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How M&A Buyers Can Guard Against Extracontractual Fraud

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Buyers routinely agree to reliance disclaimers in mergers and acquisitions agreements, which generally provide that the parties entered into the transaction in reliance solely upon the representations expressly stated in the four corners of the agreement. At the same time, buyers increasingly demand fraud carveouts, which generally provide that various limitations in the contract apply "except in cases of fraud." But reliance disclaimers and fraud carveouts exist in inherent tension because the disclaimer appears intended to vitiate extracontractual fraud claims that the fraud carveout purports to preserve.

How will courts interpret these provisions when they conflict? And, in accepting reliance disclaimers, is a buyer agreeing in advance to be defrauded notwithstanding the existence of a fraud carveout? This article will examine Delaware and New York law and offer proactive steps to tip the balance in favor of buyers.

Reliance Disclaimers

Delaware

We all learned in law school that fraud vitiates every contract.[1] Delaware courts enforce reliance disclaimers to avoid a "double fraud" — the alleged extracontractual fraud of the seller and the fraud of the buyer in falsely representing that it did not rely on extracontractual representations.[2] They treat the disclaimer as an admission and representation of a sophisticated buyer that, in entering into the transaction, it in fact did not rely on any representations not expressly stated in the agreement.[3]

The agreement must contain a clear and affirmative disclaimer of reliance "from the point of view of the aggrieved party ... to ensure the preclusion of fraud claims for extra-contractual statements."[4] It is not enough for the seller to disclaim representations outside the four corners of the agreement; the buyer must agree that it did not rely on any representations outside the agreement or specify precisely that upon which it did rely. The Delaware Chancery Court views this as a "critical" distinction that "strike[s] an appropriate balance between holding sophisticated parties to the terms of their contracts and simultaneously protecting against the abuses of fraud."[5]

New York

New York courts likewise enforce reliance disclaimers based on the sophistication of the parties, the sanctity of contract, and the theory that vitiating the disclaimer would be to sanction a double fraud.[6]

The disclaimer must be specific; "where a party specifically disclaims reliance upon a particular representation in a contract, that party cannot, in a subsequent action for common law fraud, claim it was fraudulently induced to enter into the contract by the very representation it has disclaimed reliance upon."[7] The distinction deemed "critical" by Delaware courts might not be as important in New York. If the buyer agrees that the seller made no representations other than those contained in the agreement, such a provision may preclude an extracontractual fraud claim.[8]

Will A Fraud Carveout Control Over a Reliance Disclaimer in Cases of Extracontractual Fraud?

Recent Delaware decisions suggest that strong fraud carveouts will control over contractual limitations on a buyer's remedies, including reliance disclaimers. In JCM Innovation Corporation v. FL Acquisition Holdings Inc.,[9] noting that "Delaware has a strong public policy distaste for fraud," the Delaware Superior Court allowed fraud claims based in part on allegedly fraudulent estimates of future warranty costs to proceed even though the buyer had expressly disclaimed reliance on "projections, estimates and other forecasts."[10] The court highlighted language in the reliance disclaimer that carved out "any rights that Purchaser has with respect to ... any intentional misconduct by Seller."[11] The court also highlighted four fraud carveouts contained in the exclusive remedies provision alone, holding: "The Exclusive Remedy Provision explicitly sets forth JCM's options for claims under the Agreement. JCM can go through the indemnification process, or it can bring fraud claims."[12]

In Eni Holdings LLC v. KBR Group Holdings LLC,[13] the Chancery Court denied a motion to dismiss a fraud claim brought outside the contractual limitation period despite the absence of a fraud carveout in the limitations provision based on fraud carveouts applicable to the exclusive remedies provisions in general.[14] This suggests that the fraud carveout will control even where it is not contained in the specific provision at issue.

A seller may argue that because a reliance disclaimer constitutes, as a matter of law, a factual admission that the buyer did not rely on extracontractual representations, no fraud claim exists to be "carved out." A buyer could counter that a fraud carveout tips the "balance" back in favor of the "venerable public policy to guard against fraud."[15] The Chancery Court held that the balance tips back to the buyer if the agreement does not contain a clear and affirmative disclaimer of reliance from the buyer's point of view.[16] One could argue that an express fraud carveout likewise tips Delaware's delicate balance back toward the public policy against fraud and against the enforcement of a reliance disclaimer where fraud pollutes the diligence process.[17]

Under New York law, a buyer could argue that a fraud carveout should control over a reliance disclaimer by the same logic underlying the enforcement of disclaimers. New York courts hold that a sophisticated buyer should be free to disclaim reliance on the "mix of data and information supplied to it."[18] If so, sophisticated parties should likewise be able to use fraud carveouts to restore the buyer's ability to claim actual reliance on the "total mix" of information in cases of fraud.

How Can Buyers Proactively Guard Against Extracontractual Fraud?

