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## *Fraud in No Recourse Deals: Traps for the Unwary*

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The Paul Hastings M&A practice recently presented a webinar focused on fraud-related issues that have been present in some acquisition agreements. There are several key considerations to take into account when drafting provisions regarding fraud, which have been included below. Please reach out to Jason Rabbitt-Tomita or Rick Horvath to discuss any of these issues in more detail, or if you would like a copy of the initial presentation.

1. **Fraud as the Only Remedy.** Although already common in private equity deals, sellers in strategic M&A deals are increasingly requesting “no recourse” agreements, where the seller provides no indemnity. In no recourse deals, “fraud” is typically the buyer’s only remedy for breach of representations and warranties. This places increased importance on the definition of fraud, which is often heavily negotiated.
2. **Defining Fraud.** Practitioners should pay careful attention to how fraud is defined in the agreement. That definition could significantly expand or narrow the scope of the buyer’s remedies, as well as the sellers’ exposure.

In order to negotiate the definition of Fraud, it essential to know the default common law definition of fraud (and without regard to other species of misleading representations), which, in Delaware, is as follows:

- a false representation or omission of fact there was a duty to disclose;
  - knowledge or belief that the representation was false or made with reckless indifference to truth;
  - intent to induce a person’s action or refrain from action;
  - the other person acted (or refrained from acting) with justifiable reliance on the representation; and
  - was injured by that reliance.
3. **Intentional Fraud vs. Reckless Indifference.** Of the elements for common law fraud, scienter—whether a misstatement was made knowingly or with a reckless indifference to the truth of the statement—often plays a significant role in contractual definitions of fraud.

In particular, Sellers often will seek to limit the definition of fraud to intentional fraud, thereby removing exposure for fraud claims for reckless indifference to the truth. Reckless indifference could encompass, for example, potential red flags that appeared to the seller prior to entry into the agreement, even if the seller did not have actual knowledge of a falsehood.

4. **How other elements of fraud are limited/changed.** As set forth in the following chart, practitioners may negotiate other limitations to the elements of Delaware common law fraud:

	<u>Common Law Definition of Fraud</u>	<u>Negotiated Limitations</u>
<b>Scope of reps</b>	<ul style="list-style-type: none"> <li>False representation / omission of fact where there was a duty to disclose</li> </ul>	<ul style="list-style-type: none"> <li>Limit to representations in the agreement only and exclude extra-contractual items</li> <li>Limit to parties to the agreement</li> </ul>
<b>Intent</b>	<ul style="list-style-type: none"> <li>Knew or believed representation false or made with reckless indifference to truth</li> </ul>	<ul style="list-style-type: none"> <li>Limit to intentional fraud</li> <li>Exclude reckless indifference</li> <li>Limit to actual knowledge of specified persons</li> </ul>
<b>Inducement / reliance</b>	<ul style="list-style-type: none"> <li>Intent to induce a person's action or refrain from action, and that person acted (or refrained from acting) with justifiable reliance on the representation</li> </ul>	<ul style="list-style-type: none"> <li>Add disclaimers that buyer did not rely on extra-contractual statement</li> <li>For any fraud claim, require buyer to have had no knowledge of the falsity of a representation so as to prohibit buyer sandbagging with respect to Fraud claims</li> </ul>
<b>Damages</b>	<ul style="list-style-type: none"> <li>Injured by that reliance</li> </ul>	<ul style="list-style-type: none"> <li>Include limitation on liabilities</li> </ul>
<b><u>Other</u></b>	<ul style="list-style-type: none"> <li>Other types of "fraud"</li> </ul>	<ul style="list-style-type: none"> <li>Exclude constructive fraud, equitable fraud, unfair dealings fraud, promissory fraud, negligent misrepresentation or omission, recklessness or negligence</li> </ul>

5. **Know what counts; common approaches.** Although certain limitations in the above chart may appear in heavily negotiated agreements, a common formulation is for fraud to be defined simply by reference to common law fraud, but limited to intentional fraud or excluding reckless indifference. Another approach is to define fraud by spelling out each of the separate elements of common law fraud, but leave out reckless indifference.
6. **"Missing" provisions from indemnity deals.** No recourse deals often omit limitations on buyer remedies that were common in indemnity deals, such as (i) provisions around clarifying

and limiting a selling stockholders' liability for the fraud of other parties; (ii) provisions prohibiting buyer reliance on representations outside of the four corners of the agreement; (iii) caps on sellers' liability; and (iv) prohibitions on buyer's ability to make claims for known breaches (sandbagging). As shown in the above chart, some of these provisions may make their way back into the agreement through the definition of fraud.

7. **Expansive ownership of privilege provisions.** The ability to make a post-closing fraud claim may be impeded by contractual provisions around who owns and who can use "privileged" communications. In a Delaware merger, ownership of attorney-client privilege passes to the acquirer, unless the contract provides otherwise. The attorney-client privilege generally applies only to those communications which are for the purpose of obtaining or receiving legal advice. However, Sellers will often propose that they retain ownership and exclusive use of an expansively defined set of "privileged" communications, which includes **all** pre-closing communications with target counsel (whether or not actually subject to the attorney-client privilege). In such event, after the closing, an acquirer may uncover documents critical to support a fraud claim that, by contract, the acquirer is prohibited from using, even though those documents would not normally be covered by attorney-client privilege.

Note that, in Delaware, the default rules for ownership of privilege in an asset purchase are different—the seller retains the privilege unless the contract provides otherwise. However, typical provisions in an asset purchase may result in privileged materials being transferred to an acquirer.

A practitioner who is familiar with the common law definition of fraud, and who pays careful attention to how "fraud" is defined in the agreement, will be well prepared to negotiate the narrow set of remedies available to a buyer in a no recourse deal.



*If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings lawyers:*

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