
CASE LAW

Public policy precludes contracting out of liability for outright lies in reps and warranties in a contract between sophisticated commercial parties

However, the Delaware Court of Chancery asserts that such parties are entitled to allocate risk of unintentional inaccuracies—including negligent and reckless ones—as they please

The Delaware Court of Chancery has ruled on public policy grounds, that even broad and freely negotiated liability limitations won't protect a party that knowingly makes misrepresentations in a commercial contract. Of equal importance, however, was the court's determination that it *is* possible to limit liability with respect both to misrepresentations outside the written contract and to those within the written contract that were not deliberate—even if they were reckless.

Thus the real interest of the decision may lie in the latitude the court is prepared to allow sophisticated parties when it comes to allocating the risk that contractual representations and warranties, other than outright lies, will turn out to be false. Vice Chancellor Strine is clear that reckless misrepresentations can be subject to such limitations: parties to a contract are free to allocate due diligence as they please, even to the point that the seller is not required to investigate its own representations. Of course, the parties must clearly indicate their intention to allow such limitations: the court observes, for example, that excluding fraudulent misrepresentations made outside the four corners of the agreement requires a clear disclaimer of reliance within the contract, not just a generally worded merger or integration clause.

The litigants were two private equity firms. Through a wholly-owned entity, Providence Equity Partners had sold F&W Publications to ABRY Partners. The Stock Purchase Agreement (SPA) had two critical provisions: a non-reliance provision precluding reliance on representations outside the written agreement and an indemnification provision that capped seller's liability (at \$20m, 4% of the \$500m purchase price) and that was meant to be the buyer's exclusive remedy. Any claims under the agreement were to be arbitrated.

ABRY's offer had been on the basis of 10x EBITDA. After the August 2005 closing, ABRY claimed to have found a pattern of deception on the part of F&W. The company had allegedly used what the court called "shenanigans" and "chicanery" to puff up its quarterly earnings and hence its sale price. While it was F&W that had supposedly cooked the books, Providence had provided an Officer's Certificate affirming the accuracy of F&W's reps and warranties. All of this had to be considered in the context of the liability limitation provision and the cap.

As this was a motion to dismiss, Vice Chancellor Strine assumed that the allegations against F&W were true.

ABRY advanced two arguments: (1) that on its own terms the Stock Purchase Agreement did not limit the remedy to damages capped at \$20m and (2) that, in the alternative, even if the SPA remedies limitation did apply on its face, public policy would override it. The court dismissed (1) but accepted (2).

Section 9.1 of the SPA limited the seller's indemnity to the buyer to \$20m for damages determined

...to have arisen out of or to have resulted from, in connection with, or by virtue of facts or circumstances which constitute an inaccuracy, misrepresentation, breach of, default in, or failure to perform, any of the representations, warranties or covenants.

The agreement went on to state that this "Indemnity Action" was to be the exclusive remedy with respect to "the Sale contemplated hereby". The court declined to interpret "misrepresentation" so as to exclude fraudulent misrepresentations. Such an interpretation would not accord with the ordinary meaning of the term. Moreover, the implied contrast in section 9.1 between "inaccuracy" and "misrepresentation" suggested that the parties had intended the provision to cover more than just innocent errors. The court was similarly unsympathetic to ABRY's argument that section 9.1 applied only to claims in contract, while ABRY's claim sounded in tort. Vice Chancellor Strine observed that this would maintain an artificial separation between contract and tort, with respect to actions on the basis of misrepresentation in the commercial contracting process. Because victims of such misrepresentations have always been able to proceed in either contract or tort, a clause purporting to limit damages awarded on the basis of contract law alone would make no commercial sense.

Public policy was the focal point of the decision. Although it turned out to be the winning point for ABRY, much of the significance of the decision, as indicated above, lies in the relatively limited scope the court allows to public policy considerations in the context of commercial contracts. The court observed that there is "a longstanding debate within American jurisprudence about society's relative interest in contractual freedom versus establishing minimum standards of truthful conduct for contracting parties". But he also stressed that truthfulness cuts both ways. Under Delaware law, a party that has disclaimed reliance on extra-contractual representations cannot subsequently allege "fraudulent inducement" on the basis of an alleged extra-contractual representation. That's as "untruthful" as the alleged fraudulent inducement itself, creating what Vice Chancellor Strine termed a "Double Liar" scenario, in which the courts will not favour either liar.

The court was explicit, however, that, to exclude fraudulent misrepresentations, the agreement must clearly disclaim reliance on all extra-contractual statements. A general merger or integration clause would not be sufficient.

In this case, the alleged false representations were in the contract itself. As noted, the court accepted that the language of the SPA clearly purported to exclude liability beyond the \$20m cap in all cases. However, he held that in these circumstances the alleged dishonesty, if established, would be sufficiently egregious to justify rescission on the basis of public policy.

The court rejected Providence's argument that only full exemptions from liability—as opposed to the limitation of liability at issue here—could be contrary to public policy. It then observed that, in general, U.S. courts have not permitted contractual waiver of a right to sue over a misrepresentation in the contract arising from a seller's reckless or intentional conduct. Nevertheless, the court took a more restrictive view here, concluding that public policy will prevail over even the strongest exculpatory clause, but only where there is a lie—as opposed to an innocent misrepresentation—within the four corners of a contract.

That was enough to allow ABRY's claim to go ahead in this case—since it was alleging a lie—but what may be really significant here is that the court held that public policy will not prevail over a clearly worded liability limitation where the impugned conduct fell short of an outright lie, including cases of reckless misstatements. The justification for the distinction is that sophisticated commercial parties should be allowed to allocate due diligence, even to the point that the seller is not required to investigate its own representations.

Lying, in contrast, cannot be construed in this way, as no effort or due diligence is required for the seller to say what it already knows to be true. In that sense, its burden is a moral one rather than one of effort and as such is more appropriately regulated by public policy. Note, however, that the public policy argument does not necessarily apply with respect to the selling private equity firm's responsibility for the lies of the company in which it has invested. Buyer and seller are free to allocate that type of risk as they please. In this case, however, the Officer's Certificate amounted to an effective adoption by Providence of F&W's representations and warranties.

The result was therefore that, to the extent that the SPA "purports to limit the Seller's exposure for its own conscious participation in the communication of lies to the Buyer, it is invalid under the public policy of this State", although "the Buyer may not obtain rescission or greater monetary damages upon any lesser showing". If the action proceeds to trial, ABRY will therefore bear a heavy burden of proof with respect to the defendants' state of mind.

ABRY Partners V L.P. et al. v. F&W Acquisition LLC et al., 2006 WL 1587416 (Del. Ch. 2006), Feb. 14, 2006

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