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CONTRACT PRODUCTION IN M&A MARKETS

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Contract scholarship has devoted considerable attention to how contract terms are designed to incentivize parties to fulfill their obligations. Less attention has been paid to the production of contracts and the tradeoffs between using boilerplate terms and designing bespoke provisions. In thick markets everyone uses the standard form despite the known drawbacks of boilerplate. But in thinner markets, such as the private deal M&A world, parties trade off costs and benefits of using standard provisions and customizing clauses. This Article reports on a case study of contract production in the M&A markets. We find evidence of an informal information network that transforms bespoke changes in contract terms into industry-wide standard provisions. This organic coordination structure leads to both market-wide coordination as well as a diversity in this response as individual actors implement bespoke variations of the new standard.

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INTRODUCTION

Two separate economic objectives motivate the parties who form commercial contracts.[1] A primary objective is to design contracts that induce the parties to maximize the joint gains from transactions. This is the goal of efficient contract *design*.[2] But contracting parties also pursue a second objective: they must conceive and formulate the many legal terms and conditions that implement their contract design. This is the goal of efficient contract *production*. Until recently, the efficient production objective has been largely unexplored. We know a great deal about how to design contracts to motivate parties to invest optimally in their relationships, but we know less

1 Portions of the Introduction & Part I draw from Robert E. Scott, *The Paradox of Contracting in Markets*, 83 LAW & CONTEMP. PROBS. 71 (2020).

2 *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 544-45 (2003) ("[C]ontract law should facilitate the efforts of contracting parties to maximize the joint gains . . . from transactions [by solving the] canonical 'contracting problem' of ensuring both efficient ex post trade and efficient ex ante investment . . . .").

about the process of producing the widely-used contract terms that implement the efficient design.[3] This is unfortunate because the production process is the source of a fundamental tradeoff: the factors that generate efficiencies in the production of contracts—standardization and economies of scale—are the same factors that can undermine efficient design by instantiating contract terms that do not (or no longer) maximize the parties' joint gains. And the reverse is true: customized efforts to formulate terms that implement an efficient design necessarily generate the inefficiencies in contract production that result from the inevitable loss of scale. As a consequence, while parties in thin markets may prefer more bespoke contracts that minimize errors in design, parties in thick markets, where more and more parties participate in the same or similar transactions, may prefer standardization and economies of scale even at the risk of an increase in design errors.[4]

Recognizing this tradeoff is the first step toward answering an unresolved question: how do contracting parties optimize between the efficient contract production and efficient contract design? The challenge is to exploit production efficiencies without degrading the contract design that motivates efficient performance.[5] In understanding how commercial parties respond to this tradeoff we can begin with a more precise identification of the production costs of contracting. Contract drafters that are faithful agents are motivated to optimize two principal costs: the cost of production efforts and design error

3 For examples of efforts to understand the production problem, see Stephen J. Choi, Mitu Gulati & Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate*, 67 DUKE L.J. 1, 12-14 (2017) (exploring how certain contract provisions are created and evolve over time); *see also* Robert Anderson & Jeffrey Manns, *The Inefficient Evolution of Merger Agreements*, 85 GEO. WASH. L. REV. 57, 59-61 (2017) (analyzing the evolution and relatedness of public company merger agreement language); Barak Richman, *Contracts Meet Henry Ford,* 40 HOFSTRA L. REV. 77, 85-86 (2011) (postulating that organizational tendencies toward the routine may explain the reproduction of boilerplate language in contracts); D. Gordon Smith & Brayden G. Smith, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 2 (2009) (arguing that recent studies of contract language have been too narrowly focused on economic theories of contracting and should take organizational theory into account); Kevin E. Davis, *Interpreting Boilerplate* 1-2 (N.Y.U. Ctr. for L., Econ., & Org., Working Paper No. 10-21, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1618925 [https://perma.cc/JCE9-SBDU]; Weija Rao & Cree Jones, *Sticky BITs*, 61 HARV. INT'L L.J. 357, 360 (2020) (analyzing national uptake of new bilateral treaty provisions in response to unexpected judicial treaty interpretations); Julian Nyarko, *Stickiness and Incomplete Contracts*, 88 U. CHI. L. REV. 1, 6-7 (2021) (identifying and explaining the absence of bargaining over dispute settlement clauses in commercial transactions).

4 For our purposes, a market is thick when many parties participate in similar transactions and will benefit from coordinated responses to the contracting environment. Thus, a market thickens when more and more parties participate in the same or similar transactions.

5 As we discuss in Part I, when markets are thick in the sense that many actors face similar challenges in their dealings, the affected parties often will institutionalize their innovative contract forms and terms through collective action. *Infra* Part I.

costs.[6] Efforts and error costs are substitutes: the more time and effort a drafter spends in producing a contract, *ceteris peribus*, the lower the risk of design error. Conversely, the less time and effort invested in production the higher the risk of unwanted errors.

To frame the problem, we begin by examining the poles of a production continuum with maximum production effort cost and minimum design error cost at one pole and minimum production effort cost and maximum design error cost at the other. At one pole, parties in thin markets where contracting is bilateral are impelled by their circumstances to use substantial efforts in production that will tend to minimize design errors for each transaction. For example, the parties can avoid errors by updating each contract in response to legal or economic conditions: coordinating with other transactors is not a concern.[7] By contrast, at the other pole, where markets are thick, traders can exploit economies of scale by standardizing the production of the contracts that govern their transaction. Standardization substantially reduces the transaction costs of producing contract terms by providing a prescribed menu of incentive-compatible terms. However, this standardization, most clearly found in large liquid markets such as those for corporate and sovereign bonds, leads to the inefficiencies common to boilerplate: deviating from the standard is costly and updating requires coordination among many diverse interests. Thus, while boilerplate terms require minimal investment in production cost, they are sticky, resistant to change, and subject to the anomalies we have previously described as "black holes"[8] and "landmines"[9]—errors that remain in the contract even in the face of adverse legal consequences.[10]

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6 We define design error costs as the failure of any contract term to embody optimal contract design; that is the failure to formulate a term that will (together with the other contract terms) maximize the expected contractual surplus.

7 In effect, it is the contracting parties' attempt to maximize "the incentive bang for the contracting-cost buck." Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 823 (2006).

8 *See* Stephen J. Choi, Mitu Gulati & Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate*, 67 DUKE L.J. 1, 3 n.2 (2017) (describing a contractual "black hole" as occurring when a clause's original meaning is "lost entirely by the process of repetition and the insertion of random variations").

9 *See* Robert E. Scott, Stephen J. Choi & Mitu Gulati, *Contractual Landmines*, 41 YALE J. REG. (forthcoming 2023) (describing contractual landmines as "vague and apparently purposeful changes to standard language that increases a creditor's nonpayment risk, coupled with blatant errors in expression and drafting and a continuing use of inapt terms that were historically imported from corporate transactions").

10 For discussions of how boilerplate terms become resistant to change, see Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms,* 73 CALIF. L. REV. 261, 265-73 (1985); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting*, 83 VA. L. REV. 713, 719 (1997) (describing how standardized contract terms create learning benefits because the terms have been commonly used); Stephen J. Choi, Robert E. Scott & Mitu Gulati, *Revising Boilerplate: A Comparison of Private*

We draw the distinction between bespoke contracting and standardized contracting more sharply in this paper than what we generally observe in commercial contracting. Reality is much less clear than any stylization designed to illuminate the differences between the two contracting practices. Inevitably, the lines between the two production techniques are blurred. The best way to understand this distinction, therefore, is to visualize bespoke contracting and standardized contacting as poles of a continuum where many markets along the continuum exhibit features of both.

In this Article, we examine one such market: M&A contracts that are transactions that fall between the poles of the continuum described above. The M&A market often involves large, sophisticated parties with the resources and, on occasion, the motivation to craft bespoke contracts. The market also includes a number of repeat players (including private equity funds and their law firms) that benefit from employing standardized terms across deals that provide both greater certainty than bespoke terms and reduced transactional costs. In such a market, we posit that parties will value both the option to employ bespoke terms and the ability to draw upon a pool of standardized terms. With such a preference, we expect a market structure that allows for some degree of coordination to develop standardized terms as well as the freedom for individual actors to employ their own bespoke terms. The features of the M&A market display such a structure.

The lawyers drafting these M&A agreements, and particularly the subset of private equity M&A contracts, belong to a network of practitioners that meet frequently at conferences, often together with the judges who decide litigated cases, to discuss new developments.[11] These conferences act as focal points for discussion and coordination over how contract terms should reflect new developments in the law and "best" contracting practices. We use interviews with market participants as well as data drawn from a random sample of M&A contracts to determine how and when drafters in this network respond to novel caselaw developments. As a focal point, the conferences help encourage a degree of standardization. But individual attorneys enjoy the freedom and resources (particularly from their private equity clients who will be concerned about individual liability) to design their own variations on proposed standards.[12] Consequently, the contracts

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and Public Company Transactions, 2020 WIS. L. REV. 629, 629-30 [hereinafter *Revising Boilerplate*](discussing agency costs and coordination difficulties as sources of stickiness in boilerplate terms).

11 Matthew Jennejohn, Julian Nyarko & Eric Talley, *Contractual Evolution*, 89 U. CHI. L. REV. 901, 908-09 (2021).

12 *See, e.g.*, Glenn West, *Protecting the Private Equity Firm and Its Deal Professionals From the Obligations of its Acquisition Vehicles and Portfolio Companies*, WEIL GLOB. PRIV. EQUITY BLOG (May 23, 2016), https://privateequity.weil.com/features/protecting-private-equity-firm-deal-

produced by this structure are characterized by a mixture of standardized terms—representations and warranties that are market terms used throughout the industry—as well as bespoke negotiations over terms that reflect new developments in the caselaw (drawn from the Delaware Court of Chancery where parties typically litigate).[13]

Our particular focus is on novel contract doctrines that invite sellers to erect barriers to buyers' claims for rescission based on fraud. The preliminary evidence we provide is consistent with the hypothesis that the private equity network deploys an organic, multilevel process that coordinates efforts to contract over fraud; it is a process that in time produces standardized terms dealing with fraud that are used throughout the market.

The Article proceeds as follows. Part I sets out the tradeoffs involved in contracting in different markets in some detail. We first explain how parties in thin or *bilateral* contracting markets optimize the costs of production *for each transaction* by adjusting the allocation of costs between the front-end costs of drafting ex ante agreements and the expected back-end costs of enforcing those contracts. This bespoke balancing of ex ante and ex postproduction costs is driven by the degree of uncertainty unique to that specific context. These efforts to customize the individual contract are costly but they do yield the most efficient contract for the production cost.[14] But as markets thicken, traders in *multilateral* contracting environments can exploit economies of scale by standardizing the production of the contract terms that will govern all transactions in the market thereby reducing the transaction costs of producing customized contract terms.[15] However, market standardization leads to the inefficiencies of boilerplate discussed above: standardized contract terms resist adaptation to changed conditions.[16]

professionals-obligations-acquisition-vehicles-portfolio-companies/ [https://perma.cc/HKX5-LMPJ] (describing the process for courts to "pierce" the "corporate veil" and hold a corporation's owners or affiliates liable for its actions).

13 *See, e.g.*, Glenn West, *Too Much Dynamite: The Non-Recourse and Survival Clauses Are Both Subject to Delaware's Built-In Fraud Carve-Out for Intentional Intra-Contractual Fraud*, WEIL GLOB. PRIV. EQUITY BLOG (Aug. 24, 2021), https://privateequity.weil.com/glenn-west-musings/too-much-dynamite-the-non-recourse-and-survival-clauses-are-both-subject-to-delawares-built-in-fraud-carve-out-for-intentional-intra-contractual-fraud/ [https://perma.cc/PJK9-GCJL] (prescribing M&A deal terms that are responsive to the recent Delaware Court of Chancery decision in Online Healthnow, Inc. v. CIP OCL Investments, LLC, 2021 WL 3557857(Del. Ch. Aug. 12, 2021)).

14 *See* Scott & Triantis, *supra* note 7, at 836-37 (describing the tradeoffs between front-end and back-end drafting of contracts).

