Rule 10b-5 and Related Considerations in Acquisition Agreements

Rule 10b-5 under the Securities and Exchange Act of 1934 generally makes it unlawful, in connection with the purchase or sale of any security, for a person to (i) make any untrue statement of a material fact or (ii) omit to state a material fact necessary to prevent the statements made from being misleading. Rule 10b-5 applies to purchases and sales of securities in M&A transactions as well as to more routine purchases and sales of securities.

In the United States, buyers in M&A transactions frequently request that the acquisition agreement include a representation modeled on Rule 10b-5. Sellers almost universally resist these requests. This article addresses certain matters that should be considered when negotiating the inclusion of a so-called “10b-5” representation in an agreement for an M&A transaction that is subject to Rule 10b-5 (i.e., a transaction involving the purchase and sale of securities using jurisdictional means). This article also addresses the need to consider the potential effects of common contractual provisions on a party's ability to assert a claim under Rule 10b-5.

Interplay Between Contractual Representations and Rule 10b-5

Acquisition agreements typically contain representations and warranties covering a number of specifically identified topics (referred to herein as “general representations”), the scope of which will be negotiated by the parties. In addition to general representations, some acquisition agreements will contain a 10b-5 representation.

A typical 10b-5 representation might state that neither the representations and warranties set forth in the acquisition agreement nor the related disclosure schedule contain any misstatement of a material fact or omit to state a material fact necessary to prevent the statements made therein from being misleading. A broader form of this representation might extend to the absence of material misstatements and omissions in connection with the transaction, including misstatements and omissions outside of the acquisition agreement.

Except in the case of an acquisition of a public company, an acquisition agreement will frequently provide for post-closing indemnification for breaches of representations and warranties, subject to agreed-upon survival periods, thresholds, deductibles, and/or caps. In agreements providing for such post-closing indemnification, the parties will typically agree that indemnification is to constitute the exclusive remedy for claims arising out of the subject transaction, including claims based on breaches of representations and warranties.

Claims based on breaches of contractual representations are not dependent on any culpability on the part of the representing party and reliance by the injured party on the representation will ordinarily be presumed (or, under typical indemnification provisions, will be unnecessary for recovery). Conversely, claims under Rule 10b-5 require proof that the representing party acted with scienter, and that the injured party reasonably relied on the representation to its detriment.

Because contractual representations are frequently made subject to purported limitations on recovery that are likely to be inapplicable to Rule 10b-5 claims, and Rule 10b-5 claims are dependent upon standards of culpability and reasonable reliance that are inapplicable to contractual representations, claims based on 10b-5 representations and claims under Rule 10b-5 are not functional equivalents. Moreover, as discussed below, Rule 10b-5 liability may arise out of misstatements or omissions that either do or do not also constitute breaches of general representations or breaches of 10b-5 representations. Consequently, it is critically important to consider the interplay between contractual representations, Rule 10b-5 and contract provisions that may affect the ability of a party to successfully assert a claim under Rule 10b-5.
The following examples, each of which assumes a transaction involving the purchase and sale of securities using jurisdictional means and a material misstatement or omission made with scienter, illustrate the interplay between contractual representations and Rule 10b-5:

- If the misstatement or omission constitutes a breach of a general representation, reasonable reliance by the injured party will likely be presumed, and a valid Rule 10b-5 claim may exist in addition to a claim for breach of representation. The presence or absence of a 10b-5 representation is irrelevant to this conclusion.

- If the misstatement or omission does not constitute a breach of a general representation, but constitutes a breach of a 10b-5 representation, reasonable reliance by the injured party will likely be presumed, and a valid Rule 10b-5 claim may exist in addition to a claim for breach of representation.

- If the misstatement or omission does not constitute a breach of a general representation or a 10b-5 representation, reasonable reliance by the injured party will not be presumed. Unless reasonable reliance is established, no valid claim under Rule 10b-5 will exist.

The existence of a Rule 10b-5 claim in respect of a misstatement or omission that constitutes a breach of a contractual representation is significant because, as discussed below in “Exclusive Remedy Provisions,” any agreed-upon limitation on recovery for the breach of the representation is unlikely to be applicable to the corresponding Rule 10b-5 claim. The inclusion of a 10b-5 representation in an acquisition agreement has two significant effects in this regard: First, it broadens the universe of defective disclosure that will constitute a breach of the contractual representations (at a minimum to cover omissions as well as misstatements and perhaps more broadly to cover misstatements and omissions made outside of the acquisition agreement); and second, it gives rise to a presumption that the statements or omissions made in breach of the 10b-5 representation were reasonably relied upon, thus supporting a claim under Rule 10b-5.

