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Contracting Around Fraud Claims in Merger and Acquisition Deals

Can a seller escape liability for fraud simply by including the right language in the merger agreement?

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The target company looked great on paper. The data room painted a picture of a healthy, profitable company. The target company's officers gave all the right answers to the buyer's questions. But after the acquisition, things appear less rosy. The pre-purchase picture was inaccurate, and the buyer did not get what it paid for. And the buyer now suspects fraud. What remedies, if any, are available to the buyer?

The answer under Delaware law—which is the law most commonly applied in merger and acquisition deals—depends in large part on (a) whether the purchase agreement contains well-drafted "anti-reliance" provisions and (b) whether the inaccurate statements made to the buyer were contained in the representations and warranties of the purchase agreement or were made outside of the agreement (e.g., in documents provided in the course of the buyer's diligence or in response to the buyer's questions).

Anti-Reliance Provisions Are Potent, If Worded Correctly

In an anti-reliance provision, the buyer disclaims reliance on any extra-contractual representations. For example, the provision might say

something to the effect of "Buyer disclaims that it is relying upon or has relied upon any representations or warranties made by Seller or any other persons beyond those expressly set forth by the Company in Section _ of this Agreement."

Anti-reliance provisions can even bar claims based on fraudulent misstatements. In determining whether the provision bars fraud claims, the language of the agreement is key. No specific magic words are necessary. But Delaware courts have ruled that a provision stating only that *the target* is not making extra-contractual statements to be relied on by the buyer will not bar fraud claims. *FdG Logistics LLC v. A&R Logistics Holdings, Inc.*, 131 A.3d 842, 861 (Del. Ch. 2016). A provision will bar fraud claims, however, if it says that *the buyer* is not relying on extra-contractual statements. When a merger agreement contains this buyer-focused language, as reasoned in *Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006), allowing the buyer to assert a fraud claim would "excuse a lie made by [the buyer] in writing"; namely, that it was not relying on extra-contractual representations.

Some merger agreements contain further nuances. For example, in addition to an anti-reliance provision, the agreement may also expressly provide that the buyer retains the right to bring fraud claims against the seller. Whether this carve-out is sufficient to preserve fraud claims for extra-contractual statements is a matter of contractual interpretation. *See, e.g.*, *ChyronHego Corp. v. Wight*, 2018 WL 3642132, at *5 (Del. Ch. July 31, 2018) (holding that carve-out for fraud claims applied only to contractual misrepresentations); *EMSI Acquisition, Inc. v. Contrarian Funds, LLC*, 2017 WL 1732369, at *11 (Del. Ch. May 3, 2017) (holding that meaning of carve-out for fraud claims was ambiguous).

If an anti-reliance provision effectively disclaims reliance on the alleged extra-contractual misstatement at issue, the buyer cannot bring state law fraud claims based on the misstatement, even if it was made with the intent to deceive. Claims under the antifraud provisions of the federal securities

laws may, however, still be a possibility. *See AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 180 (3d Cir. 2003). *But see Harsco Corp. v. Segui*, 91 F.3d 337, 343–44 (2d Cir. 1996) (holding that anti-reliance provisions are sufficient to defeat a Rule 10b-5 claim). And in the absence of a well-worded anti-reliance provision, even state law fraud claims for extra-contractual statements are fair game.

Claims for Fraudulent Misstatements in the Merger Agreement May Be Viable

If the allegedly fraudulent misstatements are contained in the merger agreement itself, then anti-reliance provisions are inapplicable and the buyer may have viable claims for fraud, assuming all elements of a fraud claim can be satisfied. There are various reasons why such a claim may be more valuable than a breach of contract claim based on inaccuracies in the representations or warranties in the agreement. Remedies for breaches of representations and warranties may be significantly limited by the terms of the agreement. For example, there may be a minimum deductible that has to be met before the claim can be brought or a cap on any potential recovery. And the source of recovery may be limited to an escrow created as part of the agreement (possibly supplemented by a representations and warranties insurance policy). As a result, contractual remedies may not be sufficient to make the buyer whole.

Accordingly, a buyer may wish to consider fraud claims. Fraud is, of course, generally harder to prove than breach of contract—in particular, it requires showing both intent to defraud and reasonable reliance. But if the buyer can show that the misstatements constituted fraud, the buyer may not be limited by the contractual restrictions on recovery; fraud claims are commonly excluded from such restrictions. In addition, the buyer may have nonmonetary remedies such as rescission that would not be available for a breach of contract claim.

Furthermore, claims for fraud in the making of representations and

warranties are not necessarily limited to claims against the target company. While it is generally the target company that makes the key representations and warranties in a purchase agreement, a post-closing claim against the target company is of little value to the buyer in a stock purchase deal—the buyer now owns the target (if it even still exists) and thus would essentially be making a claim against itself. Under Delaware law, however, the buyer may bring fraud claims directly against the sellers or employees of the target company who are responsible for the misrepresentations, even if the purchase agreement ascribes the representations solely to the target company. *See Prairie Capital III, L.P. v. Double E Holding Corp.*, 132 A.3d 35, 59–61 (Del. Ch. 2015) (allowing claim against corporate officers and agents who made fraudulent statements on behalf of the company); *Abry Partners*, 891 A.2d at 1064 (allowing claim against seller, a private equity firm, if the seller itself lied to the buyer or remained silent with the knowledge that the target company's representations were false).

Note that under Delaware law, it is impossible to contract around a buyer's right to bring fraud claims for deliberate misrepresentations in the purchase agreement. Provisions that purport to do so are considered contrary to public policy and void. *See Abry Partners*, 891 A.2d at 1059.

Beware the Indemnity and Advancement Burden

Even where claims against individual directors or officers of an acquired company are possible, there is a potential downside to bringing such claims. Depending on the acquired company's bylaws, the buyer may be required to indemnify the directors or officers for their defense of a lawsuit or even to advance those expenses while the litigation is ongoing.

In Delaware, a company must indemnify an officer or director who ultimately prevails in a lawsuit pertaining to his or her service. Del. Gen. Corp. Law § 145(c). And to attract officers and directors to serve, many companies' bylaws create indemnification requirements that go beyond the

statutory requirements.

Bylaws also frequently provide for full advancement of directors' and officers' expenses as they are incurred. Advancement is not required by statute; however, it is provided by many companies to help entice and retain qualified people to serve as officers or directors. Bylaws may exclude advancement for defending against claims of intentional wrongdoing. But there is frequently a carve-out requiring advancement, even when intentional misconduct is at issue, if the officer or director agrees to repay the money in the event he or she loses in the lawsuit.

If the indemnification and advancement protections in the acquired company's bylaws require the buyer to indemnify and advance funds to directors and officers of the acquired company, the buyer may be on the hook for the defendants' legal expenses, at least in the first instance.

Conclusion

Is your client feeling defrauded after buying a company? A seller cannot contract around claims for fraud based on representations within the purchase agreement. However, under Delaware law, well-drafted anti-reliance provisions can effectively shut down claims for fraud if those claims are based on representations outside of the purchase agreement. So if there are matters related to the condition or performance of a target company that are important to your client's purchase decision, make sure they are the subject of specific representations and warranties within the agreement —especially if the seller insists on strong anti-reliance provisions.

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