15 For discussion, see Mark R. Patterson, *Standardization of Standard-Form Contracts: Competition and Contract Implications*, 52 WM. & MARY L. REV. 327, 331 (2010) (noting that these common contractual formulations can reduce the need to negotiate new contracts).

16 *See supra* note 10 (citing sources on the stickiness of boilerplate terms).

Nevertheless, there is evidence that there are variations in the speed and nature of adaptation across these markets.[17]

In Part II, we frame the hypothesis that lawyers drafting private equity acquisition contracts are able to respond in a coordinated fashion to new developments in the law but do so in an "organic" fashion that results in numerous variations driven by individual actors in a multilateral environment. We use as our template the evolution of contract law over the past twenty years, as Delaware courts invited drafting lawyers to depart from common law doctrine by contracting over fraud. Initially, as sellers successfully negotiated for damage caps on their liability, buyers required a carve-out from this limitation for any claims of fraud. Thereafter, Delaware courts endorsed no-reliance clauses in which buyers affirmed that they were not relying on any claims arising from *extra contractual* representations made by sellers' agents.[18] Subsequently, the Delaware Court of Chancery in *ABRY Partners v. F&W Acquisition* affirmed the market status of the no-reliance clauses that had become ubiquitous in the interim and also endorsed efforts by sellers to limit their liability for *intra-contractual* fraud to evidence of deliberate, intentional fraud.[19] The question Part II poses, then, is whether and in what form drafters, individually or as members of a network, incorporate these novel fraud-limiting provisions into their private equity acquisition agreements.

Part III tests the coordination hypothesis by positing that the parties to M&A deals, and private acquisition deals in particular, belong to a network that facilitates the exchange of information needed to revise standard terms.[20] We explore the possible pathways that drafters in this network use to transform bespoke efforts to limit fraud claims into standardized boilerplate. Here we report on interviews with thirty practitioners who are experienced in M&A deals. We asked our respondents how and in what ways initial efforts to contract over fraud evolve into market-wide standardized terms. This

17 For a prior examination of this variation, see *Revising Boilerplate*, *supra* note 10.

18 *Infra* Part II.A.

19 891 A.2d 1032, 1034-35 (Del. Ch. 2006). Since some states continue to follow the common law prohibition on contracting over fraud, drafters were also urged to amend their governing law clauses to designate Delaware as the choice of law for both contract *and* tort claims in order to prevent buyers from pursuing their fraud claims in jurisdictions that followed the older common law rules. *See* Choi, Gulati & Scott, *infra* note 43 (discussing governing law clauses).

20 Networks are mechanisms for coordination and cooperation between formally independent but functionally interdependent entities. For prior work that studies advisory networks as conduits for information transfer and coordination among deal lawyers, see Kristina Bishop, Matthew Jennejohn & Cree Jones, *Top Ups and "Telephone"* 1 (BYU L. Sch. Working Paper, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4313301 [https://perma.cc/59HW-MN7K]; Matthew Jennejohn, Julian Nyarko & Eric Talley, *Contractual Evolution*, 89 U. CHI. L. REV. 901, 908-09 (2021); Matthew Jennejohn, *The Architecture of Contract Innovation*, 59 B.C. L. REV. 71, 73 (2018).

evidence suggests that drafters can overcome the collective action problems that impede efficient contract design by exploiting an informal network that organizes their loose web of relationships: parties rely on the information generated in the network to reach a consensus that transforms novel and initially "bespoke" terms into widely accepted "market" terms. This focus on organic coordination conceives of the contracting parties in this world as members of a commercial network that communicates important information through several different pathways.

In Part IV we present a preliminary quantitative empirical analysis that is consistent with the claim that multilayered pathways serve as unique mechanisms of coordination in the private equity acquisitions market. That analysis reveals a widespread, if gradual, diffusion of fraud carve-outs in the M&A market, first in private target transactions and then in public target deals.[21] The subsequent practice of narrowly defining fraud in the acquisition agreement—an important step if the full advantage of *ABRY* is to be obtained—followed a similar trajectory.[22] Both patterns are consistent with a coordination process rooted in information sharing within the network, as opposed to change driven by a single institution or hierarchy in a top-down process. We then dig deeper into the diffusion process, asking what dynamics within the network appear to drive the adoption of a clause narrowly limiting the fraud carve-out.

Contrary to what we might have expected based on prior research on other markets, such as the sovereign bond market,[23] we find no evidence that a vanguard of elite law firms leads the adoption of a new contract term. If anything, it appears that the top advisory firms lagged others in the adoption of a term that limits the fraud carve-out to intentional fraud.[24] We also find evidence that is suggestive of multiple diffusion mechanisms—from the writings of an influential practitioner to dissemination of market studies by the American Bar Association's M&A Subcommittee—operating in tandem.[25]

I. The Production of Contracts in Both Thin and Thick Markets

In this Part, we describe the poles of the continuum formed by efficient design at one pole and efficient production at the other. Efficient design

21 *See infra* Part IV.A.

22 *Id.*

23 *See* Choi & Gulati, *Innovation in Boilerplate*, *infra* note 82.

24 I*nfra* Part IV.C.

25 An analysis of the language advisors use in defining fraud reveals heterogeneity that persists over time, consistent with the impetus for adoption coming from multiple sources. *Id.*

occurs in bespoke transactions where parties' cost considerations are limited to optimizing the costs of production for that contract only. Here, the transaction costs of producing the contract terms are high but may be justified by the resulting design efficiencies. At the other pole we find the fully standardized contract, where a thick market produces boilerplate contract terms that substantially reduce the costs of production so long as parties use the standard terms. The tradeoff is that reliance on these standard terms necessarily leads to obsolescence and errors that inevitably emerge in the boilerplate.

A. *Bespoke Contracting in Thin Markets*

Bespoke transactions are characteristic of thin markets where the actors are few and scattered, and thus require substantial efforts to design and produce contracts efficiently.[26] Here, the goal is to weigh production costs against the incentive gains in achieving efficient investment and trade in the given transaction. The thinness of the market removes any scale economies from the production process. This leads to parameter specific strategies in which individual dyads shift costs of production between front-end transaction costs and back-end enforcement costs in different ways. It is the particular balancing of front-end and back-end costs within each transaction that optimizes contractual incentives.[27] The particular allocation of costs between front and back-end in each transaction is driven by the degree of uncertainty in that economic environment.[28] Thus, when the level of uncertainty is low, contract designers can anticipate and address (most of) the future states of the world and specify what should happen in each possible state.[29] In this case, most of the costs of production are allocated to initial efforts in negotiating and formulating fully specified contingent contract terms.

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26 Bespoke transactions are tailor-made contracts designed to fit the requirements of a single transaction or transaction type. For discussion, see Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Text* and *Context: Contract Interpretation as Contract Design*, 100 CORNELL L. REV. 1, 43-44 (2014); *see also* Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 1, 2-5 (2004) (identifying the balancing that occurs between contracting and renegotiation costs).

27 *See* Scott & Triantis, *Anticipating Litigation*, *supra* note 7, at 817 ("[T]he mix of precise and vague terms that characterize the typical commercial contract can be framed as the product of a tradeoff that the parties have made in investing in the front end or back end of the contracting process, based on their particular circumstances.").

28 Gilson, Sabel & Scott, *Text* and *Context*, *supra* note 26 at 55-57 ("In general, legally sophisticated parties designing bespoke contracts choose between text and context by trading off the front-end (or drafting) costs of contracting and the back-end (or enforcement) costs.").

29 *Cf.* Scott & Triantis, *Anticipating Litigation*, *supra* note 7, at 816 (explaining why parties sometimes consent to contracts which fail to address various contingencies appropriately).

As uncertainty increases, however, efforts to craft bespoke state contingent contracts come under pressure and parties are motivated to shift costs to the back-end enforcement process.[30] Here, parties design more flexible relational contracts by using standards governing key terms such as price, quantity, and effort that delegate ex post discretion to courts.[31] Distribution contracts are an example in this environment of the efficiency advantages of coupling an explicit statement of obligation with a broad 'best efforts' standard that gives a subsequent court discretion over how the obligation is enforced.[32] Technological change has raised the level of uncertainty even higher. As a consequence, more complex collaborative agreements have emerged that require more creative efforts to shift additional resources to the back end.[33] In these collaborative agreements, the few formal elements of the contract are designed to facilitate the growth of trust that, in turn, will regulate the substantive elements of the parties' relationship. Here, drafters create a formal governance structure designed to induce complex cooperative behaviors that are braided with a few explicit obligations.[34]

In all of these bespoke settings, where resource allocation choices are influenced primarily by the level of uncertainty, the costs of production are assessed only by reference to the incentive gains produced *in that particular transaction*. An appropriate analogy is the relationship between the costs of crafting a beautiful piece of furniture by hand and the value derived from its sale to an appreciative buyer. But those considerations are inapt once the market for furniture of this style increases and the cabinetmaker now contemplates making many sales of similarly designed pieces to many buyers. When markets thicken and scale economies can be realized—both in the

30 Gilson, Sabel & Scott, *Text* and *Context*, supra note 26, at 56-57 ("[T]he greater the uncertainty associated with a contract—the more difficult for the contracting parties to specify all the future states of the world in which the contract will have to be performed . . .—the more the contracting parties confront a dilemma.").

31 Allowing flexibility (or discretion) in relational contracts saves parties the transaction costs from continually having to update or renegotiate price or quantity in light of changed circumstances. In long-term procurement agreements, for example, an uncertain future motivates the parties to expend substantial design efforts on contextualized standards that permit quantity and price to be adjusted as circumstances change over time. *See* Alan Schwartz & Robert E. Scott, *The Common Law of Contract and the Default Rule Project*, 102 VA. L. REV. 1523, 1530 n.19 (2016) (describing how default standards shift costs from the front to the back end of the contracting process).

32 *See* Scott & Triantis, *supra* note 7, at 851–56 (discussing how parties contextualize standards to fit their circumstances).

33 For discussion of these collaborative contracts and contracting for innovation, see generally Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration,* 109 COLUM. L. REV. 431 (2009).

34 For a discussion of the interplay between the formal governance structure and the informal bonds of trust that it generates through iterative exchanges of information between the parties, see generally Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377 (2010).

underlying economic good and in the contract that regulates the trade—the cost of producing any given contract becomes economically relevant. It is in these *multilateral* contracting environments that production efficiencies can undermine efficient design.

B. *Production Efficiencies in Thick Markets*

Producing contracts more efficiently in large multilateral markets such as sovereign and corporate debt creates value that is shared among the market participants. Contract production efficiencies result primarily from the standardization of contract terms that are enabled by economies of scale.[35] In these thick markets where there is scale in the production of an economic good, standardized contract terms facilitate the scaling of the associated contracts as well. Beyond the savings in transaction costs, standardized terms bring to bear a collective wisdom and experience of ways to avoid mistakes in designing terms.[36] Standardized terms also reduce learning costs by providing a uniform system of communication: repetition reduces the cost that others must expend in learning the meaning of the clause.[37]

Standardization in the production of boilerplate is, however, a double-edged sword: the efficiencies that reduce the costs of producing contracts also make it costly for parties to deviate from the standard and are the very source of the contracts' design inefficiencies. Standard-form contract terms are different from the optimal terms in a bespoke commercial contract. The certainty that standardization imparts to the market limits the capacity of contract drafters in large and liquid markets to draft vague standards designed to grant discretion to later courts to enforce contractual rights. Here, drafters are functionally incapable of shifting the costs of production from the front end of the contracting process to the back end as they do when designing

35 *See* Robert E. Scott, *The Paradox of Contracting in Markets*, 83 LAW & CONTEMP. PROBS. 71, 72-73 (2020) ("[A]s markets thicken, traders can exploit economies of scale in *multilateral* contracting markets by standardizing the production of the contracts that govern the exchange transaction.").

36 The unique benefits of standardization derive from the process by which standard formulations of terms evolve and gain a distinct, recognized, and consistent meaning within the market. This evolutionary process tests combinations of terms for dangerous but latent defects. Over time, the consequences of standard formulations are observable over a wide range of transactions, permitting the removal of ambiguities and inconsistencies. Goetz & Scott, *supra* note 10, at 265-73. In this way, mature standardized terms become validated by experience and are therefore safer than new and innovative formulations of terms. *See* TINA L. STARK, NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE § 1.02 (2003) (observing that provisions that have been used repeatedly develop a "hallowed status" and have now been blessed).

