Global Arbitration Review

The Guide to M&A Arbitration - Sixth Edition

Navigating fraud carve-outs and risk allocation in M&A agreements

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M&A disputes can be unique in their hostility and complexity. The Guide to M&A Arbitration is a practical guide for merger parties on possible disputes. It pools the wisdom of specialists on how to prevent those arising at all, and how best to resolve them when it is too late.

The Guide is in two sections. The chapters in Part I explore planning and procedural issues, covering everything from drafting clauses to how to structure contracts to avoid disputes. Part II offers a geographical survey of important differences in national laws that may affect the outcome of a dispute.

The chapters are written by specialists from a variety of backgrounds and offer practical advice throughout.

Generated: September 10, 2026

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Navigating fraud carve-outs and risk allocation in M&A agreements

Michael M Farhang and **George B Adams**
Gibson, Dunn & Crutcher LLP

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INTRODUCTION

A central question facing parties to M&A transactions is how to allocate the economic risks of unexpected eventualities that affect the purchased entity. Buyers typically wish for these risks to remain with sellers, who in turn may try to shift them to the buyer. The role of contractual representations and warranties, and related fraud carve-out provisions, in this allocation process is key – giving each side some degree of assurance that there will be definition around responsibilities and potential liability in the event of a dispute.

Parties should focus their drafting efforts so that the contract will clearly guide what happens when a contractual representation or warranty turns out to be wrong. Because not all false statements arise from fraud, the governing law and the terms of the parties' agreement – in particular, whether the agreement addresses claims for intentional or reckless misrepresentations – will affect the contours of the dispute. The first section below discusses representation and warranty claims generally, including the circumstances when a claim for fraud may arise. The second section focuses on related forum and choice of law considerations. The third section discusses key terms that drafters may wish to consider when formulating fraud carve-out provisions in a purchase or merger agreement.

OVERVIEW OF REPRESENTATION AND WARRANTY CLAIMS

Representations and warranties are standard terms in most M&A agreements. They are typically short, affirmative statements or guarantees about material issues regarding the target entity made by the seller, buyer or target company. Their purpose is to help balance risk between the transaction parties. For example, the seller's (or target company's) representations and warranties – which tend to be more extensive and robust given that they relate to the entity being sold – typically affirm specific facts about the assets and liabilities of the business, its financial condition, its contracts and business relationships, and other matters that may be material to the buyer. These representations help allocate risk between the parties regarding the possibility that the state of the business is different from what is anticipated.

The agreement will typically set out the first required steps once a breach of representation is discovered, including the requirements for providing notice to the other party, or parties, and asserting a claim for damages or indemnification under the purchase agreement, assuming the agreement provides for such a remedy. Some purchase agreements may provide for no direct recourse at all outside a common law fraud claim. Even where recourse is provided for, purchase agreements often impose limits or caps on the parties' liability for breaches of representations or warranties. These limits may be tied to a dedicated escrow account funded by a portion of the purchase price or to funds withheld from the initial purchase price payment, used in either case to remedy breaches that may occur within a fixed period following closing.

To recover damages beyond contractual limits or where indemnification is not available, buyers may provide for recovery through dedicated insurance policies applicable to this specific type of issue – termed representation and warranty (RWI) insurance – by purchasing a policy pre-closing. RWI policies provide coverage up to fixed limits, with excess coverage also available as an additional purchase. RWI policies have become increasingly common during the past decade as a replacement or supplement for seller liability.[1] RWI policies do not require a showing of seller (ie, knowledge) regarding the falsity of representations and warranties to trigger coverage, and the policies insure buyer losses above deductibles and below policy limits, subject to certain exclusions. M&A agreement terms can be harmonised with such policies by structuring orders of recovery to prioritise buyer recovery from RWI policies prior to any recovery from the seller.

