

# Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the “Entire” Deal?

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*Although business lawyers frequently incorporate well-defined liability limitations in the written agreements that they negotiate and draft on behalf of their corporate clients, contracting parties that are dissatisfied with the deal embodied in that written agreement often attempt to circumvent those limitations by premising tort-based fraud and negligent misrepresentation claims on the alleged inaccuracy of both purported pre-contractual representations and express, contractual warranties. The mere threat of a fraud or negligent misrepresentation claim can be used as a bargaining chip by a counterparty attempting to avoid the contractual deal that it made. Indeed, fraud and negligent misrepresentation claims have proven to be tough to define, easy to allege, hard to dismiss on a pre-discovery motion, difficult to disprove without expensive and lengthy litigation, and highly susceptible to the erroneous conclusions of judges and juries. This Article traces the historical relationship between contract law and tort law in the context of commercial transactions, outlines the sources, risks, and consequences of extra-contractual liability for transacting parties today, and surveys the approaches that various jurisdictions have adopted regarding the ability of contracting parties to limit their exposure to liability for common law fraud and misrepresentation. In light of the foregoing, the authors propose a series of defensive strategies that business lawyers can employ to try to limit their clients' exposure to tort liability arising from contractual obligations.*

## I. INTRODUCTION

A sophisticated private equity buyer sought to rescind its acquisition of a portfolio company of a sophisticated private equity seller, alleging that several representations and warranties set forth in the stock purchase agreement were false.<sup>1</sup> But the indemnification provisions in the contested agreement limited the buyer's recourse for any contractual misrepresentation to a claim for damages

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1. See *ABRY Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1034 (Del. Ch. 2006). See also Todd E. Lenson & David I. Schultz, *Lies, Damn Lies and M&A Fraud*, CORP. COUNS., Aug. 2006, at 1.

capped at a specified percentage of the purchase price.<sup>2</sup> And another provision of the contested agreement expressly stated that the buyer's right to indemnification thereunder was its sole and exclusive remedy for any misrepresentation, contractually precluding the very type of rescission claim the buyer asserted in its pleadings.<sup>3</sup>

So, the seller naturally moved to dismiss the case for failure to state a claim, requesting that the court enforce the contractual limitation on liability to which the transacting parties had specifically agreed.<sup>4</sup> Indeed, "[g]iven the sophisticated nature of the parties, and the express stipulation that the exclusive remedy provision of the [a]greement was specifically bargained for and . . . reflected in setting the deal price," the seller argued that the buyer could not ignore the remedial restrictions to which it voluntarily consented.<sup>5</sup>

But the buyer countered that the contractual limitation on the seller's liability was unenforceable as a matter of public policy, claiming that Delaware law would not "tolerate an attempt by a contracting party to immunize itself from a rescission claim premised on false representations of fact contained within a written contract and recognized by the parties to be the factual predicate for their decision to contract."<sup>6</sup> To enforce such a provision, in the eyes of the buyer, "would be to sanction unethical business practices of an abhorrent kind and . . . create an unwise incentive system for contracting parties that would undermine the overall reliability of promises made in contracts."<sup>7</sup>

As most business lawyers are aware, the Delaware Court of Chancery confronted these very facts and the attendant public policy considerations in *ABRY Partners V, L.P. v. F & W Acquisition LLC*, a 2006 case that required that court to identify the boundaries of contractual freedom under Delaware law and grapple with a stark choice: Should the court give effect to the indemnification and exclusive remedy provisions, which the transacting parties negotiated at length and adjusted the purchase price to reflect?<sup>8</sup> Or, should the court override the plain terms of those provisions to provide the buyer with an opportunity to press its claim for rescission on the simple ground that the buyer had alleged "fraud?"<sup>9</sup>

In the *ABRY* opinion's most well-known holding, Vice Chancellor Leo Strine, Jr., concluded that the public policy of Delaware did not permit the court to enforce the indemnification and exclusive remedy provisions set forth in the parties' written agreement to the extent that they "purport[ed] to limit the [s]eller's exposure for its own conscious participation in the communication of lies to the [b]uyer."<sup>10</sup> Therefore, the court held, the stock purchase agreement, despite its

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2. *ABRY*, 891 A.2d at 1034.

3. *Id.* at 1035.

4. *See id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. *See id.* at 1052–65.

9. *See id.*

10. *Id.* at 1064.

express terms, could not preempt the buyer's right to bring a rescission claim if "the [s]eller knew that the [portfolio] [c]ompany's contractual representations and warranties were false" or "the [s]eller itself lied to the [b]uyer about a contractual representation and warranty."<sup>11</sup> So while the court did not reach the issue of whether the seller had, in fact, "lied" to the buyer, the effect of the decision was to allow an uncapped, extra-contractual tort claim based upon contractual warranties to proceed against the seller despite the specifically negotiated remedial limits set forth in the carefully crafted stock purchase agreement that delineated the disputed warranties.

On one level then, *ABRY* illustrates the proposition that written agreements, no matter how fervently negotiated or tightly drafted, may not always constitute the exclusive source of the rights, protections, duties, and remedies of their signatories.<sup>12</sup> Indeed, that the buyer's fraud claim survived the seller's motion to dismiss illustrates the susceptibility of contractual relationships to tort-based attacks and the reluctance of some courts to enforce the liability-limiting provisions that contracting parties employ to disable them. And this phenomenon, whereby courts permit extra-contractual misrepresentation claims based upon allegations of fraud to advance in the face of contractual provisions that expressly preclude them, presents difficult challenges for business lawyers whose clients specifically factor the remedial options available to their counterparties into the purchase price of their transactions.

But the court in *ABRY* also recognized a contracting party's enormous power to limit, waive, or disclaim certain types of tort-based causes of action.<sup>13</sup> While courts in some states permit virtually all types of extra-contractual misrepresentation claims to proceed based upon allegations of fraud and negligent misrepresentations in the face of contractual limitations on such claims,<sup>14</sup> the *ABRY* court adopted a more nuanced approach.<sup>15</sup> Indeed, Vice Chancellor Strine found it "difficult to fathom how it would be immoral for the [s]eller and [b]uyer to allocate the risk of intentional lies by the [portfolio] [c]ompany's managers to the [b]uyer, and certainly that is so as to reckless, grossly negligent, negligent, or innocent misrepresentations of fact" by the portfolio company.<sup>16</sup> As a result, the Court of

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11. *Id.*

12. See generally Allen Blair, *A Matter of Trust: Should No-Reliance Clauses Bar Claims for Fraudulent Inducement of Contract?*, 92 MARQ. L. REV. 423 (2009); Kabir Masson, Note, *Paradox of Presumptions: Seller Warranties and Reliance Waivers in Commercial Contracts*, 109 COLUM. L. REV. 503 (2009); Glenn D. West, *Avoiding Extra-Contractual Fraud Claims in Portfolio Company Sales Transactions—Is "Walk-Away" Deal Certainty Achievable for the Seller?*, PRIVATE EQUITY ALERT (Weil, Gotshal & Manges, LLP, New York, N.Y.), Mar. 2006, at 1, available at <http://www.weil.com/news/pubdetail.aspx?pub=8478>; Kevin Davis, *Licensing Lies: Merger Clauses, The Parol Evidence Rule and Pre-Contractual Misrepresentations*, 33 VAL. U. L. REV. 485 (1999); Elizabeth Cumming, Note, *Balancing the Buyer's Right to Recover for Precontractual Misstatements and the Seller's Ability to Disclaim Express Warranties*, 76 MINN. L. REV. 1189, 1207–08 (1992).

13. See *ABRY*, 891 A.2d at 1064.

14. See, e.g., *Martinez v. Zovitch*, 867 A.2d 149, 156 (Conn. App. Ct.), cert. denied, 876 A.2d 1202 (Conn. 2005); *Bates v. Southgate*, 31 N.E.2d 551, 558 (Mass. 1941); *Blanchard v. Blanchard*, 839 P.2d 1320, 1322–23 (Nev. 1992). See also *infra* notes 165–74 and accompanying text.

15. See *ABRY*, 891 A.2d at 1064.

16. *Id.* at 1063.

Chancery enforced the disputed exclusive remedy provisions—and a related non-reliance clause—to preclude most of the buyer's other tort-based misrepresentation claims, including fraud claims based upon proof of mere "recklessness," and even fraud claims premised upon purported "lies" that were not set forth within the four corners of the written agreement.<sup>17</sup> Therefore, Vice Chancellor Strine held that Delaware law only prohibited the court from enforcing the exclusive remedy and disclaimer-of-reliance provisions to dismiss the fraud claims that the plaintiff premised upon the *deliberate* lies of the seller *itself*, and then only to the extent those lies were expressed as specific contractual representations and warranties set forth in the contentious stock purchase agreement.<sup>18</sup>

Far from teaching us that agreements do not matter because contracting parties cannot prophylactically limit their exposure to tort liability for fraud and misrepresentation, *ABRY* instead illustrates the fundamental tension between the legal doctrines of contract and tort and represents one influential court's view of the extent to which the parties to a written agreement can determine for themselves whether—and to what extent—they will be exposed to liability under each. Recognizing that this tension—and the uncertainty it breeds—complicates the contract draftsman's task of defining his or her client's rights and obligations with certainty, this Article will explore the interplay of contract and tort that spawned the threat of extra-contractual liability, outline its practical implications, and suggest a series of measures that we, as sophisticated business lawyers, can employ to maximize the likelihood that a court will enforce the express terms of the written agreements our clients engage us to craft.<sup>19</sup>

Although we acknowledge that federal and state securities laws can also interfere with contract-based relationships when the subject matter of the contract is a sale of securities, we have limited the scope of our Article to common law tort-based claims.<sup>20</sup> Importantly, however, many of the issues that arise in common law tort-based fraud claims may also arise in securities fraud claims, including issues relating to the enforceability of disclaimers of reliance.<sup>21</sup> And in many

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17. *See id.* at 1064.

