CONTRACTUAL LIMITATIONS ON SELLER LIABILITY IN M&A TRANSACTIONS

By

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

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

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

ABA SECTION OF BUSINESS LAW
SPRING MEETING PROGRAM:
CREATING CONTRACTUAL LIMITATIONS ON SELLER LIABILITY THAT WORK POST-CLOSING: AVOIDING SERIOUS PITFALLS IN DOMESTIC AND INTERNATIONAL DEALS

DENVER, CO • APRIL 22, 2010

Byron F. Egan
Biographical Information

Jackson Walker L.L.P.
901 Main Street, Suite 6000
Dallas, Texas 75202

Phone: (214) 953-5727
Email: began@jw.com

Practice: Byron F. Egan is a partner of *Jackson Walker L.L.P.* in Dallas. He is engaged in a corporate, partnership, securities, mergers and acquisitions ("M&A") and financing practice. Mr. Egan has extensive experience in business entity formation and governance matters, M&A and financing transactions in a wide variety of industries including energy, financial and technology. In addition to handling transactions, he advises boards of directors and their audit, compensation and special committees with respect to fiduciary duty, Sarbanes-Oxley Act, special investigation and other issues.

Involvement: Mr. Egan is Senior Vice Chair and Chair of Executive Council of the M&A Committee of the American Bar Association and served as Co-Chair of its Asset Acquisition Agreement Task Force, which wrote the *Model Asset Purchase Agreement with Commentary* (2001). Mr. Egan is a member of the American Law Institute and is a former Chairman of the Texas Business Law Foundation, of which he is currently a director and executive committee member. He is also a former Chairman of the Business Law Section of the State Bar of Texas, and former Chairman of that section's Corporation Law Committee. On behalf of these groups, Mr. Egan has been instrumental in the drafting and enactment of many Texas business entity and other statutes.

Publications: Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer regarding M&A, corporations, partnerships, limited liability companies, securities laws, and financing techniques. Mr. Egan has written or co-authored the following law journal articles: Corporate Governance: *Fiduciary Duties of Corporate Directors and Officers in Texas*, 43 Texas Journal of Business Law 45 (Spring 2009); *Responsibilities of Officers and Directors under Texas and Delaware Law*, XXVI Corporate Counsel Review 1 (May 2007); Entity Choice and Formation: *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code*, 42 Texas Journal of Business Law 171 (Spring 2007); *Choice of Entity Alternatives*, 39 Texas Journal of Business Law 379 (Winter 2004); *Choice of State of Incorporation – Texas Versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249 (Winter 2001); M & A: *Asset Acquisitions: A Colloquy*, X U. Miami Business Law Review 145 (Winter/Spring 2002); Securities Law: *Major Themes of the Sarbanes-Oxley Act*, 42 Texas Journal of Business Law 339 (Winter 2008); *Communicating with Auditors After the Sarbanes-Oxley Act*, 41 Texas Journal of Business Law 131 (Fall 2005); *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 Texas Journal of Business Law 305 (Winter 2005); *Congress Takes Action: The Sarbanes-Oxley Act*, XXII Corporate Counsel Review 1 (May 2003); and Legislation: *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 Texas Journal of Business Law 41 (Spring 2005).

Education: Mr. Egan received his B.A. and J.D. degrees from the University of Texas. After law school, he served as a law clerk for Judge Irving L. Goldberg on the United States Court of Appeals for the Fifth Circuit.

Honors: For over ten years, Mr. Egan has been listed in *The Best Lawyers in America* under Corporate, M&A or Securities Law. He won the Burton Award for Legal Achievement in 2005, 2006, 2008 and 2009. Mr. Egan has been recognized as one of the top corporate and M&A lawyers in Texas by a number of publications, including *Corporate Counsel Magazine*, *Texas Lawyer*, *Texas Monthly*, *The M&A Journal* (which profiled him in 2005) and *Who's Who Legal*. In 2009, his paper entitled "*Director Duties: Process and Proof*" was awarded the Franklin Jones Outstanding CLE Article Award and an earlier version of that article was honored by the State Bar Corporate Counsel Section's Award for the Most Requested Article in the Last Five Years.

MORRIS, NICHOLS, ARSHT & TUNNELL LLP

Patricia O. Vella

Special Counsel

TEL: (302) 351-9349
FAX: (302) 425-4667
pvella@mnat.com

Practices

- Delaware Corporate Law Counseling

Education

- J.D., magna cum laude, 1996, Villanova University School of Law
- Member, 1994-1995 and Executive Editor, 1995-1996, Villanova Law Review
- B.S., magna cum laude, 1992, University of Delaware

Clerkships

- Law Clerk to The Honorable Randy J. Holland, Delaware Supreme Court

Patricia is special counsel for the firm's Delaware Corporate Law Counseling Group. She provides advice on corporate governance matters and a variety of corporate transactions, including mergers and acquisitions and financing transactions. Patricia's work often involves counseling boards of directors and board committees, and providing formal legal opinions on issues involving Delaware corporate law.

NEWS

- A. Gilchrist Sparks III, Patricia O. Vella Present at Office and Trial Practice: Corporate Law – Current Developments; Corporate Transactions – Best Practices

NOTABLE PUBLICATIONS AND PRESENTATIONS

- Jeffrey R. Wolters, Patricia O. Vella, *Preferred Stock and Negotiated Acquisitions*, ABA Section of Business Law, 2002 Annual Meeting

PROFESSIONAL & COMMUNITY ACTIVITIES

- ABA Business Law Section - Negotiated Acquisitions Committee
- ABA Business Law Section - Committee's Acquisitions of Public Companies Task Force
- ABA Business Law Section - Recent Judicial Developments Subcommittee
- Delaware State Bar Association

ADMISSIONS TO PRACTICE

- Delaware, 1996

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

phone: (214) 746-7780
gdwest@weil.com

Glenn D. West is the managing partner of the Dallas office of Weil, Gotshal & Manges LLP, co-head of the Firm's Private Equity Group and a member of the Firm's Management Committee. Mr. West's practice concentrates on restructurings, private equity, mergers & acquisitions and corporate finance for domestic and international clients.

Mr. West has led public and private acquisition, corporate finance and restructuring transactions for the following clients, among others: HM Capital Partners, Lindsay Goldberg, Lehman Brothers, Koch Industries, Invista, American Airlines, LIN Television Corporation, TPG Capital and Brazos Equity Partners.

Mr. West also represents Hicks Sports Group Holdings, which owns the Texas Rangers Baseball Club, the Dallas Stars Hockey Club and the Liverpool Football Club, as well as Lightning Investment Holdings, which owns the Tampa Bay Lightning Hockey Club. He also led the project finance for the American Airlines Center in Dallas.

Mr. West was honored with a 2009 Burton Award for Legal Achievement and named "Best Lawyer" in the specialities of Banking Law, Corporate Law, Leveraged Buyouts and Private Equity Law and Mergers and Acquisitions Law for the 2009 edition of The Best Lawyers in America.

Mr. West was named as a leader in the area of private equity transactions for 2008 and a leading lawyer in the area of mergers and acquisitions for 2008 by the IFLR 1000: The Guide to the World's Leading Financial Law Firms 2009 edition.

Mr. West was also named a "Leading Individual" (Band 1) for Corporate/M&A in Texas and named "Leading" Lawyer in Investment Funds: Private Equity: Buyouts in US by Chambers USA: America's Leading Lawyers for Business 2009.

Mr. West is a member of the Finance Committee and a member of the Board of Directors of the Vogel Alcove Childcare Center for the Homeless in Dallas, Texas and was co-chair for the 2004 Vogel Alcove Arts Performance Event. Mr. West is also a member of the Board of the United Way of Metropolitan Dallas.

Mr. West is admitted to practice in New York, Texas and the District of Columbia. In addition to being a U.S. lawyer, Mr. West is also a licensed solicitor qualified to practice law in England and Wales.

Publications

- Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?
  (August 2009, The Business Lawyer)

- Corporations
  (Summer 2009, Volume 62, No. 3, SMU Law Review)

- Recalibrate Your and Your Management Team's Thinking to Meet Today's Challenges
  (May 2009, Private Equity Alert)

- De-Levering Portfolio Companies Through Debt Buybacks – US and UK Perspectives
  (March 2009, Private Equity Alert)

- Yesterday's Auctions Today: 363 Sales
  (October 2008, Mergers and Acquisitions Institute)

- Corporations
  (Summer 2008, Volume 61, No. 3, SMU Law Review)

- Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements
  (May 2008, The Business Lawyer)

- Corporations
  (Summer 2007, Volume 60, No. 3, SMU Law Review)

- Debunking the Myth of the Sandbagging Buyer: When Sellers Ask Buyers to Agree to Anti-Sandbagging Clauses, Who Is Sandbagging Whom?
  (January 2007, The M&A Lawyer)

- Corporations
  (Volume 59, No. 3 Summer 2006, SMU Law Review)

- Revisiting Material Adverse Change Clauses - Private Equity Buyers Should (But Mostly Can't/Don't) Special Order their MACs
  (July 2006, Private Equity Alert)

- Avoiding Extra-Contractual Fraud Claims in Portfolio Company Sales Transactions - Is "Walk-Away" Deal Certainty Achievable for the Seller?
  (March 2006, Private Equity Alert)

- Protecting the Deal Professional from Personal Liability for Contract-Related Claims
  (March 2006, Private Equity Alert)

- Director and Officer Indemnification - How to Protect Former Directors and Officers After Their Resignation
  (August 2005, Private Equity Alert)

- Corporations
  (Volume 58, No. 3 Summer 2005, SMU Law Review)

- Sungard and Neiman Marcus LBO Transactions - Increased Liability Risk to Private Equity Sponsors?
  (June 2005, Private Equity Alert)

- Court Finds No D & O Coverage – For Any Director – Due to Personal Benefit Gained by Majority Shareholder by Obtaining Funds For Corporation
  (September 2004, Business & Securities Litigator)

- Corporations
  (Volume 57, No. 3 Summer 2004, SMU Law Review)
- Corporations
  (Volume 56, No. 3 Summer 2003, SMU Law Review)
- Corporations
  (Volume 55, No. 3 Summer 2002, SMU Law Review)
- Corporations
  (Volume 54, No. 3 Summer 2001, SMU Law Review)
- Corporations
  (Volume 53, No. 3 Summer 2000, SMU Law Review)

- The "Demandable" Note And The Obligation Of Good Faith
  (Fall 1988, Uniform Commercial Code Law Journal)

- The Texas Nonjudicial Foreclosure Process—A Proposal to Reconcile the Procedures Mandated by State Law with the Fraudulent Conveyance Principles of the Bankruptcy Code
  (Volume 43, No. 4 May 1990, Southwestern Law Journal)

TABLE OF CONTENTS

ATTACHMENTS:

Appendix A - Power Point Slides

Appendix B - Glenn D. West & 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)

Appendix C - Discussion of, and excerpts from, *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006)

Appendix D - *Lone Star Fund V, et al v. Barclays Bank PLC, et al* (5th Cir. No. 08-11038 January 11, 2010)

Appendix E - *WTG Gas Processing v. ConocoPhillips Company et al*, 2010 WL 695801 (Tex.App.-Hous. (14 Dist.) March 2, 2010)

CONTRACTUAL LIMITATIONS ON SELLER LIABILITY IN M&A TRANSACTIONS

By

Byron F. Egan, Dallas, TX*
Patricia O. Vella, Wilmington, DE
Glenn D. West, Dallas, TX

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 attempt 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 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.

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.

1 *See infra* Section IV. Indemnification Provisions.

2 *See infra* Section V. Entire Agreement.

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, citing its fiduciary duties, 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]

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

---

[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 closely held 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.

[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).

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 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

---

[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 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.

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] Each action is 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] 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 acquirer 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

---

[12] *See Phelps Dodge Corp. v. Cypress 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 (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.

[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] C.A. No. 2541-VCL (Dec. 22, 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.

(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

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.

---

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 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%.

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 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.

D. Exclusivity Provisions in Letters of Intent Can Be Enforceable

In *Global Asset Capital, LLC vs. Rubicon US REIT, Inc.*[20] 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:

> [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

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

> 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.").[21]

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*[22] 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 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:

---

[21] *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).

[22] 2010 WL 695801, ___ S.W.3d ___ (Tex. App.—Houston [14th Dist.] March 2, 2010).

- 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*,[23] 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, 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 allege that selling firm actually "lied" and knew its representations in contract were false, the Vice Chancellor 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 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.

[23] 891 A.3d 1032 (Del. Ch. 2006); *see* Appendix C.

* * *

> 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.[24]

Two years after *ABRY*, in *Transched Sys. Ltd. v. Versyss Transit Solutions, LLC*,[25] 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 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.[26]

---

[24] *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 B.

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

[26] 891 A.2d 1032, 1054 (Del. Ch. 2006).

In order to succeed in its claims for negligent misrepresentation, plaintiff had to prove it justifiably relied on the misrepresentations made by defendants. Defendants contended that the language in sections 8(f) and 3(hh) precluded plaintiff's reliance on extra-contractual representations, and therefore its negligent misrepresentation claims failed as a matter of law. The entire agreement provision is Section 8(f):

> Entire Agreement. This Agreement (including the documents referred to herein) constitutes the entire agreement between the Parties and supersedes any prior understandings, agreements, or representations by or between the Parties, written or oral, to the extent they relate in any way to the subject matter hereof.

Section 3(hh) of the agreement disclaimed other representations and made it inappropriate for it to rely on representations made outside the four corners of the agreement.

> Disclaimer of Other Representations and Warranties. Except as expressly set forth in this § 3, Sellers make no representation or warranty, express or implied, at law or in equity, in respect of any of its assets (including, without limitation, the Acquired Assets), or operations, including, without limitation, with respect to the merchantability or fitness for any particular purpose. Buyer hereby acknowledges and agrees that, except to the extent specifically set forth in this § 3, Buyer is purchasing the Acquired Assets "as-is, where-is." Without limiting the generality of the foregoing, Seller makes no representation or warranty regarding any assets other than the Acquired Assets or any liabilities other than the Assumed Liabilities, and none shall be implied at law or in equity.