Another option is for a wronged party to seek damages through a claim based on fraud. In US jurisdictions, this could be framed as either (1) a tort claim based on the applicable state common law (ie, common law fraud) or (2) as a contractual indemnification claim without normal limits or deductibles based on a carve-out provision excluding defined fraud from such strictures. In either case, these claims may expand the range of remedies and damages available. Under the law of the state of Delaware, for instance, a common buyer remedy for fraudulent misrepresentation is "expectation – or benefit-of-the-bargain – damages[,] … measured by the amount of money that would put the plaintiff in the position it would have held if the defendant's representations were true".[2] Another approach is an out-of-pocket measure of damages, which is "designed to restore the plaintiff to his financial position before the transaction occurred".[3] Parties commonly engage qualified experts to calculate damages and these experts may use a range of recognised methodologies, including a multiple of earnings metric, a discounted cash flow, an analysis of comparable companies, or others.[4]

A fraud claim may come into play where the losses or damage from the breach exceed the available recovery from indemnification or insurance. A RWI insurer may also seek recovery on a fraud claim by subrogation when it has already paid out on a representation and warranty claim. The precise elements needed to prove fraud vary by jurisdiction. Delaware, for example, requires five elements:

> (1) [the] defendant made a false representation, usually one of fact; (2) the defendant knew or believed that the representation was false, or made it with reckless indifference to the truth; (3) the defendant's false representation was intended to induce the plaintiff to act or refrain from acting; (4) the plaintiff's action or inaction was taken in justifiable reliance upon the representation; and (5) the plaintiff was damaged by such reliance.[5]

In many US jurisdictions, a party asserting fraud must meet a heightened pleading standard, requiring a plaintiff to allege facts at the outset of the case that support a rational inference of the defendant's fraud, including particularised facts showing "the time, place, and contents of the false representations; the facts misrepresented; the identity of the person(s) making the misrepresentation; and what that person(s) gained from making the misrepresentation".[6] As discussed further in the next section, the parties' choice of forum and law is a critical issue that bears directly on how the transaction parties intend to allocate the economic risk of fraud.

FORUM CONSIDERATIONS

The particular rights and remedies available when a representation or warranty is breached will be shaped in the first instance by the purchase agreement's choices of the applicable law for interpreting its terms and the available forum for disputes (ie, where claims can be brought). Agreements utilise "governing law" and "forum selection" clauses that designate the law (eg, federal or state) that governs construction of the purchase agreement and the specific forums or courts where disputes between the parties arising out of or relating to the purchase agreement can or must be brought. Because more than two-thirds of Fortune 500 companies are incorporated in the US state of Delaware,[7] Delaware law and Delaware state courts (typically the Delaware Court of Chancery) are frequent law and forum choices for parties to M&A transactions in the United States. US courts, including in Delaware, generally defer to the parties' choice of governing law and forum and usually enforce such terms.[8] Some foreign jurisdictions, including Canada and the United Kingdom, show similar deference to contractual choice-of-law provisions,[9] though other jurisdictions, such as China, may limit choice-of-law provisions and require additional proof – such as proof that one or both parties are foreigners – before enforcing a choice-of-law provision designating a foreign law.[10]

In negotiating the choice of forum and law, parties should take care to understand how their rights and remedies may be affected. For example, Delaware courts have recognised an especially strong tradition of freedom of contract, and allow parties to explicitly disclaim liability for statements made outside the agreement itself (including in diligence discussions or data rooms) and even for conduct that is grossly negligent so long as the agreement clearly states that the parties disclaim all reliance upon such statements.[11] By comparison, New York law requires more specific disclaimers. Non-reliance provisions may not necessarily preclude a claim of justifiable reliance on misrepresentations or omissions under New York law unless "(1) the disclaimer is made sufficiently specific to the particular type of fact misrepresented or undisclosed; and (2) the alleged misrepresentations or omissions did not concern facts peculiarly within the seller's knowledge".[12]

Other differences exist outside the United States. For example, some common law jurisdictions, such as Canada and the United Kingdom, include "buyer beware" principles in their regulation of private commercial relationships, allowing contractual limitations on liability and remedies or otherwise narrowing disclosure obligations.[13] By comparison, civil law jurisdictions tend to be more protective of buyers; for example, the threshold for liability due to intentional misstatements in Germany is comparatively low and may be met where the speaking party is merely aware of a possibility that the statement is incorrect, but makes the statement anyway.[14] In addition, German law does not permit parties to contractually eliminate liability for intentional misstatements.[15]

Rather than a judicial forum for potential disputes, parties may wish to include an arbitration provision in their agreement to cover future disputes. Delaware courts have explained that "arbitration provision[s are], in effect, a specialised kind of forum selection clause" and "serve a similar function".[16] Arbitration is a common contracted-for method of dispute resolution relating to M&A agreements and such provisions may be particularly useful in international transactions outside the United States, as global conventions generally consider such provisions to be presumptively valid and enforceable.[17] It should be noted that the enforceability of non-arbitration forum selection provisions by non-US courts and tribunals is not as settled and may differ depending on the applicable legal system and national laws.[18]