37 Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting*, 83 VA. L. REV. 713, 719 (1997) (describing that standardized contract terms create learning benefits because the terms have been commonly used).

bespoke contracts in bilateral markets.[38] This limitation puts even more pressure on drafters in these markets to rely on fully specified terms that will motivate parties to invest and trade efficiently.

Unfortunately, the very elements of fixed and unchanging meaning that make standardized terms attractive are the same elements that can contribute to the erosion of that meaning over time. The problem is obsolescence; standardized terms are sticky and thus slow to change in response to changes in contract law and doctrine.[39] Indeed, obsolete standardized terms in boilerplate contracts may over time lose any recoverable meaning, creating what we refer to as a contractual black hole.[40] Over time, some standardized terms are used so consistently that they lose meaning; they are used simply because everyone uses them.[41] Matters get worse if legal jargon is overlaid on standard linguistic formulations.[42] Drafters working with standard-form language that has been repeated by rote for many years often lack understanding of the contemporary purpose(s) served by the boilerplate terms. Drafting marginal modifications to fit the goals of a transaction while

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38 An illustration of the difficulty of drafting standards in multilateral markets for courts to interpret ex post is the largely futile efforts of parties seeking to have courts enforce the ubiquitous material adverse change clause (MAC) in merger and acquisition contracts. The MAC is designed as a standard term that will permit the acquirer to abandon the merger in light of specified events that occur after signing but before the deal closes. Eric L. Talley*, On Uncertainty, Ambiguity, and Contractual Conditions*, 34 DEL. J. CORP. L. 755, 760-61 (2009)(discussing the purpose and design of the modern Material Adverse Effect provision). Delaware courts rarely find a material adverse change sufficient to trigger a MAC and justify the acquirer backing out of a merger deal. *See, e.g.*, In re IBP, Inc. S'holders Litig., 789 A.2d 14 (Del. Ch. 2001)(declining to allow a buyer to terminate a transaction on the basis of an alleged Material Adverse Effect); Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 722 (Del. Ch. 2008)(granting a request for specific performance, finding that there had not been a MAC); Frontier Oil v. Holly Corp., No. CIV.A. 20502, 2005 WL 1039027, at *37 (Del. Ch. Apr. 29, 2005)(determining that nondisclosure of threatened litigation, which had not been proved likely to create a Material Adverse Effect, was not a breach of warranties and representations sufficient to permit nonperformance), *judgment entered sub nom.*, Frontier Oil Corp. v. Holly Corp. (Del. Ch. 2005); Channel Medsystems, Inc. v. Bos. Sci. Corp., No. CV 2018-0673-AGB, 2019 WL 6896462, at *1 (Del. Ch. Dec. 18, 2019), *judgment entered*, 2019 WL 7293896 (Del. Ch. Dec. 26, 2019)(finding that the inaccuracy of statements due to fraud had not been proved to rise to the level of a MAE); AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. CV 2020-0310-JTL, 2020 WL 7024929, at *1-2 (Del. Ch. Nov. 30, 2020), *judgment entered 2021 WL 426242*, (Del. Ch. Feb. 5, 2021), *and aff'd*, 268 A.3d 198 (Del. 2021) (finding no MAE). The Court of Chancery's opinion in Akorn, Inc. v. Fresenius Kabi AG, 198 A.3d 724 (Table), 2018 WL 6427137, at *1 (Del. 2018) stands out as the sole exception to that long line of recent cases. The effect of courts' reluctance to find a MAC is that the MAC clause functionally becomes a standardized "no MAC" term in the contract.

39 *See supra* note 10 (citing sources on the stickiness of boilerplate terms).

40 For discussion on this topic, see Choi, Gulati & Scott, *supra* note 3, at 3-4 n.2.

41 *See* Goetz & Scott, *supra* note 10, at 288-89 (explaining that "rote usage" of contract language corrupts its meaning so as to ultimately become meaningless).

42 *Id.*

ignorant of the contemporary function of the contract's boilerplate terms may lead to errors in an effort to clarify the boilerplate.[43]

C. *The Collective Action Problem and the Role of the M&A Network*

Given the important role that standardization plays in replicating boilerplate terms in tens of thousands of commercial contracts in large multilateral markets, and the non-trivial possibility that a court may err in interpreting terms that are obsolete or encrusted with legal jargon, parties have incentives in these markets to ensure that their standardized contract terms are continually revised. Updating standard terms in these thick markets is essential to preserving a common and *contemporary* meaning. Despite these incentives, there is evidence that parties in multilateral markets often fail to react to changes in contract law and doctrine and fail readily to convert standardized terms into new and efficient formulations.[44] Inertia results from costs that collectively deter an individual participant from revising the standard terms. Participants in multilateral markets express a strong preference for a standard package of terms because revision increases the learning costs for potential traders.[45] Since the production of network externalities is a primary value of standardized contracts, it follows that standardized contract terms will be slow to change even after market participants identify costly errors and ambiguities.[46] Meanwhile, the inefficiencies caused by linguistically obscure or obsolete boilerplate may not be fully priced by the market.[47]

There is a solution to the impediments that prevent individual traders in large, multilateral markets from revising obsolete terms. Consider the sovereign bond market as an example; if the market participants acted together, they could coordinate to create a network of traders who collectively

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43 *See* Stephen J. Choi, Mitu Gulati & Robert E. Scott, *Variation in Boilerplate: Rational Design or Random Mutation?*, 20 AM. L. & ECON. REV. 1, 41 (2017) (describing this phenomenon in the case of the *pari passu* clause in sovereign bonds); *see also* Stephen J. Choi, Robert E. Scott & Mitu Gulati, *Investigating the Contract Production Process*, 16 CAP. MKTS. L.J. 414, 425 (2021) (describing the impact of lawyerly tinkering with the standard governing law clause).

44 *See Variation in Boilerplate: Rational Design or Random Mutation?*, *supra* note 43, at 41 ("Contract clauses that no one understands can [often] become part of the standard template, and variations among those clauses that are largely meaningless can arise and even grow in usage.").

45 *See* Anna Gelpern, Mitu Gulati & Jeromin Zettelmeyer, *If Boilerplate Could Talk: The Work of Standard Terms in Sovereign Bond Contracts*, 44 LAW & SOC. INQUIRY 617, 626-27 (2019) (describing the preference for standard terms because they are simple and bring a sense of legitimacy). This preference suggests that contract terms are more endogenous than is typically assumed in models of contract where individual purchasers and sellers come to the market with their individual preferences that are independent of those of other traders.

46 For discussion about this phenomenon, see Kahan & Klausner, *supra* note 37, at 727-29.

47 For a discussion of the difficulty in pricing terms in these markets, see *Contractual Landmines*, *supra* note 9, at 40 n.100.

advance a new standard market term with a clear meaning and purpose. But it is challenging in large multilateral markets to create a functioning network that can coordinate the efforts of all the participants. In a recent study, we compared the speed with which obsolete terms are revised in M&A transactions with analogous sovereign and corporate bond contracts.[48] In each market, the contracts contained a standard No Recourse clause that had become obsolete over time. This left investors vulnerable to liability claims based on tort and other equitable theories.[49] The emerging case law should have motivated parties in all three markets to modify the obsolete clause to better protect against these non-contractual claims.[50] The modification would have been easy to implement. Yet the vast majority of the corporate and sovereign bond contracts continued to use the obsolete No Recourse clause, largely unchanged from previous decades, confirming the difficulty of revising terms in these markets.[51] By contrast, over fifty percent of the private M&A deal contracts were revised following a series of industry meetings discussing the changes in the caselaw.[52] Indeed, in the deals done by the top five law firms in the industry, every private deal contract was revised.[53]

Parties in the private M&A deal market were better able to coordinate on a standard revision via a combination of industry meetings and leadership from the top law firms. By coalescing around a standard revision to the No Recourse clause, the top firms overcame the reluctance of other drafters to change the language unilaterally. In contrast, corporate and sovereign bond contracts continued to use the obsolete No Recourse term, despite the litigation risk.[54] These findings suggest that there are variations across markets both in the capacity for coordination and the willingness of key actors to experiment with customized revisions.

The comparison between the M&A market and the bond market highlights potential differences between the two market types. In the M&A market, and particularly its private deal variant, contracting parties have devised mechanisms that support inter-party collaborations.[55] In contrast, the

48 *See generally Revising Boilerplate*, *supra* note 10.

49 *Id.* at 633-34.

50 *Id.* at 634-35.

51 *Id.* at 649.

52 *Id.* at 648.

53 *See id.* at 652 (noting that after 2014 every single top firm used the revised contract clause).

54 *Id.*

55 The market for derivatives is an example of parties devising a mechanism that functions to update contract terms in light of changed conditions. The International Swaps and Derivatives Association (ISDA) frequently updates the ISDA Master Contract. The ISDA Determination Committees are a central authority to make official, binding determinations regarding the existence of "credit events" and "succession events" (such as mergers), which may trigger obligations under a credit default swap contract. For discussion of the history of the formation of the derivatives

sovereign and corporate bond markets appear to lack a systematic means of inducing necessary changes in contract language.

In the following Parts, we test the hypothesis that parties in the smaller M&A deal market can function as mutual cooperators in a network that facilitates revisions in standardized contract terms. As the basis for this inquiry we first turn in Part II to a salient development in contemporary contract law: the willingness of Delaware courts to depart from older common law doctrine by permitting contracting parties to contract over fraud and thereby limit their exposure to fraud claims.

II. CONTRACTING OVER FRAUD: INCORPORATING NEW LAW INTO STANDARD TERMS

In this Part, we frame a test of how and to what extent the M&A market is able to coordinate on contract revisions that respond to legal change. We focus particularly on the responses by private M&A deal drafters to the evolving changes in the ability of parties to contract over fraud.

A. *From No-Reliance Clauses to the Fraud Carve-Out*

At common law, efforts by commercial parties to contract over fraud were strictly policed. Courts routinely held that claims of fraud were an exception to the parol evidence rule even where the contract contained a merger clause that most common law courts held was conclusive evidence that the written agreement was fully integrated and contained all the terms of the parties' agreement.[56] The first crack on this bulwark occurred in New York in *Danann Realty v. Harris* in 1959.[57] The contract in *Danann Realty* contained the following language:

> The Seller has not made and does not make any representations as to the physical condition, rents, leases, expenses, operation or any other matter or thing affecting or related to the aforesaid premises, except as herein specifically set forth, and the *Purchaser hereby expressly acknowledges that . . .*

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network, see Jeffrey B. Golden, *Setting Standards in the Evolution of Swap Documentation*, 13 INT'L FIN. L. REV. 18, 18-19(1994); M. Konrad Borowicz, *Contracts as Regulation: The ISDA Master Agreement*, 16 CAP. MKTS. L.J. 72, 73-75 (2021).

56 *See generally* Stephen F. Ross & Daniel Trannen, *The Modern Parol Evidence Rule and Its Implications for New Textualist Statutory Interpretation*, 87 GEO. L.J. 195 (1995) (discussing the history of the parol evidence rule).

57 Danann Realty Corp. v. Harris, 157 N.E.2d 597, 598 (N.Y. 1959) (emphasis added) (denying a claim that the plaintiff was induced to enter into the contract based on false oral statements).

> *neither party [is] relying upon any statement or representation, not embodied in this contract*, made by the other.[58]

The New York Court of Appeals held that this clause, now known as a "No-Reliance" provision, was enforceable to prevent the lessor from claiming fraudulent misrepresentations regarding the expenses for maintaining the leased property made by agents of the seller. The New York court emphasized that the clause was clear and specifically disclaimed any reliance on the representations at issue in the case.[59] In the years following *Danann Realty*, courts in New York consistently affirmed the ability of contracting parties to deploy the No-Reliance clause to bar claims of fraud for extra-contractual representations by agents of the seller.[60]

Over time, the ability of parties to contract over fraud was recognized in other jurisdictions as well. Thus, in 2003, the Delaware Chancery Court in *H-M Wexford LLC v. Encorp, Inc.* affirmed the enforceability of an explicit and clear No-Reliance clause to exclude evidence of extra contractual misrepresentations.[61]

The question of how far parties to agreements governed by Delaware law could contract over fraud became more salient when buyers in private equity acquisition agreements began in the early 2000s to insist on a "fraud carve-out."[62] The fraud carve-out originated in response to private equity deals' growing use of indemnification provisions, which limit an acquirer's remedies (generally to ten to twenty percent of the contract price), in the event a seller breaches certain representations regarding the qualities of the target company. While buyers came to accept those seller-friendly indemnification terms, they in turn negotiated for fraud carve-outs as exceptions that retained

58 *Id.*

59 *Id.* at 600.