The court found that although the agreement lacked the words "rely" or "reliance," the thrust of the language in sections 7(f), 8(f) and 3(hh) was unambiguous: no representations made outside of the four corners of the agreement are to be given consideration by the parties in interpreting the terms. Consequently, plaintiff cannot have justifiably relied on anything other than what is present in the contract. Therefore, the court found that plaintiff was unable to state a claim for negligent misrepresentation because plaintiff agreed to these provisions when it entered into the agreement with defendants - provisions that plaintiff, a sophisticated party represented by counsel, agreed to after an extensive due diligence period. Plaintiff could not have justifiably relied on the extra-contractual representations allegedly made by defendants. Defendants' motion to dismiss was granted.

G. Tension Between Contractual Exclusive Remedies Provisions and Securities Law Anti-Waiver Provisions

Under federal and state securities laws, as well as common law, contractual provisions binding any person acquiring any security to waive the seller's compliance with applicable securities act is void.[27] There is a tension between those securities law anti-waiver provisions

[27] Securities Act of 1933 § 14; Securities Exchange Act of 1934 § 29(a); Tex. Rev. Civ. Stat. art. 581-33(L); *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 184 (Tex. 1997).

and the provisions often found in acquisition agreements that the agreement represents a complete and exclusive statement of the agreement between the parties.[28]

In *Lone Star Fund V (US), LP v. Barclays Bank PLC*,[29] 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 affirmed 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.

---

[28] *See infra* Section V. Entire Agreement.

[29] 5th Cir. No. 08-11038 (Jan. 11, 2010).

> 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.

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.[30] 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 which follow.[31]

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 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

---

[30] 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.

[31] 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 ten 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.

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 Corporation v. Argan, Inc.*, 2008 U.S. App. LEXIS 18147 (9th Cir. August 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.").
>
> 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.
>
> * * *
>
> 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.

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 (2008) ("[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.

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 Publishing 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 Management 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 International Corporation*, 401 F.3d 28 (2d Cir. 2005), the Second Circuit upheld a lower court determination that the acquirer 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 188 (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 NY2d 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 dependant 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.3d 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* and the discussion of *ABRY Partners V, L.P. v. F&W Acquisition LLC* in Appendix A.

The suggestion in *The Hartz Consumer Group v. JWC Hartz Holdings, Inc.*, New York Law Journal Vol. 234 (New York County Supreme Court, November 18, 2005), *aff'd* 2006 NY Slip Op 07805 (NY Appellate Division, First Department October 31,

2006) available at http://www.courts.state.ny.us/reporter/3dseries/2006/2006_07805.htm, 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 International, 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. United States*, 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.

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 [Omitted]

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. A more aggressive buyer may wish to provide for a "threshold" deductible that, once crossed, entitles the indemnified party to recover all damages, rather than merely the excess over the basket. 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.

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.

In *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006), which is discussed further in the Comment to Section 13.7 and in Appendix A, 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.

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 for a discussion of the *Herring v. Teradyne, Inc.* and *Western Filter Corporation v. Argan, Inc.* 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 International, 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 [Omitted]

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 unforseen 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*, 458 N.Y.S.2d 162 (1983)(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 Intern*, 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 Corporation v. Daniel Construction Company*, 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 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 Ry.*, 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 Intern. 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:[32]

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.

[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 ten years. The authors express appreciation to the many members of the Task Force 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 ABA Mergers & Acquisitions Committee or its Asset Acquisition Agreement Task Force.

COMMENT

This Section provides that the Model Agreement (along with the documents referred to in the acquisition 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 Corporation*, 2005 WL 612835 (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 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 a statement such as the following:

> 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.

Such a statement would be intended 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.*, *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").

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").

In *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006), which is discussed further in Appendix A, 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.
>
> * * *
>
> 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.

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 B.

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 . . . .'" *Caio/a 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 188 (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".

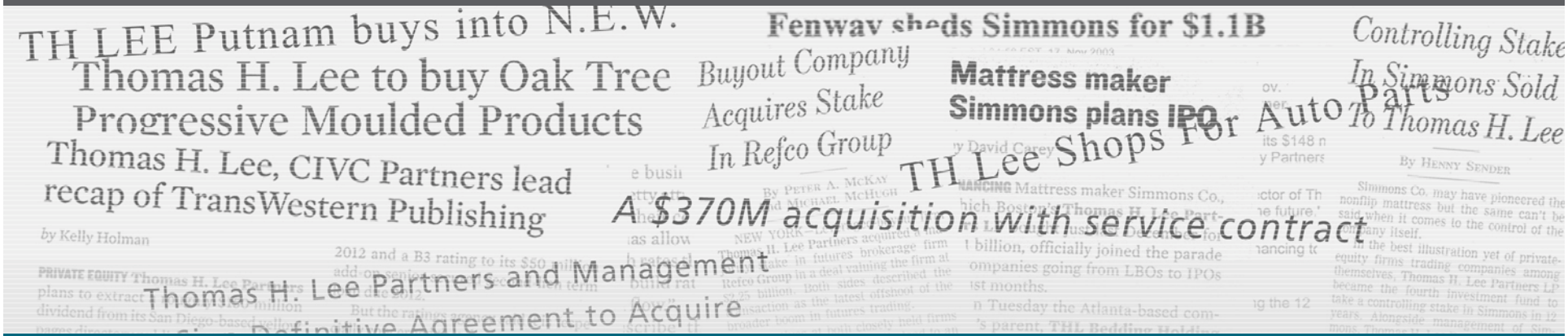
In the event that the transaction in the *Merrill Lynch* case had involved a "security" within the meaning of the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (the "*1934 Act*"), and the purchasers were asserting claims under Rule 10b-5 under the 1934 Act, the 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 (2nd 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.

This Section 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).

APPENDIX A

POWER POINT SLIDES

CONTRACTUAL LIMITATIONS ON SELLER LIABILITY IN M&A TRANSACTIONS



Byron F. Egan, Jackson Walker LLP
Patricia O. Vella, Morris, Nichols, Arsht, & Tunnell LLP
Glenn D. West, Weil, Gotshal & Manges LLP

April 22, 2010

Table of Contents

Perspective

- Purchase agreements frequently incorporate well-defined indemnification and liability limitation provisions
- Buyers dissatisfied with the deal often attempt to circumvent such provisions by premising tort-based fraud and negligent misrepresentation claims on the alleged inaccuracy of purported pre-contractual representations and/or express, contractual representations
- Tough to define, easy to allege, hard to dismiss on a pre-discovery motion, difficult to disprove without expensive and lengthy litigation, highly susceptible to the erroneous conclusions of judges and juries

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

Hypothetical 1: Pre-Signing

- WTG Gas Processing, L.P. v. ConocoPhillips Co., 2010 Tex. App. (Tex. App. Houston 14th Dist. March 2, 2010) held:
  - The unsigned bid procedures letter controls because the parties relied on it
  - The non-binding and "no legal obligation" language in the bid procedures letter allowed the Seller to continue to shop the deal up until execution and delivery of a purchase agreement
  - The phone conversation was insufficient to constitute a waiver of the bid procedures letter

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, citing its fiduciary duties, and signs a merger agreement with Buyer 2
- Buyer 1 sues Target for breach of the merger agreement

Hypothetical 2: Between Sign and Close

- NACCO Indus. v. Applica Inc., 2009 Del. Ch. LEXIS 217 (Del. Ch. Dec. 22, 2009) held that the "no-shop" and "prompt notice" provisions in the merger agreement are enforceable against the Seller, even to the extent that the provisions conflict with the fiduciary duties of the Seller's board
- Global Asset Capital, LLC v. Rubicon US REIT, Inc., C.A. No. 5071-VCL (Del. Ch. Nov. 16, 2009) held that similar lock-up provisions in a letter of intent are enforceable against the Seller, enjoining the Seller from engaging in sale discussions with third parties while declining to negotiate with Buyer

Hypothetical 3: Post-Closing

- Buyer and Seller sign a purchase agreement and close the acquisition
- The purchase agreement provides for survival of Seller's representations and warranties as well as Seller's broad indemnification of Buyer
- 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

Hypothetical 3: Post-Closing

- ABRY Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032 (Del. Ch. 2006) held that Seller should not receive the benefit of the exclusive remedy provision – opening the door for Buyer to collect more than the $20M indemnity cap or rescind the acquisition – if Seller knew that one of Target's contractual representations and warranties was false or if Seller otherwise "lied" to Buyer about a contractual representation and warranty
- If, however, Seller made an innocent, negligent or even grossly negligent (but not reckless or intentional) false representation or if Seller was unaware that one of Target's contractual representations was false, then Buyer would not be entitled to an equitable remedy and would be stuck with the bargained-for exclusive remedy of capped indemnity

More on Fraud: Extra-Contractual Representations

- Transched Sys. v. Versyss Transit Solutions, LLC, 2008 Del. Super. LEXIS 120 (Del. Super. Ct. Apr. 2, 2008), involving a buyer that sued a seller for misrepresenting the condition of the purchased asset, illustrates the value to a seller of a well-drafted disclaimer of extra-contractual representations clause
  - The representations and warranties stated that the seller was making no representation or warranty, extra-contractual or contractual, in respect of any of its assets. The exclusive remedy provision stated that indemnification was the sole remedy "in respect of any breach of or default" under the purchase agreement. And the merger clause stated that the written agreement was the entire agreement
  - The court held that "no representations made outside of the four corners of the agreement are to be given consideration by the parties in interpreting the terms." That is, the provisions precluded the buyer's argument that it justifiably relied on the extra-contractual claims made by the seller
- ABRY, summarizing Delaware case law, concluded that merger clauses that do not clearly state that the parties disclaim reliance upon extra-contractual statements will not relieve a party of its oral and extra-contractual fraudulent representations
  - An ambiguous waiver of extra-contractual representations combined with any Seller-made extra-contractual "lies" may as a matter of public policy give rise to buyer-favorable equitable remedies that the exclusive remedy provision expressly prohibits

More on Fraud: Exclusive Remedies

- In Lone Star Fund V (US), LP v. Barclays Bank PLC, 594 F.3d 383 (5th Cir. Tex. 2010), Seller sold a set of mortgage-backed securities to Buyer via a prospectus that contained a representation that none of the mortgages are delinquent at the time of purchase
- 290 of 10,000+ mortgages backing the securities were delinquent at the time of purchase, so Buyer sued Seller for fraud
- Seller argued that because it had performed under a separate "repurchase or substitute" exclusive remedy clause in the prospectus, whereby Seller repurchases or substitutes a performing mortgage for any delinquent mortgages, Seller did not make an actionable misrepresentation
- The court sided with Seller, interpreting the representation to read "the mortgages should be non-delinquent," but if some mortgages are delinquent then Seller will repurchase or substitute
- 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
- Here, implicit in the court's ruling that Seller did not defraud Buyer is the fact that Buyer and Seller agreed ex ante to an equitable exclusive remedy – "repurchase or substitute" – designed to return Buyer to its 0% delinquent position

Model Provision – 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.

Model Provision – Nature of Representations and Warranties

- 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.

Model Provision – 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 as further limited by the specifically bargained-for exclusive remedies as set forth in Article [_].

Model Provision – 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.

Model Provision – 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.

Further Reading

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

APPENDIX B

Glenn D. West & 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

---

> [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

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

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]

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.

---

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.

APPENDIX C

Discussion of, and excerpts from,
ABRY Partners V, L.P. v.
F&W Acquisition LLC,
891 A.3d 1032 (Del. Ch. 2006)

Appendix C

ABRY Partners V, L.P., et al., Plaintiffs
v.
F&W Acquisition LLC, et al., Defendants

Civil Action No. 1756-N
In the Court of Chancery of the State of Delaware
(Decided February 14, 2006)

891 A.3d 1032

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 often arises during the negotiation of an acquisition agreement. In *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006), a "sophisticated private equity firm" purchased for $500 million 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, 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." The purchaser was permitted to proceed to trial on its rescission claims to the extent that they allege that selling firm actually "lied" and knew its representations in contract were false.

Background

In 2005, ABRY Partners V, L.P., a sophisticated media-focused private equity firm, and a group of affiliated entities (collectively "*Buyer*") bought F&W Publications Inc. (the "*Company*") from Providence Equity Partners Inc., another sophisticated private equity firm ("*Seller*"), for $500 million pursuant to a Stock Purchase Agreement. The Company, incorporated in Delaware and based in Ohio, is a publisher of special interest books and magazines, including Popular Woodworking, Scuba Diving, Family Tree Magazine, and Writer's Digest. Seller had owned the Company since 2002.

However once it took over, Buyer uncovered a host of allegedly serious financial and operational problems, and concluded that it had been defrauded. The Company allegedly had manipulated its earnings and falsely stated that its new book-ordering system was fully

functional when in fact it was not working properly such that distributors had refused to do business with the Company.

Buyer asked Seller to rescind the deal, claiming that it would never have bought the Company if it had known about its fraudulent accounting and unethical business practices, that the true value of the Company was more like $400 million than the $500 million purchase price paid, and that the failure of the new book-ordering system was a material adverse event under the Stock Purchase Agreement. When Seller refused, Buyer sued Seller for rescission of the contract. Buyer included claims of fraudulent inducement and negligent misrepresentation, both based on nondisclosure of the financial manipulation.

Stock Purchase Agreement Provisions

The Stock Purchase Agreement recognized a distinction between Seller and the Company and gave this distinction importance in addressing questions relating to liability. The Stock Purchase Agreement did not make Seller responsible for everything the Company and the Company's management did or said. Rather, Seller only accepted responsibility for the Company's actions and words to the extent set forth in the Stock Purchase Agreement and the required Officer's Certificate of its representative which was a closing condition under the Stock Purchase Agreement.

