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WHY IT'S IMPORTANT TO DRAFT CLEAR AND UNAMBIGUOUS PROVISIONS ON FRAUD CLAIMS IN M&A AGREEMENTS

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A RECENT DELAWARE Court of Chancery decision in the dispute between Airborne Health Inc. and Squid Soap LP illustrates that, absent appropriate contractual provisions, parties may be exposed to extracontractual liability for fraud in M&A transactions, thereby eviscerating the otherwise carefully negotiated terms of their contracts.

In 2007, Squid Soap entered into an asset purchase agreement to sell its assets to Airborne for a \$1 million cash payment at closing and the right to an earnout of up to \$26.5 million. Following closing, Squid Soap learned that the pre-existing Airborne business was the subject of many critical reports, investigations and lawsuits that negatively affected Squid Soap's ability to attain the earnout. Yet the parties' contract contained no express warranties that were breached by these revelations. Squid Soap, dissatisfied with its deal with Airborne, asserted that Airborne made fraudulent extracontractual statements to induce Squid Soap to enter into their contract. The threshold question for the court was whether Squid Soap could bring a fraud claim with respect to extracontractual statements.

Dissatisfied parties to a contract often resort to claims under tort law for fraud and misrepresentation to avoid or modify the express terms of the contract. As a default rule, Delaware courts recognize these claims and the more traditional claims under contract law for breach of warranty.

Breach-of-warranty claims generally require showing only that the defendant made an inaccurate statement within a contract, without regard to intention. Misrepresentation or fraud claims can include claims that the defendant made an inaccurate statement

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within or outside of a contract, and take intention into account. Fraud claims generally require showing that the defendant, intending to induce the plaintiff, knowingly or recklessly made a false statement or concealed the truth and that the plaintiff was injured when it justifiably relied on such statement or concealment.

The remedies for fraud may include punitive damages or equitable relief in addition to contract damages.

Accordingly, sophisticated contracting parties frequently seek to limit their exposure to fraud claims by including contractual provisions that disclaim reliance on any extracontractual statements.

Delaware courts have permitted parties to immunize themselves from extracontractual liability by using "anti-reliance" and "disclaimer" provisions, but they also require that such language be clear and unambiguous. The courts rationalize that if sophisticated parties have explicitly bargained away their right to rely on extracontractual statements, the element of justifiable reliance required for a finding of fraud cannot be satisfied.

In addition, Delaware courts have held that, while parties may use contractual devices to shield themselves from fraud claims with respect to extracontractual statements, they may not do so with respect to false statements knowingly made within a written contract, no matter how explicit the language limiting such liability.

The court in the Squid Soap case found that the standard integration clause in the disputed contract was not a sufficiently express



anti-reliance or disclaimer provision that could preclude Squid Soap from asserting fraud claims relating to extracontractual statements. Moreover, the court found that the exception to the exclusive remedies provision for “claims involving fraud” contractually permitted Squid Soap to assert such fraud claims, as the contract did not limit “fraud” to statements made only within the contract.

Fortunately for Airborne, the court did not reach the merits of these fraud claims because of certain pleading defects. Nonetheless, this case serves as a good reminder of the importance of drafting unambiguous anti-reliance and disclaimer provisions. In addition, M&A practitioners should note that exceptions for

fraud can take on unintended meaning unless precisely defined. To protect against extracontractual liability, parties should specify that fraud refers only to actual and intentional fraud with respect to statements in the written contract and that such fraud can exist only if certain parties had actual knowledge of the falsity of such statements. As the Squid Soap case demonstrates, failure to follow these rules can potentially expose parties in M&A transactions to unexpected liability for extracontractual statements. ■

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