60 ROBERT E. SCOTT & JODY S. KRAUS, CONTRACT LAW AND THEORY 433-35 (5th ed. 2013).

61 832 A.2d. 129, 142-43 (Del. Ch. 2003).

62 One seasoned partner explained that the emergence of the fraud carve out could be traced to the rise of indemnification provisions in private equity deals:

> "People started to say a buyer shouldn't have all the remedies available at common law in the event of a breach, and so the indemnification regime began to emerge. Indemnification was supposed to be the sole remedy . . . . At some point, buyers said, 'I'm fine with limiting my ability to recover for a breach of the seller's reps to a 10 percent limitation of the purchase price, but if you literally lie to me, and I rely on that to my detriment, then that shouldn't be subject to the cap.' Sellers would say, 'Sure I can agree to that, because the law doesn't allow me to limit my liability for fraud.' That's the start of the fraud carve out."

Zoom Interview with Anonymous Source Thirteen (Dec. 4, 2022).

a broader range of remedies for a buyer in the event the seller was found to have committed fraud in the transaction.[63]

From this perspective, the fraud carve-out was one side of a swinging pendulum. Sellers' desire for finality and a clean break upon the sale of a company led to increasing use of indemnification provisions, which circumscribed buyers' remedies to a certain percentage of the purchase price, among other limitations.[64] The fraud carve-out was the buyers' reaction: they were willing to swallow the limitations the indemnification regime imposed on their potential recovery, but not when the seller had defrauded them.[65]

The fraud carve-out has now been used in acquisition agreements for at least two decades. These carve-outs can appear in multiple places in a private equity acquisition contract, most commonly in the indemnification and damages-cap provisions.[66] They have a simple structure. Whatever the primary clause provides, typically a limitation on the type or quantity of damages, the fraud carve-out specifies that the limitation does not apply if the party in question (typically the seller) commits fraud.[67] But this led to the question: what do the parties mean by fraud given its numerous and varied meanings across jurisdictions?[68] If bound by the laws of a jurisdiction with an expansive view of fraud, sellers could be subject to a much greater liability than they had anticipated. Could sellers contract for a specific (and limited) fraud liability at the outset? The Delaware courts, understanding this concern in the private equity industry, said yes.[69]

B. ABRY Partners*: From the Fraud Carve-Out to Limited Fraud Clauses*

The subsequent evolution of the fraud carve-out accelerated when the Delaware Court of Chancery decided *ABRY Partners v. F&W Acquisition* in 2006. The issue posed was whether the parties could contract out of fraud liability for statements made both within the contract (that is, as part of the representations and warranties) and outside the contract (informal statements about the company made by the sellers or their agents in the course of negotiations or due diligence).

63 *Id.*

64 *Id.*

65 *Id.*

66 *See* Sarah McLean & Sarah Nealis, *Fraud Carve-Out Provisions for M&A Agreements*, ENERGY L. ADVISOR (Institute Energy L., Plano, Tex.), Oct. 2018 ("One of the most heavily negotiated provisions of a private M&A transaction agreement is the indemnification provision . . . commonly referred to as 'fraud carve-outs.'").

67 *Id.*

68 Glenn West, *The Pesky Little Thing Called Fraud*, 69 BUS. LAW. 1049, 1052 (2014).

69 *See, e.g.*, *H-M Wexford LLC v. Encorp Inc.*, 832 A.2d. 129, 140 (Del. Ch. 2003) (concluding the parties can contract around fraud).

Vice Chancellor Strine, while acknowledging the prior legal regime that strongly disfavored parties contracting out of fraud liability, moved Delaware law in a more "contractarian" direction.[70] He first affirmed the general market acceptance of No-Reliance clauses in the acquisitions world. The No-Reliance clause, however, only applied to extra-contractual representations. Strine then explained that, while parties still could not contract out of fraud liability for representations and warranties in the contract, they could limit their fraud liability for intra-contractual misrepresentations by specifying that the fraud carve-out only applied to deliberate or intentional misrepresentations. Such an exclusion would then be effective to eliminate claims based on reckless or negligent misstatements.[71]

As noted in Part II, our prior work compared the speed with which obsolete No Recourse terms are revised in M&A transactions (private and public) with public company bond issues.[72] Based on that earlier study, we would expect the M&A market, and particularly its private equity subset, to follow Strine's invitation to precisely define the fraud carve-out in order to limit its effect to intentional fraud only. For the current project, the question was not whether the market would respond by producing a "Limited Fraud" clause, but rather (1) how quickly did it respond and (2) what was the mechanism that propelled coordination among different parties to agree on a Limited Fraud carve-out as a standardized term?[73]

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70 For Judge Strine's own description of what *ABRY* did, see University of Virginia Law School, *Judge Leo Strine Jr. on Contracts Law*, YOUTUBE (Nov. 30, 2021), https://www.youtube.com/watch?v=FEUHP9XmuLI [https://perma.cc/45KC-X4P5].

71 Strine subsequently provided an account of how the fraud carve out emerged. He placed the fraud carve out within a broader evolution of M&A deal architecture, which included no-reliance provisions, variations in the common law of fraud by jurisdiction, and the emergence of representations and warranties insurance for private target M&A deals:

> "Originally it wasn't really sure how reliable the no-reliance clause [in an acquisition agreement] was . . . . It wasn't really sure that you could even confine the statements on which people could sue. People got more comfortable with that. [Second], fraud is also not a self-defining term in the common law . . . . Over time there's been much more expansion of the concept of misrepresentation to cover things like negligent misrepresentation and so-called equitable fraud, which is essentially a statement by a fiduciary. And so I think part of this fraud exception also came with the need to define the state of mind of the statement more precisely. And [finally] there's also this emergence of an insurance product here . . . essentially to ensure against the risk of misstatements, but I think primarily designed to cover the indemnity bucket . . . . So I think what's developed is to have a strong no reliance cause that you can insist on if you're a seller, an indemnity basket for non-scienter breaches of reps and warranties that are found out, but with a fraud exception, with a scienter definition that allows for recovery if you can prove, essentially, intentional misstatement that caused harm." *Id.*

72 *Revising Boilerplate*, *supra* note 10, at 633 (examining the progression of these clauses by asking whether it was caused by "exogenous shocks").

73 But even if drafters were able to coordinate on a standard No-Reliance clause and a Limited Fraud carve out, a further legal challenge emerged that motivated even more revisions to the basic

We turn now in Parts III and IV to examine both the speed and the several pathways by which parties in the public and private variants of the M&A network coordinated on standardizing the No-Reliance clause and the Limited Fraud carve-out in order to effectively contract over fraud within the space created by the recent changes in the contract law of Delaware.

III. UNPACKING THE NETWORK

Commercial networks provide parties in multilateral markets with cognitive resources and frameworks for addressing coordination problems.[74] Parties in these thick markets have limited information about the universe of possible partners. It follows that it is worthwhile to search for potential partners who know solutions a single party could not reach alone.[75] It is therefore appropriate to conceive of the diverse contracting parties in the private equity acquisition subset of the M&A market as members of a network of collaborators. All of the participants in the market stand to be harmed by the inefficiencies of standardization, yet no single party can update standard terms as conditions change or adjust to aberrant judicial interpretations of ossified boilerplate. By participating in a network, the parties in multilateral markets can collectively ameliorate these inefficiencies.

To evaluate the nature and effect of the private equity network, we interviewed thirty practitioners with experience in M&A deals. We first note the unique relationship this network has to the legal system in the M&A context studied here. Unlike in other markets, where it is not unusual to find a disconnect between highly specialized market participants and generalist

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acquisition agreement. No-Reliance clauses and Limited Fraud clauses are not universally enforceable. A number of states—particularly California and Massachusetts—decline to enforce provisions that purport to eliminate fraud claims by contract. Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 100 BUS. LAW. 999, 1024-25 (2009). In several cases, buyers claimed that a governing law clause designating Delaware law as the basis for evaluating claims under the contract did not apply to claims for fraud that were grounded in tort rather than contract.

74 *See* Lisa Bernstein, *Beyond Relational Contracts: Social Capital and Network Governance in Procurement Contracts*, 7 J. LEGAL ANALYSIS 561, 563 (2016) (noting the power of "network governance" to empower the enforcement of contractual duties).

75 Networks that form to obtain information about potential partners, including most famously the biotech collaborations in Silicon Valley, have been studied by organizational sociologists. *See, e.g.*, Walter W. Powell, Kenneth Koput & Laurel Smith-Doerr, *Inter-organizational Collaboration and the Locus of Innovation: Networks of Learning in Biotechnology*, 41 ADMIN. SCI. Q. 116, 119 (1996) ("We argue that when knowledge is broadly distributed and brings a competitive advantage, the locus of innovation is found in a network of interorganizational relationship."); Walter W. Powell, *Inter-Organizational Collaboration in the Biotechnology Industry*, 152 J. INST. & THEORETICAL ECON. 197, 198 (1996)(analyzing the effects that institutional designs can have on increasing cooperation).

courts, the Delaware Court of Chancery is embedded within the M&A ecosystem.[76] One respondent explained,

> You have to understand. Unlike perhaps in other contexts, such as the federal courts in New York, things are different in Delaware. The judges in the Delaware courts are an integral part of the legal community. They listen to the concerns of the lawyers, go to their conferences, and answer questions about the direction of the law. Federal judges in New York do not do this. It is rare that you will get a real shock in a Delaware case—these judges are all experienced and careful lawyers. They think hard about what is best for the market. Judge Strine, who wrote *ABRY*, prided himself in understanding the bar and what was needed. I think that that's true of the other judges too.[77]

The Court of Chancery alone is not the sole coordinating institution in the M&A market. As reported in the empirical analysis below, the *ABRY* opinion, standing alone, was insufficient to spark swift and comprehensive adoption of fraud carve-outs and Limited Fraud definitions in private equity acquisition agreements. Nor does the private bar operate wholly divorced from the bench when periodic judicial interventions make a mess of things. Rather, the judiciary and advisory network work hand-in-glove, the former seeking to anticipate the latter, and the latter translating the former's decisions into practice.

The Court of Chancery's place in that ecosystem is visible due to its public status, but the precise way that the advisory network facilitates coordination among market participants is less clear. Our prior work suggests several different mechanisms that a lawyer network could possibly deploy to coordinate needed changes in the standard acquisition contract.[78] One possibility is the capacity of the leading law firms in the industry to serve as the "spider in the web"—a governing structure or hierarchy that functions as an agent of coordination.[79] Another coordinating factor could be the influence of a voluntary "spider" such a leading lawyer who uses their voice to influence change. A third avenue of coordination is the evolutionary process of learning. This process proceeds from the individual level of deal partners

76 *See* William Savitt, *The Genius of the Modern Chancery System*, 2012 COLUM. BUS. L. REV. 570, 570-71 (2012) (arguing that the Delaware Court of Chancery's circumscribed jurisdiction and deep connection to a specialized bar has allowed it to play a leading role in U.S. corporate governance).

77 Zoom Interview with Anonymous Source Thirteen (Dec. 4, 2022).

78 *Revising Boilerplate*, *supra* note 10, at 633.

79 The evidence of the role of the five leading law firms motivating coordination over changes to the No Recourse clause in private equity suggests this possibility. *See Revising Boilerplate, supra* note 10, at 651-53. The conception of the spider in the network web was introduced in Ariel Porat & Robert E. Scott, *Can Restitution Save Fragile Spiderless Networks?*, 8 HARV. BUS. L. REV. 1, 3 (2018) (contending that a controlling relationship in the center of a network dictates its success).

teaching each other during bespoke negotiations to the group level of collective engagement in conferences and bar meetings between drafters and the judges who rule on litigated cases.

