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Limits on Anti-Fraud Provisions in Private Investment Agreements

This article explores the limits that three frequently chosen bodies of state law—California, New York, and Delaware—place on the enforceability of two common provisions: non-reliance terms and fraud waivers or releases.

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It is no secret that equity investing outside public markets has grown dramatically in recent years. A recent report from PriceWaterhouseCoopers puts this trend in perspective: the number of domestic private companies in the United States with over 500 employees now exceeds the number of domestic public companies in the United States, the European Union and the United Kingdom *combined*. PwC, Asset and wealth management revolution, at 5 (2020).

Disputes over these private investments inevitably arise. Yet unlike disputes over transactions in publicly traded companies that often follow a well-worn path of federal-court securities and Delaware Chancery Court litigation, disputes over private investments often turn on bespoke provisions in heavily negotiated investment contracts, which might be litigated in an arbitral forum, or one of many state or federal courts. Many of these disputes involve allegations of fraud, where a party claims material facts were misrepresented or omitted in negotiations.

Private agreements often contain provisions that, if enforced, make it impossible (or very difficult) to satisfy the elements of a fraud claim. But the degree to which these provisions are enforced varies widely between jurisdictions, meaning that transactional and litigation counsel should pay close attention to contract terms on governing law and forum.

This article explores the limits that three frequently chosen bodies of state law—California, New York, and Delaware—place on the enforceability of two common provisions: non-reliance terms and fraud waivers or releases.

Non-Reliance Provisions

A standard non-reliance provision states that each party performed its own diligence in the transaction and disclaims reliance on any representations made by the other party other than express representations in the agreement. If enforced, such provisions ordinarily prevent a party from satisfying the "reasonable reliance" element of a fraud-based claim. However, the enforceability of such provisions depends significantly on which state's law governs the agreement.

California. Under California law, non-reliance provisions are generally deemed unenforceable. Since 1872, California law has codified the principle that any contract attempting to exempt a party from its own fraud is against California law and public policy. Cal. Civ. Code §1668; see also 1 Witkin, Summary of Cal. Law, Contracts, §304, p. 330 (10th ed. 2005). This statute extends to claims for negligent misrepresentation as well. *SI 59 LLC v. Variel Warner Ventures, LLC*, 29 Cal. App. 5th 146, 154 (2018); *Blankenheim v. E.F. Hutton & Co.*, 217 Cal. App. 3d 1463, 1471-73 (1990).

California courts thus typically find the argument that a non-reliance provision bars a fraud claim "untenable." *E.H. Morrill Co. v. State of California*, 65 Cal.2d 787, 794 (1967); *McClain v. Octagon Plaza, LLC*, 159 Cal. App. 4th 784, 795 (2008) (quoting *E.H. Morrill Co.*).

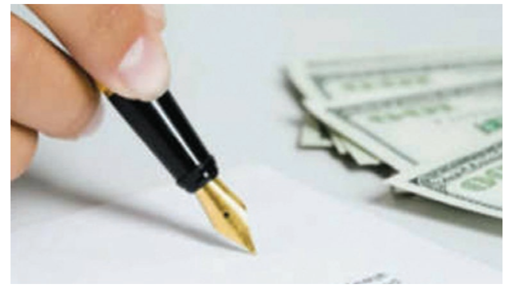
New York. New York law, by contrast, generally holds that non-reliance provisions can be a full defense to fraud claims, if (1) the parties to the contract are sophisticated and bargaining at arm's length; (2) the fact misrepresented or omitted is not peculiarly within the defendant's knowledge; and (3) the non-reliance provision tracks the subject matter of the fraud claim asserted by the plaintiff. *Danann Realty v. Harris*, 5 N.Y.2d 317 (1959); *TIAA Glob. Invs. v. One Astoria Square*, 7 N.Y.S.3d 1, 10 (App. Div. 2015); *DiBuono v. Abbey*, 944 N.Y.S.2d 280, 284 (App. Div. 2012).

In *Danann*—the seminal New York case on this issue that remains in force (see supra; see also *Subramanian v. Lupin*, No. 17-cv-5040 (RA) (KHP), 2020 WL 7029273, at *15 (S.D.N.Y. Aug. 21, 2020))—the Court of Appeals held that a purchaser could not maintain his claim for fraud based on oral representations where he had expressly represented in the contract that he was *not* relying on oral representations. *Danann*, 5 N.Y.2d 317 (1959). Failing to enforce the non-reliance waiver and allowing the claim to go forward, the court reasoned, would render any other contractual language attempting to allocate such risks futile. Id. at 323.

There is, however, a notable exception when the non-reliance provision is boilerplate and does not track the misrepresented or omitted subject matter. While a "precise identity between the misrepresentation and the particular disclaimer" is not necessary, the disclaimer must have sufficient clarity and specificity to be entitled to the benefit of *Danann*. *Grumman Allied Industries v. Rohr Industries*, 748 F.2d 729, 735 (2d Cir. 1984). A generic non-reliance disclaimer stating no party is relying on advice, statements, or recommendations of the other party, without more, typically lacks the necessary specificity. *Caiola v. Citibank, N.A., New York*, 295 F.3d 312, 330 (2d Cir. 2002).

Delaware. Delaware has a general public policy that favors enforcement of contractual disclaimers of reliance on representations not included in a final agreement. *RAA Mgmt. v. Savage Sports Holdings*, 45 A.3d 107, 118-19 (Del. 2012). The Court of Chancery explained this policy rationale in *Abry Partners V, L.P. v. F & W Acquisition*, stating that the failure to enforce non-reliance provisions would "excuse a lie made by one contracting party in writing—the lie that it was relying only on contractual representations and that no other representations had been made—to enable it to prove that another party lied orally or in a writing outside the contract's four corners." 891 A.2d 1032, 1057-58 (Del. Ch. 2006).

