Chancery Ruling Clarifies M&A Fraud Claim Limits

By **Lacey Croy, Lindsey Dundas and Seth Belzley** (September 1, 2021)


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In Online Healthnow Inc. and Bertelsmann Inc. v. CIP OCL Investments LLC, the Delaware Court of Chancery addressed whether the court should broadly limit the right to bring post-closing claims "so potent they effectively eviscerate all claims, including those that allege the contract itself is an instrument of fraud."

In the August decision, Vice Chancellor Joseph R. Slights III, though, opened his argument in a bit more colorfully, writing:

> In a scene from the classic film Butch Cassidy and the Sundance Kid, the scofflaw protagonists are frustrated in their attempts to gain entry into a cash-filled train car as they attempt to rob it.[1] In his frustration, Butch resorts to a heavy dose of dynamite, apparently too heavy. On detonation, the entire train car, and its contents, are blown to bits. As the ash from incinerated currency rains down, Sundance turns to Butch and asks sarcastically, "Think you used enough dynamite there, Butch?"

Thus, the Online Healthnow court continues the line of Delaware cases asking the following question: When it comes to contractual provisions in an acquisition agreement that seek to protect a seller from post-closing fraud claims, how much dynamite is too much?

Background

When negotiating a purchase agreement, buyers and sellers rarely reach swift agreement on the issue of post-closing indemnification. Indeed, the indemnification provisions in an acquisition agreement are often the most difficult to negotiate. When asked what keeps sellers up at night, undoubtedly, a primary concern is any liability that may continue to lurk after the sale and potentially expose the seller to payments of substantial amounts from the sales proceeds to the buyer after closing.

Sellers want security and certainty. In short, the ideal structure allows the seller to walk away from the deal and ensure that the sales proceeds will remain in its pocket.

On the contrary, buyers proceed cautiously as they negotiate indemnity provisions, wary of potentially paying millions of dollars to a seller at closing, only later to discover that the purchased business is worth substantially less than what was believed based on pre-closing information and related representations and warranties. Throughout these negotiations, one issue in particular seems to trip up buyers and sellers the most — limitations on the seller's liability for fraud.

It will come as no surprise that clever counsel for sellers seek to limit exposure for fraud claims arising out of an acquisition agreement as much as possible. These limitations usually appear in several provisions in the agreement including nonreliance and exclusive remedy provisions, as well as limits on the maximum amount of damages payable and the length of indemnification periods, and more creatively, through providing specific, narrow definitions of "fraud" and providing that all other claims for fraud are subject to limitations in the acquisition agreement.

For some time, it has been clear that Delaware courts would enforce some limitations on the extent to which a seller could protect itself from claims of fraud arising out of an acquisition agreement, but the exact edges of those limitations have been a bit blurry. Online Healthnow sharpens those edges a bit.

Settled Delaware Limitations

In developing the extent to which fraud claims can be eliminated in an acquisition agreement, Delaware courts attempt to strike a balance between two somewhat competing public policy principles. First, Delaware embraces the notion that sophisticated parties should be free to negotiate contractual understandings and that courts should enforce those agreements. Second, Delaware is loath to allow a party to be released from committing fraud.

Since the seminal 2006 Delaware case of ABRY Partners v. F & W Acquisition, it has been clear that provisions seeking to limit fraud claims based on statements made outside the four corners of an acquisition agreement can be enforced.

In the M&A context, in which sellers are required to provide a lot of information through a sometimes long diligence process, all of which could form the basis for a fraud claim, courts respect the agreement among buyers and sellers to limit the universe of statements on which a fraud claim could be based to only those within the acquisition agreement.

However, the ABRY court confirmed that it is against public policy to allow an acquisition agreement to release a seller from fraud claims based upon statements made within the acquisition agreement itself. Thus, the ABRY case makes clear that a clause purporting to prevent fraud claims arising from the representations and warranties found within an acquisition agreement is unenforceable.

Sellers will also typically seek to limit the extent of their indemnification obligations under an acquisition agreement by imposing a cap on the damages that a buyer can seek from the seller. ABRY also makes clear that these contractual caps on damages cannot cap damages arising out of fraud claims even when the fraud claim is based upon a breach of a representation and warranty in the acquisition agreement.

Online Healthnow Provides Additional Clarifications

The court in Online Healthnow recognized that the ABRY court had squarely addressed these questions of whether fraud limitations related to what and how such limitations were enforceable. But in addition to these, counsel to sellers also often try to impose other limitations as well, such as who can be pursued by a buyer in respect of fraud claims, or the time period following closing within which a claim must be brought. These questions of the extent to which fraud limitations related to when and who were enforceable remained less clear after ABRY.

On the first issue, when a buyer must bring a claim of fraud, acquisition agreements nearly always include a concept regarding the expiration of representations and warranties or other explicit limitations on when a fraud claim can be brought.

On this front, the Online Healthnow court reviewed prior case law, including in Sterling

Network Exchange LLC v. Digital Phoenix Van Buren LLC, a 2008 Delaware Superior Court case that tended to say that when limitations could be enforceable as long as the limitations were reasonable in light of the facts, and expressed "skepticism that Sterling is an accurate expression of Delaware law."

Rather, the Online Healthnow court summarized its position as follows:

> Based on the weight of authority, and Delaware's public policy, I am satisfied that the SPA's survival clause cannot, and does not, defeat Plaintiffs' contractual fraud claims. To be clear, the clause serves its purpose — there can be no post-closing claim for breach of a warranty that did not survive closing. But the Sellers cannot invoke a clause in a contract allegedly procured by fraud to eviscerate a claim that the contract itself is an instrument of fraud. That is not, and cannot be, countenanced by Delaware law.

On the second issue, who can be held liable for fraud claims, parties will often include in an acquisition agreement explicit statements along the lines that only parties to the contract, and not their affiliates, can be held liable. Another approach is to limit the parties making contractual representations and warranties, or include specific definitions of fraud that limit fraud claims to be based only on statements made by certain parties, or only by parties with a particular state of mind.

Online Healthnow makes clear that any of these limitations in an acquisition agreement cannot protect a party who actually knew of and participated in the fraud. This is significant because counsel on deals often spend considerable time negotiating around these topics, which it seems clear now is not time well spent.

Conclusion

In summary, the Online Healthnow court reemphasized that ABRY is settled law and allows buyers and sellers to limit what statements can form the basis of a fraud claim to only those within the acquisition agreement, and that limitations in an acquisition agreement on how much a buyer can seek in respect of a fraud claim are not enforceable.

And the court went further to clarify that limitations on when a buyer must bring a fraud claim are not generally enforceable, particularly when they are not reasonable in the circumstances, and that notwithstanding explicit or creative approaches to limiting who can be liable for fraud in an acquisition agreement, Delaware courts will not allow parties who actually knew and participated in a fraud to be released by the acquisition agreement.

In other words, contractual limitations are like dynamite — they can be useful and are acceptable in measured doses, but when a seller uses an acquisition agreement to commit fraud, it cannot use that same agreement to protect itself from liability for fraud. That's too much dynamite.

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[1] Butch Cassidy and the Sundance Kid (Campanile Productions, Newman-Forman Co. 1969).

[2] See Glenn D. West, That Pesky Little Thing Called Fraud: An Examination of Buyers' Insistence Upon (and Sellers' Too ready Acceptance of) Undefined "Fraud Carve-Outs" in Acquisition Agreements, 21 (2015).