18. *See id.*

19. This Article expands upon an earlier, less comprehensive article and two conference papers authored or co-authored by Mr. West, and seeks to provide both a practical guide for business lawyers and a more complete academic approach to this subject in an effort to influence both the attorneys and deal professionals who negotiate sophisticated business agreements and the courts that interpret and enforce them. *See West, supra* note 12; Glenn D. West & Emmanuel Obi, *Avoiding Fraud and Other Extra-Contractual Claims: There May Be More to the Deal than the Contract—2007*, MERGERS & ACQUISITIONS INST. (Univ. of Tex. Sch. of L., Austin, Tex.), Oct. 4, 2007; Glenn D. West & Benton B. Bodamer, *Avoiding Fraud and Other Extra-Contractual Claims: There May Be More to the Deal than the Contract*, MERGERS & ACQUISITIONS INST. (Univ. of Tex. Sch. of L., Austin, Tex.), Sept. 7–8, 2006.

20. For example, state securities laws, also known as "blue sky laws," may constitute a source of contract-related fraud liability relating to transactions involving securities. *See, e.g.*, N.Y. GEN. BUS. LAW §§ 352 to 359-H (McKinney 1996).

21. To establish an actionable claim under section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), a private plaintiff must demonstrate that the defendant: "[(1)] made a misstatement or an omission of a material fact (2) with scienter (3) in connection with the purchase or the sale of a security (4) upon which the plaintiff reasonably relied and (5) that the plaintiff's reliance

cases, the principles and techniques that we describe in this Article are also applicable to securities fraud claims, with a significant difference being that federal securities fraud claims are brought exclusively in federal court, and not in state court.<sup>22</sup>

We begin in Part II of this Article with a review of the historical development of the common law principles that govern contract making and enforcement, on the one hand, and the principles that inspired the tort duties that courts impose independently of contractual undertakings, on the other hand. We then describe the process by which early courts blended tort duties and contractual obligations in the context of representations and warranties and eventually molded the common law fraud and negligent misrepresentation claims out of which most extra-contractual liability arises today. Because understanding our clients' exposure to extra-contractual liability (and the extent to which that exposure may vary by jurisdiction) informs our ultimate ability to limit it, in Part III we provide both an overview of the common law fraud and negligent misrepresentation causes of action that reflect the "contortion"<sup>23</sup> of contract and tort that we describe in Part II and an outline of the consequences that tort liability threatens for sophisticated contracting parties. In Part IV, we then illuminate the extent to which a transacting party's ability to disclaim or limit its contractual liability under the foregoing types of claims often depends on the law of the specific jurisdiction that the

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was the proximate cause of his or her injury." *AES Corp. v. Dow Chem. Co.*, 325 F3d 174, 178 (3d Cir.) (internal quotation marks omitted), *cert. denied*, 540 U.S. 1068 (2003). So, as under the common law, sophisticated transacting parties seek to mitigate their exposure to securities fraud liability by contractually limiting their counterparties' ability to rely upon extra-contractual representations. Note that proof of "recklessness" is generally sufficient to establish the scienter element of a securities fraud claim. *See, e.g., Ronconi v. Larkin*, 253 F3d 423, 429 (9th Cir. 2001); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F2d 1033, 1039 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

22. 15 U.S.C. § 77v(a) (2006). *Express* waivers of securities fraud claims are not likely enforceable under section 29(a) of the Exchange Act, which provides that "any condition, stipulation, or provision binding any person to waive compliance with any provision" of the federal securities laws or any rule, regulation, or exchange rule promulgated or required thereunder "shall be void." 15 U.S.C. § 78cc(a) (2006). But clauses disclaiming (i) the existence of other pre- or extra-contractual representations or (ii) reliance appear to offer at least some utility in the federal circuits that have examined their enforceability. Though the U.S. Court of Appeals for the Third Circuit has held that section 29(a) forbids enforcement of an express disclaimer provision to preclude the mandatory reliance element of a securities fraud claim as a matter of law, the same court conceded that such a provision at least offers evidence of the plaintiff's non-reliance at both the trial and summary judgment stages. *See AES*, 325 F3d at 180–81; *see also Rogen v. Ilikon Corp.*, 361 F2d 260, 268 (1st Cir. 1996). The U.S. Court of Appeals for the Second Circuit, by contrast, has held that section 29(a) does not prohibit enforcement of an express disclaimer of reliance to preclude the mandatory reliance element of a securities fraud claim as a matter of law, and can thereby justify dismissal of such a claim at the motion to dismiss stage. *See Harsco Corp. v. Segui*, 91 F3d 337, 343 (2d Cir. 1996). And some courts have enforced contractual disclaimer-of-reliance provisions to render a securities fraud plaintiff's reliance on extra-contractual representations unreasonable as a matter of law without even acknowledging section 29(a). *See, e.g., Rissman v. Rissman*, 213 F3d 381, 384 (7th Cir.), *cert. denied*, 531 U.S. 987 (2000); *One-O-One Enters., Inc. v. Caruso*, 848 F2d 1283, 1286 (D.C. Cir. 1988). *See generally* David K. Lutz, Note, *The Law and Economics of Securities Fraud: Section 29(A) and the Non-Reliance Clause*, 79 CHI.-KENT L. REV. 803 (2004).

23. Grant Gilmore coined the term "contort" in his 1974 book entitled *The Death of Contract*. GRANT GILMORE, *THE DEATH OF CONTRACT* 98 (Roland K.L. Collins ed., 2d ed. 1995) (1974).

parties have selected to govern their agreement.<sup>24</sup> And, taking into account each of these nuances, in Part V we propose specific drafting tips that will maximize the likelihood that courts will reject most, if not all, tort-based claims arising out of written agreements between sophisticated business parties. Finally, in Part VI, we suggest the approach that we believe courts should adopt when they evaluate the enforceability of contractual provisions in written agreements between sophisticated parties that specifically allocate the risk of allegedly “fraudulent” or negligent misrepresentations.

## II. THE “CONTORTION” OF CONTRACT AND TORT

Good business lawyers understand the effect of case law developments on contract making and enforcement and adjust their negotiating and drafting strategies accordingly to maximize the likelihood that courts will interpret the written agreements they negotiate in a manner that advances their clients’ best interests. Staying current with the reported decisions of courts that interpret business agreements, therefore, is a critical part of the business lawyer’s job. Indeed, “predicting” how a court will construe written agreements is an important reason our clients hire us.<sup>25</sup>

But to predict the manner in which courts will interpret the contracts that we negotiate, it is also necessary to understand the policies and legal theories that underlie the doctrines that judges invoke to justify their decisions. While legislative enactments like the Uniform Commercial Code, the Securities Act of 1933, and other business-related statutes can impact the formation or enforceability of certain agreements, judge-made common law still predominates as the primary source of the legal rules that govern contract making and enforcement in the United States.<sup>26</sup> And while the common law has evolved independently in each American state since its original adoption therein, there remain certain consistent themes that are attributable to the fact that the common law of each jurisdiction is derived not only from judge-made decisions extending from “the present time back into the ancient courts of England,”<sup>27</sup> but also from a “system of reasoning

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24. A properly drafted choice-of-law provision that states the law applicable not only to the contract itself, but also to all tort claims that may arise out of that contract, can be enforceable as to such tort claims. See, e.g., *Benchmark Elecs., Inc. v. J.M. Huber Corp.*, 343 F.3d 719, 726–28 (5th Cir. 2003); *Kuehn v. Childrens Hosp.*, 119 F.3d 1296, 1302 (7th Cir. 1997); *Karnes v. Fleming*, No. H-070620, 2008 WL 4528223, at \*4 (S.D. Tex. July 31, 2008); *Hughes v. LaSalle Bank, N.A.*, No. 02 CIV 6384 (MGM), 2006 WL 620654, at \*8 (S.D.N.Y. Mar. 13, 2006).

25. See Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 457 (1897).

26. See Elizabeth Warren, *Formal and Operative Rules Under Common Law and Code*, 30 UCLA L. REV. 898, 925 (1983).

27. *Morningstar v. Black & Decker Mfg. Co.*, 253 S.E.2d 666, 675 (W. Va. 1979). There is a remarkable consistency between English case law, the case law of other former English commonwealth jurisdictions, and the American courts on basic contract and tort issues. See, e.g., Glenn D. West & Sarah G. Duran, *Reassessing the “Consequences” of Consequential Damage Waivers in Acquisition Agreements*, 63 BUS. LAW. 777, 791 n.66 (2008).

from case to case precedent that [has permitted] the common law to grow with and adapt to changing conditions of society.”<sup>28</sup>

### A. NEGOTIATING THE DIVIDING LINE BETWEEN CONTRACT AND TORT

The common law of contracts is studied separately and considered distinct from the common law of torts—the body of law that governs civil liability for the negligent or intentional infliction of harm to persons or property.<sup>29</sup> And although the separation between these purportedly distinct bodies of common law has been blurred to a point that some have argued they are inextricably intertwined,<sup>30</sup> the principles that govern contract law are based upon policies that are clearly distinct from and, in many cases, directly in conflict with, the principles that govern tort law.<sup>31</sup>

The common law has developed a strong policy preference, known as “freedom of contract,”<sup>32</sup> which favors the ability of private parties to make any contract that does not promote or facilitate unlawful activity.<sup>33</sup> And as a corollary, courts have generally proven willing to enforce such contracts as written, engendering a respect for the mutually agreed upon terms and conditions of private agreements that has become recognized as the “sanctity of contract.”<sup>34</sup>

Influenced by these fundamental principles of contract law, then, courts have often said that they will neither make a contract for private parties, nor excuse a party’s performance of its obligations under an agreement because that party realized it made a bad deal.<sup>35</sup> Although courts often infer “default provisions” in

28. *Morningstar*, 253 S.E.2d at 675.