The Stock Purchase Agreement provided in § 7.8 that neither the Company nor Seller had made any representation or warranty as to the accuracy of any information about the Company except as set forth in the Agreement itself and that neither Seller nor the Company would have any liability to Buyer or any other person for any extra-contractual information made available to Buyer in connection with the contemplated sale of the Company, as follows:

> Acquiror acknowledges and agrees that neither the Company nor the Selling Stockholder has made any representation or warranty, expressed or implied, as to the Company or any Company Subsidiary or as to the accuracy or completeness of any information regarding the Company or any Company Subsidiary furnished or made available to Acquiror and its representatives, except as expressly set forth in this Agreement . . . and neither the Company nor the Selling Stockholder shall have or be subject to any liability to Acquiror or any other Person resulting from the distribution to Acquiror, or Acquiror's use of or reliance on, any such information or any information, documents or material made available to Acquiror 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.

The Court found the foregoing § 7.8 to be a critical provision that operated to define what information Buyer relied upon in deciding to execute the Stock Purchase Agreement. In the Stock Purchase Agreement carefully delineated that the Company was making the exhaustive representations and warranties regarding the Company's business and condition. With respect to the Company's financial statements, the Company (not Seller) in Stock Purchase Agreement § 3.6 represented as follows:

> The Company Financial Statements: (i) are derived from and reflect, in all material respects, the books and records of the Company and the Company Subsidiaries; (ii) fairly present in all material respects the financial condition of the Company and the Company Subsidiaries at the dates therein indicated and the results of operations for the periods therein specified; and (iii) have been prepared in accordance with GAAP applied on a basis consistent with prior periods except, with respect to the unaudited Company Financial Statements, for any absence of required footnotes and subject to the Company's customary year-end adjustments.

Seller's representations and warranties in the Stock Purchase Agreement were limited to matters such as its existence and authority to act and that it owned the shares of the Company that were to be transferred to Buyer in the sale.

The Company's representations and warranties were Article III, which contained twenty-two general representations and warranties and included in § 3.23, the following promise of Buyer that it was not relying on extra-contractual representations:

> EXCEPT AS EXPRESSLY SET FORTH IN THIS ARTICLE III, THE COMPANY MAKES NO REPRESENTATION OR WARRANTY, EXPRESSED OR IMPLIED, AT LAW OR IN EQUITY IN RESPECT OF THE COMPANY OR THE COMPANY SUBSIDIARIES, OR ANY OF THEIR RESPECTIVE ASSETS, LIABILITIES OR OPERATIONS, INCLUDING WITH RESPECT TO MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE, AND ANY SUCH OTHER REPRESENTATIONS OR WARRANTIES ARE HEREBY EXPRESSLY DISCLAIMED. ACQUIROR HEREBY ACKNOWLEDGES AND AGREES THAT, EXCEPT TO THE EXTENT SPECIFICALLY SET FORTH IN THIS ARTICLE III, THE ACQUIROR IS ACQUIRING THE COMPANY ON AN "AS IS, WHERE IS" BASIS. THE DISCLOSURE OF ANY MATTER OR ITEM IN ANY SCHEDULE HERETO SHALL NOT BE DEEMED TO CONSTITUTE AN ACKNOWLEDGEMENT THAT ANY SUCH MATTER IS REQUIRED TO BE DISCLOSED.

Buyer got Seller to back up the Company's representations and warranties by (i) a closing condition in § 8.2(h)(i) of the Stock Purchase Agreement that required Seller to provide an Officer's Certificate stating that the closing conditions relating to the accuracy of not only Seller's, but also the Company's, representations and warranties, were satisfied, that the Company and Seller had complied with the covenants applicable to them, and also that the Company had not suffered events that had had or would reasonably be expected to constitute a material adverse effect ("*MAE*"). In compliance with that requirement, Seller provided the Officer's Certificate which stated:

> Pursuant to Section 8.2(h)(i) of the Agreement, the undersigned duly elected and authorized officer of the Selling Stockholder, hereby certifies that . . . (1) Each representation and warranty of the Company set forth in Article III and the Selling Stockholder set forth in Article IV of the Agreement or in each case deemed made pursuant to Section 7.10(a) is true and correct as of the Closing Date . . . (2) Each

> of the Selling Stockholder and the Company have performed and complied in all material respects with the agreements and covenants required to be performed or complied with by it on or prior to the Closing Date . . . (3) Since the date of the Agreement, there has been no change, event or condition of any character (whether or not covered by insurance) which, in the aggregate, has had or would reasonably be expected to have a Company Material Adverse Effect.

Seller agreed in Stock Purchase Agreement § 9.1 to indemnify Buyer in respect of its and the Company's representations and warranties as follows:

> [T]he Selling Stockholder agrees that, after the Closing Date, the Acquiror and the Company and . . . each controlling shareholder of the Acquiror or the Company . . . shall be indemnified and held harmless by the Selling Stockholder from and against, any and all claims, demands, suits, actions, causes of actions, losses, costs, damages, liabilities and out-of-pocket expenses incurred or paid, including reasonable attorneys' fees, costs of investigation or settlement, other professionals' and experts' fees, and court or arbitration costs but specifically excluding consequential damages, lost profits, indirect damages, punitive damages and exemplary damages . . . to the extent such Damages . . . have arisen out of or . . . have resulted from, in connection with, or by virtue of the facts or circumstances (i) which constitute an *inaccuracy*, *misrepresentation*, *breach of*, default in, or failure to perform any of the *representations, warranties or covenants* given or made by the *Company* or the *Selling Stockholder* in this Agreement . . .

Section 9.1(c) of the Stock Purchase Agreement, however, limited the aggregate liability of Seller for conduct covered by § 9.1(a) to the amount of a $20 million escrowed Indemnity Fund.

The Stock Purchase Agreement in § 9.9(a) contained the following "*Exclusive Remedy Provision*:"

> Except as may be required to enforce post-closing covenants hereunder . . . after the Closing Date the indemnification rights in this Article IX are and shall be the sole and exclusive remedies of the Acquiror, the Acquiror Indemnified Persons, the Selling Stockholder, and the Company with respect to this Agreement and the Sale contemplated hereby; provided that this sentence shall not be deemed a waiver by any party of its right to seek specific performance or injunctive relief in the case of another party's failure to comply with the covenants made by such other party.

In addition, Stock Purchase Agreement § 9.9(b) provided that "[t]he provisions of Article IX were specifically bargained for and reflected in the amounts payable to the Selling Stockholder in connection with the Sale pursuant to Article II." The provisions of Article IX included the Exclusive Remedy Provision, the Indemnity Claim provision, and the Indemnity Fund provision.

Further, the Stock Purchase Agreement required that Indemnity Claims be arbitrated in Massachusetts if they could not be resolved consensually. Despite the selection of Massachusetts as an arbitration forum, the Stock Purchase Agreement, in § 9.5 and § 11.9, chooses Delaware law to govern any claim submitted to arbitration.

Buyer ignored the arbitration provisions in the Stock Purchase Agreement and sued for the equitable remedy of rescission in the Delaware Court of Chancery.

This case was decided in the context of a Court of Chancery Rule 12(b)(6) motion to dismiss. As a result, the Court assumed that all well pled facts were true although Buyer would have to, and might not be able to, prove them at trial.

Legal Analysis

A. Choice Of Law.

Buyer claimed that Massachusetts law governed its claims because its operations were located in Massachusetts. The Court, however, noted that (1) Buyer, Seller and the Company were all Delaware corporations; (2) the Stock Purchase Agreement, even though it required arbitration of an Indemnity Claim to occur in Massachusetts, provided Delaware law was to govern the burden of proof in such proceedings and Delaware courts are to review the arbitrators' rulings and (3) § 11.9(a) of the Stock Purchase Agreement provides: "This Agreement shall be governed by, and construed in accordance with, the Laws of the State of Delaware, regardless of the Laws that might otherwise govern under applicable principles of conflicts of law."

Finding that Delaware law clearly had a material relationship to the transaction among Buyer, Seller, and the Company and that Delaware courts are bound to respect the chosen law of contracting parties, so long as that law has a material relationship to the transaction, the Court focused on Delaware's public policy expressed 6 *Del. C.* § 2708, which provides:

> (a) The parties to any contract, agreement or other undertaking, contingent or otherwise, may agree in writing that the contract, agreement or other undertaking shall be governed by or construed under the laws of this State, without regard to principles of conflicts of laws, or that the laws of this State shall govern, in whole or in part, any or all of their rights, remedies, liabilities, powers and duties if the parties, either as provided by law or in the manner specified in such writing are, (i) subject to the jurisdiction of the courts of, or arbitration in, Delaware and, (ii) may be served with legal process. *The foregoing shall conclusively be presumed to be a significant, material and reasonable relationship with this State and shall be enforced whether or not there are other relationships with this State* . . . (b) Any person may maintain an action in a court of competent jurisdiction in this State where the action or proceeding arises out of or relates to any contract, agreement or other undertaking for which a choice of Delaware law has been made in whole or in part and which contains the provision permitted by subsection (a) of this section . . . (c) This section shall not apply to any contract, agreement or other undertaking . . . (ii) involving less than $100,000.

The Court rejected as "not sensible" the Buyer argument that the choice of law provision in the Stock Purchase Agreement only meant for Delaware law to govern contract claims that might arise among the parties, but not claims in tort seeking rescission of the Stock Purchase Agreement on grounds that false contractual representations were made.

B. Entire Agreement/Merger/Non-Reliance Clauses.

In finding that the non-reliance provision in § 7.8 of the Stock Purchase Agreement was enforceable and barred Buyer from making any claim in respect of any information or representation not set forth in the four corners of the Stock Purchase Agreement, the Court wrote:

> 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.
>
> * * *
>
> 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.

C. Exculpation for Lies in Purchase Agreement Unenforceable—Public Policy.

In holding that the Exclusive Remedy Provision in § 9.9 of the Stock Purchase Agreement was unenforceable as a matter of public policy, Vice Chancellor Strine wrote:

> This case, however, raises a related, but more difficult, question: to what extent may a contract exculpate a contracting party from a rescission or damages claim based on a false representation of fact made within the contract itself? May parties premise a contract on defined representations but promise in advance to accept a less-than-adequate remedy if one of them has been induced by lies about one of those material facts?
>
> * * *
>
> There are various reconciliations of this clash of interests. At one extreme, some courts are extremely grudging about enforcing contractual limitations on a buyer's right to sue for rescission or damages for an innocent misrepresentation. This reluctance has generally manifested itself in refusals to preclude negligent misrepresentation claims based on general merger clauses and in requiring very specific waivers of negligence-based claims. The balancing possibilities extend from there, with some courts willing to tolerate waivers of the right to sue for negligent or even grossly negligent misrepresentations. As § 195 of the Restatement [(Second) of Contracts] reflects, however, courts have generally refused to go further and allow a contractual waiver of the buyer's right to sue on the basis that a contractually-represented fact was false as a result of the seller's reckless or intentional conduct. Abundant case law to this effect exists.
>
> Delaware courts have shared this distaste for immunizing fraud. As the Buyer notes, prior Delaware decisions have used language that is generally condemnatory of contractual limitations on a party's exposure to a fraud claim for making a false statement. To wit, our courts have said that "[a] perpetrator of fraud cannot close the lips of his innocent victim by getting him blindly to agree in advance not to complain against it" and "fraud vitiates every contract, and no man may invoke the law to enforce his fraudulent acts." Those decisions primarily involve the protection of a relatively unsophisticated party or a party lacking bargaining clout who signs a contract with a boilerplate merger clause.
>
> * * *
>
> When fashioning common law limits on contractual freedom, we must be mindful of these factors and other commercial realities, lest we inhibit economic activity that might be valuable to the parties and society more generally. In that respect, the common law ought to be especially chary about relieving sophisticated business entities of the burden of freely negotiated contracts. There remains much harshness in the world, and such entities are unlikely candidates to

place at the head of the line for judicial protection, especially when the legislature is free to consider providing such relief. . . .

At the same time, a concern for commercial efficiency does not lead ineluctably to the conclusion that there ought to be no public policy limitations on the contractual exculpation of misrepresented facts. Even commentators who recognize that there are aspects of bargaining in which it is often expected that parties will lie — such as when agents refuse to disclose or misrepresent their principals' reservation price — 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.

I use the plain word "lie" intentionally because there is a moral difference between a lie and an unintentional misrepresentation of fact. This moral difference also explains many of the cases in the *fraus omnia corrumpit* strain, which arose when the concept of fraud was more typically construed as involving lying, and thus it is understandable that courts would find it distasteful to enforce contracts excusing liars for responsibility for the harm their lies caused.

There is also a practical difference between lies and unintentional misrepresentations. A seller can make a misrepresentation of fact because it was misinformed by someone else, was negligent, or even was reckless. All of those possibilities can be enhanced if the seller does little to investigate its own representations and compounded if the buyer does little independent due diligence of its own. The level of self-investigation expected from a seller, to me, seems to be a more legitimate subject for bargaining than whether the seller can insulate itself from liability for lies.

This case involves a good example of this aspect of the problem. The Seller did not manage the Company being sold directly. Most of the key representations of fact were made by the Company to the Buyer in the first instance, primarily through managers working directly for the Company who were not otherwise affiliated with the Seller. The Seller did not necessarily possess the same information as the managers of the Company.

In this circumstance, it seems legitimate for the Seller to create exculpatory distance between itself and the Company. That is, I find it difficult to fathom how it would be immoral for the Seller and Buyer to allocate the risk of intentional lies by the Company's managers to the Buyer, and certainly that is so as to reckless, grossly negligent, negligent, or innocent misrepresentations of fact by the Company. Such an allocation of risk does not permit the Seller to engage in consciously improper conduct itself, it simply requires the Buyer to hold the Company and its speaking managers exclusively responsible for their own misstatements of fact.

In considering how to allocate the risk of misrepresentations consistent with public policy, I also consider our General Assembly's approach to

exculpation in the case of business entities. In the corporate context, the General Assembly has permitted corporate charters to exculpate directors for liability for gross negligence. In the alternative entity context, where it is more likely that sophisticated parties have carefully negotiated the governing agreement, the General Assembly has authorized even broader exculpation, to the extent of eliminating fiduciary duties altogether.

