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"Too Much Dynamite": Buyer's Fraudulent Inducement Claim Survives Seller's Defense Based on Contractual Limitations on Post-Closing Liability

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DELAWARE CORPORATE LAW BULLETIN

***“TOO MUCH DYNAMITE”*: BUYER’S FRAUDULENT INDUCEMENT CLAIM SURVIVES SELLER’S DEFENSE BASED ON CONTRACTUAL LIMITATIONS ON POST-CLOSING LIABILITY**

Chancery Court permits buyer to challenge allegedly fraudulent representations in purchase agreement, despite “remarkably robust” contractual provisions designed to shield seller and its affiliates from post-closing liability

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INTRODUCTION

When negotiating and documenting a merger and acquisition (“M&A”) transaction, a selling party will generally seek to limit its exposure for problems with the sold business discovered *post-closing* by the purchasing party. One such provision, the *survival clause*, limits the period, post-closing, during which breach of contract claims may be brought. Another, the *nonreliance clause*, requires a buyer to represent it is not relying on any representation or warranty of seller beyond those included in the purchase agreement. Finally, the *nonrecourse provision* shields individuals affiliated or associated with a seller from liability in connection with the M&A transaction.

While Delaware, as a procontractarian state, prefers that its judiciary not meddle in contractual arrangements negotiated by sophisticated and well-represented parties at arm’s length, Delaware courts have drawn certain lines that limit freedom of contract in the M&A context. For instance, in *Online HealthNow, Inc. v. CIP OCL Invs., LLC*, No. 2020-0654-JRS, 2021 WL 3557857 (Del. Ch. Aug. 12, 2021) (“*Online HealthNow*”), Vice Chancellor Joseph R. Slights III (“*Vice Chancellor*”) of the Delaware Court of Chancery (“*Chancery Court*”) described four limits that a seller may seek to “modify its exposure to a post-closing fraud claim”:

- “‘*what*’ information the buyer is relying upon”;
- “‘*when*’ the buyer may bring a claim”;
- “‘*who*’ among the sellers may be held liable and ‘*who*’ among the buyers may pursue a claim”; and
- “‘*how much*’ the buyer may recover if it proves its claim” (emphasis added).

According to Vice Chancellor Slights, the “seminal” decision authored by then-Vice Chancellor Leo E. Strine, Jr. in *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006) (“*ABRY*”), addressed both the “What” and “How Much” limits. The *ABRY* court concluded that (i) a purchaser may “contractually disclaim reliance on extra-contractual statements whether true or false, but a seller may not contractually limit its liability for making knowingly false statements *within the contract itself*” (emphasis added); and (ii)

“contractual caps for indemnification claims will not cap the recovery for contractual fraud.”

The “When” and “Who” limits, not at issue in *ABRY*, were the subject of a contractual dispute between parties to an M&A transaction in *Online HealthNow*. According to Vice Chancellor Slight, the key question before him was

whether, in the context of an acquisition agreement, Delaware courts should enforce broad contractual limitations on the right of contracting parties to bring post-closing claims that are so potent they effectively eviscerate all claims, including those that allege the contract itself is an instrument of fraud. In other words, can parties to a contract . . . detonate all *bona fide* contractual fraud claims (discovered or undiscovered) with a stroke of their pens at the closing table.

The Vice Chancellor answered this question in the negative, opining that

[u]nder Delaware law, a party cannot invoke provisions of a contract he knew to be an instrument of fraud as a means to avoid a claim grounded in that very same contractual fraud. Stated more vividly, while contractual limitations on liability are effective when used in measured doses, the Court cannot sit idly by at the pleading stage while a party alleged to have lied in a contract uses that same contract to detonate the counter-party’s contractual fraud claim. That’s too much dynamite.

