CORPORATE LITIGATION:

THE EFFECTIVENESS OF NON-RELIANCE PROVISIONS

JOSEPH M. MCLAUGHLIN AND YAFIT COHN*
SIMPSON THACHER & BARTLETT LLP

April 15, 2016

This month we continue our discussion of contractual non-reliance provisions. Under Delaware law, a prima facie claim for fraudulent misrepresentation requires the plaintiff to plead facts supporting an inference that, among other things, the plaintiff acted in justifiable reliance on the misrepresentation. In the context of private mergers and acquisitions, a buyer bringing a post-transaction fraud claim against the seller may be precluded from claiming reasonable reliance on any representations made by the seller outside the four corners of the contract if the agreement contained a clear "non-reliance provision."

Such a provision, which is often included in acquisition agreements in private transactions, amounts to a representation by the buyer that it has made its investment decisions based on its own knowledge and independent investigation—without regard to anything the seller has said or not said—and/or that the buyer only relied on the specific representations contained in the parties' definitive agreement.

While a non-reliance provision that is not boilerplate, but is instead the product of negotiation between sophisticated parties dealing at arm's length, may negate claims of reasonable reliance on extra-contractual representations, Delaware courts have in some cases sustained fraud claims based on extra-contractual information despite a non-reliance provision. The Delaware Court of Chancery's recent decision in *FdG Logistics v. A&R Logistics Holdings*—the court's second opinion in recent months regarding the enforceability of non-reliance provisions—reconciles at least some of these decisions.[1]

FdG Logistics reinforces that an unambiguous provision disclaiming reliance on extra-contractual representations, coupled with an integration clause, is enforceable under Delaware law, but clarifies that the provision must be drafted from the point of view of the buyer, rather than the seller, in order to bar fraud claims based on statements not included in the final agreement.

Underlying Principles

As a general matter, Delaware courts enforce provisions agreed to by sophisticated parties that disclaim reliance on extra-contractual representations. In the 2006 decision *Abry Partners V v. F&W Acquisition*, the Delaware Court of Chancery explained the rationale behind its enforcement of non-reliance provisions: "a party cannot promise, in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a 'but we did rely on those other representations' fraudulent inducement claim."[2] This view was confirmed several years later by the Delaware Supreme Court in *RAA Management v. Savage Sports Holdings*, which stated that "Delaware's public policy [is] in favor of enforcing contractually binding, written disclaimers of reliance on representations outside of a final sale agreement."[3]

* ***Joseph M. McLaughlin*** *is a partner and* ***Yafit Cohn*** *is an associate at Simpson Thacher & Bartlett LLP.*

The court in *Abry*, however, also recognized an ostensibly conflicting public policy to guard against fraud. The court explained that "[b]ecause of that policy concern, we have not given effect to so-called merger or integration clauses that do not clearly state that the parties disclaim reliance upon extra-contractual statements."[4] Such "murky integration clauses, or standard integration clauses without explicit anti-reliance representations," said the court, "will not relieve a party of its oral and extra-contractual fraudulent representations."

Abry held that in order for contractual language to bar claims based on extra-contractual representations, it must "'add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract.'"[5] The *Abry* court believed that "[t]his approach achieves a sensible balance," allowing parties to "protect themselves against unfounded fraud claims through explicit anti-reliance language" without precluding liability for fraudulent extra-contractual representations where the parties did not incorporate an unambiguous anti-reliance provision.

Subsequent Delaware decisions have applied the principles set forth in *Abry* to determine whether to give effect to the purported non-reliance language at issue. In *Anvil Holding Corp. v. Iron Acquisition Co.*, for example, the agreement at issue contained a provision stating that, except for the representations and warranties in the agreement, neither the company nor any seller "makes any other express or implied representation or warranty with respect to the Company…or any Seller or the transactions contemplated by this Agreement."[6] The agreement also included an integration clause that indicated that the agreement "constitutes the entire Agreement among the Parties (and the Sellers' Representatives) with respect to the subject matter of this Agreement and supersede[s] all other prior agreements and understandings…" between the parties.

The Court of Chancery held that these provisions did not preclude the buyer's fraud claim asserting extra-contractual representations, because they did "not state that the parties disclaim reliance upon extra-contractual statements." Rather, the court explained, the contractual language at issue was simply a representation by the sellers that they were not making any representations other than those contained in the agreement and that the purchase agreement constitutes the entire agreement of the parties.

According to the court, this language did not raise a "'double liar' problem where allowing the Buyer to prevail on its fraud claim would sanction its own fraudulent conduct in having falsely asserted that it was relying only on contractual representations." In addition, the court stated that the parties to the agreement "agreed to 'reserve[ ] all rights with respect to' any claims based on fraud or the bad faith of any party," bolstering the conclusion that the parties intended to permit fraud claims based on extra-contractual representations. The court, therefore, denied the sellers' motion to dismiss the buyer's fraud claim.

