

Delaware Supreme Court Holds That Diligence Gaps Do Not Defeat Fraud Claims Based on Contractual Representations

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KEY POINTS

- In *Paragon Metals Holdings LLC v. Smith*, the Delaware Supreme Court held that a buyer's reliance on a seller's false contractual representations was justifiable even though the buyer's due diligence missed several "red flags."
- In assessing justifiable reliance in a common law fraud claim, the Delaware Supreme Court held that willful blindness requires both a subjective belief that a fact is highly probable and deliberate action to avoid learning it.
- The *Paragon Metals* ruling held that a buyer's acknowledgment it conducted an independent investigation functioned as a one-sided anti-reliance clause, not a duty to conduct reasonable diligence.
- The court confirmed in *Paragon Metals* that Delaware common law fraud claims are governed by the preponderance of the evidence standard, not clear and convincing evidence.
- Because the anti-reliance clause in *Paragon Metals* barred the buyer from relying on extra-contractual statements, buyers should, among other steps, convert key diligence responses into specific representations or schedules.

In *Paragon Metals Holdings LLC v. Smith*, the Delaware Supreme Court reversed a post-trial judgment for a seller who knowingly made false representations in a purchase agreement. The court held that the buyer justifiably relied on those representations even though its diligence missed several "red flags." The court also confirmed that common law fraud in Delaware need only be proved by a preponderance of the evidence. The decision reinforces that a seller who lies in the agreement cannot escape liability by pointing to what the buyer should have found. Only a buyer's actual knowledge, or deliberate avoidance of the truth, will defeat reliance.

BACKGROUND

Affiliates of Stellex Capital (the buyer) acquired Paragon Metals LLC (the company), an automotive components manufacturer, from its founder (the seller) for \$100 million. Before closing, two of the company's three largest customers told the seller they would materially reduce their future orders, and one told him the company would no longer be its sole supplier for certain components. The seller then took several steps to conceal the changes:

- He insisted that the customer remove the reduced volumes from a contract amendment.
- He promised the customer a \$300,000 rebate, larger than any it had previously been offered, routed it through an overseas affiliate to keep it off the company's books and subsequently discarded his work cellphone in the trash.

- When the buyer asked about a struck-through reference to the customer's letter in a draft document, the seller told the buyer the customer's order changes would be volume neutral.
- He removed the customer's letter announcing the volume reduction as an attachment to a pre-closing email to the buyer, leaving only a brief reference to it in the body.

The agreement nonetheless represented that the seller had no knowledge that any major customer would, outside the ordinary course, decrease or change the terms of its purchases, and that no event had occurred that would reasonably be expected to have a material adverse effect on the company. After closing, the buyer defaulted on its acquisition financing, invested an additional \$37 million, and sued for fraud.

Following a five-day bench trial, the Delaware Superior Court found that the seller's representations were false and that he intended to defraud the buyer, but ruled for the seller on the ground that the buyer's reliance was not justified. The court reasoned that the buyer's acknowledgment that it had "conducted to its satisfaction an independent investigation" imposed a duty of reasonable diligence. Given the red flags, the court held that the buyer was "willfully blind" to the truth.

HOLDING

The Delaware Supreme Court affirmed the findings on falsity and scienter, reversed on justifiable reliance, and remanded for a determination of damages.

First, the court held that the buyer's acknowledgment did not impose a diligence obligation. Drawing on its recent decision in *Johnson & Johnson v. Fortis Advisors LLC*, the court treated the provision as a one-sided anti-reliance clause. Through that clause the buyer waived claims based on extra-contractual statements; it did not promise to investigate. Even if the provision required some diligence, its text measured that diligence by the buyer's own satisfaction, not an objective reasonableness standard. Any shortcomings in the buyer's diligence therefore did not prevent it from relying on the seller's representations.

Second, the court held that willful blindness requires two things: a subjective belief that a fact is highly probable, and deliberate action to avoid learning it. Failing to uncover fraud in diligence does not, without more, amount to deliberate avoidance. The buyer's trust in the seller fell short of that standard, particularly because the seller actively concealed the truth when the buyer asked questions.

Third, the court rejected the seller's argument that fraud must be proved by clear and convincing evidence, confirming that preponderance of the evidence governs common law fraud claims in Delaware. Neither the stigma of a fraud finding nor fraud's typical reliance on circumstantial evidence warrants a higher standard of proof.

TAKEAWAYS

- **Contractual representations remain a buyer's core protection.** A buyer's failure to uncover fraud in diligence generally will not defeat its reliance on the seller's representations, unless the buyer actually knew the truth or deliberately avoided learning it.
- **Diligence answers that matter belong in the agreement.** The court held that the anti-reliance clause barred reliance on statements made outside the agreement, including the buyer's customer meetings and the seller's informal explanations. Buyers should convert key diligence responses into specific representations or schedules.

- **Standard buyer acknowledgments do not create a diligence defense.** Sellers who want a buyer's knowledge to limit its claims must say so expressly. Even then, the court reiterated that a contract may not shield a party from liability for knowingly false representations in the agreement itself.

For questions about how this decision may affect deal documents, diligence, or fraud claims, contact author [Taylor B. Bartholomew](#) or any member of Troutman Pepper Locke's [Mergers + Acquisitions](#) or [Private Equity](#) teams. Our attorneys help buyers and sellers negotiate representations, warranties, and acknowledgment provisions and advise on fraud claims arising from transactions.

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