29. See *S.C.M. (U.K.) Ltd. v. W.J. Whithall & Son Ltd.*, [1971] 1 Q.B. 337, 347 (U.K.) (“the law of torts can be defined as the complexus of civil liability for wrongs done by one person to another”); see also Charles Miller, Comment, *Contortions over Contorts: A Distinct Damages Requirement*, 28 TEX. TECH L. REV. 1257, 1257 (1997).

30. See, e.g., Miller, *supra* note 29, at 1257; WILLIAM LLOYD PROSSER, *SELECTED TOPICS ON THE LAW OF TORTS* 452 (1953); GILMORE, *supra* note 23, at 98–99 (suggesting that many doctrines of contracts and torts could be combined to form a doctrine called “contorts”).

31. See *Erlich v. Menezes*, 981 P.2d 978, 982 (Cal. 1999) (“Whereas contract actions are created to enforce the intentions of the parties to the agreement, tort law is primarily designed to vindicate ‘social policy.’”); see also *Etoll, Inc. v. Elias/Savion Adver., Inc.*, 811 A.2d 10, 14 (Pa. Super. Ct. 2002); Miller, *supra* note 29, at 1275.

32. See BLACK’S LAW DICTIONARY 689 (8th ed. 2004).

33. Courts will not aid parties in pursuing unlawful objectives by enforcing promises made in furtherance of those unlawful objectives. See, e.g., *McMullen v. Hoffman*, 174 U.S. 639, 646–47 (1899); see also *Levy v. Brush*, 45 N.Y. 589, 594–95 (1871); *Johnson v. Hulings*, 103 Pa. 498, 504 (1883); William Rennie Riddell, *A Legal Scandal Two Hundred Years Ago*, 16 A.B.A. J. 422, 422–23 (1930).

34. See P.S. ATIYAH, *AN INTRODUCTION TO THE LAW OF CONTRACT* 12 (3d ed. 1981) (“The sanctity of contractual obligations is merely an expression of the principle that once a contract is freely and voluntarily entered into, it should be held sacred, and should be enforced by the [c]ourts if it is broken.”); see also *In re Schenck Tours, Inc.*, 69 B.R. 906, 910–11 (Bankr. E.D.N.Y.), *aff’d*, 75 B.R. 249 (E.D.N.Y. 1987).

35. See, e.g., *Burger King Corp. v. Mason*, 710 F.2d 1480, 1490 (11th Cir. 1983), *cert. denied*, 465 U.S. 1102 (1984); *Heyman v. CBS, Inc.*, 423 A.2d 887, 894 (Conn. 1979); *Maslow v. Vanguri*, 896 A.2d 408, 421 (Md. Ct. Spec. App.), *cert. denied*, 903 A.2d 416 (Md. 2006) (unpublished table decision); *Rainbow Oil Co. v. Christmann*, 656 P.2d 538, 545 (Wyo. 1982). An early recognition of this rule may be found in *Adams v. Nichols*, 36 Mass. (19 Pick.) 275 (1825). The court stated:

agreements that fail to provide guidance on the subject of a given contractual dispute, they generally do not impose these provisions on the contracting parties.<sup>36</sup> Instead, a “default provision” becomes part of an agreement only in the absence of a contract clause that addresses the subject of the provision, and is designed to approximate the agreement the contracting parties would have reached if their contract had considered the relevant issue.<sup>37</sup>

Courts have also proven unwilling to relieve parties from their contractual obligations based upon the extra-contractual motives of their counterparties. Indeed, “in the realm of contract law, why or even how a contract was breached” is not an issue because “contracting parties are generally free to breach a contract for almost any reason as long as they are prepared to pay the damages resulting from that breach.”<sup>38</sup>

But while the culpability of a party that breaches a legally enforceable agreement is generally irrelevant under the law of contract, it can be a dispositive consideration under the law of torts.<sup>39</sup> An outgrowth of our primitive desire for

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[W]here the party by his agreement voluntarily assumes or creates a duty or charge upon himself, he shall be bound by his contract, and the non-performance of it will not be excused by accident or inevitable necessity; for if he desired any such exception, he should have provided for it in his contract. . . . [T]he law does no more than enforce the exact contract entered into. If there be any hardship, it arises from the indiscretion or want of foresight of the suffering party. It is not the province of the law to relieve persons from the improvidence of their own acts.

*Id.* at 276, 278, cited in GILMORE, *supra* note 23, at 50.

36. See, e.g., *Teachers Ins. & Annuity Ass'n of Am. v. LaSalle Nat'l Bank*, 691 N.E.2d 881, 890 (Ill. App. Ct.), *appeal denied*, 705 N.E.2d 450 (Ill. 1998), *cert. denied*, 525 U.S. 1146 (1999); *Haines v. City of N.Y.*, 364 N.E.2d 820, 822 (N.Y. 1977); *Toch v. Eric Schuster Corp.*, 490 S.W.2d 618, 622 (Tex. Civ. App. 1972).

37. See Steven M. Haas, *Contracting Around Fraud Under Delaware Law*, 10 DEL. L. REV. 49, 50 (2008) (citing Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87 (1989) (“Default rules fill the gaps in incomplete contracts; they govern unless the parties contract around them.”); Jules L. Coleman, Douglas D. Heckathorn & Steven M. Maser, *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639, 641 (1989) (noting the theory that default rules “mimic” the outcome that the parties would have intended had they foreseen the need to provide for it in the contract)).

38. *West & Obi*, *supra* note 19, at 2; see also *Globe Ref. Co. v. Landa Cotton Oil Co.*, 190 U.S. 540, 544 (1903) (“The motive for the breach commonly is immaterial in an action on the contract.”); *In re Salvinio*, 373 B.R. 578, 589 (Bankr. N.D. Ill. 2007) (“‘Willful’ breaches have not been distinguished from other breaches . . . .”), *aff'd*, No. 07 C 4756, 2008 WL 182241 (N.D. Ill. 2008); *Briefstein v. Rotondo Constr. Co., Inc.*, 187 N.Y.S.2d 866, 868 (App. Div. 1959) (“The policy which runs through the fabric of the law of contracts is to bind a party by what he agrees to do whether or not he intends to do what he agrees.”); *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289 (7th Cir. 1985). This is in contrast, of course, to a circumstance where parties deliberately contract for a different set of consequences for an “intentional breach.” See *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, No. 3841-VCL, 2008 WL 4457544, at \*4 (Del. Ch. Sept. 29, 2008) (discussing the significance of a contractual provision providing for uncapped damages in the event of a “knowing and intentional breach of any covenant” by the buyer); see also RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 119–20, 270–73 (7th ed. 2007).

39. See 86 C.J.S. *Torts* § 2 (2009) (Westlaw) (“[I]n order to impose tort liability, there must be fault.”); OLIVER WENDALL HOLMES, JR., *THE COMMON LAW* 37 (photo. reprint 1991) (1881) (“My aim and purpose have been to show that the various forms of liability known to modern law spring from the common ground of revenge . . . . [T]hey have started from a moral basis, from the thought that some one was to blame.”).



revenge—or redress—when another causes us harm, tort law is tinged with moral language and concepts of fault.<sup>40</sup> Consequently, courts have fashioned tort law remedies to serve two purposes: (i) to restore the victim of another’s culpable harm to his or her status quo before the tortious act occurred; and (ii) in some cases, to punish the culpable party by assessing punitive damages against him or her that exceed the actual damages that the aggrieved party sustained.<sup>41</sup>

Unlike contract duties, then, tort duties arise by operation of law in recognition of each individual’s right to be compensated for the damages he or she suffers as a result of the intentional, reckless, or negligent conduct of others.<sup>42</sup> Indeed, as the California Supreme Court has explained:

“[Whereas] [c]ontract actions are created to protect the interest in having promises performed,’ [t]ort actions are created to protect the interest in freedom from various kinds of harm. The duties of conduct which give rise to them are imposed by law, and are based primarily on social policy, and not necessarily based upon the will or intention of the parties.”<sup>43</sup>

## B. THE “CONTORTION” OF CONTRACT AND TORT IN THE CONTEXT OF COMMERCIAL TRANSACTIONS

In the context of commercial transactions, the principles underlying contract and tort law often converge and, in some cases, collide to expose contracting parties to tort liability that the written agreement governing their relationship does not contemplate or permit. Part of the reason for this is the historical fact that tort law filled in the void created by the early common law’s refusal to allow a cause of action for mutual promises made in the absence of a “deed under seal.”<sup>44</sup> But as contract law developed, and courts recognized that the enforcement of mutual promises should be a function of the law of contract, not tort, their early attempts to fill those gaps created “concurrent” obligations arising from both the law of tort and the written agreements that contracting parties drafted to govern their specific relationship.<sup>45</sup> While many common law courts viewed these “concurrent” obligations as conflicting and believed that tort law effectively provided default provisions “out of which the parties may, if they can, contract,” other common law courts believed that “the law of tort is not limited to filling in gaps left by the law of contract,” but instead effectively imposed independent duties on contracting parties whether they agreed to accept them or not.<sup>46</sup>

40. See HOLMES, *supra* note 39, at 37.

41. See West, *supra* note 12, at 2.

42. See *id.*

43. *Applied Equip. Corp. v. Litton Saudi Arabia Ltd.*, 869 P.2d 454, 460 (Cal. 1994) (quoting *Tameny v. Atl. Richfield Co.*, 610 P.2d 1330, 1335 (Cal. 1980)) (alterations and ellipses in original).

