumstances of the transaction."

The court found that the evidence was sufficient to support a finding that HCP's "improper interference" caused injury to Ventas, despite HCP's arguments that Ventas had not proven that but for HCP's improper interference, Ventas would have acquired Sunrise at $15.00 per unit. HCP argued that Ventas had not separated the impact of any misrepresentations by HCP from the impact of HCP's truthful statements. The appellate court rejected the argument that any truthful statement that accompanied a false statement defeated the element of causation. Rather, the court found that the jury could have concluded that none of HCP's press releases—even its expressed willingness to acquire Sunrise at $18.00 per unit—were truthful, thereby

providing the basis for causation. The appellate court also rejected HCP's argument that Ventas did not establish causation because HCP corrected any misrepresentations in the market prior to the unitholder vote on Ventas's offer, finding that based on the totality of the evidence presented at trial, including the market price of Sunrise's stock during the relevant period, the jury arrived at a reasonable conclusion regarding causation.

The court also affirmed the district court's decision to allow the jury to give some, though not decisive, weight to HCP's breach of the standstill agreement. The district court instructed the jury that the breach "alone is not sufficient to establish tortious interference" but "may be considered along with the other evidence in determining whether HCP engaged in improper interference." The court rejected HCP's challenge to the jury instructions, noting that the breach "illuminates the anti-competitive activities in which HCP engaged" and "is central to an understanding of Ventas' allegations of fraud and deception."

On Ventas's cross-appeal on the district court's ruling precluding Ventas from recovering for punitive damages, the court reversed the district court's holding that Ventas could not seek punitive damages from HCP. Under Kentucky law, punitive damages can be available where a defendant acts toward the plaintiff with "oppression, fraud, or malice." Here, Ventas was claiming fraud, which Kentucky law defined as "an intentional misrepresentation, deceit or concealment of a material fact known to the defendant and made with the intention of causing harm to the plaintiff." The court concluded that based on the evidence presented, including false statements by the HCP CEO, "a reasonable jury could conclude that HCP engaged in its fraudulent conduct with the intention of inflicting harm on Ventas." In addition to the misrepresentations by HCP, the court noted that HCP's conduct suggested that "its purported offer was not genuine," given, among other things, that the initial proffered agreement was unsigned, that the CEO then stated that he had sent a signed copy to Sunrise when he in fact had not, and that HCP seemed to be moving "on to other things" with its potential acquisition of another company.

Notably, although *Ventas* involved a significant damages verdict against a rival bidder, Ventas, as the winning bidder, also initially sued the target, seeking $250 million in damages arising from the target's efforts to facilitate the rival bidder's bid. The *Ventas* decision notes that that matter was resolved with the ultimate purchase by Ventas of the target. Had Ventas not ultimately been the winning bidder, the target could have been subject to significant liability for its actions in facilitating the other bid.

D. Exclusivity Provisions in Letters of Intent Can Be Enforceable

In *Global Asset Capital, LLC vs. Rubicon US REIT, Inc.*[21] in the context of explaining why he granted a temporary restraining order enjoining the target and its affiliates from disclosing any of the contents of a letter of intent or soliciting or entertaining any third-party offers for the duration of the letter of intent, Vice Chancellor Laster wrote:

[21] C.A. No. 5071-VCL (Del. Ch. Nov. 16, 2009) (TRANSCRIPT).

> [I]f parties want to enter into nonbinding letters of intent, that's fine. They can readily do that by expressly saying that the letter of intent is nonbinding, that by providing that, it will be subject in all respects to future documentation, issues that, at least at this stage, I don't believe are here. I think this letter of intent is binding . . . [A] no-shop provision, exclusivity provision, in a letter of intent is something that is important. . . . [A]n exclusivity provision or a no-shop provision is a unique right that needs to be protected and is not something that is readily remedied after the fact by money damages. . . . [C]ontracts, in my view, do not have inherent fiduciary outs. People bargain for fiduciary outs because, as our Supreme Court taught in Van Gorkom, if you do not get a fiduciary out, you put yourself in a position where you are potentially exposed to contract damages and contract remedies at the same time you may potentially be exposed to other claims. Therefore, it is prudent to put in a fiduciary out, because otherwise, you put yourself in an untenable position. That doesn't mean that contracts are options where boards are concerned. Quite the contrary. And the fact that equity will enjoin certain contractual provisions that have been entered into in breach of fiduciary duty does not give someone carte blanche to walk as a fiduciary. . . . I don't regard fiduciary outs as inherent in every agreement.[22]

E. Unsigned Bid Procedures Can Govern Rights of Parties

Documents disseminated by an investment banker as part of an auction process can affect the contractual rights of the parties even though none of the parties signed them. *WTG Gas Processing, L.P. v. ConocoPhillips Company*[23] arose from ConocoPhillips sale of a natural-gas processing facility to Targa Resources instead of WTG Gas Processing, L.P. WTG sued ConocoPhillips for breach of contract, fraud and negligent misrepresentation and Targa for tortious interference with contract or prospective business relationship. The trial court granted separate motions for summary judgment filed by ConocoPhillips and Targa and signed a final judgment that WTG take nothing on all its claims.

ConocoPhillips decided to sell several of its natural gas processing plants and pipelines and engaged Morgan Stanley to conduct the sale. Morgan Stanley issued a "teaser," inviting interested parties to potentially bid on individual assets or certain assets combined. After WTG signed a confidentiality agreement, Morgan Stanley gave WTG a confidential information memorandum, which described the assets in more detail and outlined the progressive steps of the transaction process: interested parties submit a non-binding indication of interest ("IOI") containing requisite items; Morgan Stanley and ConocoPhillips would evaluate the IOIs and invite a limited number of bidders to attend a management presentation, participate in due diligence, receive further information, including a draft purchase and sale agreement ("PSA"), and attend a site visit from which to submit bids; and upon evaluation of the final bids, Morgan

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[22] *But see Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1994) (noting that a board cannot "contract away" its fiduciary duties); *ACE Ltd. v. Capital Re Corp*., 747 A. 2d 95, 107-08 (Del. Ch. 1999).

[23] 309 S.W.3d 635 (Tex. App.—Houston [14th Dist.] March 2, 2010).

Stanley would narrow the number of bidders and enter into final PSA negotiations. The confidential information memorandum also provided in pertinent part:

> Morgan Stanley and ConocoPhillips reserve the right to . . . negotiate with one or more parties at any time and . . . enter into preliminary or definitive agreements at anytime and without notice or consultation with any other parties. Morgan Stanley and ConocoPhillips also reserve the right, in their sole discretion, to reject any and all final bids without assigning reasons and to terminate discussions and/or negotiations at any time for any reason or for no reason at all.

After submitting an IOI for one of the pipelines, WTG was invited to, and did, participate in the next stage of the process. Then Morgan Stanley invited WTG to submit a binding proposal and outlined the requirements for such a bid ("the bid procedures"). The proposal was required to include ConocoPhillips's draft PSA marked by WTG to show its proposed changes. Among other provisions, the bid procedures contained the following language:

- A Proposal will only be deemed to be accepted upon the execution and delivery by ConocoPhillips of a [PSA].

- [ConocoPhillips] expressly reserves the right, in its sole discretion and at any time and for any reason, to exclude any party from the process or to enter into negotiations or a [PSA] with any prospective purchaser or any other party . . . and to reject any and all Proposals for any reason whatsoever . . . . [ConocoPhillips] also expressly reserves the right to negotiate at any time with any prospective purchaser individually or simultaneously with other prospective purchasers . . . . None of ConocoPhillips, its affiliates, representatives, related parties or Morgan Stanley will have any liability to any prospective purchaser as a result of the rejection of any Proposal or the acceptance of another Proposal at any time.

- Until the [PSA] for this transaction is executed by ConocoPhillips and a purchaser, [ConocoPhillips], its affiliates and related parties shall not have any obligations to any party with respect to the contemplated transaction, and following such execution and delivery, the only obligations of ConocoPhillips, its affiliates and related parties will be to the other party to the [PSA], and only as set forth therein.

WTG submitted a "final binding bid." Subsequently WTG increased its bid after being informed that its offer was lower than others under consideration, but that ConocoPhillips was more comfortable with WTG because of fewer changes needed to its PSA and the parties' past relationship. WTG was then informed by Morgan Stanley that it likely would be the winning bidder if it increased its bid to a specified amount to make it comparable to another offer ConocoPhillips was considering, and WTG increased its bid accordingly.

Morgan Stanley thereafter telephoned WTG stating that ConocoPhillips had decided to "go forward with" WTG; ConocoPhillips and WTG had a "deal"; ConocoPhillips had some "immaterial" changes—"wording" issues—to WTG's draft PSA; the parties would "proceed to get it signed;" and ConocoPhillips would forward a revised version of the PSA. At that point,

WTG's draft PSA was not in executable form as it did not fully describe the assets to be purchased or include all exhibits. WTG and ConocoPhillips did not thereafter engage in any negotiations relative to a PSA, ConocoPhillips made no counter proposal, and the parties never executed a PSA.

Meanwhile, Targa had submitted bids for multiple assets and expressed a strong preference to make a group purchase. At that point, although Targa's single bid was higher than the total separate offers, ConocoPhillips viewed the separate sales as more optimal than a package sale to Targa. Thereafter, Targa submitted another bid and made some concessions on terms in light of ongoing discussions with Morgan Stanley. Morgan Stanley forwarded this proposal to ConocoPhillips, noting it was a total premium of $22 million over the existing offers. ConocoPhillips indicated to Morgan Stanley that this offer had potential if the parties could negotiate other details.

Morgan Stanley informed WTG that ConocoPhillips was considering another offer. In response to e-mail from WTG regarding its plans to conduct the due diligence, ConocoPhillips confirmed to WTG that ConocoPhillips was considering another offer and a decision about the new bid would not likely be made for perhaps another month.

For the ensuing two months, ConocoPhillips negotiated with Targa. During this period, WTG, ConocoPhillips and Morgan Stanley continued to communicate regarding the status of the sale, and WTG periodically apprised them regarding the status of WTG's due diligence efforts, while they kept WTG informed that ConocoPhillips was still evaluating the other offer.

Morgan Stanley then notified WTG that due diligence should be conducted at WTG's own risk and reminded WTG the bid materials advised that ConocoPhillips could negotiate with any party until a PSA was signed. After WTG informed ConocoPhillips and Morgan Stanley that once certain aspects of due diligence were complete, WTG would be prepared to "finalize and sign" a PSA, Morgan Stanley advised WTG that negotiations with the other party were down to the "critical stage," but ConocoPhillips wanted to keep communications open with WTG as a "good alternative."

After ConocoPhillips and Targa executed a PSA, WTG sued ConocoPhillips for breach of contract, fraud and negligent misrepresentation and Targa for tortious interference with contract or prospective business relationship. ConocoPhillips and Targa each filed a traditional motion for summary judgment, which the trial court granted.

Although a PSA was never executed, WTG contended ConocoPhillips accepted WTG's offer during the phone conversation by saying that ConocoPhillips had decided to "go forward with" WTG, they had a "deal," ConocoPhillips had "immaterial" changes to WTG's PSA, and "the parties would 'proceed' to get it signed."

Based on the following provisions in the bid procedures, ConocoPhillips argued that these oral representations, if any, did not constitute acceptance of WTG's offer:

> A Proposal will only be deemed to be accepted upon the execution and delivery by ConocoPhillips of a [PSA].

> Until the [PSA(s)] for this transaction is executed by ConocoPhillips and a purchaser, [ConocoPhillips] . . . shall not have any obligations to any party with respect to the contemplated transaction, and following such execution and delivery, the only obligations of ConocoPhillips . . . will be to the other party to the [PSA(s)], and only as set forth therein.

In support of its contention that the above-cited bid procedures negated any purported acceptance of WTG's offer, ConocoPhillips cited several cases to the effect that words in a letter of intent to the effect that "does not address all of the terms and conditions which the parties must agree upon to become binding and consummated . . . that this letter is an expression of the parties' mutual intent and is not binding upon them except for the provisions of [several numbered paragraphs]" are sufficient to defeat a suitors' breach of contract claim. WTG in turn cited several cases to support its position that the fact the parties contemplated later execution of a written agreement did not necessarily preclude their informal agreement from constituting a binding contract.

In granting defendants' motion for summary judgment, the court found that the ConocoPhillips bid procedures were much more definitive than the "subject to legal documentation" language in cases cited by WTG and that the bid procedures unequivocally provided that ConocoPhillips did not intend to accept an offer, or bear any contractual obligations to another party, absent execution of a PSA. Thus, execution of a PSA was clearly a condition precedent to contract formation and not merely a memorialization of an existing contract. The court acknowledged that the provisions reflecting intent not to be bound in the letter of intent cases cited by defendants were contained in a written agreement signed by both parties, and concluded that WTG accepted them by making its bid "[i]n accordance with the [CIM] . . . and the [bid procedures]."

Additionally, WTG argued "Texas jurisprudence allows parties to orally modify a contract even if the contract itself contains language prohibiting oral modification, if parties agree to disregard this language," and that a party may waive a condition it originally imposed as prerequisite to contract formation. The court concluded the oral representations were insufficient as a matter of law to constitute waiver of the bid procedures at issue because allowing a jury to decide the oral representations alone constituted waiver would vitiate the purpose of the overall bid process and the procedures, which provided that one of ConocoPhillips's "key objectives" was "to obtain the highest possible value" and it would evaluate proposals "with the goal of negotiating and executing a [PSA(s)] with the party that submits the Proposal which best meets [ConocoPhillips's] objectives."

Both the offering memorandum and the bid procedures demonstrated they were intended to ensure that ConocoPhillips achieved its objectives by prescribing an aggressive, competitive bidding process. ConocoPhillips reserved the right to pursue the most favorable bid until execution of a PSA by specifying it could entertain a bid at any time, negotiate with any prospective purchaser at any time, and negotiate with multiple parties at the same time.

The court noted that arriving at the final terms of a complex, commercial transaction involves extensive time, effort, research, and finances, and that parties to a complex transaction may need to reach a preliminary agreement in order to proceed toward execution of a final

agreement. Consequently, parties may structure their negotiations so that they preliminarily agree on certain terms, yet protect themselves from being prematurely bound in the event they disagree on other terms.

Accordingly, the court found that the bid procedures at issue were intended in part to prevent an informal, preliminary agreement with a prospective purchaser from forming a binding contract before execution of the formal writing and held that representations during a phone conversation cannot alone constitute waiver of the bid procedures and acceptance of WTG's offer when the bid procedures were implemented partly to prevent such representations from constituting acceptance of an offer.

Targa's claims for tortious interference with contract likewise failed. The court noted: "The elements of tortious interference with contract are (1) existence of a contract subject to interference, (2) willful and intentional interference, (3) interference that proximately caused damage, and (4) actual damage or loss." Because it had concluded there was no contract between WTG and ConocoPhillips, the court held that, as a matter of law, Targa is not liable for tortious interference.

F. Extra-Contractual Representations

Whether contractual limitations on liability are enforceable for breaches of seller representations in an agreement for the purchase of the stock or assets of a private company was the subject of *ABRY Partners V, L.P. v. F&W Acquisition LLC*,[24] in which a "sophisticated private equity firm" purchased the stock of a portfolio company from another sophisticated private equity firm and then sued in Delaware Chancery Court to rescind the stock purchase agreement on the basis that factual representations therein turned out not to be true. In filing suit, the purchaser ignored and repudiated the arbitration, exculpation and liability cap provisions in the purchase agreement. In an opinion that denied the selling firm's motion to dismiss, then-Vice Chancellor Leo Strine wrote: "Delaware law permits sophisticated commercial parties to craft contracts that insulate a seller from a rescission claim for a contractual false statement of fact that was not intentionally made . . . parties may allocate the risk of factual error freely as to any error where the speaking party did not consciously convey an untruth." However, "the contractual freedom to immunize a seller from liability for a false contractual statement of fact ends there . . . when a seller intentionally misrepresents a fact embodied in a contract – that is, when a seller lies – public policy will not permit a contractual provision to limit the remedy of the buyer to a capped damage claim [and] the buyer is free to press a claim for rescission or for full compensatory damages." Holding that the purchaser was permitted to proceed to trial on its rescission claims to the extent that they alleged that the selling firm actually "lied" and knew its representations in the contract were false, the court explained:

> When addressing contracts that were the product of give-and-take between commercial parties who had the ability to walk away freely, this court's jurisprudence has . . . honored clauses in which contracted parties have disclaimed

[24] 891 A.3d 1032 (Del. Ch. 2006).

reliance on extra-contractual representations, which 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 an effect on it.

* * *

The teaching of this court . . . is that a party cannot promise, in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a "but we did rely on those other representations" fraudulent inducement claim. The policy basis for this line of cases is, in my view, quite strong. If there is a public policy interest in truthfulness, then that interest applies with more force, not less, to contractual representations of fact. 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.

* * *

Nonetheless, . . . we have not given effect to so-called merger or integration clauses that do not clearly state that the parties disclaim reliance upon extra-contractual statements. Instead, we have held . . . that murky integration clauses, or standard integration clauses without explicit anti-reliance representations, will not relieve a party of its oral and extra-contractual fraudulent representations. The integration clause must contain "language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract." This approach achieves a sensible balance between fairness and equity — parties can protect themselves against unfounded fraud claims through explicit anti-reliance language. 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.[25]

Two years after *ABRY*, in *Transched Sys. Ltd. v. Versyss Transit Solutions, LLC*,[26] a buyer sued a seller for misrepresenting the condition of the purchased transportation software asset. The asset purchase agreement contained a well-drafted disclaimer of extra-contractual representations clause. The crux of defendants' argument for dismissal of plaintiff's claims for negligent misrepresentation rested on its interpretation of three contractual provisions in the asset

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[25] *See* Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 63 Bus. Law. 999 (August 2009), which is attached as Appendix A.

[26] Del. Super., C.A. No. 07C-08-286 WCC, Carpenter, J. (April 2, 2008) (Mem. Op.).

purchase agreement: the exclusive remedy clause in section 7(f), the integration clause in section 8(f), and the disclaimer of extra-contractual representations in section 3(hh). Section 7(f) stated:

> Other Indemnification Provisions. The foregoing indemnification provisions shall constitute the sole and exclusive remedy for monetary damages in respect of any breach of or default under this Agreement by any Party and each Party hereby waives and releases any and all statutory, equitable, or common law remedy for monetary damages any Party may have in respect of any breach of or default under this Agreement.

The court found unpersuasive plaintiff's claims the language "in respect of any breach of or default under *this Agreement*" (emphasis added) in 7(f) limited the indemnification remedy only to contract claims, while allowing plaintiff to bring tort claims, and quoted from *Abry Partners*:

> It is difficult to fathom why rational contracting parties would attempt to cut, by contract, a clear division that American jurisprudence has never been able to achieve: a division between the role of contract and tort law in addressing the consequences of false representations inducing the making and closing of contracts.[27]

More recently, however, in *OverDrive v. Baker & Taylor, Inc.*,[28] then-Chancellor Chandler of the Delaware Court of Chancery refused to dismiss a claim for fraud concerning extra-contractual statements made with respect to a distribution agreement and venture between two companies that included a clear anti-reliance provision. OverDrive, a leader in the field of digital media distribution, and Baker & Taylor, a leading distributor of physical media, entered into a "Digital Distribution & Technology License Agreement" (the "Agreement"), under which OverDrive would serve as Baker & Taylor's "exclusive" provider of digital media for distribution to Baker & Taylor's customers. The Agreement specified certain exceptions to this "exclusive" arrangement—specifically, any of Baker & Taylor's "pre-existing agreements" listed on a schedule (the "Schedule") to the Agreement. As the court emphasized, Baker & Taylor requested the inclusion of these exceptions and the Schedule only one week before the execution of the Agreement, the Schedule only listed six agreements and did not describe them, and Baker & Taylor never provided the agreements to OverDrive (although it was not required to do so).

The explicit purpose of the Agreement was to "prevent or restrict" Baker & Taylor "from developing and/or offering a catalog of aggregated download eBooks, audiobooks, music and/or video that is directly competitive to the hosted materials" and services provided by OverDrive, subject to the scheduled exceptions. OverDrive proceeded to invest significant resources to custom-develop an online digital platform that would enable Baker & Taylor to distribute digital media and provided Baker & Taylor with access to a "mass amount" of OverDrive's proprietary

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[27] 891 A.2d 1032, 1054 (Del. Ch. 2006).

[28] 2011 Del. Ch. LEXIS 91 (Del. Ch. June 17, 2011).

information, including OverDrive's custom sales and marketing data, inventory, and customer lists.

Several months after the Agreement was executed, OverDrive learned that Baker & Taylor had entered into arrangements with another digital media distributor, LibreDigital, whereby Baker & Taylor would distribute an e-reader and accompanying digital media through LibreDigital. LibreDigital was listed as one of Baker & Taylor's preexisting agreements on the Schedule, and Baker & Taylor maintained that "the decision to partner with LibreDigital to develop a competing platform for digital media distribution is simply an amendment to a pre-existing agreement, and is explicitly contemplated under the Agreement with OverDrive."

OverDrive brought several claims against Baker & Taylor, including a claim for fraud. With regard to the fraud claim, OverDrive alleged that Baker & Taylor "made intentional misrepresentations and omissions relating to (1) the LibreDigital Agreement, (2) [its] true intentions with respect to the Baker & Taylor-OverDrive [d]igital [m]edia [p]latform, and (3) [Baker & Taylor's] interest in having LibreDigital provide digital distribution services for it and in developing a competing digital distribution platform." Baker & Taylor filed a motion to dismiss.

The court denied Baker & Taylor's motion to dismiss the fraud claim. In order to state a claim for common law fraud, a plaintiff must allege "(1) that defendant made a false representation, usually one of fact; (2) with the knowledge or belief that the representation was false, or with reckless indifference to the truth; (3) with an intent to induce the plaintiff to act or refrain from acting; (4) that plaintiff's action or inaction was taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of its reliance on the representation." The court held that, although OverDrive's "allegations may be difficult to prove at a trial," OverDrive's allegations were sufficient to defeat a motion to dismiss. The court also, significantly, rejected Baker & Taylor's contention that the fraud claim was barred by an anti-reliance clause in the Agreement, which provided that "[n]either party is relying on any representations, except those set forth herein, as inducement to execute this Agreement." Among other things, Baker & Taylor cited *Abry*, in which, as noted above, then-Vice Chancellor Strine held that (1) an anti-reliance clause in an agreement barred fraud claims based on alleged misrepresentations outside of the agreement, but would not bar fraud claims concerning misrepresentations in the agreement and (2) in the face of a valid fraud claim, a damages cap would not be enforced as a matter of public policy.

In concluding that the anti-reliance clause in the Agreement before him did not bar OverDrive's fraud claim, the court noted OverDrive's argument that Baker & Taylor "lied about specific provisions in the Agreement at the time the parties were entering into the Agreement--in particular, Baker & Taylor not only failed (allegedly intentionally) to reveal the actual scope of the LibreDigital relationship and Baker & Taylor's plan to use the digital media distribution information in its planned business relationship with LibreDigital, but defendant also (allegedly) affirmatively represented to OverDrive that the carveouts in [the Schedule] were nothing to worry about and assured OverDrive that the LibreDigital relationship "was limited to digital book conversion and warehousing services, and would never be expanded to include the distribution of digital content because distribution was going to be OverDrive's exclusive role under the Agreement." The court went on to note that "under the teaching of" *Abry*, "use of an

anti-reliance clause in such a manner is contrary to public policy if it would operate as a shield to exculpate" Baker & Taylor for its own "intentional fraud." The court further explained that "Baker & Taylor's (alleged) misrepresentations and omissions with respect to LibreDigital (both the true nature of its relationship and its intention to develop a competitive digital distribution platform) relate directly to [the exceptions listed in and the Schedule attached to] the Agreement and, indeed, go to the very core of the Agreement between OverDrive and Baker & Taylor. Such material misrepresentations and omissions in the Agreement--if proven to be true--frustrate the very purpose and nature of the Agreement, and OverDrive purportedly would not have entered into the Agreement with Baker & Taylor otherwise." Perhaps notably, in also refusing to dismiss breach of contract claims by OverDrive, the court noted that "[y]es, the Agreement was always subject to the exceptions 'identified' in [the Schedule], but the clear meaning and intent of the exclusivity and non-compete provisions could fairly be read to create an exclusive arrangement--one in which OverDrive would be the exclusive provider of Baker & Taylor's eBooks and digital audiobook products. The fact that [the Schedule] 'lists' LibreDigital as one of its pre-existing partners explicitly allows Baker & Taylor to work with LibreDigital--it does not give Baker & Taylor free reign to ignore the obvious intent of the Agreement and form a directly competitive platform."

Following *OverDrive,* it was unclear what impact, if any, *OverDrive* had on *Abry* and the seemingly settled rule in Delaware that in the face of an unambiguous anti-reliance clause in an agreement, a party cannot successfully pursue a claim for fraud based on representations made outside the four corners of the agreement. However, the Delaware Supreme Court, in its recent opinion, *RAA Management, LLC v. Savage Sports Holdings, Inc.,* No. 577, 2011 (Del. May 18, 2012), affirmed the rule announced in *Abry*, noting that "*Abry Partners* accurately states Delaware law and explains Delaware's public policy in favor of enforcing contractually binding written disclaimers of reliance on representations outside of a final agreement of sale or merger."[29]

In *RAA Management*, two sophisticated parties entered into a non-disclosure agreement ("NDA") in connection with RAA's interest in acquiring Savage Sports Holdings, Inc., a large rifle manufacturer. The NDA contained a non-reliance clause and a waiver of claims clause. In its entirety the non-reliance clause provided:

> You [RAA] understand and acknowledge that neither the Company [Savage] nor any Company Representative is making any representation or warranty, express or implied, as to the accuracy or completeness of the Evaluation Material or of any other information concerning the Company provided or prepared by or for the Company, and none of the Company nor the Company Representatives, will have any liability to you or any other person resulting from your use of the Evaluation Material or any such other information. Only those representations or warranties that are made to a purchaser in the Sale Agreement when, as and if it is executed,

[29] *RAA Management, LLC v. Savage Sports Holdings, Inc*., No. 577,2011, slip op. at 22 (Del. May 18, 2012).

and subject to such limitations and restrictions as may be specified [in] such a Sale Agreement, shall have any legal effect.[30]

RAA's complaint had alleged that Savage told RAA at the outset of their discussions that there were no significant unrecorded liabilities or claims against Savage, but then during RAA's due diligence into Savage, Savage disclosed three such matters, which caused RAA to abandon negotiations for the transaction. RAA sought to recover from Savage the $1.2 million in due diligence and negotiation costs. The trial court (the Delaware Superior Court) held otherwise and dismissed RAA's complaint.

On appeal, RAA argued (i) that the Delaware Superior Court erroneously read the non-reliance disclaimer language in the NDA to absolve Savage of fraud rather than unintentional inaccuracies; (ii) that the Delaware Superior Court incorrectly allowed an ambiguous disclaimer in the NDA to absolve Savage of all liability for fraud; (iii) that the Delaware Superior Court incorrectly enforced the NDA to preclude RAA's fraud claims because Savage allegedly made misrepresentations "about material facts within the defendant's peculiar-knowledge"; and (iv) that, to the extent that the NDA absolved Savage from fraudulent misrepresentations, the NDA is unenforceable for public policy reasons.

The Delaware Supreme Court rejected all of these arguments finding that the non-disclosure agreement between RAA and Savage contained an unambiguous "non-reliance" clause, similar to the contractual language found in *Great Lakes Chemical Corp. v. Pharmacia Corp*., 788 A.2d 554 (Del. Ch. 2001), and *In re IBP, Inc. Shareholders Litigation*, 789 A.2d 14 (Del. Ch. 2001), which the Delaware Supreme Court refused to construe as either an express or implicit exception for intentional or fraudulent misrepresentations. The Delaware Supreme Court also held that the "peculiar-knowledge" exception was inapplicable here because the exception generally does not apply where two sophisticated parties could have easily insisted on contractual protections for themselves. Lastly, the Delaware Supreme Court held that it should not decline to enforce the agreed-upon language of the non-reliance clauses in the NDA on policy grounds because of Delaware's public policy in favor of enforcing contractually binding written disclaimers of reliance on representations outside of a final agreement of sale or merger, as articulated in *Abry*.

The Delaware Supreme Court emphasized that the purpose of a confidentiality agreement is to promote and facilitate pre-contractual negotiations; and non-reliance clauses in a confidentiality agreement are intended to limit or eliminate liability from misrepresentations during the due diligence process. The Delaware Supreme Court opined that "the efficient operation of capital markets is dependent upon the uniform interpretation and application of the same language and contracts or other documents" and therefore "the reasonable commercial expectations of the parties, as set forth in the non-reliance disclaimer clauses . . . must be enforced."

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[30] *Id.* at 4-5.

IV. INDEMNIFICATION PROVISIONS

Generally, the buyer of a privately-held company in the United States seeks to impose not only on the seller, but also on its shareholders, financial responsibility for breaches of representations and covenants in the acquisition agreement and for other specified matters that may not be the subject of representations. This allocated risk of loss is accomplished through indemnification provisions that provide that if one party suffers specified losses (the "indemnified party"), the other party (the "indemnifying party") will protect or "indemnify" the indemnified party against the specified losses.[31] There are, however, public policy limits on the extent a party may shift responsibility for loss to other parties. These limits are expressed in statutes and in judicial decisions. There is also a judicial hostility to indemnification provisions that tend to shift risk of loss from a culpable party to innocent parties. These matters are illustrated in the indemnification provisions and commentary based on Article 11 of the ABA Model Asset Purchase Agreement which follow.[32]

11. INDEMNIFICATION; REMEDIES

COMMENT

Article 11 of the ABA Model Asset Purchase Agreement provides for indemnification and other remedies. Generally, the buyer of a privately-held company seeks to impose not only on the seller, but also on its shareholders, financial responsibility for breaches of representations and covenants in the acquisition agreement and for other specified matters that may not be the subject of representations. The conflict between the buyer's desire for that protection and the shareholders' desire not to have continuing responsibility for a business that they no longer own often results in intense negotiations. Thus, there is no such thing as a set of "standard" indemnification provisions. There is, however, a standard set of issues to be dealt with in the indemnification provisions of an acquisition agreement. Article 11 of the Model Agreement addresses these issues in a way that favors the Buyer. The Comments identify areas in which the Seller may propose a different resolution.

The organization of Article 11 of the Model Agreement is as follows. Section 11.1 provides that the parties' representations survive the closing and are thus available as the basis for post-closing monetary remedies. It also attempts to negate defenses based on knowledge and implied waiver. Section 11.2 defines the matters for which the Seller

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[31] Indemnification provisions are uncommon where the acquired company has equity securities that are publicly traded. The acquisition of a subsidiary or division of a public company, however, typically involves indemnification provisions comparable to those involved in the acquisition of a privately-held company.

[32] The indemnification provisions included herein and related commentary have been derived from a June 2000 draft of the ABA Model Asset Purchase Agreement (which was first published in May 2001), with the Comments updated to incorporate case law developments in the ensuing years. The authors express appreciation to the many members of the Asset Acquisition Agreement Task Force of the ABA Mergers & Acquisitions Committee whose contributions have made these materials possible. These materials, however, are solely the responsibility of the authors and have not been reviewed or approved by either the Committee or its Task Force.

The Model Asset Purchase Agreement represents a buyer's first draft. As a result, the following indemnification provisions do not incorporate limits on seller liability discussed elsewhere in this paper or that might be expected in a fully negotiated agreement.

and the Shareholders will have post-closing monetary liability. It is not limited to matters arising from inaccuracies in the Seller's representations. Section 11.3 provides a specific monetary remedy for environmental matters. It is included as an example of a provision that deals specifically with contingencies that may not be adequately covered by the more general indemnification provisions. The types of contingencies that may be covered in this manner vary from transaction to transaction. Section 11.4 defines the matters for which the Buyer will have post-closing monetary liability. In a cash acquisition, the scope of this provision is very limited; indeed, it is often omitted entirely. Sections 11.5 and 11.6 set forth levels of damage for which post-closing monetary remedies are not available. Section 11.7 specifies the time periods during which post-closing monetary remedies may be sought. Section 11.8 provides setoff rights against the promissory note delivered as part of the purchase price as an alternative to claims under the escrow. Section 11.9 provides procedures to be followed for, and in the defense of, third party claims. Section 11.10 provides the procedure for matters not involving third party claims. Section 11.11 provides that the indemnification provided for in Article 11 is applicable notwithstanding the negligence of the indemnitee or the strict liability imposed on the indemnitee.

11.1 SURVIVAL

All representations, warranties, covenants, and obligations in this Agreement, the Disclosure Letter, the supplements to the Disclosure Letter, the certificates delivered pursuant to Section 2.7, and any other certificate or document delivered pursuant to this Agreement shall survive the Closing and the consummation of the Contemplated Transactions, subject to Section 11.7. The right to indemnification, reimbursement, or other remedy based on such representations, warranties, covenants and obligations shall not be affected by any investigation (including any environmental investigation or assessment) conducted with respect to, or any Knowledge acquired (or capable of being acquired) at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of or compliance with, any such representation, warranty, covenant or obligation. The waiver of any condition based on the accuracy of any representation or warranty, or on the performance of or compliance with any covenant or obligation, will not affect the right to indemnification, reimbursement, or other remedy based on such representations, warranties, covenants and obligations.

COMMENT

The representations and warranties made by the seller and its shareholders in acquisitions of assets of private companies are typically, although not universally, intended to provide a basis for post-closing liability if they prove to be inaccurate. In acquisitions of assets of public companies without controlling shareholders, the seller's representations typically terminate at the closing and thus serve principally as information gathering mechanisms, closing conditions, and a basis for liability if the closing does not occur (see the introductory Comment to Article 3 under the caption 'Purposes of the Seller's Representations'). If the shareholders of a private company selling its assets are numerous and include investors who have not actively participated in the business (such as venture capital investors in a development stage company), they may analogize their situation to that of the shareholders of a public company and argue that their representations should not survive the closing. However, it would be unusual for the shareholders' representations to terminate at the closing in a private sale. If the

shareholders are numerous, they can sign a joinder agreement, which avoids having each of them sign the acquisition agreement.

If the seller's representations are intended to provide a basis for post-closing liability, it is common for the acquisition agreement to include an express survival clause (as set forth above) to avoid the possibility that a court might import the real property law principle that obligations merge in the delivery of a deed and hold that the representations merge with the sale of the assets and thus cannot form the basis of a remedy after the closing. *Cf. Business Acquisitions* ch. 31, at 1279-80 (Herz & Baller eds., 2d ed. 1981). A survival clause was construed in *Herring v. Teradyne, Inc*., 242 F. App'x 469, 2007 WL 2034502 (9th Cir. 2007), which stated that its "disposition is not suitable for publication and is not precedent" and reversed *Herring v. Teradyne, Inc.*, 256 F. Supp.2d 1118 (S.D. Cal. 2002). *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 63 Bus. Law. 531, 551-552 (2008). The *Herring* case arose out of a stock-for-stock merger in which Teradyne, a publicly held company, purchased two closely held companies from plaintiffs after an auction. After the merger closed on August 15, 2000, plaintiffs discovered that Teradyne's true performance had been spiraling downward, allegedly contrary to representations in the merger agreement and unknown to plaintiffs. On September 5, 2001, more than a year after closing, plaintiffs filed suit alleging fraud and breach of contract. The breach of contract claims were based primarily on the "no material adverse change" and "no failure to disclose" representations of Teradyne contained in the merger agreement.

Unlike Section 11.1 above from the Model Agreement, which simply provides that '[a]ll representations, warranties, covenants…shall survive the Closing…subject to Section 11.7 [which essentially provides that notice of claims (but not lawsuits thereon) must be given to the other party within the time periods provided therein],' the survival clause in the *Herring* merger agreement read as follows:

> ***11.01 Survival.*** The covenants, agreements, representations and warranties of the parties hereto contained in this Agreement or in any certificate or other writing delivered pursuant hereto or in connection herewith shall survive the Closing until the first anniversary of the Closing Date [except for certain enumerated sections which were to survive either indefinitely, or until the expiration of the applicable statutory period of limitations, or for other periods specified elsewhere in the agreement]. No claim for indemnity under this Agreement with respect to any breach of any representations, warranties and/or covenants of Company and/or Seller shall be made after the applicable period specified in the preceding sentence and all such claims shall be made in accordance with the applicable provisions of the Escrow Agreement. [Emphasis added].

In *Herring*, the defendant buyer contended that the first sentence of the language quoted above created a one-year statute of limitations applicable to contract claims based on the merger agreement and, since plaintiffs did not sue within one year after closing, plaintiffs' claims were barred by the contractual one year limitations period instead of California's four year statute of limitations for contract claims. The plaintiffs argued, in effect, that such a result would require something more explicit, similar to the second sentence, but specifically requiring that indemnification lawsuits must be brought within

the survival period set forth in the first sentence. The second sentence limited the period for notifying the other party of a claim, not the period within which a lawsuit would be required to be filed.

In its opinion, after a review of numerous cases and treatises, including Samuel C. Thompson, *Business Planning for Mergers and Acquisitions* 779-80 (2nd ed. 2001), the District Court stated that neither it nor the parties had found binding precedent, but that:

> [T]he treatises presented to the Court indicate that where an agreement does not provide that representations and warranties survive the closing, they extinguish on the closing date…. It follows then that where an agreement provides that representations and warranties 'survive', a party can sue for breaches of the representations and warranties, but only during the time period the contract states those representations and warranties survive. Therefore, if they survive indefinitely, then the state's four-year statute of limitations would apply from the date of the breach. But if [they] survive for a fixed period of time, it follows that once that time period has elapsed, a party cannot sue for breach of the representations and warranties, absent circumstances surrounding the negotiations that would counsel against such an interpretation….

The Ninth Circuit's July l3, 2007 opinion, in reversing the District Court and in effect holding that California's four year statute of limitations for contract claims controlled, explained:

> Parties may contractually reduce the statute of limitations, but any reduction is construed with strictness against the party seeking to enforce it. Here, we find no clear and unequivocal language in the survival clauses that permits the conclusion that the parties have unambiguously expressed a desire to reduce the statute of limitations.

The *Herring* saga was replicated in *Western Filter Corp. v. Argan, Inc.*, 2008 U.S. App. LEXIS 18147 (9th Cir. Aug. 25, 2008), in which the Ninth Circuit had to decide whether a provision within a stock purchase agreement providing that the representations and warranties of the parties survive closing for one year also served as a contractual statute of limitation that reduced a longer period otherwise provided by California law. The Court held that the stock purchase agreement's one-year survival period served only to specify when a breach of the representations and warranties could occur, but not when an action had to be filed. The portion of the stock purchase agreement at issue (the "*Survival Clause*") provided that "[t]he representations and warranties of [buyer] and [seller] in this Agreement shall survive the Closing for a period of one year, except the representations and warranties contained in Section 3.1(a), (b), (c), and (f) and 3.2(a) and (b) shall survive indefinitely."

After closing, the buyer found that the target's inventory was worth significantly less than what seller represented. Less than one year after closing, buyer sent written notice to seller, claiming that "the management of [seller and the target] grossly misrepresented the financial condition of [the target]." About 1½ years after the closing, the buyer filed suit against seller and its officers for breach of contract, intentional

misrepresentation, concealment and nondisclosure, negligent misrepresentation, false promise, negligence, and declaratory relief.

The trial court granted seller's motion for summary judgment, concluding that buyer's claims were barred by the one-year limitation set forth in the Survival Clause, accepting and adopting the trial court's decision in *Herring*.

On appeal buyer argued that the Survival Clause's one-year limitation serves only to set forth the time period for which a breach may occur or be discovered, whereas seller maintained that the Survival Clause serves as a contractual limitation on the applicable statute of limitation. In accepting buyer's position and reversing the trial court, the Ninth Circuit wrote:

> Both parties agree that without the Survival Clause the representations and warranties would have terminated at the time of closing. "[R]epresentations and warranties are statements of fact as of the date of the execution of the acquisition agreement, and the truthfulness of the representations and warranties as of both the date of execution and, when appropriate, the date of the closing is generally a condition to the closing." Samuel C. Thompson, Jr., *Business Planning for Mergers and Acquisitions* 780 (Carolina Academic Press 2001) (1997). In other words, the representations and warranties serve as a safety net for the seller and buyer. If, prior to closing, either the seller or buyer discovers that a representation or warranty made by the other party is not true, they have grounds for backing out of the deal. *See id.* ("If prior to closing a party discovers that a representation or warranty is materially inaccurate, the party can refuse to close and possibly sue for damages.").
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> The closing date itself triggers the contractual limitation on liability. Unless the parties agree to a survival clause--extending the representations and warranties past the closing date--the breaching party cannot be sued for damages post-closing for their later discovered breach. With that premise in mind, [seller] reasonably argues that the one-year limitation in the Survival Clause was intended to serve as a contractual time limit on any action brought based on a breach of the contract's representations and warranties. Under [seller's] theory, [buyer] could not bring a claim without the Survival Clause, and, even with the Survival Clause, [buyer] only had one year after closing to bring such a claim.
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> * * *
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> Although [seller's] interpretation is reasonable--and ultimately may be more practical--the Survival Clause can also be reasonably read as [buyer] suggests: that the one-year limitation serves only to specify when a breach of the representations and warranties may occur, but not when an action must be filed. [Buyer's] interpretation becomes even more reasonable in light of California's policy of strictly construing any contractual limitation against the party seeking to invoke the time limitation. * * * Because the language of the Survival Clause is

ambiguous, the district court erred in holding that the clause created a limitation period. Accordingly, we reverse the summary judgment entered by the district court.