In the absence of a breach of a contractual representation, reasonable reliance on a misstatement or omission for purposes of a Rule 10b-5 claim may be difficult to establish, particularly if the acquisition agreement contains substantial representations and the injured party is sophisticated. Common contractual provisions and other factors that may affect a party’s ability to establish reasonable reliance, or may otherwise affect a party’s ability to successfully assert a Rule 10b-5 claim, are discussed below.

### Non-Reliance Clauses

Acquisition agreements frequently include an express declaration by a party that it is not relying on any representations and warranties that are not contained in the agreement. Taken at face value, such “non-reliance” clauses would appear to negate the party’s reasonable reliance on extra-contractual representations and, accordingly, preclude a party from successfully asserting a Rule 10b-5 claim based upon them. However, the actual effect of non-reliance clauses may vary among the federal appellate circuits.

The Second Circuit (which encompasses New York) and the Seventh Circuit (which encompasses Illinois) have held that non-reliance clauses should generally be given effect to bar Rule 10b-5 claims based upon extra-contractual representations. See *Harsco Corp. v. Segui*, 91 F.3d 337 (2nd Cir. 1996) and *Rissman v. Rissman*, 213 F.3d 381 (7th Cir. 2000). Conversely, the First Circuit (which encompasses Massachusetts) and the Third Circuit (which encompasses Delaware) have held that giving absolute effect to non-reliance clauses would violate Section 29(a) of the Exchange Act, which voids any purported waiver of compliance with the Exchange Act or any rule or regulation thereunder. See *Rogen v. Illikon Corp.*, 361 F.2d 260 (1st Cir. 1966) and *AES Corp. v. Dow Chemical Co.*, 325 F.3d 174 (3rd Cir. 2003).

In *Harsco*, the Second Circuit affirmed the dismissal of a Rule 10b-5 claim based upon extra-contractual representations, holding that the presence in the acquisition agreement of a non-reliance clause, together with 14 pages of representations and warranties, established that the buyer (a sophisticated party) could not have reasonably relied on the extra-contractual representations. In particular, the Harsco court concluded that the non-reliance clause at issue did not violate Section 29(a) of the Exchange Act because the buyer did not indiscriminately waive the protections afforded by Rule 10b-5, but instead limited to a reasonable degree the universe of statements (i.e., the 14 pages of representations) in respect of which the buyer could assert a claim under Rule 10b-5. Similarly, in *Rissman*, the Seventh Circuit affirmed the grant of the seller’s motion for summary judgment, concluding that disregarding a non-reliance clause would allow the
buyer to say in effect that it lied when it represented that it was not relying on any of the seller’s extra-contractual representations.

Although the First Circuit in *Rogen* and the Third Circuit in *AES* allowed Rule 10b-5 claims to survive pre-trial motions based upon their shared view that giving literal effect to a non-reliance clause would violate Section 29(a) of the Exchange Act, both courts indicated that such clauses may constitute evidence of a party’s non-reliance on, or the unreasonableness of a party’s reliance on, extra-contractual representations. Consequently, even under the more liberal approach taken in these federal appellate circuits, the presence of a non-reliance clause may materially impair the ability of a party to assert a Rule 10b-5 claim based upon representations not contained in the acquisition agreement.

**Integration Clauses**

In some circumstances, “integration” clauses (i.e., provisions to the effect that the acquisition agreement constitutes the entire and exclusive agreement of the parties with respect to the subject matter thereof) may have an effect similar to non-reliance clauses, on the basis that an acknowledgement that the acquisition agreement is exclusive is tantamount to a declaration of non-reliance on extra-contractual representations. The likelihood of an integration clause having such an effect will depend upon the specific language employed. In this regard, an integration clause that specifically references representations and warranties would likely have an effect similar to that of a non-reliance clause, while a more customary reference only to “agreements and understandings” probably would not.

**Due Diligence Clauses**

Acquisition agreements frequently contain a representation by a party to the effect that it has made all inquiries and investigations that it deemed necessary or appropriate. In some circumstances, these “due diligence” clauses can have a powerful effect in negating the reasonable reliance element of Rule 10b-5 claims based upon extra-contractual representations. In this regard, some courts have concluded that if a sophisticated party has an opportunity, but fails, to either verify pre-contractual disclosures or have them incorporated into the definitive agreement, it will be deemed to have willingly assumed the risk that the truth may not be as disclosed. It is important to note, however, that these cases involve only Rule 10b-5 claims based upon material misstatements (as opposed to omissions of material fact), reflecting a judicial reluctance to impose a burden on parties to uncover information that has been withheld from them.