44. See *Macpherson & Kelly v. Kevin J. Prunty & Assocs.* (1983) 1 V.R. 573 (Austl.), available at 1982 VIC LEXIS 176, at \*39.

45. See *id.*

46. *Goodman Fielder Consumer Foods Ltd. v. Cospack Int’l Pty Ltd.* (2004) N.S.W.S.C. 704, ¶¶ 91–96 (Austl.) (internal quotation marks omitted), available at <http://www.austlii.edu.au/au/cases/nsw/NSWSC/2004/704.html>.

## 1. Tort-Based Representations vs. Contract-Based Warranties

A comparison of tort-based misrepresentation claims and contract-based warranty claims illuminates this phenomenon.<sup>47</sup> In drafting business agreements today, business lawyers might assume that the terms “representations” and “warranties” are synonyms, and sellers generally both “represent” and “warrant” to buyers all statements of existing fact that form the basis for the contractual indemnification provisions that sellers provide in favor of buyers. But although some modern commentators disagree about whether there is a difference between “representations” and “warranties,”<sup>48</sup> there is a very clear distinction between actions premised upon misrepresentations and actions premised upon breaches of express warranties (including representations that become warranties by virtue of their incorporation in a written agreement).<sup>49</sup>

A misrepresentation claim is grounded in tort and seeks to redress breaches of a party’s common law duty to establish honestly the “factual predicates” to his or her commercial relationships.<sup>50</sup> But misrepresentation liability is generally not imposed strictly on the basis that a given representation was incorrect. Instead, liability only attaches if the defendant made a material misrepresentation fraudulently or, in some cases, negligently, upon which the recipient justifiably relied to his or her detriment.<sup>51</sup>

A claim based upon a breach of an express warranty, by contrast, is premised upon one party’s specific contractual promise that a stipulated fact or set of facts is

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47. See, e.g., Glenn D. West & Kim M. Shah, *Debunking the Myth of the Sandbagging Buyer: When Sellers Ask Buyers to Agree to Anti-Sandbagging Clauses, Who Is Sandbagging Whom?*, M&A LAW (Thompson/West, New York, N.Y.), Jan. 2007, at 4.

48. Compare Kenneth A. Adams, *A Lesson in Drafting Contracts: What’s Up with “Representations and Warranties,”* BUS. L. TODAY, Nov./Dec. 2005, at 32, 33–35 (suggesting that the terms “representations” and “warranties” are near synonyms that each “flag an assertion of fact but . . . don’t affect the meaning of that assertion”), with Tina L. Stark, *Another View on Reps and Warranties*, BUS. L. TODAY, Jan./Feb. 2006, at 8, 8–9 (suggesting that an assertion’s status as either a representation or warranty affects the remedies available to a plaintiff if the assertion is false), and 11 SIMON M. LORNE & JOY MARLENE BRYAN, *ACQUISITIONS & MERGERS: NEGOTIATED & CONTESTED TRANSACTIONS* § 3:57, at 3-317 to 3-319 (2009) (suggesting that the distinction between “warranties” and “representations” is that representations assert the truth of the represented statements, while warranties simply “allocate financial responsibility” for the warranted statement’s accuracy). See also West & Shah, *supra* note 47, at 4–5.

49. See, e.g., *Stevenson v. B.B. Kirkland Seed Co.*, 180 S.E. 197, 200 (S.C. 1935) (“In the case of a warranty, the rights of the parties rest in contract, while in the case of deceit, misrepresentations and fraud, they are based in tort.”). See also *Hecht v. Components Int’l, Inc.*, 867 N.Y.S.2d 889, 895–96 (Sup. Ct. 2008) (distinguishing between fraud actions and breach of warranty actions). See also West & Shah, *supra* note 47, at 4 (discussing differing jurisdictional approaches, both contract-based and tort-based, toward a buyer’s burden of proof for a claim on an extra-contractual representation versus an express contractual warranty); *ABRY Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1054 (Del. Ch. 2006) (discussing the meaning of the term “misrepresentations” as being a term “commonly associated with fraud claims sounding in tort”).

50. See 37 AM. JUR. 2D *Fraud and Deceit* § 128 (2002); see also *Hartwell Corp. v. Bumb*, 345 F.2d 453, 455–56 (9th Cir.), cert. denied, 382 U.S. 891 (1965); *Kroc v. Curaflex Health Servs. of Ill., Inc.*, No. 88 C 10578, 1989 WL 100000, at \*7 (N.D. Ill. 1989); *Hecht*, 867 N.Y.S.2d at 895–96. We have borrowed the term “factual predicate” from Vice Chancellor Strine. See *ABRY*, 891 A.2d at 1035.

51. See 37 AM. JUR. 2D *Fraud and Deceit* § 128 (2002). See also *In re Welding Fume Prods. Liab. Litig.*, No. 1:03-CV-17000, 2007 WL 1087605, at \*7 (N.D. Ohio Apr. 9, 2007); *Cole v. New Eng. Mut. Life Ins. Co.*, 729 N.E.2d 319, 323 (Mass. App. Ct. 2000); *Cumming*, *supra* note 12, at 1198.

correct.<sup>52</sup> If the warranty set forth in the written agreement is incorrect, it would be irrelevant that the warranting party honestly believed that the disputed statement was true, that the recipient of the warranty did not rely upon the incorrect statement, or that the warranty was not a material basis upon which the complaining party entered into the contract.<sup>53</sup> Indeed, a warranty is strictly enforced like any other contractual covenant or agreement, generally without regard for intention, materiality, or reliance.<sup>54</sup> And for this very reason, our English colleagues often describe their contractual assurances of factual matters as “warranties,” but not “representations.”<sup>55</sup>

But courts have not always recognized the distinction between tort-based misrepresentation claims and contract-based warranty claims.<sup>56</sup> Indeed, because the modern law of contract only later evolved as an independent legal doctrine, courts did not even recognize breach of express warranty as a separate, contract-based action until 1778<sup>57</sup> and instead viewed these claims as grounded in deceit or fraud.<sup>58</sup> Accordingly, early courts did not treat representations and warranties that were specifically set forth in a written agreement as part of a contract, but simply as statements of the “factual predicate” to the contract that were only actionable as misrepresentations under tort law, not as actions to enforce promises made under contract law.<sup>59</sup> Even since courts have enforced express warranties

52. See *Metro. Coal Co. v. Howard*, 155 F.2d 780, 784 (2d Cir. 1946) (“A warranty is an assurance by one party to a contract of the existence of a fact . . . [and] a promise to indemnify the promisee for any loss if the fact warranted proves untrue . . .”).

53. See *Am. Family Brands, Inc. v. Giuffrida Enters., Inc.*, Nos. 96-7062, 96-7256, 1998 WL 196402, at \*4 (E.D. Pa. Apr. 23, 1998); *Pegasus Mgmt. Co., Inc. v. Lyssa, Inc.*, 995 F. Supp. 43, 44 (D. Mass. 1998); *CBS v. Ziff-Davis Publ'g Co.*, 553 N.E.2d 997, 1001 (N.Y. 1990). It is important to note that some courts do in fact require proof of reliance as a condition to the enforcement of an express contractual warranty. See Robert J. Johannes & Thomas A. Simonis, *Buyer's Pre-Closing Knowledge of Seller's Breach of Warranty*, Wis. LAW., July 2002, at 18, 21 (citing *Hendricks v. Callahan*, 972 F.2d 190, 194 (8th Cir. 1992) (applying Minnesota law); *Land v. Roper Corp.*, 531 F.2d 445, 449 (10th Cir. 1976) (applying Kansas law); *Middleby Corp. v. Hussman Corp.*, No. 90 C 2744, 1992 WL 220922, at \*6 (N.D. Ill. Aug. 27, 1992) (applying Delaware law); *Kazerouni v. De Satnick*, 279 Cal. Rptr. 74, 75 (Ct. App. 1991); see also *Cumming*, *supra* note 12, at 1192; *Masson*, *supra* note 12, at 509–12.

54. See, e.g., *Lee v. State Bank & Trust Co.*, 54 F.2d 518, 521 (2d Cir. 1931) (“the law of contracts does not judge a promisor's obligation by what is in his mind”), *cert. denied*, 285 U.S. 547 (1932); *Ainger v. Mich. Gen. Corp.*, 476 F. Supp. 1209, 1223 (S.D.N.Y. 1979) (“The warranty is as much a part of the contract as any other part, and the right to damages on the breach depends on nothing more than the breach of warranty.”); *Indeck N. Am. Power Fund, L.P. v. Norweb PLC*, 735 N.E.2d 649, 658 (Ill. App. Ct. 2000), *appeal denied*, 744 N.E.2d 285 (Ill. 2001) (unpublished table decision); *Ziff-Davis Publ'g Co.*, 553 N.E.2d at 1001 (“This view of ‘reliance’—i.e., as requiring no more than reliance on the express warranty as being a part of the bargain between the parties—reflects the prevailing perception of an action for breach of express warranty as one that is no longer grounded in tort, but essentially in contract.”); *Randy Knitwear, Inc. v. Am. Cyanamid Co.*, 181 N.E.2d 399, 401 n.2 (N.Y. 1962); *Stevenson*, 180 S.E. at 200 (“If a representation amounts to a warranty, an action . . . may be maintained whether the defendant knew the representation was false or not.”); see generally *Masson*, *supra* note 12.

55. Leona N. Ferera, John R. Phillips & Julian Runnicles, *Some Differences in Law and Practice Between U.K. and U.S. Stock Purchase Agreements*, JONES DAY COMMENTS., Apr. 2007, [http://www.jonesday.com/pubs/pubs\\_detail.aspx?pubID=S4140](http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4140).