* * *

With that in mind, I resolve this case in the following manner. To the extent that the Stock Purchase Agreement purports to limit the Seller's exposure for its own conscious participation in the communication of lies to the Buyer, it is invalid under the public policy of this State. That is, I find that the public policy of this State will not permit the Seller to insulate itself from the possibility that the sale would be rescinded if the Buyer can show either: 1) that the Seller knew that the Company's contractual representations and warranties were false; or 2) that the Seller itself lied to the Buyer about a contractual representation and warranty. This will require the Buyer to prove that the Seller acted with an illicit state of mind, in the sense that the Seller knew that the representation was false and either communicated it to the Buyer directly itself or knew that the Company had. In this case, that distinction is largely of little importance because of the Officer's Certificate provided by the Seller. In that certificate, the Seller certified that (1) each representation and warranty of the Company and Seller was true and correct as of the closing date; (2) the Seller and Company performed and complied in all material respects with the agreements and covenants required to be performed or complied with; and (3) between the date of signing the Stock Purchase Agreement and closing, there had been no change, event or condition of any character which had or would reasonably be expected to constitute a material adverse effect for the Company.

By contrast, the Buyer may not obtain rescission or greater monetary damages upon any lesser showing. If the Company's managers intentionally misrepresented facts to the Buyer without knowledge of falsity by the Seller, then the Buyer cannot obtain rescission or damages, but must proceed with an Indemnity Claim subject to the Indemnity Fund's liability cap. Likewise, the Buyer may not escape the contractual limitations on liability by attempting to show that the Seller acted in a reckless, grossly negligent, or negligent manner. The Buyer knowingly accepted the risk that the Seller would act with inadequate deliberation. It is an experienced private equity firm that could have walked away without buying. It has no moral justification for escaping its own voluntarily-accepted limits on its remedies against the Seller absent proof that the Seller itself acted in a consciously improper manner.[1]

[1] As a matter of logical consistency and intellectual candor, it is important to recognize that the line I draw still leaves a residual double liar problem. That is, if the Buyer in fact promised not to sue for rescission even if the Seller lied to it about the accuracy of a contractual representation, its decision to later renege on that promise suggests that it was untruthful in making the promise in the first instance. This concern is far less compelling than

> In sum, I conclude that the Seller's motion to dismiss the complaint in its entirety must be denied. But the Buyer may only obtain its desired relief — rescission or in the alternative, full compensatory damages — if it meets the burden of proof described.[2]

The Court thus granted Seller's motion to dismiss the claim for rescission and claims based on negligent misrepresentation. It allowed to go forward only the claims that Seller intentionally misrepresented a fact within the Stock Purchase Agreement or knew that the Company had misrepresented such a fact.

D. Negotiating/Drafting Considerations.

Citing the *ABRY* decision that public policy will preclude a party from contractually limiting its liability for its own fraud, a buyer may seek a statement in the acquisition agreement to the effect that the contractual limitations on indemnification such as Section 11.5 are not

---

in a situation when a buyer that has expressly disclaimed reliance upon, or the existence of, extra-contractual statements of fact claims that it relied upon such statements in determining to sign or close a contract. For one thing, the promise is far more explicit than the usual remedial limitations buyers accept, as this case illustrates. Although I agree with the Seller's reading of the Agreement, the Agreement does not explicitly state that the Buyer was waiving the right to rescind even if the Seller and Company lied about contractual representations. Furthermore, in this context, it is also not unrealistic to assume that the contracting parties knew that there were public policy limitations that would come into play, to the extent that the contract attempted to exculpate the Seller for lies about contractual representations, and that the Buyer was not necessarily lying when it promised to limit its remedial options. *See* **ABA Comm. on Negotiated Acquisitions, Model Stock Purchase Agreement 143** ("In the absence of a specific provision to the contrary, the Buyer's remedies for inaccuracies in the Sellers' 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 . . . The Sellers 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 shares . . . Other claims, including those based on common law fraud, may also survive an exclusivity clause under applicable state law."); *cf.* **ABA Comm. on Negotiated Acquisitions, Model Agreement and Plan of Merger and Reorganization 207** (noting that, even in the context of a public company merger, irrespective of a contractual provision stating that representations and warranties do not survive the closing, such a provision would not normally preclude post-closing fraud claims by one party against former officers and directors of the other party). Finally, sellers do not face as much evidentiary uncertainty as a result of this balance as they do from a refusal to enforce a non-reliance provision. By refusing to enforce a non-reliance provision, a court subjects a seller to the risk that the court will erroneously conclude that the seller even made an extra-contractual representation of fact. By contrast, by refusing to allow a contract to exculpate a seller for lies about contractual representations of fact, there is no evidentiary uncertainty over whether the allegedly false representations were made, only over whether they were materially false and whether the seller knew them to be false.

[2] Of course, it will be incumbent upon the Buyer to prove reasonable reliance, an element that is required by common law fraud and that also has relevance in contract law in this context. *See Browne v. Robb*, 583 A.2d 949, 955 (Del. 1990) ("The general elements of common law fraud [include] . . . action or inaction [resulting] from a reasonable reliance on the representation."); *H-M Wexford*, 832 A.2d at 142-43 ("Justifiable reliance is an element of common law fraud, equitable fraud, and negligent misrepresentation under Delaware law. Because Wexford cannot claim that it justifiably relied on the information in the PPM, these claims must fail as a matter of law."). In that respect, nothing in this opinion suggests that a buyer can escape an exclusive remedy provision when it was aware of the falsity of a contractual representation of fact before the closing and nonetheless elected to close on the contract, despite having a contractual right to terminate. *See* **ABA Comm. on Negotiated Acquisitions, Model Stock Purchase Agreement 139** ("The Buyer's ability to assert a fraud claim based on . . . the common law after the closing may be adversely affected if the Buyer discovers an inaccuracy before the closing but fails to disclose the inaccuracy to the Sellers until after the closing."). In that scenario, there is no public policy interest in permitting the buyer to escape a remedial limitation when they could have avoided the contract simply by refraining from closing.

intended to affect the common law liability of a seller for that seller's own fraud and may seek to craft an exception that goes beyond *ABRY*:

> The buyer's counsel might, for example, attempt to expand the exception clause so that it refers to something beyond fraud – to "fraud *or willful misconduct*," for example. This type of expanded language may be controversial because the additional words may not have as well established a meaning as "fraud" (which we know must be pleaded with particularity and which typically requires proof of a number of distinct elements, such as scienter and reliance).
>
> The buyer's counsel may also seek to expand the scope of the fraud exception in other ways. For example, the buyer may attempt to word the exception to say generally that the limitations on indemnification won't apply "in the event of fraud." Now this particular formulation does not really make it clear whose fraud will make the indemnification limitations inapplicable, leaving open the possibility that a completely innocent seller which did not itself commit fraud may be obligated to indemnify the buyer without limitation, beyond the negotiated dollar cap and after the expiration of the negotiated survival period, for the consequences of a fraud committed *by someone else* – by another, unrelated seller, for example. This is a result that is not necessarily compelled by law, and needless to say, a result that many sellers and their counsel might find objectionable.[3]

[3] Wilson Chu, Rick Climan and Joel Greenberg, "*M&A 'Nuggett' – The 'Fraud Exception' to Limitations on Indemnification*," Deal Points, Volume XI, Issue 2 (Summer 2006) at Page 17.

APPENDIX D

Lone Star Fund V, et al v.
Barclays Bank PLC, et al
(5th Cir. No. 08-11038 January 11, 2010)

LONE STAR FUND V (US), LP; LSF5 BOND HOLDING LLC, Plaintiffs - Appellants v. BARCLAYS BANK PLC; BARCLAYS CAPITAL INC, Defendants - Appellees

No. 08-11038

UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

594 F.3d 383*; *2010 U.S. App. LEXIS 631*; *52 Bankr. Ct. Dec. 167

January 11, 2010, Filed

PRIOR HISTORY: [*1]

Appeal from the United States District Court for the Northern District of Texas.

Lone Star Fund V (U.S.), L.P. v. Barclays Bank PLC, 2008 U.S. Dist. LEXIS 77146 (N.D. Tex., Sept. 30, 2008)

COUNSEL: For LONE STAR FUND V (US), LP, LSF5 BOND HOLDING LLC, Plaintiff - Appellants: David E. Keltner, Marianne Marsh Auld, Kelly, Hart & Hallman, L.L.P., Fort Worth, TX.

For BARCLAYS BANK PLC, BARCLAYS CAPITAL INC, Defendant - Appellees: Mark Tad Josephs, William Ross Forbes, Jr., Jackson Walker, L.L.P., Dallas, TX; Kathleya Chotiros, Evan A. Davis, Rachel Anne Goldbrenner, Mitchell A. Lowenthal, Cleary, Gottlieb, Steen & Hamilton, New York, NY.

JUDGES: Before JONES, Chief Judge, and GARZA and STEWART, Circuit Judges.

OPINION BY: EDITH H. JONES

OPINION

EDITH H. JONES, Chief Judge:

Lone Star Fund V (U.S.), L.P. and LSF5 Bond Holdings, LLC (collectively "Lone Star" or "Appellants") allege that Barclays Bank PLC and Barclays Capital, Inc. (collectively "Barclays" or "Appellees") engaged in a $ 60 million fraud relating to mortgage-backed securities that Barclays sold to Lone Star. The district court dismissed the case for failure to state a claim. Because Lone Star fails to allege a misrepresentation in light of the "repurchase or substitute" clauses in the parties' mortgage-backed securities contracts, we affirm the district court's dismissal.

I. [*2] **BACKGROUND**

Among its other enterprises, Barclays sells mortgage-backed securities. As their name suggests, mortgage-backed securities are secured by pools of mortgages. To grossly simplify the series of transactions involved here, mortgage-backed securities work in the following manner: Mortgages 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 quality of the mortgage pool is crucial. If the mortgage pool comprises loans whose borrowers consistently pay in a timely manner, securities holders will receive a steady stream of income. In contrast, if the mortgage pool is "sub-prime," or at risk for missed payments, then securities holders may not receive the forecast income stream. Delinquent mortgages result in smaller payment streams and smaller payments to securities holders.

This dispute involves two sets of mortgage-backed

securities that Barclays sold to Lone Star. To create the securities, in 2006, Barclays purchased residential mortgages from NC Capital Corporation ("New Century") pursuant to the Mortgage Loan Purchase Agreement ("MLPA"). According to the MLPA's terms, New Century agreed to [*3] indemnify and hold harmless Barclays (or provide contribution rights where indemnity might not be available) against all losses, claims, damages, and liabilities in a variety of circumstances, including any breach of a representation about the mortgages (such as payment defaults), and any claims made against Barclays by third parties. [1] This allowed Barclays to serve as an effective distributor of mortgage-backed securities. New Century would bear the risk of having sold bad mortgage loans, while Barclays could focus on packaging the loans into securities and marketing them to potential investors.

1 Appellants do not dispute New Century's indemnification and contribution obligations to Barclays.

After purchasing the mortgages from New Century, Barclays pooled them into two separate trusts: the BR2 Trust and the BR3 Trust. The BR2 and BR3 Trusts issued the securities to Lone Star in two separate transactions. In May 2007, Barclays Capital, Inc. as underwriter, sold approximately $ 45 million in securities backed by the BR2 Trust mortgages to LSF5 Bond Holdings, LLC pursuant to a prospectus and prospectus supplement (the "BR2 Supplemental Prospectus"). In June 2007, in a similar transaction, [*4] Barclays Capital, Inc. underwrote approximately $ 16 million of securities backed by the BR3 Trust to LSF5 Bond Holdings, LLC pursuant to a prospectus and prospectus supplement (the "BR3 Supplemental Prospectus"). Both the BR2 and BR3 Supplemental Prospectuses included, inter alia, representations and warranties guaranteeing the quality of the mortgage pools, which together contained more than ten thousand residential mortgages. [2]

2 On April 2, 2007, however, New Century filed for reorganization in Delaware, and Barclays later filed a proof of claim for potential indemnification.

Shortly after the purchases, Lone Star discovered that 290 mortgages in the BR2 Trust were more than thirty days overdue ("delinquent") at the time of purchase. In a letter dated November 7, 2007, Barclays admitted that 144 of the mortgages were delinquent and promptly substituted new mortgages to replace any that were still delinquent. Lone Star investigated the BR3 Trust further and found that 848 of the loans in the BR3 Trust had been delinquent at the time of purchase.

In January 2008, Lone Star sued Barclays under both state and federal law for material misrepresentations and fraud in a Dallas, Texas state [*5] court. Lone Star alleged that, contrary to Barclays' representations, the BR2 and BR3 Trusts had a substantial number of delinquent loans, and that the misrepresentations constituted fraud. Barclays removed the case to federal court pursuant to *28 U.S.C. §§ 1334(b)* and *1452(a)*. The district court accepted the removal, upholding jurisdiction because the dispute was "related to" New Century's bankruptcy. Following the removal, Barclays moved to dismiss the case pursuant to *Fed. Rule Civ. Proc 12(b)(6)* for Lone Star's failure to state a claim. The district court granted the motion. Lone Star appeals.

II. JURISDICTION

Before discussing the merits, this court must first address the issue of subject matter jurisdiction, which is reviewed *de novo*. *Gasch v. Hartford Accident & Indem. Co., 491 F.3d 278, 281 (5th Cir. 2007)*. Bankruptcy jurisdiction, like all federal jurisdiction, must be based in statute. *In re Bass, 171 F.3d 1016, 1022 (5th Cir. 1999)*. In this case, the MLPA's indemnity provisions are sufficient to create a dispute that is "related to" New Century's bankruptcy. *28 U.S.C. § 1334(b)*. Federal courts have "related to" subject matter jurisdiction over litigation arising from a bankruptcy [*6] case if the "proceeding could conceivably affect the estate being administered in bankruptcy." *In re TXNB Internal Case, 483 F.3d 292, 298 (5th Cir.)* (citation omitted), *cert denied, 552 U.S. 1022, 128 S. Ct. 613, 169 L. Ed. 2d 393 (2007)*. "Related to" jurisdiction includes any litigation where the "outcome could alter, positively or negatively, the debtor's rights, liabilities, options, or freedom of action or could influence the administration of the bankrupt estate." *Id*. Barclays maintains that because the MLPA renders New Century liable for all damages that could be imposed on Barclays by this litigation, the district court had jurisdiction to rule on the case.