Against this backdrop, the post-closing dispute in *Online HealthNow* raised two questions regarding the efficacy of “remarkably robust” contractual liability limitations in the context of a fraudulent inducement claim: (i) whether a survival clause purporting to terminate representations and warranties at closing may be invoked by the selling party to bar a contractual fraud claim based on those representations and warranties; and (ii) whether nonrecourse and antireliance provisions may be called upon to block a contractual fraud claim against affiliates and associates of the selling party. Invoking principles of Delaware public policy, the Vice Chancellor denied defendants’ pleading-stage motion to dismiss, determining that, in the context of contractual fraud claims, the purchase agreement’s limitations on post-closing liability provided defendants with “too much dynamite.”

I. FACTUAL BACKGROUND

A. OCL Accumulates Unpaid Tax Liabilities

CIP Capital Fund, L.P. (“*CIP Capital*”), a private equity fund, indirectly owned, through three intermediate holding companies (“*Holding Companies*”), 100% of the equity in OnCourse Learning Corporation (“*OCL*”). The Holding Companies were (i) CIP Capital’s direct subsidiary, CIP OCL Investments, LLP (“*Seller*”), (ii) Seller’s direct subsidiary, CIP OCL Holdings, Inc. (“*Company*”), and (iii) the

Company's direct subsidiary, CIP OCL Acquisition, Inc. ("*Acquisition*"). Acquisition directly owned OCL.

OCL "provides continuing education programs to millions of adult professionals, mainly in the United States." In June 2015, OCL discovered it had been improperly tracking online sales of its educational service products, "result[ing] in significant state sales and use taxes that were not collected and/or remitted over a period of several years" ("*Tax Issue*"). In June 2018, an outside accounting firm retained by OCL to investigate the Tax Issue found "a significant portion of OCL's revenue streams to be free of taxation."

B. CIP Capital Explores Selling OCL

About the same time as the outside accounting firm conducted its Tax Issue investigation, CIP Capital initiated a process to monetize its interest in OCL via a sale of the Company. For this purpose, CIP Capital retained Harris Williams & Company ("*Harris Williams*") as its financial advisor. In turn, CIP Capital and Harris Williams formed a working group to manage the sale process ("*Working Group*"), consisting of representatives of Harris Williams as well as four members of top management of CIP Capital and OCL (these individuals, the "*Individual Defendants*").

C. Inconsistent Disclosures Across Bidders

Among the bidders for the Company was Bertelsmann, Inc. ("*Bertelsmann*"), which ultimately proved to be the winning bidder. The Individual Defendants "instructed Harris Williams that only certain categories of data should be included in particular data rooms made available to particular bidders, including Bertelsmann." In fact, another bidder was furnished with "information concerning the scope and severity" of the Tax Issue, leading this bidder to estimate OCL's "sales and use tax liability exposure to be in the range of \$8–9 million." When this bidder demanded either a significant purchase price reduction or escrowing a portion of the purchase price to address its potential exposure to the Tax Issue, CIP Capital rejected its offer. Notably, the Working Group failed to provide Bertelsmann with any information concerning the Tax Issue.

D. Seller and Bertelsmann Sign the SPA

Ultimately, when "Bertelsmann emerged as the successful bidder," CIP Capital caused Seller to enter into a stock purchase

agreement dated August 20, 2018 (“SPA”), providing for sale of the Company to Bertelsmann. The sale closed on November 1, 2018 (“Closing”). In the SPA, Seller represented (among other things) that (i) “all [Company] tax returns had been ‘duly and timely’ filed and were ‘true, complete and correct in all material respects,’” and (ii) the Company “had no undisclosed liabilities” (collectively, “Representations”). For its part, Bertelsmann represented that it had been “‘provided adequate access to the properties, premises and records of the Company and each Company Subsidiary for the purpose of [its] review’ and that it did not rely on ‘any representation or warranty by, or information from, the Seller, the Company,’ or anyone else . . . ,” other than those made in the SPA (“Antireliance Clause”).

The Seller also negotiated for SPA provisions intended to limit its liability, post-Closing, for indemnity claims that may be brought by Bertelsmann if it discovered inaccuracies in the Representations. These included (i) a provision (“Survival Clause”) terminating the Representations “effective as of the Closing,” and (ii) a provision (“Nonrecourse Provision”) providing that Bertelsmann could bring claims under the SPA against only the Seller and the Company “and their respective successors and permitted assigns,” but expressly excluding any “officer, director, partner, manager, equityholder, employee or Affiliate” of Seller or the Company (i.e., CIP Capital).

