Contractual Limits On Liability Only Go So Far In Delaware

By **George Casey, Scott Petepiece and Derrick Lott** (October 20, 2021)

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On Aug.12, in Online HealthNow Inc. and Bertelsmann Inc. v. CIP OCL Investments LLC, Vice Chancellor Joseph Slights of the Delaware Court of Chancery denied the defendants' motion to dismiss a buyer's post-closing fraud claims arising from representations and warranties in a purchase agreement that allegedly were known to be false when made.

Vice Chancellor Slights noted that a seller may not use a limitation of liability clause in a contract obtained by fraudulent inducement to bar a buyer's fraudulent contract claim.

Background

During 2018, CIP Capital Fund LP, a private equity fund that indirectly owned CIP OCL Investments LLC, initiated an auction process to sell OnCourse Learning Corp. The auction process was managed by a working group that comprised representatives from CIP Capital's financial adviser, representatives of CIP Capital — the co-managing partner and a vice president of CIP Capital — and the CEO and chief financial officer of OCL.

As part of the auction process, the representatives of CIP Capital directed the CIP working group to disclose certain categories of information only to certain bidders. CIP Capital, the seller, the co-managing partner and vice president, the CEO and CFO of OCL were all named as defendants.

OCL sold its products through its website using an e-commerce system that was connected to OCL's tax reporting software, and when properly used, this system would apply the appropriate state sales and use tax to a customer's purchase at checkout. OCL discovered that it had not been using the tax reporting system properly as early as June 2015.

In June 2018, OCL retained an outside accounting firm to investigate this misuse, which investigation determined that, between 2014 and 2018, OCL had failed to pay sales and use taxes on a significant portion of its revenues. The outside accounting firm informed the CIP working group of the magnitude of OCL's sales and use tax liability on Aug. 14, 2018.

On or about Aug.15, 2018, the CIP working group provided a bidder with information regarding OCL's sales and use tax liability. This informed bidder estimated OCL's sales and use tax liability was between $8 million and $9 million, and as a condition to the acquisition, the bidder proposed an escrow of $15 million or a purchase price reduction based on the bidder's final determination of the potential tax liability prior to the closing of the transaction. CIP Capital rejected the informed bidder's proposals.

Bertelsmann Inc., the winning bidder in the auction process, was not informed of OCL's sales and use tax liability prior to the parties executing a share purchase agreement on Aug. 20, 2018, or following execution of the SPA and prior to the closing of the transaction, which occurred on November 1, 2018.

In the SPA, OCL represented, among other things, that:

- All tax returns had been duly and timely filed and were true, complete and correct in all material respects;
- The OCL had no undisclosed liabilities; and
- There were no material changes to OCL or its subsidiaries' accounting policies and practices with respect to collections of accounts receivable.

The buyer alleged that each of these representations were knowingly false when made in order to fraudulently induce the buyer into executing the SPA. Also, the SPA contained customary provisions through which a seller limits liability for post-closing claims, including:

- An anti-reliance clause, pursuant to which the buyer agreed that it did not rely on any representation or warranty by, or information from, the seller or OCL other than as expressly set forth in the representations or warranties of the seller and OCL in the SPA;
- A survival clause pursuant to which the parties agreed that none of the representations and warranties in the SPA survived the closing; and
- A nonrecourse provision, pursuant to which the parties agreed that the SPA may only be enforced against the express SPA parties and not any other persons.

During the post-closing purchase price adjustment process, the buyer uncovered the extent of the defendants' fraudulent scheme and surmised that "OCL's financial and accounting irregularities ... resulted from Defendants' intentional misrepresentations."

The defendants sought dismissal of plaintiffs' claim of fraudulent inducement through contractual fraud on two grounds:

- The plaintiffs failed to plead the claim with particularity; and
- The contractually bargained-for limitations of the SPA — i.e., the survival clause, anti-reliance clause and nonrecourse provision — shield the defendants from liability.

With respect to particularity, the court noted that the plaintiffs had identified the specific false representations and "satisfied the requirement to allege facts sufficient to support a reasonable inference that the representations were knowingly false" by alleging, among other things, that members of the CIP working group were informed of OCL's sales and use tax liability prior to signing the SPA, which knowledge was imputed to CIP Capital and OCL.

The defendants' primary argument was that the contractually bargained-for limitations of the SPA — i.e., the survival clause, anti-reliance clause and nonrecourse provision — expressly preclude the plaintiffs' claim.

The defendants asserted that:

- The survival clause provides that the claims predicated on false representations and warranties expired at the closing; and
- Even if such limitation does not bar the claim, the anti-reliance and nonrecourse provisions, together, bar the fraud claim against CIP Capital.

Vice Chancellor Slights rejected this theory, relying on the 2006 decision in ABRY Partners V LP v. F&W Acquisition LLC and its progeny as dispositive. In ABRY Partners, then-Vice Chancellor Leo E. Strine Jr. held that, "[t]o the extent that the Stock Purchase Agreement 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 [Delaware]."

Vice Chancellor Slights further relied on the prior holdings that:

- A survival clause would not defeat an otherwise well-pled contractual fraud claim, and;
- A nonrecourse provision does not protect a third party from liability when it facilitated the target's lies.

After determining that plaintiffs adequately alleged that CIP Capital knew about and facilitated the fraudulent misrepresentations in the SPA through its participation in the CIP working group, Vice Chancellor Slights denied the defendants' motion to dismiss. Citing Delaware's public policy against intentional fraud, he held that "a party cannot invoke provisions of a contract it knew to be an instrument of fraud as a means to avoid a claim grounded in that very same contractual fraud."

Our View

The court's decision in Online HealthNow reaffirms ABRY Partners as the settled law in Delaware governing the ability of buyers and sellers to eliminate fraud claims in an acquisition agreement.

Both ABRY Partners and Online HealthNow acknowledge that Delaware law strongly favors the enforcement of negotiated contracts and permits parties to eliminate claims for extracontractual statements if an acquisition agreement includes a properly drafted anti-reliance clause given by the buyer.

Notwithstanding the freedom to contract, Online HealthNow reiterates that parties to a contract cannot "detonate all bona fide contractual fraud claims — discovered or undiscovered — with the stroke of their pens" and serves as an important reminder that Delaware courts will not permit contractual limitations on liability to excuse intentional fraud.

Furthermore, Online HealthNow acknowledges that a properly drafted nonrecourse provision in an acquisition agreement will effectively bar fraud claims against nonparty affiliates; however, when the nonparty affiliate "knowingly participated in the alleged contractual

fraud," such nonparty affiliate will not be insulated from liability regardless of the limitation of liability provisions in the acquisition agreement.

Holistically, Online HealthNow demonstrates the constraints inherent in contractually bargained-for limitation of liability provisions in acquisition agreements when the information disclosed by a seller and its representatives during a sale process is intentionally deficient.

Accordingly, sellers and their representatives should be particularly careful with the level of disclosure in a sell-side process and provide all relevant information to bidders, including information that may negatively impact purchase price.

Otherwise, they may find themselves party to a lawsuit that could result in a meaningful-damages finding by a court or monetary settlement, neither of which would be the outcome a seller or its representatives would have expected when bargaining for the protection intended to be provided by the limitation of liability provisions in acquisition agreements.

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