In *GRT, Inc. v. Marathon GTF Technology, Ltd.* (Del. Ch. No. 5571-CS July 11, 2011), Delaware Chancellor Strine in granting a motion to dismiss held that a provision in a joint venture contract that particular representations would survive for one year, and thereafter terminate along with any remedy for breach thereof, effectively operated to shorten the statute of limitations with respect to claims relating to those representations. The survival provision at issue in GRT read as follows:

> The representations and warranties of the Parties contained in Sections 3.1, 3.3, 3.6, 4.1 and 4.2 shall survive the Closing indefinitely, together with any associated right of indemnification pursuant to Section 7.2 or 7.3. The representations and warranties of [GRT] contained in Section 3.16 shall survive until the expiration of the applicable statutes of limitations . . . , and will thereafter terminate, together with any associated right of indemnification pursuant to Section 7.3. *All other representations and warranties in Sections 3 and 4 will survive for twelve (12) months after the Closing Date, and will thereafter terminate, together with any associated right of indemnification pursuant to Section 7.2 or 7.3 or the remedies provided pursuant to Section 7.4*.

To explain why he concluded that the survival clause at issue should be read as establishing a discrete, one-year period within which claims for breach of the representations must be brought, the Chancellor began by observing that there are at least four distinct possible ways to draft a contract addressing the life span of the contract's representations and warranties, each of which can affect the extent and nature of the representing and warranting party's post-closing liability for alleged misrepresentations:

> The first possibility — i.e., where the contract expressly provides that the representations and warranties terminate upon closing — is the clearest of all. In that case, all the major commentaries agree that by expressly terminating representations and warranties at closing, the parties have made clear their intent that they can provide no basis for a post-closing suit seeking a remedy for an alleged misrepresentation. That is, when the representations and warranties terminate, so does any right to sue on them. *** It is therefore common in cases where the representations and warranties expire at closing for the parties to conduct robust due diligence *pre-closing*, with it being understood that the contractual representations and warranties will be true as of the closing date and can provide a basis to avoid closing to the extent that their truth is made a condition to closing, but will not provide a basis for a post-closing lawsuit.
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> The second possibility — i.e., where the contract is silent as to whether the representations and warranties survive or expire upon closing — is perhaps the least clear. The lack of clarity is most likely because it is a rare instance that parties to an M&A contract fail to address the issue of survival given the important implications survival or non-survival has for the representing and warranting party's potential

post-closing liability, and for the non-representing and warranting party's post-closing remedy in the event it discovers that certain representations and warranties were not true when made. Thus, some commentaries and treatises take a cautionary approach, advising parties to make explicit their intentions with respect to survival. ***

The third situation — i.e., where the contract contains a discrete survival period during which the representations and warranties will continue to be binding on the party who made them — is the one encountered here. The commentators and scholars *** view that the effect of a survival clause with a discrete survival period is to limit the time period during which a claim for breach of a representation or warranty may be filed. ***

The fourth situation — i.e., where the contract provides that the representations and warranties will survive indefinitely or otherwise does not bound their survival — is perhaps the most interesting. As a matter of strict or literal construction, one might imagine that a clause which provides that the representations and warranties shall survive indefinitely would mean that the representing and warranting party would face indefinite post-closing liability for its representations and warranties. But, in light of the public policy underlying statutes of limitations in general, and the widespread refusal of courts to permit parties to extend the limitations period beyond the legislatively determined statute of limitations and thereby violate the legislature's mandate, the general rule is that in such a situation, courts will treat the indefinite survival of representations and warranties as establishing that the ordinarily applicable statute of limitations governs the time period in which actions for breach can be brought. In other words, a survival clause that states generally that the representations and warranties will survive closing, or one that provides that the representations and warranties will survive indefinitely, is treated as if it expressly provided that the representations and warranties would survive for the applicable statute of limitations.

Considering these scenarios and what they suggest about the case at hand, two general points about survival clauses and the third situation emerge that support my conclusion that the Survival Clause established a one-year limitations period. The first is that the presence (or absence) of a survival clause that expressly states that the covered representations and warranties will survive beyond the closing of the contract, although it may act to *shorten* the otherwise applicable statute of limitations, never acts to lengthen the statute of limitations, at least in jurisdictions, like Delaware, whose statutes have been read to forbid such extensions. This strengthens the argument of those commentators who equate the termination date for representations and warranties with the last date to sue on those representations and warranties.

Second, and consistent with the prior point, the most persuasive authorities conclude that survival clause with a discrete survival period has the effect of granting the non-representing and warranting party a limited period of time in which to file a post-closing lawsuit. A survival

> clause is like a provision expressly terminating representations and warranties at closing in the sense that it is a tool utilized by contracting parties to avoid the uncertainty that learned commentary suggests exists where the contract is silent on the issue of survival. Where a given contract expressly terminates the representations and warranties at closing, it is understood that there can be no post-closing lawsuit for their breach. Thus, a party to a contract with an express termination clause ordinarily has no post-closing recourse against the representing and warranting party because the grounds for such a remedy were expressly terminated in the contract. By parity of reasoning, then, a survival clause, like the one found in the Purchase Agreement, that expressly states that the covered representations and warranties will survive for a discrete period of time, but will thereafter "terminate," makes plain the contracting parties' intent that the non-representing and warranting party will have a period of time, i.e., the survival period, to file a claim for a breach of the surviving representations and warranties, but will thereafter, when the surviving representations and warranties terminate, be precluded from filing such a claim.

Some state statutes limit the ability of parties by contract to limit the applicable statutory statute of limitations. *See, e.g., Tex. Civ. Practices & Remedies Code* § 16.070 (2010) ("[A] person may not enter into a stipulation…or agreement that purports to limit the time in which to bring suit [thereon] to a period shorter than two years [and one that does] is void in this state"; provided that the foregoing "does not apply to a stipulation…or agreement relating to the sale or purchase of a business entity if a party [thereto] pays or receives or is obligated to pay or entitled to receive consideration [thereunder] having an aggregate value of not less than $500,000.")

Even in the relatively rare cases in which the shareholders of a private company selling its assets are able to negotiate the absence of contractual post-closing remedies based on their representations, they may still be subject to post-closing liability based on those representations under principles of common law fraud. *See* Comment to Section 13.7 (Entire Agreement and Modification) *infra* regarding the elements of fraud and negligent misrepresentation claims and contractual provisions to limit exposure to extra contractual claims.

Section 11.1 provides that knowledge of an inaccuracy by the indemnified party is not a defense to the claim for indemnity, which permits the buyer to assert an indemnification claim not only for inaccuracies first discovered after the closing, but also for inaccuracies disclosed or discovered before the closing. This approach is often the subject of considerable debate. A seller may argue that the buyer should be required to disclose a known breach of the seller's representations before the closing, and waive it, renegotiate the purchase price or refuse to close. The buyer may respond that it is entitled to rely on the representations made when the acquisition agreement was signed — which presumably entered into the buyer's determination of the price that it is willing to pay — and that the seller should not be able to limit the buyer's options to waiving the breach or terminating the acquisition. The buyer can argue that it has purchased the representations and the related right to indemnification and is entitled to a purchase price adjustment for an inaccuracy in those representations, regardless of the buyer's knowledge. In addition, the buyer can argue that any recognition of a defense based on the buyer's knowledge could convert each claim for indemnification into an extensive discovery inquiry into the

state of the buyer's knowledge. *See generally* Committee on Negotiated Acquisitions, *Purchasing the Stock of a Privately Held Company: The Legal Effect of an Acquisition Review*, 51 Bus. Law. 479 (1996).

If the buyer is willing to accept some limitation on its entitlement to indemnification based on its knowledge, it should carefully define the circumstances in which knowledge is to have this effect. For example, the acquisition agreement could distinguish between knowledge that the buyer had before signing the acquisition agreement, knowledge acquired through the buyer's pre-closing investigation, and knowledge resulting from the seller's pre-closing disclosures, and could limit the class of persons within the buyer's organization whose knowledge is relevant (for example, the actual personal knowledge of named officers). An aggressive seller may request a contractual provision requiring that the buyer disclose its discovery of an inaccuracy immediately and elect at that time to waive the inaccuracy or terminate the acquisition agreement, or an "anti-sandbagging" provision precluding an indemnity claim for breaches known to the buyer before closing. An example of such a provision follows:

> [Except as set forth in a Certificate to be delivered by Buyer at the Closing,] to the Knowledge of Buyer, Buyer is not aware of any facts or circumstances that would serve as the basis for a claim by Buyer against Seller or any Shareholder based upon a breach of any of the representations and warranties of Seller and Shareholders contained in this Agreement [or breach of any of Seller's or any Shareholders' covenants or agreements to be performed by any of them at or prior to Closing]. Buyer shall be deemed to have waived in full any breach of any of Seller's and Shareholders' representations and warranties [and any such covenants and agreements] of which Buyer has such awareness [to its Knowledge] at the Closing.

A buyer should be wary of such a provision, which may prevent it from making its decision on the basis of the cumulative effect of all inaccuracies discovered before the closing. The buyer should also recognize the problems an "anti-sandbagging" provision presents with respect to the definition of "Knowledge". See the Comment to that definition in Section 1.1.

The buyer's ability to assert a fraud claim after the closing may be adversely affected if the buyer discovers an inaccuracy before the closing but fails to disclose the inaccuracy to the seller until after the closing. In such a case, the seller may assert that the buyer did not rely on the representation, or that its claim is barred by waiver or estoppel.

The doctrine of substituted performance can come into play when both parties recognize before the closing that the seller and the shareholders cannot fully perform their obligations. If the seller and the shareholders offer to perform, albeit imperfectly, can the buyer accept without waiving its right to sue on the breach? The common law has long been that if a breaching party expressly conditions its substitute performance on such a waiver, the non-breaching party may not accept the substitute performance, even with an express reservation of rights, and also retain its right to sue under the original contract. *See United States v. Lamont*, 155 U.S. 303, 309-10 (1894); *Restatement, (Second) of Contracts* §278, comment a. Thus, if the seller offers to close on the condition that the buyer waive its right to sue on the breach, under the common law the buyer must choose whether to close or to sue, but cannot close and sue. Although the

acquisition agreement may contain an express reservation of the buyer's right to close and sue, it is unclear whether courts will respect such a provision and allow the buyer to close and sue for indemnification.

The survival of an indemnification claim after the buyer's discovery during pre-closing investigations of a possible inaccuracy in the seller's representations was the issue in *CBS, Inc. v. Ziff-Davis Publ'g Co.*, 553 N.E.2d 997 (N.Y. 1990). The buyer of a business advised the seller before the closing of facts that had come to the buyer's attention and, in the buyer's judgment, constituted a breach of a warranty. The seller denied the existence of a breach and insisted on closing. The buyer asserted that closing on its part with this knowledge would not constitute a waiver of its rights. After the closing, the buyer sued the seller on the alleged breach of warranty. The New York Court of Appeals held that, in contrast to a tort action based on fraud or misrepresentation, which requires the plaintiff's belief in the truth of the information warranted, the critical question in a contractual claim based on an express warranty is "whether [the buyer] believed [it] was purchasing the [seller's] promise as to its truth." The Court stated:

> The express warranty is as much a part of the contract as any other term. Once the express warranty is shown to have been relied on as part of the contract, the right to be indemnified in damages for its breach does not depend on proof that the buyer thereafter believed that the assurances of fact made in the warranty would be fulfilled. The right to indemnification depends only on establishing that the warranty was breached.

Id. at 1001 (citations omitted).

Although the *Ziff-Davis* opinion was unequivocal, the unusual facts of this case (a pre-closing assertion of a breach of warranty by the buyer and the seller's threat to litigate if the buyer refused to close), the contrary views of the lower courts, and a vigorous dissent in the Court of Appeals all suggest that the issue should not be regarded as completely settled. A decision of the U.S. Court of Appeals for the Second Circuit (applying New York law) increased the uncertainty by construing *Ziff-Davis* as limited to cases in which the seller does not acknowledge any breach at the closing and, thus, as inapplicable to situations in which the sellers disclose an inaccuracy in a representation before the closing. *See Galli v. Metz*, 973 F.2d 145, 150-51 (2d Cir. 1992). The *Galli* Court explained:

> In *Ziff-Davis*, there was a dispute at the time of closing as to the accuracy of particular warranties. *Ziff-Davis* has far less force where the parties agree at closing that certain warranties are not accurate. Where a buyer closes on a contract in the full knowledge and acceptance of facts disclosed by the seller which would constitute a breach of warranty under the terms of the contract, the buyer should be foreclosed from later asserting the breach. In that situation, unless the buyer expressly preserves his rights (as CBS did in *Ziff-Davis*), we think the buyer has waived the breach.

Id.

It is not apparent from the *Galli* opinion whether the agreement in question contained a provision similar to Section 11.1 purporting to avoid such a waiver; under an agreement containing such a provision, the buyer could attempt to distinguish *Galli* on that basis. It is also unclear whether *Galli* would apply to a situation in which the disclosed inaccuracy was not (or was not agreed to be) sufficiently material to excuse the buyer from completing the acquisition (see Section 7.1 and the related Comment).

The Eighth Circuit seems to agree with the dissent in *Ziff-Davis* and holds, in essence, that if the buyer acquires knowledge of a breach from any source (not just the seller's acknowledgment of the breach) before the closing, the buyer waives its right to sue. *See Hendricks v. Callahan*, 972 F.2d 190, 195-96 (8th Cir. 1992) (applying Minnesota law and holding that a buyer's personal knowledge of an outstanding lien defeats a claim under either a property title warranty or a financial statement warranty even though the lien was not specifically disclosed or otherwise exempted).

The conflict between the *Ziff-Davis* approach and the *Hendricks* approach has been resolved in subsequent decisions under Connecticut, Delaware, Missouri, New York and Pennsylvania law in favor of the concept that an express warranty in an acquisition agreement is now grounded in contract, rather than in tort, and that the parties should be entitled to the benefit of their bargain expressed in the purchase agreement. In *Pegasus Mgmt. Co., Inc. v. Lyssa, Inc.*, 995 F. Supp. 43 (D. Mass. 1998), the Court followed *Ziff-Davis* and held that Connecticut law does not require a claimant to demonstrate reliance on express warranties in a purchase agreement in order to recover on its warranty indemnity claims, commenting that under Connecticut law indemnity clauses are given their plain meaning, even if the meaning is very broad. The Court further held that the claimant did not waive its rights to the benefits of the express warranties where the purchase agreement provided that "[e]very . . . warranty . . . set forth in this Agreement and . . . the rights and remedies . . . for any one or more breaches of this Agreement by the Sellers shall . . . not be deemed waived by the Closing and shall be effective regardless of . . . any prior knowledge by or on the part of the Purchaser." Similarly in *American Family Brands, Inc. v. Giuffrida Enterprises, Inc.*, 1998 1998 WL 196402 (E.D. Pa. Apr. 23, 1998), the Court, following Pennsylvania law and asset purchase agreement sections providing that "[a]ll of the representations . . . shall survive the execution and delivery of this Agreement and the consummation of the transactions contemplated hereunder" and "no waiver of the provisions hereof shall be effective unless in writing and signed by the party to be charged with such waiver," sustained a claim for breach of a seller's representation that there had been no material adverse change in seller's earnings, etc. even though the seller had delivered to the buyer interim financial statements showing a significant drop in earnings. *Id.* at *6. Further, in *Schwan-Stabilo Cosmetics GmbH & Co. v. PacificLink Int'l Corporation*, 401 F.3d 28 (2d Cir. 2005), the Second Circuit upheld a lower court determination that the acquiror was entitled to indemnification under a stock-purchase agreement, despite the acquiror's pre-closing knowledge of the liabilities for which indemnification was sought and cited *Ziff-Davis* favorably; and again in *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 500 F.3d 171 (2d Cir. 2007) the Second Circuit cited *Ziff-Davis* in holding:

> Under New York law, an express warranty is part and parcel of the contract containing it and an action for its breach is grounded in contract. *See CBS, Inc. v. Ziff-Davis Publ'g Co.*, 75 N.Y.2d 496, 503 (1990). A party injured by breach of contract is entitled to be placed in

> the position it would have occupied had the contract been fulfilled according to its terms.
>
> * * *
>
> In contrast to the reliance required to make out a claim for fraud, the general rule is that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue. [Citations omitted] This rule is subject to an important condition. The plaintiff must show that it believed that it was purchasing seller's promise regarding the truth of the warranted facts. [Citation omitted] We have held that where the seller has disclosed at the outset facts that would constitute a breach of warranty, that is to say, the inaccuracy of certain warranties, and the buyer closes with full knowledge and acceptance of those inaccuracies, the buyer cannot later be said to believe he was purchasing the seller's promise respecting the truth of the warranties. [Citations omitted]

See Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 61 Bus. Law. 987, 1002 (2006). In 2007 there were two additional cases following the *Ziff-Davis* approach: (i) *Power Soak Systems, Inc. v. Emco Holdings, Inc.*, 482 F. Supp. 2d 1125 (W.D. Mo. March 20, 2007) ("The key question is not 'whether the buyer believed in the truth of the warranted information … but whether it believed it was purchasing the promise as to its truth'"); (ii) *Cobalt Operating, LLC v. James Crystal Enterprises LLC* (Del. Ch. No. 714 VCS July 20, 2007) (the Cobalt decision involved indemnification claims based on breaches of representations in an asset purchase agreement as to financial statements, conduct of business and no untrue material information provided; in holding for the plaintiff buyer as to the claims for indemnification under the purchase agreement, Delaware Vice Chancellor Leo Strine rejected defendant's "sandbagging" contention that buyer's preclosing due diligence had surfaced the facts that buyer initially discounted as immaterial discrepancies and later made a central part of its lawsuit evidence, which plaintiff contended thereby precluded plaintiff from suing on those facts, and held that a breach of a contractual representation claim is not dependent on a showing of justifiable reliance, noting that the purchase agreement expressly provided that no inspection, etc. shall affect seller's representations: "[h]aving contractually promised [buyer] that it could rely on certain representations, [seller] is in no position to contend that [buyer] was unreasonable in relying on [seller's] own binding words"). *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 63 Bus. Law. 531, 546-547 (2008).

Given the holdings of *Galli* and *Hendricks* and notwithstanding the trend of more recent cases to follow the *Ziff-Davis* approach, uncertainties remain as to the effect of the survival and non-waiver language in Section 11.1. Section 11.1 protects the Buyer if, in the face of a known dispute, the Seller and the Shareholders close believing or asserting that they are offering full performance under the acquisition agreement when, as adjudged later, they have not. However, reliance on Section 11.1 may be risky in cases in which there is no dispute over the inaccuracy of a representation. A Buyer that proceeds with the closing and later sues for indemnification can expect to be met with a defense based upon waiver and nonreliance with an uncertain outcome.

There does not appear to be any legitimate policy served by refusing to give effect to an acquisition agreement provision that the buyer is entitled to rely on its right to indemnification and reimbursement based on the seller's representations even if the buyer learns that they are inaccurate before the closing. Representations are often viewed by the parties as a risk allocation and price adjustment mechanism, not necessarily as assurances regarding the accuracy of the facts that they state, and should be given effect as such. *Galli* should be limited to situations in which the agreement is ambiguous with respect to the effect of the buyer's knowledge.

11.2 INDEMNIFICATION AND REIMBURSEMENT BY SELLER AND SHAREHOLDERS

Seller and each Shareholder, jointly and severally, will indemnify and hold harmless Buyer, and its Representatives, shareholders, subsidiaries, and Related Persons (collectively, the "**Buyer Indemnified Persons"**), and will reimburse the Indemnified Persons, for any loss, liability, claim, damage, expense (including costs of investigation and defense and reasonable attorneys' fees and expenses) or diminution of value, whether or not involving a Third-Party Claim (collectively, "**Damages"**), arising from or in connection with:

(a) any Breach of any representation or warranty made by Seller or either Shareholder in (i) this Agreement (without giving effect to any supplement to the Disclosure Letter), (ii) the Disclosure Letter, (iii) the supplements to the Disclosure Letter, (iv) the certificates delivered pursuant to Section 2.7 (for this purpose, each such certificate will be deemed to have stated that Seller's and Shareholders' representations and warranties in this Agreement fulfill the requirements of Section 7.1 as of the Closing Date as if made on the Closing Date without giving effect to any supplement to the Disclosure Letter, unless the certificate expressly states that the matters disclosed in a supplement have caused a condition specified in Section 7.1 not to be satisfied), (v) any transfer instrument or (vi) any other certificate, document, writing or instrument delivered by Seller or either Shareholder pursuant to this Agreement;

(b) any Breach of any covenant or obligation of Seller or either Shareholder in this Agreement or in any other certificate, document, writing or instrument delivered by Seller or either Shareholder pursuant to this Agreement;

(c) any Liability arising out of the ownership or operation of the Assets prior to the Effective Time other than the Assumed Liabilities;

(d) any brokerage or finder's fees or commissions or similar payments based upon any agreement or understanding made, or alleged to have been made, by any Person with Seller or either Shareholder (or any Person acting on their behalf) in connection with any of the Contemplated Transactions;

(e) any product or component thereof manufactured by or shipped, or any services provided by, Seller, in whole or in part, prior to the Closing Date;

(f) any matter disclosed in Parts _____ of the Disclosure Letter;

(g) any noncompliance with any Bulk Sales Laws or fraudulent transfer law in respect of the Contemplated Transactions;

(h) any liability under the WARN Act or any similar state or local Legal Requirement that may result from an "**Employment Loss**", as defined by 29 U.S.C. § 2101(a)(6), caused by any action of Seller prior to the Closing or by Buyer's decision not to hire previous employees of Seller;

(i) any Employee Plan established or maintained by Seller; or

(j) any Retained Liabilities.

COMMENT

Although the inaccuracy of a representation that survives the closing may give rise to a claim for damages for breach of the acquisition agreement without any express indemnification provision, it is customary in the acquisition of assets of a privately held company for the buyer to be given a clearly specified right of indemnification for breaches of representations, warranties, covenants, and obligations and for certain other liabilities. Although customary in concept, the scope and details of the indemnification provisions are often the subject of intense negotiation.

Indemnification provisions should be carefully tailored to the type and structure of the acquisition, the identity of the parties, and the specific business risks associated with the seller. The Model Agreement indemnification provisions may require significant adjustment before being applied to a merger or stock purchase, because the transfer of liabilities by operation of law in each case is different. Other adjustments may be required for a purchase from a consolidated group of companies, a foreign corporation, or a joint venture, because in each case there may be different risks and difficulties in obtaining indemnification. Still other adjustments will be required to address risks associated with the nature of the seller's business and its past manner of operation.

Certain business risks and liabilities are not covered by traditional representations and may be covered by specific indemnification provisions (see, for example, subsections (c) through (i)). Similar provision may also be made for liability resulting from a pending and disclosed lawsuit against the Seller which is not an assumed liability. See also the discussion concerning WARN Act liabilities in the Comment to Section 10.1.

In the absence of explicit provision to the contrary, the buyer's remedies for inaccuracies in the seller's and the shareholders' representations may not be limited to those provided by the indemnification provisions. The buyer may also have causes of action based on breach of contract, fraud and misrepresentation, and other federal and state statutory claims, until the expiration of the applicable statute of limitations. The seller, therefore, may want to add a clause providing that the indemnification provisions are the sole remedy for any claims relating to the sale of the assets. This clause could also limit the parties' rights to monetary damages only, at least after the closing. (See Section 13.5 with respect to equitable remedies for enforcement of the Model Agreement and the first sentence of Section 13.6 relating to cumulative remedies.) In some cases, the seller may prefer not to raise the issue and instead to rely on the limitations on when claims may be asserted (Section 11.7) and the deductible or "basket" provisions (Sections

11.5 and 11.6) as evidence of an intention to make the indemnification provisions the parties' exclusive remedy. The Model Agreement does not state that indemnification is the exclusive remedy, and these limitations expressly apply to liability "for indemnification or otherwise", indicating a contrary intention of the parties.

The scope of the indemnification provisions is important. A buyer generally will want the indemnification provisions to cover breaches of representations in the disclosure letter, any supplements to the disclosure letter, and any other certificates delivered pursuant to the acquisition agreement, but may not want the indemnification provisions to cover breaches of noncompetition agreements, ancillary service agreements, and similar agreements related to the acquisition, for which there would normally be separate breach of contract remedies, separate limitations (if any) regarding timing and amounts of any claims for damages, and perhaps equitable remedies.

The Model Agreement provides for indemnification for any inaccuracy in the documents delivered pursuant to the acquisition agreement. Broadly interpreted, this could apply to any documents reviewed by the buyer during its due diligence investigation. The buyer may believe that it is entitled to this degree of protection, but the seller can argue that (a) if the buyer wants to be assured of a given fact, that fact should be included in the representations in the acquisition agreement, and (b) to demand that all documents provided by the seller be factually accurate, or to require the seller to correct inaccuracies in them, places unrealistic demands on the seller and would needlessly hamper the due diligence process. As an alternative, the seller and its shareholders may represent that they are not aware of any material inaccuracies or omissions in certain specified documents reviewed by the buyer during the due diligence process.

Section 11.2(a)(i) provides for indemnification for any breach of the Seller's and the Shareholders' representations in the acquisition agreement and the Disclosure Letter as of the date of signing. A seller may seek to exclude from the indemnity a breach of the representations in the original acquisition agreement if the breach is disclosed by amendments to the disclosure letter before the closing. This provides an incentive for the seller to update the disclosure letter carefully, although it also limits the buyer's remedy to refusing to complete the acquisition if a material breach of the original representations is discovered and disclosed by the Seller. For a discussion of related issues, see the Comment to Section 11.1.

Section 11.2(a)(iv) also provides for indemnification for an undisclosed breach of the Seller's representations as of the closing date through the reference in subsection (a) to the closing certificate required by Section 2.7. This represents customary practice. However, the Model Agreement departs from customary practice by providing that, if a certificate delivered at Closing by the Seller or a Shareholder discloses inaccuracies in the Seller's representations as of the closing date, this disclosure will be disregarded for purposes of an indemnification claim under Section 11.2(a)(iv) (that is, the Seller and the Shareholders will still be subject to indemnification liability for such inaccuracies) unless the Seller states in the certificates delivered pursuant to Section 2.7 that these inaccuracies resulted in failure of the condition set forth in Section 7.1, thus permitting the Buyer to elect not to close. Although unusual, this structure is designed to protect the Buyer from changes that occur after the execution of the acquisition agreement and before the closing that are disclosed before the closing. The provision places an additional burden upon the Seller to expressly state in writing that due to inaccuracies in its representations and warranties as of the closing date, Buyer has no obligation to close

the transaction. Only if the Buyer elects to close after such statement is made in the certificate, will the Buyer lose its right to indemnification for damages resulting from such inaccuracies. Such disclosure, however, would not affect the Buyer's indemnification rights to the extent that the representations and warranties were also breached as of the signing date.

Sections 11.2(c) – (j) are intended to be standalone provisions that allocate the specified risks independently of any allocation in the representations and warranties or in the covenants stated elsewhere in the Model Agreement. Thus, Seller could be obligated to indemnify Buyer under Section 11.2(c) – (j) irrespective of whether the claim could be based a breach of a representation or warranty in Article III or any of Seller's promises elsewhere in the agreement. This is significant because the limitation on Seller's indemnification obligations in Section 11.5 references only Section 11.2(a) and thus is only applicable to breeches of representations. This significance is increased by *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006), which held that a seller cannot limit its liability for knowing breaches of its representations and warranties in a stock purchase agreement. In *ABRY*, the Court held that a seller cannot protect itself from the possibility that the sale could be rescinded if the buyer can show that either (1) the seller knew the contractual representations and warranties were false, or (2) the seller lied to the buyer about a contractual representation or warranty; but, conversely, the seller will be protected – and the buyer will not be permitted to seek rescission- if the buyer's claim is premised on intentional misrepresentation by the seller as to matters that the buyer expressly agreed to leave outside of the scope of the representations and warranties written into the agreement. See Comments to Sections 11.5 and 11.7 *infra*.

Most recently, however, in *OverDrive v. Baker & Taylor, Inc.*, 2011 Del. Ch. LEXIS 91 (Del. Ch. June 17, 2011), the Delaware Court of Chancery refused to dismiss a claim for fraud concerning extra-contractual statements made with respect to a distribution agreement and venture between two companies that included a clear anti-reliance provision. It is unclear how the court's holding at the motion to dismiss stage in *OverDrive* will impact the seemingly settled rule from *ABRY* that a party cannot successfully pursue a claim for fraud based on representations made outside the four corners of an agreement with an unambiguous anti-reliance clause.

The suggestion in *The Hartz Consumer Group, Inc. v. JWC Hartz Holdings, Inc.*, Index No. 600610/03 (N.Y. Sup. Ct. Oct. 27, 2005), *aff'd*, 33 A.D.3d 555 (N.Y. App. Div. 2006), that a provision in the Model Stock Purchase Agreement comparable Section 11.2(e) is not a standalone provision that allocates the specified risks independently of any breech of the representations and warranties is incorrect, represents a misreading of the ABA Model Stock Purchase Agreement, and should not be authoritative in respect of Section 11.2 of the Model Agreement or otherwise.

Section 11.2(c) provides that Buyer will be indemnified for "any Liability arising out of the ownership or operation of the [purchased] Assets prior to the Effective Time other than Assumed Liabilities." In *Honeywell Int'l, Inc. v. Phillips Petroleum Co.*, 415 F.3d 429 (5th Cir. 2005), the Fifth Circuit held that such a provision did not obligate buyer to indemnify seller for liabilities related to assets of the sold business that had been previously sold to a third party as the liabilities did not relate to assets transferred in the transaction to which the indemnification related.

Section 11.2 provides for joint and several liability, which the buyer will typically request and the seller, seeking to limit the exposure of its shareholders to several liability (usually in proportion to each shareholder's percentage ownership), may oppose. Occasionally, different liability will be imposed on different shareholders, depending on the representations at issue, and the seller itself will almost always be jointly and severally liable to the buyer without any such limitation. The shareholders may separately agree to allocate responsibility among themselves in a manner different from that provided in the acquisition agreement (for example, a shareholder who has been active in the business may be willing to accept a greater share of the liability than one who has not).

Factors of creditworthiness may influence the buyer in selecting the persons from whom to seek indemnity. For example, a seller would not be creditworthy after the closing if it were likely to distribute its net assets to its shareholders as soon as practicable thereafter. If the seller is part of a consolidated group of companies, it may request that the indemnity be limited to, and the buyer may be satisfied with an indemnity from, a single member of the seller's consolidated group (often the ultimate parent), as long as the buyer is reasonably comfortable with the credit of the indemnitor. In other circumstances, the buyer may seek an indemnity (or guaranty of an indemnity) from an affiliate (for example, an individual who is the sole shareholder of a thinly capitalized holding company). For other ways of dealing with an indemnitor whose credit is questionable, see the Comment to Section 11.8.

The persons indemnified may include virtually everyone on the buyer's side of the acquisition, including directors, officers, and shareholders who may become defendants in litigation involving the acquired business or the assets or who may suffer a loss resulting from their association with problems at the acquired business. It may be appropriate to include fiduciaries of the buyer's employee benefit plans if such plans have played a role in the acquisition, such as when an employee stock ownership plan participates in a leveraged buyout. These persons are not, however, expressly made third-party beneficiaries of the indemnification provisions, which may therefore be read as giving the buyer a contractual right to cause the seller to indemnify such persons, and Section 13.9 provides that no third-party rights are created by the acquisition agreement. Creation of third-party beneficiary status may prevent the buyer from amending the indemnification provisions or compromising claims for indemnification without obtaining the consent of the third-party beneficiaries.

The scope of damage awards is a matter of state law. The definition of "Damages" in the Model Agreement is very broad and includes, among other things, "diminution of value" and other losses unrelated to third-party claims. Moreover, the definition of "Damages" does not exclude incidental, consequential or punitive damages, thereby reserving to the buyer a claim for these damages in an indemnification dispute. A seller may seek to narrow the definition. *See* Glenn D. West and Sara G. Duran, *Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements*, 63 Bus. Law. 777 (May 2008). A seller may also seek to include "lost shareholder premium" in Damages for the purposes of claims by seller. See the Comment to Section 13.9 *infra*.

The common law definition of the term "indemnification" describes a restitutionary cause of action in which a plaintiff sues a defendant for reimbursement of payments made by the plaintiff to a third party. A court may hold, therefore, that a

drafter's unadorned use of the term "indemnification" (usually coupled with "and hold harmless") refers only to compensation for losses due to third-party claims. *See Pacific Gas & Electric Co. v. G. W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 646 n.9 (Cal. 1968) (indemnity clause in a contract ambiguous on the issue; failure to admit extrinsic evidence on the point was error); *see also Mesa Sand & Gravel Co. v. Landfill, Inc.*, 759 P.2d 757, 760 (Colo. Ct. App. 1988), *rev'd in part on other grounds*, 776 P.2d 362 (Colo. 1989) (indemnification clause covers only payments made to third parties). *But see Atari Corp. v. Ernst & Whinney*, 981 F.2d 1025, 1031 (9th Cir. 1992) (limiting *Pacific Gas & Electric* and relying on Black's Law Dictionary; the term "indemnification" is not limited to repayment of amounts expended on third party claims); *Edward E. Gillen Co. v. U.S.*, 825 F.2d 1155, 1157 (7th Cir. 1987) (same). Modern usage and practice have redefined the term "indemnification" in the acquisition context to refer to compensation for all losses and expenses, from any source, caused by a breach of the acquisition agreement (or other specified events). The courts presumably will respect express contract language that incorporates the broader meaning. In Section 11.2 of the Model Agreement, the express language that a third-party claim is not required makes the parties' intent unequivocally clear that compensable damages may exist absent a third-party claim and if no payment has been made by the Buyer to any person.

The amount to be indemnified is generally the dollar value of the out-of-pocket payment or loss. That amount may not fully compensate the buyer, however, if the loss relates to an item that was the basis of a pricing multiple. For example, if the buyer agreed to pay $10,000,000, which represented five times earnings, but it was discovered after the closing that annual earnings were overstated by $200,000 because inventories were overstated by that amount, indemnification of $200,000 for the inventory shortage would not reimburse the buyer fully for its $1,000,000 overpayment. The acquisition agreement could specify the basis for the calculation of the purchase price (which may be hotly contested by the seller) and provide specifically for indemnification for overpayments based on that pricing methodology. The buyer should proceed cautiously in this area, since the corollary to the argument that it is entitled to indemnification based on a multiple of earnings is that any matter that affects the balance sheet but not the earnings statement (for example, fixed asset valuation) should not be indemnified at all. Furthermore, raising the subject in negotiations may lead to an express provision excluding the possibility of determining damages on this basis. The inclusion of diminution of value as an element of damages gives the buyer flexibility to seek recovery on this basis without an express statement of its pricing methodology.

The seller often argues that the appropriate measure of damages is the amount of the buyer's out-of-pocket payment, less any tax benefit that the buyer receives as a result of the loss, liability, or expense. If this approach is accepted, the logical extension is to include in the measure of damages the tax cost to the buyer of receiving the indemnification payment (including tax costs resulting from a reduction in basis, and the resulting reduction in depreciation and amortization or increase in gain recognized on a sale, if the indemnification payment is treated as an adjustment of purchase price). The resulting provisions, and the impact on the buyer's administration of its tax affairs, are highly complex and the entire issue of adjustment for tax benefits and costs is often omitted to avoid this complexity. The seller may also insist that the acquisition agreement explicitly state that damages will be net of any insurance proceeds or payments from any other responsible parties. If the buyer is willing to accept such a limitation, it should be careful to ensure that it is compensated for any cost it incurs due to insurance or other

third-party recoveries, including those that may result from retrospective premium adjustments, experience-based premium adjustments, and indemnification obligations.

An aggressive seller may also seek to reduce the damages to which the buyer is entitled by any so-called "found assets" (assets of the seller not reflected on its financial statements). The problems inherent in valuing such assets and in determining whether they add to the value to the seller in a way not already taken into account in the purchase price lead most buyers to reject any such proposal.

Occasionally, a buyer insists that damages include interest from the date the buyer first is required to pay any expense through the date the indemnification payment is received. Such a provision may be appropriate if the buyer expects to incur substantial expenses before the buyer's right to indemnification has been established, and also lessens the seller's incentive to dispute the claim for purposes of delay.

If the acquisition agreement contains post-closing adjustment mechanisms, the seller should ensure that the indemnification provisions do not require the seller and the shareholders to compensate the buyer for matters already rectified in the post-closing adjustment process. This can be done by providing that the damages subject to indemnification shall be reduced by the amount of any corresponding post-closing purchase price reduction.

Generally, indemnification is not available for claims made that later prove to be groundless. Thus, the buyer could incur substantial expenses in investigating and litigating a claim without being able to obtain indemnification. In this respect, the indemnification provisions of the Model Agreement, and most acquisition agreements, provide less protection than indemnities given in other situations such as securities underwriting agreements.

One method of providing additional, if desired, protection for the buyer would be to insert "defend," immediately before "indemnify" in the first line of Section 11.2. Some attorneys would also include any allegation, for example, of a breach of a representation as a basis for invoking the seller's indemnification obligations. Note the use of "alleged" in Section 11.2(d). "Defend" has not been included in the first line of Section 11.2 for several reasons: (i) Sections 11.2, 11.3 and 11.4 address the monetary allocation of risk; (ii) Section 11.9 deals specifically with the procedures for handling the defense of Third Party Claims; and (iii) perhaps most importantly, the buyer does not always want the seller to be responsible for the actual defense of a third party claim, as distinguished from the issue of who bears the cost of defense. Note that Section 11.10 provides that a claim for indemnification not involving a third party claim must be paid promptly by the party from whom indemnification is sought.

The Model Stock Purchase Agreement uses the term "Loss" instead of "Damages," and defines and explains "Loss" as follows in Article I:

> "Loss"—any cost, loss, liability, obligation, claim, cause of action, damage, deficiency, expense (including costs of investigation and defense and reasonable attorneys' fees and expenses), fine, penalty, judgment, award, assessment, or diminution of value.

COMMENT

The term "Loss" is used instead of the term "Damages" to avoid judicial construction that the term includes a requirement that the Loss arise from a breach of duty. *See* The Hartz Consumer Group, Inc. v. JWC Hartz Holdings, Inc., Index No. 600610/03 (N.Y. Sup. Ct. Oct. 27, 2005), *aff'd*, 33 A.D.3d 555 (N.Y. App. Div. 2006). The definition of "Loss" sets forth a broad range of matters that connote harm to a Person; limitations as to how a Loss may arise in a given context are left to the provisions that use the defined term.

See commentary to Section 11.2.

The reasons for the use of the term "Loss" in the Model Stock Purchase Agreement are further explained in the Comment to Section 11.2 of the Model Stock Purchase Agreement as follows:

DEFINITION OF LOSS

COMMENT

Loss. The definition of "Loss" set forth in Section 1.1 is very broad and includes, among other things, losses unrelated to third-party claims. However, the common law definition of the term "indemnification" describes a restitutionary cause of action in which a plaintiff sues a defendant for reimbursement of payments made by the plaintiff to a third party. A court may hold, therefore, that a drafter's unadorned use of the term "indemnify" (usually coupled with "and hold harmless") refers only to compensation for losses due to third-party claims. *See Pacific Gas & Electric Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641 (Cal. 1968) (indemnity clause in a contract ambiguous on the issue; failure to admit extrinsic evidence on the point was error); *see also Mesa Sand & Gravel Co. v. Landfill*, 759 P.2d 757 (Colo. Ct. App. 1988), *rev'd in part on other grounds*, 776 P.2d 362 (Colo. 1989) (indemnification clause covers only payments made to third parties). But see *Atari Corp. v. Ernst & Whinney*, 981 F.2d 1025 (9th Cir. 1992) (limiting *Pacific Gas & Electric* and relying on Black's Law Dictionary; the term "indemnification" is not limited to repayment of amounts expended on third-party claims); *Edward E. Gillen Co. v. U.S.*, 825 F.2d 1155 (7th Cir. 1987). Modern usage and practice have redefined the term "indemnification" in the acquisition context to refer to compensation for all losses and expenses, regardless of source, caused by a breach of the acquisition agreement (or other specified events). The courts should respect express contract language that incorporates the broader meaning.

The Model Agreement also includes the requirement of Sellers to "pay" and "reimburse" Buyer Indemnified Persons. Reference to payment and reimbursement is intended to further avoid potentially troublesome case law regarding the implications of narrowly defining the word "indemnify."

The Model Agreement does not expressly include interest within the definition of Loss. Buyer may provide that damages include interest from the date Buyer first is required to pay any expense through the date the indemnification payment is received. Such a provision may be appropriate if Buyer expects to incur substantial expenses before Buyer's right to indemnification has been established and also lessens Sellers' incentive to dispute the claim for purposes of delay. If any indemnification is fully litigated to a judgment, state law may provide for pre-judgment interest in any event.

The amount to be indemnified is generally the dollar value of the out-of-pocket payment or loss. That amount may not fully compensate Buyer, however, if the loss relates to an item that was the basis of a pricing multiple.

For example, if Buyer agreed to pay $10 million, which represented five times the target's earnings for the prior year, but it was discovered after the closing that annual earnings were overstated by $200,000, indemnification of $200,000 would not reimburse Buyer fully for its $1 million overpayment. The Model Agreement could specify the basis for the calculation of the purchase price (which may be vigorously contested by Sellers) and provide specifically for indemnification for overpayments based on that pricing methodology. Buyer should proceed cautiously in this area, since the corollary to the argument that it is entitled to indemnification based on a multiple of earnings is that any matter that affects the balance sheet, but not the earnings statement (for example, fixed asset valuation), should not be indemnified at all. Furthermore, raising the subject in negotiations may lead to an express provision excluding the possibility of determining damages on this basis. The inclusion of diminution in value as an element of damages gives a buyer flexibility to seek recovery on this basis without an express statement of its pricing methodology. In *Cobalt Operating, LLC v. James Crystal Enterprises, Inc.*, 2007 WL 2142926 (Del. Ch. 2007), *aff'd*, 945 A.2d 594 (Del. 2008), the court looked very carefully at a claim based on a deficiency in represented cash flow and awarded a multiple. *See* KLING & NUGENT § 15.02[3].