E. Litigation Ensues

Several months after the Closing, through its “investigation of OCL’s . . . internal communications and books and records,” Bertelsmann discovered the Tax Issues and related inaccuracies in the Representations. Moreover, Bertelsmann “concluded OCL’s financial and accounting irregularities were not the product of mere negligence or sloppy bookkeeping, but rather resulted from . . . intentional misrepresentations.”

After settlement negotiations failed, Bertelsmann filed a complaint in Chancery Court bringing a variety of claims against CIP Capital, Seller, and the Individual Defendants (collectively, “Defendants”). Bertelsmann claimed, among other things, “fraud in the inducement” on the part of CIP Capital and Seller “based on the allegedly false” Representations and “aiding and abetting that fraud” by the Individual Defendants. Defendants moved to dismiss all claims.

II. VICE CHANCELLOR SLIGHTS' ANALYSIS

With a focus on public policy, Vice Chancellor Slight denied Defendants' motion to dismiss. The Vice Chancellor opined that despite the SPA's "remarkably robust survival, anti-reliance and non-recourse provisions," dismissal would be improper where contractual limitations on liability are employed to bar fraud claims by a party alleged to have lied to induce such provisions.

At the outset, the Vice Chancellor determined that Bertelsmann adequately alleged "a claim for fraudulent inducement" by pleading "the circumstances constituting fraud . . . with particularity." Specifically, in its complaint, Bertelsmann both (i) identified the specific false Representations and (ii) "allege[d] facts sufficient to support a reasonable inference that the [R]epresentations were knowingly false." And, "[b]ecause knowledge of the wrongdoing by officers or directors can be imputed to the corporation, [Bertelsmann] well plead particularized allegations of knowledge against CIP Capital and OCL."

Next, Vice Chancellor Slight turned to "Defendants' showcase argument . . . that the SPA expressly disassembles [Bertelsmann's fraud] claim through at least two bargained-for limits": (i) by virtue of the Survival Clause, the Representations "terminate[d] upon closing, and therefore any claim (including a fraud claim) arising [therefrom] . . . was extinguished when the deal closed" and, even if the Survival Clause did not so operate, (ii) the Antireliance Clause and Nonrecourse Provisions together acted to bar Bertelsmann's "fraud claim against CIP Capital." Bertelsmann countered that Delaware law does not allow Seller and CIP Capital to "attempt to escape the consequences of their fraud by pointing to other provisions within the same fraudulently-procured contract that purport to limit the seller's liability." For Vice Chancellor Slight, resolution of this dispute rested on an application of *ABRY*.

A. *Abry and Sterling*

ABRY instructed "that the 'strong American tradition of freedom of contracts' . . . must give way to Delaware's venerable public policy against fraud, rooted fundamentally in the 'societal consensus that lying is wrong.'" Accordingly, when "an agreement purports to limit liability for a lie made within the contract itself," and the selling party and its affiliates "*know* of the lie, such parties cannot skirt liability through contractual limits within the very contract they procured by fraud." *ABRY*'s "thorough and thoughtful treatment of post-closing

fraud claims,” Vice Chancellor Slight observed, “is now engrained in Delaware’s common law.”

Defendants sought to avoid application of *ABRY* by arguing that while *ABRY* focused on “contractual limitations on reliance and knowledge,” it did not “address the impact of clear non-recourse and survival clauses like those in the SPA.” This argument led the Vice Chancellor to consider a post-*ABRY* decision of the Delaware Superior Court in *Sterling Network Exch., LLC v. Digit. Phoenix Van Buren, LLC*, No. 07C-08-050WLW, 2008 WL 2582920 (Del. Super. Ct. Mar. 28, 2008) (“*Sterling*”). According to the Vice Chancellor, while the *Sterling* court “appears to acknowledge that *ABRY* [’s] rationale applies to survival clauses, it apparently did not view *ABRY Partners* as foreclosing the application of survival clauses to fraud claims as a matter of law on public policy grounds.” Rather, the *Sterling* court focused on whether the purchase agreement in question “failed to provide a reasonable period of opportunity to unearth possible misrepresentations.”