To aid in identifying the likely pathway(s) to coordination, we explained to our experts that we were interested in understanding the evolution of standardization of terms relevant to contracting over fraud. We asked (1) what impediments might explain the time lag between bespoke efforts to contract over fraud and the standardization of those changes in the market contract, and (2) what factors were most likely to affect the speed of a successful coordination on new clauses.[80] We report below on the responses.

A. *Leading Law Firms as a Spider*

Our prior study of changes to the No Recourse clause found that coordination in the market occurred among the five leading law firms who had the largest share of the private equity acquisitions market. This finding suggests that perhaps these law firms assumed a special responsibility to function as the spider in the network web. Thus, even if the private acquisition market lacks an obvious controlling entity or hierarchy (such as the way the ISDA Determination Committees function in the derivatives market),[81] drafters in these leading law firms could nonetheless work together to coordinate changes in response to new legal developments.[82] By acting as first movers, they could provide key information to others in the market regarding the efficiency benefits of the new contract terms. Moreover, by being the first drafters in the market to design new terms, the design costs for subsequent drafters would be measurably reduced. Our respondents, however, rejected the prediction that we would see particular law firms as leading the move to a new contractual standard. That was simply not how contract innovation was likely to spread in this market. Instead, it was likely spread through a more organic process, via industry conferences, meetings, and other collective events.[83]

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80 Our interviews were generally done over Zoom and typically lasted between a half hour and an hour. At the start of each conversation, we assured our respondents that nothing they said would be attributed to them and their identities would be kept confidential. We then gave a short explanation of why we had found the fraud carve out provision and the process of defining it intriguing. In a handful of cases, we had follow-up conversations by email.

81 See Kahan & Klausner, supra note 10, at 727 (discussing the different sources from which network benefits can come).

82 For a similar finding on the effect of leading law firms in coordinating innovation regarding sovereign bonds, see Stephen J. Choi & Mitu Gulati, *Innovation in Boilerplate: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 930, 948 (2004) (predicting that law firms experienced with a "large volume" of sovereign bonds can lead the path towards newer terms in bonds).

83 Zoom Interview with Anonymous Source Thirteen (Dec. 4, 2022).

B. *The Influence of the Voluntary Spider*

In a pair of articles in the *Business Lawyer*, the first in 2009 and the second in 2014, Glenn West, a private equity specialist at Weil Gotshal, flagged undefined fraud in fraud carve-outs as a persistent issue in private equity deals. West's basic exhortation (gentle in 2009, strident in 2014)[84] was clear. Sell-side clients were willing to agree to fraud carve-outs from the various damage cap provisions in their contracts because they understood fraud as intentional misbehavior and they didn't plan to engage in such behavior. But the case law in many jurisdictions did not always match the clients' understanding of fraudulent behavior. Instead, the term "fraud" was susceptible to a range of meanings beyond intentional misstatements of the particular private equity seller, including reckless and negligent misstatement. Moreover, some courts showed a willingness to attribute the misstatements of agents (managers of the company the private equity group was trying to sell) to the sellers themselves. West proposed a solution: parties could define precisely what they meant by fraud in their contracts. In contractarian jurisdictions, like Delaware and New York, courts would likely defer to the agreement the parties had voluntarily made.

It is plausible to ask whether West's two publications in the *Business Lawyer*, the preeminent business law publication for U.S. practitioners, were the key factors motivating the market to coordinate on standard terms for contracting over fraud.[85] We did not explicitly bring up West's articles in our interviews. Instead, we asked what might cause the market to coordinate on a standard market definition of fraud.

A number of our respondents flagged West's writings as important. Multiple respondents even urged us to read them in order to better understand the fraud carve-out issue.[86] That said, no respondent thought the West articles on their own were capable of causing a move toward a standardized clause. One respondent wryly observed:

> I don't know many senior lawyers who would actually sit down and read an academic article. Most don't even read the important Delaware cases. And

84 West & Lewis, supra note 72 at 1024-25; West, *supra* note 40.

85 There were also several Delaware cases touching on the fraud carve out issue in the 2013-2017 period. *See* ENI Holdings LLC v. KBR Grp. Holdings, LLC, C.A. No. 8075-VCG, 2013 BL 332008, 2013 WL 6186326, at *39-41 (Del. Ch. Nov. 27, 2013) (discussing whether an agreement carved out claims grounded in fraud from being subject to the contractual limitations period); JCM Innovation Corp. v. FL Acquisition Holdings, Inc., C.A. No. N15C-10-255 EMD CCLD, 2016 BL 325304, 2016 WL 5793192, at *11 (Del. Super. Ct. Sept. 30, 2016) ("JCM counters that the exclusive provision expressly carves out 'claims arising from fraud.'"); EMSI Acquisition Inc. v. Contrarian Funds LLC, C.A. No. 12648-VCS, at *11-12 (Del. Ch. May 3, 2017) (explaining that an agreement appeared to carve out claims based on fraud from a section limiting remedies to indemnification).

86 We did not reveal that we knew West or were familiar with West's work.

> make no mistake; Glenn [West] may be a senior partner at a big firm–but those articles are academic. You need much more than just a couple of such [academic] articles for change.[87]

In other words, West's academic writings alone were not the spider in the network. For change, there needed to be more. Another respondent described the dynamic as follows:

> Glenn [West] had been telling us to define fraud for years and we'd all nod our heads and then just copy the old provisions from the prior deals. But at some point, and probably after that [2014 *Business Lawyer*] article, the rhetoric got ramped up. He and others at the ABA's M&A meetings began telling us that we were essentially committing malpractice by failing to define fraud. That got people to listen. There may have been something else going on as well. There had always been the threat that opportunistic claims for fraud would be made. It might have then happened in a few cases like *EMSI*.[88]

C. *The Influence of Multilevel, Collective Engagement*

The evidence suggests that the network lacks a single spider. In that respect, the M&A world, and particularly its private equity subset, more closely resembles the sovereign debt market than it does the trade association networks such as those studied by Lisa Bernstein.[89] But unlike sovereign debt, there is a practice of information exchange among the leading players in the M&A/private equity market.[90] For example, in 2009 the M&A Committee of the American Bar Association's Business Law Section began sharing information about the fraud carve-out issue with practitioners in two ways. First, the M&A Committee's Deal Points study,[91] which gives deal lawyers insight into the current state of market practice, began reporting data on what fraction of a sample of deals were limiting fraud to intentional actions in their fraud carve-outs.[92] Practitioners could see in the study the initial uptake in

87 Zoom Interview with Anonymous Source Eighteen (Feb. 26, 2022).

88 Zoom Interview with Anonymous Source Twenty-five (Feb. 18, 2022).

89 *See e.g.,* Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1725-25 (2001) (describing the private legal systems that govern trade association dealings); Lisa Bernstein, *Merchant Law in a Modern Economy*, *in* PHILOSOPHICAL FOUNDATIONS OF CONTRACT LAW 246-49 (Gregory Klass et. al. eds., 2015) (illustrating the transactional practices used in merchant communities).

90 For empirical evidence of this information exchange within the M&A network, see Bishop, Jennejohn & Jones, *supra* note 20.

91 *Public Company Acquisitions of Private Targets: The Results of the 2009 Deal Points Study*, PRAC. L. (Dec. 4, 2009), https://us.practicallaw.thomsonreuters.com/9-500-9034 [https://perma.cc/RP5A-4FL5].

92 *See id.* (providing evidence that the ABA Deal Points Study affects diffusion patterns of new deal terms in the M&A market).

fraud definitions. And because this information on the market practice in defining fraud was reported by the Deal Points study every year since 2009, drafters could follow the evolution toward standardization of the fraud definition development in the market over time.

Second, the issue of precisely defining fraud was discussed in the programming provided at the M&A Committee annual meetings. Beginning roughly in 2010, West and colleagues began presenting on fraud carve-outs at industry gatherings of lawyers. They informed their audiences of the issues and staged mock negotiations to illustrate the bargaining dynamics that might arise in the design of a fraud carve-out.[93] These presentations contextualized the raw numbers provided in the Deal Points Studies.

The judiciary stayed involved throughout, though it would not provide another paradigm shifting treatment of the issue like the original *ABRY* decision. The Chancery Court interpreted fraud carve-outs and Limited Fraud clauses from time to time and applied *ABRY* with fidelity.[94] Finally, to close the circle, the Delaware Supreme Court affirmed Judge Strine's *ABRY* decision in 2021, citing Glenn West's 2014 *Business Lawyer* article.[95]

Taken together, we see interventions by both the judiciary and leaders within the bar woven together. *ABRY*'s message ratifying the "market" status of the No-Reliance clause was understood by 2006 and the implicit invitation to draft a Limited Fraud clause was taken up by a few first movers in bespoke transactions. Leading practitioners, and in particular, the M&A Committee amplified Judge Strine's teaching over time, drawing attention to and educating deal lawyers about the *ABRY* decision. All the while, the Delaware judiciary continued to sound a steady drumbeat in support of respecting parties freedom to contract over fraud.[96]

93 *See* Zoom Interview with Anonymous Source Thirteen (Dec. 4, 2022) ("At that point, I took the fraud carve out on the road. I felt like John the Baptist crying in the wilderness to the unconverted. . . . We created a script for a negotiation [to demonstrate the typical bargaining dynamic and how to address it]."); Zoom Interview with Anonymous Source Fourteen (Oct. 16, 2021) ("I've certainly talked about "fraud carve outs" at ABA meetings."); Interview 26 (Oct. 5, 2022) (noting the discussion of fraud carve outs at ABA meetings and that "those were really well attended meetings" where there "were some wake up calls").

94 *See, e.g.*, Fortis Advisors LLC v. Johnson & Johnson, No. CV 2020-0881-LWW, 2021 WL 5893997, at *7-8 (Del. Ch. Dec. 13, 2021) (analyzing a fraud carve out); EMSI Acquisition, Inc. v. Contrarian Funds, LLC, No. CV 12648-VCS, 2017 WL 1732369, at *18-24 (Del. Ch. May 3, 2017) (applying *ABRY*); Prairie Cap. III, L.P. v. Double E Holding Corp., 132 A.3d 35, 60-61 (Del. Ch. 2015) (using *ABRY* to analyze fraud).

95 Express Scripts, Inc. v. Bracket Holdings Corp., 248 A.3d 824, 830 (2021).

96 *See supra* notes 92-93 and accompanying text.

D. *Summary*

Our respondents resisted our attempt to find a single mechanism that might have produced the coordination that changed the terms for contracting over fraud. In particular, they resisted the hypothesis that either a group of leading law firms or a single spider, such as Glenn West or Judge Strine, were the sole moving factors behind any coordination. As we report in Part IV, the rate of standardization did increase around the 2015-17 period, but these participants rejected the claim that changes to standard terms were attributed to any individual or group. Rather, as one interviewee noted, "mostly this is about conversations among practitioners in the industry on how best to draft. These are discussed at the meetings and conferences."[97] This story is consistent with the hypothesis that, even in an environment like the M&A acquisition market that lacks a controlling entity or "spider," coordination can proceed in a multilevel organic way. The evolutionary process begins with individual drafters experimenting with bespoke Limited Fraud clauses but then the efficiency advantages of these revisions are transmitted between negotiating partners and ultimately through a well-integrated collective of lawyers and judges. And eventually, through this process, a more standard product emerges.

IV. Empirical Data and Analysis

In this section, we report data on both public and private M&A deals from the period 2000 to 2020, with the goal of observing when changes to fraud carve-out clauses began and how coordination on revised clauses was achieved. For each deal, we collected background variables, such as deal size, industry type, and the law firms advising on the deal, to determine who were the first movers in changing contract terms.