For parties opting for arbitration, selecting the right arbitral forum or arbitral organisation is also important, as differences can be significant. Agreements may permit claims to be resolved by a single arbitrator or by panels or tribunals with multiple members. Arbitral organisation rules may specify discovery rules and practices, whether pre-hearing dispositive motions are allowed, the speed and timeline of the arbitration, whether awards are subject to review or appeal, expert procedures and discovery, and trial or hearing logistics. For example, the rules of the International Centre for Dispute Resolution (ICDR) – one of the major international arbitration institutions – state that the tribunal "shall allow" early dispositive motions:

> if it determines that the application (a) has a reasonable possibility of succeeding, (b) will dispose of, or narrow, one or more issues in the case, and (c) that consideration of the application is likely to be more efficient or economical than leaving the issue to be determined with the merits.[19]

By comparison, the international arbitration rules for JAMS – another major international arbitration institution – gives arbitrators greater discretion and provides that early dispositive motion "may" be permitted if (1) "the requesting party has shown that the proposed motion is likely to succeed and dispose of or narrow the issues in the case" or (2) the "Tribunal … determine[s] that any claim or defense is outside of the jurisdiction of the Tribunal or manifestly without merit".[20]

Both the ICDR and JAMS – as well as other arbitration institutions – provide model clauses for designating arbitration under each institution,[21] and typically permit the arbitral tribunal to rule on issues of its own jurisdiction.[22] Likewise, many arbitral organisations, including the ICDR and JAMS, affirm in their rules that the arbitrator or tribunal will apply the law or rules of law agreed to by the parties in the governing arbitration provision.[23] Before selecting a particular arbitral organisation, parties should carefully review that institution's operative rules and may want to make clear in the agreement that the rules in effect as of the agreement will govern any future dispute, thereby avoiding ambiguity or uncertainty if an organisation's rules are later amended.

DRAFTING FRAUD CARVE-OUTS

Fraud carve-outs preserve the buyer's right to recover under the parties' contract for fraudulent conduct above and beyond contractual limitations on liability that may otherwise apply. By comparison, such carve-outs typically do not affect the buyer's ability to pursue common law or other statutory claims for intentional fraud under governing laws, and most jurisdictions prohibit a seller from eliminating liability for intentional fraud through clever drafting.[24]

DEFINING FRAUD

Fraud carve-outs are defined terms governing extra or additional remedies in the case of intentionally false representations and warranties and can modify the standard for fraud under the governing law. For instance, a fraud carve-out may specify a different level of required intent or *scienter* than the applicable governing law. In Delaware, for example, a contractual proviso that fraud means only "deliberate" or "intentional" fraud in the making of a representation and warranty has been upheld as eliminating liability for recklessness under that agreement.[25] Accordingly, a party wishing to exclude recklessness from a fraud carve-out may wish to include in the provision or in a separate definition language to the effect that fraud means only "actual and intentional fraud with respect to the making of an express representation or warranty" and to expressly preclude recklessness as a qualifying factor.[26]

Carve-out provisions can also modify the legal standard for fraud by specifying that damage must be "material" or meet some other threshold to be actionable under the agreement's contractual remedies. In addition, the parties may wish to expressly eliminate contractual recovery for certain types of fraud that may otherwise be permitted under the governing law, such as promissory fraud, negligent fraud, constructive fraud and fraud based on principal-agency liability, among others.

DEFINING "KNOWLEDGE" AND "KNOWLEDGE PARTIES"

In drafting fraud carve-outs to contractual indemnification claims, the parties may also consider carefully defining what constitutes "knowledge" of fraud under the carve-out. For example, where the intent is to require an objective (and not subjective) standard for knowledge, the parties to an agreement governed by Delaware law can consider defining knowledge as "actual knowledge (and not imputed or constructive knowledge) … of the inaccuracy of [the covered] representation or warranty".[27] The parties may also wish to limit knowledge to specified persons or parties, which then become the relevant "knowledge parties" or "knowledge group" when evaluating claims for fraud – limiting liability where, for example, other employees not part of the knowledge group may have had pertinent information that was not communicated to management or to the sellers.

DISCLAIMING RELIANCE

As noted above, a further consideration is whether to limit contractual remedies for fraud (both contractual and common law) to the contractual representations and warranties contained in the purchase agreement itself (as opposed to extra-contractual statements) through a "non-reliance" provision.

Where the parties wish to preclude fraud claims based on extra-contractual statements, they should be mindful of the governing law, as different jurisdictions may approach non-reliance provisions differently. In Delaware, non-reliance language may not be deemed effective unless it contains a specific promise by the buyer that it is not relying on extracontractual representations by the seller.[28] Even language providing that the buyer agrees that the seller has not made extracontractual representations has been held insufficient to bar reliance on representations outside the agreement's terms.[29] As a result, unless sellers insist upon specific language stating that the buyer agrees it has not relied upon representations outside the four corners of the agreement, the ability to limit such reliance in the case of a later fraud claim is questionable. One example of language held to be sufficient is the following:

> [Buyer] is not relying (for purposes of entering into this [a]greement or otherwise) upon any advice, counsel or representations (whether written or oral) of the [s]eller[ ] ... other than those representations expressly made hereunder.[30]

Careful drafting of anti-reliance disclaimers is therefore advisable to ensure predictability about whether written or oral representations in different contexts (including diligence discussions and in virtual data rooms) can serve as the basis for later fraud claims.

CONCLUSION

While preserving recourse in the case of business-related fraud may seem straightforward in principle, in practice it can be a complex and nuanced endeavour. This is particularly true in the context of M&A disputes, where claims for fraud may run headlong into robust and heavily negotiated contract terms intended to allocate the economic risks of unexpected events or outcomes. In addressing and accounting for the risk of fraud in a transaction, the parties should give careful thought to their choice of forum (including court versus arbitration), the choice of law and the drafting of any fraud carve-out. With respect to the latter, the way that fraud and the elements of knowledge and reliance are defined and potentially limited will have a direct effect on the parties' rights and remedies if something later goes wrong. Further, defining what is and is not the subject of justifiable reliance in an M&A transaction is key. All these issues should be approached with care and diligence and parties will be well served by looking to clear guidance – including the case law and evolving market standard language – in drafting their agreement terms. Adhering to such guidance may prove to be determinative in the outcome of later disputes.

ENDNOTES

[1] See "Mind the (Coverage) Gap", Wilmington Trust, https://www.wilmingtontrust.com/library/article/rwi-policies-mind-the-coverage-gap; see also "Announcing the ABA's 2025 Private Target Mergers & Acquisitions Deal Points Study", American Bar Association, https://www.americanbar.org/groups/business_law/resources/business-law-today/2025-december/aba-2025-private-target-mergers-acquisitions-deal-points-study.

[2] See ***NetApp, Inc. v Cinelli***, No.2020-1000-LWW, 2023 WL 4925910, at *17 (Del. Ch. Aug. 2, 2023).

[3] ibid. (internal quotation marks omitted).

[4] id. at 23 (assessing competing expert submissions on projected cash flow and fair market value and awarding "damages based upon the diminution in value [plaintiff] experienced because of [seller's] misrepresentations").

[5] ***Oglesby v Conover***, No.CIV.A. K10C08017 RBY, 2011 WL 3568276, at *3 (Del. Super. Ct. May 16, 2011) (internal quotation marks omitted).

[6] See ***Valley Joist BD Holdings, LLC v EBSCO Indus., Inc.***, 269 A.3d 984, 988 (Del. 2021); see also N.Y. C.P.L.R. 3016 (***McKinney***); ***Lazar v Superior Ct***, 12 Cal. 4th 631, 645 (1996).

[7] "A Message from the Secretary of State Charuni Patibanda-Sanchez", Delaware Division of Corporations, https://corp.delaware.gov/stats.

[8] See, eg, ***Coface Collections N. Am. Inc. v Newton***, 430 F. App'x 162, 166 (3d Cir. 2011) (noting "it is only in rare circumstances that Delaware courts do not honor the choice-of-law provisions agreed to by parties in a binding contract"); ***Masimo Corp. v Kiani***, No.2024-1086-NAC, 2026 WL 1080396, at *5 (Del. Ch. Apr. 21, 2026).

[9] Ted Frankel, Colin Pendrith and Robert Sniderman, "Canada", ***The Guide to M&A Arbitration*** (Fifth Edition, Global Arbitration Review (GAR)), https://globalarbitrationreview.com/guide/the-guide-ma-arbitration-archived/5th-edition/article/canada; William Hooker and Irene Ding, "United Kingdom", ***The Guide to M&A Arbitration*** (Fifth Edition, GAR), https://globalarbitrationreview.com/guide/the-guide-ma-arbitration-archived/5th-edition/article/united-kingdom.

[10] Yan Zhang and Michael Wang, "China", ***The Guide to M&A Arbitration*** (Fifth Edition, GAR), https://globalarbitrationreview.com/guide/the-guide-ma-arbitration-archived/5th-edition/article/china.

[11] See, eg, ***Express Scripts, Inc. v Bracket Holdings Corp.***, 248 A.3d 824, 830-32 (Del. 2021); ***Abry Partners V, L.P. v F & W Acquisition LLC***, 891 A.2d 1032, 1058-59 (Del. Ch. 2006); see also ***Maka v Musial***, No.N24C-06-155 PRW CCLD, 2025 WL 1744936, at *7 (Del. Super. Ct. June 11, 2025) (explaining that Delaware courts "use a pragmatic approach to analyzing [non-reliance provisions], and no 'magic words' are required").

[12] See, eg, ***Basis Yield Alpha Fund (Master) v Goldman Sachs Grp., Inc.***, 115 A.D.3d 128, 137 (2014).

[13] See Frankel, et al., supra note 9; see Hooker and Ding, supra note 9.

[14] Michael Rohls, "Germany", ***The Guide to M&A Arbitration*** (Fifth Edition, GAR), http://globalarbitrationreview.com/guide/the-guide-ma-arbitration-archived/5th-edition/article/germany.

[15] ibid.

[16] See, eg, ***Anew Ventures II, LLC v Terra Glob. Inv. Mgmt., LLC***, No.N25C-05-094 MAA, 2025 WL 3188312, at *6 (Del. Super. Ct. Nov. 14, 2025).

[17] See, eg, Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958) (New York Convention), https://uncitral.un.org/en/texts/arbitration/conventions/foreign_arbitral_awards.

[18] For example, while the Convention of 30 June 2005 on Choice of Court Agreements entered into force in 2015, many countries, including the United States and China, have yet to ratify it. See Status Table, "37: Convention of 30 June 2005 on Choice of Court Agreements", Hague Conference on Private International Law, https://www.hcch.net/en/instruments/conventions/status-table/?cid=98.

[19] International Centre for Dispute Resolution (ICDR), "International Dispute Resolution Procedures – Amended and Effective March 1, 2021" (ICDR Rules), Article 23(1).

[20] JAMS, "International Arbitration Rules and Procedures" (JAMS Rules), Article 25.

[21] See, eg, ICDR Rules at 6-7; JAMS Rules, Standard JAMS International Arbitration Clause, https://www.jamsadr.com/international-arbitration-rules#Article1.

[22] See, eg, ICDR Rules, Article 21(1); JAMS Rules, Article 17.1.

[23] ICDR Rules, Article 34(1); JAMS Article 18.1.

[24] See, eg, ***Online HealthNow, Inc. v CIP OCL Invs., LLC***, No.CV 2020-0654-JRS, 2021 WL 3557857, at *18 (Del. Ch. Aug. 12, 2021) ("Sellers cannot invoke a clause in a contract allegedly procured by fraud to eviscerate a claim that the contract itself is an instrument of fraud."); see also ***Persson v Smart Inventions, Inc.***, 125 Cal. App. 4th 1141, 1153 (2005) (similar).

[25] See, eg, ***Express Scripts, Inc. v Bracket Holdings Corp.***, 248 A.3d 824, 834 (Del. 2021) (finding a carve-out for "deliberate" fraud did not cover a claim based on recklessness).

[26] *PPG Holdco, LLC v RAC PPG Buyer LLC*, No. 2025-0240-EMD, 2026 WL 1210271, at *10–11 (Del. Ch. Apr. 23, 2026) (finding this "definition provides for intentional fraud … . Reckless indifference does not suffice").

[27] eg, ibid. (holding this language requires "clear and direct knowledge").

[28] eg, *Labyrinth, Inc. v Urich*, 2024 WL 295996 * 15–19 (Del.Ch. 2024).

[29] id. at 15–19.

[30] *ITW Glob. Invs. Inc. v Am. Indus. Partners Capital Fund IV*, 2015 WL 3970908, at *8–9 (Del. Sup. Ct. June 24, 2015).

GIBSON DUNN

Michael M Farhang mfarhang@gibsondunn.com
George B Adams gadams@gibsondunn.com

http://www.gibsondunn.com/