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Fraud Claims under Delaware Law: Drafting Effective Disclaimers of Extra-Contractual Representations

Background

In M&A transactions involving private targets, the purchase agreement typically includes extensive representation, warranty and indemnification provisions intended to provide the purchaser with recourse against the seller if there are deficiencies or problems with the purchased business. Although these provisions may potentially provide the purchaser with broad recourse against the seller, sellers are often able to negotiate a variety of limitations (*e.g.,* caps, deductibles, damages waivers, etc.) designed to minimize their exposure. In many cases, however, even if a seller has successfully negotiated a number of such limitations, the purchase agreement will specifically provide that those limitations will not be given effect in the case of the seller's fraud. In other words, if the seller makes fraudulent representations, the purchaser will have a significantly broader possible scope of recovery against the seller. Depending on which state's laws govern the transaction, rescission (*i.e.*, the complete unwinding of the transaction) might even be available as a remedy. Accordingly, it is crucial for M&A practitioners to understand the scope of a party's representations that might give rise to a fraud claim.

Two recent decisions by the Delaware Chancery Court have refined the circumstances in which extra-contractual representations (*i.e.*, representations or statements made outside of the purchase agreement) may form the basis for a fraud claim under Delaware law.

The Decisions

Prairie Capital III, L.P. v. Double E Holding Corp.[1] involved the 2012 sale of a middle market manufacturing business by one private equity group to another for approximately $26.5 million. During the end of 2011 and into 2012, the purchaser conducted legal and financial due diligence on the target company, and the parties negotiated a stock purchase agreement. In March 2012, the purchaser informed the seller that it intended to walk away from the deal if the target did not satisfy its March 2012 revenue goals. As March neared its close, it became clear to the seller that the business would fall significantly short of those goals. As

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recounted in the opinion, some of the seller's directors, acting in concert with the target's CEO and CFO, decided to fabricate additional March revenue within the target's financial information. As a result, the purchaser believed that the March revenue goal had been achieved and proceeded to close the deal.

The purchaser ultimately uncovered the deception and sued the seller. The suit included a number of fraud claims. One of the elements of a fraud claim is reasonable reliance by the plaintiff on a false representation made by the defendant. In this case, as the basis for the fraud claim, the purchaser pointed to both express representations made by the seller in the purchase agreement and extra-contractual representations made by the seller outside the purchase agreement. The extra-contractual representations consisted of statements and written materials provided by the seller to the purchaser during due diligence that were not covered by the express representations in the purchase agreement.

The Chancery Court granted the seller's motion to dismiss the purchaser's fraud claims to the extent they relied on extra-contractual representations of the seller. The court's primary rationale was the presence of an "exclusive representations" provision in the purchase agreement. The provision consisted of a statement *by the purchaser* acknowledging that the seller's representations and warranties in the purchase agreement were the only representations made by the seller, and relied on by the purchaser, in the transaction. Because of the purchaser's acknowledgement, the court determined that the purchaser could not have relied on extra-contractual representations. Accordingly, a fraud claim based on extra-contractual representations could not succeed.

FdG Logistics LLC v. A&R Logistics Holdings, Inc.[2] arose out of the 2012 sale of a trucking company to a Milwaukee-based private equity firm through a merger transaction. Post-closing litigation ensued. As part of the litigation, the purchaser asserted a number of claims against the sellers, including a fraud claim based on alleged misrepresentations and omissions in documents provided to the purchaser during due diligence. The sellers moved to dismiss the purchaser's fraud claim on the grounds that it was based on representations made outside the four corners of the merger agreement.

The sellers' argument relied on two provisions in the merger agreement. First, the agreement included a disclaimer by the selling company which stated that the company was not making any representations or warranties except for those expressly set forth in the merger agreement. The disclaimer specifically provided that the company was not making any representation or warranty about any

projections, estimates, budgets or any other information or documents made available to the purchaser prior to the merger. Second, the agreement contained an integration clause stating that the merger agreement and the transaction documents contained the entire agreement among the parties and superseded any prior understandings, agreements or representations. The sellers argued that these provisions precluded the purchaser from reasonably relying on representations made in the premerger due diligence materials.

The Chancery Court denied the sellers' motion to dismiss, holding that the provisions on which the sellers relied were missing a critical piece needed to bar a fraud claim based on extra-contractual misrepresentations. The court explained that it will not bar a party from bringing a fraud claim for extra-contractual representations unless *that party* unambiguously disclaims reliance on the extra-contractual representations. The court found that, unlike in *Prairie Capital*, the FdG merger agreement did not contain an affirmative statement from the *purchaser* addressing the scope of the representations on which it was relying. Rather, the disclaimer was merely a statement by the selling company of what the company was and was not intending to represent. The court further noted that, although the integration clause stated in general terms that the merger agreement was the entire agreement between the parties, it did not contain the required statement by the *purchaser* disclaiming reliance on extra-contractual statements. Accordingly, the purchaser's fraud claim was allowed to continue. Under the terms of the purchase agreement, if the purchaser ultimately prevails on the fraud claim, the $1 million deductible, the $20.3 million cap and certain other provisions protecting the seller would not apply.

Analysis

Prairie Capital and *FdG Logistics* make it clear that, under Delaware law, a disclaimer of reliance upon extra-contractual representations must be drafted from the perspective of the plaintiff to effectively bar a fraud claim based on those representations. The Chancery Court explained in both cases, however, that a specific formulation is not required. The disclaimer may be framed affirmatively or negatively, and does not need to contain magic words, such as "disclaims reliance." As long as the agreement contains an acknowledgement by the plaintiff (or both parties) that clearly identifies the scope of information on which the plaintiff relied when entering into the transaction, the plaintiff should be barred from asserting a fraud claim based on information outside of that scope. In addition, although both *Prairie Capital* and *FdG Logistics* address disclaimers of

extra-contractual representations in the M&A context, the principles underlying these cases may likely be applicable to a wider range of contractual business transactions.

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[1] 132 A.3d 35 (Del. Ch. 2015).

[2] 131 A.3d 842 (Del. Ch. 2016).