Just Say No

The Chancery Court challenged buyers to resist reliance disclaimers: "The enforcement of non-reliance clauses recognizes that parties with free will should say no rather than lie in a contract."[19] Buyers should just say no to the inclusion of broad reliance disclaimers because the justifications for those provisions do not hold water. Citing "the need for commerce to proceed in a rational and certain way,"

the Chancery Court “respect[s] the ability of sophisticated businesses ... to make their own judgments about the risk they should bear and the due diligence they undertake, recognizing that such parties are able to price factors such as limits on liability.”[20] But a buyer cannot price fraud into the deal because it does not know it has been defrauded and has no knowledge of the misrepresented or omitted facts. And contrary to the legal fiction that a disclaimer is an admission that the buyer did not rely on extracontractual representations, a sophisticated buyer (such as a private equity professional, officer or director) may be duty-bound to consider the “total mix” of information not only in closing the deal, but also in deciding the extent to which it will limit a buyer’s remedies (through a disclaimer or otherwise).

The only legitimate basis for inclusion of a reliance disclaimer is the avoidance of litigation costs in the event of nonmeritorious fraud claims.[21] But, as discussed below, this concern can be addressed through threshold alternative dispute resolution (ADR).

Limit the Reliance Disclaimer

If a seller insists on a reliance disclaimer, consider the following limitations:

- Limit disclaimer to specific representations or information not relied upon.
- Limit disclaimer to specific categories of known unknowns, such as forward-looking projections or estimates.[22]
- Request a broad, centralized fraud carveout that makes clear all bets are off in the case of fraud and cross-refers specifically to the reliance disclaimer, exclusive remedies, indemnification and integration provisions.
- Alternatively, include fraud carveouts in as many of those limitations on remedies as possible.

Include Threshold ADR

If a seller complains about litigation risk/cost, agree to limited threshold arbitration at the pleading stage as a condition precedent to litigation, subject to heightened Private Securities Litigation Reform Act-style pleading standards, and a discovery stay. The parties could also agree to a loser pays attorneys’ fees provision applicable only at the pleading stage.

Conclusion

No sophisticated buyer would agree to be defrauded. Care should be taken to preserve legitimate fraud claims through the liberal inclusion of clear and unambiguous fraud carveouts in M&A agreements.

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Timothy Miller founded the Silicon Valley office of Valle Makoff after 14 years as a litigation partner at Skadden Arps Slate Meagher & Flom LLP. Miller routinely advises buyers and sellers regarding the drafting and litigation of provisions related to post-closing disputes in M&A transactions, including contract claims for indemnification or extracontractual claims for fraud. His practice is focused on commercial, fiduciary and securities litigation, claims of trade secret misappropriation, unfair and anti-competitive business practices, and business and investment fraud. He is admitted to practice in California.

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[1] See Abry Partners V LP v. F&W Acquisition LLC, 891 A.2d 1032, 1061 (Del. Ch. 2006); Danann Realty Corp. v. Harris, 157 N.E.2d 597, 600-606 (N.Y. 1959) (Fuld, J., dissenting).

[2] Abry, 891 A.2d at 1058.

[3] See, e.g., id. at 1061.

[4] FdG Logistics LLC v. A&R Logistics Holdings Inc., 131 A.3d 842, 860 (Del. Ch. 2016).

[5] Id. at 858.

[6] See, e.g., Danann Realty, 157 N.E.2d at 599-601; DynCorp v. GTE Corp., 215 F. Supp. 2d 308, 319-320 (S.D.N.Y. 2002).

[7] Harsco Corp. v. Segui, 91 F.3d 337, 345 (2d Cir. 1996)); see also DynCorp, 215 F.Supp.2d at 319.

[8] Harsco Corp., 91 F.3d at 342-43.

[9] C.A. No. N15C-10-255 EMD CCLD, 2016 WL 5793192 (Del. Super. Ct. Sep. 30, 2016).

[10] Id. at *7-9.

[11] Id. at *8.

[12] Id. at *7.

[13] C.A. No. 8075-VCG, 2013 WL 6186326 (Del. Ch. Nov. 27, 2013).

[14] Id. at *15-16.

[15] FdG Logistics LLC, 131 A.3d at 858, 859.

[16] Id. at 860-861.

[17] See E.I. DuPont de Nemours & Co. v. Florida Evergreen Foliage, 744 A.2d 457, 461-62 (Del. 1999) (allowing claims for fraudulent inducement of a settlement agreement and release based on fraud in the litigation discovery process).

[18] DynCorp, 215 F. Supp. 2d at 311.

[19] Abry, 891 A.2d at 1058.

[20] Id. at 1061.

[21] Id. at 1058 ("courts are not perfect in distinguishing meritorious from non-meritorious claims of fraud"); Danann Realty, 157 N.E.2d at 604 (Fuld, J., dissenting) ("The merits of defendant's claim reach only the expense and annoyance of litigation.") (internal quotation and citation omitted).

[22] See Eni Holdings LLC, 2013 WL 6186326, at *14 ("where the inherent unknowability of a potential claim is itself knowable or predictable," it is "the proper source of negotiation and resolution between the parties to the contract").

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