In this case, a decade passed from the time that the *ABRY Partners* decision was issued to the point at which contracts were narrowly defining fraud at a meaningful rate. In 2006, the fraud carve-out provision was itself relatively new and non-standard—so efforts to craft Limited Fraud clauses were similarly uncommon. What the data show is an evolutionary process by which bespoke terms are negotiated between individual parties to particular deals. It then takes a half-dozen years or more after these bespoke transactions

97 Zoom Interview with Anonymous Source Fifteen (Feb. 3, 2022). The same respondent also sent us a typescript of a mock negotiation from one of the industry meetings that they said was illustrative of how the senior members of the bar tried to persuade their colleagues to better define fraud in their contracts.

appear for them to emerge as standard terms and for Limited Fraud clauses to become "market."

Below, we report on data for contracts from public and private M&A deals from the period 2000 to 2020. For each year, we searched material contracts on the SEC's EDGAR database with the goal of collecting 100 randomly selected contracts: fifty private target deals and fifty public deals. Deals were identified by running searches on Westlaw's and Bloomberg Law's respective EDGAR material contracts databases. The actual number of deals analyzed for each year occasionally exceeded or fell short of that 100-deal goal for either of two reasons: (1) from time to time, the actual date that an M&A agreement was executed differed from the date as reflected in the Westlaw or Bloomberg platform, leading us to reassign the deal to the proper year; or (2) facially distinct but functionally duplicative agreements were later dropped from the dataset during the coding process.

Table 1: Number of Deals By Year

Year	Number of Deals	Percent
2000	107	5.2
2001	115	5.5
2002	83	4.0
2003	99	4.8
2004	88	4.2
2005	107	5.2
2006	92	4.4
2007	90	4.3
2008	102	4.9
2009	89	4.3
2010	95	4.6
2011	100	4.8
2012	115	5.5
2013	100	4.8
2014	98	4.7
2015	93	4.5
2016	96	4.6
2017	100	4.8
2018	95	4.6
2019	105	5.1
2020	108	5.2
Total	2,077	100.0

For the contracts that were sampled, we coded each contract for both the presence of fraud carve-out provisions (it is not unusual for fraud carve-outs to be used in more than one provision of an acquisition agreement) and whether fraud was narrowly defined. We also collected information about each deal such as the identities of the merging parties, the date of execution, the value of the transaction, the identities of the law firms advising the buyer and seller, the law chosen to govern the transaction, and the industry sector.

The agreements in our sample are material contracts filed with the U.S. Securities and Exchange Commission, usually on Form 8-K. The SEC hosts those filings and the underlying material contracts on its EDGAR database, which we searched using the search functions available on two proprietary

databases.[98] Given our source-–filings by SEC registered companies of "materially" important contracts—our data source is biased. It contains no private-buyer/private-target deals and it may not contain deals where the registered company that bears the disclosure obligation has operations so large that many of its modest-sized mergers are considered immaterial.

In what follows, we report results from the data, starting with the overall picture on the use of the fraud carve-out and then Limited Fraud provisions. We then cut the data in terms of the types of fraud definitions and the types of actors most actively involved in the move towards Limited Fraud terms.

A. *The Fraud Carve-Out*

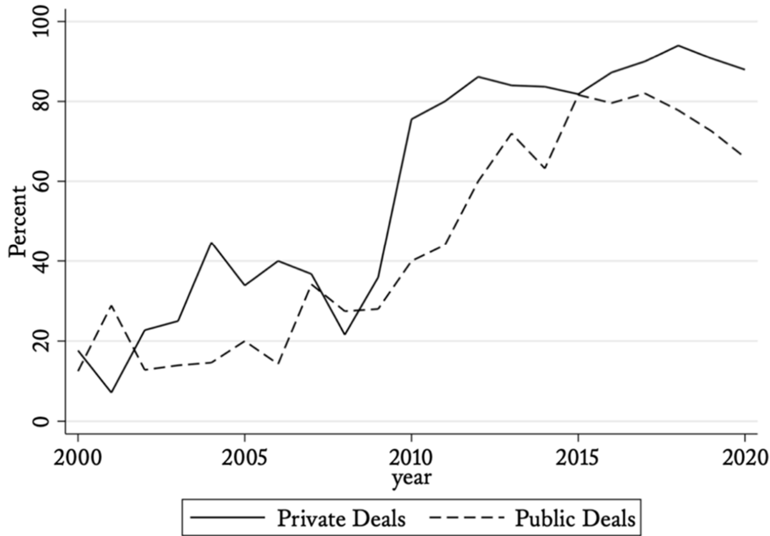
Figure 1 below reports the incidence of fraud carve-out provisions in our data. Overall, these figures show that the clause emerges in the early 2000s and by 2020 it has become standard.

To construct the variable reported in the figures below, we look across the M&A agreement to identify the instances where a fraud carve-out appears. We coded six different provisions in each contract where these carve-outs tend to be found: Indemnification, Exclusive Remedy, Survival, Financing, Termination, and No Additional Representations. We then track the incidence of fraud carve-outs in those provisions in two ways.

First, we track the number of deals in our dataset with at least one fraud carve-out in any of the six provisions listed above. Fraud carve-out incidence is captured as a binary variable, which is set to one if a fraud carve-out appears in any of the six provisions above (and zero, if not). Figure 1 depicts the percentage of deals with at least one fraud carve-out. The solid trend line depicts the percentage of private target transactions and the dotted one depicts public targets.

98 For 2009 onward, we collected agreements from the EDGAR data reported in Westlaw's private target and public target acquisitions databases. For the period prior to that (2000 through 2008), for which Westlaw does not report data, we collected agreements from Bloomberg Law's private target and public target acquisitions databases.

Figure 1: Fraction of Deals with at Least One Fraud Carve-Out



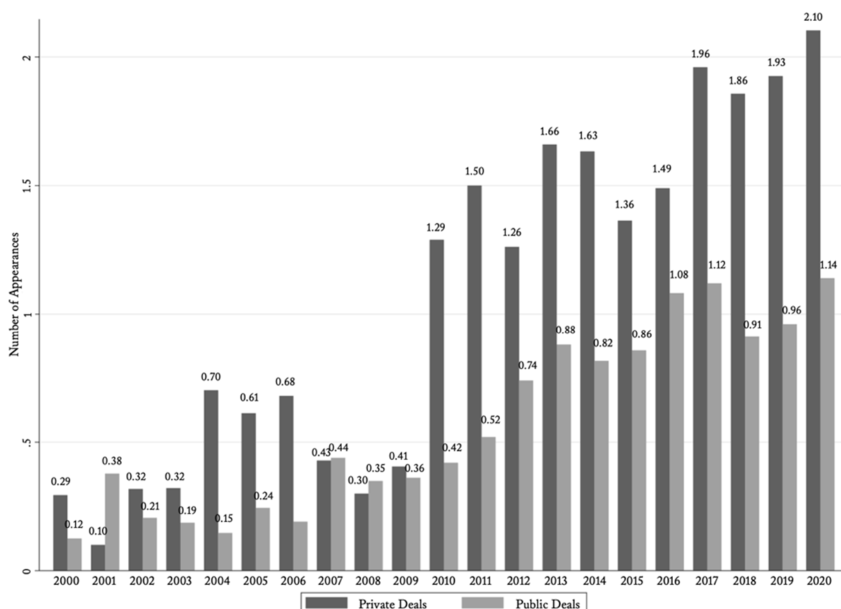
From Figure 1, we observe that fraud carve-outs are more prevalent in private compared with public deals across our sample period. For all private deals in our dataset, 57.8% have at least one fraud carve-out compared with 46.0% for public deals (difference significant at the 1% confidence level).

In our second approach, reported in Figure 2 below, we take a different tack. Since we are interested in the adoption of the fraud carve-out, we tally the fraud carve-out's incidence across all six provisions, rather than using a binary variable that indicates whether a contract contains at least one fraud carve-out provision (or not). For example, if there is a fraud carve-out in any one of the six common provisions in a given contract, we code that as a one. If there is a fraud carve-out in all six provisions, that is a six. This approach allows us to track, for instance, the mean number of fraud carve-outs per agreement in our sample. Over our sample period from 2000 to 2020, the mean number of fraud carve-out terms for private deals (1.05) is greater than the mean for public deals (0.59) and this difference is significant at the 1% confidence level.

Figure 2 breaks out the frequency data in terms of public and private deals by year. Across the 2000 to 2020 period, there is an upward trend in the number of fraud carve-outs for both public and private deals. In the early 2000s, there is less than 0.5 instances of a fraud carve-out on average in both public and private deals, corresponding to less than one fraud carve-out in

every two deals. By 2020, there are over two fraud carve-outs on average in private deals and over one fraud carve-out on average in public deals.

Figure 2: Frequency of Fraud Carve-Out Incidence, Private and Public Target Deals



The greater number of fraud carve-outs in private deals is consistent with the greater importance of carve-outs (and corresponding Limited Fraud provisions) for private deals. In the public company world, there is no real benefit to carving out fraud or defining it narrowly. One cannot contract around whatever fraud standard the federal securities laws impose, nor is there much risk of stockholders being held liable for the misstatements of company managers.[99]

B. *Defining Fraud: The Incidence of Limited Fraud Clauses*

We turn now to the efforts to narrowly define fraud: the "Limited Fraud" terms. Over our sample period from 2000 to 2020, 17.3% of private deals with a fraud carve-out also included a Limited Fraud term. In comparison, only

99 *See* 15 U.S.C. § 77(n) ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void."); 15 U.S.C. § 78cc(a) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.").

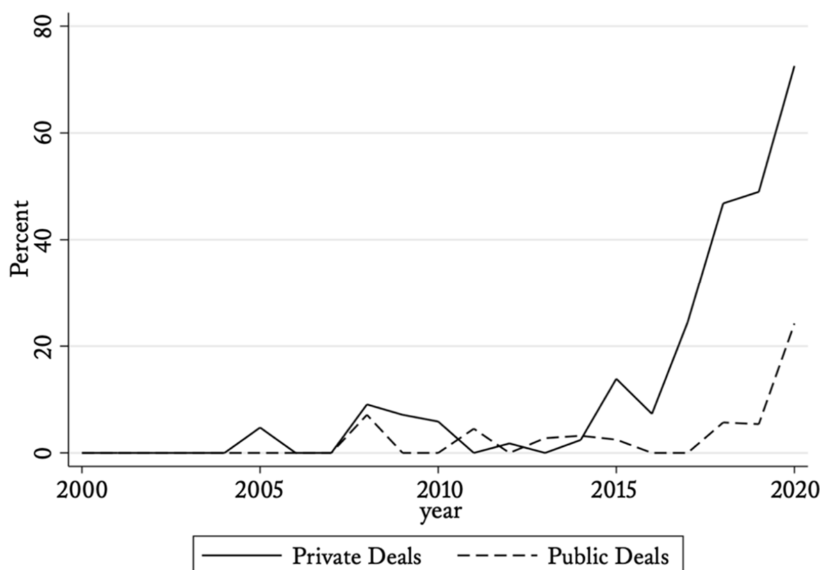
3.7% of public deals with a fraud carve-out contained a Limited Fraud provision. This difference is significant at the 1% confidence level.

Figure 3 reports on the incidence of a Limited Fraud term in deals with at least one fraud carve-out for both the public and private markets by year. For both markets, we see that only a few deals with a fraud carve-out also included a Limited Fraud provision until around 2015. From then, with a dip in 2016, we see a steady growth to the end of the dataset particularly in the private deal market. That marks about a decade after Judge Strine's *ABRY* decision and eight years after Glenn West's 2009 *Business Lawyer* article urging practitioners to narrowly define fraud.[100] In terms of proximity in time, Glenn West's 2014 *Business Lawyer* article is the closest to the acceleration in the rate of adoption of Limited Fraud provisions. In addition, as mentioned earlier, the ABA's Deal Points study had started reporting in 2009 the fraction of deals in their sample that contained Limited Fraud terms.[101] But we cannot tell from the data whether Glenn West's 2014 article was an impetus for the shift or whether there was an accumulation of pressure from *ABRY*, subsequent Glenn West blog posts on the topic, the ABA Deal Points studies, and other events such as conferences of M&A lawyers where the topic was discussed, that accumulated to effect the shift.

100 ABRY Partners v. F&W Acquisition, 891 A.2d 1032 (Del. Ch. 2006); Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?* 100 BUS. LAWYER 1024-25 (2009).