In *Prairie Capital III v. Double E Holding Corp.*, decided by the Court of Chancery late last year, the court reached the opposite conclusion regarding the effectiveness of the non-reliance provision at issue.[7] In *Prairie Capital*, the buyer's fraud claims were based, in part, on oral and written communications that were not included in the relevant stock purchase agreement. The seller took the position that these claims were precluded by a non-reliance provision in the agreement that stated as follows:

> The Buyer acknowledges that it has conducted to its satisfaction an independent investigation of the financial condition, operations, assets, liabilities and properties of the Double E Companies….[T]he representations and warranties…expressly and specifically set forth in this Agreement…constitute the sole and exclusive representations and warranties of the Double E Parties to the Buyer in connection with the transaction, and the Buyer understands, acknowledges, and agrees that all other representations and warranties of any kind or nature express or implied…are specifically disclaimed by the Double E Parties.

In response to the buyer's argument, based on its interpretation of *Anvil*, that this provision does not preclude its claims because it "does not affirmatively disclaim reliance," the Court of Chancery clarified that "Delaware law does not require magic words," such as the two words "disclaim reliance"; rather, "[l]anguage is sufficiently powerful to reach the same end by multiple means, and drafters can use any of them to identify with sufficient clarity the universe of information on which the contracting parties relied." The court reiterated the principle expressed in *Abry* that "[t]o be effective, a contract 'must contain language that, when read together, can be said to add up to a clear anti-reliance clause'" indicating that the plaintiff did not rely on extra-contractual statements in entering into the agreement.

The court in *Prairie Capital* opined that the exclusive representation provision in the case before it, coupled with the standard integration clause in the agreement, amounted to a clear promise that the buyer relied exclusively on the representations and warranties in the agreement. Accordingly, unlike the court in *Anvil*, the *Prairie Capital* court held that the agreement at issue foreclosed any claims of fraud based on extra-contractual representations.

'FdG Logistics'

In *FdG Logistics*, decided three months after *Prairie Capital*, the Court of Chancery further clarified the enforceability of non-reliance provisions under Delaware law, articulating the key difference between *Anvil* and *Prairie Capital*. At issue in *FdG Logistics* was the enforceability of a purported non-reliance provision in an agreement relating to the sale of a trucking company, A&R Logistics, through a merger transaction. The company as it existed before the transaction (Old A&R) was controlled by FdG Associates, which held a 62-percent ownership in the company through FdG Logistics, LLC and was an active manager of Old A&R.

After the merger closed, the surviving entity in the merger, A&R Logistics Holdings, Inc. (A&R or the Buyer), asserted claims against FdG Associates, FdG Logistics, and various individuals (collectively, the Securityholders) as a result of the Buyer's alleged post-merger discovery that "Old A&R had engaged in an extensive series of illegal and improper activities that were concealed from it during pre-merger due diligence."[8]

Among other things, A&R asserted a claim for common law fraud against the Securityholders "based, in part, on alleged misrepresentations and omissions concerning certain documents they provided to [the] Buyer before it entered into" the merger agreement, such as a confidential information memorandum prepared by Old A&R and a slide presentation presented by Old A&R's management to representatives of the Buyer. The Securityholders moved to dismiss the claim insofar as it related to extra-contractual representations, arguing that the Buyer could not, as a matter of law, establish justifiable reliance on the representation because of two provisions in the merger agreement.

First, the merger agreement contained a clause that, except as expressly provided in the agreement, Old A&R "makes no representation or warranty, express or implied, at law or in equity and any such other representations or warranties are hereby expressly disclaimed."[9] The clause continued:

> Notwithstanding anything to the contrary, (A) [Old A&R] shall not be deemed to make to Buyer any representation or warranty other than as expressly made by [Old A&R] in this agreement and (B) [Old A&R] makes no representation or warranty to Buyer with respect to (I) any projections, estimates or budgets heretofore delivered to or made available to Buyer or its counsel, accountants or advisors of future revenues, expenses or expenditures or future financial results of operations of [Old A&R] unless also expressly included in the representations and warranties contained in this Article 5, or (II) except as expressly covered by a representation and warranty contained in this Article 5, any other information or documents (financial or otherwise) made available to Buyer or its counsel, accountants or advisors with respect to [Old A&R].[10]

Second, the agreement included an integration clause that provided that "[t]his Agreement, the Transaction Documents and the documents referred to herein and therein contain the entire agreement between the Parties and supersede any prior understandings, agreements or representations by or between the Parties, written or oral, which may have related to the subject matter hereof in any way."

In its analysis of the contractual language at issue, the Court of Chancery, in an opinion by Chancellor Andre Bouchard, highlighted a crucial difference between the operative language in *Anvil* and that in *Prairie Capital*: "unlike in *Anvil*, the Court [in *Prairie Capital*] found that the provisions at issue reflected an affirmative expression by the aggrieved buyer that it had relied only on the representations and warranties in the purchase agreement." As the court emphasized, the *Prairie Capital* decision explicitly noted that the representations clause was "'framed positively,'" representing "'affirmatively that the Buyer only relied on the representations and warranties in the [agreement].'"[11]

The court in *FdG Logistics* then reasoned that, in the case before it, "similar to *Anvil* but unlike *Prairie Capital*, the critical language missing from…the Merger Agreement is any affirmative expression by Buyer of (1) specifically what it was relying on when it decided to enter the Merger Agreement or (2) that it…was not relying on any representations made outside of the Merger Agreement." Instead, the language in the agreement was simply "a disclaimer by the selling company (Old A&R) of what it was and was not representing and warranting." Furthermore, the integration clause was merely a general statement "that the Merger Agreement constitutes the entire agreement between the parties, and does not contain an unambiguous statement by Buyer disclaiming reliance on extra-contractual statements."

The "difference between a disclaimer from the point of view of a party accused of fraud and from the point of view of a counterparty who believes it has been defrauded" is critical, the court explained, "because of the strong public policy against fraud." Citing *Abry*, the court elucidated that a Delaware court will not prevent a contracting party from bringing claims based on extra-contractual representations "unless that contracting party unambiguously disclaims reliance on such statements." Having found that the agreement at issue did not contain a clear clause from the buyer's point of view disclaiming reliance on extra-contractual representations, the court in *FdG Logistics* concluded that the buyer's fraud claim was not precluded by the operative provisions in the agreement.

Implications of 'FdG Logistics'

Like previous Delaware decisions regarding the enforceability of non-reliance provisions, *FdG Logistics* emphasizes that the precise language used in non-reliance provisions is often determinative of whether they will be given effect by the courts. Read in conjunction with the Court of Chancery's recent decision in *Prairie Capital*, *FdG Logistics* clarifies that although Delaware law does not require contracting parties to use specific language to disclaim reliance on extra-contractual representations, the disclaimer must be unambiguous with regard to the parties' intent and "must come from the point of view of the aggrieved party (or all parties to the contract) to ensure the preclusion of fraud claims for extra-contractual statements under *Abry* and its progeny."

Despite the apparent drafting latitude accorded by *Prairie Capital*, *FdG Logistics* serves to remind practitioners seeking to maximize the effectiveness of a non-reliance provision that it is essential to draft the provision to clearly state, from the buyer's perspective, that the buyer did not rely on any statements outside the four corners of the contract in deciding to enter into the transaction. In particular, these practitioners should ensure that, in addition to including an integration clause, the contract explicitly provide—in a clause that is the product of negotiation between sophisticated parties—that the buyer:

- had the opportunity to conduct its own due diligence;
- relied exclusively on its own due diligence sources of information (subject to any specific warranties, which should be designated as exclusive of any others); and
- disclaims reliance on any representations not made in the contract.

In addition, if practicable, the agreement should contain reasonably specific categories of information that the seller did not provide to the buyer and as to which the seller is not making any warranty (e.g., earnings projections and financial statements). As an additional measure of protection, the agreement should also contain an acknowledgment by the buyer that it understands that its counterparty may have non-public information regarding the relevant company but that, notwithstanding the information asymmetry, the buyer wishes to proceed with the transaction. Finally, the buyer should warrant that it will require any subsequent downstream purchaser to be bound by the non-reliance provision.

Endnotes:

1 2016 WL 819215 (Del. Ch. Feb. 23, 2016).

2 891 A.2d 1032, 1057 (Del. Ch. 2006).

3 45 A.3d 107, 116-17 (Del. 2012).

4 *Abry*, 891 A.2d at 1058.

5 Id. at 1059 (quoting *Kronenberg v. Katz*, 872 A.2d 568, 593 (Del. Ch. 2004)).

6 2013 WL 2249655, at *8 (Del. Ch. May 17, 2013) (quoting purchase agreement).

7 2015 WL 10464814 (Del. Ch. Nov. 24, 2015).

8 *FdG Logistics*, 2016 WL 819215, at *5.

9 Id. at * 11 (quoting merger agreement).

10 Id. (quoting merger agreement).

11 Id. at *13 (quoting *Prairie Capital*, 2015 WL 10464814, at *8).