Buyer Side Representation & Warranty Insurance Policies – Subrogation Rights

As the market for Representation & Warranty insurance matures and large pay outs on such policies are being made, there have been occasions where there is evidence that certain of the sellers had historically received evidence from management of the portfolio companies they sold of the transactions or behavior that gave rise to the claims. Typically, Buyer Side Representation & Warranty Insurance Policies provide a right of subrogation against the seller in the event the insurer must pay the insured under the policy. After making a payment to the insured, the insurer succeeds to the rights of the insured against the seller, such as they are. Acquisition agreements generally provide that the indemnification provisions therein, subject to the cap on indemnification (often equal to the amount escrowed by the seller), is the maximum amount that can be recovered as indemnifiable loss, subject to certain exceptions. A common exception to the exclusive remedy provision is in the event of "fraud."

In cases where the acquisition agreement provides an exclusion for "fraud," the normal Delaware scienter standard applies. In the recent case of *Prairie Capital III L.P. v. Double E. Holding Corp*., 2015 Westlaw 4461807 at 13 (Del. Ch. 2015), the Court cited the pleading standard for fraud as stated in *Stephenson v. Capano Dev., Inc.*, 426 A, 2d 1069, 1074 (Del 1983):

> A claim for fraud requires (i) a false representation, (ii) *the defendant's knowledge of or belief in its falsity or the defendant's reckless indifference to its truth*, (iii) the defendant's intention to induce action based on the representation, (iv) reasonable reliance by the plaintiff on the representation, and (v) causally related damages. [Emphasis added]

According to this line of cases, if the seller had actual knowledge of the falsity of a statement made by it or the company it was selling, or the seller was recklessly indifferent to the falsity of the statement, and an exclusion for "fraud" was provided in the acquisition agreement, the exclusive remedy provisions of the agreement will not impair the rights of the buyer, or the subrogated insurer, to make claims against the seller for the entire loss.

In certain transactions, however, the parties choose not to provide an exception for "fraud" in the exclusive remedy provisions. In *Abry Partners V, L.P. v. F & W Acq. LLC*, 891 A 2d 1032 (Del. Ch. 2006), the Delaware Chancery Court held that even in the absence of an explicit fraud exclusion to the exclusive remedy clause, the public policy of the state of Delaware will impose a remedy outside of the limitations cap for a seller's actual knowledge of the falsehood of its representations or those of the company it is selling. But the proof merely of a scienter standard of recklessness or negligence by the seller will not in the absence of an explicit exclusion for fraud in the agreement be sufficient for the buyer or its insurer to avoid the limitations set by the exclusive remedy clause. Delaware courts exert every effort to carry out the expressed bargain of the parties and are loathe to undermine a bargain reached by sophisticated parties. Nonetheless, there is a limit to how far parties can go in absolving one another of fraud, and actual knowledge is that bright line. Justice Strine held that even where parties had agreed not to provide any relief from the indemnification cap in an agreement, Delaware public policy mandates that a seller cannot bargain away its responsibility for what it actually knew:

> 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…. 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. *Abry Partners* at 1065.

There may yet exist a form of acquisition agreement that would make a court sympathetic to the grant of equitable or tort based remedy where a buyer's loss is great, the seller was negligent (it should have known of the fraud), or grossly negligent, and the seller was paid for the transfer of the entirety of the company that perpetrated the fraud to an innocent buyer. The analysis of the terms of the agreement and the atmospherics are extremely important in deciding whether it would be possible to distinguish a particular set of facts from the already decided cases in this area.

Another issue to consider is that not all exclusive remedy provisions are effective. An insurer that has paid the buyer's loss may, pursuant to a properly constructed subrogation right in a policy, recover against the seller for conscious or reckless misrepresentations outside the representations set forth in the acquisition agreement if the integration clause in the acquisition agreement does not amount to a clear promise of the buyer not to rely upon statements made outside the four corners of the acquisition agreement. *True Blue, Inc. vs. Leeds Equity Partners IV, L.P.*, 2015 WL 5968726 (Del. Sup. Ct. 2015). Careful analysis of the terms of the acquisition agreement, as well as the data room, management presentation and other documents provided to the buyer during the sale process are critical in determining whether subrogation rights exist in favor of the insurer in the absence of a properly constructed integration clause.