The Fraud Carve-Out Revisited - EMSI and its Warnings for Dealmakers

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In private mergers and acquisitions transactions in the United States, it has long been customary to exclude certain kinds of fraudulent conduct from negotiated limits of liability and exclusivity of legal remedies for losses arising out of the transaction, on the theory that the party that is defrauded should not be subject to such negotiated liability limits or be limited in its remedies. Traditionally, “fraud” was simply excluded from the coverage of the liability allocation provisions of the definitive agreement. More recently, however, parties have revisited this so called “fraud carve-out,” including the types of fraud and circumstances in which fraud should be excluded from a liability cap and who should be responsible for such uncapped liability. Without specificity, there is the potential for unintended consequences to the parties of converting claims that ostensibly are covered by the negotiated liability/remedy scheme into uncapped claims and the perceived unfairness of allocating that liability to investors not involved in the operations.[1] The recent case of EMSI Acquisition Inc. v. Contrarian Funds, LLC, et al. is illustrative, particularly for transactions governed by Delaware law.

CASE BACKGROUND

In EMSI, the buyer of EMSI made post-closing indemnification claims against the sellers, the former investors in EMSI, for allegedly fraudulent contractual representations made by managers and employees of the company. Specifically, the buyer claimed that the sellers made intentionally false representations in the purchase agreement regarding EMSI’s financial position by including in its financial statements, and elsewhere in the purchase agreement, inflated volume and process of EMSI’s work-in-process, accelerated revenue recognition for projects EMSI was not yet working on, overstated assumptions about the percentage of contracts completed, and falsified progress of ongoing projects. Buyer and sellers disagreed over whether broad language in the fraud carve-out to the liability cap could render defendant investors, who were not directly involved in the preparation of the incorporated financial information, liable for the fraud. Sellers and buyer also disagreed over whether sellers had the requisite knowledge to be liable for the fraud underlying the breach of representations and warranties. Buyer commenced an action in Delaware Chancery Court based on contractual fraud.

AMBIGUITY IN THE FRAUD CARVE-OUT CLAUSE

The sellers first argued that the buyer’s claims should be dismissed because the purchase agreement contained a general cap on post-closing indemnification claims made by the buyer against the sellers. That cap limited the contractual indemnifications claim to $9.5 million, and had already been reached by claims previously made by the buyer. The buyer maintained that the liability cap should not be applicable to the claims, since the purchase agreement contained a provision that expressly permitted uncapped claims for “any action or claim based upon fraud.”[2] Both the indemnification cap (which sellers believe is applicable to buyer’s claims) and the fraud carve-out (which buyer believes is applicable to its claims) were preceded by a clause stating that each such provision would apply “n[otwithstanding] anything in this Agreement to the contrary...” The inclusion of these competing “notwithstanding” clauses caused the
provisions to directly contradict one another and created ambiguity in the language of the purchase agreement.

In light of the ambiguity in the purchase agreement, the court, in an opinion written by Vice Chancellor Joseph R. Slights, found both buyer’s and sellers’ interpretations of the relevant provisions to be reasonable constructions based on the four corners of the agreement. “[I]nelegant drafting has left the court unable definitively to construe the indemnification provisions of the [purchase agreement] in a manner that would enable final adjudication of this dispute at the pleading stage,” the court concluded.[3] Therefore, the court decided, extrinsic evidence to be discovered through trial is necessary to determine which provision supersedes the other.

**LIABILITY AND KNOWLEDGE**

Sellers also argued that even if the language in the purchase agreement did not support a cap on buyer’s indemnification claims, sellers still should not be found liable because they lacked the knowledge requisite to commit the fraud underlying those same indemnification claims. Specifically, sellers argued the fraud claim underlying buyer’s indemnification claims was not properly pled because “[buyer] has not tied any knowledge of wrongdoing to the corporate agents responsible for making the Company’s representations.”[4] The court rejected this argument and found that buyer’s allegations of sellers’ imputed or actual knowledge of the alleged fraudulent actions had merit. In so holding, the court found that since in the purchase agreement sellers agreed to indemnify buyer “from any and all Losses which any of the Buyer Indemnified Parties may sustain arising out of: (a) any breach of any representation or warranty of such Seller or the Company contained in this agreement …” and since buyer pled that based on the actions of EMSI’s employees and managers, under an agency theory, the company had imputed knowledge of the alleged fraud, the sellers could be found liable for the alleged fraud of the company’s employees.

**THE LESSON FROM EMSI**

EMSI serves as an important lesson that imprecise drafting of liability limitation provisions and the exceptions to such limitations, including fraud carve-outs, can create real and unexpected liability for parties in a M&A transaction. In order to minimize the likelihood of such occurrence, liability limitation and exclusivity of remedy provisions should clearly specify whether, and if any, causes of action are excluded from such provisions. If fraud is to be excluded, the definitive agreement should clearly indicate the kind(s) of fraud that should be so excluded and who should be responsible for such fraud.

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[1] In the context of an M&A transaction, there are two principal forms of potential fraud that should be addressed in the definitive agreement, contractual fraud and extra-contractual fraud. Contractual fraud occurs when a seller knowingly and with the intent to deceive includes or allows its representatives to include false representations and warranties in the definitive agreement. Extra-contractual fraud, by contrast, exists when a seller knowingly makes a misrepresentation about a material fact with the intention to deceive through the negotiating process, but outside of the representations and warranties. For example, extra-contractual fraud may occur through statements made or documents provided in a management presentation, in the confidential information memorandum or through other due diligence discussions or
The court noted that the buyer only brought a claim based on contractual fraud because the purchase agreement contained a non-reliance clause that specifically disclaimed buyer’s reliance on extra-contractual representations. In Delaware, negotiating parties can disclaim extra-contractual fraud through a non-reliance provision. See *Abry Partners V, L.P. v. F&W Acquisitions, LLC*, 891 A.2d 1032 (Del. Ch. 2006) (the court denied plaintiff buyers the ability to make extra-contractual fraud claims when a non-reliance clause is contained in the purchase documents). In *Abry*, the court held that in order for sellers to contract around liability for extra-contractual fraud “[t]he 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.”


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