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'Sparton v. O'Neil': The Effect of Disclaimers on M&A Fraud Claims

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To what extent can parties to a merger agreement contract around Delaware common-law protections against extracontractual fraud? *Sparton v. O'Neil*, C.A. No. 12403-VCMR (Aug. 9), a recent Delaware Court of Chancery decision, reinforces a line of Delaware precedent holding that anti-reliance disclaimers in merger agreements can be used to defeat subsequent buyer claims for intentional fraud outside of the four corners of the contract, and that such claims can be defeated as early as the pleading stage.

In *Sparton*, Sparton Corp. (the buyer) sued certain stockholders and optionholders (the sellers) of Hunter Technology Corp. (the acquisition target) for fraud and breach of contract, alleging in part that the sellers had presented fabricated financial statements in order to induce Sparton to purchase Hunter for an inflated purchase price of $55 million. According to the allegations of the complaint, the sellers collaborated to overstate certain accounts receivable of Hunter prior to the calculation of an agreed-upon working capital estimate by the parties. This overstatement allegedly convinced Sparton to agree to an artificially high working capital amount and an artificially low cap for any working capital adjustment. The complaint further alleged that the lead representative for the seller group had specifically assured Sparton before closing that "any resulting post-closing working capital adjustment would be minimal," further encouraging Sparton to agree to the adjustment cap that the sellers sought.

Sparton claimed that the sellers' alleged manipulation of company books and records cost them dearly in the transaction. According to the complaint, after the deal closed Sparton discovered that it was entitled to a working capital adjustment of $2,579,455 due to the overstatement. Because of the $750,000 working capital adjustment cap, Sparton was ultimately unable to recover the full amount it claimed to have overpaid due to the alleged fraud.

The Sparton-Hunter merger agreement contained a specific anti-reliance provision applying to extra-contractual representations. Specifically, the merger language stated that the contract's representations and warranties represented the "sole and exclusive representations, warranties and statements … of [the sellers] … as to any matter concerning [Hunter]," and contained an express disclaimer regarding any other representations, warranties, or statements as to any matter concerning Hunter or the "accuracy or completeness" of any information provided by the sellers to Sparton in connection with the transaction.

In reviewing the defendants' motion to dismiss the fraud and contract claims, the *Sparton* court made short work of Sparton's fraudulent inducement claim on two principal grounds. Although the court held that Sparton's allegations of fraud relating to the financial statements fell short of particularized pleading requirements, the court also specifically held that Sparton could not premise its fraud claim on any alleged conduct or statements by the sellers encouraging them to rely on purportedly manipulated books and records. The court concluded that by virtue of the disclaimer provisions, "Sparton agreed that it did not rely on anything outside the representations and warranties contained in the [merger agreement.]" The court cited Delaware precedent holding that a buyer cannot premise fraud claims on extracontractual

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statements where it has agreed to a specific disclaimer regarding reliance on anything outside of the four corners of the contract.

As a result, the court held that Sparton could not have relied on any seller statements regarding working capital issues prior to the merger transaction, even though Sparton claimed that the sellers' lead representative had intentionally falsified the books and records he provided to Sparton and then specifically assured it that a working capital escrow of $750,000 would cover any post-closing adjustment.

The specificity and breadth of the disclaimer provision in *Sparton* was likely a strong influence on the court's holding. As noted, the disclaimer was not merely a general merger clause limiting the terms of the sale to the written merger agreement but was instead a highly specific disclaimer of the accuracy or completeness of any representations made outside the written contract and an agreement not to rely on them. In the context of a merger agreement that is carefully negotiated between two sophisticated parties assisted by experienced legal counsel, Delaware precedent on disclaimers provides a seller with an extremely strong position against a later fraudulent inducement claim, even where the facts may at the very least raise strong questions about intentional fraud outside of the written terms of the contract. In a consistent line of cases like *Abry Partners v. F & W Acquisition*, 891 A.2d 1032 (Del. Ch. 2006), *H-M Wexford v. Encorp*, 832 A.2d 129 (Del. Ch. 2003), and *Great Lakes Chemical v. Pharmacia*, 788 A.2d 544 (Del. Ch. 2001), Delaware courts have ruled that sellers who willingly agree to such clear disclaimer provisions cannot recover for fraud without proof that a specific contractual representation and warranty was false. As noted above, the complaint here alleged manipulated invoices, false financials, and lulling messages from the sellers' lead representative, and despite these allegations the Court held that as a matter of law there was no buyer reliance due to the clear disclaimer.

The result in *Sparton* is a cautionary example for buyers given that, according to the allegations of the complaint, it's unclear how a buyer in Sparton's position could have been expected to independently discover the alleged fraud in order to adequately protect itself. Interestingly, some other jurisdictions might have offered the buyer greater protection under similar circumstances. In California, for example, a provision of the civil code renders disclaimers that purport to apply to fraudulent conduct void and unenforceable, see California Civil Code Section 1668. California courts have generally applied this provision to prevent defendants from arguing that a disclaimer provision contracted away their liability for fraud and deceit based on intentional misrepresentation, see, e.g., *McClain v. Octagon Plaza*, 159 Cal.App.4th 784 (Cal. Ct. App. 2008); *Manderville v. PCG & S Group*, 146 Cal. App. 4th 1486 (Cal. Ct. App. 2007). In New York, while an agreement's disclaimer of reliance can sometimes defeat a later fraud claim, this is only so where the disclaimer was sufficiently specific and applicable to a particular type of information that was either misrepresented or not disclosed and did not concern facts to which only the seller could have access. In decisions like *DIMON v. Folium*, 48 F. Supp. 2d 359 (S.D.N.Y. 1999), and *Steinhardt Group v. Citicorp*, 272 A.D.2d 255 (N.Y. 1st Dep't 2000), courts applying New York law have limited the effect of contractual disclaimers where only the seller, not the buyer, was in a position to know the true facts.

In *Sparton*, it's unclear given the pleading deficiencies found by the court whether the buyer could have ultimately alleged and proven that the conduct at issue concealed facts about the company that were within the sellers' exclusive knowledge and were not otherwise discoverable by Sparton even with effective diligence. Because Delaware precedent ultimately does not recognize limits on disclaimers similar to those imposed by other jurisdictions like California and New York, however, such allegations and proof would have likely been immaterial.

Sparton, therefore, counsels a strong warning to prospective buyers regarding specific anti-reliance disclaimers in agreements governed by Delaware law, as such provisions should be considered carefully and with a full awareness of their likely scope and preclusive effect in the event of a later claim that the seller induced the agreement through fraud outside of the written agreement itself.

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