On appeal, Appellants have supplemented their argument and contend that "related to" jurisdiction only arises if claims for contribution or indemnity have "accrued." Appellants mean that a right to indemnity or contribution must be established such that no further

litigation is required to substantiate such rights against the debtor. Their reliance for this proposition on the Third Circuit's decision *In re Federal-Mogul Global, Inc., 300 F.3d 368, 382 (3d Cir. 2002)*, is misplaced. *Federal-Mogul* concerned tort contribution principles where the debtor's liability [*7] for asbestos-caused injuries would ultimately have to be litigated before contribution rights would "accrue" in favor of other producers of asbestos products. We take no position on the *Federal-Mogul* situation. *Compare Arnold v. Garlock, Inc., 288 F.3d 234, 238-39 (5th Cir. 2002)* (holding that absent a judgment against a defendant at time of removal, common law contribution could not give rise to "related to" jurisdiction). In this case, Barclays relies heavily, if not exclusively, on contractual indemnity provisions with New Century containing representations about the quality of the mortgage loans purchased by Barclays, which are nearly identical to the representations Barclays made to Lone Star. This circuit has already ruled, moreover, that contractual indemnification rights may give rise to "related to" jurisdiction. *See In re Stonebridge Techs., Inc., 430 F.3d 260, 266 (5th Cir. 2005)* (holding that a debtor's letter of credit obligation triggered "related to" jurisdiction in a dispute between two non-bankrupt third parties).

III. DISCUSSION

Appellate review of a district court's dismissal for failure to state a claim under *Rule 12(b)(6)* is *de novo*. *Jones v. Greninger, 188 F.3d 322, 324 (5th Cir. 1999)*. [*8] The ultimate question in a *Rule 12(b)(6)* motion is whether the complaint states a valid claim when all well-pleaded facts are assumed true and are viewed in the light most favorable to the plaintiff. *In re Katrina Canal Breaches Litig., 495 F.3d 191, 205 (5th Cir. 2007)*. The court's review is limited to the complaint, any documents attached to the complaint, and any documents attached to the motion to dismiss that are central to the claim and referenced by the complaint. *Collins v. Morgan Stanley Dean Witter, 224 F.3d 496, 498-99 (5th Cir. 2000)*. The court's task is to determine whether the plaintiff has stated a legally cognizable claim that is plausible, not to evaluate the plaintiff's likelihood of success. *Ashcroft v. Iqbal, U.S. , 129 S. Ct. 1937, 1949, 173 L. Ed. 2d 868 (2009)*. Further, as the claims sound in fraud and negligent misrepresentation, Appellants must plead the misrepresentations with particularity under *Fed. Rule Civ. Proc. 9(b)*. *Benchmark Elecs., Inc. v. J.M. Huber Corp., 343 F.3d 719, 723-24 (5th Cir. 2003)*. [3]

3 Barclays also contends that Lone Star did not meet the pleading requirements of *Rule 9(b)*. Lone Star asserts that it does not need to satisfy *Rule 9(b)* for claims [*9] that do not involve fraud. Belying this contention is the fact that Lone Star's complaint, on its face, pleads with particularity the exact representations it claims were false. Moreover, *Rule 9(b)* does apply. "[T]his court has applied the heightened pleading requirements when the parties have not urged a separate focus on the negligent misrepresentation claims" such as when "fraud and negligent misrepresentation claims are based on the same set of alleged facts." *Benchmark, 343 F.3d at 724*. We need not determine, however, whether Lone Star fully complied with *Rule 9(b)* because taken, as a whole, the agreements covered by the complaint do not allege a misrepresentation in the first instance.

All of Appellants' [4] various claims [5] are predicated upon Barclays' alleged misrepresentation that there were no delinquent loans in the BR2 and BR3 Trusts when Lone Star purchased the securities. Consequently, to prevail, Appellants must successfully allege both that Barclays represented that the BR2 and BR3 Trusts had no delinquent mortgages and that the representations were false when made. We accept as true for present purposes that there were delinquent mortgages in the trusts when Lone Star [*10] purchased the securities. Appellants' remaining burden is to demonstrate how Barclays misrepresented that the BR2 and BR3 Trusts contained no delinquent mortgages.

4 Barclays contends that Lone Star Fund V does not have standing to bring any claims because it did not purchase the securities or suffer any direct harm. Only LSF5 Bond Holdings LLC, Lone Star Fund V's subsidiary, purchased the securities and suffered direct economic harm. If Lone Star Fund V were the sole plaintiff, we might have to address the issue of standing or real party in interest. However, LSF5 Bond Holdings LLC, which unquestionably has standing, is co-plaintiff.

5 Appellants alleged claims related to Sections 11, 12(a)(2) and 15 of the Securities Act of 1933, *15 U.S.C. §§ 77k, 77l(a)(2)* and *77o*; Section 33 of the Texas Securities Act, *Tex. Rev. Civ. Stat. art. 581-33(A)(2)*; *Tex. Bus. and Comm. Code § 27.01*; and common law fraud, fraudulent

inducement, and negligent misrepresentation.

To do this, Appellants first reference the BR2 and BR3 Supplemental Prospectuses, each of which stated:

> Barclays will make representations and warranties with respect to each mortgage loan [New Century] sold to the sponsor as of the closing [*11] date, including, but not limited to:
>
> > (1) As of the servicing transfer date, except with respect to the Delinquent mortgage loans described under "*The Mortgage Loan Pool-General*" in this prospectus supplement, 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.

In addition, both prospectuses reference a Representations and Warranties Agreement that Barclays signed, detailing similar representations and warranties about the mortgages. Appellants assert that the Representations and Warranties Agreement repeated Barclays' misrepresentations in the following pertinent clause:

> Payments Current. (i) All payments required to be made up to the Closing Date for the Mortgage Loan under the terms of the Mortgage Note, other than payments not yet 30 days delinquent, have been made and credited, [and] (ii) no payment required under the Mortgage Loan has been 30 days or more delinquent at any time since the origination of the Mortgage Loan[.]

Appellants also allege that less than two months before New Century went bankrupt, Barclays touted the due diligence [*12] it had perform ed on the underlying mortgage loan pools before soliciting Lone Star to buy the Securities.

Standing alone, these "no delinquency" provisions would support Appellants' contentions. Nevertheless, the representations are isolated portions of complex contractual documents that must be read in their entirety to be given effect. *Transitional Learning Community at Galveston, Inc. v. U.S. Office of Personnel Mgmt., 220 F.3d 427, 431 (5th Cir. 2000)* ("[A] contract should be interpreted as to give meaning to all of its terms--presuming that every provision was intended to accomplish some purpose, and that none are deemed superfluous"); *also see Olkey v. Hyperion 1999 Term Trust, Inc., 98 F.3d 2, 5 (2d Cir. 1996)* ("It is undisputed that the prospectuses must be read as a whole.") (internal quotations and citations omitted); *Kass v. Kass, 91 N.Y.2d 554, 696 NE 2d 174, 180-81, 673 N.Y.S.2d 350 (N.Y. 1998)* ("Particular words should be considered, not as if isolated from the context, but in the light of the obligation as a whole and the intention of the parties as manifested thereby.") (quoting *Atwater & Co. v. Panama R.R. Co., 246 N.Y. 519, 159 N.E. 418, 419 (N.Y. 1927)*). Read as a whole, the prospectuses and warranties provide [*13] 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. One way or another, Barclays committed that the mortgage loan pools would be free of delinquent mortgages. These "repurchase or substitute" clauses appear in both the BR2 and BR3 Supplemental Prospectuses [6] and the Representations and Warranties Agreement. [7] Moreover, the clauses constitute the "sole remedy" for material breach for purchasers like Lone Star.

6 Both the BR2 and BR3 Prospectuses stated:

> The obligations of Barclays to cure such breach or to substitute or purchase the applicable mortgage loan will constitute the sole remedies respecting a material breach of any such representation or warranty to the holders of the [Securities], the servicer, the trustee, the depositor and any of its affiliates.

7 The Representations and Warranties Agreements included the following clause:

> It is understood and agreed that the obligation of [Barclays PLC] set forth in Section 3(a) to purchase or substitute for a New Century Mortgage Loan in breach of a representation or warranty contained in Section 2 constitutes the sole [*14] remedy of the Depositor or any other person or entity with respect to such breach.

Thus, Barclays did not represent that the BR2 and BR3 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 [*15] 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.

As a fallback, Appellants assert that the "repurchase or substitute" clauses are void as against public policy because they waive Appellants' right to sue for fraud. This argument is meritless. Under federal and Texas securities laws and Texas common law, a party cannot waive its right to bring fraud claims by contract or otherwise. *See 15 U.S.C. § 77n*; *Tex. Rev. Civ. Stat. art. 581-33(L)*; *Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171, 181 (Tex. 1997)*. Rather than waive Appellants' right to pursue claims of fraud, the "repurchase or substitute" clauses change the nature of Barclays' representation. If Appellants had alleged that Barclays falsely represented to prospective investors [*16] that it would repurchase or substitute delinquent mortgages, they might have stated a case of fraud under the pertinent agreements. This is not their claim.

IV. CONCLUSION

Because a consideration of the parties' entire agreement reveals that Barclays has not made any misrepresentations, Appellants' claims fail as a matter of law. The district court correctly held that the allegations of Appellants' amended complaint do not set forth sufficient facts to state a claim for relief that is plausible on its face. The judgment of dismissal is **AFFIRMED**.

APPENDIX E

WTG Gas Processing v.
ConocoPhillips Company et al,
2010 WL 695801
(Tex.App.-Hous. (14 Dist.) March 2, 2010)

Opinion of February 23, 2010 Withdrawn; Affirmed and Corrected Opinion filed March 2, 2010.

In The

Fourteenth Court of Appeals

NO. 14-08-00019-CV

WTG GAS PROCESSING, L.P., Appellant

V.

CONOCOPHILLIPS COMPANY, TARGA RESOURCES TEXAS GP LLC, TARGA RESOURCES, INC., TARGA TEXAS FIELD SERVICES, LP, AND WARBURG PINCUS, LLC, Appellees

On Appeal from the 333rd District Court
Harris County, Texas
Trial Court Cause No. 2005-77919

C O R R E C T E D O P I N I O N

We withdraw our opinion of February 23, 2010 and substitute this corrected opinion in its place.

This suit arises from appellee, ConocoPhillips Company=s (AConocoPhillips@), sale of a natural-gas processing facility to appellees, Targa Resources Texas GP LLC, Targa Resources, Inc., Targa Texas Field Services, LP, and Warburg Pincus, LLC (collectively ATarga@),[1] instead of appellant, WTG Gas Processing, L.P. (AWTG@). 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.

In two issues, encompassing numerous sub-issues, WTG contends the trial court erred by granting summary judgment on the breach-of-contract claim against ConocoPhillips and the tortious-interference-with-contract claim against Targa. WTG challenges the grounds on which the trial court explicitly granted summary judgment. Both ConocoPhillips and Targa present cross-points, contending the summary judgments should be upheld on alternative grounds, which were denied by the trial court. As explained below, we agree with a cross-point raised by both ConocoPhillips and Targa, and, therefore, affirm the final judgment.

I. BACKGROUND[2]

WTG is a limited partnership which owns midstream natural-gas gathering and processing systems. In 2003, ConocoPhillips decided to sell several of its natural gas processing plants and pipelines, including San Angelo Operating Unit (ASAOU@), Louisiana Operating Unit (ALOU@), and Southeast New Mexico assets (ASENM@). ConocoPhillips engaged Morgan Stanley & Co., Incorporated (AMorgan Stanley@) to conduct the sale.

Morgan Stanley issued a ATeaser,@ inviting interested parties to potentially bid on an individual asset or certain assets combined. After WTG signed a confidentiality agreement, Morgan Stanley gave WTG a Confidential Information Memorandum (ACIM@), 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 (AIOI@) containing requisite items; Morgan Stanley and ConocoPhillips will 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 (APSA@), and attend a site visit from which to submit bids; and upon evaluation of the final bids, Morgan Stanley will narrow the number of bidders and enter into final PSA negotiations. The CIM 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 SAOU, WTG was invited to, and did, participate in the next stage of the process. Then, on October 30, 2003, via letter, Morgan Stanley invited WTG to submit a binding proposal and outlined the requirements for such a bid (Athe 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(s)].
>
> ! [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(s)] 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(s)] 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(s)], and only as set forth therein.

By letter dated November 19, 2003, WTG submitted a Afinal binding bid@ of $135.4 million for SAOU A[i]n accordance with the [CIM] . . . and the [bid procedures].@ WTG subsequently increased its bid to $145.4 million after being informed that its offer was lower than others under consideration but 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 $148.4 million to make it comparable to another offer ConocoPhillips was considering. On December 10, 2003, WTG increased its bid to $148.4 million.

According to the deposition testimony of Dave Freeman (WTG=s employee who was its principle contact for the transaction), on December 11, 2003, Garrett Rychlik

(ConocoPhillips=s Coordinator of Business Development responsible for managing the auction of SAOU), Robert Friedsam (Morgan Stanley), and Ryan Engle (Morgan Stanley), telephoned Freeman stating the following: ConocoPhillips had decided to Ago forward with@ WTG; ConocoPhillips and WTG had a Adeal,@ ConocoPhillips had some Aimmaterial@ changesCAwording@ issuesCto WTG=s draft PSA; the parties would Aproceed to get it signed@; and ConocoPhillips would forward a revised version the next day or at least by December 15.

At that point, WTG=s draft PSA was not in executable form and did not, among other omissions, 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 these parties never executed a PSA.

Meanwhile, in November and early December of 2003, Targa had submitted bids for multiple assets, including SAOU, and expressed a strong preference to make a group purchase. On December 10, Targa resubmitted a bid of $335 million for SAOU, SENM, and LOU combined and reiterated its interest in acquiring several assets in a single transaction.

