

Fraud Carve-Out Provisions for M&A Agreements¹

Written By:

Sarah McLean, Partner

Sarah Nealis, Associate

Shearman & Sterling LLP, Houston, TX

One of the most heavily negotiated provisions of a private M&A transaction agreement is the indemnification provision, which governs each party's remedies in the event the other party breaches the agreement. Indemnification provisions commonly provide that such indemnification is each party's sole recourse in the event of breach other than for breaches involving fraud. Such clauses are commonly referred to as "fraud carve-outs".

Fraud carve-outs are intended to protect a buyer in the event the seller lies about matters relating to the transaction that are specifically within the seller's knowledge. However, without careful drafting, a fraud carve-out may result in exposing the seller to post-closing liabilities beyond the intent of the provision. For this reason, a seller should ensure the fraud carve-out provision is drafted to clearly define the post-closing liabilities being preserved.

When drafting a fraud carve-out, a seller can protect itself from unintended post-closing liabilities by addressing at least three key issues within the carve-out provision. First, the term "fraud" should be clearly defined to only include intentional acts and misrepresentations. Without such a definition, the term "fraud" may be broadly construed to include constructive fraud or negligent misrepresentation.

Second, the fraud carve-out should also identify the applicable subject matter of the fraud. The fraud carve-out should only apply to frauds involving the representations and warranties made in the purchase agreement and should not apply to acts or omissions during the negotiation and due diligence phase of the transaction. By limiting the subject matter of the fraud to the four corners of the document, or even a specific section of the document, a seller should have more comfort in understanding its potential post-closing liabilities.

Third, a seller should also consider identifying the individuals who may commit the fraud. A seller may have several employees involved in the due diligence and disclosure process of negotiating and preparing a purchase agreement. For this reason, it is in the seller's best interest to define the particular individuals who may commit a fraud, or have knowledge of the commission of a fraud, for which the seller will have uncapped post-closing liabilities.

Below are three examples of fraud carve-out provisions ranked from good to better to best practices.

Good:

¹ This article was originally published by the Institute for Energy Law in The Energy Law Advisor, Volume 12, No. 3 – October 2018.

Nothing herein shall operate to relieve Seller of any common law liability to Buyer for fraud in the event such Seller is finally determined by a court of competent jurisdiction to have willfully and knowingly committed fraud against any Buyer, with the specific intent to deceive and mislead any Buyer, regarding the representations and warranties made in this Agreement.

Better:

Nothing herein shall operate to relieve Seller of any common law liability to Buyer for Fraud in the event Seller is finally determined by a court of competent jurisdiction to have committed Fraud against any Buyer, regarding the representations and warranties made in this Agreement. For purposes herein, “**Fraud**” shall mean an actual and intentional misrepresentation of a fact with the express intention that the other party rely thereon.

Best:

Nothing herein shall operate to relieve a Seller Party of any common law liability to Buyer for Fraud in the event such Seller Party is finally determined by a court of competent jurisdiction to have committed Fraud against any Buyer; provided, however, in no event shall a Seller Party incur liability for an act of Fraud committed by another Seller Party. For purposes herein, “**Fraud**” shall mean an actual and intentional misrepresentation of fact with respect to the making of the representations and warranties set forth in Article V Seller’s Representations and Warranties, provided that such misrepresentation shall only be deemed to exist if any of the individuals included in the definition of “Knowledge” with respect to such Seller Party, as applicable, had actual knowledge that the representations and warranties made by such Seller Party were actually breached when made with the express intention that the other party relies thereon to its detriment.