56. See *West & Shah*, *supra* note 47, at 4.

57. See *Strika v. Neth. Ministry of Traffic*, 185 F.2d 555, 558 (2d Cir. 1950), *cert. denied*, 342 U.S. 904 (1951).

58. See *id.*; see also *Cumming*, *supra* note 12, at 1192 n.13; *Masson*, *supra* note 12, at 508.

59. See *West & Shah*, *supra* note 47, at 4.

as contractual promises, many courts have continued to recognize a separate tort claim for breaches of those express warranties to the extent that such claims also satisfy the culpability, materiality, and reliance requirements of a misrepresentation claim brought in tort.<sup>60</sup> And as a result, a confusing and conflicting body of case law has emerged, leading one commentator to characterize the concept of warranty as a “freak hybrid born of the illicit intercourse of tort and contract.”<sup>61</sup>

One method that courts have sometimes employed to distinguish between tort-based misrepresentation claims and contract-based warranty claims is the so-called “economic loss” rule.<sup>62</sup> A confusing doctrine that appears to have originated as an effort to curb damages in negligence actions,<sup>63</sup> and which American courts have applied most frequently in the context of product liability law,<sup>64</sup> the economic loss rule also has been applied across a broad spectrum of commercial relationships based in contract.<sup>65</sup> At its simplest, the rule prohibits a tort claimant from recovering damages for purely economic loss unless the claimant also suffered directly related physical damage to his or her person or property as a result of the allegedly tortious conduct of another.<sup>66</sup> Similarly, buyers of products in the United States were generally prohibited from recovering in tort for economic losses they sustained where they could have bargained for a specific warranty in the purchase agreement.<sup>67</sup> As one court noted:

[W]here a purchaser's expectations in a sale are frustrated because the product he bought is not working properly, his remedy is said to be in contract alone, for he has suffered only “economic” losses. This doctrine hinges on a distinction drawn between transactions involving the sale of goods for commercial purposes where economic expectations are protected by commercial and contract law, and those involving the sale of defective products to individual consumers who are injured in a manner which has traditionally been remedied by resort to the law of torts.<sup>68</sup>

But many courts disregarded the rule as it would apply to fraud—particularly fraud in the inducement—and negligent misrepresentation claims, reasoning that

60. See *Ainger v. Mich. Gen. Corp.*, 476 F. Supp. 1209, 1225 (S.D.N.Y. 1979).

61. William L. Prosser, *The Fall of the Citadel (Strict Liability to the Consumer)*, 50 MINN. L. REV. 791, 800 (1966), quoted in 3 PHILIP L. BRUNER & PATRICK J. O'CONNOR, JR., BRUNER & O'CONNOR ON CONSTRUCTION LAW § 9:4 (2009) (referring to warranty as having a “hermaphroditic nature”).

62. See Blair, *supra* note 12, at 438 n.50. See generally Stewart I. Edelman, *Beware the Economic Loss Rule* (Cohen & Wolf P.C., Bridgeport, Conn.), <http://www.cohenandwolf.com/CM/CommercialLitigationPublications/Beware-The-Economic-Loss-Rule.asp> (last visited July 27, 2009).

63. See S.C.M. (U.K.) Ltd. v. W.J. Whithall & Son Ltd., [1971] 1 Q.B. 337, 340 (U.K.). In this context, the rule was called the “exclusionary rule” because it prohibited recovery of “economic loss” in negligence actions in the absence of actual physical harm to person or property. For a full description of the history of the economic loss doctrine in this context, see *Perre v. Apand Pty Ltd.* (1999) 198 C.L.R. 180 (Austl.).

64. See generally Christopher Scott D'Angelo, *The Economic Loss Doctrine: Saving Contract Warranty Law from Drowning in a Sea of Torts*, 26 U. TOL. L. REV. 591 (1995).

65. See R. Joseph Barton, Note, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, 41 WM. & MARY L. REV. 1789, 1803–05 (2000).

66. See *id.* at 1795–96.

67. See *id.* at 1796.

68. *Neibarger v. Universal Coops., Inc.*, 486 N.W.2d 612, 615 (Mich. 1992) (internal quotation marks omitted).

such claims always involve economic, rather than physical, harm.<sup>69</sup> Indeed, although fraud and negligent misrepresentation are grounded in tort, the causes of action originated as means to redress commercial harms where contract law was otherwise insufficient.<sup>70</sup> Other courts, by contrast, rigidly enforced the economic loss rule in both fraud and negligent misrepresentation cases such that, if there was a contract, any tort claim arising out of that contract would be dismissed.<sup>71</sup>

The better reasoned decisions applying the economic loss rule to fraud and negligent misrepresentation claims seem to be based on the premise that an action brought to recover the economic losses occasioned by the breach of a contractual promise should be classified as a claim for breach of warranty, but an action brought to recover damages that arose independently of the economic losses caused by the contractual breach should be classified as a tort claim for misrepresentation.<sup>72</sup> By this logic, any action that depends upon the existence of a contract to calculate the damages alleged is essentially “interwoven with” that contract and properly brought as a claim for breach of express warranty (which, in turn, would be subject to any contractual limitations on the remedies available for breach of that express warranty).<sup>73</sup>

## 2. The Equitable Right of Rescission v. Tort-Based Damages Claims

Tort and contract principles often converge when one contracting party alleges that his or her counterparty made a misrepresentation during the contract formation process. Under the early common law of contract, courts appeared to impose a default condition to every agreement’s validity that neither party had made a false representation that induced the other party’s assent to the deal.<sup>74</sup> Accordingly, even where a party who made a false representation harbored no malicious intent, the counterparty could equitably rescind the contract if it would not have executed the agreement with knowledge that the representation was false.<sup>75</sup> Importantly, however, the complaining party in such an action could not recover any non-rescissory damages<sup>76</sup> that he or she suffered as a result of the pre-

69. See Barton, *supra* note 65, at 1819–24.

70. See *id.* at 1811–12, 1822–23.

71. See *id.* at 1821.

72. See, e.g., Best Buy Stores, L.P. v. Developers Diversified Realty Corp., No. 05-2310 (DSD/JJG), 2007 WL 4191717, at \*4–5 (D. Minn. Nov. 21, 2007).

73. See Maxcess, Inc. v. Lucent Techs., Inc., No. 6:04-cv-204-Orl-31DAB, 2005 WL 6125471, at \*6–7 (M.D. Fla. Jan. 5, 2005), *aff’d*, 433 F.3d 1337 (11th Cir. 2005).

74. See HOLMES, *supra* note 39, at 324–25 (“It is no doubt only by reason of a condition construed into the contract that fraud is a ground of rescission . . .”).

75. See, e.g., Graves v. Tulleners, 134 P.3d 990, 996 (Or. Ct. App. 2006) (“Where a person makes a false representation of a material fact, and the person to whom the representation is made is induced to and does rely on that representation in entering into an agreement, that is sufficient for the purpose of avoiding the contract, irrespective of the intent and purpose of the person making the false representation.” (internal quotation marks omitted)). See also Derry v. Peek, [1889] 14 App. Cas. 337, 359 (H.L.) (U.K.).

76. “Rescissory damages” are money damages designed to approximate financially the remedy of rescission. See *Std. Chartered PLC v. Price Waterhouse*, 945 P.2d 317, 345 (Ariz. Ct. App. 1996). Rescissory damages are awarded “[w]hen rescission, though appropriate, is impossible or infeasible.” *Id.*

contractual misrepresentation or omission.<sup>77</sup> And, like other default provisions, there was no apparent common law basis for a rule that would deprive transacting parties of the right to waive that default condition contractually.<sup>78</sup>

While courts did not permit *contract* claims for non-rescissory damages resulting from pre-contractual misrepresentations, the common law recognized an increasingly broad set of *tort-based* actions designed to compensate plaintiffs for these losses.<sup>79</sup> In what was originally known as an action for “deceit,”<sup>80</sup> nineteenth century English courts only permitted monetary recovery where the aggrieved party demonstrated that the individual who made a pre-contractual misrepresentation did so with dishonest intent.<sup>81</sup> But courts gradually began to hold that mere recklessness satisfied the “dishonesty” requirement of the tort-based damages claim.<sup>82</sup> And over time, the common law recognized an action for “negligent misrepresentation,” under which a contracting party could recover damages arising from a false pre-contractual misrepresentation that his or her counterparty made without exercising ordinary care.<sup>83</sup>

### III. SOURCES AND CONSEQUENCES OF EXTRA-CONTRACTUAL LIABILITY IN MODERN CORPORATE TRANSACTIONS

For business lawyers negotiating large-scale corporate transactions today, many courts have translated the tort-based duties discussed in Part II into a “commercial honor code” that effectively superimposes extra-contractual obligations on contracting parties.<sup>84</sup> Accordingly, we will now outline the nuances of the specific causes of action in which the “contortion” of contracts and torts is manifested today. Indeed, understanding the sources of extra-contractual liability as it arises in jurisdictions across the United States is essential to understanding how to contain it.<sup>85</sup>

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77. See RESTATEMENT (SECOND) OF CONTRACTS ch. 7, topic 1, introductory note (1981); see also Davis, *supra* note 12, at 488–89.

78. See HOLMES, *supra* note 39, at 324 (“Parties could agree, if they chose, that a contract should be binding without regard to truth or falsehood outside of it on either part.”); *Tullis v. Jackson*, [1892] 3 Ch. 441, 445 (U.K.) (“I myself see no reason why grown men should not be allowed to contract in these terms. ‘Neither of us,’ each says to the other, and each agrees with the other, ‘will ever raise the charge of fraud.’”). See also Davis, *supra* note 12, at 485 (“Many judges and scholars seem to consider the rules assigning liability for fraud—and sometimes even negligence—in contract formation to be among the few mandatory rules of the contracting game. This belief persists in spite of the fact that virtually every other rule of contract is treated as a default rule, and therefore, subject to modification by agreement of the parties.”).