However, as of December 11, ConocoPhillips had decided to pursue PSA negotiations with WTG for SAOU, Targa for LOU only, and another entity for SENM. During the days immediately following the December 11th phone conversation with WTG, several ConocoPhillips employees who were responsible for various aspects of the sale generated some internal e-mails. The e-mails reflected that, 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. The employees discussed the status of the sale in light of this decision. Specifically, on December 12, Will Duey wrote William Earnest and Mary Pearce:

> [W]e are moving forward with due diligence and PSA negotiations with DEFS for SENM, [WTG] for [SAOU] and [Targa] for LOU. It is our goal to have PSAs for SENM and [SAOU] mid-January and close both before the end of February. These dates are subject to both due diligence and HSR requirements; however, they seem achievable at this point in time. Because of [Targa=s] requirements LOU is expected to close later . . . .
>
> . . . .
>
> Morgan Stanley is notifying the unsuccessful bidders that we are starting down the road with other parties.

About two hours later, William Earnest forwarded the message to John Lowe (a ConocoPhillips vice-president) stating:

> fyi - We are going down the path of 3 sales vs. one transaction with Targa due to closing concerns (new entity), due diligence requirements and [PSA] markup by Targa. We have done deals with [WTG] and DEFS before and are more confident of closing with them. . . .

Later that day, Mary Pearce wrote to Sigmund Cornelius and William Earnest, warning of a potential Apolitical problem@ due to Targa=s latest bid:

> We had already released DEFS and WTG to start due diligence on SENM and [SAOU], respectively. We also believe that there is a high risk that Targa will whittle the price down and WTG will not and DEFS may not based on our past dealings. When we advised Targa that we would not stop the due diligence and give them an exclusive on the 3 properties, they become [sic] upset and threatened to not buy LOU. We do plan to tell them that we want to work with them on LOU and will give them the opportunity if the negotiations fall apart with our primaries. If they do not buy LOU - we have other options.
>
> We wanted you to know as you may hear complaints from Targa. We are committed to obtain the best value as well as live with our deals.

On December 15, Will Duey e-mailed John Lowe, expressing:

> [Targa] seem[s] to be fishing for a magic number rather than raising their bid or modifying the PSA that they marked up. It seems late to ask them to submit a new PSA as we have already started due diligence with DEFS and [WTG]. Certainly Targa is a great option if those deals fall apart.

Then, on December 15, Targa did submit another bid of $255 million for SAOU and LOU combined, recognizing a package purchase which also included SENM may Ano longer be an option.@ Targa also made some concessions on terms and guaranteed flexibility relative to negotiating other terms in light of ongoing discussions with Morgan Stanley which clarified ConocoPhillips=s Akey considerations.@ 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. On December 19, Morgan Stanley informed Freeman that ConocoPhillips was considering another offer.

On December 22, Freeman e-mailed Rychlik (ConocoPhillips) inquiring about the status of the PSA in light of the December 11th phone conversation and offering a meeting between the parties= attorneys to discuss the PSA. Freeman stated WTG was anxious to conclude this transaction because it was in the process of purchasing another interdependent facility in the area. He also stated that WTG had completed some aspects of due diligence and requested permission to conduct further due diligence during the first week of January.

On the same day, Engle (Morgan Stanley) responded to Freeman=s e-mail, confirming WTG could conduct the requested due diligence. Engle advised that ConocoPhillips=s attorney for the sale process was on vacation for the remainder of December and could not devote significant time to the PSA that week, and A[a]s previously mentioned, we believe the two parties are close enough on the PSA that finalizing that document can be done in an expedious [sic] fashion (most likely during the week of Jan. 5).@ Also that day, Rychlik confirmed to Freeman that ConocoPhillips was considering another offer, which included SAOU, and a decision about the new bid would not likely be made before January. Rychlik stated he was not Aplaying games@ with WTG but ConocoPhillips had to consider the other offer. Freeman replied that WTG would be Aextremely upset@ if a transaction between WTG and ConocoPhillips were not consummated because it had offered a Apremium@ for SAOU and the complementary facility and would be Avery upset@ if ConocoPhillips took the other offer without giving WTG an opportunity to adjust its bid although it might not do so. The next day, Freeman expressed to Morgan Stanley and Rychlik via e-mail that allowing WTG to continue a brisk pace on due diligence would enable it to sign a PSA Aas soon as the attorneys have negotiated the agreement.@

Throughout late December 2003 and January and February of 2004, ConocoPhillips negotiated with Targa. During this period, WTG, ConocoPhillips, and Morgan Stanley continued to communicate, in writing or orally, regarding the status of the sale. WTG periodically apprised Morgan Stanley and ConocoPhillips regarding the status of WTG=s due diligence efforts, and they kept WTG informed that ConocoPhillips was still evaluating the other offer.

At one point in early January, Freeman again asked if WTG would be given the opportunity to revise its bid before ConocoPhillips accepted the other offer. Morgan Stanley

replied that ConocoPhillips would likely proceed with the other party if its bid were the best offer but WTG was free to submit a revised bid before that time. J.L. Davis, owner of WTG, subsequently wrote two letters to Morgan Stanley stating WTG would not increase its offer because it believed the parties had an Aagreement@ on price, the offer was fair, and WTG had expended considerable resources and made another commitment based on advice it had been selected to purchase SAOU; expressing Akeen disappointment@ if the sale were not concluded; and reiterating WTG=s Aexpectation that ConocoPhillips will honor its commitment to accept our bid.@

Morgan Stanley then notified WTG that due diligence should be conducted at its own risk and reminded WTG the bid materials advised that ConocoPhillips could negotiate with any party until a PSA was signed. A few days later, Freeman informed ConocoPhillips and Morgan Stanley that once certain aspects of due diligence were complete, it would be prepared to Afinalize and sign@ a PSA. Subsequently, Morgan Stanley advised Freeman that negotiations with the other party were down to the Acritical stage@ but ConocoPhillips wanted to keep communications open with WTG as a Agood alternative.@ Morgan Stanley inquired about WTG=s status should ConocoPhillips decide to proceed with WTG. Freeman replied that WTG was Abasically down to finalizing the PSA and verifying volumes.@

On February 28, 2004, ConocoPhillips and Targa executed PSAs for SAOU and LOU. A few days later, Morgan Stanley informed Freeman that ConocoPhillips had now executed a Adefinitive agreement.@ The closing for the transaction with Targa occurred in April 2004.

In December 2005, 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 followed by a supplement to the motion. On October 2, 2007, the trial court signed a AMemorandum Opinion and Order@ granting both motions for summary judgment and explaining at length the reasons for its decision. On October 4, 2007, the trial court signed a final judgment referencing its previous order and ruling that WTG take nothing on all its claims. WTG appeals the summary judgment in favor of both ConocoPhillips and Targa.[3]

II. STANDARD OF REVIEW

A party moving for traditional summary judgment must establish there is no genuine

issue of material fact and it is entitled to judgment as a matter of law. *See* Tex. R. Civ. P. 166a(c); *Provident Life & Accident Ins. Co. v. Knott*, 128 S.W.3d 211, 215B16 (Tex. 2003). A defendant moving for summary judgment must conclusively negate at least one element of the plaintiff=s theory of recovery or plead and conclusively establish each element of an affirmative defense. *Centeq Realty, Inc. v. Siegler*, 899 S.W.2d 195, 197 (Tex. 1995). If the defendant establishes its right to summary judgment, the burden shifts to the plaintiff to raise a genuine issue of material fact. *Id.* We review a summary judgment *de novo*. *Knott*, 128 S.W.3d at 215. We take as true all evidence favorable to the nonmovant and indulge every reasonable inference and resolve any doubts in favor of the nonmovant. *Id.*

III. CONOCOPHILLIPS=S MOTION FOR SUMMARY JUDGMENT

In its first issue, WTG contends the trial court erred by granting summary judgment in favor of ConocoPhillips on WTG=s breach-of-contract claim.[4]

A. The Issues

ConocoPhillips moved for summary judgment on two alternative grounds: (1) WTG cannot prove existence of a valid contract because the evidence conclusively established there was no meeting of the minds; and (2) the statute of frauds bars WTG=s claim.[5] In its responses, WTG addressed these grounds and also raised a promissory-estoppel defense to the statute-of-frauds contention.[6]

In its order, the trial court found a genuine issue of material fact on whether a contract was formed. However, the trial court concluded that an *enforceable* contract did not exist as a matter of law because there was no writing satisfying the statute of frauds and WTG failed to present evidence supporting its promissory-estoppel argument.

On appeal, WTG challenges both conclusions concerning the statute of frauds. In addition to arguing that the trial court correctly concluded the statute of frauds was not satisfied, ConocoPhillips raises two cross-points. In one such cross-point, ConocoPhillips challenges the trial court=s ruling that there was a genuine issue of material fact on whether a contract was formed.

As discussed below, we agree that, as a matter of law, ConocoPhillips negated formation of a contract. Therefore, we need not address the statute-of-frauds issue and will uphold the

summary judgment based on ConocoPhillips=s cross-point. *See Cincinnati Life Ins. Co. v. Cates*, 927 S.W.2d 623, 625B26 (Tex. 1996) (holding appellate court, when reviewing summary judgment, should consider all grounds on which the trial court ruled and the movant preserved for appellate review that are necessary for final disposition of appeal).[7]

B. Analysis

To prevail on a breach-of-contract claim, a plaintiff must prove (1) a valid contract existed between the plaintiff and the defendant, (2) the plaintiff tendered performance or was excused from doing so, (3) the defendant breached the terms of the contract, and (4) the plaintiff sustained damages as a result of the defendant=s breach. *West v. Triple B Servs., LLP*, 264 S.W.3d 440, 446 (Tex. App.CHouston [14th Dist] 2008, no pet.). In its motion for summary judgment, ConocoPhillips asserted the evidence conclusively negated the existence of a valid contract because the parties did not have a meeting of the minds; i.e. offer and acceptance.

Among other elements, a party must prove offer and acceptance to demonstrate existence of a valid contract. *DeClaire v. G & B Mcintosh Family Ltd. P=ship*, 260 S.W.3d 34, 44 (Tex. App.CHouston [1st Dist.] 2008, no pet.); *Wal-Mart Stores, Inc. v. Lopez*, 93 S.W.3d 548, 555B56 (Tex. App.CHouston [14th Dist.] 2002, no pet.). A Ameeting of the minds@ is Amerely a mutuality subpart of the offer and acceptance elements.@ *Domingo v. Mitchell*, 257 S.W.3d 34, 40 (Tex. App.CAmarillo 2008, pet. denied). Although whether the parties intended to be bound is often a question of fact, it may be determined as a matter of law. *See Foreca, S.A. v. GRD Devel. Co.*, 758 S.W.2d 744, 746 (Tex. 1988); *John Wood Group USA, Inc. v. ICO, Inc.*, 26 S.W.3d 12, 16 (Tex. App.CHouston [1st Dist.] 2000, pet. denied); *see also COC Servs., Ltd. v. CompUSA, Inc.*, 150 S.W.3d 654, 662B70 (Tex. App.CDallas 2004, pet. denied).

Although a PSA was never executed, WTG contends ConocoPhillips accepted WTG=s offer during the December 11th phone conversation by representing that ConocoPhillips had decided to Ago forward with@ WTG, they had a Adeal,@ ConocoPhillips had Aimmaterial@ changes to WTG=s PSA, and Athe parties would Aproceed to get it signed.@[8]

Based on the following provisions in the bid procedures, ConocoPhillips argues 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.[9]

In contrast, for two reasons, WTG contends these provisions did not conclusively negate acceptance of its offer: (1) the fact that the parties contemplated later execution of a PSA did not necessarily preclude their informal agreement from constituting a binding contract; and (2) a fact issue existed on whether ConocoPhillips modified or waived these provisions. The trial court seemed to conclude the above-cited provisions might otherwise have negated that ConocoPhillips orally accepted WTG=s offer, but a fact issue existed on whether ConocoPhillips waived these procedures.

1. Bid Procedures Precluding Acceptance Absent Execution of a PSA

ConocoPhillips cites several cases to support its contention that the above-cited bid procedures negated any purported acceptance of WTG=s offer, including *John Wood Group* and *COC Services*.

In *John Wood Group*, after negotiating the potential sale of certain assets, the parties signed a letter of intent containing the following provision:

> 15. *Binding Effect*. This Letter Agreement constitutes a summary of the principal terms and conditions of the understanding which has been reached regarding the sale of certain assets to Purchaser . . . . *It does not address all of the terms and conditions which the parties must agree upon to become binding and consummated.* The Purchaser, however, does intend to move forward with its due diligence and expects to expend considerable sums to review the Sellers= Business. In consideration therefor, the parties have agreed to make certain covenants of this letter binding upon the parties notwithstanding the fact that not all details of the transactions have been agreed upon. *Accordingly, it is understood and agreed 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].*

26 S.W.3d at 15 (emphasis added in original opinion). The seller refused to consummate the transaction because of disputes on certain matters and sold the assets to another company. *Id.* In the prospective buyer=s subsequent suit, a jury found that the seller breached the letter agreement. *Id.* at 16. The court of appeals held this issue was improperly submitted to a jury and there was no contract as a matter of law because the parties unambiguously expressed their intent not to be bound by the letter agreement except for certain paragraphs. *See id.* at 16B20.

In *COC Services*, the parties signed a letter of intent with a form master franchise agreement attached. 150 S.W.3d at 660. The letter provided that, if the master franchise agreement were not signed by a certain date, the letter Awill expire, *and neither of the undersigned shall have any further obligation or liability hereunder with respect to a potential master franchise or license for the development and operation of the Stores . . . .@ Id.* at 663 (emphasis added in original opinion). Relying primarily on this language, the court held that, as a matter of law, the parties did not intend to be bound by the master franchise agreement which was never completed and executed. *See id.* at 665B70.

WTG cites 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. For example, in *Foreca,* the parties initialed a handwritten document which included several terms concerning the sale of amusement-park rides and the language, ASUBJECT TO LEGAL DOCUMENTATION CONTRACT TO BE DRAFTED BY [SELLER=S ATTORNEY].@ 758 S.W.2d at 744B45. Subsequently, the seller sued the prospective buyer for breach of contract after it refused to purchase the rides. *Id.* at 745. Relying on the above-quoted language, the buyer urged that no enforceable agreement was made. *Id.* The Texas Supreme Court held this language was not conclusive on intent to contract because a fact question existed on whether the contemplated formal writing was a condition precedent to contract formation or merely a memorial of an already enforceable contract. *Id.* at 745B46.