101 *Public Company Acquisitions of Private Targets: The Results of the 2009 Deal Points Study*, PRAC. L. (Dec. 4, 2009), https://us.practicallaw.thomsonreuters.com/9-500-9034 [https://perma.cc/RP5A-4FL5].

Figure 3: Percent of Deals with a Fraud Carve-Out that Include a Limited Fraud Provision



C. *Digging Deeper: Who Moved First and How Fast?*

We next test the importance of specific law firms in driving the change in contracting over fraud. Under one theory of contractual change, for which we have found evidence elsewhere, top law firms are likely to drive contract innovation.[102] Temporally, we expect under this theory that change should occur first for deals involving a top law firm and then later for deals with other law firms that follow the example set by the top firms.[103] In the context of private equity deals, the absence of a Limited Fraud term exposes the seller to potentially expansive application of a fraud carve-out. We therefore might expect that the top seller law firms will push first for the adoption of a narrow definition of fraud.

To identify the top seller law firms, we use the Vault 2020 ranking of private equity law firms.[104] For our top law firms, we select the top 5 firms in

102 *See* Choi & Gulati, *supra* note 82, at 988 (describing the incentives of a top law firm to drive contractual change).

103 *Id.*

104 Vault uses a peer voting system where associates in the relevant area vote on which the best law firms are. For details on their methodology, see *Best Law Firms by Practice Area*, VAULT,

the Vault 2020 ranking: (1) Kirkland & Ellis, (2) Simpson Thacher, (3) Latham & Watkins, (4) Skadden Arps, and (5) Cravath, Swaine & Moore. We add Wachtell Lipton, which is the 6th ranked firm in the Vault 2020 ranking, because it is the most frequent seller's attorney in our dataset. We call these firms the "Top Seller Law Firms." Table 2 reports on the number of deals in our dataset for which a Top Seller Law Firm acted as the seller's attorney.

Table 2: Top Seller Law Firms

Law Firm	Number of Deals as Seller Attorney	Percent of Deals
Wachtell Lipton	77	4.5
Skadden Arps	72	4.2
Latham & Watkins	66	3.8
Kirkland & Ellis	60	3.5
Simpson Thacher	35	2.0
Cravath, Swaine & Moore	30	1.7

We compare the overall adoption of a Limited Fraud term for Top Seller Law Firm and other seller law firm deals. For deals with a fraud carve-out and a Top Seller Law Firm, only 5.4% of the deals had a Limited Fraud term. In comparison, for deals with a fraud carve-out and other seller law firms, 11.9% of the deals had a Limited Fraud term. The difference is significant at the 1% confidence level. Instead of leading the adoption of Limited Fraud provisions, Top Seller Law Firms correspond with a lower incidence of these terms compared with deals with other seller law firms.

As a multivariate test of the probability of a Limited Fraud term, we estimate the following multinomial logit model. We use deals with a fraud carve-out but no Limited Fraud term as (0) the base outcome. We estimate two different outcomes from the base outcome in the multinomial logit model: (1) no fraud carve-out and (2) a fraud carve-out with a Limited Fraud term. The multinomial logit model includes an indicator variable for whether a private equity firm is the seller in the deal (Private Equity Seller). The model also includes indicator variables for the presence of a Top Seller Law

https://firsthand.co/best-companies-to-work-for/law/best-law-firms-in-each-practice-area/private-equity [https://perma.cc/3SB5-832J] (last visited June 28, 2023). Chambers & Partners provides a similar ranking of private equity advisors, also based on regular surveys of professionals. *See USA - Nationwide Private Equity: Fund Formation Legal Rankings*, CHAMBERS & PARTNERS (2022), https://chambers.com/legal-rankings/private-equity-fund-formation-usa-nationwide-5:290:12788:1 [https://perma.cc/VUU5-JP4H].

Firm and whether the deal is a public deal (Public). As control variables, we include the log of the deal value in millions of dollars and indicator variables for whether the contract includes New York or Delaware as the choice of law. Lastly, the model includes the one-digit SIC industry code for the acquisition target as Industry Effects.

The model is as follows: Prob(Fraud Carve-Out Outcome)= $\alpha + ß_1$Private Equity Seller$_i$ + $ß_2$Top Seller Law Firm$_i$ + $ß_3$Public$_i$ + $ß_4$ln(Deal Value$_i$) + $ß_5$New York$_i$ + $ß_6$Delaware$_i$ + Industry Fixed Effects + $\varepsilon_{i.}$

Table 3 reports the results of the multinomial logit model.

Table 3: Multinomial Model of the Fraud Carve-Out Term
Base Outcome = Fraud Carve-Out with No Limited Fraud

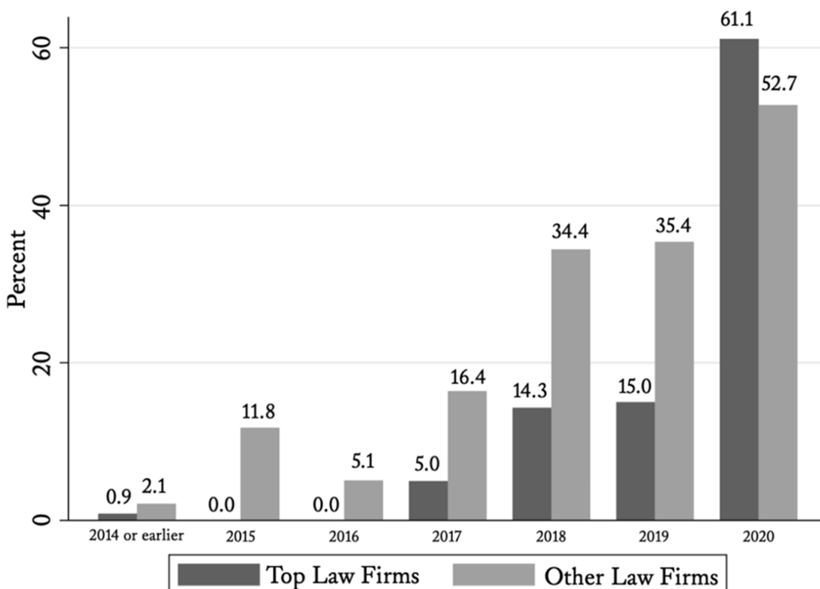
	(1) Outcome = No Fraud Carve-Out	(2) Outcome = Fraud Carve-Out with Limited Fraud
Private Equity Seller	-0.135	0.675
	(-0.28)	(1.60)
Top Seller Law Firm	-0.188	-0.587^{+}
	(-1.17)	(-1.91)
Public	1.698^{**}	-2.296^{**}
	(10.43)	(-6.72)
ln(Deal Value)	-0.252^{**}	0.235^{**}
	(-6.71)	(3.18)
New York	-0.656^{**}	-0.214
	(-2.87)	(-0.45)
Delaware	-0.847^{**}	0.748^{*}
	(-4.92)	(2.09)
Constant	24.60	22.44
	(0.00)	(0.00)
Industry Effects	Yes	Yes
N		1419
pseudo R^2		0.141

z statistics in parentheses; $^{+}p < 0.10$, $^{*}p < 0.05$, $^{**}p < 0.01$

From the multinomial logit model in Table 3, note that the coefficient on Top Seller Law Firm is negative and significant at the 10% confidence level for the Fraud Carve-Out with Limited Fraud outcome. Top Seller Law Firms correspond with lower incidences of Limited Fraud provisions in a fraud carve-out compared with the base outcome of Fraud Carve-Out with No Limited Fraud. The average marginal effect of a Top Seller Law Firm on the probability of a Limited Fraud provision compared with the base outcome is -3.1 percentage points. Note also that public deals have a lower probability of a Limited Fraud provision in a fraud carve-out compared with the base outcome of Fraud Carve-Out with No Limited Fraud. The average marginal effect of a public deal (compared with a private deal) on the probability of a Limited Fraud provision compared with the base outcome is -15.6 percentage points. In contrast, public deals have a higher probability of having No Fraud Carve-Out clause compared with the base outcome of Fraud Carve-Out with No Limited Fraud. The average marginal effect of a public deal (compared with a private deal) on the probability of No Fraud Carve-Out compared with the base outcome is 35.6 percentage points.

Even though Top Seller Law Firms do not correspond in general with a greater level of adoption of a narrow fraud definition within fraud carve-outs, it is possible that the Top Seller Law Firms were the first in the market to adopt Limited Fraud terms, leading other law firms to follow their lead. To assess this first mover possibility, we report the percentage of deals with a fraud carve-out that also includes a Limited Fraud term by year for both Top Seller Law Firms and other seller law firms in Figure 4.

Figure 4: Percent of Deals with a Fraud Carve-Out that Include a Limited Fraud Definition for Top and Other Law Firms



Note from Figure 4 that the percent of deals with a fraud carve-out that also includes a Limited Fraud definition in 2020 is greater for the Top Seller Law Firm (61.1%) when compared with other seller law firms' driven deals (52.7%). However, in 2015 and 2016, the two years immediately following Glenn West's August 2014 *Business Lawyer* article, none of the private equity deals with a Top Seller Law Firm that employed a fraud carve-out had a Limited Fraud definition. In contrast, the law firms that appeared to lead the adoption of a Limited Fraud definition were the other law firms in 2015 (11.8%) and in 2016 (5.1%). Rather than being the leaders, the Top Seller Law Firms follow other firms, adopting Limited Fraud definitions more widely than other firms only after Limited Fraud definitions became adopted in a majority of fraud carve-out provisions.

Perhaps the mechanism of change in this industry is not through the top law firms. Instead, the mechanism could be a single spider—Glenn West himself. We do not have data on the specific deals involving Glenn West. However, we can identify those deals where Glenn West's law firm, Weil Gotshal, was the seller's attorney. For deals with a fraud carve-out and Weil Gotshal as the seller's law firm, 9.1% of the deals had a Limited Fraud definition. In comparison, for deals with a fraud carve-out and other seller law firms, 11.7% of the deals had a fraud carve-out. If anything, Weil Gotshal corresponds to an overall lower incidence of a Limited Fraud definition in the fraud carve-out. The difference in any case is not statistically significant. We re-estimated the multinomial logit model in Table 2 above replacing Top Seller Law Firm with an indicator variable for Weil Gotshal. Unreported, the coefficient on Weil Gotshal is not significantly different from zero for either the No Fraud Carve-Out or Fraud Carve-Out with Limited Fraud outcomes in the model. Looking at the timing of the use of a fraud definition when Weil Gotshal was the seller's attorney, a Limited Fraud definition was used only once in our dataset in a public deal in 2014. For the subsequent eight deals with a fraud carve-out that had Weil Gotshal as the seller's attorney after 2014, none of these deals had a Limited Fraud provision. We take this as inconsistent with Weil Gotshal leading the adoption of Limited Fraud clauses for the market to use as an example.

D. *Deeper Still: Variation in Limited Fraud Provisions*

What drives change if neither the top law firms nor Weil Gotshal are the agents for change? We posit that multilevel interactions among attorneys and between attorneys and judges in the private equity industry and, in particular, at private equity and M&A conferences, over time play an important role in change. In such a collaborative model for change, we predict that there will be many separate agents for change that both act independently and also learn

from each other. In this context, we predict that evolution will occur but in a non-uniform way as different agents adopt varying types of change.

For the Limited Fraud provisions, we observe that there are several different variations possible. West's articles, building on Judge Strine's *ABRY* decision, did not merely urge private equity lawyers to narrowly define fraud to protect their sell side clients against what would be an unexpected liability. He also explained precisely how fraud needed to be narrowly defined to protect the private equity seller maximally. Simplifying, he had three sets of instructions as to how fraud was to be narrowly defined. Failure to follow these instructions could undermine the purpose behind efforts to define fraud. The provision needed to make clear:

- that the fraud carve-out applied only to explicit factual representations in the contract's representations and warranties (or some other relevant section) and not extra-contractual statements ("Scope");
- that the statements for which fraud claims could be brought were only those of the individual private equity sellers and not their agents (e.g., management at the company they were trying to sell) ("Define the Speaker");
- that fraud in question for which liability was being agreed to was only intentional and knowing fraud; not reckless, negligent, constructive, or common law fraud ("Intentional Fraud Only").[105]

If multilevel interactions drive change, we predict that adopted Limited Fraud clauses will contain variation along these three dimensions, with Limited Fraud clauses providing varying combinations of Scope, Define the Speaker, and Intentional Fraud Only. In contrast, if a more centralized force drives the change, we predict that adopted Limited Fraud clauses will converge on the form preferred by the central agent for change.[106]

To examine variations in the deals with a fraud carve-out that include a Limited Fraud clause, we track four different variations: deals with no Scope, Define the Speaker, or Intentional Fraud Only language recommended by Glenn West (None), deals with only one of the three recommended additions (One), deals with two of the three recommended additions (Two), and deals

[105] *ABRY Partners*, 891 A.2d at 1063-64.