Duty to Mitigate. The duty to mitigate is a principle of contract law requiring that a party exert reasonable efforts to minimize losses. RESTATEMENT (SECOND) OF CONTRACTS § 350; 11 CORBIN ON CONTRACTS § 57.11. While this principle is generally referred to as a duty, it is really a means by which a party breaching a contract can invoke a failure to mitigate as a defense to reduce the damages for which it otherwise might be liable. For example, in *Vigortone AG Products, Inc. v. AG Products, Inc.*, 316 F.3d 641 (7th Cir. 2002), the court considered charges of fraud and breach of contract in the sale of a business. It appeared to the court that the buyer could have averted most of the loss by hedging contracts that it had inherited, in which case it would not be entitled to recover damages that it could readily have avoided. The decision of the lower court was reversed and this matter was left to be dealt with on remand.

SELLERS' RESPONSE

Loss. The definition of "Loss" may be found by Sellers to be exceedingly broad. Sellers can argue that "costs of investigation" should not be an element of damages, except perhaps in response to a Third-Party Claim. Sellers can object to being put in a position of financing a voluntary investigation by Buyer (a "fishing expedition") to find fault in order to make the case against Sellers, as opposed to some legally mandated investigation (for example, in the case of an environmental matter where there is an indication of a spill or discharge that Buyer is legally obligated to investigate).

Sellers may assert that incidental or consequential damages should be expressly excluded, as should punitive damages. It is one thing for Buyer to be entitled to compensatory or actual damages (i.e., damages that flow directly and immediately from the breach,) but any damages other than compensatory damages are speculative and remote and will encourage contention between Buyer and Sellers. *See* West & Duran, *Reassessing the Consequences of "Consequential" Damage Waivers in Acquisition Agreements*, 63 BUS. LAW. 777 (2008).

The inclusion of "reasonable attorneys' fees and expenses" may also be objectionable to Sellers, except perhaps in connection with the defense of a third-party action against Buyer. Sellers can argue that a well-financed Buyer could intimidate or take advantage of weaker Sellers by holding over their heads the threat of massive legal fees. Moreover, as in the case of expenses of investigation, Sellers would have the same objection to attorneys' fees that Buyer might incur in investigating nonthird-party claims and in developing the case against Sellers.

Sellers are likely to resist inclusion of "diminution of value" precisely to preclude a multiple-of-earnings theory. Sellers could argue that they have no control or influence on how Buyer makes its price determination, and that, if it were to have been the subject of open negotiations, Sellers would never have agreed to it.

Reduction by Tax Benefit and Insurance. Sellers often argue that the appropriate measure of damages is the amount of Buyer's out-of-pocket payment, less any tax benefit that Buyer receives as a result of the loss, liability, or expense. If this approach is accepted, the logical extension is to include in the measure of damages the tax cost to Buyer of receiving the indemnification payment (including tax costs resulting from a reduction in basis, and the resulting reduction in depreciation and amortization or increase in gain recognized on a sale, if the indemnification payment is treated as an adjustment of purchase price). These tax provisions are often highly complex and dependent on Buyer's particular tax status and administration of its tax affairs. Consequently, the entire issue of offsets against indemnification for tax benefits is often omitted.

Sellers may also argue that the Model Agreement should explicitly state that damages will be net of any insurance proceeds or payments from any other responsible parties. If Buyer is willing to accept such a limitation on the amount of its indemnification recovery, it may wish to consider seeking to be compensated for any cost it incurs due to its efforts to obtain insurance or other third-party recoveries, including those that may result from retrospective premium adjustments, experience-based premium adjustments, and indemnification obligations. Including insurance raises timing issues since insurance payments are often delayed, and are frequently subject to negotiations and disputes with the insurance carriers. *See* KLING & NUGENT § 15.03[2].

Purchase Price Adjustment. The Model Agreement contains a purchase price adjustment mechanism in Sections 2.5 and 2.6. Sellers will often request a provision to the effect that the indemnification provisions do not require Sellers to compensate Buyer for matters already taken into account through the post-closing adjustment mechanism provided for elsewhere in the Agreement. This can be done by providing that the losses subject to indemnification for a matter that was also the subject of a post-closing adjustment are reduced by the amount of the corresponding purchase price reduction. *See* commentary to Section 2.5.

11.3 INDEMNIFICATION AND REIMBURSEMENT BY SELLER — ENVIRONMENTAL MATTERS

In addition to the other indemnification provisions in this Article 11, Seller and each Shareholder, jointly and severally, will indemnify and hold harmless Buyer and the other Buyer Indemnified Persons, and will reimburse Buyer and the other Buyer Indemnified Persons, for any Damages (including costs of cleanup, containment, or other remediation) arising from or in connection with:

(a) any Environmental, Health and Safety Liabilities arising out of or relating to: (i) the ownership or operation by any Person at any time on or prior to the Closing Date of any of the Facilities, Assets, or the business of Seller, or (ii) any Hazardous Materials or other contaminants that were present on the Facilities or Assets at any time on or prior to the Closing Date; or

(b) any bodily injury (including illness, disability and death, and regardless of when any such bodily injury occurred, was incurred, or manifested itself), personal injury, property damage (including trespass, nuisance, wrongful eviction, and deprivation of the use of real property), or other damage of or to any Person or any Assets in any way arising from or allegedly arising from any Hazardous Activity conducted by any Person with respect to the business of Seller or the Assets prior to the Closing Date, or from any Hazardous Material that was (i) present or suspected to be present on or before the Closing Date on or at the Facilities (or present or suspected to be present on any other property, if such Hazardous Material emanated or allegedly emanated from any Facility and was present or suspected to be present on any Facility on or prior to the Closing Date) or Released or allegedly Released by any Person on or at any Facilities or Assets at any time on or prior to the Closing Date.

Buyer will be entitled to control any Remedial Action, any Proceeding relating to an Environmental Claim, and, except as provided in the following sentence, any other Proceeding with respect to which indemnity may be sought under this Section 11.3. The procedure described in Section 11.9 will apply to any claim solely for monetary damages relating to a matter covered by this Section 11.3.

COMMENT

It is not unusual for an asset purchase agreement to contain indemnities for specific matters that are disclosed by the seller and, therefore, would not be covered by an indemnification limited to breaches of representations (such as a disclosed pending litigation) or that represent an allocation of risks for matters not known to either party. The Section 11.3 provision for indemnification for environmental matters is an example of this type of indemnity, and supplements and overlaps the indemnification provided in Section 11.2(a), which addresses inaccuracies in or inconsistencies with the Seller's representations (including those pertaining to the environment in Section 3.22).

There are several reasons why a buyer may seek to include separate indemnification for environmental matters instead of relying on the general indemnification based on the seller's representations. Environmental matters are often the subject of a risk allocation agreement with respect to unknown and unknowable liabilities, and sellers who are willing to assume those risks may nevertheless be reluctant to make representations concerning factual matters of which they can not possibly have knowledge. An indemnification obligation that goes beyond the scope of the representation implements such an agreement. In addition, the nature of, and the potential for disruption arising from, environmental clean up activities often leads the buyer to seek different procedures for handling claims with respect to environmental matters. A buyer will often feel a greater need to control the clean up and related proceedings than it will to control other types of litigation. Finally, whereas indemnification with respect to representations regarding compliance with laws typically relates to laws in effect as of the closing, environmental indemnification provisions such as that in Section 11.3 impose an indemnification obligation with respect to Environmental, Health and Safety Liabilities, the definition of which in Section 1.1 is broad enough to cover liabilities under not only existing, but future, Environmental Laws.

The seller may object to indemnification obligations regarding future environmental laws and concomitant liabilities arising from common law decisions interpreting such laws. From the buyer's perspective, however, such indemnification is needed to account for strict liability statutes such as CERCLA that impose liability retroactively. The seller may insist that the indemnification clearly be limited to existing or prior laws.

The effectiveness of contractual provisions such as indemnification in protecting the buyer against environmental liabilities is difficult to evaluate. Such liabilities may be discovered at any time in the future and are not cut off by any statute of limitations that refers to the date of release of hazardous materials. In contrast, a contractual provision may have an express temporal limitation, and in any event should be expected to decrease in usefulness over time as parties go out of existence or become difficult to locate (especially when the shareholders are individuals). The buyer may be reluctant to assume that the shareholders will be available and have adequate resources to meet an obligation that matures several years after the acquisition. In addition, environmental liabilities may

be asserted by governmental agencies and third parties, which are not bound by the acquisition agreement and are not bound to pursue only the indemnitor.

It is often difficult to assess the economic adequacy of an environmental indemnity. Even with an environmental audit, estimates of the cost of remediation or compliance may prove to be considerably understated years later when the process is completed, and the shareholders' financial ability to meet that obligation at that time cannot be assured. These limitations on the usefulness of indemnification provisions may lead, as a practical matter, to the negotiation of a price reduction, environmental insurance or an increased escrow of funds or letter of credit to meet indemnification obligations, in conjunction with some limitation on the breadth of the provisions themselves. Often, the amount of monies saved by the buyer at the time of the closing will be far more certain than the amount it may receive years later under an indemnification provision.

Despite some authority to the effect that indemnity agreements between potentially responsible parties under CERCLA are unenforceable (*see CPC Int'l, Inc. v. Aerojet-General Corp.*, 759 F. Supp. 1269 (W.D. Mich. 1991); *AM Int'l Inc. v. International Forging Equip.*, 743 F. Supp. 525 (N.D. Ohio 1990)), it seems settled that Section 107(e)(1) of CERCLA (42 U.S.C. Section 9607(e)(1)) expressly allows the contractual allocation of environmental liabilities between potentially responsible parties, and such an indemnification provision would thus be enforceable between the buyer and the seller. *See*, *e.g.*, *Smith Land & Improvement Corp. v. Celotex Corp.*, 851 F.2d 86 (3rd Cir.1988), *cert. denied*, 488 U.S. 1029 (1989); *Mardan Corp. v. CGC Music, Ltd.*, 804 F.2d 1454 (9th Cir. 1986); Parker and Savich, *Contractual Efforts to Allocate the Risk of Environmental Liability: Is There a Way to Make Indemnities Worth More Than the Paper They Are Written On?*, 44 Sw. L.J. 1349 (1991). Section 107(e)(1) of CERCLA, however, bars such a contractual allocation between parties from limiting the rights of the government or any third parties to seek redress from either of the contracting parties.

One consequence of treating an unknown risk through an indemnity instead of a representation is that the buyer may be required to proceed with the acquisition even if a basis for the liability in question is discovered prior to the closing, because the existence of a liability subject to indemnification will not by itself cause a failure of the condition specified in Section 7.1. The representations in Section 3.22 substantially overlap this indemnity in order to avoid that consequence.

The issue of control of cleanup and other environmental matters is often controversial. The buyer may argue for control based upon the unusually great potential that these matters have for interference with business operations. The seller may argue for control based upon its financial responsibility under the indemnification provision.

If the seller and the shareholders are unwilling to commit to such broad indemnification provisions, or if the buyer is not satisfied with such provisions because of specific environmental risks that are disclosed or become known through the due diligence process or are to be anticipated from the nature of the seller's business, several alternatives exist for resolving the risk allocation problems that may arise. For example, the seller may ultimately agree to a reduction in the purchase price in return for deletion or limitation of its indemnification obligations.

The seller and the shareholders are likely to have several concerns with the indemnification provisions in Section 11.3. Many of these concerns are discussed in the comments to Section 3.22, such as the indemnification for third-party actions and with respect to substances that may be considered hazardous in the future or with respect to future environmental laws. The seller and the shareholders may also be interested in having the buyer indemnify them for liabilities arising from the operation of the seller's business after the closing, although they may find it difficult to articulate the basis on which they may have liability for these matters.

Although representations and indemnification provisions address many environmental issues, it is typical for the buyer to undertake an environmental due diligence process prior to acquiring any interest from the seller. See the Comment to Section 7.10.

11.4 INDEMNIFICATION AND REIMBURSEMENT BY BUYER

Buyer will indemnify and hold harmless Seller, and will reimburse Seller, for any Damages arising from or in connection with:

(a) any Breach of any representation or warranty made by Buyer in this Agreement or in any certificate, document, writing or instrument delivered by Buyer pursuant to this Agreement;

(b) any Breach of any covenant or obligation of Buyer in this Agreement or in any other certificate, document, writing or instrument delivered by Buyer pursuant to this Agreement;

(c) any claim by any Person for brokerage or finder's fees or commissions or similar payments based upon any agreement or understanding alleged to have been made by such Person with Buyer (or any Person acting on Buyer's behalf) in connection with any of the Contemplated Transactions;

(d) any obligations of Buyer with respect to bargaining with the collective bargaining representatives of Active Hired Employees subsequent to the Closing; or

(e) any Assumed Liabilities.

COMMENT

In general, the indemnification by the buyer is similar to that by the seller. The significance of the buyer's indemnity will depend to a large extent on the type of consideration being paid and, as a result, on the breadth of the buyer's representations. If the consideration paid to a seller is equity securities of the buyer, the seller may seek broad representations and indemnification comparable to that given by the seller, including indemnification that covers specific known problems. In all cash transactions, however, the buyer's representations are usually minimal and the buyer generally runs little risk of liability for post-closing indemnification. It is not unusual for the buyer's first draft to omit this provision entirely.

A seller might request that the acquisition agreement contain an analogue to Section 11.2(c) to allocate the risk of post-closing operations more clearly to the buyer. Such a provision could read as follows:

> "(c) Any Liability arising out of the ownership or operation of the Assets after the Closing Date other than the Retained Liabilities."

In the event that a buyer wrongfully terminates the purchase agreement or refuses to close, the buyer could be liable under Section 11.4 of the Model Agreement and under common law for breach of contract. *Rus, Inc. v. Bay Industries, Inc. and SAC, Inc.*, 2004 WL 1240578 (S.D.N.Y. May 25, 2004), was a breach of contract action arising out of the proposed sale by Rus. Inc. ("*Seller*") of a wholly owned subsidiary to Bay Industries, Inc. ("*Buyer*") and SAC, Inc. (Buyer's newco acquisition subsidiary) pursuant to a stock purchase agreement they entered into on January 29, 2001. Buyer refused to close the sale on the grounds that certain conditions to closing enumerated in the purchase agreement had not been satisfied by the Seller. Seller brought a breach of contract action, asserting that in fact all purchase agreement conditions to the closing had been fulfilled and seeking money damages from the Buyer for its failure to close pursuant to the purchase agreement. In a lengthy and detailed factual analysis in which the Court weighed the testimony of expert and party witnesses, the Court concluded that these closing conditions had been satisfied and that the real reason for the Buyer's decision to walk was Buyer's remorse – concern on the Buyer's part that it had over-extended itself financially and that it had made a bad deal. The Court found that the Buyer had breached the contract and awarded substantial damages to the Seller. The *Rus* case is interesting both for (i) its focus on the contemporaneous actions of the parties in weighing the materiality of the developments and the reasonableness of the actions in response and (ii) its analysis in calculating the damages awarded to Seller to compensate it for Buyer's breach of contract.

In *Russ* the two purchase agreement conditions to closing that were relied upon by Buyer in aborting the transaction were receipt of (1) a satisfactory Phase I environmental report and (2) two landlord consents. As to the Phase I environmental report, the purchase agreement only required that the report be delivered, which happened, and that "Buyer shall be *reasonably satisfied* therewith," which was the issue. The Court held that "*reasonably satisfied*" required that Buyer act in "good faith" in evaluating the issues raised by the report. After weighing testimony and noting that that (i) Seller had agreed to pay the cost of remediation, which was nominal in view of the size of the transaction and could have been completed prior to closing if Buyer had not agreed to postpone the work until after closing, (ii) there was no evidence of any material environmental liabilities or any governmental enforcement action, and (iii) the parties, their consultants and counsel did not act as if the environmental issues identified in the report were serious until Buyer decided to abort the deal, the Court found that the environmental issues were trivial and that Buyer was not acting in good faith and reasonably in refusing to close on the basis thereof.

As to the landlord consents, the Court found that (a) the landlords had initially declined to consent because Buyer's credit was not as good as Seller's, (b) after Seller had agreed to guarantee Buyer's leasehold obligations, the landlords agreed to consent, and (c) Buyer knew the written consents would be forthcoming when it declined to close. Thus, the Court found the landlord consents were no justification for Buyer not closing.

Finally, Buyer argued that the target's financial condition was deteriorating such that there had been a "material adverse change" that would entitle Buyer to abort the deal in accordance with the purchase agreement. The Court, noting that the Buyer was a strategic buyer whose owner testified that "short-term swings in profits" were not particularly significant as Buyer was focused on "long-term synergies" and that the material adverse change ground appeared to be an afterthought defense, found that the financial change concerns were little more than "buyer's remorse" and that Buyer's "belated effort…to renegotiate the purchase price further bolsters this conclusion, indicating [Buyer's] belief that it had agreed to too high a price."

On the issue of damages, the Court held that "[u]nder New York law, the measure of damages for the breach of a contract of sale is the difference between the contract price and the fair market value of the item or property being sold at the time of the breach…Fair market value means the price that a willing buyer would pay a willing seller in a fair transaction." The Court found that business had been seriously damaged as a result of its aborted sale, noting testimony to the effect that "sales suffered because employees were 'demotivated' and distracted by the uncertainty surrounding the pending transition in ownership….[the business] lost key personnel…and [c]ompetitors took advantage to make inroads into [its] customer base." At the time of trial Seller had been unable to find another purchaser for the business, and argued that the damages should be equal to the difference between the purchase price and the liquidation value of the assets of the business. The Court found that Seller's inability to find a purchaser by the time of trial did not mean that the business had no going concern value. The Court ultimately found that the value of the business was 50% above its liquidation value, and awarded damages equal to the difference between that value and what Seller would have received if Buyer had performed under the purchase agreement.

11.5 LIMITATIONS ON AMOUNT — SELLER AND SHAREHOLDERS

Seller and Shareholders shall have no liability (for indemnification or otherwise) with respect to claims under Section 11.2(a) until the total of all Damages with respect to such matters exceeds $_____, and then only for the amount by which such Damages exceed $_____. However, this Section 11.5 will not apply to claims under Section 11.2(b) through (i) or to matters arising in respect of Sections 3.9, 3.11, 3.14, 3.22, 3.29, 3.30, 3.31 or 3.32 or to any Breach of any of Seller's and Shareholders' representations and warranties of which the Seller had Knowledge at any time prior to the date on which such representation and warranty is made or any intentional Breach by Seller or either Shareholder of any covenant or obligation, and Seller and the Shareholders will be jointly and severally liable for all Damages with respect to such Breaches.

COMMENT

Section 11.5 provides the Seller and the Shareholders with a safety net, or "basket," with respect to specified categories of indemnification but does not establish a ceiling, or "cap." The basket is a minimum amount that must be exceeded before any indemnification is owed — in effect, it is a deductible. The purpose of the basket or deductible is to recognize that representations concerning an ongoing business are unlikely to be perfectly accurate and to avoid disputes over insignificant amounts. In addition, the buyer can point to the basket as a reason why specific representations do not need materiality qualifications.

A more aggressive buyer may wish to provide for a "threshold" deductible (sometimes called a "tipping basket") that, once crossed, entitles the indemnified party to recover all damages, rather than merely the excess over the basket. This "threshold" alternative is illustrated by Section 11.6(a) of the Model Stock Purchase Agreement which provides in relevant part as follows:

> (a) If the Closing occurs, Sellers shall have no liability with respect to claims under Section 11.2(a) until the aggregate of all Losses suffered by all Buyer Indemnified Persons with respect to such claims exceeds $_____; provided, however, that if the aggregate of all such Losses exceeds $_____, Sellers shall be liable for all such Losses.

In the Model Agreement, the Seller's and Shareholders' representations are generally not subject to materiality qualifications, and the full dollar amount of damages caused by a breach must be indemnified, subject to the effect of the basket established by this Section. This framework avoids "double-dipping" — that is, the situation in which a seller contends that the breach exists only to the extent that it is material, and then the material breach is subjected to the deduction of the basket. If the acquisition agreement contains materiality qualifications to the seller's representations, the buyer should consider a provision to the effect that such a materiality qualification will not be taken into account in determining the magnitude of the damages occasioned by the breach for purposes of calculating whether they are applied to the basket; otherwise, the immaterial items may be material in the aggregate, but not applied to the basket. Another approach would involve the use of a provision such as the following:

> If Buyer would have a claim for indemnification under Sections 11.2(a) [and others] if the representation and warranty [and others] to which the claim relates did not include a materiality qualification and the aggregate amount of all such claims exceeds $__X__, then the Buyer shall be entitled to indemnification for the amount of such claims in excess of $__X__ in the aggregate (subject to the limitations on amount in Section 11.5) notwithstanding the inclusion of a materiality qualification in the relevant provisions of this Agreement.

A buyer will usually want the seller's and the shareholders' indemnity obligation for certain matters, such as the retained liabilities, to be absolute or "first dollar" and not subject to the basket. For example, the buyer may insist that the seller pay all tax liabilities from a pre-closing period or the damages resulting from a disclosed lawsuit without regard to the basket. Section 11.5 lists a number of Sections to which the basket would not apply, including title, labor and environmental matters. The parties also may negotiate different baskets for different types of liabilities; the buyer should consider the aggregate effect of those baskets.

The shareholders may also seek to provide for a maximum indemnifiable amount. The shareholders' argument for such a provision is that they had limited liability as shareholders and should be in no worse position with the seller having sold the assets than they were in before the seller sold the assets; this argument may not be persuasive to a buyer that views the assets as a component of its overall business strategy or intends to invest additional capital. If a maximum amount is established, it usually does not apply to liabilities for taxes, environmental matters, or ERISA matters — for which the buyer

may have liability under applicable law — or defects in the ownership of the Assets. The parties may also negotiate separate limits for different kinds of liabilities.

Often, baskets and thresholds do not apply to breaches of representations of which the seller had knowledge or a willful failure by the seller to comply with a covenant or obligation — the rationale is that the seller should not be allowed to reduce the purchase price or the amount of the basket or threshold by behavior that is less than forthright. Similarly, the buyer will argue that any limitation as to the maximum amount should not apply to a seller that engages in intentional wrongdoing.

The basket in Section 11.5 only applies to claims under Section 11.2(a), which provides for indemnification for breaches of representations and warranties. The basket does not apply to any other indemnification provided in Section 11.2 (*e.g.*, breaches of obligations to deliver all of the Assets as promised or from Seller's failure to satisfy retained liabilities) or 11.3 (environmental matters). This distinction is necessary to protect the buyer from net asset shortfalls that would otherwise preclude the buyer from receiving the net assets for which it bargained.

The Model Stock Purchase Agreement adds the words "if the Closing occurs" to its cap provision to make it clear that caps and baskets are inapplicable to a claim against sellers for a breach of their representations if the acquisition fails to close.

In *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006), which is discussed further in the Comment to Section 13.7, the Delaware Chancery Court held that a contractual damage cap would not be enforced to limit a rescission claim where the buyer could prove intentional false statements in representations set forth in the purchase agreement.

In *Ameristar Casinos, Inc. v. Resorts International, Inc.*, C.A. No. 3685-VCS (Del.Ch. May 11, 2010), an indemnity cap provision said that it was inapplicable "in the event of fraud or any willful breach of the representation" and plaintiff claimed a willful breach of the tax representation because defendant had received notice of a 248% increase in the ad valorem tax valuation of defendant's principal asset – a casino – which would inevitably lead to a substantial increase in the ad valorem taxes on it, and the Court found this was sufficient pleading of both actual fraud and willful breach of representations so as to avoid the indemnity cap for purposes of denial of a motion to dismiss.

11.6 LIMITATIONS ON AMOUNT – BUYER

Buyer will have no liability (for indemnification or otherwise) with respect to claims under Section 11.4(a) until the total of all Damages with respect to such matters exceeds $_____, and then only for the amount by which such Damages exceed $_____. However, this Section 11.6 will not apply to claims under Section 11.4(b) through (e) or matters arising in respect of Section 4.4 or to any Breach of any of Buyer's representations and warranties of which Buyer had Knowledge at any time prior to the date on which such representation and warranty is made or any intentional Breach by Buyer of any covenant or obligation, and Buyer will be liable for all Damages with respect to such Breaches.

COMMENT

In its first draft, the buyer will usually suggest a basket below which it is not required to respond in damages for breaches of its representations, typically the same dollar amount as that used for the seller's basket.

11.7 TIME LIMITATIONS

(a) If the Closing occurs, Seller and Shareholders will have liability (for indemnification or otherwise) with respect to any Breach of (i) a covenant or obligation to be performed or complied with prior to the Closing Date (other than those in Sections 2.1 and 2.4(b) and Articles 10 and 12, as to which a claim may be made at any time) or (ii) a representation or warranty (other than those in Sections 3.9, 3.14, 3.16, 3.22, 3.29, 3.30, 3.31 and 3.32 as to which a claim may be made at any time), but only if on or before _____, 20__ Buyer notifies Seller or Shareholders of a claim specifying the factual basis of the claim in reasonable detail to the extent then known by Buyer.

(b) If the Closing occurs, Buyer will have liability (for indemnification or otherwise) with respect to any Breach of (i) a covenant or obligation to be performed or complied with prior to the Closing Date (other than those in Article 12, as to which a claim may be made at any time) or (ii) a representation or warranty (other than that set forth in Section 4.4, as to which a claim may be made at any time), but only if on or before _____, 20__ Seller or Shareholders notify Buyer of a claim specifying the factual basis of the claim in reasonable detail to the extent then known by Seller or Shareholders.

COMMENT

It is common for an acquisition agreement to specify the time period within which a claim for indemnification must be made. The seller and its shareholders want to have uncertainty eliminated after a period of time, and the buyer wants to have a reasonable opportunity to discover any basis for indemnification. The time period will vary depending on factors such as the type of business, the adequacy of financial statements, the buyer's plans for retaining existing management, the buyer's ability to perform a thorough investigation prior to the acquisition, the method of determination of the purchase price, and the relative bargaining strength of the parties. A two-year period may be sufficient for most liabilities because it will permit at least one post-closing annual audit and because, as a practical matter, many hidden liabilities will be uncovered within two years. However, an extended or unlimited time period for title to assets, products liability, taxes, employment issues, and environmental issues is not unusual.

Section 11.7 provides that claims generally with respect to representations or covenants must be asserted by the buyer giving notice to seller and the shareholders (as contrasted with filing a lawsuit) within a specified time period known as a "survival" period, except with respect to identified representations or covenants as to which a claim may be made at any time. *See* Comment to Section 11.1 Survival for a discussion of the *Herring v. Teradyne, Inc.*, *Western Filter Corporation v. Argan, Inc.* and *GRT, Inc. v. Marathon GTF Technology, Ltd.* cases in which it was argued that acquisition agreement

wording that covenants, representations and warranties shall survive the Closing until the first anniversary of the Closing Date created a one year contractual statute of limitations requiring a claimant to file a lawsuit (not merely give notice asserting a claim) within the contractual limitation period. Unlike the Model Agreement, some purchase agreements provide that the failure to give timely notice of a claim will not bar the claim if the recipient is not prejudiced thereby. *See Schrader-Bridgeport Int'l, Inc. v Arvinmeritor, Inc.*, 2008 WL 977604 (W.D.N.C. 2008) ("While . . . the Stock Purchase Agreement requires the [buyer] to give the [seller] 'prompt written notice' of an indemnity claim, it also provides that the [buyer's] failure to give such notice 'within the time frame specified shall not release the [seller], in whole or in part, from its obligations hereunder except to the extent that the [seller's] ability to defend such claim is prejudiced thereby.'"; Court found that buyer had "alleged sufficient facts, which if taken as true, support its contention that the [seller] was not prejudiced by the [buyer's] untimely notice of its indemnity claims").

It is also possible to provide that a different (than the general) survival period will apply to other identified representations or covenants. Some attorneys request that representations which are fraudulently made survive indefinitely. It is also important to differentiate between covenants to be performed or complied with before and after closing.

The appropriate standard for some types of liabilities may be the period of time during which a private or governmental plaintiff could bring a claim for actions taken or circumstances existing prior to the closing. For example, indemnification for tax liabilities often extends for as long as the relevant statute of limitations for collection of the tax. If this approach is taken, the limitation should be drafted to include extensions of the statute of limitations (which are frequently granted in tax audits), situations in which there is no statute of limitations (such as those referred to in Section 6501(c) of the Code), and a brief period after expiration of the statute of limitations to permit a claim for indemnification to be made if the tax authorities act on the last possible day.

The seller's obligations with respect to retained liabilities should not be affected by any limitations on the time or amount of general indemnification payments.

The buyer should consider the relationship between the time periods within which a claim for indemnification may be made and the time periods for other post-closing transactions. For example, if there is an escrow, the buyer will want to have the escrow last until any significant claims for indemnification have been paid or finally adjudicated. Similarly, if part of the purchase price is to be paid by promissory note, or if there is to be an "earn-out" pursuant to which part of the consideration for the assets is based on future performance, the buyer will want to be able to offset claims for indemnification against any payments that it owes on the promissory note or earn-out (see Section 11.8).

In drafting time limitations, the buyer's counsel should consider whether they should apply only to claims for indemnification (see the Comment to Section 11.2).

11.8 RIGHT OF SET-OFF; ESCROW

Upon notice to Seller specifying in reasonable detail the basis therefor, Buyer may setoff any amount to which it may be entitled under this Article 11 against amounts otherwise payable

under the Promissory Note or may give notice of a claim in such amount under the Escrow Agreement. The exercise of such right of setoff by Buyer in good faith, whether or not ultimately determined to be justified, will not constitute an event of default under the Promissory Note or any instrument securing the Promissory Note. Neither the exercise of nor the failure to exercise such right of setoff or to give a notice of a claim under the Escrow Agreement will constitute an election of remedies or limit Buyer in any manner in the enforcement of any other remedies that may be available to it.

COMMENT

Regardless of the clarity of the acquisition agreement on the allocation of risk and the buyer's right of indemnification, the buyer may have difficulty enforcing the indemnity — especially against shareholders who are individuals — unless it places a portion of the purchase price in escrow, holds back a portion of the purchase price (often in the form of a promissory note, an earn-out, or payments under consulting or non-competition agreements) with a right of setoff, or obtains other security (such as a letter of credit) to secure performance of the seller's and the shareholders' indemnification obligations. These techniques shift bargaining power in post-closing disputes from the seller and the shareholders to the buyer and usually will be resisted by the seller.

An escrow provision may give the buyer the desired security, especially when there are several shareholders and the buyer will have difficulty in obtaining jurisdiction over the shareholders or in collecting on the indemnity without an escrow. Shareholders who are jointly and severally liable may also favor an escrow in order to ensure that other shareholders share in any indemnity payment. The amount and duration of the escrow will be determined by negotiation, based on the parties' analyses of the magnitude and probability of potential claims and the period of time during which they may be brought. The shareholders may insist that the size of the required escrow diminish in stages over time. The buyer should be careful that there is no implication that the escrow is the exclusive remedy for breaches and nonperformance, although a request for an escrow is often met with a suggestion by the shareholders that claims against the escrow be the buyer's exclusive remedy.

The buyer may also seek an express right of setoff against sums otherwise payable to the seller or the shareholders. The buyer obtains more protection from an express right of setoff against deferred purchase price payments due under a promissory note than from a deposit of the same amounts in an escrow because the former leaves the buyer in control of the funds, thus giving the buyer more leverage in resolving disputes with the seller. The buyer may also want to apply the setoff against payments under employment, consulting, or non-competition agreements (although state law may prohibit setoffs against payments due under employment agreements). The comfort received by the buyer from an express right of setoff depends on the schedule of the payments against which it can withhold. Even if the seller agrees to express setoff rights, the seller may attempt to prohibit setoffs prior to definitive resolution of a dispute and to preserve customary provisions that call for acceleration of any payments due by the buyer if the buyer wrongfully attempts setoff. Also, the seller may seek to require that the buyer exercise its setoff rights on a pro rata basis in proportion to the amounts due to each shareholder. If the promissory note is to be pledged to a bank, the bank as pledgee will likely resist setoff rights (especially because the inclusion of express setoff rights will

make the promissory note non-negotiable). As in the case of an escrow, the suggestion of an express right of setoff often leads to discussions of exclusive remedies.

The buyer may wish to expressly provide that the setoff applies to the amounts (principal and interest) first coming due under the promissory note. This is obviously more advantageous to the buyer from a cash flow standpoint. The seller will prefer that the setoff apply to the principal of the promissory note in the inverse order of maturity. This also raises the question of whether the seller is entitled to interest on the amount setoff or, in the case of an escrow, the disputed amount. The buyer's position will be that this constitutes a reduction in the purchase price and therefore the seller should not be entitled to interest on the amount of the reduction. The seller may argue that it should be entitled to interest, at least up to the time the buyer is required to make payment to a third party of the amount claimed. It may be difficult, however, for the seller to justify receiving interest when the setoff relates to a diminution in value of the assets acquired.

Rather than inviting counterproposals from the seller by including an express right of setoff in the acquisition agreement, the buyer's counsel may decide to omit such a provision and instead rely on the buyer's common law right of counter-claim and setoff. Even without an express right of setoff in the acquisition agreement or related documents such as a promissory note or an employment, consulting, or non-competition agreement, the buyer can, as a practical matter, withhold amounts from payments due to the seller and the shareholders under the acquisition agreement or the related documents on the ground that the buyer is entitled to indemnification for these amounts under the acquisition agreement. The question then is whether, if the seller and the shareholders sue the buyer for its failure to make full payment, the buyer will be able to counterclaim that it is entitled to setoff the amounts for which it believes it is entitled to indemnification.

The common law of counterclaim and setoff varies from state to state, and when deciding whether to include or forgo an express right of setoff in the acquisition agreement, the buyer's counsel should examine the law governing the acquisition agreement. The buyer's counsel should determine whether the applicable law contains requirements such as a common transaction, mutuality of parties, and a liquidated amount and, if so, whether those requirements would be met in the context of a dispute under the acquisition agreement and related documents. Generally, counterclaim is mandatory when both the payment due to the plaintiff and the amount set off by the defendant relate to the same transaction, *see United States v. So. California Edison Co.*, 229 F. Supp. 268, 270 (S.D. Cal. 1964); when different transactions are involved, the court may, in its discretion, permit a counterclaim, *see Rochester Genesee Regional Transp. Dist., Inc. v. Trans World Airlines, Inc.*, 383 N.Y.S.2d 856, 857 (1976), but is not obligated to do so, *see Columbia Gas Transmission v. Larry H. Wright, Inc.*, 443 F. Supp. 14 (S.D. Ohio 1977); *Townsend v. Bentley*, 292 S.E.2d 19 (N.C. Ct. App. 1982). Although a promissory note representing deferred purchase price payments would almost certainly be considered part of the same transaction as the acquisition, it is less certain that the execution of an employment, consulting, or non-competition agreement, even if a condition to the closing of the acquisition, and its subsequent performance would be deemed part of the same transaction as the acquisition. In addition, a counterclaim might not be possible if the parties obligated to make and entitled to receive the various payments are different (that is, if there is not "mutuality of parties").

Under the *D'Oench, Duhme* doctrine, which arose from a 1942 Supreme Court decision and has since been expanded by various statutes and judicial decisions, defenses

such as setoff rights under an acquisition agreement generally are not effective against the Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (RTC), and subsequent assignees or holders in due course of a note that once was in the possession of the FDIC or the RTC. *See D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942); *see also* 12 U.S.C. § 1823(e); *Porras v Petroplex Sav. Ass'n*, 903 F.2d 379 (5th. Cir. 1990); *Bell & Murphy Assoc., Inc. v. InterFirst Bank Gateway, N.A.*, 894 F.2d 750 (5th. Cir. 1990), *cert. denied*, 498 U.S. 895 (1990); *FSLIC v. Murray*, 853 F.2d 1251 (5th. Cir. 1988). An exception to the *D'Oench, Duhme* doctrine exists when the asserted defense arises from an agreement reflected in the failed bank's records. *See FDIC v. Plato*, 981 F.2d 852 (5th. Cir. 1993); *Resolution Trust Corp. v. Oaks Apartments Joint Venture*, 966 F.2d 995 (5th. Cir. 1992). Therefore, if a buyer gives a seller a negotiable promissory note and that note ever comes into the possession of a bank that later fails, the buyer could lose its setoff rights under the acquisition agreement unless the failed bank had reflected in its records the acquisition agreement and the buyer's setoff rights. As an alternative to nonnegotiable notes, a buyer could issue notes that can be transferred only to persons who agree in writing to recognize in their official records both the acquisition and the buyer's setoff rights.

Section 11.8 addresses the possible consequences of an unjustified setoff. It allows the Buyer to set off amounts for which the Buyer in good faith believes that it is entitled to indemnification from the Seller and the Shareholders against payments due to them under the promissory note without bearing the risk that, if the Seller and the Shareholders ultimately prevail on the indemnification claim, they will be able to accelerate the promissory note or obtain damages or injunctive relief. Such a provision gives the Buyer considerable leverage and will be resisted by the Seller. To lessen the leverage that the Buyer has from simply withholding payment, the Seller might require that an amount equal to the setoff be paid by the Buyer into an escrow with payment of fees and costs going to the prevailing party.

11.9 THIRD PARTY CLAIMS

(a) Promptly after receipt by a Person entitled to indemnity under Section 11.2, 11.3 (to the extent provided in the last sentence of Section 11.3) or 11.4 (an "**Indemnified Person**") of notice of the assertion of a Third-Party Claim against it, such Indemnified Person shall give notice to the Person obligated to indemnify under such Section (an "**Indemnifying Person**") of the assertion of such Third-Party Claim; provided that the failure to notify the Indemnifying Person will not relieve the Indemnifying Person of any liability that it may have to any Indemnified Person, except to the extent that the Indemnifying Person demonstrates that the defense of such Third-Party Claim is prejudiced by the Indemnified Person's failure to give such notice.

(b) If an Indemnified Person gives notice to the Indemnifying Person pursuant to Section 11.9(a) of the assertion of such Third-Party Claim, the Indemnifying Person shall be entitled to participate in the defense of such Third-Party Claim and, to the extent that it wishes (unless (i) the Indemnifying Person is also a Person against whom the Third-Party Claim is made and the Indemnified Person determines in good faith that joint representation would be inappropriate, or (ii) the Indemnifying Person fails to provide reasonable assurance to the Indemnified Person of its financial capacity to defend such Third-Party Claim and provide indemnification with respect to such Third-Party Claim),

to assume the defense of such Third-Party Claim with counsel satisfactory to the Indemnified Person. After notice from the Indemnifying Person to the Indemnified Person of its election to assume the defense of such Third-Party Claim, the Indemnifying Person shall not, as long as it diligently conducts such defense, be liable to the Indemnified Person under this Article 11 for any fees of other counsel or any other expenses with respect to the defense of such Third-Party Claim, in each case subsequently incurred by the Indemnified Person in connection with the defense of such Third-Party Claim, other than reasonable costs of investigation. If the Indemnifying Person assumes the defense of a Third-Party Claim, (i) such assumption will conclusively establish for purposes of this Agreement that the claims made in that Third-Party Claim are within the scope of and subject to indemnification; and (ii) no compromise or settlement of such Third-Party Claims may be effected by the Indemnifying Person without the Indemnified Person's Consent unless (A) there is no finding or admission of any violation of Legal Requirement or any violation of the rights of any Person, (B) the sole relief provided is monetary damages that are paid in full by the Indemnifying Person, and (C) the Indemnified Person shall have no liability with respect to any compromise or settlement of such Third-Party Claims effected without its Consent. If notice is given to an Indemnifying Person of the assertion of any Third-Party Claim and the Indemnifying Person does not, within ten days after the Indemnified Person's notice is given, give notice to the Indemnified Person of its election to assume the defense of such Third-Party Claim, the Indemnifying Person will be bound by any determination made in such Third-Party Claim or any compromise or settlement effected by the Indemnified Person.

(c) Notwithstanding the foregoing, if an Indemnified Person determines in good faith that there is a reasonable probability that a Third-Party Claim may adversely affect it or its Related Persons other than as a result of monetary damages for which it would be entitled to indemnification under this Agreement, the Indemnified Person may, by notice to the Indemnifying Person, assume the exclusive right to defend, compromise, or settle such Third-Party Claim, but the Indemnifying Person will not be bound by any determination of any Third-Party Claim so defended for the purposes of this Agreement or any compromise or settlement effected without its Consent (which may not be unreasonably withheld).

(d) Notwithstanding the provisions of Section 13.4, Seller and each Shareholder hereby consent to the non-exclusive jurisdiction of any court in which a Proceeding in respect of a Third-Party Claim is brought against any Buyer Indemnified Person for purposes of any claim that a Buyer Indemnified Person may have under this Agreement with respect to such Proceeding or the matters alleged therein, and agree that process may be served on Seller and Shareholders with respect to such a claim anywhere in the world.

(e) With respect to any Third-Party Claim subject to indemnification under this Article 11: (i) both the Indemnified Person and the Indemnifying Person, as the case may be, shall keep the other Person fully informed of the status of such Third-Party Claims and any related Proceedings at all stages thereof where such Person is not represented by its own counsel, and (ii) the parties agree (each at its own expense) to render to each other such assistance as they may reasonably require of each other and to cooperate in

good faith with each other in order to ensure the proper and adequate defense of any Third-Party Claim.

(f) With respect to any Third-Party Claim subject to indemnification under this Article 11, the parties agree to cooperate in such a manner as to preserve in full (to the extent possible) the confidentiality of all Confidential Information and the attorney-client and work-product privileges. In connection therewith, each party agrees that: (i) it will use its Best Efforts, in respect of any Third-Party Claim in which it has assumed or participated in the defense, to avoid production of Confidential Information (consistent with applicable law and rules of procedure), and (ii) all communications between any party hereto and counsel responsible for or participating in the defense of any Third-Party Claim shall, to the extent possible, be made so as to preserve any applicable attorney-client or work-product privilege.

COMMENT

It is common to permit an indemnifying party to have some role in the defense of the claim. There is considerable room for negotiation of the manner in which that role is implemented. Because the buyer is more likely to be an indemnified party than an indemnifying party, the Model Agreement provides procedures that are favorable to the indemnified party.