WTG also relies on *Murphy v. Seabarge, Ltd.*, 868 S.W.2d 929, 933 (Tex. App.CHouston [14th Dist] 1994, writ denied), in which a AMemorandum of Understanding@ between partners provided it was Anot intended to be a binding contract@ but an outline of proposals in the event the partnership filed bankruptcy and thus was subject to Apreparation of

appropriate documentation@ and approval of the bankruptcy court. When the partnership sued one partner for taking management fees beyond those authorized by the memorandum, he relied on the foregoing provision to argue the memorandum was not an enforceable contract. *Id.* at 932B33. The court held that a fact issue existed on whether the parties intended to be bound by the memorandum. *Id.* at 933B34.

The *Foreca* and *Murphy* courts recited, and WTG also relies on, the following well-established general contract principles: (1) the fact that parties to an informal agreement contemplate a formal writing does not necessarily prevent formation of a binding contract even if the formal writing is never drafted and executed; *see Scott v. Ingle Brothers Pacific, Inc.*, 489 S.W.2d 554, 556 (Tex. 1972) (citing 17 Am. Jur. 2d, Contracts ' 28); and (2) parties may form a binding contract if they agree on material terms although they leave other terms open for later negotiation; *see id.* (quoting 1 Arthur Corbin, *Corbin on Contracts* ' 28, at 93B95 (1963)); *see also Foreca*, 758 S.W.2d at 746 (citing *Scott*, 489 S.W.2d at 556); *Murphy*, 868 S.W.2d at 933 (citing *Scott*, 489 S.W.2d at 556).

We conclude that *John Wood Group* and *COC Services* are persuasive in the present case and *Foreca* and *Murphy*, as well as the general contract principles recited therein, are distinguishable. The ConocoPhillips bid procedures were much more definitive than the Asubject to legal documentation@ language in *Foreca*. Instead, like the pertinent provisions in *John Wood Group* and *COC Services*, 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. *See John Wood Group*, 26 S.W.3d at 16B19 (stating the Ais not binding@ language in the *John Wood Group* letter of intent was more definitive than the language in *Foreca* and compelled only the conclusion that the parties did not intend to be bound).

The language disavowing intent to be bound in *Murphy* was more emphatic than the pertinent language in *Foreca*. *See Murphy*, 868 S.W.2d at 933. Nevertheless, the evidence raising a fact issue was the partner=s admitted partial performance of the agreement despite his later attempt to disavow an enforceable contract. *Id.* at 932B34; *see John Wood Group*, 26 S.W.3d at 17 (distinguishing *Murphy* because its party=s partial performance after agreement was signed created fact question on intent to be bound despite Ano intent@ provision whereas

no such partial performance occurred in *John Wood Group*). In the present case, the parties did not engage in partial performance; indeed, this dispute arose because ConocoPhillips sold the facility to another party.

In fact, the *John Wood Group* court acknowledged the general principles recited in *Foreca*, *Murphy*, and *Scott* when cautioning that a party may risk being contractually bound by a letter of intent which includes essential terms although it does not contain all protections for which the parties would ordinarily negotiate or on which due diligence is incomplete. *See John Wood Group*, 26 S.W.3d at 19B20. ATherefore, a party who does not wish to be prematurely bound by a letter agreement should include >a provision clearly stating that the letter is nonbinding, as such negations of liability have been held to be effective.=@ *Id.* at 19 (quoting E. Allan Farnsworth, *Farnsworth On Contracts* ' 3.8b, at 193 (1990)). The court stated that the case did not merely involve missing unessential terms, but whether there was mutual consent on essential terms. *Id.* at 20. Although the parties may have reached a preliminary agreement on essential termsCthe item to be sold and the priceCthe seller withheld its consent to be bound on those agreed-upon terms until a final purchase agreement was signed. *Id.* Similarly, ConocoPhillips withheld its acceptance of an offer until execution of a PSA, despite any preliminary Adeal@ on essential terms made during the December 11th phone conversation.

We acknowledge that the present case differs from *John Wood Group* and *COC Services* in that the provisions reflecting intent not to be bound in those cases were contained in a written agreement signed by both parties. *See John Wood Group*, 26 S.W.3d at 15; *COC Servs.*, 150 S.W.3d at 663. In this case, the language precluding acceptance of an offer absent execution of a PSA was contained within the bid procedures promulgated by ConocoPhillips. Nonetheless, WTG made its bid A[i]n accordance with the [CIM] . . . and the [bid procedures].@ WTG argued this language did not necessarily mean it agreed to the bid procedures, but merely that it was responding to the procedures by submitting all items required therein. Although the trial court ultimately agreed with WTG on the contract-formation dispute, it disagreed with this point, stating Ait appears the procedures were incorporated into WTG=s offer . . . .@

We agree that, under the plain meaning of A[i]n accordance with,@ WTG submitted its offer subject to the bid procedures. *See* WEBSTER=S THIRD NEW INT=L DICTIONARY 12 (1993) (defining Aaccordance@ to mean AAgreement, Accord@); BLACK=S LAW DICTIONARY 18 (8th ed. 2004) (defining Aaccordant@ to mean AIn agreement@).

Nevertheless, by acknowledging the bid procedures, WTG knew that ConocoPhillips, at least, had no intent to be bound absent execution of a PSA. *See* RESTATEMENT (SECOND) OF CONTRACTS ' 27 cmt. B (1981) (A[I]f either party knows or has reason to know that the other party regards the agreement as incomplete and intends that no obligation shall exist until other terms are assented to or until the whole has been reduced to another written form, the preliminary negotiations and agreements do not constitute a contract.@); *see also RHS Interests, Inc. v. 2727 Kirby Ltd.*, 994 S.W.2d 895, 897B99 (Tex. App.CHouston [1st. Dist.] 1999, no pet.) (holding there was no contract for purchase of property where buyer stated its written offer was Anot binding as an agreement unless and until a fully executed Earnest Money contract is signed,@ but even under buyer=s position that subsequent oral negotiations replaced this offer, no contract was formed because *seller=s* response indicated Adeal@ would be consummated only by Aexecution of the binding Purchase and Sale Agreement.@).

2. Modification or Waiver of Bid Procedures

Next, WTG contends, and the trial court agreed, that the language at issue in the bid procedures did not conclusively negate acceptance of WTG=s offer because a genuine issue of material fact existed on whether ConocoPhillips modified or waived the procedures. In support, WTG and the trial court cited another provision in the bid procedures:

> ConocoPhillips reserves the right, without explanation, to amend, modify or waive the procedures, terms and conditions set forth herein at any time, with or without sending notice of the waivers or changes to prospective purchasers.

Additionally, WTG argued, and the trial court stated, ATexas 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.@ *See Morrison v. Ins. Co. of N. Am.*, 69 Tex. 353, 364, 6 S.W. 605, 609 (Tex. 1887); *Mar-Lan Indus., Inc. v. Nelson*, 635 S.W.2d 853, 855 (Tex. App.CEl Paso 1982, no writ).@[10]

Relying on the above-cited provision and the general principle regarding contract modification, the trial court concluded:

> It is possible ConocoPhillips had the requisite intent to form a contract without the added protection of the bid procedures and, that though the parties still intended to

> execute a final agreement, ConocoPhillips forwent such as a requirement and accepted on the spot, thus waiving the condition precedent by its acceptance. Though the proposition that ConocoPhillips did so may seem dubious, this is a matter for the finder of fact to determine. Whether intent was present, acceptance given, and oral agreement made are matters best left to a finder of fact. The Court finds that the bid procedures promulgated by ConocoPhillips did not limit ConocoPhillips= ability to accept WTG=s PSA as it was and at that time for the purposes of summary judgment.

WTG also cites authority recognizing a party may waive a condition it originally imposed as prerequisite to contract formation, although the trial court did not recite this principle in its order. *See, e.g.*, *Padilla v. LaFrance*, 907 S.W.2d 454, 460B61 (Tex. 1995) (recognizing offer prescribing time and manner of acceptance must ordinarily be complied with to create contract, but different method of acceptance may be effectual where offeror agrees to modification of terms of acceptance).

Waiver is Aan intentional relinquishment of a known right or intentional conduct inconsistent with claiming that right.@ *Jernigan v. Langley*, 111 S.W.3d 153, 156 (Tex. 2003) (per curiam). Initially, Freeman acknowledged in his deposition that ConocoPhillips never expressed to WTG it had waived the bid procedures that precluded acceptance of an offer absent execution of a PSA. Nonetheless, the fact that ConocoPhillips did not communicate any express waiver to WTG is inconclusive because ConocoPhillips reserved the right to unilaterally waive the procedures without informing WTG. However, WTG also cites no evidence indicating ConocoPhillips made any express, internal decision to waive these procedures.[11] Therefore, the gist of WTG=s argument, and the trial court=s reasoning, was that a jury might decide the oral representations during the December 11th phone conversation themselves constituted ConocoPhillips=s waiver of these bid procedures.

Consequently, we construe the issue as whether ConocoPhillips waived the bid procedures through its conduct; i.e. representations which did not expressly relinquish its rights. For implied waiver to be found through a party=s conduct, intent must be clearly demonstrated by the surrounding facts and circumstances. *Id.*; *see Van Indep. Sch. Dist. v. McCarty*, 165 S.W.3d 351, 353 (Tex. 2005) (A[T]hat conduct must be unequivocally inconsistent with claiming a known right.@). AThere can be no waiver of a right if the person

sought to be charged with waiver says or does nothing inconsistent with an intent to rely upon such right.@ *Jernigan*, 111 S.W.3d at 156. Waiver is ordinarily a question of fact, but when the surrounding facts and circumstances are undisputed, the question becomes one of law. *Id.* at 156B57. Considering the surrounding facts and circumstances, including the purpose of the bid process and procedures and ConocoPhillips=s actions after the phone conversation, we conclude the oral representations were insufficient as a matter of law to constitute waiver of the bid procedures at issue.

a. The purpose of the bid process and procedures

First, allowing a jury to decide the oral representations alone constituted waiver would vitiate the purpose of the overall bid process and the procedures. The bid procedures provided that one of ConocoPhillips=s Akey objectives@ was Ato obtain the highest possible value@ and it would evaluate proposals Awith the goal of negotiating and executing a [PSA(s)] with the party that submits the Proposal which best meets [ConocoPhillips=s] objectives.@ ConocoPhillips=s internal e-mails reflect that the Ahighest possible value@ involved considerations of purchase price and contract terms.

Both the CIM and the bid procedures demonstrate 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.

Additionally, arriving at the final terms of a complex, commercial transaction involves extensive time, effort, research, and finances. *See John Wood Group*, 26 S.W.3d at 19. Further, it is axiomatic 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. *See id.* (discussing purpose of a letter of intent). Indeed, the CIM reflected that ConocoPhillips viewed a preliminary agreement as different from a PSA because it reserved the right to Aenter into preliminary or definitive agreements at any time.@ Thus, entering into a preliminary Adeal@ was not necessarily inconsistent with requiring an executed PSA to form a binding contract.[12]

Accordingly, the bid procedures at issue were intended in part to protect ConocoPhillips in a situation such as the present dispute; i.e. prevent an informal, preliminary agreement with a prospective purchaser from forming a binding contract before execution of the formal writing. Consequently, we employ an opposite reasoning to that urged by WTG and adopted by the trial court: in short, the representations during the December 11th 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.

Again, we find *COC Services*, as well as a federal case cited therein, are illustrative. In *COC Services*, the plaintiff buyer argued that the following conduct by the seller after signing the letter of intent indicated the parties had entered into a contract although no master franchise agreement was ever signed: the seller sent potential licensees materials indicating the master franchise agreement was already binding; the seller acquiesced in materials the buyer prepared for potential licensees stating that it Acurrently owns@ a franchise; and the seller=s representative stated in a meeting that the partners of the buyer were Aowners of right for the franchise.@ *COC Servs.*, 150 S.W.3d at 669. The court held that the seller=s conduct did not eclipse the other factors showing lack of intent to be bound absent execution of a master franchise agreement. *Id.* at 669B70.

The *COC Services* court cited *Arcadian Phosphates, Inc. v. Arcadian Corp.*, 884 F.2d 69, 72B73 (2nd Cir. 1989), in which the court concluded that the parties to a memorandum Aagreement@ concerning the sale of certain assets did not intend to be bound until execution of a formal agreement. The court reached this conclusion although the seller, who ultimately refused to consummate the transaction and disavowed existence of a binding contract, engaged in the following conduct after signing the memorandum agreement: obtained its board=s approval of the Aproposed agreement@; informed third-parties of an Aagreed-upon@ sale with a Asigned agreement@; referred to the buyer as the Anew owner@; took various steps to consummate the transaction; and referred to on-going Afinal@ negotiations with an absolute closing date. *See id.* at 71.

We recognize the *COC Services* and *Arcadian* courts did not use the term Awaiver.@ *See generally COC Servs.*, 150 S.W.3d 654; *Arcadian*, 884 F.2d. 69. Nevertheless, their

discussions were similar to a waiver analysis because the courts refused to disregard the parties= expression of no intent to be bound by a preliminary agreement despite one party=s subsequent conduct which might otherwise have shown acknowledgment of a binding contract. *See COC Servs.*, 150 S.W.3d at 669B70; *Arcadian*, 884 F.2d at 71B77. Likewise, ConocoPhillips=s representations of a Adeal@ and promise to negotiate and sign a PSA did not eclipse the bid procedures precluding its acceptance of an offer until execution of the PSA.[13]

b. ConocoPhillips=s actions after the December 11th representations

Additionally, ConocoPhillips=s subsequent actions were insufficient to raise a fact issue on whether the December 11th oral representations constituted waiver of the bid procedures and acceptance of WTG=s offer. To the contrary, ConocoPhillips=s subsequent actions negated that it had waived the procedures and accepted WTG=s offer.