Given this, it is not surprising that Delaware law mirrors New York law



with respect to its treatment of non-reliance provisions. *RAA Mgmt.*, at 112 (concluding that "the outcome would be the same" under Delaware or New York law); *Abry Partners*, 891 A.2d at 1057-59; *Great Lakes Chem. v. Pharmacia*, 788 A.2d 544, 555-56 (Del. Ch. 2001); *In re IBP S'holders Litig.*, 789 A.2d 14, 32 & 72-74 (Del. Ch. 2001).

For example, in *Great Lakes*, the Court of Chancery held that the buyer could not have justifiably relied on any representations made by the seller during the due diligence process, because the record reflected that "two highly sophisticated parties, assisted by industry consultants and experienced legal counsel, entered into carefully negotiated disclaimer language after months of extensive due diligence." 788 A.2d at 551-56. Thus, the court concluded that "the parties' contractually agreed-to disclaimers extinguish the fraud claims being asserted" by the plaintiff. Id. at 556.

Fraud Waiver and Release Provisions

Many private agreements also include provisions that seek to prospectively release claims that parties to an agreement may have against one another, including unknown claims and fraud claims. California, New York and Delaware each approach these types of provisions in the same way they do non-reliance provisions.

California. The California laws and statute discussed above apply with equal force to the enforcement, or lack thereof, of fraud waivers and releases. Additionally, California bars the enforcement of general releases that attempt to waive claims that a party does not yet know exists, i.e., a fraud claim, that would have "materially affected" the released party. Cal. Civ. Code §1542. Thus, courts applying California law typically find preemptive fraud waiver and release provisions to be unenforceable. *Farnham v. Superior Ct.*, 60 Cal. App. 4th 69, 74-75 (1997) (collecting cases) ("[E]xemptions from all liability for intentional wrongs, gross negligence and violations of the law have been consistently invalidated.").

Notably, California law does not apply in the same way to purely backward-looking releases of fraud in the context of a settlement or other disposition of claims. At least one California court has held that the statute barring enforcement of general releases does not negate a release provision "when all of the elements [of the tort] are past events" (as opposed to torts based on concurrent or future events). *SI 59*, 29 Cal. App. 5th at 152-53 ("We are not aware of any case law applying section 1668 to torts where all elements are past events."). Such releases may still be enforceable so long as the typical contractual requirements are met—i.e. offer and acceptance, consideration, meeting of the minds—and the release was not otherwise procured by fraud.

New York. New York law is likewise consistent in its treatment of non-reliance provisions and waivers or releases of fraud claims. So long as the parties entered into the release at arm's length, fully understood the scope of the release, and the release is clear and unambiguous, such releases will be binding on the parties, even in the case of fraud and other yet unknown claims. *Mangini v. McClurg*, 24 N.Y.2d 556, 563-64 (1969); see also *Centro Empresarial Cempresa S.A. v Am. Movil, S.A.B. de C. V,* 17 N.Y.S.3d 269, 276 (2011) (citing *Mangini); Matter of Est. of Walter*, 119 N.Y.S.3d 278, 280 (2020) (collecting cases).

If a defendant presents a signed release of a fraud claim in response to a suit alleging fraud, the burden shifts to the plaintiff to show why the release should be invalidated. *Centro Empresarial Cempresa S.A. v. Am. Movil, S.A.B. de C.V.*, 17 N.Y.3d 269, 276-78 (2011) (quoting *Fleming v. Ponziani*, 24 N.Y.2d 105, 111 (1969)). In this instance, a plaintiff alleging fraudulent inducement in the face of a release must point to a fraud external to the agreement itself. *Matter of Est. of Walter*, 119 N.Y.S.3d 278, 280 (App. Div. 2020). Representations or information within the scope of the contract—such as the exchange of financial information with a corollary representation that the buyer is not relying on the financials—cannot be the basis of a fraud claim. *Centro Empresarial Cempresa S.A.*, 17 N.Y.3d at 276-78.

Delaware. Delaware law is again consistent with New York law in its treatment of fraud waivers and releases, and premised on the basis that failure to enforce well-negotiated provisions between sophisticated parties operating at arm's-length is against public policy. Courts applying Delaware law have found that failure to enforce the clear and mutually agreed upon provisions of an agreement, following careful negotiation between the parties to allocate or hedge certain risks, would allow legal action "explicitly precluded by contract, would defeat the reasonable commercial expectations of the contracting parties and eviscerate the utility of written contractual agreements." *Great Lakes*, 788 A.2d at 555-56 (discussing *One-O-One Enters. v. Caruso*, 848 F.2d 1283, 1287 (D.C. Cir.1988) (Ginsburg, J.)); see also *In re IBP S'holders Litig.*, 789 A.2d at 73.

This same principle extends not only to specific releases of certain claims, such as fraud, but also to expansive general releases so long as the court can clearly ascertain the intent of the parties from the face of the provision, whether the releases are forward or backward-looking. *Seven Invs. v. AD Cap.*, 32 A.3d 391, 398 (Del. Ch. 2011).

Conclusion

The law governing an agreement can matter tremendously if non-reliance and fraud waiver/release provisions are at issue. Parties and their counsel should bear these differences in mind negotiating or litigating such terms.

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