The indemnified party normally will be required to give the indemnifying party notice of third-party claims for which indemnity is sought. The Model Agreement requires such notice only after a proceeding is commenced, and provides that the indemnified party's failure to give notice does not affect the indemnifying party's obligations unless the failure to give notice results in prejudice to the defense of the proceeding. A seller may want to require notice of threatened proceedings and of claims that do not yet involve proceedings and to provide that prompt notice is a condition to indemnification; the buyer likely will be very reluctant to introduce the risk and uncertainty inherent in a notice requirement based on any event other than the initiation of formal proceedings.

The Model Agreement permits the indemnifying party to participate in and assume the defense of proceedings for which indemnification is sought, but imposes significant limitations on its right to do so. The indemnifying party's right to assume the defense of other proceedings is subject to (a) a conflict of interest test if the claim is also made against the indemnifying party, (b) a requirement that the indemnifying party demonstrate its financial capacity to conduct the defense and provide indemnification if it is unsuccessful, and (c) a requirement that the defense be conducted with counsel satisfactory to the indemnified party. The seller will often resist the financial capacity requirement and seek either to modify the requirement that counsel be satisfactory with a reasonableness qualification or to identify satisfactory counsel in the acquisition agreement (the seller's counsel should carefully consider in whose interest they are acting if they specify themselves). The seller may also seek to require that, in cases in which it does not assume the defense, all indemnified parties be represented by the same counsel (subject to conflict of interest concerns).

The seller may seek to modify the provision that the indemnifying party is bound by the indemnified party's defense or settlement of a proceeding if the indemnifying

party does not assume the defense of that proceeding within ten days after notice of the proceeding. The seller may request a right to assume the defense of the proceeding at a later date and a requirement for advance notice of a proposed settlement.

An indemnified party usually will be reluctant to permit an indemnifying party to assume the defense of a proceeding while reserving the right to argue that the claims made in that proceeding are not subject to indemnification. Accordingly, the Model Agreement excludes that possibility. However, the seller may object that the nature of the claims could be unclear at the start of a proceeding and may seek the right to reserve its rights in a manner similar to that often permitted to liability insurers.

An indemnifying party that has assumed the defense of a proceeding will seek the broadest possible right to settle the matter. The Model Agreement imposes strict limits on that right; the conditions relating to the effect on other claims and the admission of violations of legal requirements are often the subject of negotiation.

Section 11.9(c) permits the indemnified party to retain control of a proceeding that presents a significant risk of injury beyond monetary damages that would be borne by the indemnifying party, but the price of that retained control is that the indemnifying party will not be bound by determinations made in that proceeding. The buyer may want to maintain control of a proceeding seeking equitable relief that could have an impact on its business that would be difficult to measure as a monetary loss, or a proceeding involving product liability claims that extend beyond the seller's businesses (a tobacco company that acquires another tobacco company, for example, is unlikely to be willing to surrender control of any of its products liability cases).

Section 11.9(d) permits the Buyer to minimize the risk of inconsistent determinations by asserting its claim for indemnification in the same proceeding as the claims against the Buyer.

Environmental indemnification often presents special procedural issues because of the wide range of remediation techniques that may be available and the potential for disruption of the seller's businesses. These matters are often dealt with in separate provisions (see Section 11.3).

11.10 PROCEDURE FOR INDEMNIFICATION — OTHER CLAIMS

A claim for indemnification for any matter not involving a Third-Party Claim may be asserted by notice to the party from whom indemnification is sought and shall be paid promptly after such notice.

COMMENT

This Section emphasizes the parties' intention that indemnification remedies provided in the acquisition agreement are not limited to third-party claims. Some courts have implied such a limitation in the absence of clear contractual language to the contrary. See the Comment to Section 11.2.

11.11 INDEMNIFICATION IN CASE OF STRICT LIABILITY OR INDEMNITEE NEGLIGENCE

THE INDEMNIFICATION PROVISIONS IN THIS ARTICLE 11 SHALL BE ENFORCEABLE REGARDLESS OF WHETHER THE LIABILITY IS BASED ON PAST, PRESENT OR FUTURE ACTS, CLAIMS OR LEGAL REQUIREMENTS (INCLUDING ANY PAST, PRESENT OR FUTURE BULK SALES LAW, ENVIRONMENTAL LAW, FRAUDULENT TRANSFER ACT, OCCUPATIONAL SAFETY AND HEALTH LAW, OR PRODUCTS LIABILITY, SECURITIES OR OTHER LEGAL REQUIREMENT), AND REGARDLESS OF WHETHER ANY PERSON (INCLUDING THE PERSON FROM WHOM INDEMNIFICATION IS SOUGHT) ALLEGES OR PROVES THE SOLE, CONCURRENT, CONTRIBUTORY OR COMPARATIVE NEGLIGENCE OF THE PERSON SEEKING INDEMNIFICATION, OR THE SOLE OR CONCURRENT STRICT LIABILITY IMPOSED ON THE PERSON SEEKING INDEMNIFICATION.

COMMENT

Purpose of Section. The need for this section is illustrated by *Fina, Inc. v. ARCO*, 200 F.3rd 266 (5th Cir. 2000) in which the U.S. Court of Appeals for the Fifth Circuit invalidated an asset purchase agreement indemnification provision in the context of environmental liabilities. In the *Fina* case, the liabilities arose from actions of three different owners over a thirty-year period during which both seller and buyer owned and operated the business and contributed to the environmental condition. The asset purchase agreement indemnification provision provided that the indemnitor "shall indemnify, defend and hold harmless [the indemnitee] . . . against all claims, actions, demands, losses or liabilities arising from the use or operation of the Assets . . . and accruing from and after closing." The Fifth Circuit, applying Delaware law pursuant to the agreement's choice of law provision, held that the indemnification provision did not satisfy the Delaware requirement that indemnification provisions that require payment for liabilities imposed on the indemnitee for the indemnitee's own negligence or pursuant to strict liability statutes such as CERCLA must be clear and unequivocal. The Court explained that the risk shifting in such a situation is so extraordinary that to be enforceable the provision must state with specificity the types of risks that the agreement is transferring to the indemnitor.

There are other situations where the acquisition agreement may allocate the liability to the seller while the buyer's action or failure to act (perhaps negligently) may contribute to the loss. For example, a defective product may be shipped prior to closing but the buyer may fail to effect a timely recall which could have prevented the liability, or an account receivable may prove uncollectible because of the buyer's failure to diligently pursue its collection or otherwise satisfy the customer's requirements.

This section is intended to prevent the allocation of risks elsewhere in Article 11 from being frustrated by court holdings, such as the *Fina* case, that indemnification provisions are ambiguous and unenforceable because they do not contain specific words that certain kinds of risks are intended to be shifted by the Agreement. As discussed below, the majority rule appears to be that agreements that have the effect of shifting liability for a person's own negligence, or for strict liability imposed upon the person, must at a minimum be clear and unequivocal, and in some jurisdictions must be expressly

stated in so many words. The section is in bold faced type because a minority of jurisdictions require that the risk shifting provision be conspicuously presented.

Indemnification for Indemnitee's Own Negligence. Indemnities, releases and other exculpatory provisions are generally enforceable as between the parties absent statutory exceptions for certain kinds of liabilities (*e.g.*, Section 14 of the Securities Act and Section 29 of the Exchange Act) and judicially created exceptions (e.g. some courts as a matter of public policy will not allow a party to shift responsibility for its own gross negligence or intentional misconduct). *See* RESTATEMENT (SECOND) OF CONTRACTS §195 cmt.b (1981) ("Language inserted by a party in an agreement for the purpose of exempting [it] from liability for negligent conduct is scrutinized with particular care and a court may require specific and conspicuous reference to negligence . . . . Furthermore, a party's attempt to exempt [itself] from liability for negligent conduct may fail as unconscionable.") As a result of these public policy concerns or seller's negotiations, some counsel add an exception for liabilities arising from an indemnitee's gross negligence or willful misconduct.

Assuming none of these exceptions is applicable, the judicial focus turns to whether the words of the contract are sufficient to shift responsibility for the particular liability. A minority of courts have adopted the "literal enforcement approach" under which a broadly worded indemnity for any and all claims is held to encompass claims from unforeseen events including the indemnitee's own negligence. The majority of courts closely scrutinize, and are reluctant to enforce, indemnification or other exculpatory arrangements that shift liability away from the culpable party and require that provisions having such an effect be "clear and unequivocal" in stating the risks that are being transferred to the indemnitor. *See* Conwell, *Recent Decisions: The Maryland Court of Appeals*, 57 MD. L. REV. 706 (1998). If an indemnity provision is not sufficiently specific, a court may refuse to enforce the purported imposition on the indemnitor of liability for the indemnitee's own negligence or strict liability. *Fina, Inc. v. ARCO*, 200 F.3d 266 (5th Cir. 2000).

The actual application of the "clear and unequivocal" standard varies from state to state and from situation to situation. Jurisdictions such as Florida, New Hampshire, Wyoming and Illinois do not mandate that any specific wording or magic language be used in order for an indemnity to be enforceable to transfer responsibility for the indemnitee's negligence. *See Hardage Enterprises v. Fidesys Corp.*, 570 So.2d 436, 437 (Fla. App. 1990); *Audley v. Melton*, 640 A. 2d 777 (N.H. 1994); *Boehm v. Cody Country Chamber of Commerce*, 748 P.2d 704 (Wyo.1987); *Neumann v. Gloria Marshall Figure Salon*, 500 N.E. 2d 1011, 1014 (Ill. 1986). Jurisdictions such as New York, Minnesota, Missouri, Maine, North Dakota, and Delaware require that reference to the negligence or fault of the indemnitee be set forth within the contract. *See Gross v. Sweet*, 400 N.E. 2d 306 (1979) and *Geise v. County of Niagra*, 458 N.Y.S.2d 162 (1983)(both holding that the language of the indemnity must plainly and precisely indicate that the limitation of liability extends to negligence or fault of the indemnitee); *Schlobohn v. Spa Petite, Inc.*, 326 N.W.2d 920, 923 (Minn. 1982)(holding that indemnity is enforceable where "negligence" is expressly stated); *Alack v. Vic Tanny Int'l*, 923 S.W.2d 330 (Mo. 1996)(holding that a bright-line test is established requiring that the words "negligence" or "fault" be used conspicuously); *Doyle v. Bowdoin College*, 403 A.2d 1206, 1208 (Me. 1979); (holding that there must be an express reference to liability for negligence); *Blum v. Kauffman*, 297 A.2d 48,49 (Del. 1972) (holding that a release did not "clearly and unequivocally" express the intent of the parties without the word "negligence"); *Fina v.*

Arco, 200 F.3d 266, 270 (5th Cir. 2000)(applying Delaware law and explaining that no Delaware case has allowed indemnification of a party for its own negligence without making specific reference to the negligence of the indemnified party and requiring at a minimum that indemnity provisions demonstrate that "the subject of negligence of the indemnitee was expressly considered by the parties drafting the agreement"). Under the "express negligence" doctrine followed by Texas courts, an indemnification agreement is not enforceable to indemnify a party from the consequences of its own negligence unless such intent is specifically stated within the four corners of the agreement. *See Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987); *Atlantic Richfield Co. v. Petroleum Personnel, Inc.*, 768 S.W.2d 724 (Tex. 1989).

Indemnification for Strict Liability. Concluding that the transfer of a liability based on strict liability involves an extraordinary shifting of risk analogous to the shifting of responsibility for an indemnitee's own negligence, some courts have held that the clear and unequivocal rule is equally applicable to indemnification for strict liability claims. *See, e.g., Fina, Inc. v. ARCO*, 200 F.2d 266, 300 (5th Cir. 2000); *Purolator Products v. Allied Signal, Inc.*, 772 F. Supp. 124, 131 n.3 (W.D.N.Y. 1991; and *Houston Lighting & Power Co. v. Atchison, Topeka & Santa Fe R.R.*, 890 S.W.2d 455, 458 (Tex. 1994); *see also* Parker and Savich, *Contractual Efforts to Allocate the Risk of Environmental Liability: Is There a Way to Make Indemnities Worth More Than the Paper They Are Written On?*, 44 Sw. L.J. 1349 (1991). The Court concluded that this broad clause in the *Fina* asset purchase agreement did not satisfy the clear and unequivocal test in respect of strict liability claims since there was no specific reference to claims based on strict liability.

In view of the judicial hostility to the contractual shifting of liability for strict liability risks, counsel may wish to include in the asset purchase agreement references to additional kinds of strict liability claims for which indemnification is intended.

Conspicuousness. In addition to requiring that the exculpatory provision be explicit, some courts require that its presentation be conspicuous. *See Dresser Industries v. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993) ("Because indemnification of a party for its own negligence is an extraordinary shifting of risk, this Court has developed fair notice requirements which . . . include the express negligence doctrine and the conspicuousness requirements. The express negligence doctrine states that a party seeking indemnity from the consequences of that party's own negligence must express that intent in specific terms within the four corners of the contract. The conspicuous requirement mandates that something must appear on the face of the [contract] to attract the attention of a reasonable person when he looks at it."); *Alack v. Vic Tanny Int'l of Missouri, Inc.*, 923 S.W.2d 330, 337 (Mo. banc 1996). Although most courts appear not to have imposed a comparable "conspicuousness" requirement to date, some lawyers feel it prudent to put their express negligence and strict liability words in bold face or other conspicuous type, even in jurisdictions which to date have not imposed a conspicuousness requirement.

V. ENTIRE AGREEMENT

Acquisition agreements typically include among the miscellaneous provisions at the end of the document a provision to the effect that the agreement supersedes all prior agreements, whether written or oral, between the parties with respect to its subject matter (including any letter of intent and any confidentiality agreement between Buyer and Seller) and constitutes (along

with the Disclosure Letter, Exhibits and other documents delivered pursuant to this Agreement) a complete and exclusive statement of the terms of the agreement between the parties with respect to its subject matter. A typical such provision appears below:

13.7 ENTIRE AGREEMENT AND MODIFICATION

This Agreement supersedes all prior agreements, whether written or oral, between the parties with respect to its subject matter (including any letter of intent and any confidentiality agreement between Buyer and Seller) and constitutes (along with the Disclosure Letter, Exhibits and other documents delivered pursuant to this Agreement) a complete and exclusive statement of the terms of the agreement between the parties with respect to its subject matter. This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

COMMENT

Pre-existing Agreements and Parol Evidence Barred. This Section provides that the Model Agreement (along with the documents referred to in the Model Agreement) contains the entire understanding of the Buyer and the Seller regarding the acquisition so that, unless otherwise specified, all prior agreements (whether written or oral) between the parties relating to the acquisition are superseded by (and not incorporated into) the terms of the acquisition agreement and any conflicts between previous agreements and the acquisition agreement are eliminated. *Dujardin v. Liberty Media Corp.*, 359 F. Supp.2d 337 (S.D.N.Y. March 16, 2005) ("It is generally understood that the purpose of an integration clause 'is to require full application of the parol evidence rule in order to bar the introduction of extrinsic evidence to vary or contradict the terms of the writing'"). Accordingly, if the parties were to agree that any pre-existing agreements between the parties regarding the acquisition (such as the confidentiality agreement or certain provisions in the letter of intent) should remain in effect, this Section would have to be revised accordingly. The Model Agreement addresses confidentiality (see Article 12) and "no-shop" (see Section 5.6) obligations; thus, there is no need for the letter of intent or any confidentiality agreement to remain in effect. For an example of the codification of non-integration clauses, see CAL. CIV. PROC. CODE § 1856.

As discussed in the Comment to Section 3.33 (Disclosure) above, a seller may seek to contractually negate that seller has made any representations beyond those expressly set forth in Article 3 by inserting, either in Article 3 or in Section 13.7, provisions like the alternative Sections 3.33 and 3.34 set forth above in the Comment to Section 3.33. Additionally, a seller might propose to limit its exposure to extracontractual liabilities with a provision reading as follows:

> *Exclusive Remedies*. Following the Closing, the sole and exclusive remedy for any and all claims arising under, out of, or related to this Agreement, or the sale and purchase of the Seller, shall be the rights of indemnification set forth in Article 11 only, and no person will have any other entitlement, remedy or recourse, whether in contract, tort or otherwise, it being agreed that all of such other remedies, entitlements and recourse are expressly waived and released by the parties hereto to the fullest extent permitted by law. [Notwithstanding the foregoing, the parties have agreed that if the Buyer can demonstrate, by clear and

> convincing evidence, that a material representation and warranty made by the Seller or the Selling Shareholder in this Agreement was deliberately made and known to be materially untrue by any of the Seller Knowledge Parties, then the Deductible shall not apply and the Cap shall be increased to the Purchase Price with respect to any resulting indemnification claim under Section 11.2.] The provisions of this Section 13.7, together with the provisions of Section 3.33 and 3.34, and the limited remedies provided in Article 11, were specifically bargained-for between Buyer and Sellers and were taken into account by Buyer and the Sellers in arriving at the Purchase Price. The Sellers have specifically relied upon the provisions of this Section 13.7, together with the provisions of Section 3.33 and 3.34, and the limited remedies provided in Article 11, in agreeing to the Purchase Price and in agreeing to provide the specific representations and warranties set forth herein.[33]

Negate Reliance Element in Common Law Fraud. Such a statement would be sought by the seller both to emphasize that the Agreement is not intended to include any representations not expressly set forth therein, and also to negate common law claims such as fraud or negligent misrepresentation that occurred in the negotiations or due diligence that preceded the execution of the Agreement. A common law fraud claim generally requires the plaintiff to prove: (1) the speaker knowingly or recklessly made a misrepresentation of, or failed to disclose, a material fact known to the speaker; (2) the speaker knew that the other party did not know the fact and did not have an equal opportunity to discover it; (3) the speaker intended thereby to induce the other party to act on the misrepresentation or omission; and (4) the other party relied on the misrepresentation or omission and suffered injury as a result. *See*, *e.g.*, *Kevin M. Ehringer Enterprises, Inc. v. McData Services Corp.*, 646 F.3d 321 (5th Cir. 2011); *Daldav Assocs., L.P. v. Lebor*, 391 F. Supp. 2d 472 (N.D. Tex. 2005); *Cronus Offshore, Inc. v. Kerr McGee Oil & Gas Corp.*, 369 F. Supp. 2d 848 (E.D. Tex. 2004), *affirmed* 133 Fed. App'x 944 (5th Cir. 2005); *Stephenson v. Capano Dev., Inc.*, 462 A.2d 1069, 1074 (Del. Super. 1983) (under Delaware law the elements of fraud are: "(1) a false or misleading representation, or deliberate concealment of a material fact, by the defendant; (2) the defendant's knowledge or belief that the representation was false, or was made with reckless indifference to the truth; (3) an intent to induce the plaintiff to act or refrain from acting; (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of such reliance"; "one is equally culpable of fraud who by omission fails to reveal that which it is his duty to disclose in order to prevent statements actually made from being misleading"). *See ERI Consulting Engineers v. Swinnea*, 318 S.W.3d 867 (Tex. 2010), in which the Texas Supreme Court held that consideration received for the sale of a business interest is subject to equitable forfeiture as a remedy for breach of seller's fiduciary duty and wrote.

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[33] This alternative Section 13.7 is derived from the Model Provisions suggested in Glenn D. West and W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 64 Bus. Law. 999, 1038 (Aug. 2009); *see* Byron F. Egan, Patricia O. Vella and Glenn D. West, *Contractual Limitations on Seller Liability in M&A Transactions*, ABA Section of Business Law Spring Meeting Program on "Creating Contractual Limitations on Seller Liability that Work Post-Closing: Avoiding Serious Pitfalls in Domestic and International Deals," Denver, CO, April 22, 2010, at Appendix B, *available at* http://images.jw.com/com/publications/1362.pdf.

> We hold that when a partner in a business breached his fiduciary duty by fraudulently inducing another partner to buy out his interest, the consideration received by the breaching party for his interest in the business is subject to forfeiture as a remedy for the breach, in addition to other damages that result from the tortious conduct.

The opinion involved a purchase of corporate stock, but there was also a related partnership interest acquired in the transaction. Since the Texas Supreme Court's opinion dealt only with remedies and appellant did not contest liability for breach of contract or fiduciary duty, the Court did not provide guidance on what it takes to establish liability. *But see Plotkin v. Joekel*, 304 S.W.3d 455, 479 (Tex. App.—Houston [1st Dist.] 2009), in which the Court held "To impose an informal fiduciary duty in a business transaction, the special relationship of trust and confidence must exist prior to, and apart from, the agreement made the basis of the suit, quoting from *Assoc. Indem. Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276, 287 (Tex. 1998)."

A negligent misrepresentation claim is similar to a common law fraud claim, but does not require proof of a knowing or reckless misrepresentation. *See*, *e.g.*, *In re Med. Wind Down Holdings III, Inc.*, 332 B.R. 98, 102 (Bankr. D. Del. 2005); *BCY Water Supply Corp. v. Residential Inv., Inc.*, 170 S.W.3d 596, 602 (Tex. App.—Tyler 2005, pet. denied).

The element of reliance that a plaintiff must prove in a fraud or negligent misrepresentation case may be negated as to extra-contractual statements or omissions by a non-reliance provision such as the one quoted above. *See*, *e.g.*, *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129, 142 n.18 (Del. Ch. 2003) ("sophisticated parties to negotiated commercial contracts may not reasonably rely on information that they contractually agreed did not form a part of the basis for their decision to contract"); *Prudential Ins. Co. of Am. v. Jefferson Assocs., Ltd.*, 896 S.W.2d 156 (Tex. 1995); *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171 (Tex. 1997); *see also* Glenn D. West and Adam Nelson, *Corporations*, 57 SMU L. Rev. 799, 814-17 (2004); *but see Kronenberg v. Katz*, 872 A.2d 568, 591 (Del. Ch. 2004) (a general integration clause is insufficient to bar claims of fraud: "for a contract to bar a fraud in the inducement claim, the contract must contain language that, when read together, can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract. The presence of a standard integration clause alone, which does not contain explicit anti-reliance representations and which is not accompanied by other contractual provisions demonstrating with clarity that the plaintiff had agreed that it was not relying on facts outside the contract, will not suffice to bar fraud claims").

ABRY and Delaware Progeny. In *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006), a stock purchase agreement included a merger clause or a "buyer's promise" that it was not relying upon any representations and warranties not stated in the contract, and the Delaware Chancery Court wrote that such provisions are generally enforceable:

> When addressing contracts that were the product of give-and-take between commercial parties who had the ability to walk away freely, this court's jurisprudence has . . . honored clauses in which contracted parties have disclaimed reliance on extra-contractual

> representations, which 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 an effect on it.
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> * * *
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> The teaching of this court . . . is that a party cannot promise, in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a "but we did rely on those other representations" fraudulent inducement claim. The policy basis for this line of cases is, in my view, quite strong. If there is a public policy interest in truthfulness, then that interest applies with more force, not less, to contractual representations of fact. 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.
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> * * *
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> Nonetheless, . . . we have not given effect to so-called merger or integration clauses that do not clearly state that the parties disclaim reliance upon extra-contractual statements. Instead, we have held . . . that murky integration clauses, or standard integration clauses without explicit anti-reliance representations, will not relieve a party of its oral and extra-contractual fraudulent representations. The integration clause must contain "language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract." This approach achieves a sensible balance between fairness and equity — parties can protect themselves against unfounded fraud claims through explicit anti-reliance language. 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.

In *Abry*, however, the Court allowed a fraud claim to proceed where, notwithstanding a clear anti-reliance provision, the plaintiff alleged that the defendant had intentionally lied within the four corners of the agreement. *See* Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 63 Bus. Law. 999 (August 2009).

ABRY was explained in *OverDrive, Inc. v. Baker & Taylor, Inc.*, 2011 WL 2448209 (Del.Ch. June 17, 2011), which arose out of a failed joint venture in *which* defendant allegedly breached its promises to exclusively distribute plaintiff's audiobooks and other digital media to defendant's books and physical media customers. The joint venture agreement provided that "[n]either party is relying on any representations, except those set forth herein, as inducement to execute this Agreement." Plaintiff alleged that defendant intentionally lied about specific provisions in the agreement in failing to reveal plans to use digital media information received from plaintiff in digital media

arrangements with competitors. In denying defendant's motion to dismiss, Chancellor Chandler wrote:

> Under the teaching of *ABRY Partners V, L.P. v. F&W Acquisition LLC*, use of an anti-reliance clause in such a manner is contrary to public policy if it would operate as a shield to exculpate defendant from liability for its own intentional fraud—"there is little support for the notion that it is efficient to exculpate parties when they lie about the material facts on which a contract is premised." Defendant responds that the public policy exception in *ABRY* is limited to situations where a defendant "intentionally misrepresents a fact embodied in a contract," and that the only alleged misrepresentations at issue in this case are pre-contractual statements that were not embodied in the Agreement. I decline to accept defendant's argument because, as noted earlier, Baker & Taylor's (alleged) misrepresentations and omissions with respect to LibreDigital (both the true nature of its relationship and its intention to develop a competitive digital distribution platform) relate directly to Section 10.1 and Schedule J of the Agreement and, indeed, go to the very core of the Agreement between OverDrive and Baker & Taylor. Such material misrepresentations and omissions in the Agreement—if proven to be true—frustrate the very purpose and nature of the Agreement, and OverDrive purportedly would not have entered into the Agreement with Baker & Taylor otherwise. Although the language of the anti-reliance clause in the Agreement is clear and unambiguous, I conclude that it is barred by public policy at this stage, construing facts and inferences in plaintiff's favor and accepting the allegations in the Complaint as true.

The Delaware Supreme Court in *RAA Management, LLC v. Savage Sports Holdings, Inc.,* 45 A.3d 107 (Del. May 18, 2012), affirmed the rule announced in *Abry*, noting that "*Abry* Partners accurately states Delaware law and explains Delaware's public policy in favor of enforcing contractually binding written disclaimers of reliance on representations outside of a final agreement of sale or merger," thereby removing any uncertainty regarding whether *Abry* was still good law following *OverDrive*.[34] In *RAA Management*, two sophisticated parties entered into a non-disclosure agreement ("NDA") in connection with RAA's interest in acquiring Savage Sports Holdings, Inc., a large rifle manufacturer.

RAA's complaint had alleged that Savage told RAA at the outset of their discussions that there were no significant unrecorded liabilities or claims against Savage, but then during RAA's due diligence into Savage, Savage disclosed three such matters, which caused RAA to abandon negotiations for the transaction. RAA sought to recover from Savage the $1.2 million in due diligence and negotiation costs. The trial court (the Delaware Superior Court) held otherwise and dismissed RAA's complaint.

The Delaware Supreme Court affirmed, finding that the non-disclosure agreement between RAA and Savage contained an unambiguous "non-reliance" clause, which the Delaware Supreme Court refused to construe as either an express or implicit

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[34] *RAA Management, LLC v. Savage Sports Holdings, Inc*., No. 577,2011, slip op. at 22 (Del. May 18, 2012).

exception for intentional or fraudulent misrepresentations. The Delaware Supreme Court also held that the "peculiar-knowledge" exception was inapplicable here because the exception generally does not apply where two sophisticated parties could have easily insisted on contractual protections for themselves. Lastly, the Delaware Supreme Court held that it should not decline to enforce the agreed-upon language of the non-reliance clauses in the NDA on policy grounds because of Delaware's public policy in favor of enforcing contractually binding written disclaimers of reliance on representations outside of a final agreement of sale or merger, as articulated in *Abry*.

Italian Cowboy and *Allen*. In *Italian Cowboy Partners, Ltd. v. Prudential Ins. Co.*, 341 S.W.3d 323 (Tex. 2011), the Texas Supreme Court held that a merger clause does not waive the right to sue for fraud should a party later discover that the representations it relied upon before signing the contract were fraudulent, unless the clause also disclaims reliance on representations (thus negating an essential element of a claim for fraudulent inducement) and it is insufficient to merely state that promisor has not made any representations or promises except as expressly set forth in the agreement.

Italian Cowboy Partners was influential in *Allen v. Devon Energy Holdings, L.L.C. F/K/A Chief Holdings, L.L.C. and Trevor Rees-Jones*, 367 S.W.3d 355, (Tex. App.—Houston [1st Dist.] March 9, 2012), in which Allen alleged that Chief and Trevor Rees-Jones, Chief's manager and majority owner, fraudulently induced him to redeem his interest two years before the company sold for almost 20 times the redemption sales price to Devon Energy Production Company, L.P. The defense focused on disclaimers and release provisions in the redemption agreement, which it contended barred Allen's fraud claims by negating reliance or materiality as a matter of law. The Court of Appeals held that the redemption agreement did not bar Allen's claims, and that fact issues existed as to fraud and the existence of a fiduciary relationship, in reversing the trial court's summary judgment for the defense and for such purpose assuming the correctness of the facts alleged by Allen below.

Allen and Rees-Jones served together as partners at a prominent Dallas law firm. Allen was an oil and gas transactions lawyer, and Rees-Jones was a bankruptcy lawyer before leaving the firm to go into the oil and gas business. Allen was one of Chief's early investors, and relied on investment advice from Rees-Jones.

In November 2003, Rees-Jones decided to redeem the minority equity interests in Chief. He sent to the minority members a letter explaining the reasons for and terms of the redemption offer, to which he attached (1) an independent valuation firm's opinion on Chief's market value and (2) an appraisal of Chief's existing gas reserves and future drilling prospects. The valuation report included discounts for the sale of a minority interest and for lack of marketability. The letter also included Rees-Jones's pessimistic assessment of a number of facts and events that could negatively impact Chief's value in the future.

The redemption proposal languished for seven months until June 2004 when Rees-Jones notified the minority members that Chief was ready to proceed with the redemption. Three of the minority members (including Allen) accepted the redemption offer, and four others chose to retain their interests. There were positive developments in the Barnett Shale area where Chief operated and within Chief in the seven months between the November 2003 offer and the June 2004 redemption, and Allen asserts that

these events, which Allen claimed were not disclosed to him and would have materially impacted his decision to redeem his interest.

Chief provided Allen with a written redemption agreement for the first time in June 2004, and "insisted" that the contract be signed by the end of the month. The parties did not exchange drafts, and Allen stated that he had only three days to review the agreement before signing because, as he was on vacation for much of the time.

The redemption agreement contained several release clauses which are discussed below, including an "independent investigation" paragraph, a general "mutual release," and a merger clause which defendants claimed barred Allen's fraud claims negating reliance or materiality as a matter of law. The "independent investigation" paragraph provided that (1) Allen based his decision to sell on his independent due diligence, expertise, and the advice of his own engineering and economic consultants; (2) the appraisal and the reserve analysis were estimates and other professionals might provide different estimates; (3) events subsequent to the reports might "have a positive or negative impact on the value" of Chief; (4) Allen was given the opportunity to discuss the reports and obtain any additional information from Chief's employees as well as the valuation firm and the reserve engineer; and (5) the redemption price was based on the reports regardless of whether those reports reflected the actual value and regardless of any subsequent change in value since the reports. The independent investigation paragraph also included mutual releases "from any claims that might arise as a result of any determination that the value of [Chief] . . . was more or less than" the agreed redemption price at the time of the closing.

In a separate paragraph entitled "mutual releases" each party released the other from all claims that "they had or have arising from, based upon, relating to, or in connection with the formation, operation, management, dissolution and liquidation of [Chief] or the redemption of" Allen's interest in Chief, except for claims for breach of the redemption agreement or breach of the note associated with the redemption agreement. Another paragraph contained a "merger clause" stating that the redemption agreement "supersedes all prior agreements and undertakings, whether oral or written, between the parties with respect to the subject matter hereof."

Allen argued that fraudulent inducement invalidates the release provisions in the redemption agreement as "fraud vitiates whatever it touches," citing *Stonecipher v. Butts*, 591 S.W.2d 806, 809 (Tex. 1979). In rejecting that argument but holding that the release provisions in the redemption agreement were not sufficiently explicit to negate Allen's fraud in the inducement claims, the Court of Appeals wrote:

> The threshold requirement for an effective disclaimer of reliance is that the contract language be "clear and unequivocal" in its expression of the parties' intent to disclaim reliance. [citations omitted] In imposing this requirement, the Texas Supreme Court has balanced three competing concerns. First, a victim of fraud should not be able to surrender its fraud claims unintentionally. [citations omitted] Second, the law favors granting parties the freedom to contract knowing that courts will enforce their contracts' terms, as well as the ability to contractually resolve disputes between themselves fully and finally. [citations omitted] Third, a party should not be permitted to claim fraud when he represented in the parties' contract that he did not rely on a representation . . .

The Court then said that in view of these competing concerns, Texas allows a disclaimer of reliance to preclude a fraudulent inducement claim only if the parties' intent to release such claims "is clear and specific." Among the failings the Court found with the disclaimer language in the redemption agreement were: (i) it did not say none of the parties is relying upon any statement or any representation of any agent of the parties being released hereby; (ii) the broad language releasing "all claims, demands, rights, liabilities, and causes of action of any kind or nature" did not specifically release fraudulent inducement claims or disclaim reliance on Rees-Jones and Chief"s representations (although it did release claims "of any kind or nature" (which necessarily includes fraudulent inducement), the elevated requirement of precise language requires more than a general catch-all--it must address fraud claims in clear and explicit language); (iii) the merger clause stated that the contract is the "final integration of the undertakings of the parties hereto and supersedes all prior agreements and undertakings," but did not include clear and unequivocal disclaimer of reliance on oral representations; (iv) the redemption agreement failed to state that the only representations that had been made were those set forth in the agreement; (v) it did not contain a broad disclaimer that no extra-contractual representations had been made and that no duty existed to make any disclosures; (vi) it did not provide that Allen had not relied on any representations or omissions by Chief; or (vii) it did not include a specific "no liability" clause stating that the party providing certain information will not be liable for any other person's use of the information.

The Court was careful to state it was not requiring that the words "disclaimer of reliance" must be stated in order for a disclaimer to preclude a fraudulent inducement claim or that each one of these issues must be addressed in every disclaimer. Rather, the Court stated that the redemption agreement lacked the following: "(1) an all-embracing disclaimer that Allen had not relied on any representations or omissions by Chief; (2) a specific 'no liability' clause stating that the party providing certain information will not be liable for any other person's use of the information; and (3) a specific waiver of any claim for fraudulent inducement based on misrepresentations or omissions."

Although the independent investigation clause stated that Allen "based his decision to sell" on (1) his own independent due diligence investigation, (2) his own expertise and judgment, and (3) the advice and counsel of his own advisors and consultants, the Court found that the statement of reliance on the identified factors did not clearly and unequivocally negate the possibility that Allen also relied on information he had obtained from Chief and Rees-Jones, and consistent with the terms of the redemption agreement, Allen could have relied on both. The Court found it incongruous to state that Allen could not rely on the information he was given, and noted the absence of the words "only," "exclusively," or "solely" are of critical importance in this case.

Rees-Jones and Devon argued that the redemption agreement contained language that released Allen's claims against them and that this language shows that the parties agreed broadly to disavow the factual theories he now asserts in his lawsuit. Although the redemption agreement released the parties from claims that arise from a determination that the redemption price did not reflect Chief's market value at closing, it did not negate Allen's claims that Rees-Jones made misrepresentations and omissions concerning Chief's future prospects. Further the release disclaimed any claim by Allen based on a change in value from the 2003 appraisal to the date of redemption only, but the language did not cover Allen's claims that Rees-Jones and Chief withheld information relating to Chief's future prospects and potential value.

The Court further wrote, citing *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51 (Tex. 2008), that even a clear and unequivocal disclaimer of reliance may not bar a fraudulent inducement claim unless (1) the terms of the contract were negotiated or boilerplate; (2) the complaining party was represented by counsel; (3) the parties dealt with each other at arm's length; and (4) the parties were knowledgeable in business matters. The Court found for defendants on two of the factors (Allen as an oil and gas attorney could not complain that he was not represented by counsel and was not knowledgeable). The Court, however, found fact issues as to the other two factors (whether the contract was negotiated and whether the parties dealt with each other at arm's length) and declined to grant Defendant's motion for summary judgment. The Court declined to say whether all four tests must be satisfied for an otherwise clear and unequivocal disclaimer of reliance to be enforceable.

With respect to fiduciary duties, the Court held a formal fiduciary relationship is not created automatically between co-shareholders simply because the plaintiff is a minority shareholder in a closely-held corporation. The Court, however, held even if a formal fiduciary relationship did not ordinarily exist, "special facts" can create a fiduciary relationship and explained:

> We conclude that there is a formal fiduciary duty when (1) the alleged-fiduciary has a legal right of control and exercises that control by virtue of his status as the majority owner and sole member-manager of a closely-held LLC and (2) either purchases a minority shareholder's interest or causes the LLC to do so through a redemption when the result of the redemption is an increased ownership interest for the majority owner and sole manager.

In *Staton Holdings, Inc. v. Tatum, L.L.C.*, 345 S.W.3d 729 (Tex.App.—Dallas 2011), a Texas Court of Appeals held, as a matter of first impression, that an express-intent requirement, under which a release of liability is enforceable only if the intent to grant such a release is expressed in specific terms within the four corners of the contract, applies to prospective releases of future breaches of warranty in service transactions. In so holding, the Court wrote:

> We begin by reviewing Texas's express-negligence jurisprudence. Under Texas law, certain kinds of contractual provisions that call for an extraordinary shifting of risk between the parties are subject to the fair-notice doctrine. *See Dresser Indus., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505, 508 (Tex. 1993). In *Dresser Industries*, the Texas Supreme Court held that a release of liability for future negligence is enforceable only if it comports with both prongs of the fair-notice doctrine: the conspicuousness requirement and the express-negligence test. Id. at 509. Under the express-negligence test, a release of future negligence is enforceable only if the intent to grant such a release is expressed in specific terms within the four corners of the contract. *Id.* at 508; *see also Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987) (adopting the express-negligence test in the context of indemnity clauses). If a similar express-intent rule applies to breach-of-warranty claims, the release involved in this case is suspect because it does not expressly state that Staton is waiving claims for future breaches of warranty.

> The Texas Supreme Court has extended the express-negligence test to some claims besides negligence. In 1994, the supreme court held that an indemnity agreement will not be construed to indemnify a party against statutorily imposed strict liability unless the agreement expressly states the parties' intent to provide for indemnification of such claims. *Houston Lighting & Power Co. v. Atchison, Topeka & Santa Fe Ry. Co.*, 890 S.W.2d 455, 458-59 (Tex. 1994). The court indicated that the same express-intent rule would apply to claims for strict products liability.
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> * * *
>
> After considering the reasons supporting *HL & P's* extension of the express-intent rule to strict liability, we conclude the express-intent rule applies to breach-of-warranty claims.
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> * * *
>
> The release involved in this case does not expressly release claims for future breaches of warranty, so it does not bar Staton's breach-of-warranty claims . . .

The *Staton Holdings* case is another example of a Texas court acknowledgement that Texas law respects freedom of contract, including the right of parties to contractually limit their tort and other liabilities arising in respect of contracts, but that the Texas courts regard such a shifting of liability as so extraordinary that they require it to be clear, unequivocal and conspicuous in the contract so that there is no question that the parties knowingly bargained for that outcome. In that respect *Staton Holdings* is consistent with the results in *Italian Cowboy* and *Allen*, although the application of express negligence principles is new and an extension. These three 2011 cases suggest that the following principles should be considered when attempting to contractually limit liabilities under Texas law:

- Do not appear to use boilerplate provisions, however comprehensive, and tailor the limitation of liability provision for each transaction in a way that shows that it has been specifically negotiated and is not merely a boilerplate provision.

- Expressly disclaim reliance on any representations that are not embodied in the four corners of the agreement, and perhaps even in particular enumerated sections thereof.

- Expressly state that no reliance is being placed on any statements (i) by any representative of any of the parties whose liability is limited or (ii) in the dataroom (if such is the case).

- Expressly state that fraud in the inducement claims are being released.

- Expressly state that no reliance has been placed on any prior representations.

- Include both broad inclusive words of limitation of liability and then specifically address the particular kinds of representations not being relied upon.

- Put the limitation of liability provision in italics, bold face or other conspicuous type. See Comment to Section 11.11, supra, regarding the express negligence doctrine.

An alternative to Section 13.7 based on those Texas principles might read as follows:

13.7 ENTIRE AGREEMENT, NON-RELIANCE, EXCLUSIVE REMEDIES AND MODIFICATION

(a) This Agreement supersedes all prior agreements, whether written or oral, between the parties with respect to its subject matter (including any letter of intent and any confidentiality agreement between Buyer and Seller) and constitutes (along with the Disclosure Letter, Exhibits and other documents delivered pursuant to this Agreement) a complete and exclusive statement of the terms of the agreement between the parties with respect to its subject matter. This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

(b) Except for the representations and warranties contained in Article 3, none of Seller or any Shareholder has made any representation or warranty, expressed or implied, as to Seller or as to the accuracy or completeness of any information regarding Seller furnished or made available to Buyer and its representatives, and none of Seller or any Shareholder shall have or be subject to any liability to Buyer or any other Person resulting from the furnishing to Buyer, or Buyer's use of or reliance on, any such information or any information, documents or material made available to Buyer in any form in expectation of, or in connection with, the transactions contemplated by this Agreement.

(c) Following the Closing, the sole and exclusive remedy for any and all claims arising under, out of, or related to this Agreement, or the sale and purchase of the Seller, shall be the rights of indemnification set forth in Article 11 only, and no person will have any other entitlement, remedy or recourse, whether in contract, tort or otherwise, it being agreed that all of such other remedies, entitlements and recourse are expressly waived and released by the parties hereto to the fullest extent permitted by law. [Notwithstanding the foregoing, the parties have agreed that if the Buyer can demonstrate, by clear and convincing evidence, that a material representation and warranty made by the Seller or the Selling Shareholder in this Agreement was deliberately made and known to be materially untrue by any of the Seller Knowledge Parties, then the Deductible shall not apply and the Cap shall be

increased to the Purchase Price with respect to any resulting indemnification claim under Section 11.2.]