Vice Chancellor Slight “offered [his] two cents,” noting “the basis for *Sterling*’s rationale is questionable, and a reflexive application of a ‘reasonableness’ standard to survival clauses in the context of contractual fraud is likely not warranted.” Against this backdrop, the Vice Chancellor turned to the relevant clauses of the SPA.

B. Survival Clause Efficacy

Seeking to rely on the *Sterling* rationale, Defendants offered as their “premiere contractual argument” the fact that Bertelsmann had a seventy-three day period in which to conduct due diligence before entering into the SPA. This period, according to Defendants, afforded Bertelsmann “a reasonable period to discover the potential misrepresentations.” Defendants also criticized Bertelsmann for delaying bringing its claim until “eight months after closing,” despite the “ample opportunity” for Bertelsmann to discover the alleged fraud presigning. For its part, rather than challenging *Sterling* directly, Bertelsmann sought to distinguish the relevant facts by noting it was “not provided a reasonable period to unearth possible misrepresentations given the relevant information was not in the data room and the fraud related to the . . . sales and use tax liability did not surface until well after closing.”

As noted above, Vice Chancellor Slight was “reticent to endorse the rationale adopted in *Sterling*” and noted that, in any case, “the ‘reasonableness’ of [Bertelsmann’s] delay [in bringing its claim] would . . . be nuanced and ultimately require a fact intensive inquiry.”

Rather than adopting this approach, the Vice Chancellor ruled that “[b]ased on the weight of authority, and Delaware’s public policy, I am satisfied that the SPA’s survival clause cannot, and does not, defeat [Bertelsmann’s] contractual fraud claims.” Regardless of the efficacy of the Survival Clause generally to defeat a post-closing indemnity claim based on breach of the Representations, the Vice Chancellor refused to permit Defendants to “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, and cannot be, countenanced by Delaware law.”

C. Efficacy Of Nonrecourse Provision

CIP Capital argued that even if Vice Chancellor Slight’s was not prepared to accept Defendants’ arguments with respect to the Survival Clause, CIP Capital itself “cannot be held liable” for misrepresentations made by Seller in the SPA by virtue of the Antireliance Clause and the Nonrecourse Provision. Bertelsmann countered “that it expressly relied on the allegedly fraudulent misrepresentations made by [Seller], and *ABRY* . . . does not permit CIP Capital to take cover behind a non-recourse provision if it knowingly participated in the alleged contractual fraud.”

Vice Chancellor Slight’s again sided with Bertelsmann, explaining that Delaware law “is generally understood . . . to disregard non-recourse clauses where the parties purportedly insulated by those clauses were complicit in contractual fraud.” Thus, because Bertelsmann “well pled that CIP Capital did, in fact, know of and facilitate the fraudulent misrepresentations in the SPA through its participation in the CIP Working Group, CIP Capital cannot invoke the non-recourse provision to avoid liability under *ABRY* . . . and its progeny.”

CONCLUSION

In *Online HealthNow*, Vice Chancellor Slight’s applied the “now engrained” principles of *ABRY* to standard protections negotiated by selling parties to limit their post-closing liability for inaccuracies in contractual representations and warranties. While Delaware remains a procontractarian jurisdiction, when sellers make fraudulent representations and warranties *in a purchase agreement*, those protections “must give way to Delaware’s venerable public policy against fraud, rooted fundamentally in ‘the societal consensus that lying is wrong.’” On this basis, the Vice Chancellor opined that Delaware law and public policy prevent sellers from employing a

survival clause “in a contract allegedly procured by fraud to eviscerate a claim that the contract itself is an instrument of fraud.” The Vice Chancellor also clarified that a purchase agreement’s nonrecourse and antireliance provisions are not effective to shield a seller’s affiliated entities from fraudulent inducement claims when it is well pled that the affiliates were aware of, and facilitated, the fraudulent conduct.