79. See RESTATEMENT (SECOND) OF CONTRACTS ch. 7, topic 1, introductory note (1981).

80. *Derry v. Peek*, [1889] 14 App. Cas. 337, 359 (H.L.) (U.K.).

81. See *id.*

82. See *id.*

83. See *Ultramares Corp. v. Touche*, 174 N.E. 441, 446–47 (N.Y. 1931); *Hedley Byrne & C. Ltd. v. Heller & Partners Ltd.*, [1964] A.C. 465 (H.L.) (U.K.). Rescission may also be available as a remedy for negligent misrepresentation. See, e.g., *Wallenta v. Moscowitz*, 839 A.2d 641, 643 (Conn. App. Ct.), *cert. denied*, 845 A.2d 414 (Conn. 2004); *Darnell v. Myers*, No. 14859-NC, 1998 WL 294012, at \*1 (Del. Ch. May 27, 2008).

84. See West, *supra* note 12, at 3.

85. Note that while we will discuss general principles that apply across the United States in Part III, we have focused our discussion of specific state law differences on three jurisdictions, namely

Common law fraud and negligent misrepresentation claims are the most common sources of contract-related tort liability in modern commercial transactions. In each case, the claimant seeks either to impose liability on a contracting party for an extra-contractual representation that the defendant refused to warrant in the written agreement or, as in *ABRY*, to avoid bargained-for limits on the remedies available for the breach of a contractual warranty.

#### A. UNDERSTANDING THE NATURE OF CONTRACT-RELATED FRAUD CLAIMS—FRAUD IS NOT LIMITED TO DELIBERATE LYING

Generally speaking, the core elements of a prima facie case of contract-related fraud are consistent from state to state.<sup>86</sup> In most jurisdictions, a plaintiff must establish that: (i) the defendant made a representation; (ii) the representation was false; (iii) the defendant acted with scienter (i.e., knew the representation was false or made it recklessly without sufficient knowledge as to whether it was true or false); (iv) the defendant intended that the plaintiff rely on the representation; (v) the plaintiff reasonably or justifiably relied on the representation; and (vi) the plaintiff suffered injury as a result of the representation.<sup>87</sup> But within these basic elements, there are distinctions between states that become particularly salient in the context of sophisticated business transactions.<sup>88</sup>

Notably, states differ on the types of representations that are actionable in tort.<sup>89</sup> Generally, only misrepresentations of present or existing fact may constitute the basis of a fraud claim.<sup>90</sup> Indeed, in New York, misrepresentations regarding a party's future intention to perform under an agreement are no different from the contractual promise "either to perform or to pay damages for breach of contract, and should be penalized no more extensively."<sup>91</sup> The courts of some states, however, circumvent the foregoing principle by stipulating that a contracting party may

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New York, Delaware, and Texas. We have chosen these states not only because the laws of New York, Delaware, and Texas govern the majority of the agreements that we negotiate, but also because they are representative of the different approaches that courts in jurisdictions across the United States take with respect to the issues covered in this Article. In some cases, we have noted the specific nuances of the laws of jurisdictions other than New York, Delaware, and Texas.

86. See PETER A. ALCES, *THE LAW OF FRAUDULENT TRANSACTIONS* § 2:3, at 2-13 (2006).

87. See *id.*; see also, e.g., *Dallas Aerospace, Inc. v. CIS Air Corp.*, 352 F.3d 775, 784-85 (2d Cir. 2003); *Daldav Assocs., L.P. v. Lebor*, 391 F. Supp. 2d 472, 475 (N.D. Tex. 2005); *Stephenson v. Capano Dev., Inc.*, 462 A.2d 1069, 1074 (Del. 1983).

88. See West, *supra* note 12, at 3-4; Glenn D. West & Adam D. Nelson, *Corporations*, 57 SMU L. REV. 799, 815-17 (2004) (citing *Benchmark Elecs., Inc. v. J.M. Huber Corp.*, 343 F.3d 719 (5th Cir.), modified by 355 F.3d 356 (5th Cir. 2003)); see generally ALCES, *supra* note 86, §§ 2:4-2:27.

89. See generally ALCES, *supra* note 86, § 2:4.

90. See *id.* §§ 2:4, 2:6, at 2-17, 2-21 (citing *Clearly Can. Beverage Corp. v. Am. Winery, Inc.*, 257 F.3d 880 (8th Cir. 2001); *Tom Hughes Marine, Inc. v. Am. Honda Motor Co., Inc.*, 219 F.3d 321, 325 (4th Cir. 2000); *Nestor v. Kapetanovic*, 573 N.E.2d 457 (Ind. Ct. App. 1991); *Tate v. Colony House Builders, Inc.*, 508 S.E.2d 597 (Va. 1999)); see also *Great Earth Int'l Franchising Corp. v. Milks Dev.*, 311 F. Supp. 2d 419, 427-28 (S.D.N.Y. 2004).

91. *Great Earth*, 311 F. Supp. 2d at 427-28; see also *Gould Paper Corp. v. Madisen Corp.*, 614 F. Supp. 2d 485, 492 (S.D.N.Y. 2009) ("A claim for fraud cannot stand where the only allegation is 'that defendant entered into a contract with no intention of performing.'").

premise a fraud claim on the basis of a contractual promise that the defendant made, but never intended to perform.<sup>92</sup> In Texas, for example, “a promise of future performance (under a contract) constitutes an actionable misrepresentation if the promise was made with no intention of performing at the time it was made” because “the legal duty not to fraudulently procure a contract is separate and independent from the duties established by the contract itself.”<sup>93</sup> Importantly, proof of fraud can be premised on purely circumstantial evidence, and non-performance of a contract coupled with “some” circumstances indicating an intention never to perform is sufficient to sustain a claim of fraud in some states.<sup>94</sup>

In deciding whether an allegedly fraudulent statement is actionable in tort, some courts also consider whether the contracting parties incorporated the representation in the agreement out of which their dispute arose.<sup>95</sup> Under Texas law, for example, “tort damages are recoverable for a fraudulent inducement claim irrespective of whether the fraudulent representations are later subsumed in a contract or whether the plaintiff only suffers an economic loss related to the subject matter of the contract.”<sup>96</sup> But New York courts generally require that an allegedly fraudulent representation be “collateral or extraneous to the terms of the parties’ agreement.”<sup>97</sup>

Though fraud, “unlike negligence, breach of warranty or breach of contract, is premised upon the “actual moral guilt” of the defrauding party,” many states

92. See *ALCES*, *supra* note 86, § 2:6, at 2-24 (citing *Tom Hughes Marine*, 219 F.3d at 325; *Lovejoy Elecs., Inc. v. O'Berto*, 873 F.2d 1001 (7th Cir. 1989); *Wagstaff v. Protective Apparel Corp.*, 760 F.2d 1074 (10th Cir. 1985); *Armani v. Maxim Healthcare Servs., Inc.*, 53 F. Supp. 2d 1120 (D. Colo. 1999)); see also *Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc.*, 960 S.W.2d 41, 48 (Tex. 1998). But see *Bridgeway Corp. v. Citibank, N.A.*, 132 F. Supp. 2d 297, 304 (S.D.N.Y. 2001).

93. *Formosa Plastics*, 960 S.W.2d at 46-48.

94. See, e.g., *O'Neil v. Coll. Loan Special Purpose Corp.*, No. D047000, 2006 WL 1742836, at \*4 (Cal. Ct. App. 2006); *Va. Acad. of Clinical Psychologists v. Group Hospitalization & Med. Servs., Inc.*, 878 A.2d 1226, 1234-35 (D.C. 2005); *Spoljaric v. Percival Tours, Inc.*, 708 S.W.2d 432, 435 (Tex. 1986).

95. See, e.g., *Great Earth*, 311 F. Supp. 2d at 426-28; *Formosa*, 960 S.W.2d at 47; see also *Benchmark Elecs., Inc. v. J.M. Huber Corp.*, 343 F.3d 719, 729-30 (5th Cir.), modified by 355 F.3d 356 (5th Cir. 2003).

96. *Formosa*, 960 S.W.2d at 47. See also *ABRY Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1037, 1057 (Del. Ch. 2006) (declining to enforce an exclusive remedy provision that purported to defeat a tort-based rescission and damages claim premised upon an intentionally false representation of fact made within a stock purchase agreement).