In the trial court, WTG emphasized the following statements in the internal e-mails generated by ConocoPhillips in the days immediately after the December 11th conversation, discussing the decision to proceed with WTG for SAOU, as opposed to a package sale to Targa: AWe are committed to obtain the best value as well as live with our deals@; and ACertainly Targa is a great option if those deals fall apart.@ Even if these references to Adeals@ all meant an agreement with WTG, we employ the same reasoning relative to the e-mails as to the representations in the phone conversation regarding a Adeal.@[14] The e-mails indeed indicated ConocoPhillips had decided at that point to reach a preliminary agreement and continue negotiations with only WTG for SAOU. However, they were not unequivocally inconsistent with ConocoPhillips=s reserving the right to insist on execution of a PSA as prerequisite to forming a *definitive* agreement.

Rather, these e-mails reflected ConocoPhillips=s view that it had not yet formed a binding contract, particularly the references to:

- Astarting down the road@ with WTG;
- Amoving forward with due diligence and PSA negotiations@;
- Agoing down the path@ of a sale to WTG;
- being Amore confident@ of closing with WTG;
- anticipating little risk WTG would Awhittle the price down@; and
- considering Targa as an option if Anegotiations@ and a Adeal[s]@ with WTG should Afall apart.@

Significantly, ConocoPhillips would not have needed to express even the slightest concern that WTG might Awhittle the price down@ or the deal could Afall apart@ if it believed the parties had already formed a contract for the amount of WTG=s final bid.

WTG also relied on the December 22nd e-mail from Engle (Morgan Stanley) to WTG authorizing it to proceed with due diligence and stating, Awe believe the two parties are close enough on the PSA that finalizing that document can be done in an expedious [sic] fashion (most likely during the week of Jan. 5).@ Contrary to WTG=s suggestion, this statement did not show that ConocoPhillips had accepted WTG=s offer and viewed signing a PSA as merely a ceremonial step remaining in the process. In his deposition, Engle explained that Afinalizing@ meant:

> A[T]he two parties would come together . . . and we were always talking about scheduling aside two or three full days to negotiate the outstanding terms of the PSA, but . . . who knows when you get the lawyers in the room negotiating these things, how long that could take, . . . but there were still at least several days away of negotiation from signing the PSA. . . . After having negotiated all of the points, finalizing is when the two sides sign the PSA.

Therefore, the Engle e-mail indicated, at most, that ConocoPhillips intended to engage in negotiating a PSA, which could then be signed by the parties, although this process never materialized. Again, the e-mail was insufficient to show that ConocoPhillips had relinquished its right to withhold its acceptance until the PSA was actually signed.

In fact, the following communications of ConocoPhillips and Morgan Stanley to WTG during late December 2003 and January and February of 2004 negate that ConocoPhillips had waived the bid procedures and accepted WTG bid before execution of a PSA:

- informing WTG that ConocoPhillips was considering another offer several days before the above-referenced December 22nd e-mail from Engle to WTG;
- confirming this fact to WTG on the same day Engle sent the above-referenced e-mail;
- periodically advising WTG regarding the status of negotiations with the other party;
- reminding WTG that ConocoPhillips was allowed to negotiate with another party at any time pursuant to the bid procedures;

- telling WTG it was free to submit a revised bid; and
- referring to WTG as a Agood alternative.@[15]

Finally, we acknowledge the bid procedures were one-sided in ConocoPhillips=s favor. In fact, they also provided that ConocoPhillips=s Ainterpretation of the [bid procedures] shall be final and binding on all parties submitting a Proposal.@ In its summary-judgment response, WTG asserted that ConocoPhillips Aattempt[s] to have everything its way, and to give itself free reign to do whatever it pleases, regardless of what it has said . . . .@ We also acknowledge that, under our reasoning, it would be difficult for WTG to raise a fact issue on waiver short of an express statement of waiver by ConocoPhillips, whether communicated to WTG or formulated internally, or its engaging in partial performance of the contract. Regardless, WTG chose to participate in the process knowing ConocoPhillips precluded its acceptance of a bid, and essentially reserved the right to change its mind, before execution of a PSA.

In sum, ConocoPhillips proved as a matter of law there was no meeting of the minds necessary to form a binding contract because it did not accept WTG=s offer Accordingly, we sustain ConocoPhillips=s cross-point and uphold the summary judgment in its favor.

IV. TARGA=S MOTION FOR SUMMARY JUDGMENT

In its second issue, WTG contends the trial court erred by granting summary judgment on its cause of action against Targa for tortious interference with contract.[16]

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. *Powell Indus., Inc. v. Allen*, 985 S.W.2d 455, 456 (Tex. 1998). In essence, WTG asserts Targa knew, or should have known, about the alleged oral contract between WTG and ConocoPhillips and intentionally interfered by subsequently making a higher offer.

Targa moved for summary judgment on the following grounds: (1) WTG=s claim fails because there was no valid contract between ConocoPhillips and WTG; and (2) WTG cannot prove Targa knew, or should have known, about any contract between WTG and ConocoPhillips and, thus, cannot establish intentional interference. Targa contends it was simply the highest bidder in a competitive auction process that allowed ConocoPhillips to

consider any bid, and negotiate with any party, before execution of a PSA.

In its order, the trial court stated that it granted summary judgment in favor of Targa on the tortious-interference claim because A[t]he Court has found that no contract existed between WTG and ConocoPhillips.@ However, as we have discussed, the trial court actually found a fact issue on existence of a contract but ruled any such contract was unenforceable under the statute of frauds. Therefore, the trial court implicitly denied summary judgment in Targa=s favor on the ground there was no contract. We construe the trial court=s ruling on Targa=s motion as concluding the tortious-interference claim failed because there was no *enforceable* contract under the statute of frauds. The trial court also analyzed Targa=s alternate summary-judgment ground A[i]n the interests of completeness.@ In essence, the court found that Targa, when submitting the December 15th bid, did not know, and had no duty to inquire whether, ConocoPhillips had entered into a contract with another party for sale of the assets and could not be liable for simply making a superior offer.

On appeal, WTG challenges both rulings. Targa presents a cross-point challenging the trial court=s conclusion that a genuine issue of material fact existed on whether WTG and ConocoPhillips entered into a contract. Because we have concluded there was no contract, we agree that, as a matter of law, Targa is not liable for tortious interference. Therefore, we sustain Targa=s cross-point and uphold the summary judgment in its favor.

We affirm the trial court=s final judgment in its entirety.

/s/ Charles W. Seymore
Justice

Panel consists of Chief Justice Hedges and Justices Anderson and Seymore.

---

[1] The ATarga@ entities bought the assets, and Warburg Pincus financed a portion of the purchase. Because the same claims were asserted against these defendants, we refer to them collectively as ATarga.@

[2] The summary-judgment motions, responses, and record in this case are voluminous. We set forth only the facts pertinent to our disposition which nonetheless are somewhat extensive.

[3] WTG also sued Morgan Stanley, and the trial court granted summary judgment in its favor, which WTG does not challenge on appeal.

[4] WTG does not challenge summary judgment on its fraud and negligent-misrepresentation claims.

[5] *See* Tex. Bus. & Com. Code Ann. ' 26.01(a), (b)(4) (Vernon 2009) (providing that a promise or agreement for the sale of real property Ais not enforceable unless the promise or agreement, or a memorandum of it, is (1) in writing; and (2) signed by the person to be charged with the promise or agreement or by someone lawfully authorized to sign for him.@).

[6] *See Nagle v. Nagle*, 633 S.W.2d 796, 800 (Tex. 1982) (recognizing courts will enforce oral promise to sign instrument complying with statute of frauds if (1) promisor should have expected his promise would lead promisee to some definite and substantial injury, (2) such injury occurred, and (3) court must enforce promise to avoid injustice).

[7] Although we need not address the statute-of-frauds issue, in essence, WTG maintains (1) a contract was memorialized in writing through ConocoPhillips=s internal e-mails after the December 11th phone conversation, together with WTG=s PSA and other documents relative to the bid process; or (2) alternatively, ConocoPhillips was estopped to raise the statute of frauds because WTG relied on ConocoPhillips=s promise to sign a PSA when purchasing the complementary facility, missing an opportunity to buy another property, and expending funds on due diligence for SAOU. The trial court concluded that the December 12th e-mail from Mary Pearce to other ConocoPhillips employees included the material terms of an oral contract, if any, either in the e-mail or through incorporation of other documents, and was signed electronically; however, the e-mail did not include sufficient language of assent to show an agreement between the parties. The trial court also rejected the promissory-estoppel argument because (1) there was no evidence of a promise to sign a prepared, written agreement that would satisfy the statute of frauds, *see 1001 McKinney Ltd. v. Credit Suisse First Boston Mortg. Capital*, 192 S.W.3d 20, 29 (Tex. App.CHouston [14th Dist.] 2005, pet. denied); (2) WTG acquired the complementary facility, forfeited the other purchase opportunity, and pursued due diligence on SAOU *after* learning ConocoPhillips was considering another offer; and (3) evidence indicated WTG would have acquired the complementary facility regardless of whether it purchased SAOU.

[8] ConocoPhillips seemed to dispute WTG=s version of the phone conversation. In his deposition, Freeman added details, including ConocoPhillips=s alleged reference to a Adeal@ and Aimmaterial@ PSA changes, that had not been included in WTG=s interrogatory response describing the conversation. ConocoPhillips also disputed that any proposed changes were Aimmaterial.@ The other evidence relative to our contract-formation analysis is undisputed because it consists of the documents relative to the bid process and the parties= documented or undisputed communications before and after the phone conversation. Consistent with our standard of review, we will treat WTG=s version of the phone conversation as correct solely for summary-judgment purposes because, as explained below, we nevertheless conclude there was no fact issue regarding contract formation.

[9] Although these provisions mention Aexecution and delivery@ of a PSA, for ease of reference, we will refer to these steps collectively as Aexecution@ of a PSA.

[10] Despite ConocoPhillips=s disagreement, the trial court suggested that this general principle regarding oral modification of an *existing* contract was applicable to a question of contract *formation*. *See W. Hatcheries v. Byrd*, 218 S.W.2d 342, 343 (Tex. Civ. App.CDallas 1949, no writ) (APower to modify a pre-existing contract is coextensive with the power to initiate it . . . .@ (quoting 10 Tex. Jur. ' 203)). ConocoPhillips also notes the full holding of *Mar-Lan Industries* referred to oral modification of Aa written contract *not required by law to be in writing*.@ 635 S.W.2d at 855 (emphasis added). We need not decide the extent to which a written contract may be modified by oral agreement or whether principles regarding contract modification are applicable here because there is no fact issue on whether ConocoPhillips waived the bid procedures.

[11] Garrett Rychlik, ConocoPhillips=s representative who actually participated in the December 11th phone conversation and was deposed as ConocoPhillips=s corporate representative, expressly testified it did not Achange those procedures.@ However, in a letter filed before the summary-judgment hearing regarding the parties= agreements relative to evidentiary objections, ConocoPhillips=s counsel wrote, ADefendants are willing to limit their reliance on depositions attached as exhibits to their briefs to the specific pages of those exhibits cited within those briefs.@ Rychlik=s entire deposition was attached to ConocoPhillips=s motion for summary judgment, but the above excerpt was not cited in ConocoPhillips=s summary-judgment filings. We note the trial court did not specifically strike all deposition testimony that was not cited in the parties= briefs. Nonetheless, even if we disregard the above excerpt, WTG failed to present any evidence that ConocoPhillips expressly decided to waive the bid procedures.

[12] ConocoPhillips did not sign a PSA with WTG because it received a better offerCnot because the parties failed to agree on additional terms. Nonetheless, ConocoPhillips reserved the right to condition its acceptance on an executed PSA regardless of the reason it might never be executed. Further, as the trial court suggested relative to the statute-of-frauds analysis, despite ConocoPhillips=s purported representations to Freeman on December 11 that its revisions to WTG=s PSA were immaterial, it is unknown whether they truly would have been immaterial once negotiated. As the trial court further recognized, if WTG were unwilling to sign an agreement incorporating ConocoPhillips=s revisions, WTG would likely have been the party claiming ConocoPhillips never accepted WTG=s offer.

[13] We do not necessarily agree that the language in the *Arcadian* memorandum agreement negating contract formation would do so under Texas law. Regardless, we do not cite *Arcadian* relative to the language sufficient to negate intent to be bound absent a final agreement. Rather, we cite *Arcadian* for the proposition that the seller=s conduct after signing the memorandum agreement was insufficient to override language that at least the *Arcadian* court considered sufficient to negate intent to be bound.

[14] Relative to the statute-of-frauds issue, the trial court concluded AWe are committed to . . . live with our deals@ did not clearly mean an agreement with WTG, as opposed to some other agreement or general Asentiment.@ We will assume solely for purposes of the contract-formation issue that this statement referred to a preliminary agreement with WTG because it nonetheless did not raise a fact issue on waiver.

[15] WTG=s post-December 11th communications were somewhat inconsistent regarding whether it believed ConocoPhillips had accepted WTG=s offer. On one hand, Freeman=s asking if WTG would be given the opportunity to submit a revised bid and urging ConocoPhillips to Anegotiate@ and Afinalize@Cnot just Asign@Ca PSA indicated WTG did not view the parties as already having a binding contract for the amount of its final bid. Further, WTG cites no portion of the record reflecting that Freeman insisted ConocoPhillips cease negotiations with the other party because WTG and ConocoPhillips already had a contract. On the other hand, Davis=s letters, stating the parties had an Aagreement@ on price and WTG had been Aselected@ to purchase SAOU and urging ConocoPhillips to Ahonor its commitment to accept our bid,@ arguably support that WTG did view the parties as already having a contract. Regardless of WTG=s beliefs, the issue is whether *ConocoPhillips* waived the pertinent bid procedures because it reserved the right to *unilaterally* change the procedures and was the only party who could do so.

[16] The record reflects WTG conceded in the trial court that summary judgment was appropriate on its claim for tortious interference with business relationship and, on appeal, WTG does not challenge summary judgment on this claim.