(d) The provisions of this Section 13.7, together with the provisions of Sections 3.33 and 3.34, and the limited remedies provided in Article 11, were specifically bargained for between Buyer and Sellers and were taken into account by Buyer and the Sellers in arriving at the Purchase Price. The Sellers have specifically relied upon the provisions of this Section 13.7, together with the provisions of Sections 3.33 and 3.34, and the limited remedies provided in Article 11, in agreeing to the Purchase Price and in agreeing to provide the specific representations and warranties set forth herein.[35]

(e) All claims or causes of action (whether in contract or in tort, in law or in equity) that may be based upon, arise out of or relate to this Agreement, or the negotiation, execution or performance of this Agreement (including any representation or warranty, whether written or oral, made in or in connection with this Agreement or as an inducement to enter into this Agreement), may be made only against the entities that are expressly identified as parties hereto. No Person who is not a named party to this Agreement, including without limitation any director, officer, employee, incorporator, member, partner, stockholder, Affiliate, agent, attorney or representative of any named party to this Agreement ("Non-Party Affiliates"), shall have any liability (whether in contract or in tort, in law or in equity, or based upon any theory that seeks to impose liability of an entity party against its owners or affiliates) for any obligations or liabilities arising under, in connection with or related to this Agreement or for any claim based on, in respect of, or by reason of this Agreement or its negotiation or execution; and each party hereto waives and releases all such liabilities, claims and obligations against any such Non-Party Affiliates. Non-Party Affiliates are expressly intended as third party beneficiaries of this provision of this Agreement.

(f) This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

While the foregoing provision is lengthy and is intended to address the concerns expressed by the courts in the *Italian* Cowboy, *Allen* and *Staton Holdings* cases,

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[35] This alternative Section 13.7 is derived from the Model Provisions suggested in Glenn D. West and W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 64 Bus. Law. 999, 1038 (Aug. 2009), as well as the *Italian Cowboy*, *Allen* and *Staton Holdings* discussed above; *see* Byron F. Egan, Patricia O. Vella and Glenn D. West, *Contractual Limitations on Seller Liability in M&A Agreements*, University of Texas School of Law 7th Annual Mergers and Acquisitions Institute, Dallas, TX, October 20, 2011, at Appendix B, *available at* http://images.jw.com/com/publications/1669.pdf.

circumstances and future cases will no doubt suggest revision of the foregoing in particular cases.

In *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 2003 U.S. Dist. Lexis 21122 (S.D.N.Y. 2003), an asset purchase agreement contained a "merger clause" equivalent to Section 13.7. After closing, the purchasers alleged that the sellers failed to disclose sham trades with Enron, which inflated the profitability of the business and violated applicable laws. Sellers argued that the analogue to Section 13.7 and a provision in the confidentiality agreement (which survived the making of the asset purchase agreement, unlike this Agreement in which the confidentiality agreement does not survive) precluded purchasers from making fraud in the inducement claims since they were not based on specific representations in the agreement. In ruling that purchasers' allegations were sufficient to survive a motion to dismiss, the Court wrote:

> In its counterclaim, Allegheny [purchaser] alleges that Merrill Lynch [seller] misrepresented GEM's [acquired business] internal controls, its infrastructure, its historical revenues, its trading volume, its growth rate, and the qualifications of Gordon. Merrill Lynch contends that Allegheny's counterclaims for fraudulent inducement should be dismissed because the alleged misrepresentations are not in Article III of the Purchase Agreement and the Purchase Agreement provided that only those representations and warranties in Article III had any legal effect [the Purchase Agreement provided: "Except for the representations and warranties contained in this Article III, neither the Sellers nor any other Person make any express or implied representation or warranty on behalf of or with respect to the Sellers, the Business or the Purchased Assets, and the Sellers hereby disclaim any representation or warranty not contained in this Article III."] Also, the Purchase Agreement contains a standard merger clause [like Section 13.7, the Purchase Agreement provided that the Purchase Agreement shall "constitute the entire agreement of the parties hereto with respect to the subject matter hereof . . . and supercede all prior agreements and undertakings, both written and oral, between the Purchasers and the Sellers . . . other than the Confidentiality Agreement," which does not survive in this Agreement]. In addition, the Confidentiality Agreement provided that "neither party makes any representation or warranty as to the accuracy or completeness of the Evaluation Material and that only those representations and warranties made in a definitive agreement, if any, shall have any legal effect." Merrill Lynch contends that given the disclaimer and the merger clause in the Purchase Agreement and the disclaimer in the Confidentiality Agreement, both of which documents were negotiated between sophisticated parties represented by counsel, Allegheny relied at its peril on any representations not included in the Purchase Agreement and that this lack of reasonable reliance is fatal to a claim for fraudulent inducement, whether the remedy is rescission or money, and negligent misrepresentation. Allegheny advances two theories to get their claim for fraudulent inducement around the provisions in the Purchase Agreement and the Confidentiality Agreement: First, they contend a general, non-specific disclaimer does not bar a fraudulent-inducement claim, and second, the matters misrepresented were peculiarly within Merrill Lynch's knowledge.

As the Second Circuit noted, "Where sophisticated businessmen engaged in major transactions enjoy access to critical information but fail to take advantage of that access, New York courts are particularly disinclined to entertain claims of justifiable reliance." *Grumman Allied Industries, Inc. v. Rohr Industries, Inc.,* 748 F.2d 729, 737 (2d Cir. 1984). "In assessing the reasonableness of a plaintiff's alleged reliance, we consider the entire context of the transaction, including factors such as its complexity and magnitude, the sophistication of the parties, and the content of any agreements between them." *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.,* 343 F.3d 189, 195 (2d Cir. 2003). It is settled in New York that "Where a party specifically disclaims reliance upon a representation in a contract, that party cannot, in a subsequent action for fraud, assert it was fraudulently induced to enter into the contract by the very representation it has disclaimed." *Banque Arabe Et Internationale D'Investissement v. Maryland Nat'l Bank*, 57 F.3d 146, 155 (2d Cir. 1995) (quoting *Grumman Allied Indus. Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 734-35 (2d Cir. 1984)). However, a "disclaimer is generally enforceable only if it 'tracks the substance of the alleged misrepresentation . . . .'" *Caiola v. Citibank, NA.,* 295 F.3d 312, 330 (2d Cir. 2002) (quoting *Grumman Allied,* 748 F.2d at 735). As Merrill Lynch concedes, the disclaimer at issue here is general and does not track the substance of the alleged misrepresentations — *i.e.*, it does not state that Merrill Lynch disclaims any prior representations about the Enron transactions or Gordon's qualifications. Nevertheless, there is considerable authority for Merrill Lynch's position that this general disclaimer, which was between sophisticated entities negotiated at arms' length, should nevertheless be given effect and deprive Allegheny of a claim for reasonable reliance on any other representation — especially where the agreement enumerates representations in detail and contains a merger clause. *See, e.g., Harsco Corp. v. Segui*, 91 F.3d 337, 345-46 (2d Cir, 1996); *Consolidated Edison, Inc. v. Northeast Utilities*, 249 F. Supp. 2d 387, 401 (S.D.N.Y. 2003) ("In this case, the specific disclaimer in the Confidentiality Agreement combined with the merger clause in the Merger Agreement defeat any claim of reasonable reliance on the alleged oral statements in the course of due diligence and the written August Policies."). In *Harsco*, the Court explained:

> [R]elying on the sophisticated context of this transaction, we hold that Harsco must be held to its agreement. . . . We think Harsco should be treated as if it meant what it said when it agreed in Section 2.05 that there were no representations other than those contained in Sections 2.01 through 2.04 that were part of the transaction. [T]he exhaustive nature of the Section 2.04 representations adds to the specificity of Section 2.05's disclaimer of other representations. We can see no reason not to hold Harsco to the deal it negotiated.

Harsco, 91 F.3d at 346; *see also id.* ("Under the circumstances of this case, 'no other representations' means no other representations.").

Despite the general hostility of courts to claims by sophisticated business entities for fraudulent inducement, under the standards applicable at this stage of the litigation, I am unwilling to conclude as a matter of law that Allegheny's reliance on these alleged misrepresentations was unreasonable. Most significantly, the agreements in the cases that Merrill Lynch relies on placed the burden on the buyer to perform its due diligence and to ensure that the representations in the final agreement covered known or readily

knowable risks. Here, the Purchase Agreement places at least some of that burden on Merrill Lynch, *e.g.*, "all information known to Sellers which, in their reasonable judgment exercised in good faith, is appropriate for Purchasers to evaluate the trading positions and trading operations of the Business." Also significant is the fiduciary relationship, which, though terminated when the alleged misrepresentations and/or omissions were made, had existed until shortly before the representations. Finally, Allegheny Energy has alleged that the information was peculiarly within Merrill Lynch's knowledge. *See Banque Arabe*, 57 F.3d at 155 ("[E]ven such an express waiver or disclaimer 'will not be given effect where the facts are peculiarly within the knowledge of the party invoking it.'" (quoting *Stambovsky v. Ackley*, 572 N.Y.S.2d 672, 677 (App. Div. 1st Dep't 1991)). In *Banque Arabe*, the court determined that the party could not reasonably rely on the other party to disclose the allegedly fraudulently concealed information because the information generally was readily accessible to anyone who inquired and the risk associated with this information was known and disclosed. *BanqueArabe*, 57 F.3d at 156-57. Here, in contrast, Allegheny has alleged that the information at issue was not generally known nor readily accessible because it pertained to potentially illegal activity that Merrill Lynch would not want to disclose.

After a bench trial on the merits, the Court commented that the case is a "saga of missteps taken by two of America's largest and most respected entities and which it is sad to say can only be characterized as having happened through a combination of fraud and greed." *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 2005 WL 1663265 (S.D.N.Y. 2005). The Court found that Merrill Lynch had unknowingly provided false and misleading information during the course of a four-month $6 million due diligence process conducted for Allegheny by a team of "revered" accounting, legal and investment banking firms, but that Allegheny was never in the dark about "the incredible difficulty in nailing down any sort of concrete value" for a key asset and had received corrected financial data as the asset purchase agreement was being finally negotiated and before it was signed. The Court concluded that there was no proof the Merrill Lynch provided "financial material was not prepared in good faith or that it is not basically accurate." In holding against Allegheny on its breach of warranty and fraudulent inducement claims, the Court wrote:

> It is not enough that Allegheny show that warranties in the Purchase Agreement were breached. In order to prevail in its breach of contract claims, Allegheny must show that the misrepresentations or omissions were the proximate cause of reasonably certain damages.
>
> * * *
>
> Allegheny conflates proximate cause and calculation of damages through its assertion that it is entitled to the difference between the price it paid and the hypothetical "true value" of the GEM at the time of purchase. Allegheny claims that it was deceived into paying a premium for GEM by Merrill Lynch's misrepresentations about GEM's earnings and the quality and integrity of its personnel and this translates directly into money damages. But Allegheny has not been able to overcome the hurdle of proving that the damages, if any, were proximately caused by any of Merrill Lynch's misdeeds, so any discussion of damages, which in this Court's view are too speculative anyway, is misplaced.

* * *

Moreover, Allegheny's claim for benefit-of-the-bargain damages must be based on the "bargain that was actually struck, not on a bargain whose terms must be supplied by hypothesis about what the parties would have done if the circumstances surrounding their transaction had been different." * * *

To prevail on its claim of fraudulent inducement, Allegheny must prove (1) that Merrill Lynch made a material misrepresentation of fact or omission of fact; (2) Merrill Lynch acted knowingly or with reckless disregard of the truth; (3) Merrill Lynch intended to induce Allegheny's reliance; (4) Allegheny justifiably relied on ML's misrepresentation or omission; and (5) Allegheny suffered injury as a result. [citation omitted]

Allegheny argues there was a conspiracy afoot at Merrill Lynch to gain a fraudulent purchase price for its energy trading desk, the GEM. While it is certain that through its agent, Dan Gordon [a confessed embezzler who admitted he altered certain data to make GEM look more profitable], and perhaps others, Merrill Lynch made material misrepresentations of fact with regard to the financial documents provided to Allegheny, and these documents made the GEM look more attractive for purchase than it really was. The critical problem for Allegheny is with regard to its justifiable reliance on any of the representations or omissions made by Merrill Lynch. * * * "Where sophisticated businessmen engaged in major transactions enjoy access to critical information but fail to take advantage of that access, New York courts are particularly disinclined to entertain claims of justifiable reliance." [citation omitted] Allegheny is undoubtedly a sophisticated party that was represented at every step by competent, experienced, and expensive advisors. Without exploring the parameters of their legal obligations, suffice it to say that by reputation at least they are the best in the business. Further, the evidence shows that Merrill Lynch opened its books and records and accorded Allegheny four months of due diligence. Allegheny cannot now claim to have reasonably relied on non-disclosures as to information that was available had it pursued its due diligence with a little more pizzazz.

* * *

The misrepresentations of which Allegheny now complains could have been discovered without great difficulty. It would not have taken much effort to discover the $43 million fraudulent insurance contract sold to the GEM by Dan Gordon, and pocketed by him, considering that the entire existence of the insurance company was a sham.

Moreover, Allegheny's fraud claim suffers from the same deficiency as its breach of contract claims in that it has failed to prove that its injury was the result of Merrill Lynch's misrepresentations or

omissions. In actions for fraud too, proximate cause (or loss causation) requires a plaintiff to show a direct link between the wrongdoings complained of and the damages alleged.

* * *

The District Court's dismissal, following a bench trial, of Allegheny's fraudulent inducement and breach of warranty claims was reversed by the Second Circuit in *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 500 F.3d 171 (2d Cir. 2007). *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 63 Bus. Law. 531, 543-546 (2008). As to liability, the Second Circuit focused on Merrill Lynch's warranties relating to the material accuracy of the financial records of the acquired business ("*GEM*"), as well as a broad warranty that the material Merrill Lynch had provided to Allegheny "in the aggregate, includes all information known to the Sellers which, in their reasonable judgment exercised in good faith, is appropriate for [Allegheny] to evaluate [GEM's] trading positions and trading operations".

On the fraudulent inducement claim, the Second Circuit held that the warranties "imposed a duty on [Merrill Lynch] to provide accurate and adequate facts and entitled [Allegheny] to rely on them without further investigation or sleuthing" (although, upon the retrial, Allegheny would be required to offer proof "that its reliance on the alleged misrepresentations was not so utterly unreasonable, foolish or knowingly blind as to compel the conclusion that whatever injury it suffered was its own responsibility"). For purposes of the breach of warranty claim, the Second Circuit cited "the general rule" "that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue", although if "the seller has disclosed at the outset facts that would constitute a breach of warranty" and "the buyer closes with full knowledge and acceptance of those inaccuracies", the buyer could not prevail on the breach of warranty claim.

As to claims for causation and damages for fraudulent inducement, the Second Circuit ruled that if the seller of the business fraudulently misrepresented the qualities of the business (including its key personnel and financial performance), the buyer would be entitled to an award of damages measured by the extent to which the purchase price overstated the value of the business on the date of sale as a result of the sellers' misrepresentations and omissions. On the breach of warranty contract claim, the buyer would be "entitled to the benefit of its bargain", measured as the difference between the value of the business as warranted by the seller and its true value "as delivered" at the time of the transaction. This "value as delivered", in the Court's view, "should reflect any deductions from [the] purchase price necessary to reflect the broken warranties".

Securities Law Anti-Waiver Provisions. In the event that the transaction in the *Merrill Lynch* case had involved a "security" within the meaning of the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (the "*1934 Act*"), and the purchasers were asserting claims under Rule 10b-5 under the 1934 Act, the sellers could have argued that the combination of the merger clause and the provision that no representations were made beyond those expressly set forth in Article 3 negated the "reliance" necessary to state a claim for fraud under Rule 10b-5. Purchasers would have countered that such a provision constitutes an "anticipatory waiver" which is void under Section 29(a) of the 1934 Act, which provides: "Any condition, stipulation, or provision

binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder…shall be void." The result is a matter of federal law, and may vary depending upon the circuit in which the matter is litigated. *Compare AES Corp. v. Dow Chemical Co.*, 325 F.3d 174 (3d Cir. 2003) and *Rogen v. Illikon*, 361 F.2d 260 (1st Cir. 1966) holding that such a non-reliance provision is not enforceable as a matter of law, although it may support a finding of fact that purchasers' alleged reliance was not reasonable under the circumstances, *with Harsco Corp. v. Sequi*, 91 F.3d 337 (2d Cir. 1966) holding that such a provision does not constitute a forbidden waiver where it is developed via negotiations among sophisticated business entities and their advisors.

In *Lone Star Fund V (US), LP v. Barclays Bank PLC*, 594 F.3d 383 (5th Cir. 2010), Lone Star alleged that Barclays engaged in a $60 million fraud relating to mortgage-backed securities that Barclays sold to Lone Star. The Fifth Circuit allowed a nuanced contractual limitation on remedies to preclude a securities fraud claim by affirming the district court dismissal of the case because Lone Star failed to allege a misrepresentation in light of the "repurchase or substitute" clauses in the parties' mortgage-backed securities purchase contracts. Mortgage-backed securities are secured by pools of mortgages which are collected into a trust, mortgage payments are sent to that trust, then pooled, and then paid out to the holders of the securities. The value of the mortgage pool turns on whether borrowers consistently pay in a timely manner so that the holders will receive a steady stream of income.

The dispute before the Fifth Circuit involved two sets of mortgage-backed securities that Barclays sold to Lone Star under prospectuses that included representations and warranties guaranteeing the quality of the mortgage pools, which together contained more than 10,000 residential mortgages. Shortly after the purchases, Lone Star discovered that 290 mortgages were more than thirty days overdue ("delinquent") at the time of purchase. Barclays admitted that 144 of the mortgages were delinquent and promptly substituted new mortgages to replace any that were still delinquent. Lone Star then investigated further and found that 848 of the loans had been delinquent at the time of purchase.

Lone Star sued Barclays under both state and federal law for material misrepresentations and fraud. Lone Star alleged that, contrary to Barclays' representations, the trusts had a substantial number of delinquent loans, and that the misrepresentations constituted fraud. Since Lone Star's claims were predicated upon Barclays' alleged misrepresentation that there were no delinquent loans in the trusts when Lone Star purchased the securities, Lone Star had to successfully allege both that Barclays represented that the trusts had no delinquent mortgages and that the representations were false when made.

In the prospectuses, Barclays made representations and warranties with respect to each mortgage loan "no payment required under the mortgage loan is 30 days or more Delinquent nor has any payment under the mortgage loan been 30 days or more Delinquent at any time since the origination of the mortgage loan." The court found that, standing alone, these "no delinquency" provisions would support Lone Star's contentions, but that the representations were isolated portions of complex contractual documents that must be read in their entirety to be given effect:

> Read as a whole, the prospectuses and warranties provide that the mortgages *should be* non-delinquent, but if some mortgages were

> delinquent then Barclays would either repurchase them or substitute performing mortgages into the trusts. . . . Moreover, the clauses constitute the "sole remedy" for material breach for purchasers like Lone Star.
>
> Thus, Barclays did not represent that the . . . mortgage pools were absolutely free from delinquent loans at the time of purchase. The agreements envision that the mortgage pools might contain delinquent mortgages, and they impose a "sole" remedy to correct such mistakes. Indeed, Barclays fulfilled the repurchase or substitute obligations when Lone Star informed it of the delinquent mortgages in November 2007. Lone Star does not and cannot allege that Barclays breached its duty to remediate the mortgage pools.
>
> These provisions are sensible given the difficulties of investigating the underlying residential mortgages. Even the best due diligence may overlook problems. A mortgage may become delinquent from a single missed payment. Some of the loans might fall into delinquency during the pendency of the transactions leading to an investor's purchases. Because mistakes are inevitable, both seller and purchaser are protected by a promise that the mortgage pools will be free from later-discovered delinquent mortgages. This is what Barclays promised and Lone Star agreed. As a sophisticated investor placing a $60 million investment in the trusts, Lone Star has no basis to ignore these provisions or their consequences.
>
> Consequently, Barclays made no actionable misrepresentations. Even though the mortgage pools contained delinquent mortgages, Appellants have not alleged that Barclays failed to substitute or repurchase the delinquent mortgages. Appellants' efforts to focus on a single representation amid hundreds of pages of contractual documents are misplaced. They are bound by the entirety of the contract.

Lone Star asserted that the "repurchase or substitute" clauses were void as against public policy because they waive its right to sue for fraud. Rejecting this argument, the court held that "[r]ather than waive [Lone Star's] right to pursue claims of fraud, the 'repurchase or substitute' clauses change the nature of Barclays' representation." The court found that Lone Star did not allege that Barclays falsely represented to prospective investors that it would repurchase or substitute delinquent mortgages, which the court said might have stated a case of fraud under the pertinent agreements.

Thus a contractual limitation on remedies – an agreement to restore the quality of the securities to the level represented – would preclude a securities law fraud claim. In the typical M&A context (e.g., *ABRY*), a judgment regarding the exclusive remedy provision and what type of misrepresentation occurred can mean the difference between capped indemnity on the one hand and uncapped indemnity or rescission on the other hand (i.e., millions of dollars in a zero-sum game between buyer or seller). In this case, implicit in the Fifth Circuit's ruling that seller did not defraud buyer is the fact that buyer and seller agreed in advance to an equitable exclusive remedy – "repurchase or substitute" – designed to return buyer to its promised position.

Section 13.7 also states that the acquisition agreement may be amended only by a written agreement signed by the party to be charged with the amendment. This Section reflects the principle that a contract required by the Statute of Frauds to be in writing may not be orally modified, and follows Section 2-209(2) of the Uniform Commercial Code, which provides that "[a] signed agreement which excludes modification or recision except by a signed writing cannot be otherwise modified or rescinded. . . ." *Cf.* CAL. CIV. CODE § 1698; *Deering Ice Cream Corp. v. Columbo, Inc.*, 598 A.2d 454, 456 (Me. 1991) ("The parties never memorialized any meeting of the minds on modifying their contract in the form required by the contract documents.") However, the rule prohibiting oral modification of contracts within the Statute of Frauds has not been applied in cases in which there has been partial performance of an oral agreement to modify the written contract, especially if one party's conduct induces another to rely on the modification agreement. *See, e.g.*, *Rose v. Spa Realty Assoc.*, 42 N.Y.2d 338, 340-41 (1977); *Ridley Park Shopping Ctr., Inc. v. Sun Ray Drug Co.*, 180 A.2d 1 (Pa. 1962); *Paul v. Bellavia*, 536 N.Y.S.2d 472, 474 (App. Div. 1988); *cf.* Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203 (1997).

A sale of *assets* may yield more employment or labor issues than a stock sale or statutory combination, because the seller will typically terminate its employees who may then be employed by the buyer or have to seek other employment.

VI. GOVERNING LAW

13.13 GOVERNING LAW

This Agreement will be governed by and construed under, and all claims or causes of action (whether in contract or in tort, in law or in equity) that may be based upon, arise out of or relate to this Agreement, or the negotiation, execution or performance of this Agreement (including any representation or warranty made in or in connection with this Agreement or as an inducement to enter into this Agreement) shall be determined and adjudicated under, the laws of the State of _____ without regard to conflicts of laws principles that would require the application of any other law.

COMMENT

The parties' choice of law can affect the outcome of litigation over a merger agreement. In a case granting specific performance to a target, *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001), the Delaware Court of Chancery suggested that its decision might have been different if it had applied Delaware rather than New York law (the law chosen by the parties to govern the merger agreement) as governing the burden of proof to justify that remedy. The standard under New York law is a "preponderance of the evidence," whereas Delaware law would have required a showing by "clear and convincing" evidence. Of course it may be impractical to fully evaluate at the drafting stage the potential effect of choosing the law of one state over another because of the many ways in which disputes can arise over the interpretation and enforcement of a merger agreement.

This Section allows the parties to select the law that will govern the contractual rights and obligations of the Buyer, the Seller and the Shareholders. (The parties may want to specify a different choice of law with regard to non-competition provisions.)

Without a choice of law provision, the court must assess the underlying interest of each jurisdiction to determine which jurisdiction has the greatest interest in the outcome of the matter. The part of Section 13.13 following the designation of a state seeks to have applied only those conflicts of laws principles of the state designated that validate the parties' choice of law. As for which laws the parties may select, the *Restatement, (Second) of Conflict of Laws* § 187 provides:

> § 187. Law of the State Chosen by the Parties
>
> (1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.
>
> (2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either
>
> > (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
> >
> > (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.
>
> (3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.

In *Nedlloyd Lines B.V. v. Superior Court of San Mateo County (Seawinds Ltd.)*, 3 Cal. 4th 459 (1992), the Supreme Court of California applied these principles to uphold a choice of law provision requiring a contract between commercial entities to finance and operate an international shipping business to be governed by the laws of Hong Kong, a jurisdiction having a substantial connection with the parties:

> Briefly restated, the proper approach under Restatement section 187, subdivision (2) is for the court first to determine either: (1) whether the chosen state has a substantial relationship to the parties or their transaction, or (2) whether there is any other reasonable basis for the parties' choice of law. If neither of these tests is met, that is the end of the inquiry, and the court need not enforce the parties' choice of law . . . . If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a *fundamental* policy of California. . . . If there is no such conflict, the court shall enforce the parties' choice of law. If, however, there is a fundamental conflict with California law, the court must then determine whether California has a "materially greater

> interest than the chosen state in the determination of the particular issue."... If California has a materially greater interest than the chosen state, the choice of law shall not be enforced, for the obvious reason that in such circumstance we will decline to enforce a law contrary to this state's fundamental policy.

Id. at 466 (footnotes omitted); *see also Kronovet v. Lipchin*, 415 A.2d 1096, 1104 n.16 (Md. Ct. App. 1980) (noting that "courts and commentators now generally recognize the ability of parties to stipulate in the contract that the law of a particular state or states will govern construction, enforcement and the essential validity of their contract" but recognizing that "the parties' ability to choose governing law on issues of contract validity is not unlimited and will not be given effect unless there is a 'substantial' or 'vital' relationship between the chosen sites and issues to be decided.").

However, choice of law provisions have not been uniformly upheld by the courts. *See, e.g., Rosenmiller v. Bordes*, 607 A.2d 465, 469 (Del. Ch. 1991) (holding that, notwithstanding an express choice of New Jersey law in the agreement, Delaware had a greater interest than New Jersey in regulating stockholder voting rights in Delaware corporations, and therefore the parties' express choice of New Jersey law could not apply to this issue); *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 677-78 (Tex. 1990) (Supreme Court of Texas adopted the choice of law rule set forth in § 187 of the *Restatement, (Second) of Conflict of Laws*, and held that a choice of law provision (such as Section 13.13) will be given effect if the contract bears a reasonable relation to the state whose law is chosen and no public policy of the forum state requires otherwise; at issue in that case was a covenant not to compete in an employment context and the court held that its holdings on the nonenforceability of covenants not to compete were a matter of fundamental public policy which overrode the parties' choice of law agreement. *DeSantis* was in turn overridden by the subsequent enactment of Section 35.51 of the Texas Business and Commerce Code which generally validates the contractual choice of governing law for transactions involving at least $1,000,000).

Historically, courts had applied rigid tests for determining what substantive law was to govern the parties' relationship. In a contractual setting, the applicable test, *lex contractus*, stated that the substantive law of the place of contract formation governed that contract. As interstate and international commerce grew, several problems with this test became evident. First, at all times it was difficult to determine which jurisdiction constituted the place of contract formation. Second, this rule frustrated the ability of sophisticated parties to agree on the law that would govern their relationship.

A modern approach, exemplified in the *Restatement, (Second) of Conflict of Laws* (particularly Sections 6, 187 and 188), focuses on the jurisdiction with the "most significant relationship" to the transaction and the parties where the parties did not choose a governing law. Where the parties did choose a governing law, that choice was to be respected if there was a reasonable basis for the choice and the choice did not offend a fundamental public policy of the jurisdiction with the "most significant relationship."

Several states have now gone a step further by enacting statutes enabling parties to a written contract to specify that the law of that state would govern the parties' relationship, notwithstanding the lack of any other connection to that state. *See e.g.*, Del. Code tit. 6, § 2708; Fla. Stat. § 685.101; 735 Ill. Comp. Stat. 105/5-5; N.Y. Gen. Oblig.

Law § 5-1401; and Ohio Rev. Code § 2307.39. These statutes recognize that sophisticated parties may have valid reasons to choose the law of a given jurisdiction to govern their relationship, even if the chosen jurisdiction is not otherwise involved in the transaction.

These statutes contain several criteria intended to ensure that they are used by sophisticated parties who understand the ramifications of their choice. The primary requirement is that the transaction involve a substantial amount. Certain of these statutes do not apply to transactions for personal, family or household purposes or for labor or personal services. Further, these statutes do not apply to transactions where Section 1-105(2) of the Uniform Commercial Code provides another governing law. One of these statutes requires the parties to be subject to the jurisdiction of the courts of that jurisdiction and subject to service of process. That statute also specifically authorizes courts of that jurisdiction to hear disputes arising out of that contract. Del. Code tit. 6. § 2708. *See also* Ohio Rev. Code § 2307.39 (authorizing commencement of a civil proceeding in Ohio courts if the parties choose Ohio governing law and consent to jurisdiction of its courts and further providing that Ohio law would be applied). See the Comment to Section 13.4.

Practitioners may wish to consider the use of one of these statutes in appropriate circumstances, perhaps to choose a neutral jurisdiction if the choice of law negotiation has become heated. However, these statutes are a relatively new development and, as such, are not free from uncertainty. Perhaps the most significant uncertainty is whether the choice of law based on such a statute would be respected by a court of a different jurisdiction. While valid reasons (such as protecting the parties' expectations) suggest their choice is likely to be respected, the outcome is not yet clear.

While a choice of law clause should be enforceable as between the parties where the appropriate relationship exists, the parties' choice of law has limited effect with respect to third party claims (*e.g.*, claims under Bulk Sales Laws, Fraudulent Transfer Laws or various common law successor liability theories). *But c.f. Oppenheimer v. Prudential Securities, Inc.*, 94 F.3d 189 (5th Cir. 1996) (choice of New York law in asset purchase agreement applied in successor liability case without dispute by any of parties). Further, an asset transaction involving the transfer of assets in various jurisdictions may be governed as to title transfer matters by the law of each jurisdiction in which the transferred assets are located. *Restatement, (Second) of Conflict of Laws* §§ 189, 191, 222 and 223. In particular, the transfer of title to real estate is ordinarily governed by the laws of the state where the real estate is located. *Restatement, (Second) of Conflict of Laws* § 223.

A seller might propose an alternative governing law provision to support seller proposed provisions in Sections 3.33 (Disclosure) and 13.7 (Entire Agreement and Modification) to limit seller exposure to extracontractual liabilities reading as follows:

> *Governing Law*. This Agreement, and all claims or causes of action (whether in contract or tort) that may be based upon, arise out of or relate to this Agreement, or the negotiation, execution or performance of this Agreement (including any claim or cause of action based upon, arising out of or related to any representation or warranty made in or in connection with this Agreement or as an inducement to enter into this

Agreement), shall be governed by the internal laws of the State of [_____].[36]

VII. CONCLUSION

As the above discussion highlights, sellers can be exposed to significant liability in acquisition agreements. Accordingly, practitioners should pay particularly close attention to the drafting of anti-reliance, integration and indemnification provisions to ensure the most protection possible for the seller.

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[36] This alternative Section 13.13 is derived from the Model Provisions suggested in Glenn D. West and W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 64 Bus. Law. 999, 1038 (Aug. 2009), as well as the *Italian Cowboy*, *Allen* and *Staton Holdings* discussed above; *see* Byron F. Egan, Patricia O. Vella and Glenn D. West, *Contractual Limitations on Seller Liability in M&A Agreements*, University of Texas School of Law 7th Annual Mergers and Acquisitions Institute, Dallas, TX, October 20, 2011, at Appendix B, *available at* http://images.jw.com/com/publications/1669.pdf.

APPENDIX A

Glenn D. West & W. Benton Lewis, Jr.,
Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?,
64 Bus. Law. 999 (Aug. 2009)

Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?

*By Glenn D. West and W. Benton Lewis, Jr.** | Author Bios

Although business lawyers frequently incorporate well-defined liability limitations in the written agreements that they negotiate and draft on behalf of their corporate clients, contracting parties that are dissatisfied with the deal embodied in that written agreement often attempt to circumvent those limitations by premising tort-based fraud and negligent misrepresentation claims on the alleged inaccuracy of both purported pre-contractual representations and express, contractual warranties. The mere threat of a fraud or negligent misrepresentation claim can be used as a bargaining chip by a counterparty attempting to avoid the contractual deal that it made. Indeed, fraud and negligent misrepresentation claims have proven to be tough to define, easy to allege, hard to dismiss on a pre-discovery motion, difficult to disprove without expensive and lengthy litigation, and highly susceptible to the erroneous conclusions of judges and juries. This Article traces the historical relationship between contract law and tort law in the context of commercial transactions, outlines the sources, risks, and consequences of extra-contractual liability for transacting parties today, and surveys the approaches that various jurisdictions have adopted regarding the ability of contracting parties to limit their exposure to liability for common law fraud and misrepresentation. In light of the foregoing, the authors propose a series of defensive strategies that business lawyers can employ to try to limit their clients' exposure to tort liability arising from contractual obligations.

I. Introduction

A sophisticated private equity buyer sought to rescind its acquisition of a portfolio company of a sophisticated private equity seller, alleging that several representations and warranties set forth in the stock purchase agreement were false.[1] But the indemnification provisions in the contested agreement limited the buyer's recourse for any contractual misrepresentation to a claim for damages

* Glenn D. West is a partner and W. Benton Lewis, Jr., is an associate in the Corporate Transactions Group of Weil, Gotshal & Manges LLP. Mr. West and Mr. Lewis wish to thank Stacie L. Cargill and Paul M. McBride for their research assistance with this Article and Irwin H. Warren for his helpful editorial comments. The views expressed in this Article are solely those of the authors, and are not necessarily shared or endorsed by Weil, Gotshal & Manges LLP or its partners.

1. *See* ABRY Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1034 (Del. Ch. 2006). *See also* Todd E. Lenson & David I. Schultz, *Lies, Damn Lies and M&A Fraud*, Corp. Couns., Aug. 2006, at 1.

capped at a specified percentage of the purchase price.[2] And another provision of the contested agreement expressly stated that the buyer's right to indemnification thereunder was its sole and exclusive remedy for any misrepresentation, contractually precluding the very type of rescission claim the buyer asserted in its pleadings.[3]

So, the seller naturally moved to dismiss the case for failure to state a claim, requesting that the court enforce the contractual limitation on liability to which the transacting parties had specifically agreed.[4] Indeed, "[g]iven the sophisticated nature of the parties, and the express stipulation that the exclusive remedy provision of the [a]greement was specifically bargained for and . . . reflected in setting the deal price," the seller argued that the buyer could not ignore the remedial restrictions to which it voluntarily consented.[5]

But the buyer countered that the contractual limitation on the seller's liability was unenforceable as a matter of public policy, claiming that Delaware law would not "tolerate an attempt by a contracting party to immunize itself from a rescission claim premised on false representations of fact contained within a written contract and recognized by the parties to be the factual predicate for their decision to contract."[6] To enforce such a provision, in the eyes of the buyer, "would be to sanction unethical business practices of an abhorrent kind and . . . create an unwise incentive system for contracting parties that would undermine the overall reliability of promises made in contracts."[7]

As most business lawyers are aware, the Delaware Court of Chancery confronted these very facts and the attendant public policy considerations in *ABRY Partners V, L.P. v. F & W Acquisition LLC*, a 2006 case that required that court to identify the boundaries of contractual freedom under Delaware law and grapple with a stark choice: Should the court give effect to the indemnification and exclusive remedy provisions, which the transacting parties negotiated at length and adjusted the purchase price to reflect?[8] Or, should the court override the plain terms of those provisions to provide the buyer with an opportunity to press its claim for rescission on the simple ground that the buyer had alleged "fraud?"[9]

In the *ABRY* opinion's most well-known holding, Vice Chancellor Leo Strine, Jr., concluded that the public policy of Delaware did not permit the court to enforce the indemnification and exclusive remedy provisions set forth in the parties' written agreement to the extent that they "purport[ed] to limit the [s]eller's exposure for its own conscious participation in the communication of lies to the [b]uyer."[10] Therefore, the court held, the stock purchase agreement, despite its

2. *ABRY*, 891 A.2d at 1034.
3. *Id.* at 1035.
4. *See id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. *See id.* at 1052–65.
9. *See id.*
10. *Id.* at 1064.

express terms, could not preempt the buyer's right to bring a rescission claim if "the [s]eller knew that the [portfolio] [c]ompany's contractual representations and warranties were false" or "the [s]eller itself lied to the [b]uyer about a contractual representation and warranty."[11] So while the court did not reach the issue of whether the seller had, in fact, "lied" to the buyer, the effect of the decision was to allow an uncapped, extra-contractual tort claim based upon contractual warranties to proceed against the seller despite the specifically negotiated remedial limits set forth in the carefully crafted stock purchase agreement that delineated the disputed warranties.

On one level then, *ABRY* illustrates the proposition that written agreements, no matter how fervently negotiated or tightly drafted, may not always constitute the exclusive source of the rights, protections, duties, and remedies of their signatories.[12] Indeed, that the buyer's fraud claim survived the seller's motion to dismiss illustrates the susceptibility of contractual relationships to tort-based attacks and the reluctance of some courts to enforce the liability-limiting provisions that contracting parties employ to disable them. And this phenomenon, whereby courts permit extra-contractual misrepresentation claims based upon allegations of fraud to advance in the face of contractual provisions that expressly preclude them, presents difficult challenges for business lawyers whose clients specifically factor the remedial options available to their counterparties into the purchase price of their transactions.

But the court in *ABRY* also recognized a contracting party's enormous power to limit, waive, or disclaim certain types of tort-based causes of action.[13] While courts in some states permit virtually all types of extra-contractual misrepresentation claims to proceed based upon allegations of fraud and negligent misrepresentations in the face of contractual limitations on such claims,[14] the *ABRY* court adopted a more nuanced approach.[15] Indeed, Vice Chancellor Strine found it "difficult to fathom how it would be immoral for the [s]eller and [b]uyer to allocate the risk of intentional lies by the [portfolio] [c]ompany's managers to the [b]uyer, and certainly that is so as to reckless, grossly negligent, negligent, or innocent misrepresentations of fact" by the portfolio company.[16] As a result, the Court of

11. *Id.*

12. *See generally* Allen Blair, *A Matter of Trust: Should No-Reliance Clauses Bar Claims for Fraudulent Inducement of Contract?*, 92 MARQ. L. REV. 423 (2009); Kabir Masson, Note, *Paradox of Presumptions: Seller Warranties and Reliance Waivers in Commercial Contracts*, 109 COLUM. L. REV. 503 (2009); Glenn D. West, *Avoiding Extra-Contractual Fraud Claims in Portfolio Company Sales Transactions—Is "Walk-Away" Deal Certainty Achievable for the Seller?*, PRIVATE EQUITY ALERT (Weil, Gotshal & Manges, LLP, New York, N.Y.), Mar. 2006, at 1, *available at* http://www.weil.com/news/pubdetail.aspx?pub=8478; Kevin Davis, *Licensing Lies: Merger Clauses, The Parol Evidence Rule and Pre-Contractual Misrepresentations*, 33 VAL. U. L. REV. 485 (1999); Elizabeth Cumming, Note, *Balancing the Buyer's Right to Recover for Precontractual Misstatements and the Seller's Ability to Disclaim Express Warranties*, 76 MINN. L. REV. 1189, 1207–08 (1992).

13. *See ABRY*, 891 A.2d at 1064.

14. *See, e.g.*, Martinez v. Zovitch, 867 A.2d 149, 156 (Conn. App. Ct.), *cert. denied*, 876 A.2d 1202 (Conn. 2005); Bates v. Southgate, 31 N.E.2d 551, 558 (Mass. 1941); Blanchard v. Blanchard, 839 P.2d 1320, 1322–23 (Nev. 1992). *See also infra* notes 165–74 and accompanying text.

15. *See ABRY*, 891 A.2d at 1064.

16. *Id.* at 1063.

Chancery enforced the disputed exclusive remedy provisions—and a related non-reliance clause—to preclude most of the buyer's other tort-based misrepresentation claims, including fraud claims based upon proof of mere "recklessness," and even fraud claims premised upon purported "lies" that were not set forth within the four corners of the written agreement.[17] Therefore, Vice Chancellor Strine held that Delaware law only prohibited the court from enforcing the exclusive remedy and disclaimer-of-reliance provisions to dismiss the fraud claims that the plaintiff premised upon the *deliberate* lies of the seller *itself*, and then only to the extent those lies were expressed as specific contractual representations and warranties set forth in the contentious stock purchase agreement.[18]

Far from teaching us that agreements do not matter because contracting parties cannot prophylactically limit their exposure to tort liability for fraud and misrepresentation, *ABRY* instead illustrates the fundamental tension between the legal doctrines of contract and tort and represents one influential court's view of the extent to which the parties to a written agreement can determine for themselves whether—and to what extent—they will be exposed to liability under each. Recognizing that this tension—and the uncertainty it breeds—complicates the contract draftsman's task of defining his or her client's rights and obligations with certainty, this Article will explore the interplay of contract and tort that spawned the threat of extra-contractual liability, outline its practical implications, and suggest a series of measures that we, as sophisticated business lawyers, can employ to maximize the likelihood that a court will enforce the express terms of the written agreements our clients engage us to craft.[19]

Although we acknowledge that federal and state securities laws can also interfere with contract-based relationships when the subject matter of the contract is a sale of securities, we have limited the scope of our Article to common law tort-based claims.[20] Importantly, however, many of the issues that arise in common law tort-based fraud claims may also arise in securities fraud claims, including issues relating to the enforceability of disclaimers of reliance.[21] And in many

17. *See id.* at 1064.