97. See *Great Earth*, 311 F. Supp. 2d at 425 (internal quotation marks omitted); see also *DynCorp v. GTE Corp.*, 215 F. Supp. 2d 308, 326 (S.D.N.Y. 2002); *Astroworks, Inc. v. Astroexhibit, Inc.*, 257 F. Supp. 2d 609, 616-17 (S.D.N.Y. 2003). But see *VTech Holdings Ltd. v. Lucent Techs., Inc.*, 172 F. Supp. 2d 435, 439-40 (S.D.N.Y. 2001) (“While the dominant trend is that a fraud claim cannot be based solely on the allegation that a party has made a contractual promise with no intention of performing it, some cases have stated that ‘[a] false statement of intention is sufficient to support an action for fraud, even where that statement relates to an agreement between the parties.’” (quoting *Graubard Mollen Dannett & Horowitz v. Moskovitz*, 653 N.E.2d 1179, 1184 (N.Y. 1995))). Note that New York law recognizes three categories of fraud claims that may arise out of a contractual relationship, namely (i) where a party demonstrates that its adversary had a legal duty that was separate from its duty to perform under the contract, and the alleged fraud was a breach of that separate legal duty; (ii) where a party demonstrates a fraudulent misrepresentation “collateral or extraneous to the contract”; and (iii) where a party shows “special damages that are caused by [a] misrepresentation and [are] unrecoverable as contract damages.” *Great Earth*, 311 F. Supp. 2d at 425.



expose individuals to fraud liability not only for intentional misrepresentations, but also for “reckless” misrepresentations.<sup>98</sup> For example, a misrepresentation is reckless, and therefore actionable as fraud in Texas, if:

- (i) it is made without any knowledge of the truth and as a positive assertion; (ii) if the person making the representation knows that she does not have sufficient information or basis to support it; or (iii) if she realizes that she does not know whether or not the statement is true.<sup>99</sup>

Even where a transacting party cautiously abstains from making potentially actionable representations, that party’s silence may constitute actionable fraud in jurisdictions that impose a “duty to speak” under certain circumstances.<sup>100</sup> Under New York law, for example, the duty to speak arises in any of three situations:

- (i) when one party makes a partial or incomplete statement that requires clarification; (ii) when the parties are in a fiduciary or confidential relationship; and (iii) when one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge.<sup>101</sup>

## B. UNDERSTANDING THE NATURE OF CONTRACT-RELATED NEGLIGENT MISREPRESENTATION CLAIMS

Most jurisdictions also recognize the tort of negligent misrepresentation.<sup>102</sup> According to the Delaware Court of Chancery, “a negligent misrepresentation claim . . . is in essence a fraud claim with a reduced state of mind requirement”

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98. *ALCES*, *supra* note 86, §§ 2:13–2:14, at 2-53 to 2-57 (quoting *Lively v. Garnick*, 287 S.E.2d 553, 555 (Ga. Ct. App. 1981)); *see also* *Addy v. Piedmont*, No. 3571-VCP, 2009 WL 707641, at \*18 (Del. Ch. Mar. 18, 2009) (stipulating that the scienter element of a fraud claim in Delaware requires proof that the defendant “had knowledge or believed that the [relevant] representation was false, or made the representation with requisite indifference to the truth”); *West*, *supra* note 12, at 3.

99. *ALCES*, *supra* note 86, § 2:14, at 2-55 (citing *Livingston Livestock Exch., Inc. v. Hull State Bank*, 14 S.W.3d 849 (Tex. App. 2000)).

100. *See West*, *supra* note 12, at 2 (citing *Cronus Offshore, Inc. v. Kerr McGee Oil & Gas Corp.*, 369 F. Supp. 2d 848, 858 (E.D. Tex. 2004), *aff’d*, 133 F. App’x 944 (5th Cir. 2005); *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 872 A.2d 611, 629 (Del. Ch. 2005), *aff’d in part, rev’d in part*, 901 A.2d 106 (Del. 2006); *Chase Manhattan Bank v. N.H. Ins. Co.*, 749 N.Y.S.2d 632, 645 (App. Div. 2002)); *Greenberg Traurig v. Moody*, 161 S.W.3d 56, 77–79 (Tex. App. 2005) (applying New York Law).

101. *Greenberg Traurig*, 161 S.W.3d at 77. Texas law is similar. *See Cronus Offshore*, 369 F. Supp. 2d at 858. Note that the *Cronus* court stated that “a seller of real estate may commit fraud without actually making an affirmative misrepresentation if the seller fails to disclose material facts which would not have been discoverable by a purchaser exercising ordinary care and diligence, or which could not be uncovered by a reasonable investigation and inquiry.” *Id.*; *see also* RESTATEMENT (SECOND) OF TORTS § 551 cmt. b (1977).

102. *See ALCES*, *supra* note 86, § 2:15, at 2-58 to 2-71; *West & Obi*, *supra* note 19, at 8 (citing *Daldav Assocs., L.P. v. Lebor*, 391 F. Supp. 2d 472, 475 (N.D. Tex. 2005); *BCY Water Supply Corp. v. Residential Invs., Inc.*, 170 S.W.3d 596, 602 (Tex. App. 2005)); *see also* Corp. Prop. Assocs. 14 Inc. v. CHR Holding Corp., No. 3231-VCS, 2008 WL 963048, at \*1 (Del. Ch. Apr. 10, 2008); *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179 (1931); *see generally* Robert K. Wise & Heather E. Poole, *Negligent Misrepresentation in Texas: The Misunderstood Tort*, 40 TEX. TECH L. REV. 845 (2008).

such that “[s]cienter is replaced by negligence.”<sup>103</sup> But “to compensate for this significant concession,”<sup>104</sup> courts generally require that the defendant owe some legal duty to impart accurate information to the plaintiff.<sup>105</sup>

The scope of negligent misrepresentation liability varies from state to state.<sup>106</sup> To establish a claim for negligent misrepresentation in New York, the plaintiff must show that the defendant “possess[ed] unique or specialized expertise” or was in a “special position of confidence and trust with the injured party such that reliance on the negligent misrepresentation [was] justified.”<sup>107</sup> New York courts have disagreed as to whether the relationship between a buyer and seller in an arm’s-length commercial transaction qualifies under the foregoing standard where the duty to provide accurate information arises solely from their written agreement.<sup>108</sup> Delaware courts, by contrast, more broadly extend negligent misrepresentation liability to parties who make representations “in the course of a business or a transaction in which the [party] has a pecuniary interest.”<sup>109</sup>

### C. IMPLICATIONS OF EXTRA-CONTRACTUAL LIABILITY IN MODERN CORPORATE TRANSACTIONS

Extra-contractual liability threatens serious consequences for corporate clients that value the certainty that contract law—including the remedial limitations facilitated thereby—provides. First, as noted above, while rescission is the only remedy

103. *Corp. Prop.*, 2008 WL 963048, at \*8. In *Addy v. Piedmonte*, the Delaware Court of Chancery also affirmed the existence under Delaware law of a concept known as “equitable fraud,” which differs from common law fraud in one material respect, namely that “a plaintiff is not required to show that the defendant committed fraud knowingly or recklessly. . . . [I]nnocent or negligent misrepresentations or omissions suffice to prove equitable fraud.” No. 3571-VCP, 2009 WL 707641, at \*18 (citing *Mark Fox Group, Inc. v. E.I. du Pont de Nemours & Co.*, No. 20081, 2003 WL 21524886, at \*5 n.15 (Del. Ch. July 2, 2003) (“The count at issue was entitled ‘equitable fraud,’ but it is well known that such a term refers interchangeably to claims based on negligent or innocent misrepresentation.”)).

104. *Corp. Prop.*, 2008 WL 2963048, at \*8.

105. See *ALCES*, *supra* note 86, § 2:15, at 2-67 to 2-71.

106. See *id.* § 2:15, at 2-58 to 2-71.

107. *Id.* § 2:15, at 2-64. The elements of negligent misrepresentation under New York law are:

(1) carelessness in imparting words; (2) upon which others were expected to rely; (3) and upon which they did or failed to act; (4) to their damage; and (5) the declarant must express the words directly, with knowledge or notice that they will be acted upon, to one whom the declarant is bound by some relation or duty of care.

*Dallas Aerospace, Inc. v. CIS Air Corp.*, 352 F.3d 775, 788 (2d Cir. 2003).

108. *Compare JP Morgan Chase Bank v. Winnick*, 350 F. Supp. 2d 393, 402 (S.D.N.Y. 2004) (finding no special relationship because “[t]he relationship between a bank and a borrower is the very epitome of an arm’s length commercial transaction: the borrower must comply with the negotiated terms of its contract, and may not defraud the lender by deliberate falsehood, but it is not liable in tort for mere carelessness about its representations”), and *PPI Enters. (U.S.), Inc. v. Del Monte Foods Co.*, No. 99 Civ. 3794 (BSJ), 2003 WL 22118977, at \*26 (S.D.N.Y. Sept. 11, 2003) (holding that where “the contract itself is the sole basis for the imposition of a special duty . . . the duty extends only as far as the contact’s scope”), with *Kimmell v. Shafer*, 675 N.E.2d 450, 454–55 (N.Y. 1996) (holding that an energy company executive owed a duty of care to plaintiff investors whose investment he induced with negligent misrepresentations).

109. *Corp. Prop.*, 2008 WL 963048, at \*8–9 (internal quotation marks omitted).

available for a pre-contractual misrepresentation under contract law,<sup>110</sup> a plaintiff may seek compensatory damages for the same misrepresentation under tort law.<sup>111</sup> Second, most states permit awards of punitive damages in fraud cases, exposing transacting parties to potential liability that could drastically exceed the losses that the aggrieved party actually suffered.<sup>112</sup> Third, carefully crafted deductibles and caps on a seller's obligation to indemnify a buyer for losses arising from breaches of contractually bargained-for warranties, which are designed to define precisely the parameters of each party's post-closing liability, may not apply to tort-based claims premised upon pre-contractual representations.<sup>113</sup> Fourth, even where our clients have exercised the utmost care in connection with a given transaction, fraud and negligent misrepresentation claims are subject to the subjective determination of a judge or jury about a person's state of mind, and therefore present a very real risk of an erroneous verdict.<sup>114</sup> And finally, in light of the foregoing, our clients' counterparties can use the mere threat of these tort-based causes of action as "bargaining chips" if they ever become dissatisfied with the deal that they made.<sup>115</sup>

Contract-related tort claims also present a serious risk of personal liability for individuals who participate in the transaction process as agents of contracting entities.<sup>116</sup> Under the common law of contract, the individuals who sign an agreement on behalf of their entity-level principals are not personally liable under that agreement if they expressly stipulate that they are executing the contract as an agent or representative of the entity party to the transaction.<sup>117</sup> But under traditional principles of agency law, representatives of entity-level contract signatories may be personally liable for the contract-related tortious acts that they direct, or in which they participate.<sup>118</sup> So the plaintiff in a fraud or negligent misrepresentation action may seek damages from any officer or employee who participated in the purportedly tortious conduct on behalf of the limited liability entity against which the plaintiff is seeking judgment.<sup>119</sup> And that conduct may be as innocuous as negligently failing to schedule an appropriate exception to a contractual representation that purportedly induced the contract's formation.<sup>120</sup>

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110. See *supra* notes 76–77 and accompanying text. Importantly, rescissory damages awarded where actual rescission is not possible could exceed the agreed upon caps on contractual damages set forth in the written agreement.