**Scope of Representations and Warranties**

If the injured party is sophisticated, the presence in an acquisition agreement of comprehensive or broad representations and warranties may result in a judicial presumption that all of the representations and warranties that the party was relying on were included in the agreement. The presumption is strongest when the agreement contains numerous representations and warranties addressing the same topic as the alleged extra-contractual representation, and is correspondingly weakest when there are not any representations and warranties in the agreement addressing that topic. However, even the weaker form of this presumption can be difficult to overcome in a Rule 10b-5 case. For example, in *Emergent Capital Inv. Mgmt. v. Stonepath Group*, 343 F.3d 189 (2nd Cir. 2003), the Second Circuit affirmed the dismissal of a Rule 10b-5 claim based upon an extra-contractual representation, holding that the size of the transaction, the sophistication of the buyer, the extensive representations in the acquisition agreement addressing other topics and the failure of the buyer to insist that a particular pre-contractual representation be repeated in the acquisition agreement precluded a finding of the buyer’s reasonable reliance on the omitted representation.

**Exclusive Remedy Provisions**

Many acquisition agreements (other than agreements relating to acquisitions of public companies) provide for indemnification as a post-closing remedy for, among other things, breaches of representations and warranties. Because the parameters of such indemnification (including survival periods, thresholds, deductibles, and/or caps) are specifically agreed upon, such agreements typically contain a provision to the effect that indemnification is to be the exclusive remedy for the failure of one or more of the representations and warranties to be true. It is important to note, however, that such “exclusive remedy” clauses are unlikely to be effective to preclude a claim under Rule 10b-5. In *Citibank v. Itochu Intl.*, 2003 U.S. Dist. LEXIS 5519 (2nd Cir. April 4, 2003), the Second Circuit held that, unlike non-reliance clauses (which, according to its *Harsco* decision, may limit to a reasonable scope the subject matter upon which Rule 10b-5 claims may be based), “exclusive
remedy” provisions violate Section 29(a) of the Exchange Act because they purport to waive the remedies available under Rule 10b-5 by requiring a buyer to seek redress solely through the indemnification provisions.

**Venue, Jurisdiction, and Arbitration Provisions**

When determining whether to request or agree to exclusive venue and/or jurisdiction provisions, the parties to an acquisition agreement that contains a non-reliance clause (or a broadly worded integration clause) should consider the split among the federal appellate courts regarding the effect of such clauses on a party’s ability to assert a Rule 10b-5 claim based upon extra-contractual representations. In this regard, a potential Rule 10b-5 plaintiff (e.g., the buyer) may prefer to select a federal court sitting in Massachusetts or Delaware, to take advantage of the First Circuit’s holding in *Rogen* or the Third Circuit’s holding in *AES*, while a potential defendant (e.g., the seller) may prefer to select a federal court sitting in New York or Illinois, to take advantage of the Second Circuit’s holding in *Harsco* or the Seventh Circuit’s holding in *Rissman*.

In a similar vein, parties should consider the effect that an agreement to submit all transaction-related disputes to binding arbitration might have on potential Rule 10b-5 claims involving extra-contractual representations. In *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220 (1987), the U.S. Supreme Court held that Rule 10b-5 claims are arbitrable and that pre-dispute arbitration agreements do not violate Section 29(a) of the Exchange Act. However, because arbitrators generally are not bound by legal precedent and frequently appear to base their decisions on their own perceptions of equity, it is difficult to predict in the abstract whether the arbitration of Rule 10b-5 claims based upon extra-contractual representations would be likely to impede or facilitate the successful assertion of such claims.

**Conclusion**

There is no single formulation or combination of the provisions discussed above that is appropriate for all buyers or all sellers in all circumstances. However, when drafting or negotiating an acquisition agreement, thoughtful consideration of the interplay between the presence or absence of a 10b-5 representation, the presence or absence of the other provisions discussed above and the scope and specific wording of all of the foregoing should increase the likelihood of reaching a result that is consistent with a party’s objectives in any particular circumstance.

**Further Information**

For further information, readers are encouraged to contact their regular Jones Day attorney or the principal authors of this *Commentaries*, Mark Betzen in the Dallas Office (telephone: 214.969.3704; e-mail: mbetzen@jonesday.com) and Richard Meamber in the Menlo Park Office (telephone: 650.739.3970; e-mail: rmeamber@jonesday.com). General e-mail messages may be sent using our Web site feedback form, which can be found at www.jonesday.com.

*Jones Day Commentaries* are a publication of Jones Day and should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at its discretion. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship.