CORPORATE LITIGATION:

ENFORCEABILITY OF NON-RELIANCE PROVISIONS

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Acquisition agreements in private transactions often include a "non-reliance provision" in which the buyer represents 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—or that the buyer only relied on the specific representations contained in the parties' definitive agreement. Chief among the virtues of non-reliance provisions is that the contracting parties share an understanding of exactly what has and has not been represented, allowing each side to make a fair evaluation of the value of the transaction. Moreover, the buyer may be able to obtain a discounted price to compensate it for its assumed risk.

A non-reliance provision that is not boilerplate, but is instead the product of negotiation between sophisticated parties dealing at arm's length, may also negate claims of reasonable reliance on any extra-contractual representations in a subsequent lawsuit alleging fraud related to the transaction. The effect of non-reliance provisions on a buyer's claims premised on extra-contractual representations, however, has varied. The main line of division in the case law is whether a non-reliance provision renders reliance on extra-contractual representations unreasonable as a matter of law or is only evidence relevant to reliance—one of the elements of a prima facie claim for fraudulent misrepresentation.

The Delaware Court of Chancery's November 2015 decision in *Prairie Capital III v. Double E Holding Corp.*[1] reinforces that an "exclusive representations" provision, coupled with an integration clause and a clear non-reliance on extra-contractual representations provision, should bar fraud claims based on extra-contractual representations (including omission claims). The decision also rejected suggestions in prior decisions that specific "magic words" are required to make a provision disclaiming reliance on representations outside a final agreement enforceable under Delaware law. The key to enforcement, the court said, is that the contract language "add up to a clear anti-reliance clause."

Reception in Delaware Courts

Delaware courts have generally enforced non-reliance provisions agreed to by sophisticated parties. In 2012, the Delaware Supreme Court in *RAA Management v. Savage Sports Holdings* confirmed that "Delaware's public policy [is] in favor of enforcing contractually binding, written disclaimers of reliance on representations outside of a final sale agreement."[2] Nonetheless, in certain circumstances, Delaware courts have sustained fraud claims based on alleged extra-contractual representations despite a negotiated non-reliance provision. At least one case has suggested that Delaware courts would not give effect "to so-called merger or integration clauses that do not clearly state that the parties disclaim reliance upon extra-contractual statements."[3]

In *Anvil Holding Corp. v. Iron Acquisition Co.*, the Court of Chancery held that the relevant agreement did not preclude a buyer's fraud claim because the agreement did "not state that the parties disclaim reliance upon extra-contractual statements." Rather, the agreement indicated only that neither party was "'making any

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other express or implied representation or warranty with respect to the Company' and that the Purchase Agreement constitutes the entire agreement of the parties."[4] In addition, *Anvil* held, the parties had "agreed to 'reserve[ ] all rights with respect to' any claims based on fraud or the bad faith of any party."

Moreover, some Delaware courts have concluded that non-reliance provisions that do not clearly disclaim reliance on the omission of information do not bar recovery for fraudulent and active concealment of material information. In *Transdigm v. Alcoa Global Fasteners*, for example, the buyer contractually agreed that it was not relying on "'any express or implied representations or warranties of any nature, whether in writing, orally or otherwise'" made by the seller, except as set forth in the agreement.[5] The buyer argued, however, that this non-reliance provision did not bar its fraud claim because its claim was "not based on any extra-contractual representation by [the seller]; rather, it [arose] from the intentional and affirmative concealment of material facts." The court agreed that the buyer had a claim for fraudulent and active concealment because the seller did not make any contractual representation "as to the 'accuracy and completeness' of the information" it provided to the buyer, nor did the buyer "disclaim reliance on extra-contractual omissions." The court explained that the buyer "reasonably could have relied on the assumption that [the seller] was not actively concealing information that was responsive to [the buyer's] inquiries and that [the seller] was not engaged in a scheme to hide information material to" the purchase of the company.

'Prairie Capital'

Private equity funds sponsored by Prairie Capital Partners sold a portfolio company, Double E Parent LLC, to another private equity fund sponsored by Incline Equity Partners. In 2012, Incline offered to buy the Double E company, conditioned on "conducting due diligence and verifying that the Company had met its financial goals for 2011" and "on the Company continuing to meet its monthly sales goals through closing," which was anticipated to occur in March 2012.[6] Incline specified that its offer was contingent on actual company sales during March 2012.

As alleged by Incline, the company understood by mid-March that it would not meet its March sales target. The company's CEO and CFO, however, continued to represent that the company would have sufficient orders to meet the target. In response to Incline's concerns regarding the March sales figures and whether the company's scheduled shipments through month-end represented a departure from the company's ordinary course of business, the company's management reassured Incline all was well. Incline alleged that these representations were fraudulent.

Incline alleged that the company's CEO pressured the company's employees to manufacture product and ship orders and that, consequently, company employees reviewed the company's pipeline to determine which orders could be manufactured and shipped in March. When it became evident to the sellers that the company would nonetheless miss the March sales target, the company's CEO and CFO allegedly "falsified the Company's financial records to make it appear that the Company achieved the March Sales Target."

Incline further averred that even pre-March, management "falsely inflated the Company's monthly sales results by invoicing and including in the Company's accounts receivable orders that had not yet been manufactured or shipped" and even shipped products to a non-existent address at the end of the month in order to book revenue.

In early April 2012, the sellers informed Incline that the company had achieved the March sales target. In alleged reliance on this information, Incline proceeded with its acquisition of the company, executing a stock purchase agreement and related agreements several days later.

Incline sued Prairie Capital and the company's CEO and CFO, alleging fraud and conspiracy to commit fraud (in addition to indemnification claims for the company's alleged breaches of the stock purchase agreement). The buyer's fraud claims were based on extra-contractual representations—*i.e.*, oral and written

communications that did not appear in the stock purchase agreement—plus four representations included in the stock purchase agreement.

Central to the Chancery Court's decision on the sellers' motion to dismiss was whether fraud claims asserting extra-contractual misrepresentations are actionable despite an exclusive representations provision in the stock purchase agreement. It is worth seeing the relevant portion of the exclusive representations provision in full:

> 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.[7]

The agreement also contained an integration clause, providing that the agreement sets forth "the entire understanding of the Parties with respect to the Transaction." It did not include a provision expressly disclaiming reliance on extra-contractual representations.

In determining the effect of the exclusive representations provision, Vice Chancellor J. Travis Laster began with the premise that Delaware law enforces such provisions. In line with Delaware precedent, the court explained that 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."

In response to Incline's argument—based on its reading of *Anvil*—that the non-reliance provision failed to "affirmatively disclaim reliance," the *Prairie Capital* court 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." In other words, "[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 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.'"

The court held that the Prairie Capital exclusive representation provision, coupled with the integration clause, clearly indicated that the buyer relied exclusively on the representations and warranties specified in the agreement. The court therefore concluded that the stock purchase agreement foreclosed any claims of fraud based on extra-contractual misrepresentations.

Incline next argued that its fraud claim was based on material omissions, not affirmative misrepresentations, so that even if the agreement's exclusive representations provision barred claims based on extra-contractual representations, it had no effect on claims of fraudulent omission and concealment. The court disagreed, noting that the "critical distinction" under Delaware law "is not between misrepresentations and omissions, but between information identified in the written agreement and information outside of it."

The court reasoned that because a party to arms'-length negotiations has no affirmative duty to speak, any fraud claim arising in such a setting "necessarily depends on some form of representation"; it cannot be premised on pure omission. Thus, while a party "may use external sources of information to plead that a contractually identified fact was false or misleading," it may not "point to extra-contractual information and escape the contractual limitation by arguing that the extra-contractual information was incomplete."

The court further noted that allowing a plaintiff to circumvent a non-reliance provision by reframing an extra-contractual misrepresentation as an omission would render non-reliance provisions "largely ineffective." The court concluded that the exclusive representations and integration provisions in the stock purchase agreement extend to claims purportedly based on omissions, expressly disagreeing with any interpretation of *Transdigm* that "suggests that an agreement must use a magic word like 'omissions.'"

The court also rejected Incline's argument that the "exclusive remedies" provision in the stock purchase agreement preserved a right to bring a fraud claim for extra-contractual representations. Because the "exclusive remedies" clause provided that the agreement's indemnification remedies "constitute the sole and exclusive remedies for recovery of [l]osses" arising from the transaction except in the case of fraud, Incline maintained that the fraud carve-out preserved the ability to sue for extra-contractual fraud. The court disagreed, stating that while the "exclusive remedies" provision "recognizes that a party is not limited to the indemnification framework when it sues for fraud," it "does not address the representations that a party can rely on in those circumstances." Accordingly, the "exclusive remedies" provision does not change the representations on which a fraud claim may be based.

Significance of 'Prairie Capital'

Consistent with prior Delaware decisions enforcing non-reliance provisions, *Prairie Capital* underscores that the scope of the representations and warranties included in a purchase agreement with a non-reliance provision will be central to the parties' subsequent ability to bring a fraud action with regard to the transaction. Parties entering into agreements with non-reliance clauses should, therefore, give full and deliberate consideration to the specific representations and warranties that should be included in the agreement.

Contrary to certain prior Delaware opinions *Prairie Capital* moves Delaware law in a direction that (1) no "magic words" are required to implement a non-reliance provision that clearly conveys that the buyer did not rely upon any extra-contractual representations when entering into the agreement, and (2) a clear non-reliance provision serves to preclude "not only fraud claims based on extra-contractual representations but also fraud claims based on extra-contractual omissions." While *Prairie Capital* grants more drafting latitude in writing an enforceable Delaware law non-reliance provision, its departure from recent Court of Chancery decisions, such as *Anvil* and *Transdigm*, counsels that practitioners continue to draft non-reliance provisions with an eye toward eliminating any potential ambiguity in the parties' intent.

Practitioners seeking to maximize the effectiveness of a non-reliance provision should ensure that it is the product of negotiation between sophisticated parties. Alongside an integration clause, the provision should contain an acknowledgement that the buyer had the opportunity to conduct its own due diligence, evaluated the merits and risks of the transaction without reliance on the counterparty, 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 extra-contractual representations.

If practicable, the agreement should be reasonably specific as to categories of information not provided to the buyer and as to which no warranty is made, *e.g.*, earnings projections and financial statements. The buyer should acknowledge it understands that its counterparty may have non-public information concerning the relevant company, but notwithstanding the information asymmetry, wishes to proceed with the transaction. The buyer also should warrant that it will require any subsequent downstream purchaser to be bound by the non-reliance provision.

Endnotes:

1. 2015 WL 7461807 (Del. Ch. Nov. 24, 2015).

2. *RAA Management v. Savage Sports Holdings*, 45 A.3d 107, 116-17 (Del. 2012).

3. *Anvil Holding Corp. v. Iron Acquisition Co.*, 2013 WL 2249655, at *8 (Del. Ch. May 17, 2013) (quotations and citation omitted).

4. Id. (quoting purchase agreement).

5. 2013 WL 2326881, at *7 (Del. Ch. May, 29, 2013) (quoting purchase agreement).

6. *Prairie Capital*, 2015 WL 7461807, at *3.

7. Id. at *7 (quoting stock purchase agreement).

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