18. *See id.*

19. This Article expands upon an earlier, less comprehensive article and two conference papers authored or co-authored by Mr. West, and seeks to provide both a practical guide for business lawyers and a more complete academic approach to this subject in an effort to influence both the attorneys and deal professionals who negotiate sophisticated business agreements and the courts that interpret and enforce them. *See* West, *supra* note 12; Glenn D. West & Emmanuel Obi, *Avoiding Fraud and Other Extra-Contractual Claims: There May Be More to the Deal than the Contract—2007*, MERGERS & ACQUISITIONS INST. (Univ. of Tex. Sch. of L., Austin, Tex.), Oct. 4, 2007; Glenn D. West & Benton B. Bodamer, *Avoiding Fraud and Other Extra-Contractual Claims: There May Be More to the Deal than the Contract*, MERGERS & ACQUISITIONS INST. (Univ. of Tex. Sch. of L., Austin, Tex.), Sept. 7–8, 2006.

20. For example, state securities laws, also known as "blue sky laws," may constitute a source of contract-related fraud liability relating to transactions involving securities. *See, e.g.*, N.Y. GEN. BUS. LAW §§ 352 to 359-H (McKinney 1996).

21. To establish an actionable claim under section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), a private plaintiff must demonstrate that the defendant: "[(1)] made a misstatement or an omission of a material fact (2) with scienter (3) in connection with the purchase or the sale of a security (4) upon which the plaintiff reasonably relied and (5) that the plaintiff's reliance

cases, the principles and techniques that we describe in this Article are also applicable to securities fraud claims, with a significant difference being that federal securities fraud claims are brought exclusively in federal court, and not in state court.[22]

We begin in Part II of this Article with a review of the historical development of the common law principles that govern contract making and enforcement, on the one hand, and the principles that inspired the tort duties that courts impose independently of contractual undertakings, on the other hand. We then describe the process by which early courts blended tort duties and contractual obligations in the context of representations and warranties and eventually molded the common law fraud and negligent misrepresentation claims out of which most extra-contractual liability arises today. Because understanding our clients' exposure to extra-contractual liability (and the extent to which that exposure may vary by jurisdiction) informs our ultimate ability to limit it, in Part III we provide both an overview of the common law fraud and negligent misrepresentation causes of action that reflect the "contortion"[23] of contract and tort that we describe in Part II and an outline of the consequences that tort liability threatens for sophisticated contracting parties. In Part IV, we then illuminate the extent to which a transacting party's ability to disclaim or limit its contractual liability under the foregoing types of claims often depends on the law of the specific jurisdiction that the

was the proximate cause of his or her injury." AES Corp. v. Dow Chem. Co., 325 F.3d 174, 178 (3d Cir.) (internal quotation marks omitted), *cert. denied*, 540 U.S. 1068 (2003). So, as under the common law, sophisticated transacting parties seek to mitigate their exposure to securities fraud liability by contractually limiting their counterparties' ability to rely upon extra-contractual representations. Note that proof of "recklessness" is generally sufficient to establish the scienter element of a securities fraud claim. *See, e.g.*, Ronconi v. Larkin, 253 F.3d 423, 429 (9th Cir. 2001); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1039 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

22. 15 U.S.C. § 77v(a) (2006). *Express* waivers of securities fraud claims are not likely enforceable under section 29(a) of the Exchange Act, which provides that "any condition, stipulation, or provision binding any person to waive compliance with any provision" of the federal securities laws or any rule, regulation, or exchange rule promulgated or required thereunder "shall be void." 15 U.S.C. § 78cc(a) (2006). But clauses disclaiming (i) the existence of other pre- or extra-contractual representations or (ii) reliance appear to offer at least some utility in the federal circuits that have examined their enforceability. Though the U.S. Court of Appeals for the Third Circuit has held that section 29(a) forbids enforcement of an express disclaimer provision to preclude the mandatory reliance element of a securities fraud claim as a matter of law, the same court conceded that such a provision at least offers evidence of the plaintiff's non-reliance at both the trial and summary judgment stages. *See AES*, 325 F.3d at 180–81; *see also* Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1996). The U.S. Court of Appeals for the Second Circuit, by contrast, has held that section 29(a) does not prohibit enforcement of an express disclaimer of reliance to preclude the mandatory reliance element of a securities fraud claim as a matter of law, and can thereby justify dismissal of such a claim at the motion to dismiss stage. *See* Harsco Corp. v. Segui, 91 F.3d 337, 343 (2d Cir. 1996). And some courts have enforced contractual disclaimer-of-reliance provisions to render a securities fraud plaintiff's reliance on extra-contractual representations unreasonable as a matter of law without even acknowledging section 29(a). *See, e.g.*, Rissman v. Rissman, 213 F.3d 381, 384 (7th Cir.), *cert. denied*, 531 U.S. 987 (2000); One-O-One Enters., Inc. v. Caruso, 848 F.2d 1283, 1286 (D.C. Cir. 1988). *See generally* David K. Lutz, Note, *The Law and Economics of Securities Fraud: Section 29(A) and the Non-Reliance Clause*, 79 CHI.-KENT L. REV. 803 (2004).

23. Grant Gilmore coined the term "contort" in his 1974 book entitled *The Death of Contract*. GRANT GILMORE, THE DEATH OF CONTRACT 98 (Roland K.L. Collins ed., 2d ed. 1995) (1974).

parties have selected to govern their agreement.[24] And, taking into account each of these nuances, in Part V we propose specific drafting tips that will maximize the likelihood that courts will reject most, if not all, tort-based claims arising out of written agreements between sophisticated business parties. Finally, in Part VI, we suggest the approach that we believe courts should adopt when they evaluate the enforceability of contractual provisions in written agreements between sophisticated parties that specifically allocate the risk of allegedly "fraudulent" or negligent misrepresentations.

II. The "Contortion" of Contract and Tort

Good business lawyers understand the effect of case law developments on contract making and enforcement and adjust their negotiating and drafting strategies accordingly to maximize the likelihood that courts will interpret the written agreements they negotiate in a manner that advances their clients' best interests. Staying current with the reported decisions of courts that interpret business agreements, therefore, is a critical part of the business lawyer's job. Indeed, "predicting" how a court will construe written agreements is an important reason our clients hire us.[25]

But to predict the manner in which courts will interpret the contracts that we negotiate, it is also necessary to understand the policies and legal theories that underlie the doctrines that judges invoke to justify their decisions. While legislative enactments like the Uniform Commercial Code, the Securities Act of 1933, and other business-related statutes can impact the formation or enforceability of certain agreements, judge-made common law still predominates as the primary source of the legal rules that govern contract making and enforcement in the United States.[26] And while the common law has evolved independently in each American state since its original adoption therein, there remain certain consistent themes that are attributable to the fact that the common law of each jurisdiction is derived not only from judge-made decisions extending from "the present time back into the ancient courts of England,"[27] but also from a "system of reasoning

24. A properly drafted choice-of-law provision that states the law applicable not only to the contract itself, but also to all tort claims that may arise out of that contract, can be enforceable as to such tort claims. *See, e.g.*, Benchmark Elecs., Inc. v. J.M. Huber Corp., 343 F.3d 719, 726–28 (5th Cir. 2003); Kuehn v. Childrens Hosp., 119 F.3d 1296, 1302 (7th Cir. 1997); Karnes v. Fleming, No. H-070620, 2008 WL 4528223, at *4 (S.D. Tex. July 31, 2008); Hughes v. LaSalle Bank, N.A., No. 02 CIV 6384 (MGM), 2006 WL 620654, at *8 (S.D.N.Y. Mar. 13, 2006).

25. *See* Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 Harv. L. Rev. 457, 457 (1897).

26. *See* Elizabeth Warren, *Formal and Operative Rules Under Common Law and Code*, 30 UCLA L. Rev. 898, 925 (1983).

27. Morningstar v. Black & Decker Mfg. Co., 253 S.E.2d 666, 675 (W. Va. 1979). There is a remarkable consistency between English case law, the case law of other former English commonwealth jurisdictions, and the American courts on basic contract and tort issues. *See, e.g.*, Glenn D. West & Sarah G. Duran, *Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements*, 63 Bus. Law. 777, 791 n.66 (2008).

from case to case precedent that [has permitted] the common law to grow with and adapt to changing conditions of society."[28]

A. Negotiating the Dividing Line Between Contract and Tort

The common law of contracts is studied separately and considered distinct from the common law of torts—the body of law that governs civil liability for the negligent or intentional infliction of harm to persons or property.[29] And although the separation between these purportedly distinct bodies of common law has been blurred to a point that some have argued they are inextricably intertwined,[30] the principles that govern contract law are based upon policies that are clearly distinct from and, in many cases, directly in conflict with, the principles that govern tort law.[31]

The common law has developed a strong policy preference, known as "freedom of contract,"[32] which favors the ability of private parties to make any contract that does not promote or facilitate unlawful activity.[33] And as a corollary, courts have generally proven willing to enforce such contracts as written, engendering a respect for the mutually agreed upon terms and conditions of private agreements that has become recognized as the "sanctity of contract."[34]

Influenced by these fundamental principles of contract law, then, courts have often said that they will neither make a contract for private parties, nor excuse a party's performance of its obligations under an agreement because that party realized it made a bad deal.[35] Although courts often infer "default provisions" in

28. *Morningstar*, 253 S.E.2d at 675.

29. *See* S.C.M. (U.K.) Ltd. v. W.J. Whithall & Son Ltd., [1971] 1 Q.B. 337, 347 (U.K.) ("the law of torts can be defined as the complexus of civil liability for wrongs done by one person to another"); *see also* Charles Miller, Comment, *Contortions over Contorts: A Distinct Damages Requirement*, 28 Tex. Tech L. Rev. 1257, 1257 (1997).

30. *See, e.g.*, Miller, *supra* note 29, at 1257; William Lloyd Prosser, Selected Topics on the Law of Torts 452 (1953); Gilmore, *supra* note 23, at 98–99 (suggesting that many doctrines of contracts and torts could be combined to form a doctrine called "contorts").

31. *See* Erlich v. Menezes, 981 P.2d 978, 982 (Cal. 1999) ("Whereas contract actions are created to enforce the intentions of the parties to the agreement, tort law is primarily designed to vindicate 'social policy.'"); *see also* Etoll, Inc. v. Elias/Savion Adver., Inc., 811 A.2d 10, 14 (Pa. Super. Ct. 2002); Miller, *supra* note 29, at 1275.

32. *See* Black's Law Dictionary 689 (8th ed. 2004).

33. Courts will not aid parties in pursuing unlawful objectives by enforcing promises made in furtherance of those unlawful objectives. *See, e.g.*, McMullen v. Hoffman, 174 U.S. 639, 646–47 (1899); *see also* Levy v. Brush, 45 N.Y. 589, 594–95 (1871); Johnson v. Hulings, 103 Pa. 498, 504 (1883); William Rennick Riddell, *A Legal Scandal Two Hundred Years Ago*, 16 A.B.A. J. 422, 422–23 (1930).

34. *See* P.S. Atiyah, An Introduction to the Law of Contract 12 (3d ed. 1981) ("The sanctity of contractual obligations is merely an expression of the principle that once a contract is freely and voluntarily entered into, it should be held sacred, and should be enforced by the [c]ourts if it is broken."); *see also In re* Schenck Tours, Inc., 69 B.R. 906, 910–11 (Bankr. E.D.N.Y.), *aff'd*, 75 B.R. 249 (E.D.N.Y. 1987).

35. *See, e.g.*, Burger King Corp. v. Mason, 710 F.2d 1480, 1490 (11th Cir. 1983), *cert. denied*, 465 U.S. 1102 (1984); Heyman v. CBS, Inc., 423 A.2d 887, 894 (Conn. 1979); Maslow v. Vanguri, 896 A.2d 408, 421 (Md. Ct. Spec. App.), *cert. denied*, 903 A.2d 416 (Md. 2006) (unpublished table decision); Rainbow Oil Co. v. Christmann, 656 P.2d 538, 545 (Wyo. 1982). An early recognition of this rule may be found in *Adams v. Nichols*, 36 Mass. (19 Pick.) 275 (1825). The court stated:

agreements that fail to provide guidance on the subject of a given contractual dispute, they generally do not impose these provisions on the contracting parties.[36] Instead, a "default provision" becomes part of an agreement only in the absence of a contract clause that addresses the subject of the provision, and is designed to approximate the agreement the contracting parties would have reached if their contract had considered the relevant issue.[37]

Courts have also proven unwilling to relieve parties from their contractual obligations based upon the extra-contractual motives of their counterparties. Indeed, "in the realm of contract law, why or even how a contract was breached" is not an issue because "contracting parties are generally free to breach a contract for almost any reason as long as they are prepared to pay the damages resulting from that breach."[38]

But while the culpability of a party that breaches a legally enforceable agreement is generally irrelevant under the law of contract, it can be a dispositive consideration under the law of torts.[39] An outgrowth of our primitive desire for

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> [W]here the party by his agreement voluntarily assumes or creates a duty or charge upon himself, he shall be bound by his contract, and the non-performance of it will not be excused by accident or inevitable necessity; for if he desired any such exception, he should have provided for it in his contract. . . . [T]he law does no more than enforce the exact contract entered into. If there be any hardship, it arises from the indiscretion or want of foresight of the suffering party. It is not the province of the law to relieve persons from the improvidence of their own acts.

Id. at 276, 278, *cited in* GILMORE, *supra* note 23, at 50.

36. *See, e.g.*, Teachers Ins. & Annuity Ass'n of Am. v. LaSalle Nat'l Bank, 691 N.E.2d 881, 890 (Ill. App. Ct.), *appeal denied*, 705 N.E.2d 450 (Ill. 1998), *cert. denied*, 525 U.S. 1146 (1999); Haines v. City of N.Y., 364 N.E.2d 820, 822 (N.Y. 1977); Toch v. Eric Schuster Corp., 490 S.W.2d 618, 622 (Tex. Civ. App. 1972).

37. *See* Steven M. Haas, *Contracting Around Fraud Under Delaware Law*, 10 DEL. L. REV. 49, 50 (2008) (citing Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87 (1989) ("Default rules fill the gaps in incomplete contracts; they govern unless the parties contract around them.")); Jules L. Coleman, Douglas D. Heckathorn & Steven M. Maser, *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639, 641 (1989) (noting the theory that default rules "mimic" the outcome that the parties would have intended had they foreseen the need to provide for it in the contract).

38. West & Obi, *supra* note 19, at 2; *see also* Globe Ref. Co. v. Landa Cotton Oil Co., 190 U.S. 540, 544 (1903) ("The motive for the breach commonly is immaterial in an action on the contract."); *In re* Salvino, 373 B.R. 578, 589 (Bankr. N.D. Ill. 2007) ("'Willful'" breaches have not been distinguished from other breaches . . . ."), *aff'd*, No. 07 C 4756, 2008 WL 182241 (N.D. Ill. 2008); Briefstein v. Rotondo Constr. Co., Inc., 187 N.Y.S.2d 866, 868 (App. Div. 1959) ("The policy which runs through the fabric of the law of contracts is to bind a party by what he agrees to do whether or not he intends to do what he agrees."); Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985). This is in contrast, of course, to a circumstance where parties deliberately contract for a different set of consequences for an "intentional breach." *See* Hexion Specialty Chems., Inc. v. Huntsman Corp., No. 3841-VCL, 2008 WL 4457544, at *4 (Del. Ch. Sept. 29, 2008) (discussing the significance of a contractual provision providing for uncapped damages in the event of a "knowing and intentional breach of any covenant" by the buyer); *see also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 119–20, 270–73 (7th ed. 2007).

39. *See* 86 C.J.S. *Torts* § 2 (2009) (Westlaw) ("[I]n order to impose tort liability, there must be fault."); OLIVER WENDALL HOLMES, JR., THE COMMON LAW 37 (photo. reprint 1991) (1881) ("My aim and purpose have been to show that the various forms of liability known to modern law spring from the common ground of revenge . . . . [T]hey have started from a moral basis, from the thought that some one was to blame.").

revenge—or redress—when another causes us harm, tort law is tinged with moral language and concepts of fault.[40] Consequently, courts have fashioned tort law remedies to serve two purposes: (i) to restore the victim of another's culpable harm to his or her status quo before the tortious act occurred; and (ii) in some cases, to punish the culpable party by assessing punitive damages against him or her that exceed the actual damages that the aggrieved party sustained.[41]

Unlike contract duties, then, tort duties arise by operation of law in recognition of each individual's right to be compensated for the damages he or she suffers as a result of the intentional, reckless, or negligent conduct of others.[42] Indeed, as the California Supreme Court has explained:

> "'[Whereas] [c]ontract actions are created to protect the interest in having promises performed,' '[t]ort actions are created to protect the interest in freedom from various kinds of harm. The duties of conduct which give rise to them are imposed by law, and are based primarily on social policy, and not necessarily based upon the will or intention of the parties.'"[43]

B. The "Contortion" of Contract and Tort in the Context of Commercial Transactions

In the context of commercial transactions, the principles underlying contract and tort law often converge and, in some cases, collide to expose contracting parties to tort liability that the written agreement governing their relationship does not contemplate or permit. Part of the reason for this is the historical fact that tort law filled in the void created by the early common law's refusal to allow a cause of action for mutual promises made in the absence of a "deed under seal."[44] But as contract law developed, and courts recognized that the enforcement of mutual promises should be a function of the law of contract, not tort, their early attempts to fill those gaps created "concurrent" obligations arising from both the law of tort and the written agreements that contracting parties drafted to govern their specific relationship.[45] While many common law courts viewed these "concurrent" obligations as conflicting and believed that tort law effectively provided default provisions "out of which the parties may, if they can, contract," other common law courts believed that "the law of tort is not limited to filling in gaps left by the law of contract," but instead effectively imposed independent duties on contracting parties whether they agreed to accept them or not.[46]

40. *See* Holmes, *supra* note 39, at 37.

41. *See* West, *supra* note 12, at 2.

42. *See id.*

43. Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454, 460 (Cal. 1994) (quoting Tameny v. Atl. Richfield Co., 610 P.2d 1330, 1335 (Cal. 1980)) (alterations and ellipses in original).

44. *See* Macpherson & Kelly v. Kevin J. Prunty & Assocs. (1983) 1 V.R. 573 (Austl.), *available at* 1982 VIC LEXIS 176, at *39.

45. *See id.*

46. Goodman Fielder Consumer Foods Ltd. v. Cospack Int'l Pty Ltd. (2004) N.S.W.S.C. 704, ¶¶ 91–96 (Austl.) (internal quotation marks omitted), *available at* http://www.austlii.edu.au/au/cases/nsw/NSWSC/2004/704.html.

1. Tort-Based Representations vs. Contract-Based Warranties

A comparison of tort-based misrepresentation claims and contract-based warranty claims illuminates this phenomenon.[47] In drafting business agreements today, business lawyers might assume that the terms "representations" and "warranties" are synonyms, and sellers generally both "represent" and "warrant" to buyers all statements of existing fact that form the basis for the contractual indemnification provisions that sellers provide in favor of buyers. But although some modern commentators disagree about whether there is a difference between "representations" and "warranties,"[48] there is a very clear distinction between actions premised upon misrepresentations and actions premised upon breaches of express warranties (including representations that become warranties by virtue of their incorporation in a written agreement).[49]

A misrepresentation claim is grounded in tort and seeks to redress breaches of a party's common law duty to establish honestly the "factual predicates" to his or her commercial relationships.[50] But misrepresentation liability is generally not imposed strictly on the basis that a given representation was incorrect. Instead, liability only attaches if the defendant made a material misrepresentation fraudulently or, in some cases, negligently, upon which the recipient justifiably relied to his or her detriment.[51]

A claim based upon a breach of an express warranty, by contrast, is premised upon one party's specific contractual promise that a stipulated fact or set of facts is

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47. *See, e.g.*, Glenn D. West & Kim M. Shah, *Debunking the Myth of the Sandbagging Buyer: When Sellers Ask Buyers to Agree to Anti-Sandbagging Clauses, Who Is Sandbagging Whom?*, M&A Law (Thompson/West, New York, N.Y.), Jan. 2007, at 4.

48. *Compare* Kenneth A. Adams, *A Lesson in Drafting Contracts: What's Up with "Representations and Warranties,"* Bus. L. Today, Nov./Dec. 2005, at 32, 33–35 (suggesting that the terms "representations" and "warranties" are near synonyms that each "flag an assertion of fact but . . . don't affect the meaning of that assertion"), *with* Tina L. Stark, *Another View on Reps and Warranties*, Bus. L. Today, Jan./Feb. 2006, at 8, 8–9 (suggesting that an assertion's status as either a representation or warranty affects the remedies available to a plaintiff if the assertion is false), *and* 11 Simon M. Lorne & Joy Marlene Bryan, Acquisitions & Mergers: Negotiated & Contested Transactions § 3:57, at 3-317 to 3-319 (2009) (suggesting that the distinction between "warranties" and "representations" is that representations assert the truth of the represented statements, while warranties simply "allocate financial responsibility" for the warranted statement's accuracy). *See also* West & Shah, *supra* note 47, at 4–5.

49. *See, e.g.*, Stevenson v. B.B. Kirkland Seed Co., 180 S.E. 197, 200 (S.C. 1935) ("In the case of a warranty, the rights of the parties rest in contract, while in the case of deceit, misrepresentations and fraud, they are based in tort."). *See also* Hecht v. Components Int'l, Inc., 867 N.Y.S.2d 889, 895–96 (Sup. Ct. 2008) (distinguishing between fraud actions and breach of warranty actions). *See also* West & Shah, *supra* note 47, at 4 (discussing differing jurisdictional approaches, both contract-based and tort-based, toward a buyer's burden of proof for a claim on an extra-contractual representation versus an express contractual warranty); ABRY Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1054 (Del. Ch. 2006) (discussing the meaning of the term "misrepresentations" as being a term "commonly associated with fraud claims sounding in tort").

50. *See* 37 Am. Jur. 2d *Fraud and Deceit* § 128 (2002); *see also* Hartwell Corp. v. Bumb, 345 F.2d 453, 455–56 (9th Cir.), *cert. denied*, 382 U.S. 891 (1965); Kroc v. Curaflex Health Servs. of Ill., Inc., No. 88 C 10578, 1989 WL 100000, at *7 (N.D. Ill. 1989); *Hecht*, 867 N.Y.S.2d at 895–96. We have borrowed the term "factual predicate" from Vice Chancellor Strine. *See ABRY*, 891 A.2d at 1035.

51. *See* 37 Am. Jur. 2d *Fraud and Deceit* § 128 (2002). *See also In re* Welding Fume Prods. Liab. Litig., No. 1:03-CV-17000, 2007 WL 1087605, at *7 (N.D. Ohio Apr. 9, 2007); Cole v. New Eng. Mut. Life Ins. Co., 729 N.E.2d 319, 323 (Mass. App. Ct. 2000); Cumming, *supra* note 12, at 1198.

correct.[52] If the warranty set forth in the written agreement is incorrect, it would be irrelevant that the warranting party honestly believed that the disputed statement was true, that the recipient of the warranty did not rely upon the incorrect statement, or that the warranty was not a material basis upon which the complaining party entered into the contract.[53] Indeed, a warranty is strictly enforced like any other contractual covenant or agreement, generally without regard for intention, materiality, or reliance.[54] And for this very reason, our English colleagues often describe their contractual assurances of factual matters as "warranties," but not "representations."[55]

But courts have not always recognized the distinction between tort-based misrepresentation claims and contract-based warranty claims.[56] Indeed, because the modern law of contract only later evolved as an independent legal doctrine, courts did not even recognize breach of express warranty as a separate, contract-based action until 1778[57] and instead viewed these claims as grounded in deceit or fraud.[58] Accordingly, early courts did not treat representations and warranties that were specifically set forth in a written agreement as part of a contract, but simply as statements of the "factual predicate" to the contract that were only actionable as misrepresentations under tort law, not as actions to enforce promises made under contract law.[59] Even since courts have enforced express warranties

52. *See* Metro. Coal Co. v. Howard, 155 F.2d 780, 784 (2d Cir. 1946) ("A warranty is an assurance by one party to a contract of the existence of a fact . . . [and] a promise to indemnify the promisee for any loss if the fact warranted proves untrue . . . .").

53. *See* Am. Family Brands, Inc. v. Giuffrida Enters., Inc., Nos. 96-7062, 96-7256, 1998 WL 196402, at *4 (E.D. Pa. Apr. 23, 1998); Pegasus Mgmt. Co., Inc. v. Lyssa, Inc., 995 F. Supp. 43, 44 (D. Mass. 1998); CBS v. Ziff-Davis Publ'g Co., 553 N.E.2d 997, 1001 (N.Y. 1990). It is important to note that some courts do in fact require proof of reliance as a condition to the enforcement of an express contractual warranty. *See* Robert J. Johannes & Thomas A. Simonis, *Buyer's Pre-Closing Knowledge of Seller's Breach of Warranty*, Wis. Law., July 2002, at 18, 21 (citing Hendricks v. Callahan, 972 F.2d 190, 194 (8th Cir. 1992) (applying Minnesota law); Land v. Roper Corp., 531 F.2d 445, 449 (10th Cir. 1976) (applying Kansas law); Middleby Corp. v. Hussman Corp., No. 90 C 2744, 1992 WL 220922, at *6 (N.D. Ill. Aug. 27, 1992) (applying Delaware law); Kazerouni v. De Satnick, 279 Cal. Rptr. 74, 75 (Ct. App. 1991); *see also* Cumming, *supra* note 12, at 1192; Masson, *supra* note 12, at 509–12.

54. *See, e.g.*, Lee v. State Bank & Trust Co., 54 F.2d 518, 521 (2d Cir. 1931) ("the law of contracts does not judge a promisor's obligation by what is in his mind"), *cert. denied*, 285 U.S. 547 (1932); Ainger v. Mich. Gen. Corp., 476 F. Supp. 1209, 1223 (S.D.N.Y. 1979) ("The warranty is as much a part of the contract as any other part, and the right to damages on the breach depends on nothing more than the breach of warranty."); Indeck N. Am. Power Fund, L.P. v. Norweb PLC, 735 N.E.2d 649, 658 (Ill. App. Ct. 2000), *appeal denied*, 744 N.E.2d 285 (Ill. 2001) (unpublished table decision); *Ziff-Davis Publ'g Co.*, 553 N.E.2d at 1001 ("This view of 'reliance'—i.e., as requiring no more than reliance on the express warranty as being a part of the bargain between the parties—reflects the prevailing perception of an action for breach of express warranty as one that is no longer grounded in tort, but essentially in contract."); Randy Knitwear, Inc. v. Am. Cyanamid Co., 181 N.E.2d 399, 401 n.2 (N.Y. 1962); *Stevenson*, 180 S.E. at 200 ("If a representation amounts to a warranty, an action . . . may be maintained whether the defendant knew the representation was false of not."); *see generally* Masson, *supra* note 12.

55. Leona N. Ferera, John R. Phillips & Julian Runnicles, *Some Differences in Law and Practice Between U.K. and U.S. Stock Purchase Agreements*, Jones Day Comments., Apr. 2007, http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4140.

56. *See* West & Shah, *supra* note 47, at 4.

57. *See* Strika v. Neth. Ministry of Traffic, 185 F.2d 555, 558 (2d Cir. 1950), *cert. denied*, 342 U.S. 904 (1951).

58. *See id.*; *see also* Cumming, *supra* note 12, at 1192 n.13; Masson, *supra* note 12, at 508.

59. *See* West & Shah, *supra* note 47, at 4.

as contractual promises, many courts have continued to recognize a separate tort claim for breaches of those express warranties to the extent that such claims also satisfy the culpability, materiality, and reliance requirements of a misrepresentation claim brought in tort.[60] And as a result, a confusing and conflicting body of case law has emerged, leading one commentator to characterize the concept of warranty as a "freak hybrid born of the illicit intercourse of tort and contract."[61]

One method that courts have sometimes employed to distinguish between tort-based misrepresentation claims and contract-based warranty claims is the so-called "economic loss" rule.[62] A confusing doctrine that appears to have originated as an effort to curb damages in negligence actions,[63] and which American courts have applied most frequently in the context of product liability law,[64] the economic loss rule also has been applied across a broad spectrum of commercial relationships based in contract.[65] At its simplest, the rule prohibits a tort claimant from recovering damages for purely economic loss unless the claimant also suffered directly related physical damage to his or her person or property as a result of the allegedly tortious conduct of another.[66] Similarly, buyers of products in the United States were generally prohibited from recovering in tort for economic losses they sustained where they could have bargained for a specific warranty in the purchase agreement.[67] As one court noted:

> [W]here a purchaser's expectations in a sale are frustrated because the product he bought is not working properly, his remedy is said to be in contract alone, for he has suffered only "economic" losses. This doctrine hinges on a distinction drawn between transactions involving the sale of goods for commercial purposes where economic expectations are protected by commercial and contract law, and those involving the sale of defective products to individual consumers who are injured in a manner which has traditionally been remedied by resort to the law of torts.[68]

But many courts disregarded the rule as it would apply to fraud—particularly fraud in the inducement—and negligent misrepresentation claims, reasoning that

60. *See* Ainger v. Mich. Gen. Corp., 476 F. Supp. 1209, 1225 (S.D.N.Y. 1979).

61. William L. Prosser, *The Fall of the Citadel (Strict Liability to the Consumer)*, 50 MINN. L. REV. 791, 800 (1966), *quoted in* 3 PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., BRUNER & O'CONNOR ON CONSTRUCTION LAW § 9:4 (2009) (referring to warranty as having a "hermaphroditic nature").

62. *See* Blair, *supra* note 12, at 438 n.50. *See generally* Stewart I. Edelstein, *Beware the Economic Loss Rule* (Cohen & Wolf P.C., Bridgeport, Conn.), http://www.cohenandwolf.com/CM/Commercial LitigationPublications/Beware-The-Economic-Loss-Rule.asp (last visited July 27, 2009).

63. *See* S.C.M. (U.K.) Ltd. v. W.J. Whithall & Son Ltd., [1971] 1 Q.B. 337, 340 (U.K.). In this context, the rule was called the "exclusionary rule" because it prohibited recovery of "economic loss" in negligence actions in the absence of actual physical harm to person or property. For a full description of the history of the economic loss doctrine in this context, see Perre v. Apand Pty Ltd. (1999) 198 C.L.R. 180 (Austl.).

64. *See generally* Christopher Scott D'Angelo, *The Economic Loss Doctrine: Saving Contract Warranty Law from Drowning in a Sea of Torts*, 26 U. TOL. L. REV. 591 (1995).

65. *See* R. Joseph Barton, Note, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, 41 WM. & MARY L. REV. 1789, 1803–05 (2000).

66. *See id.* at 1795–96.

67. *See id.* at 1796.

68. Neibarger v. Universal Coops., Inc., 486 N.W.2d 612, 615 (Mich. 1992) (internal quotation marks omitted).

such claims always involve economic, rather than physical, harm.[69] Indeed, although fraud and negligent misrepresentation are grounded in tort, the causes of action originated as means to redress commercial harms where contract law was otherwise insufficient.[70] Other courts, by contrast, rigidly enforced the economic loss rule in both fraud and negligent misrepresentation cases such that, if there was a contract, any tort claim arising out of that contract would be dismissed.[71]

The better reasoned decisions applying the economic loss rule to fraud and negligent misrepresentation claims seem to be based on the premise that an action brought to recover the economic losses occasioned by the breach of a contractual promise should be classified as a claim for breach of warranty, but an action brought to recover damages that arose independently of the economic losses caused by the contractual breach should be classified as a tort claim for misrepresentation.[72] By this logic, any action that depends upon the existence of a contract to calculate the damages alleged is essentially "interwoven with" that contract and properly brought as a claim for breach of express warranty (which, in turn, would be subject to any contractual limitations on the remedies available for breach of that express warranty).[73]

2. The Equitable Right of Rescission v. Tort-Based Damages Claims

Tort and contract principles often converge when one contracting party alleges that his or her counterparty made a misrepresentation during the contract formation process. Under the early common law of contract, courts appeared to impose a default condition to every agreement's validity that neither party had made a false representation that induced the other party's assent to the deal.[74] Accordingly, even where a party who made a false representation harbored no malicious intent, the counterparty could equitably rescind the contract if it would not have executed the agreement with knowledge that the representation was false.[75] Importantly, however, the complaining party in such an action could not recover any non-rescissory damages[76] that he or she suffered as a result of the pre-

69. *See* Barton, *supra* note 65, at 1819–24.

70. *See id.* at 1811–12, 1822–23.

71. *See id.* at 1821.

72. *See, e.g.*, Best Buy Stores, L.P. v. Developers Diversified Realty Corp., No. 05-2310 (DSD/JJG), 2007 WL 4191717, at *4–5 (D. Minn. Nov. 21, 2007).

73. *See* Maxcess, Inc. v. Lucent Techs., Inc., No. 6:04-cv-204-Orl-31DAB, 2005 WL 6125471, at *6–7 (M.D. Fla. Jan. 5, 2005), *aff'd*, 433 F.3d 1337 (11th Cir. 2005).

74. *See* Holmes, *supra* note 39, at 324–25 ("It is no doubt only by reason of a condition construed into the contract that fraud is a ground of rescission . . . .").

75. *See, e.g.*, Graves v. Tulleners, 134 P.3d 990, 996 (Or. Ct. App. 2006) ("Where a person makes a false representation of a material fact, and the person to whom the representation is made is induced to and does rely on that representation in entering into an agreement, that is sufficient for the purpose of avoiding the contract, irrespective of the intent and purpose of the person making the false representation." (internal quotation marks omitted)). *See also* Derry v. Peek, [1889] 14 App. Cas. 337, 359 (H.L.) (U.K.).

76. "Rescissory damages" are money damages designed to approximate financially the remedy of rescission. *See* Std. Chartered PLC v. Price Waterhouse, 945 P.2d 317, 345 (Ariz. Ct. App. 1996). Rescissory damages are awarded "[w]hen rescission, though appropriate, is impossible or infeasible." *Id.*

contractual misrepresentation or omission.[77] And, like other default provisions, there was no apparent common law basis for a rule that would deprive transacting parties of the right to waive that default condition contractually.[78]

While courts did not permit *contract* claims for non-rescissory damages resulting from pre-contractual misrepresentations, the common law recognized an increasingly broad set of *tort-based* actions designed to compensate plaintiffs for these losses.[79] In what was originally known as an action for "deceit,"[80] nineteenth century English courts only permitted monetary recovery where the aggrieved party demonstrated that the individual who made a pre-contractual misrepresentation did so with dishonest intent.[81] But courts gradually began to hold that mere recklessness satisfied the "dishonesty" requirement of the tort-based damages claim.[82] And over time, the common law recognized an action for "negligent misrepresentation," under which a contracting party could recover damages arising from a false pre-contractual misrepresentation that his or her counterparty made without exercising ordinary care.[83]

III. Sources and Consequences of Extra-Contractual Liability in Modern Corporate Transactions

For business lawyers negotiating large-scale corporate transactions today, many courts have translated the tort-based duties discussed in Part II into a "commercial honor code" that effectively superimposes extra-contractual obligations on contracting parties.[84] Accordingly, we will now outline the nuances of the specific causes of action in which the "contortion" of contracts and torts is manifested today. Indeed, understanding the sources of extra-contractual liability as it arises in jurisdictions across the United States is essential to understanding how to contain it.[85]

77. *See* Restatement (Second) of Contracts ch. 7, topic 1, introductory note (1981); *see also* Davis, *supra* note 12, at 488–89.

78. *See* Holmes, *supra* note 39, at 324 ("Parties could agree, if they chose, that a contract should be binding without regard to truth or falsehood outside of it on either part."); Tullis v. Jackson, [1892] 3 Ch. 441, 445 (U.K.) ("I myself see no reason why grown men should not be allowed to contract in these terms. 'Neither of us,' each says to the other, and each agrees with the other, 'will ever raise the charge of fraud.'"). *See also* Davis, *supra* note 12, at 485 ("Many judges and scholars seem to consider the rules assigning liability for fraud—and sometimes even negligence—in contract formation to be among the few mandatory rules of the contracting game. This belief persists in spite of the fact that virtually every other rule of contract is treated as a default rule, and therefore, subject to modification by agreement of the parties.").

79. *See* Restatement (Second) of Contracts ch. 7, topic 1, introductory note (1981).

80. Derry v. Peek, [1889] 14 App. Cas. 337, 359 (H.L.) (U.K.).

81. *See id.*

82. *See id.*

83. *See* Ultramares Corp. v. Touche, 174 N.E. 441, 446–47 (N.Y. 1931); Hedley Bryrne & C. Ltd. v. Heller & Partners Ltd., [1964] A.C. 465 (H.L.) (U.K.). Rescission may also be available as a remedy for negligent misrepresentation. *See, e.g.*, Wallenta v. Moscowitz, 839 A.2d 641, 643 (Conn. App. Ct.), *cert. denied*, 845 A.2d 414 (Conn. 2004); Darnell v. Myers, No. 14859-NC, 1998 WL 294012, at *1 (Del. Ch. May 27, 2008).

84. *See* West, *supra* note 12, at 3.

85. Note that while we will discuss general principles that apply across the United States in Part III, we have focused our discussion of specific state law differences on three jurisdictions, namely

Common law fraud and negligent misrepresentation claims are the most common sources of contract-related tort liability in modern commercial transactions. In each case, the claimant seeks either to impose liability on a contracting party for an extra-contractual representation that the defendant refused to warrant in the written agreement or, as in *ABRY*, to avoid bargained-for limits on the remedies available for the breach of a contractual warranty.

A. Understanding the Nature of Contract-Related Fraud Claims—Fraud Is Not Limited to Deliberate Lying

Generally speaking, the core elements of a prima facie case of contract-related fraud are consistent from state to state.[86] In most jurisdictions, a plaintiff must establish that: (i) the defendant made a representation; (ii) the representation was false; (iii) the defendant acted with scienter (i.e., knew the representation was false or made it recklessly without sufficient knowledge as to whether it was true or false); (iv) the defendant intended that the plaintiff rely on the representation; (v) the plaintiff reasonably or justifiably relied on the representation; and (vi) the plaintiff suffered injury as a result of the representation.[87] But within these basic elements, there are distinctions between states that become particularly salient in the context of sophisticated business transactions.[88]

Notably, states differ on the types of representations that are actionable in tort.[89] Generally, only misrepresentations of present or existing fact may constitute the basis of a fraud claim.[90] Indeed, in New York, misrepresentations regarding a party's future intention to perform under an agreement are no different from the contractual promise "either to perform or to pay damages for breach of contract, and should be penalized no more extensively."[91] The courts of some states, however, circumvent the foregoing principle by stipulating that a contracting party may

New York, Delaware, and Texas. We have chosen these states not only because the laws of New York, Delaware, and Texas govern the majority of the agreements that we negotiate, but also because they are representative of the different approaches that courts in jurisdictions across the United States take with respect to the issues covered in this Article. In some cases, we have noted the specific nuances of the laws of jurisdictions other than New York, Delaware, and Texas.

86. *See* Peter A. Alces, The Law of Fraudulent Transactions § 2:3, at 2-13 (2006).

87. *See id.*; *see also, e.g.*, Dallas Aerospace, Inc. v. CIS Air Corp., 352 F.3d 775, 784–85 (2d Cir. 2003); Daldav Assocs., L.P. v. Lebor, 391 F. Supp. 2d 472, 475 (N.D. Tex. 2005); Stephenson v. Capano Dev., Inc., 462 A.2d 1069, 1074 (Del. 1983).

88. *See* West, *supra* note 12, at 3–4; Glenn D. West & Adam D. Nelson, *Corporations*, 57 SMU L. Rev. 799, 815–17 (2004) (citing Benchmark Elecs., Inc. v. J.M. Huber Corp., 343 F.3d 719 (5th Cir.), *modified by* 355 F.3d 356 (5th Cir. 2003)); *see generally* Alces, *supra* note 86, §§ 2:4–2:27.

89. *See generally* Alces, *supra* note 86, § 2:4.

90. *See id.* §§ 2:4, 2:6, at 2-17, 2-21 (citing Clearly Can. Beverage Corp. v. Am. Winery, Inc., 257 F.3d 880 (8th Cir. 2001); Tom Hughes Marine, Inc. v. Am. Honda Motor Co., Inc., 219 F.3d 321, 325 (4th Cir. 2000); Nestor v. Kapetanovic, 573 N.E.2d 457 (Ind. Ct. App. 1991); Tate v. Colony House Builders, Inc., 508 S.E.2d 597 (Va. 1999)); *see also* Great Earth Int'l Franchising Corp. v. Milks Dev., 311 F. Supp. 2d 419, 427–28 (S.D.N.Y. 2004).

91. *Great Earth*, 311 F. Supp. 2d at 427–28; *see also* Gould Paper Corp. v. Madisen Corp., 614 F. Supp. 2d 485, 492 (S.D.N.Y. 2009) ("A claim for fraud cannot stand where the only allegation is 'that defendant entered into a contract with no intention of performing.'").

premise a fraud claim on the basis of a contractual promise that the defendant made, but never intended to perform.[92] In Texas, for example, "a promise of future performance (under a contract) constitutes an actionable misrepresentation if the promise was made with no intention of performing at the time it was made" because "the legal duty not to fraudulently procure a contract is separate and independent from the duties established by the contract itself."[93] Importantly, proof of fraud can be premised on purely circumstantial evidence, and non-performance of a contract coupled with "some" circumstances indicating an intention never to perform is sufficient to sustain a claim of fraud in some states.[94]

In deciding whether an allegedly fraudulent statement is actionable in tort, some courts also consider whether the contracting parties incorporated the representation in the agreement out of which their dispute arose.[95] Under Texas law, for example, "tort damages are recoverable for a fraudulent inducement claim irrespective of whether the fraudulent representations are later subsumed in a contract or whether the plaintiff only suffers an economic loss related to the subject matter of the contract."[96] But New York courts generally require that an allegedly fraudulent representation be "collateral or extraneous to the terms of the parties' agreement."[97]

Though fraud, "'unlike negligence, breach of warranty or breach of contract, is premised upon the "actual moral guilt" of the defrauding party,'" many states

92. *See* ALCES, *supra* note 86, § 2:6, at 2-24 (citing *Tom Hughes Marine*, 219 F.3d at 325; Lovejoy Elecs., Inc. v. O'Berto, 873 F.2d 1001 (7th Cir. 1989); Wagstaff v. Protective Apparel Corp., 760 F.2d 1074 (10th Cir. 1985); Armani v. Maxim Healthcare Servs., Inc., 53 F. Supp. 2d 1120 (D. Colo. 1999)); *see also* Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc., 960 S.W.2d 41, 48 (Tex. 1998). *But see* Bridgeway Corp. v. Citibank, N.A., 132 F. Supp. 2d 297, 304 (S.D.N.Y. 2001).

