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Disclaiming Fraud Under Delaware Law

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A recent decision[1] by the Delaware Court of Chancery makes clear that extra-contractual fraud claims may only be eliminated through explicit anti-reliance provisions, not through other contractual mechanisms, such as exclusive remedy provisions.

Generally speaking, there are two varieties of intentional fraud under Delaware law — contractual fraud and extra-contractual fraud. Contractual fraud is a fraudulent statement made within the contract itself. Extra-contractual fraud is a fraudulent statement made outside of the contract, such as oral or written statements made during contract negotiations or statements made in documents in the due diligence data room.

As case law makes clear, public policy considerations prevent contracting parties from eliminating or cabining *contractual* fraud claims under Delaware law.[2] For instance, liability for contractual fraud claims cannot be eliminated, damages resulting from contractual fraud cannot be capped, and certain parties cannot be insulated from liability for contractual fraud through nonrecourse provisions or otherwise.

Delaware law is equally clear, however, that contracting parties can agree to eliminate *extra*-contractual fraud claims.[3] Delaware courts are clear that such claims can be disclaimed through explicit anti-reliance provisions — that is an acknowledgement by a party that it is only relying on information contained within the four corners of the agreement, not statements made outside the agreement.

Until recently, however, it was unclear whether extra-contractual fraud claims could be eliminated or cabined through other contractual mechanisms. The court's decision answers that question in the negative by holding that extra-contractual fraud claims may only be eliminated through explicit anti-reliance provisions.

The court made clear in its opinion that exclusive remedy provisions in acquisition agreements are not sufficient to bar extra-contractual fraud claims, even where the exclusive remedy provision stated that the indemnification provisions were the sole and exclusive remedy for all claims arising from the transactions memorialized by the agreement and did not contain any carve-out for extra-contractual fraud. Instead, explicit anti-reliance provisions are required to disclaim extra-contractual fraud claims.

Background and Court Analysis

In late 2018, Johnson & Johnson, through its subsidiary Ethicon, Inc. (Buyer), began negotiating an acquisition of Auris Health, Inc. (Company) from its stockholders (Sellers). The Buyer, Company, and Sellers entered into a merger agreement in February 2019. Under the agreement, the Buyer was to pay the Sellers $3.4 billion at closing and $2.35 billion in additional earnout payments. The agreement contained a one-sided anti-reliance provision in

which the Buyer disclaimed reliance on any representations made outside of the merger agreement. It did not contain a provision in which the Sellers disclaimed reliance on representations made outside of the merger agreement.

The merger agreement also included a set of indemnification provisions under which the parties agreed to indemnify each other against losses deriving from any breach, inaccuracy, or failure to perform a representation, warranty, or covenant found in the merger agreement. Indemnification was subject to certain limitations, such as a one-year limitations period to bring certain claims.

The parties agreed that the indemnification provisions would "be the exclusive remedy with respect to claims made after the Closing that relate to this Agreement or the transactions contemplated by this Agreement," subject to specified exceptions. Those exceptions included one for contractual fraud. It did not contain an exception for extra-contractual fraud.

After closing, the Sellers' stockholder representative asserted 12 claims against the Buyer and others, including a claim for extra-contractual fraud. The Buyer moved to dismiss the extra-contractual fraud claim on the basis that the claim was barred by the exclusive remedy provision in the merger agreement. Specifically, the Buyer argued that the exclusive remedy provision, which stated that the indemnifications provisions were the sole and exclusive remedy for any and all claims arising in connection with the transaction, did not have a carve-out for extra-contractual fraud, and that the extra-contractual fraud claims that the Sellers' representative brought were beyond the one-year limitations period in the indemnification provisions and were therefore untimely.

The court disagreed. It held that, in the absence of an explicit non-reliance provision, an exclusive remedy provision in the merger agreement does not bar the plaintiff from pursuing extra-contractual fraud claims based on allegedly false representations and omissions made during merger negotiations. The court stated that:

[an] exclusive remedy provision … cannot … eliminate [seller's] fraud claims. To find otherwise would ignore the delicate balance that Delaware courts have struck between supporting freedom of contract and condemning fraud. If the [buyers] intentionally misrepresented a fact that induced [sellers] to enter into the Merger Agreement, and [sellers] did not explicitly disclaim reliance on extra-contractual representations, [they] cannot be barred from recovering for that purported fraud.

Instead, the court found that an explicit anti-reliance provision is necessary to eliminate claims for extra-contractual fraud under Delaware law. Parties negotiating merger and acquisition agreements under Delaware law should be mindful of this ruling when seeking to eliminate or limit claims for extra-contractual fraud.

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[1] *Fortis Advisors, LLC v. Johnson & Johnson*, C.A. No. 2020-0881-LWW (Del. Ch. Dec. 13, 2021).

[2] *ABRY Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006); *Online Healthnow, Inc., v. CIP OCL Investments, LLC*, C.A. No. 2020-0654-JRS (Del. Ch. 2021).

[3] *See e.g.*, *FdG Logistics LLC v. A&R Logistics Hldgs., Inc.*, 131 A.3d 842, 859 (Del. Ch. 2016).

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