[106] In a prior study of sovereign bonds, where there was an identifiable set of change agents coordinating an industry wide change, we found that a market where different actors who were using different formulations of a problematic clause subsequently, after there was a coordinating event, almost all moved to a single formulation of the clause. *See* Stephen J. Choi, Mitu Gulati & Robert E. Scott, *Variation in Boilerplate: Rational Design or Random Mutation?*, 20 AM. L. & ECON. REV. 1, 17 (2018).

with all three recommended additions (All).[107] We tabulate in Table 5 the number of deals in each of the four variations in defining fraud by year (with 2014 and earlier combined into a single year period).

107 In addition to this hand-coded approach to measuring variation in fraud definitions, we also employed quantitative text analysis to study variation (namely, analyzing the "cosine similarity" among the fraud definitions in our dataset). The results of that complementary analysis, which are unreported here, are consistent with the results below; different linguistic formulations in the definition of fraud, as measured by the cosine similarity approach, persist over the duration of the dataset.

Table 4: Variations in Deals with a Fraud Carve-Out that Include a Limited Fraud Clause

	None	One	Two	All	Total
2014 and earlier	0	4	2	5	11
	0.0	36.4	18.2	45.5	100.0
2015	0	2	2	2	6
	0.0	33.3	33.3	33.3	100.0
2016	0	1	1	1	3
	0.0	33.3	33.3	33.3	100.0
2017	1	4	5	1	11
	9.1	36.4	45.5	9.1	100.0
2018	3	9	6	6	24
	12.5	37.5	25.0	25.0	100.0
2019	5	6	5	10	26
	19.2	23.1	19.2	38.5	100.0
2020	5	4	20	19	48
	10.4	8.3	41.7	39.6	100.0
Total	14	30	41	44	129
	10.9	23.3	31.8	34.1	100.0

Pearson chi-squared(18) = 14.7834 Pr = 0.677. For each year, we report the number of deals in each of the four limited fraud provision variations and the total number of deals. For each year, we also report the percent each variation represents of the total deals in a given year.

While the overall number of deals with a fraud carve-out that also included a Limited Fraud clause increased over time in our data sample, the variation among different types of Limited Fraud clauses did not diminish over time. In 2020, Limited Fraud clauses consisted of: None (10.4), One (8.3%), Two (41.7%), and All (39.6%). Not only is the form of the fraud definition recommended by Glenn West (the All form) not the most prevalent clause, but the incidence in 2020 (39.6%) is lower than the incidence in the 2014 or earlier period (45.5%). Consistent with the persistent variation in fraud definitions, from Table 4, a chi-squared test failed to reject the null hypothesis that the distribution of the four different types of fraud definitions was different across the years.[108]

While we observe variation in the definition of fraud in Limited Fraud clauses overall, what about for deals with a Top Seller Law Firm? Even though such firms are not the leaders in the adoption of a Limited Fraud clause, perhaps when these firms do adopt a Limited Fraud term, they adopt the gold standard version with All of the suggested variations by Glenn West. To examine this possibility, we tabulate the number of deals in each of the four variations in defining fraud for Top Seller Law Firms compared with Other Seller Law Firms in Table 5.

108 Indeed, our methodology understates the amount of variation that exists in the fraud definition. Our One category includes three different sub-variations: Scope alone (seven instances in our sample), Define the Speaker alone (eleven instances), and Intentional Fraud Only alone (eight instances). Similarly, our Two category includes three different sub-variations: Scope + Define the Speaker (twenty-seven instances in our sample), Scope + Intentional Fraud Only (three instances), and Define the Speaker + Intentional Fraud Only (seven instances).

Table 5: Variations in Limited Fraud Definitions Between Top Seller Law Firms and Other Seller Law Firms

	Type of Variation				
	None	One	Two	All	Total
Other Seller Law Firm	12	23	33	35	103
	11.7	22.3	32.0	34.0	100.0
Top Seller Law Firm	2	5	6	7	20
	10.0	25.0	30.0	35.0	100.0
Total	14	28	39	42	123
	11.4	22.8	31.7	34.2	100.0

Pearson chi-squared(3) = 0.1196 Pr = 0.989.

For each category of law firms, we report the number of deals in each of the four limited fraud provision variations and the total number of deals. For each category of law firms, we also report the percent each variation represents of the total deals in a given category.

From Table 5 note that Top Seller Law Firms use the All variation of the Limited Fraud clause in roughly the same percentage (35.0%) as compared with other seller law firms (34.0%). The percentages for the other variations of the Limited Fraud clause are similar for the Top Seller Law Firms and other law firms. Consistent with Top Seller Law Firms having a similar amount of variation in the Limited Fraud clause as other seller law firms, from Table 5, a chi-squared test failed to reject the null hypothesis that the distribution of the four different types of Limited Fraud variations was different across the two groups of seller law firms.

As one last test of whether the Top Seller Law Firms are more likely to use the gold standard All variation of the Limited Fraud clause, we look at the sequence of Limited Fraud definitions adopted in deals over time in our dataset where Kirkland & Ellis, the number one ranked private equity law firm in the Vault 2020 rankings, was the seller law firm. Limited Fraud clauses were found in eight deals where Kirkland & Ellis advised the seller over the

course of our dataset.[109] Sometimes the robust All variation of the Limited Fraud clause was employed, such as:

> 'Fraud' shall mean actual and intentional fraud with respect to the making of the representations and warranties of a Seller pursuant to Section 2, provided, however, that such actual and intentional fraud of such Seller shall only be deemed to exist if such Seller had actual knowledge (as opposed to imputed or constructive knowledge) that the representations and warranties of such Seller pursuant to Section 2 were actually breached when made, with the express intention that Purchaser rely thereon to its detriment.[110]

At other times, a relatively spare definition limiting fraud was used: "'Fraud' shall mean intentional and knowing common law fraud with the intent to deceive regarding a misrepresentation in this Agreement or the Tender and Support Agreement."[111]

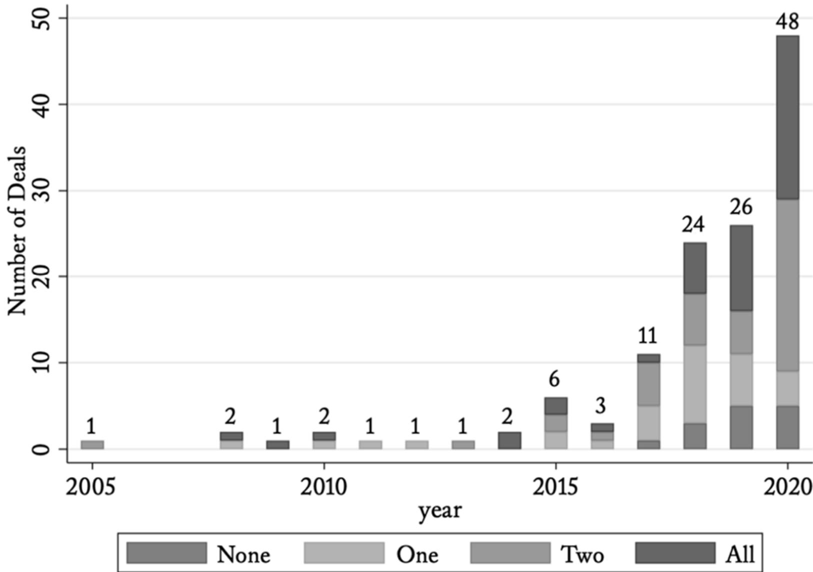
Figure 5 below depicts the variation of the Limited Fraud provisions in the eight deals on which Kirkland & Ellis advised sellers over time, with 0=None, 1=One, 2=Two, and 3=All variations.

109 Whole Earth Brands, Inc. and WSO Investments, Inc., Stock Purchase Agreement (Dec. 17, 2020); Future Infrastructure Holdings, LLC and Primoris Services Corp., Agreement and Plan of Merger (Dec. 14, 2020); NESCO Holdings II, Inc. and Blackstone Energy Partners NQ L.P., Purchase and Sale Agreement (Dec. 3, 2020); Stratus Video Holding Co. and AMN Healthcare, Inc., Stock Purchase Agreement (Jan. 26, 2020); Archrock Services L.P. and Elite Compression Services, LLC, Asset Purchase Agreement (June 23, 2019); Smart & Final Stores, Inc. and First Street Parent, Inc., Agreement and Plan of Merger (Apr. 16, 2019); Coupa Software Inc. and Opus Global Holdings, LLC, Purchase Agreement (Dec. 4, 2018); Adobe Systems Inc. and Vista Equity Partners, Share Purchase Agreement (Sept. 20, 2018).

110 Adobe Systems, Inc., *supra* note 108.

111 Smart & Final Stores, Inc., *supra* note 108.

Figure 5: Limited Fraud Provisions in Deals with Kirkland & Ellis as Seller Law Firm



Even for deals with the same Top Seller Law Firm, Kirkland & Ellis, there is considerable variation in the definition of fraud over time. The first deal with Kirkland & Ellis as the seller law firm contains the All variation. However, the next three deals contain a mixture of the One and Two variations. After another All variation, the last three deals, all in 2020, contain the Two variation for the Limited Fraud clause. Over a span of eight deals, Kirkland & Ellis as the seller's attorney firm corresponded with three of the four variations of the Limited Fraud clause. This finding is inconsistent with the top law firms acting as a central agent of change in contracting language for private equity deals (where we would expect one form—the Gold Standard All form—to be uniform among the top law firms).

We also examined Weil Gotshal acting as the seller's attorney. Weil Gotshal, however, was involved in only one deal with a Limited Fraud term in our dataset that occurred in January 2014. While the Limited Fraud term from this one deal was the All variation, we do not think it plausible that Weil Gotshal was the driving force behind change given the lack of any Limited Fraud term in the eight subsequent deals with Weil Gotshal as the seller's attorney that contained a fraud carve-out after January 2014 in our dataset.

CONCLUSION

For many years, scholars have well understood that standard form contracts in thick markets such as those for corporate and sovereign bonds evolve differently than those in markets using bespoke contracts. And that differential evolution flows from the reality that contract producers in these markets, while seeking to optimize, are engaged in different processes from producers in more bespoke deals. Bespoke contracting in thin markets yields, at least in theory, efficient design of contract terms but at a considerable expenditure in production costs. Production costs are substantially reduced in large liquid markets such as the sovereign and corporate bond markets that rely on universally adopted standardized terms. But these markets are characterized by inefficiencies in design: they lack systematic means of coordinating to produce efficient changes in contract language. The world of private M&A deals sits between the two poles of bespoke and boilerplate deals and exhibits features of both. This article seeks to add to our understanding of the contract production process by examining this hybrid world.

Participants in the private M&A market display a preference for both the option to have bespoke terms and the ability to deploy standardized terms. This intermediate preference leads to a market structure conducive to organic coordination. The lawyers drafting these M&A agreements, and particularly private equity M&A deals, belong to a network of practitioners that meet frequently at conferences, often together with the judges who decide litigated cases, to discuss and debate new developments. Using both qualitative and quantitative data, we find evidence of an informal information network. Consisting of judicial opinions, writings of elite lawyers, bar association meetings, and continuing education seminars, this network transforms bespoke changes in contract design into industry-wide standard provisions. The organic coordination structure leads to both market wide coordination over a contract term following a change in the case law as well as a diversity in this response as individual actors exercise their option to implement bespoke variations of a new standard.

We do not claim to fully understand the mechanisms through which this information system functions. Indeed, much more remains to be learned about how contracting parties in different markets optimize the various costs of contract design and production.