93. *Formosa Plastics*, 960 S.W.2d at 46–48.

94. *See, e.g.*, O'Neil v. Coll. Loan Special Purpose Corp., No. D047000, 2006 WL 1742836, at *4 (Cal. Ct. App. 2006); Va. Acad. of Clinical Psychologists v. Group Hospitalization & Med. Servs., Inc., 878 A.2d 1226, 1234–35 (D.C. 2005); Spoljaric v. Percival Tours, Inc., 708 S.W.2d 432, 435 (Tex. 1986).

95. *See, e.g., Great Earth*, 311 F. Supp. 2d at 426–28; *Formosa*, 960 S.W.2d at 47; *see also* Benchmark Elecs., Inc. v. J.M. Huber Corp., 343 F.3d 719, 729–30 (5th Cir.), *modified by* 355 F.3d 356 (5th Cir. 2003).

96. *Formosa*, 960 S.W.2d at 47. *See also* ABRY Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1037, 1057 (Del. Ch. 2006) (declining to enforce an exclusive remedy provision that purported to defeat a tort-based rescission and damages claim premised upon an intentionally false representation of fact made within a stock purchase agreement).

97. *See Great Earth*, 311 F. Supp. 2d at 425 (internal quotation marks omitted); *see also* DynCorp v. GTE Corp., 215 F. Supp. 2d 308, 326 (S.D.N.Y. 2002); Astroworks, Inc. v. Astroexhibit, Inc., 257 F. Supp. 2d 609, 616–17 (S.D.N.Y. 2003). *But see* VTech Holdings Ltd. v. Lucent Techs., Inc., 172 F. Supp. 2d 435, 439–40 (S.D.N.Y. 2001) ("While the dominant trend is that a fraud claim cannot be based solely on the allegation that a party has made a contractual promise with no intention of performing it, some cases have stated that '[a] false statement of intention is sufficient to support an action for fraud, even where that statement relates to an agreement between the parties.'" (quoting Graubard Mollen Dannett & Horowitz v. Moskovitz, 653 N.E.2d 1179, 1184 (N.Y. 1995)). Note that New York law recognizes three categories of fraud claims that may arise out of a contractual relationship, namely (i) where a party demonstrates that its adversary had a legal duty that was separate from its duty to perform under the contract, and the alleged fraud was a breach of that separate legal duty; (ii) where a party demonstrates a fraudulent misrepresentation "collateral or extraneous to the contract"; and (iii) where a party shows "special damages that are caused by [a] misrepresentation and [are] unrecoverable as contract damages." *Great Earth*, 311 F. Supp. 2d at 425.

expose individuals to fraud liability not only for intentional misrepresentations, but also for "reckless" misrepresentations.[98] For example, a misrepresentation is reckless, and therefore actionable as fraud in Texas, if:

> (i) it is made without any knowledge of the truth and as a positive assertion; (ii) if the person making the representation knows that she does not have sufficient information or basis to support it; or (iii) if she realizes that she does not know whether or not the statement is true.[99]

Even where a transacting party cautiously abstains from making potentially actionable representations, that party's silence may constitute actionable fraud in jurisdictions that impose a "duty to speak" under certain circumstances.[100] Under New York law, for example, the duty to speak arises in any of three situations:

> (i) when one party makes a partial or incomplete statement that requires clarification; (ii) when the parties are in a fiduciary or confidential relationship; and (iii) when one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge.[101]

B. Understanding the Nature of Contract-Related Negligent Misrepresentation Claims

Most jurisdictions also recognize the tort of negligent misrepresentation.[102] According to the Delaware Court of Chancery, "a negligent misrepresentation claim . . . is in essence a fraud claim with a reduced state of mind requirement"

98. Alces, *supra* note 86, §§ 2:13–2:14, at 2-53 to 2-57 (quoting Lively v. Garnick, 287 S.E.2d 553, 555 (Ga. Ct. App. 1981)); *see also* Addy v. Piedmonte, No. 3571-VCP, 2009 WL 707641, at *18 (Del. Ch. Mar. 18, 2009) (stipulating that the scienter element of a fraud claim in Delaware requires proof that the defendant "had knowledge or believed that the [relevant] representation was false, or made the representation with requisite indifference to the truth"); West, *supra* note 12, at 3.

99. Alces, *supra* note 86, § 2:14, at 2-55 (citing Livingston Livestock Exch., Inc. v. Hull State Bank, 14 S.W.3d 849 (Tex. App. 2000)).

100. *See* West, *supra* note 12, at 2 (citing Cronus Offshore, Inc. v. Kerr McGee Oil & Gas Corp., 369 F. Supp. 2d 848, 858 (E.D. Tex. 2004), *aff'd*, 133 F. App'x 944 (5th Cir. 2005); Wal-Mart Stores, Inc. v. AIG Life Ins. Co., 872 A.2d 611, 629 (Del. Ch. 2005), *aff'd in part, rev'd in part*, 901 A.2d 106 (Del. 2006); Chase Manhattan Bank v. N.H. Ins. Co., 749 N.Y.S.2d 632, 645 (App. Div. 2002)); Greenberg Traurig v. Moody, 161 S.W.3d 56, 77–79 (Tex. App. 2005) (applying New York Law).

101. *Greenberg Traurig*, 161 S.W.3d at 77. Texas law is similar. *See Cronus Offshore*, 369 F. Supp. 2d at 858. Note that the *Cronus* court stated that "a seller of real estate may commit fraud without actually making an affirmative misrepresentation if the seller fails to disclose material facts which would not have been discoverable by a purchaser exercising ordinary care and diligence, or which could not be uncovered by a reasonable investigation and inquiry." *Id.*; *see also* Restatement (Second) of Torts § 551 cmt. b (1977).

102. *See* Alces, *supra* note 86, § 2:15, at 2-58 to 2-71; West & Obi, *supra* note 19, at 8 (citing Daldav Assocs., L.P. v. Lebor, 391 F. Supp. 2d 472, 475 (N.D. Tex. 2005); BCY Water Supply Corp. v. Residential Invs., Inc., 170 S.W.3d 596, 602 (Tex. App. 2005)); *see also* Corp. Prop. Assocs. 14 Inc. v. CHR Holding Corp., No. 3231-VCS, 2008 WL 963048, at *1 (Del. Ch. Apr. 10, 2008); Ultramares Corp. v. Touche, 255 N.Y. 170, 179 (1931); *see generally* Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 Tex. Tech L. Rev. 845 (2008).

such that "[s]cienter is replaced by negligence."[103] But "to compensate for this significant concession,"[104] courts generally require that the defendant owe some legal duty to impart accurate information to the plaintiff.[105]

The scope of negligent misrepresentation liability varies from state to state.[106] To establish a claim for negligent misrepresentation in New York, the plaintiff must show that the defendant "possess[ed] unique or specialized expertise" or was in a "special position of confidence and trust with the injured party such that reliance on the negligent misrepresentation [was] justified."[107] New York courts have disagreed as to whether the relationship between a buyer and seller in an arm's-length commercial transaction qualifies under the foregoing standard where the duty to provide accurate information arises solely from their written agreement.[108] Delaware courts, by contrast, more broadly extend negligent misrepresentation liability to parties who make representations "in the course of a business or a transaction in which the [party] has a pecuniary interest."[109]

C. Implications of Extra-Contractual Liability in Modern Corporate Transactions

Extra-contractual liability threatens serious consequences for corporate clients that value the certainty that contract law—including the remedial limitations facilitated thereby—provides. First, as noted above, while rescission is the only remedy

103. *Corp. Prop.*, 2008 WL 963048, at *8. In *Addy v. Piedmonte*, the Delaware Court of Chancery also affirmed the existence under Delaware law of a concept known as "equitable fraud," which differs from common law fraud in one material respect, namely that "a plaintiff is not required to show that the defendant committed fraud knowingly or recklessly. . . . [I]nnocent or negligent misrepresentations or omissions suffice to prove equitable fraud." No. 3571-VCP, 2009 WL 707641, at *18 (citing Mark Fox Group, Inc. v. E.I. du Pont de Nemours & Co., No. 20081, 2003 WL 21524886, at *5 n.15 (Del. Ch. July 2, 2003) ("The count at issue was entitled 'equitable fraud,' but it is well known that such a term refers interchangeably to claims based on negligent or innocent misrepresentation.")).

104. *Corp. Prop.*, 2008 WL 2963048, at *8.

105. *See* Alces, *supra* note 86, § 2:15, at 2-67 to 2-71.

106. *See id.* § 2:15, at 2-58 to 2-71.

107. *Id.* § 2:15, at 2-64. The elements of negligent misrepresentation under New York law are:

> (1) carelessness in imparting words; (2) upon which others were expected to rely; (3) and upon which they did or failed to act; (4) to their damage; and (5) the declarant must express the words directly, with knowledge or notice that they will be acted upon, to one whom the declarant is bound by some relation or duty of care.

Dallas Aerospace, Inc. v. CIS Air Corp., 352 F.3d 775, 788 (2d Cir. 2003).

108. *Compare* JP Morgan Chase Bank v. Winnick, 350 F. Supp. 2d 393, 402 (S.D.N.Y. 2004) (finding no special relationship because "[t]he relationship between a bank and a borrower is the very epitome of an arm's length commercial transaction: the borrower must comply with the negotiated terms of its contract, and may not defraud the lender by deliberate falsehood, but it is not liable in tort for mere carelessness about its representations"), *and* PPI Enters. (U.S.), Inc. v. Del Monte Foods Co., No. 99 Civ. 3794 (BSJ), 2003 WL 22118977, at *26 (S.D.N.Y. Sept. 11, 2003) (holding that where "the contract itself is the sole basis for the imposition of a special duty . . . the duty extends only as far as the contact's scope"), *with* Kimmell v. Shaefer, 675 N.E.2d 450, 454–55 (N.Y. 1996) (holding that an energy company executive owed a duty of care to plaintiff investors whose investment he induced with negligent misrepresentations).

109. *Corp. Prop.*, 2008 WL 963048, at *8–9 (internal quotation marks omitted).

available for a pre-contractual misrepresentation under contract law,[110] a plaintiff may seek compensatory damages for the same misrepresentation under tort law.[111] Second, most states permit awards of punitive damages in fraud cases, exposing transacting parties to potential liability that could drastically exceed the losses that the aggrieved party actually suffered.[112] Third, carefully crafted deductibles and caps on a seller's obligation to indemnify a buyer for losses arising from breaches of contractually bargained-for warranties, which are designed to define precisely the parameters of each party's post-closing liability, may not apply to tort-based claims premised upon pre-contractual representations.[113] Fourth, even where our clients have exercised the utmost care in connection with a given transaction, fraud and negligent misrepresentation claims are subject to the subjective determination of a judge or jury about a person's state of mind, and therefore present a very real risk of an erroneous verdict.[114] And finally, in light of the foregoing, our clients' counterparties can use the mere threat of these tort-based causes of action as "bargaining chips" if they ever become dissatisfied with the deal that they made.[115]

Contract-related tort claims also present a serious risk of personal liability for individuals who participate in the transaction process as agents of contracting entities.[116] Under the common law of contract, the individuals who sign an agreement on behalf of their entity-level principals are not personally liable under that agreement if they expressly stipulate that they are executing the contract as an agent or representative of the entity party to the transaction.[117] But under traditional principles of agency law, representatives of entity-level contract signatories may be personally liable for the contract-related tortious acts that they direct, or in which they participate.[118] So the plaintiff in a fraud or negligent misrepresentation action may seek damages from any officer or employee who participated in the purportedly tortious conduct on behalf of the limited liability entity against which the plaintiff is seeking judgment.[119] And that conduct may be as innocuous as negligently failing to schedule an appropriate exception to a contractual representation that purportedly induced the contract's formation.[120]

110. *See supra* notes 76–77 and accompanying text. Importantly, rescissory damages awarded where actual rescission is not possible could exceed the agreed upon caps on contractual damages set forth in the written agreement.

111. *See* RESTATEMENT (SECOND) OF CONTRACTS ch. 7, topic 1, introductory note (1981).

112. *See* ALCES, *supra* note 86, § 2:24, at 2-119 to 2-128.

113. *See* Blair, *supra* note 12, at 468–71; West, *supra* note 12, at 2.

114. *See* Davis, *supra* note 12, at 502–03 ("An independent reason why parties may find it useful to disclaim liability for misrepresentation is because they might fear that courts are unable to determine accurately whether parties have behaved negligently or fraudulently.").

115. *See* Masson, *supra* note 12, at 513.

116. *See id.*; *see also* Glenn D. West, *Protecting the Deal Professional from Personal Liability for Contract-Related Claims*, PRIVATE EQUITY ALERT (Weil, Gotshal & Manges LLP, New York, N.Y.), Mar. 2006, at 5, *available at* http://www.weil.com/wgm/cwgmhomep.nsf/Files/PEAMar06/$file/PEAMar06.pdf.

117. *See* West, *supra* note 116, at 5–6.

118. *See, e.g.*, Alexander v. Lincare Inc., No. 3:07-CV-1137-D, 2007 WL 4178592, at *3 (N.D. Tex. Nov. 27, 2007). *See also* West, *supra* note 116, at 5.

119. *See* West, *supra* note 116, at 6–7.

120. *See* West, *supra* note 12, at 2.

IV. The Enforceability of Contractual Defenses to Tort Liability in Sophisticated Commercial Transactions

A. Negotiating Agreements in View of Extra-Contractual Liability

1. Disclaimer-of-Reliance Clauses

In view of these risks, the agreements governing sophisticated corporate transactions, like the stock purchase agreement at issue in *ABRY*, often include a series of defensive provisions designed to ensure that the contract constitutes the exclusive source of the contracting parties' post-closing rights, obligations, and remedies.[121] Given that common law fraud and negligent misrepresentation actions, including fraud claims based upon non-disclosure,[122] generally require proof that the claimant reasonably or justifiably relied on the defendant's allegedly false statement,[123] many contracts contain a "disclaimer-of-reliance" provision that requires the buyer to agree that it did not rely on any *extra-contractual* representations made by the seller.[124] These provisions purport to preclude proof of the mandatory "reliance" element of extra-contractual misrepresentation actions and either support dismissal of any such claim as a matter of law[125] or, at the very least, supply evidence at the summary judgment or trial stages that the plaintiff did not rely on the defendant's extra-contractual statements.[126]

In this context, it is important to distinguish between an explicit disclaimer-of-reliance provision and a standard merger or integration clause. A typical merger

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121. *See* ABRY Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1052 (Del. Ch. 2006).

122. *See, e.g.*, Creelman v. Rogowski, 207 A.2d 272, 274 (Conn. 1965) ("In an action based on fraudulent nondisclosure, the plaintiff must prove not only the nondisclosure but his reliance on it."); Glynn v. Atl. Seaboard Corp., 728 A.2d 117, 120 (Me. 1999) (stipulating that justifiable reliance is an element of a fraud claim premised upon the non-disclosure of a fiduciary); Berkshire-Westwood Graphics Group, Inc. v. Davidson, No. 06-WAD-13, 2007 WL 4119215, at *3 (Mass. App. Ct. Nov. 16, 2007) (holding that fraud plaintiff could not prove necessary element of reliance on the defendant's non-disclosure of company's financial status because the plaintiff knew that the defendant was in "fairly dire financial straits"); Keefhaver v. Kimbrell, 58 S.W.3d 54, 60 (Mo. Ct. App. 2001) ("The concept of fraud liability based upon nondisclosure couches reliance in terms of the availability of the information to the plaintiff and the plaintiff's diligence."); Lama Holding Co. v. Smith Barney Inc., 668 N.E.2d 1370, 1373 (N.Y. 1996) (stipulating that "justifiable reliance" is an element of a fraud claim premised upon a material omission); State Constr. Corp. v. Scoggins, 485 P.2d 391, 394 (Or. 1971) ("In most, if not all cases of fraud, one essential element is some sort of reliance . . . upon a misrepresentation of the other party, whether that misrepresentation be an affirmative one or by a nondisclosure."); Avery Pharms., Inc. v. Haynes & Boone, L.L.P., No. 2-07-317-CV, 2009 WL 279334, at *10 (Tex. App. Feb. 5, 2009) (holding that reliance is an element of fraud by non-disclosure). *But see* Farmers Ins. Exch. v. Benzing, 206 P.3d 812, 824 (Colo. 2009) (declining to rule on question of whether presumption or inference of causation or reliance should be applied in consumer protection or common law fraud class actions based upon uniform material misrepresentations or omissions).

123. *See, e.g.*, H-M Wexford LLC v. Encorp, Inc., 832 A.2d 129, 142–43 (Del. Ch. 2003); Danann Realty Corp. v. Harris, 157 N.E.2d 597, 599 (N.Y. 1959); *see also* West, *supra* note 12, at 3.

124. *See ABRY*, 891 A.2d at 1052.

125. *See, e.g.*, AES Corp. v. Dow Chem. Co., 325 F.3d 174, 183 (3d Cir.), *cert. denied*, 540 U.S. 1068 (2003); Envtl. Sys., Inc. v. Rexham Corp., 624 So. 2d 1379, 1384 (Ala. 1993); Miles Excavating, Inc. v. Rutledge Backhoe & Septic Tank Servs., Inc., 927 P.2d 517, 518 (Kan. Ct. App. 1997).

126. *See* Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966); Gibb v. Citicorp Mortgage, Inc., 518 N.W.2d 910, 918 (Neb. 1994).

clause, also known as an "entire agreement" provision, stipulates that the applicable written agreement contains all obligations between the parties that are the subject of that written agreement and specifically supersedes any other promise or understanding between the parties that is not set forth in that agreement.[127] So most contracting parties include merger clauses in their agreements to trigger the parol evidence rule, which "'limit[s] the evidence available to the parties should a dispute arise over the meaning of the contract.'"[128] But while contracting parties have argued that the existence of a merger clause should also preclude their counterparties from reasonably or justifiably relying on a representation not set forth in the exclusive, written agreement,[129] a separate disclaimer-of-reliance provision more clearly and unequivocally serves this purpose.[130]

2. Indemnification and Exclusive Remedy Provisions

Sophisticated corporate agreements also often include indemnification and exclusive remedy provisions, which work in concert to establish a set of procedures and damage caps that limit the remedies available to a party for proven breaches of *contractual* representations and warranties.[131] Indeed, many sales of private companies involve a contemporaneous distribution to the selling entity's shareholders of all proceeds derived from the sale in excess of the agreed maximum contractual liability.[132] It is critical, therefore, for business lawyers representing sellers to define precisely the extent of their clients' potential post-transaction liabilities so that such distributions can be made reliably.[133]

Indemnification and exclusive remedy provisions combine to circumscribe post-closing liability as follows.[134] First, indemnification provisions generally

127. *See, e.g.*, Joseph Wylie, *Using No-Reliance Clauses to Prevent Fraud-in-the-Inducement Claims*, 92 ILL. B.J. 536, 537 (2004) (citing Barille v. Sears Roebuck & Co., 682 N.E.2d 118, 123 (Ill. App. Ct. 1997)).

128. *Id.* (quoting Vigortone AG Prods., Inc. v. PM AG Prods., Inc., 316 F.3d 641, 644 (7th Cir. 2002)).

129. *See, e.g.*, *Barille*, 682 N.E.2d at 123.

130. While a merger clause may contain a disclaimer-of-reliance provision and, in some circumstances, could be read to serve a similar function, it is imprudent to assume that a boilerplate section labeled "merger," "entire agreement," or "integration" specifically includes, or will function as, a disclaimer-of-reliance clause. Moreover, some courts seem to require a disclaimer of reliance to be separated completely from a standard merger or entire agreement clause in order to be enforceable. *See, e.g.*, Nichols v. YJ USA Corp., No. 3:06-CV-02366-L, 2009 WL 722997, at *21 (N.D. Tex. Mar. 18, 2009) ("language that merely expressed that the agreement contained the entire understanding between the parties . . . is not tantamount to a clear expression of the parties' intent to . . . disclaim reliance on representations"); Slack v. James, 614 S.E.2d 636, 640–41 (S.C. 2005); *see also* Blair, *supra* note 12, at 424–25.

131. *See, e.g.*, ABRY Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1043–45 (Del. Ch. 2006).

132. *See id.*; *see also* West, *supra* note 12, at 1.

133. *See* West, *supra* note 12, at 1.

134. *See* Hutchinson & Mason PLLC, *Mergers and Acquisitions Basics* (Hutchinson Law Group, Raleigh, N.C.), Nov. 2001, at 3, *available at* http://www.hutchlaw.com/resources/docs/Merge%20and%20Acquisition%20Basics.pdf.

stipulate the time period after closing during which a buyer may bring a claim based upon a representation and warranty set forth in the transaction agreement.[135] Second, indemnification provisions typically restrict the amount of damages available for any post-closing breach to a specified percentage of the purchase price.[136] Third, most indemnification provisions seek to preclude small claims by establishing so-called "deductibles" or "baskets," which set a minimum dollar threshold below which a buyer's losses do not qualify for reimbursement.[137] And finally, the exclusive remedy provision is designed to prevent a plaintiff from circumventing the foregoing limitations, by stipulating that the right of indemnification constitutes the only post-closing recourse available to either party for any alleged breach of the contractual representations and warranties.[138]

Accordingly, while contracting parties employ disclaimer-of-reliance clauses to limit their liability for extra-contractual representations, they include indemnification and exclusive remedy provisions to limit their liability for representations and warranties set forth within the written contract itself.[139] And if drafted broadly to cover actions arising in both contract and tort, an exclusive remedy provision can help protect a contracting party from extra-contractual liability in jurisdictions that permit transacting parties to premise fraud claims on the basis of contractual representations and warranties.[140]

So when the Delaware Court of Chancery determined in *ABRY* that the scope of the tightly drafted exclusive remedy provision was sufficiently broad to encompass both breach of contract and tort claims, the private equity buyer's fraud action, based upon "false representations of fact embodied within the four corners of the [s]tock [p]urchase [a]greement itself," seemed doomed to fail.[141] But after the buyer argued that the defensive provisions were unenforceable as a matter of public policy, Vice Chancellor Strine sought guidance from the "longstanding debate within American jurisprudence about society's relative interest in contractual freedom versus [the need to establish] universal minimum standards of truthful conduct for contracting parties" to inform his ultimate decision in favor of the latter.[142] Indeed, although *ABRY*'s specific facts presented a question of first impression in Delaware,[143] courts have long wrestled with the propriety of imposing

135. *See id.*

136. *See id.*

137. *See id.* With a basket, a party may recover all of its damages once the proven losses exceed the stipulated basket amount. With a deductible, by contrast, a party may recover damages only to the extent that its losses exceed the stipulated deductible amount. *See id.*

138. *See* Ben Adler, Stephen M. Besen & Carole Schiffman, *Fundamentals of Private Equity Investing II (Sell-Side)*, *in* PRACTISING L. INST., COURSE HANDBOOK: PRIVATE EQUITY FORUM (EIGHTH ANNUAL) 137, 145–48 (2007).

139. *See, e.g.*, ABRY Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1052–53 (Del. Ch. 2006).

140. *See, e.g., id.* at 1055–56; Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc., 960 S.W.2d 41, 47 (Tex. 1998).

141. *See ABRY*, 891 A.2d at 1056.

142. *Id.* at 1055.

143. For a thorough discussion of Delaware law on this topic, see Haas, *supra* note 37.

tort duties, rights, and remedies upon transacting parties that have contractually disclaimed their application.

B. Enforceability of Contractual Defenses to Tort Liability: Does Fraud Vitiate Every Contract?

Courts in the late nineteenth and early twentieth centuries generally enforced clauses that disclaimed the existence of representations for which the seller refused to provide an express warranty where the complaining party premised its extra-contractual claim upon innocent, inadvertent, or negligent statements.[144] In other words, courts tended to give effect to provisions that waived, disclaimed, or excluded a buyer's remedies for misrepresentations that would only entitle the buyer to rescission, but not compensatory damages. And even though the common law gradually recognized negligent misrepresentation as a basis for recovery of compensatory damages,[145] courts remained favorably inclined toward the enforcement of waivers, disclaimers, and exclusion clauses that shielded a contracting party from extra-contractual liability for negligent statements.[146]

Decisions addressing the ability of contracting parties to disclaim liability for "fraudulent" representations, by contrast, were decidedly more negative. Indeed, influenced by the widely accepted legal maxim that "fraud vitiates everything it touches,"[147] courts often have rebuffed the efforts of contracting parties to avoid litigation over who said what to whom during pre-contract negotiations, holding that tort-based liability for fraudulent (including reckless) misrepresentations,

144. *See, e.g.*, J.B. Colt & Co. v. Clay, 288 S.W. 745, 746 (Ky. 1926); McCray Refrigerator & Cold Storage Co. v. Woods, 58 N.W. 320, 322 (Mich. 1894); Wilkinson v. Carpenter, 554 P.2d 512, 514 (Or. 1976); S. Morgan Smith Co. v. Monroe County Water Power & Supply Co., 70 A. 738, 739 (Pa. 1908).

145. *See, e.g.*, Doyle v. Chatham & Phenix Nat'l Bank of City of N.Y., 171 N.E. 574, 577 (N.Y. 1930) (allowing for damage claims in negligent misrepresentation actions); D.S.A., Inc. v. Hillsboro Ind. Sch. Dist., 973 S.W.2d 662, 663 (Tex. 1998) (allowing for pecuniary loss damages in a negligent misrepresentation action but not benefit-of-the-bargain damages).

146. *See, e.g.*, Delta Airlines, Inc. v. Douglas Aircraft Co., 47 Cal. Rptr. 518, 521 (Ct. App. 1966) (enforcing a negligence disclaimer in a contract for the sale of an aircraft); Perry v. Phila., B & W.R. Co., 77 A. 725, 726 (Del. Super. Ct. 1910) (highlighting that principles of freedom of contract support the enforcement of a knowing agreement to exempt a party to a contract from claims of negligence); Melodee Lane Lingerie Co. v. Am. Dist. Tel. Co., 218 N.E.2d 661, 667 (N.Y. 1966) ("In the absence of statute, a contracting party could exempt itself from the consequences of its own ordinary negligence if the language so specifies."). *See also infra* note 166; 15 Grace McLean Geisel, Corbin on Contracts § 85.18, at 455 (Joseph M. Perillo ed., rev. ed. 2003) ("The general rule of exculpatory agreements is that a party may agree to exempt another party from tort liability if that tort liability results from ordinary negligence.").

147. *ABRY*, 891 A.2d at 1059; *see also* Danann Realty Corp. v. Harris, 157 N.E.2d 597, 608 (N.Y. 1959); Frizzell Constr. Co., Inc. v. Gatlinburg, L.L.C., No. 03A01-9805-CH-00161, 1998 WL 761840, at *3 (Tenn. Ct. App. 1998), *aff'd*, 9 S.W.3d 79 (Tenn. 1989), *cert. denied*, 530 U.S. 1238 (2000); Wintz v. Morrison, 17 Tex. 372, 383 (1856); S. Pearson & Son Ltd. v. Dublin Corp., [1907] A.C. 351, 362 (H.L.) (U.K.); Dhillon v. Houston, 1993 Carswell BC 2215, ¶ 13 (B.C.S. Ct.) (Can.), *available at* 1993 WL 1450828; Opron Constr. Co. Ltd. v. Alberta, [1994] 151 A.R. 241, ¶¶ 718–22 (Can.).

unlike tort-based liability for negligent or innocent representations, could not be contractually disclaimed.[148]

Interestingly, however, one influential English decision from the early twentieth century contemplated a distinction between the enforceability of contract clauses purporting to disclaim liability for one's own fraud, on the one hand, and the enforceability of contract clauses purporting to disclaim liability for the fraud of one's representatives or agents, on the other hand.[149] And there is also precedent that distinguishes standard disclaimer-of-reliance clauses from provisions that specifically inform one party to a contract that the agents of its counterparty have no authority to make any representations or warranties, suggesting that a seller could mitigate its exposure to extra-contractual fraud liability by obtaining an express acknowledgment from the buyer that the seller's agents do not have the authority to make representations on the seller's behalf.[150]

Over the last half of the twentieth century, courts began to recognize more broadly the freedom and sanctity of contract as considerations to be weighed against society's distaste for fraud.[151] Indeed, courts began to appreciate that the intrusion of tort-based principles into bargained-for contractual relationships may be "unwarranted."[152] After all, what policy justifies "such a radical shift from bargained-for duties and liabilities to the imposition of duties and liabilities that were expressly negated by the parties themselves when they decided to abandon their status as legal strangers and define their relationship by contract[?]"[153]

And in *ABRY*, Vice Chancellor Strine highlighted a series of additional arguments supporting the enforcement of liability limitations in transactions between

148. *See, e.g., S. Pearson & Sons*, [1907] A.C. at 356 ("[N]o subtilty of language, no craft or machinery in the form of contract, can estop a person who complains that he has been defrauded from having that question of fact submitted to a jury."); *see also* Isler v. Tex. Oil & Gas Corp., 749 F.2d 22, 23–24 (10th Cir. 1984) (applying New Mexico law); Rio Grande Jewelers Supply, Inc. v. Data Gen. Corp., 689 P.2d 1269, 1271 (N.M. 1984); Snyder v. Lovercheck, 992 P.2d 1079, 1087–88 (Wyo. 1999).

149. *See S. Pearson & Sons*, [1907] A.C. at 353–54 ("Now it seems clear that no one can escape liability for his own fraudulent statements by inserting in a contract a clause that the other party shall not rely upon them. I will not say that a man himself innocent may not under any circumstances, however peculiar, guard himself by apt and express clauses from liability for the fraud of his own agents."); *see also* Davis, *supra* note 12, at 508 ("[I]t is critical to distinguish the primary responsibility of an agent who has made a false or negligent misrepresentation and the vicarious responsibility of the enterprise on whose behalf he acted."); Masson, *supra* note 12, at 514; RESTATEMENT (THIRD) OF AGENCY § 260 (2006); HIH Cas. & Gen. Ins. Ltd. v. Chase Manhattan Bank, [2003] 2 Lloyd's Rep. 61, 68 (H.L.) (U.K.). *But see* Super-Cold Sw. Co. v. Willis, 219 S.W.2d 144, 147 (Tex. Civ. App. 1949) (citing James L. Hartsfield, Jr., Comment, *The "Merger Clause" and the Parol Evidence Rule*, 27 TEX. L. REV. 361, 369 (1949) and describing a "compromise rule" that will relieve the innocent seller from liability for damages based on its agent's misrepresentations, but allows the innocent buyer to rescind the contract); Davis, *supra* note 12, at 491 (citing *Super-Cold Sw. Co.*, 219 S.W.2d 144).

150. *See* Goodyear Tire & Rubber Co. v. Chiles Power Supply, Inc., 7 F. Supp. 2d 954, 962 (N.D. Ohio 1998); Overbrooke Estates Ltd. v. Glencombe Props. Ltd., [1974] 3 All E.R. 511, ¶ 1335 (U.K.).

151. *See, e.g.*, EA Grimstead & Son Ltd. v. McGarrigan, No. QBENF 97/1641/C, 1999 WL 852482 (CA (Civ.) Oct. 27, 1999) (U.K.); Vermont Teddy Bear Co., Inc. v. 538 Madison Realty Co., 807 N.E.2d 876, 879 (N.Y. 2004); Wallace v. 600 Partners Co., 658 N.E.2d 715, 717 (N.Y. 1995); W.W.W. Assocs. v. Giancontieri, 566 N.E.2d 639, 642 (N.Y. 1990).

152. *Isler*, 749 F.2d at 23–24.

153. *Id.* at 23.

sophisticated business parties.[154] First, he noted, courts should permit businesses to "make their own judgments about the risk[s] they should bear and the due diligence they undertake, recognizing that such parties are able to price factors such as limits on liability."[155] Second, he continued, "judicial decisions are not the only way that commercial norms of fair play are instilled," for a party who "gets a rap as a fraudster" will pay a price in the marketplace.[156] Third, he observed, "there remains much harshness in the world," and sophisticated private equity firms "are unlikely candidates to place at the head of the line for judicial protection."[157] And fourth, "[p]ermitting a party to sue for relief that it has contractually promised not to pursue creates the possibility that buyers will face erroneous liability (when judges or juries make mistakes) and uncompensated costs (when they incur . . . costs . . . defending successfully against a contractually-barred claim . . .)."[158]

Even after acknowledging that "[Delaware] courts have said that . . . 'fraud vitiates every contract,'" and that "'no man may invoke the law to enforce his fraudulent acts,'"[159] Vice Chancellor Strine recognized that "[t]o fail to enforce non-reliance clauses is not to promote a public policy against lying."[160] Instead, he recognized, "it is to excuse a lie made by one contracting party in writing—the lie that it was relying only on contractual representations and that no other representations had been made—to enable it to prove that another party lied orally or in a writing" outside of the contract.[161] In such a "double liar scenario," he conceded, "[t]o allow the buyer to prevail . . . is to sanction its own fraudulent conduct."[162]

C. Survey of State Approaches to the Enforceability of Liability Disclaimers in Common Law Tort Actions

In recognition of the foregoing, the *ABRY* court ultimately held that Delaware law only categorically forbids courts from enforcing an exclusive remedy provision to the extent that it purports to insulate a party from *its own deliberate* lies regarding representations and warranties actually set forth in the written agreement.[163] And, as we noted above, the Court of Chancery's narrow opinion did not foreclose enforcement of contractual disclaimers of reliance to preclude fraud or

154. *See* ABRY Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1061 (Del. Ch. 2006).
155. *Id.*
156. *Id.*; *see also* Blair, *supra* note 12, at 477–78.
157. *ABRY*, 891 A.2d at 1062.
158. *Id.*
159. *Id.* at 1061 (citing Norton v. Poplos, 443 A.2d 1 (Del. 1982); Slessinger v. Topkins, 40 A. 717 (Del. Super. Ct. 1893)).
160. *Id.* at 1058.
161. *Id.*
162. *Id.* (citing MBIA Ins. Corp. v. Royal Indem. Co., 426 F.3d 204, 218 (3d Cir. 2006) ("The danger is that a contracting party may accept additional compensation for a risk that it has no intention of actually bearing. This prevarication may amount to a fraud all its own. . . . [T]he safer route is to leave parties that can protect themselves to their own devices, enforcing the agreement they actually fashion.")).
163. *Id.* at 1063.

negligent misrepresentation claims premised upon purported lies told outside the four corners of a written agreement.[164]

Other states, by contrast, maintain an unwavering prohibition on the enforceability of disclaimer-of-reliance clauses, no matter the nature of the purported misrepresentation or the content of the defensive provision. Massachusetts courts, for example, following the Supreme Judicial Court's influential 1941 decision in *Bates v. Southgate*,[165] decline to give effect to contractual limitations on liability for fraudulent pre-contractual representations.[166] According to the *Bates* court, "the same public policy that in general sanctions the avoidance of a promise obtained by deceit strikes down all attempts to circumvent that policy by means of contractual devices."[167] Recognizing the "principle of the common law . . . that positive fraud vitiates every thing . . . incontrovertible as [such things] are on every other ground," the New Hampshire Supreme Court recently held that a specific contractual disclaimer did not preclude a party to the contract from establishing a fraudulent inducement defense.[168] And courts in Nevada,[169] Wisconsin,[170] Wyoming,[171] California,[172]

164. *See id.* For an alternative view, see generally Jeffrey M. Lipshaw, *Of Fine Lines, Blunt Instruments, and Half-Truths: Business Acquisition Agreements and the Right to Lie*, 32 DEL. J. CORP. L. 431 (2007) (proposing a default rule whereby a purported disclaimer-of-reliance provision would only be effective where (A) (i) the disputed extra-contractual representation conflicts with a contractual representation covering the same subject matter or (ii) the applicable contract is "wholly silent" on the subject matter of the extra-contractual representation and (B) the disclaimer provision is absolutely clear in disclaiming truthfulness in the contract-making process).

165. 31 N.E.2d 551, 558 (Mass. 1941).

166. Sweeney v. DeLuca, No. 042338, 2006 WL 936688, at *5–6 (Mass. Super. Ct. Mar. 16, 2006). *But see* Sound Techniques, Inc. v. Hoffman, 737 N.E.2d 920, 924–25 (Mass. App. Ct. 2000) (holding that while a standard integration clause cannot bar a fraud claim based upon an excluded representation, such a provision may preclude a negligent misrepresentation action brought on the same basis), *review denied*, 742 N.E.2d 82 (Mass. 2001) (unpublished table decision).

167. *Bates*, 31 N.E.2d at 558.

168. Van Der Stok v. Van Voorhees, 866 A.2d 972, 976 (N.H. 2005).

169. *See* Blanchard v. Blanchard, 839 P.2d 1320, 1322–23 (Nev. 1992) ("waiver clauses cannot bar a misrepresentation claim").

170. *See* RepublicBank Dallas, N.A. v. First Wis. Nat'l Bank of Milwaukee, 636 F. Supp. 1470, 1473 (E.D. Wis. 1986) ("The Wisconsin Supreme Court has endorsed the position of the Restatement (Second) of Contracts that exculpatory clauses are unenforceable on public policy grounds where the alleged harm is caused intentionally or recklessly. There is ample Wisconsin case law in which this general principle has been applied to hold disclaimers of liability ineffective against claims of fraudulent misrepresentation. . . . [And] there is no Wisconsin authority which has limited the rule to cases involving consumers or parties of unequal bargaining power . . . nor is there any Wisconsin authority which suggests a different result depending upon the type or specificity of the disclaimer provision involved." (citations omitted)).

171. *See* Snyder v. Lovercheck, 992 P.2d 1079, 1086 (Wyo. 1999) ("[W]e decline to adopt the reasoning of [the New York Court of Appeals] in *Danann Realty Corp. [v. Harris* (enforcing a specific disclaimer of reliance)], and hold that [the plaintiff] is not precluded from asserting a claim for fraudulent misrepresentation by . . . the disclaimer clause.").

172. *See, e.g.*, Danzig v. Jack Grynberg & Assocs., 208 Cal. Rptr. 336, 342 (Ct. App. 1984) ("A party to a contract who has been guilty of fraud in its inducement cannot absolve himself from the effects of his fraud by any stipulation in the contract, either that no representations have been made, or that any right which might be grounded upon them is waived." (internal quotation marks omitted)), *cert. denied*, 474 U.S. 819 (1985); *see also* Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Dev. Corp., 38 Cal. Rptr. 2d 783, 790 (Ct. App. 1995) ("The provision in [the relevant agreement] stating that no representations were made by the parties except as set forth in the agreement does not preclude appellants from proving fraud. Thus, the provision does not establish as a matter of law that

Missouri,[173] and Oregon[174] also appear unwilling to enforce even specifically crafted contractual limitations on liability for pre-contractual fraud.

But many states employ a less rigid approach, premising the enforceability of purported disclaimer provisions on the extent to which they supply evidence sufficient to negate the "reliance" element of fraud and negligent misrepresentation claims as a matter of law.[175] And in these states, the dispositive question is whether the language of the contract clearly evinces the signatories' intent to disregard the representations upon which the complaining party grounded its claim.[176]

Accordingly, courts in these jurisdictions are generally reluctant to conclude that a general merger or integration clause, standing alone, is sufficient to preclude one contracting party from asserting a tort claim based upon the pre-contractual representations of its counterparty.[177] Rather, a merger or integration clause sim-

any reliance by appellants on misrepresentations not contained in the contract was unreasonable." (citations omitted)). *But see* Applied Elastomerics, Inc. v. Z-Man Fishing Prods., Inc., No. C 06-2469 CW, 2006 WL 3251732, at *6 (N.D. Cal. Nov. 8, 2006) ("Reliance on representations that contradict clear and unambiguous terms of an agreement is unjustified as a matter of law.").

173. *See* Hess v. Chase Manhattan Bank, USA, N.A., 220 S.W.3d 758, 767 (Mo. 2007) ("Missouri law holds that a party may not, by disclaimer or otherwise, contractually exclude liability for fraud in inducing that contract."). *But see* Luli Corp. v. El Chico Ranch, Inc., 481 S.W.2d 246, 256 (Mo. 1972) (holding disclaimer that was "positive, direct, and to the point, even of disclosing the source of the questioned representation," was sufficient to preclude a rescission claim of purchaser).

174. *See* Wilkinson v. Carpenter, 554 P.2d 512, 514–17 (Or. 1976) ("[I]n this case the contract contained a clause specifically excluding any prior warranties and declaring that there had not been any representations made which induced defendants to purchase the property. Although such a clause will not preclude relief upon a showing of [a]ctual fraud, it does prevent defendants from relying upon any innocent misrepresentations as the basis for a suit for rescission [or damages]." (citation omitted)).

175. *See, e.g.*, Student Mktg. Group, Inc. v. Coll. P'ship, Inc., 247 F. App'x 90, 99 (10th Cir. 2007) ("We conclude that [the relevant agreement]'s waiver and integration clauses contain the kind of 'specific language' necessary to preempt [claimant's] negligent misrepresentation claim as a matter of law."); Vigortone AG Prods., Inc. v. PM AG Prods., Inc., 316 F.3d 641, 644–45 (7th Cir. 2002); Kronenberg v. Katz, 872 A.2d 568, 590 (Del. Ch. 2004); Head v. Head, 477 A.2d 282, 288 (Md. Ct. Spec. App.), *cert. denied*, 483 A.2d 754 (Md. 1984) (unpublished table decision); UAW-GM Human Res. Ctr. v. KSL Recreation Corp., 579 N.W.2d 411, 418–20 (Mich. Ct. App. 1998) ("[W]hen a contract contains a valid merger clause, the only fraud that could vitiate the contract is fraud that would invalidate the merger clause itself; i.e., fraud relating to the merger clause or fraud that invalidates the entire contract . . . . The various species of fraud alleged here all require reliance on a misrepresentation. Here, the merger clause made it unreasonable for plaintiff's agent to rely on any representations not included in the letter of agreement." (citations omitted)), *appeal denied*, 590 N.W.2d 66 (Mich. 1999) (unpublished table decision); Danann Realty Corp. v. Harris, 157 N.E.2d 597, 604 (N.Y. 1959); LaFazia v. Howe, 575 A.2d 182, 185–86 (R.I. 1990) (holding that specific merger and disclaimer clauses "regarding the very matter concerning which defendants now claim they were defrauded" prevent defendants from "successfully claiming reliance on prior representations"); Forest Oil Corp. v. McAllen, 268 S.W.3d 51, 56–58 (Tex. 2008).

176. *See supra* note 175.

177. *See, e.g.*, *Vigortone AG Prods.*, 316 F.3d at 645; Envtl. Sys., Inc. v. Rexham Corp., 624 So. 2d 1379, 1383 (Ala. 1993) ("[T]he law in this state renders an integration, or merger, clause ineffective to bar parol evidence of fraud in the inducement or procurement of a contract."); Formento v. Encanto Bus. Park, 744 P.2d 22, 26–28 (Ariz. Ct. App. 1987); Martinez v. Zovich, 867 A.2d 149, 156 (Conn. App. Ct.) ("A claim that a seller's intentional, reckless or negligent misrepresentations caused a buyer to enter into a contract for the sale of property is a valid cause of action, even if [the relevant contract] constituted the entire agreement between the parties."), *cert. denied*, 876 A.2d 1202 (Conn. 2005); R.D. Greenfield v. Heckenbach, 797 A.2d 63, 76 (Md. Ct. Spec. App. 2002) ("[W]e hold that in a suit for negligent misrepresentation, where equitable relief is prayed, the existence of a general merger clause, standing alone, will not prevent the plaintiff from introducing evidence concerning pre-contractual

ply precludes a court from "threshing through the undergrowth" in search of oral terms of a contractual arrangement beyond those expressed in the four corners of the written agreement.[178] As a threshold matter, then, most courts hold that the parol evidence rule only bars a complaining party from introducing evidence of pre-contractual representations in contract actions, not tort actions.[179] Indeed, according to Judge Richard Posner of the U.S. Court of Appeals for the Seventh Circuit, "fraud is a tort, and the parol evidence rule is not a doctrine of tort law and so an integration clause does not bar a claim of fraud based on statements not contained in the contract."[180] And few courts have held that the mere existence of a merger clause renders it unreasonable as a matter of law for a contracting party to rely on any representation not set forth in its written agreement.[181]

problems, which are not mentioned in the written contract."); Van Der Stok v. Van Voorhees, 866 A.2d 972, 976 (N.H. 2005) ("We have held that neither a standard merger clause, nor the parol evidence rule, bars an action for fraud." (citations omitted)); Blanchard v. Blanchard, 839 P.2d 1320, 1322–23 (Nev. 1992) ("[I]ntegration clauses do not bar claims for misrepresentation."); Travers v. Spidell, 682 A.2d 471, 472–74 (R.I. 1996) (holding that general merger clause does not shield defendant from liability for fraud); Slack v. James, 614 S.E.2d 636, 640 (S.C. 2005) ("Neither the parol evidence rule nor a merger clause in a contract prevents one from proceeding on tort theories of negligent misrepresentation and fraud.").

178. Inntrepreneur Pub Co. (GL) v East Crown Ltd., [2000] 2 Lloyd's Rep. 611, 611 (Ch. D.) (U.K.) ("[T]he purpose of an entire agreement clause was to preclude a party to a written agreement from threshing through the undergrowth and finding in the course of negotiations some chance remark or statement on which to found a claim as to the existence of a collateral warranty . . . ."); Andrew J. Bowen, *Threshing Through the Undergrowth: Entire Agreement Clauses and Unfair Contract Terms Act 1977*, S.L.T. 2004, 7, at 37, 37–38; Simon Mills & Lawrence Jacobson, *Entire Agreement and Non-Reliance Clauses*, 22 COMPANY LAW. 189, 189–91 (2001).

179. *See, e.g.*, *Vigortone AG Prods.*, 316 F.3d at 644; Downs v. Wallace, 622 So. 2d 337, 340 (Ala. 1993) ("the parol evidence rule applies to contract actions, not actions in tort"); *Formento*, 744 P.2d at 26 ("The parol evidence rule is a rule of substantive contract law, and a claim of negligent misrepresentation sounds in tort. Therefore . . . a claim for negligent misrepresentation is governed by the law of negligence, and the parol evidence rule is inapplicable." (citations omitted)). *But see* Harrison v. Happy Day Ford, No. 87-3911, 1988 WL 57688, at *4 (9th Cir. Sept. 30, 1988) ("We find most persuasive the view that the parol evidence rule precludes consideration of any evidence of an oral promise inconsistent with the express terms of an integration, regardless of whether the claim is styled one of tort or contract.").

180. *Vigortone AG Prods.*, 316 F.3d at 644.

181. *See, e.g.*, Wylie, *supra* note 127, at 4 (citing *Harrison*, 1988 WL 57688, at *4 ("the presence of an integrated agreement precludes any right to rely on an inconsistent promise"); Props. Unlimited, Inc. v. Cendant Mobility Servs., No. 01 C 8375, 2002 WL 31155107 (N.D. Ill. Sept. 26, 2002), *appeal dismissed*, 384 F.3d 917 (7th Cir. 2004); UAW-GM Human Res. Ctr. v. KLS Recreation Corp., 579 N.W.2d 411, 418–20 (Mich. Ct. App. 1998), *appeal denied*, 590 N.W.2d 66 (Mich. 1999) (unpublished table decision)). *But see* Star Ins. Co. v. United Commercial Ins. Agency, Inc., 392 F. Supp. 2d 927, 929–30 (E.D. Mich. 2005) ("The Michigan courts have said that, as it pertains to representations regarding additional agreements or contractual terms, a party would not be justified in relying on them where there is a merger clause. . . . Yet, a party could still justifiably rely on representations made by another party regarding things outside the scope of the contractual terms . . . ."); *Downs*, 622 So. 2d at 340 ("[T]his Court has never held that a [general] integration clause renders a party's reliance on oral representations unjustifiable, or unreasonable, as a matter of law." (footnote omitted)); Keller v. A.O. Smith Harvestore Prods., Inc., 819 P.2d 69, 74 (Colo. 1991) ("[Defendant] contends that these provisions constitute a waiver by the [plaintiffs] of any claim that requires proof of reliance on statements made . . . prior to the formation of the purchase agreements. . . . We disagree. . . . A contract provision purporting to prohibit a party to the contract from asserting a claim of negligent misrepresentation must be couched in clear and specific language." (citations omitted)); Norton v. Poplos, 443 A.2d 1, 6–7 (Del. 1982).

But in contrast to a general merger or integration clause, courts in many jurisdictions are willing to enforce provisions that clearly demonstrate that the complaining party intentionally and unequivocally waived its right to rely on the extra-contractual representation upon which it based its claim.[182] In New York, for example, it is well-settled that a specific disclaimer clause stipulating that a plaintiff did not rely on the very representations that formed the basis for its fraud claim can "[destroy] the allegations in [the] plaintiff's complaint that the agreement was executed in reliance upon [the] contrary oral representations," and justify dismissal of the tort action as a matter of law.[183] Indeed, the New York State Court of Appeals has stated, "to hold otherwise would be to say that it is impossible for two businessmen dealing at arm's length to agree that the buyer is not buying in reliance on any representations of the seller as to a particular fact."[184] Importantly, although there is some conflicting authority,[185] the New York rule most reliably "'operates where the substance of the disclaimer [provision] tracks [i.e., identifies] the substance of the alleged misrepresentations.'"[186] So a general clause that merely requires each party to agree that it is not relying on any extra-contractual representation may not suffice.[187] The law in Alabama,[188] Kansas,[189] and Rhode Island[190] appears to be similar.

Delaware courts appear to effectuate anti-reliance clauses more broadly.[191] Under the Delaware Supreme Court's holding in *Kronenberg v. Katz*, for a contract

182. *See, e.g.*, Transched Sys. Ltd. v. Versyss Transit Solutions, LLC, No. 07C-08-286 WCC, 2008 WL 948307, at *3 n.14 (Del. Super. Ct. Apr. 2, 2008); Miles Excavating, Inc. v. Rutledge Backhoe & Septic Tank Servs., Inc., 927 P.2d 517, 517–18 (Kan. Ct. App. 1997); Head v. Head, 477 A.2d 282, 288 (Md. Ct. Spec. App.), *cert. denied*, 483 A.2d 754 (Md. 1984) (unpublished table decision); Danann Realty Corp. v. Harris, 157 N.E.2d 597, 601–03 (N.Y. 1959); LaFazia v. Howe, 575 A.2d 182, 185–86 (R.I. 1990); Forest Oil Corp. v. McAllen, 268 S.W.3d 51, 60–61 (Tex. 2008) (interpreting Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171 (Tex. 1997)).

183. *Danann*, 157 N.E.2d at 599.

184. *Id.* at 600.

185. *See, e.g.*, Citibank, N.A. v. Plapinger, 485 N.E.2d 974, 977 (N.Y. 1985).

186. Mfrs. Hanover Trust Co. v. Yanakas, 7 F.3d 310, 316 (2d Cir. 1993) (quoting Grumman Allied Indus., Inc. v. Rohr Indus., Inc., 748 F.2d 729, 735 (2d Cir. 1984)).

187. *See, e.g.*, *Yanakas*, 7 F.3d at 316 (holding that contract provision did not bar fraudulent inducement claim where clause "di[d] not specifically disclaim reliance on any oral representation concerning the matter as to which plaintiff now claims he was defrauded" (internal quotation marks omitted)).

188. *See, e.g.*, Envtl. Sys., Inc. v. Rexham Corp., 624 So. 2d 1379, 1384 & n.7 (Ala. 1993) (holding that "the existence of a general disclaimer clause in [the relevant agreement] does not, as a matter of law, preclude [the plaintiff] from justifiably relying on alleged [pre-contractual oral representations]," but noting that "the [relevant disclaimer] does not specifically disclaim the very representation [the plaintiff] alleges to be the foundation for fraud").

189. *See, e.g.*, Miles Excavating, Inc. v. Rutledge Backhoe & Septic Tank Servs., Inc., 927 P.2d 517, 517–18 (Kan. Ct. App. 1997) (distinguishing Edwards v. Phillips Petroleum Co., 360 P.2d 23, 28 (Kan. 1961), in which the court held that disclaimer precluded the plaintiff's action for fraud) ("[*Phillips* is] distinguishable, since both cases involved disclaimers specific to the matter about which the plaintiff claimed to have been defrauded."). *But see* Mid Continent Cabinetry, Inc. v. George Koch Sons, Inc., No. 87-1248-C, 1991 WL 177961, at *4–5 (D. Kan. Aug. 9, 1991) ("Plaintiff may bring a claim of fraud based on the same representations that were otherwise disclaimed as express warranties.").

190. *See, e.g.*, LaFazia v. Howe, 575 A.2d 182, 185–86 (R.I. 1990) (holding that specific merger and disclaimer clauses "regarding the very matter concerning which defendants now claim they were defrauded" "prevent defendants from successfully claiming reliance on prior representations").

191. *See, e.g.*, MBIA Ins. Corp. v. Royal Indem. Co., 426 F.3d 204, 218 (3d Cir. 2006); Transched Sys. Ltd. v. Versyss Transit Solutions, LLC, No. 07C-08-286 WCC, 2008 WL 948307, at *3 n.14 (Del. Super. Ct. Apr. 2, 2008).

to bar a fraud in the inducement claim, "the contract must contain language that, when read together, can be said to add up to a clear anti-reliance clause by which the plaintiff . . . contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract."[192] In contrast to New York law, then, Delaware courts may be more willing to enforce general disclaimers of reliance that do not specifically reference the extra-contractual representation upon which the tort plaintiff premised its claim.[193] Indeed, in its *MBIA Insurance Corp. v. Royal Indemnity Co.* decision, authored by then-judge, now-Justice, Samuel Alito, the U.S. Court of Appeals for the Third Circuit predicted that "when sophisticated parties [insert] clear anti-reliance language in their negotiated agreement[s], and when that language, *though broad*, unambiguously covers the fraud that actually occurs, Delaware's highest court will enforce it to bar a subsequent fraud claim."[194]

Texas courts have generally employed a more formulaic approach to the enforceability of reliance disclaimers.[195] In *Schlumberger Technology Corp. v. Swanson*, the Texas Supreme Court held that the language of a contract "and the circumstances surrounding its formation determine whether [a purported] disclaimer of reliance is binding."[196] Under this "language and circumstances" inquiry, the Texas Supreme Court has recently emphasized the following factors as most significant in a court's decision to enforce or decline to enforce a contentious disclaimer: (i) whether terms of the contract "were negotiated, rather than boilerplate," and whether, "during negotiations, the parties specifically discussed the issue which has become the topic of the subsequent dispute"; (ii) whether the "complaining party was represented by counsel"; (iii) whether the parties "dealt with each other in an arm's length transaction"; (iv) whether the parties were "knowledgeable in business matters"; and (v) whether the language of the purported disclaimer was "clear."[197] So while New York and Delaware courts focus primarily (but not exclusively)[198] on the language of a non-reliance provision, Texas courts tend to accord more weight to exogenous considerations, including the sophistication of the contracting parties and even the visual prominence of the contentious clause.[199]

192. 872 A.2d 568, 593 (Del. Ch. 2004).

193. *See, e.g., id.; MBIA*, 416 F.3d at 218; *Transched Sys.*, 2008 WL 948307, at *3; Progressive Int'l Corp. v. E.I. Dupont de Nemours & Co., No. 19209, 2002 WL 1558382, at *5 (Del. Ch. July 9, 2002).

194. 416 F.3d at 218 (emphasis added).

195. *See* Forest Oil Corp. v. McAllen, 268 S.W.3d 51, 60–61 (Tex. 2008).

196. 959 S.W.2d 171, 179 (Tex. 1997).

197. *Forest Oil*, 268 S.W.3d at 60–61 (interpreting *Schlumberger*, 959 S.W.2d at 181). The *Forest Oil* court highlighted the fact-specific approach articulated in *Schlumberger* by noting that the holding "should not be construed to mean that a mere disclaimer standing alone will forgive intentional lies regardless of context. We decline to adopt a *per se* rule that a disclaimer automatically precludes a fraudulent-inducement claim, but we hold today, as in *Schlumberger*, that 'on this record,' the disclaimer of reliance refutes the required element of reliance." *Id.* at 61.

198. *See, e.g.*, Citibank, N.A. v. Plapinger, 485 N.E.2d 974, 977 (N.Y. 1985).

199. *See, e.g., id.;* Netknowledge Techs., L.L.C. v. Rapid Transmit Techs., No. 3:02-CV-2406-M, 2007 WL 518548, at *4 (N.D. Tex. Feb. 20, 2007), *aff'd*, 269 F. App'x 443 (5th Cir. 2008).

V. Drafting Agreements to Maximize the Likelihood that the Contract Alone Will Govern Your Client's Rights, Obligations, and Liabilities

It follows from the foregoing discussion that a contracting party's susceptibility to extra-contractual liability depends upon three primary factors: (i) the breadth of the tort remedy afforded contract signatories under the governing state law; (ii) whether, and to what extent, the law of the jurisdiction chosen to govern the applicable written agreement permits transacting parties to disclaim tort liability by contract (both for extra-contractual representations and for representations and warranties set forth in the written agreement); and (iii) if the law of the jurisdiction chosen to govern the written agreement permits contracting parties to disclaim tort liability by contract, the stringency of the standards that courts of the relevant jurisdiction apply to examine the enforceability of purported disclaimer provisions.

A. Choice of Law

Because subtle jurisprudential differences among states can dispositively determine whether a contracting party is ultimately exposed to contract-related tort liability,[200] the boilerplate "choice-of-law" provision buried in the "miscellaneous" section of most stock and asset purchase agreements may ultimately dictate the effectiveness of the highly negotiated indemnification mechanics and damage caps, as well as the prudence of any related purchase price adjustments.

1. The Lessons of *Benchmark Electronics, Inc. v. J.M. Huber Corp.*

A 2003 decision from the U.S. Court of Appeals for the Fifth Circuit illustrates the importance of the contractual choice-of-law provision in this context.[201] In *Benchmark Electronics, Inc. v. J.M. Huber Corp.*, Benchmark Electronics, Inc. ("Benchmark"), a Texas corporation with its principal operations in Texas, brought suit against J.M. Huber Corporation ("Huber") for breach of contract, fraud, and negligent misrepresentation on the basis of (i) statements that Huber made before Benchmark agreed to purchase one of Huber's subsidiaries and (ii) express contractual warranties set forth within the applicable stock purchase agreement itself.[202] Importantly, the choice-of-law provision in the stock purchase agreement stipulated that the "*[a]greement* [would] be governed by, and construed in accordance with, the internal laws of the State of New York."[203] The Fifth Circuit

200. *See* Berry v. Indianapolis Life Ins. Co., No. 3:08-CV-0248-B, 2009 WL 804163, at *14–18 (N.D. Tex. Mar. 26, 2009) (discussing differences between Wisconsin, Texas, and California law regarding the effectiveness of disclaimer-of-reliance clauses).

201. Benchmark Elecs., Inc. v. J.M. Huber Corp., 343 F.3d 719 (5th Cir.), *modified by* 355 F.3d 356 (5th Cir. 2003).

202. *Id.* at 722–24.

203. *Id.* at 727 (emphasis added) (internal quotation marks omitted).

interpreted the foregoing clause narrowly and held that it only encompassed claims arising from "the construction and interpretation of the contract" and not from Benchmark's claims of fraud and misrepresentation, which were, by definition, tort claims outside of the contract.[204]

Because the stock purchase agreement included a provision pursuant to which Benchmark specifically disclaimed reliance on statements not expressly warranted in the parties' contract, the Fifth Circuit concluded that the fraud and negligent misrepresentation claims that Benchmark based upon Huber's pre-contractual representations were not actionable as a matter of New York contract law.[205] Indeed, applying New York law to determine the validity of the disclaimer provision, the court held that the "specificity" of what Huber warranted in the agreement "'preclude[d] Benchmark, a sophisticated business entity, from claiming reliance upon other *pre-contractual* representations covering the same subjects.'"[206]

But since the choice-of-law provision did not also encompass *tort* claims arising out of or related to the agreement, the Fifth Circuit determined that Texas law, and not New York law, would dictate whether the fraud claim that Benchmark based on Huber's express contractual warranties was actionable.[207] And because Texas law (like Delaware law) permits fraud and negligent misrepresentation claims "even if the representations on which those claims are [premised] are otherwise set forth in a contract,"[208] the court vacated the district court's grant of summary judgment in favor of Huber with respect to the warranty-based tort actions, permitting Benchmark to pursue tort damages, including exemplary damages, for the inaccuracy of Huber's *contractual* warranties.[209]

Benchmark, then, teaches us that the breadth of the choice-of-law provision may drastically impact our clients' exposure to extra-contractual liability.[210] Indeed, had the choice-of-law provision in that case been drafted with sufficient breadth to cover contract-related *tort* actions, the Fifth Circuit likely would have dismissed all of Benchmark's claims, since New York law, unlike Texas and Delaware law, does not generally permit contracting parties to ground fraud or misrepresentation claims on *contractual* misrepresentations.[211]

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204. *Id.*

205. *See id.*; *see also* West & Nelson, *supra* note 88, at 816–18.

206. West & Nelson, *supra* note 88, at 817 (quoting *Benchmark*, 343 F.3d at 729) (emphasis added).

207. *See Benchmark*, 343 F.3d at 728.

208. West & Nelson, *supra* note 88, at 817.

209. *Benchmark*, 343 F.3d. at 728. Under Texas law, this is possible under the theory that such contractual warranties were simply restatements of the pre-contractual representations or "factual predicates" that induced the formation of the contract.

210. *See Benchmark*, 343 F.3d at 726 (interpreting narrowly a choice-of-law clause as applying only to the construction of the agreement and not to any potential tort claims between the parties); *see also* Kuehn v. Childrens Hosp., 119 F.3d 1296, 1302 (7th Cir. 1997) (noting that a specific choice-of-law provision expressing the parties' intent to apply a particular state law to torts, as well as to contractual claims, would prevent the uncertainty of the application of another state's laws in a dispute); Karnes v. Fleming, No. 4528223, 2008 WL 4528223, at *4 (S.D. Tex. July 31, 2008) (holding that a narrow contractual choice-of-law provision in only some of the contracts giving rise to a class action was not broad enough to prevent the court from engaging in a thorough common-law choice-of-law analysis).

211. *See* West & Nelson, *supra* note 88, at 817.

2. Drafting Effective Choice-of-Law Provisions

Accordingly, consider the following suggestions when negotiating and drafting choice-of-law provisions[212]:

- Recognizing that some states afford broader tort remedies to contract signatories, and that a choice-of-law provision that names the state law to be used in the interpretation of an agreement may not also determine the state law that governs tort claims that arise in connection with that agreement, carefully review, and, if necessary, expand the scope of, the choice-of-law provision to maximize the likelihood that a court will apply the chosen state's law to both contractual and extra-contractual claims; and
- To the extent that you can, under applicable conflict of laws principles, choose among several states' laws to govern your contractual relationship, ensure that the chosen state permits sophisticated transacting parties the maximum flexibility in contractually limiting prospective tort liability since some jurisdictions, like Massachusetts, New Hampshire, Nevada, Wisconsin, Wyoming, California, Missouri, and Oregon, may unequivocally decline to enforce disclaimer-of-reliance provisions to preclude fraud claims, no matter the nature of the purported misrepresentation or the content of the defensive clause.

We have set forth in the Appendix a model "Governing Law" provision, which incorporates the foregoing recommendations.

B. Drafting Effective "Entire Agreement," Disclaimer-of-Reliance, and Related Provisions

Once you have selected the law of the best available state, ensure that the language of your agreement clearly and unequivocally demonstrates that your counterparty has knowingly waived its right to rely on, or bring suit on account of, the specific representations that could form the basis of a tort claim, whether or not such representations are set forth in the written agreement.[213] And though some jurisdictions, like Delaware, may generally enforce disclaimer provisions without extensive indicia of specificity, it is important to remember that even in

212. For earlier versions of these suggestions authored or co-authored by Mr. West, see West, *supra* note 12 at 4; West & Bodamer, *supra* note 19, at 13; and West & Obi, *supra* note 19, at 19. In stock deals and to the extent permissible under applicable choice-of-venue principles, it may also be prudent to include a "choice-of-venue" provision to ensure that any resulting securities fraud claims would be litigated in a federal circuit, like the Second or Seventh Circuit, that is amenable to enforcing disclaimer-of-reliance clauses to preclude actions brought under section 10(b) of the Exchange Act at the motion to dismiss stage. *See supra* notes 21–22 and accompanying text.

213. Clarity in drafting is critical so that a court is truly required to ignore the parties' express agreement in order to allow a tort-based claim to proceed. In deciding that a general disclaimer of reliance on pre-contractual representations "does not operate to exclude remedies for pre-contractual misrepresentations," the court in *Thomas Witter Ltd. v. TBP Indus. Ltd.*, [1996] 2 All E.R. 573 (Ch. D.) (U.K.), noted, for example, that "if a clause is to have the effect of excluding or reducing remedies for damaging untrue statements then the party seeking that protection cannot be mealy-mouthed in his clause . . . . He must bring it home that he is limiting his liability for falsehoods he may have told." For more on this point, see Lipshaw, *supra* note 164, at 457.

these states, some courts apply more stringent criteria than may be the governing rule. Accordingly, consider the following suggestions:

- Be sure to include a merger provision that stipulates the exclusivity of the agreement *and* a provision disclaiming both the existence of, and any reliance upon, any other representations or warranties, oral or written, so as to reinforce the acknowledgment of the buyer that it has waived its right to rely on extra-contractual representations;
- Be sure that the disclaimer-of-reliance provision stipulates the specific (though non-exclusive list of) extra-contractual representations on which your counterparty has agreed not to rely;
- Document the arm's-length negotiations by which the counterparty agreed to incorporate the merger and disclaimer provisions as important bases of the bargain;
- Ensure that the agreement stipulates the sophistication of the buyer as a business player and the competence of its legal counsel;
- Whenever possible, have the company being sold, rather than the selling stockholder, actually make the representations and warranties even though the selling stockholders are agreeing to indemnify the buyer contractually for their breach and disclaim the making of any representations and warranties by that selling stockholder;
- Make sure that any language suggesting the counterparty has relied upon the specific representations that are set forth in the written contract is subject to the exclusive remedy provision, so that only the agreement provides remedies for their breach (not tort law). In addition, include a provision making clear that all representations and warranties contained in the agreement are contractual in nature only, regardless of whether they were made to the counterparty pre-contract and were relied upon by the counterparty in entering into the agreement;
- Obtain a specific acknowledgment from the counterparty that no officer, employee, agent, or other person acting or purporting to act on behalf of your client has any actual or apparent authority to make any representation, warranty, assurance, or covenant that is not specifically set forth in the written agreement and subject to the limited remedies bargained for therein—and that the buyer has not relied upon any such person;
- Be certain to include express language specifying that no officers or agents of either contracting party shall have any personal liability (whether in contract or in tort) with respect to the negotiation, execution, delivery, or performance of the agreement or any misrepresentations made in connection therewith;
- To be consistent in your position that only the agreement governs the relationship between the buyer and seller, do not ask buyers to agree to anti-sandbagging clauses.[214] Asking the buyer to agree to an anti-sandbagging

214. For more information on anti-sandbagging clauses and why they are inappropriate, see generally West & Shah, *supra* note 47.

clause subjects the buyer to the very uncertainties about extra-contractual claims of "knowledge" that the seller is seeking to avoid;

- Try to avoid agreeing to deliver a "bring-down certificate" in which officers assert the continued truthfulness of the contractual representations made in the agreement because a court could view the "certification" as the officers' personal verification of the accuracy of the representations (that could generate another tort-based inducement claim). There are other means of making clear that the representations and warranties are remade at the closing for the sole purpose of the indemnification provisions; and
- Never undo all of the above by agreeing to exclude "fraud," "willful misconduct," "gross negligence," or any other tort-related claims from the exclusive remedies provision of your agreement.[215] Remember, "fraud" is not limited to deliberate lying, and can even be based on innocent misrepresentations (i.e., "equitable fraud"). If your counterparty insists on a "fraud exclusion," limit the exclusion to "intentional fraud committed with actual knowledge by the Seller Knowledge Persons [a defined group limited to persons from whom you obtained certificates indicating that they had no current actual knowledge that any representation made in the agreement was false] with respect to the specific representations and warranties set forth in Article [_] only." And make certain that the effect of such an exclusion is not to convert a contract claim into a tort claim, but to eliminate the applicability of the deductibles and caps as to those breached representations that were, in fact, "intentionally fraudulent."[216]

A series of model defensive provisions that reflect the recommendations outlined above are set forth in the Appendix.

VI. Conclusion

It has been said that "[t]he [common] law is the enforcement of common sense: or, at any rate, it should be."[217] Contracts made between sophisticated parties, represented by counsel, who freely decided after extensive negotiation to allocate risk in a carefully crafted written agreement, are fundamentally different from the adhesion contracts made by consumers who buy cars, rent jet skis, or

215. *See* Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc., No. 02 Civ. 7689, 2005 WL 832050, at *3 (S.D.N.Y. Apr. 12, 2005) ("express carve-out for causes of action arising from fraud renders [exclusive remedies provision] meaningless" if action is based on claim of fraud); Glenn D. West & Benton B. Bodamer, *Corporations*, 59 SMU L. Rev. 1143, 1166 n.149 (2006). Also, remember that the term "fraud" not only encompasses intentional fraud, but also "equitable" (i.e., negligent and even innocent misrepresentation) and "reckless" fraud. Of course, a lawyer's ethical obligations demand that he or she not counsel or assist a client in conduct that the lawyer knows is fraudulent (in this case meaning "conduct that is fraudulent under the . . . law of the applicable jurisdiction and has a purpose to deceive"). *See* Model Rules of Prof'l. Conduct R. 1.0(d), 1.2(d) (2008).

216. For earlier versions of some of these suggestions authored or co-authored by Mr. West, see generally West, *supra* note 12, at 3; West & Bodamer, *supra* note 19, at 10–11; West & Obi, *supra* note 19, at 16–18.

217. S.C.M. (U.K.) Ltd. v. W.J. Whithall & Son Ltd., [1971] 1 Q.B. 337, 344 (U.K.). *See also* Thornton v. Micrografx, Inc., 878 F. Supp. 931, 938 (N.D. Tex. 1995) ("The Court refuses to leave its common sense at the courthouse steps . . . .").

sign consents allowing their children to participate in rafting excursions.[218] It is also common sense that there is a material difference between the risk of physical harm to person or property occasioned by a product or activity and the risk of economic loss occasioned by an arm's-length business transaction.[219]

As one commentator has noted, "tort duties arise to protect individuals unable to protect themselves from the unscrupulous actions of others."[220] More specifically, "'[t]ort law . . . governs the relationship between a [buyer] and a [seller], where it is impractical or impossible . . . to negotiate the terms of a sale or each party's duty to the other.'"[221] But where sophisticated parties contract pursuant to comprehensive written agreements intended to outline the specific extent of their respective obligations and liabilities, contract law alone should be sufficient to protect them. Indeed, that is why early courts adopted the "economic loss" rule—to prevent contracting parties from compensating for their failure to bargain for a specific warranty by bringing their claim in tort instead of contract.[222] To allow tort claims to maintain a "parasitic"[223] existence within the "host" of a contractual relationship that disclaims the application of tort law to that contract "render[s] warranties duplicative, at best, and marginalize[s] the risk/benefit allocation subsumed in the contractual terms on which the transaction actually, but may not otherwise have, occurred."[224]

To create exceptions to contractual freedom in business agreements between sophisticated parties based on theories of fraud, and sometimes negligence, "disregards the memorializing function and sanctity of contracts and invites slippery-slope, second-guessing forays into the equities of contractual dealings."[225] Fraud and negligent misrepresentation claims have proven to be hard to define, easy to allege, hard to dismiss on a threshold, pre-discovery motion, difficult to disprove without expensive, lengthy litigation, and highly susceptible to the erroneous conclusions of judges and juries.[226] And ironically, it may be the one alleging

218. For a discussion of the law applicable to exculpatory clauses in contracts for which the risk of physical harm is present, see John G. Shram, Note, *Contract Law—The Collision of Tort and Contract Law: Validity and Enforceability of Exculpatory Clauses in Arkansas.* Jordan v. Diamond Equipment, *2005 WL 984513 (2005)*, 28 U. ARK. LITTLE ROCK L. REV. 279 (2006).

219. *See* Murphy v. Brentwood Dist. Council, [1991] A.C. 398, 487 (H.L.) (U.K.) ("The infliction of physical injury to the person or property of another universally requires justification. The causing of economic loss does not."), *quoted in* Perre v. Apand Pty Ltd. (1999) 198 C.L.R. 180, 209 (Austl.).

220. Barton, *supra* note 65, at 1797.

221. *Id.* (quoting Detroit Edison Co. v. NABCO, Inc., 236 F.3d 236, 240 (6th Cir. 1994)) (ellipses and alterations in original).

222. *See supra* note 72 and accompanying text.

223. *See* Spartan Steel & Alloys Ltd. v. Martin & Co. (Contractors) Ltd., [1973] Q.B. 27, 34 (U.K.) (referring to a disputed doctrine called "parasitic damages," the court noted that "[t]hey are said to be 'parasitic' because, like a parasite, in biology, they cannot exist on their own, but depend on others for their life and nourishment").

224. Maxcess, Inc. v. Lucent Techs., Inc., No. 6:04-cv-204-Orl-31DAB, 2005 WL 6125471, at *7 (M.D. Fla. Jan. 5, 2005), *aff'd*, 433 F.3d 1337 (11th Cir. 2005).

225. *Id.* at *8.

226. *See, e.g.*, Forest Oil Corp. v. McAllen, 268 S.W.3d 51, 60 (Tex. 2008) ("[a]fter-the-fact protests of misrepresentation are easily lodged"); Santanna Natural Gas Corp. v. Hamon Operating Co., 954 S.W.2d 885, 890 (Tex. App. 1997) ([f]raud "is an elusive and shadowy term").

the fraud that is the actual "fraudster"—not the person against whom the fraud is alleged.

Despite the repugnancy of seemingly sanctioning what is conveyed by the common (although not necessarily legal) understanding of the term "fraud," courts should focus instead on the nature of the bargains that parties make and the identity of the parties who make them. It is a "fundamental principle of contract law . . . [that] parties must be able to confidently allocate risks and costs during their bargaining without fear that unanticipated liability may arise in the future, effectively negating the parties' efforts to build these costs into the contract."[227] Freedom to contract, and the sanctity of contracts freely made, should remain a strong policy preference. Tort law should not interfere with business agreements made by sophisticated parties, particularly those involving business entities dealing through multiple agents, at least in cases where the parties have expressly excluded its application.[228]

As business lawyers, however, we must remain aware of the fact that there is, at present, a divergence of opinion on these issues among the common law judges who decide business-related disputes throughout the United States. And unless courts uniformly reconcile these conflicting views, business lawyers must advise their clients that the state law they choose to govern their particular agreement may dictate the certainty and predictability that they can expect from their contracts in the event that their counterparty alleges fraud or some other tort-based claim. This unpredictability runs against the very fabric of the common law because "the effectiveness of the law is seriously diminished when legal practitioners believe they cannot confidently advise what the law is."[229] But, for now at least, the answer to the question that we posed in the subtitle of this article remains: "It depends"—on both the clarity of the language in written agreements and the willingness of courts to enforce those agreements as written.

227. Vanderbeek v. Vernon Corp., 50 P.3d 866, 871 (Colo. 2002).
228. *See* Davis, *supra* note 12, at 529–30.
229. Perre v. Apand Pty Ltd. (1999) 198 C.L.R. 180, 215 (Austl.).

APPENDIX

MODEL PROVISIONS[230]

Governing Law.[231] This Agreement, and all claims or causes of action (whether in contract or tort) that may be based upon, arise out of or relate to this Agreement, or the negotiation, execution or performance of this Agreement (including any claim or cause of action based upon, arising out of or related to any representation or warranty made in or in connection with this Agreement or as an inducement to enter into this Agreement), shall be governed by the internal laws of the State of [_____].[232]

Entire Agreement. This Agreement contains the entire agreement of the parties respecting the sale and purchase of the Company and supersedes all prior agreements among the parties respecting the sale and purchase of the Company. The parties hereto have voluntarily agreed to define their rights, liabilities and obligations respecting the sale and purchase of the Company exclusively in contract pursuant to the express terms and provisions of this Agreement; and the parties hereto expressly disclaim that they are owed any duties or are entitled to any remedies not expressly set forth in this Agreement. Furthermore, the parties each hereby acknowledge that this Agreement embodies the justifiable expectations of sophisticated parties derived from arm's-length negotiations; all parties to this Agreement specifically acknowledge that no party has any special relationship with another party that would justify any expectation beyond that of an ordinary buyer and an ordinary seller in an arm's-length transaction. The sole and exclusive remedies for any breach of the terms and provisions of this Agreement (including any representations and warranties set forth herein, made in connection herewith or as an inducement to enter into this Agreement) or any claim or cause of action otherwise arising out of or related to the sale and purchase of the Company shall be those remedies available at law or in equity for breach of contract only (as such contractual remedies have been further limited or excluded pursuant to the express terms of this Agreement); and the parties hereby agree that neither party hereto shall have any remedies or cause of action (whether in contract or in tort) for any statements, communications, disclosures, failures to disclose, representations or warranties not set forth in this Agreement.

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230. *See* Glenn D. West & W. Benton Lewis, Jr., *Corporations*, 61 SMU L. REV. 743, 764–65 (2008); West & Bodamer, *supra* note 19, at 11–15; West & Obi, *supra* note 19, at 18–21; Glenn D. West & Sarah E. Stasny, *Corporations*, 58 SMU L. REV. 719, 723–27 (2006). Highlighting the model provisions in boldface font or all capital characters may maximize their respective effectiveness. It is important to note, however, that the authors do not believe that including all of these provisions is critical to accomplishing the protection they seek. Rather, these provisions are, in many cases, deliberately duplicative. The business lawyer, with knowledge of the law in the applicable jurisdiction, should adapt and modify accordingly.

231. Note that choice of forum and jury trial waiver provisions may confer additional protections against extra-contractual liability.

232. This provision appears in West & Stasny, *supra* note 230, at 724. Interestingly, the court in *ABRY* suggests that Delaware courts, unlike the Fifth Circuit and other courts, would enforce a choice-of-law provision that was limited to the interpretation and enforcement of the contract so that the contractual choice would also govern tort claims arising out of that contract. *See* ABRY Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1047–48 (Del. Ch. 2006).

Nature of Representations and Warranties.[233] All representations and warranties set forth in this Agreement are contractual in nature only and subject to the sole and exclusive remedies set forth herein. No Person is asserting the truth of any representation and warranty set forth in this Agreement; rather the parties have agreed that should any representations and warranties of any party prove untrue, the other party shall have the specific rights and remedies herein specified as the exclusive remedy therefor, but that no other rights, remedies or causes of action (whether in law or in equity or whether in contract or in tort) are permitted to any party hereto as a result of the untruth of any such representation and warranty.

Non-Reliance of Buyer. Except for the specific representations and warranties expressly made by the Company or any Selling Stockholder in Article [_] of this Agreement, (1) Buyer acknowledges and agrees that (A) neither the Company nor any Selling Stockholder is making or has made any representation or warranty, expressed or implied, at law or in equity, in respect of the Business, the Company, the Company's Subsidiaries, or any of the Company's or its Subsidiaries' respective businesses, assets, liabilities, operations, prospects, or condition (financial or otherwise), including with respect to merchantability or fitness for any particular purpose of any assets, the nature or extent of any liabilities, the prospects of the Business, the effectiveness or the success of any operations, or the accuracy or completeness of any confidential information memoranda, documents, projections, material or other information (financial or otherwise) regarding the Company or any Company Subsidiary furnished to Buyer or its representatives or made available to Buyer and its representatives in any "data rooms," "virtual data rooms," management presentations or in any other form in expectation of, or in connection with, the transactions contemplated hereby, or in respect of any other matter or thing whatsoever, and (B) no officer, agent, representative or employee of the Selling Stockholder, the Company or any of the Company's Subsidiaries has any authority, express or implied, to make any representations, warranties or agreements not specifically set forth in this Agreement and subject to the limited remedies herein provided; (2) Buyer specifically disclaims that it is relying upon or has relied upon any such other representations or warranties that may have been made by any Person, and acknowledges and agrees that the Company and the Selling Shareholders have specifically disclaimed and do hereby specifically disclaim any such other representation or warranty made by any Person; (3) Buyer specifically disclaims any obligation or duty by the Seller, the Company or any Selling Stockholder to make any disclosures of fact not required to be disclosed pursuant to the specific representations and warranties set forth in Article [_] of this Agreement; and (4) Buyer is acquiring the Company subject only to the specific representations and warranties set forth in Article [_] of this Agreement

233. Ideally, a stock or asset purchase agreement would not contain a separate section that stipulates the "representations and warranties" upon which the transaction was predicated. Instead, what we typically refer to as "representations and warranties" would be identified (and listed) as "indemnifiable matters" for which the seller would be obligated to indemnify the buyer, subject to the limitations set forth in the indemnification section. As much as we would like to see this change in convention, we are not optimistic that business lawyers are ready for such a change.

as further limited by the specifically bargained-for exclusive remedies as set forth in Article [_].

Non-Recourse. No past, present or future director, officer, employee, incorporator, member, partner, stockholder, Affiliate, agent, attorney or representative of the Company, the Selling Stockholders or any of their respective Affiliates shall have any liability (whether in contract or in tort) for any obligations or liabilities of the Company or the Selling Stockholders arising under, in connection with or related to this Agreement or for any claim based on, in respect of, or by reason of, the sale and purchase of the Company, including, without limitation, any alleged non-disclosure or misrepresentations made by any such Persons.

Exclusive Remedies. Following the Closing, the sole and exclusive remedy for any and all claims arising under, out of, or related to this Agreement, or the sale and purchase of the Company, shall be the rights of indemnification set forth in Article [_] only, and no person will have any other entitlement, remedy or recourse, whether in contract, tort or otherwise, it being agreed that all of such other remedies, entitlements and recourse are expressly waived and released by the parties hereto to the fullest extent permitted by law. [Notwithstanding the foregoing, the parties have agreed that if the Buyer can demonstrate, by clear and convincing evidence, that a material representation and warranty made by the Company or the Selling Stockholder in this Agreement was deliberately made and known to be materially untrue by any of the Seller Knowledge Parties, then the Deductible shall not apply and the Cap shall be increased to the Purchase Price with respect to any resulting indemnification claim under Section [_].] The provisions of this Section [_], together with the provisions of Sections [_], [_], and [_], and the limited remedies provided in Article [_], were specifically bargained-for between Buyer, the Company and the Selling Stockholders and were taken into account by Buyer, the Company and the Selling Stockholders in arriving at the Purchase Price. The Company and the Selling Stockholders have specifically relied upon the provisions of this Section [_], together with the provisions of Sections [_], [_], and [_], and the limited remedies provided in Article [_], in agreeing to the Purchase Price and in agreeing to provide the specific representations and warranties set forth herein.