111. See RESTATEMENT (SECOND) OF CONTRACTS ch. 7, topic 1, introductory note (1981).

112. See ALCES, *supra* note 86, § 2:24, at 2-119 to 2-128.

113. See Blair, *supra* note 12, at 468–71; West, *supra* note 12, at 2.

114. See Davis, *supra* note 12, at 502–03 (“An independent reason why parties may find it useful to disclaim liability for misrepresentation is because they might fear that courts are unable to determine accurately whether parties have behaved negligently or fraudulently.”).

115. See Masson, *supra* note 12, at 513.

116. See *id.*; see also Glenn D. West, *Protecting the Deal Professional from Personal Liability for Contract-Related Claims*, PRIVATE EQUITY ALERT (Weil, Gotshal & Manges LLP, New York, N.Y.), Mar. 2006, at 5, available at [http://www.weil.com/wgm/cwgmhomep.nsf/Files/PEAMar06/\\$file/PEAMar06.pdf](http://www.weil.com/wgm/cwgmhomep.nsf/Files/PEAMar06/$file/PEAMar06.pdf).

117. See West, *supra* note 116, at 5–6.

118. See, e.g., *Alexander v. Lincare Inc.*, No. 3:07-CV-1137-D, 2007 WL 4178592, at \*3 (N.D. Tex. Nov. 27, 2007). See also West, *supra* note 116, at 5.

119. See West, *supra* note 116, at 6–7.

120. See West, *supra* note 12, at 2.

#### IV. THE ENFORCEABILITY OF CONTRACTUAL DEFENSES TO TORT LIABILITY IN SOPHISTICATED COMMERCIAL TRANSACTIONS

##### A. NEGOTIATING AGREEMENTS IN VIEW OF EXTRA-CONTRACTUAL LIABILITY

###### 1. Disclaimer-of-Reliance Clauses

In view of these risks, the agreements governing sophisticated corporate transactions, like the stock purchase agreement at issue in *ABRY*, often include a series of defensive provisions designed to ensure that the contract constitutes the exclusive source of the contracting parties' post-closing rights, obligations, and remedies.<sup>121</sup> Given that common law fraud and negligent misrepresentation actions, including fraud claims based upon non-disclosure,<sup>122</sup> generally require proof that the claimant reasonably or justifiably relied on the defendant's allegedly false statement,<sup>123</sup> many contracts contain a "disclaimer-of-reliance" provision that requires the buyer to agree that it did not rely on any *extra-contractual* representations made by the seller.<sup>124</sup> These provisions purport to preclude proof of the mandatory "reliance" element of extra-contractual misrepresentation actions and either support dismissal of any such claim as a matter of law<sup>125</sup> or, at the very least, supply evidence at the summary judgment or trial stages that the plaintiff did not rely on the defendant's extra-contractual statements.<sup>126</sup>

In this context, it is important to distinguish between an explicit disclaimer-of-reliance provision and a standard merger or integration clause. A typical merger

121. See *ABRY Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1052 (Del. Ch. 2006).

122. See, e.g., *Creelman v. Rogowski*, 207 A.2d 272, 274 (Conn. 1965) ("In an action based on fraudulent nondisclosure, the plaintiff must prove not only the nondisclosure but his reliance on it."); *Glynn v. Atl. Seaboard Corp.*, 728 A.2d 117, 120 (Me. 1999) (stipulating that justifiable reliance is an element of a fraud claim premised upon the non-disclosure of a fiduciary); *Berkshire-Westwood Graphics Group, Inc. v. Davidson*, No. 06-WAD-13, 2007 WL 4119215, at \*3 (Mass. App. Ct. Nov. 16, 2007) (holding that fraud plaintiff could not prove necessary element of reliance on the defendant's non-disclosure of company's financial status because the plaintiff knew that the defendant was in "fairly dire financial straits"); *Keefhaver v. Kimbrell*, 58 S.W.3d 54, 60 (Mo. Ct. App. 2001) ("The concept of fraud liability based upon nondisclosure couches reliance in terms of the availability of the information to the plaintiff and the plaintiff's diligence."); *Lama Holding Co. v. Smith Barney Inc.*, 668 N.E.2d 1370, 1373 (N.Y. 1996) (stipulating that "justifiable reliance" is an element of a fraud claim premised upon a material omission); *State Constr. Corp. v. Scoggins*, 485 P.2d 391, 394 (Or. 1971) ("In most, if not all cases of fraud, one essential element is some sort of reliance . . . upon a misrepresentation of the other party, whether that misrepresentation be an affirmative one or by a nondisclosure."); *Avery Pharms., Inc. v. Haynes & Boone, L.L.P.*, No. 2-07-317-CV, 2009 WL 279334, at \*10 (Tex. App. Feb. 5, 2009) (holding that reliance is an element of fraud by non-disclosure). *But see* *Farmers Ins. Exch. v. Benzing*, 206 P.3d 812, 824 (Colo. 2009) (declining to rule on question of whether presumption or inference of causation or reliance should be applied in consumer protection or common law fraud class actions based upon uniform material misrepresentations or omissions).

123. See, e.g., *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129, 142-43 (Del. Ch. 2003); *Danann Realty Corp. v. Harris*, 157 N.E.2d 597, 599 (N.Y. 1959); see also West, *supra* note 12, at 3.

124. See *ABRY*, 891 A.2d at 1052.

125. See, e.g., *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 183 (3d Cir.), *cert. denied*, 540 U.S. 1068 (2003); *Envtl. Sys., Inc. v. Rexham Corp.*, 624 So. 2d 1379, 1384 (Ala. 1993); *Miles Excavating, Inc. v. Rutledge Backhoe & Septic Tank Servs., Inc.*, 927 P.2d 517, 518 (Kan. Ct. App. 1997).

126. See *Rogen v. Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966); *Gibb v. Citicorp Mortgage, Inc.*, 518 N.W.2d 910, 918 (Neb. 1994).

clause, also known as an “entire agreement” provision, stipulates that the applicable written agreement contains all obligations between the parties that are the subject of that written agreement and specifically supersedes any other promise or understanding between the parties that is not set forth in that agreement.<sup>127</sup> So most contracting parties include merger clauses in their agreements to trigger the parol evidence rule, which “‘limit[s] the evidence available to the parties should a dispute arise over the meaning of the contract.’”<sup>128</sup> But while contracting parties have argued that the existence of a merger clause should also preclude their counterparties from reasonably or justifiably relying on a representation not set forth in the exclusive, written agreement,<sup>129</sup> a separate disclaimer-of-reliance provision more clearly and unequivocally serves this purpose.<sup>130</sup>

## 2. Indemnification and Exclusive Remedy Provisions

Sophisticated corporate agreements also often include indemnification and exclusive remedy provisions, which work in concert to establish a set of procedures and damage caps that limit the remedies available to a party for proven breaches of *contractual* representations and warranties.<sup>131</sup> Indeed, many sales of private companies involve a contemporaneous distribution to the selling entity’s shareholders of all proceeds derived from the sale in excess of the agreed maximum contractual liability.<sup>132</sup> It is critical, therefore, for business lawyers representing sellers to define precisely the extent of their clients’ potential post-transaction liabilities so that such distributions can be made reliably.<sup>133</sup>

Indemnification and exclusive remedy provisions combine to circumscribe post-closing liability as follows.<sup>134</sup> First, indemnification provisions generally

127. See, e.g., Joseph Wylie, *Using No-Reliance Clauses to Prevent Fraud-in-the-Inducement Claims*, 92 ILL. B.J. 536, 537 (2004) (citing *Barille v. Sears Roebuck & Co.*, 682 N.E.2d 118, 123 (Ill. App. Ct. 1997)).

128. *Id.* (quoting *Vigortone AG Prods., Inc. v. PM AG Prods., Inc.*, 316 F.3d 641, 644 (7th Cir. 2002)).

129. See, e.g., *Barille*, 682 N.E.2d at 123.

130. While a merger clause may contain a disclaimer-of-reliance provision and, in some circumstances, could be read to serve a similar function, it is imprudent to assume that a boilerplate section labeled “merger,” “entire agreement,” or “integration” specifically includes, or will function as, a disclaimer-of-reliance clause. Moreover, some courts seem to require a disclaimer of reliance to be separated completely from a standard merger or entire agreement clause in order to be enforceable. See, e.g., *Nichols v. YJ USA Corp.*, No. 3:06-CV-02366-L, 2009 WL 722997, at \*21 (N.D. Tex. Mar. 18, 2009) (“language that merely expressed that the agreement contained the entire understanding between the parties . . . is not tantamount to a clear expression of the parties’ intent to . . . disclaim reliance on representations”); *Slack v. James*, 614 S.E.2d 636, 640–41 (S.C. 2005); see also Blair, *supra* note 12, at 424–25.

131. See, e.g., *ABRY Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1043–45 (Del. Ch. 2006).

132. See *id.*; see also West, *supra* note 12, at 1.

133. See West, *supra* note 12, at 1.

134. See Hutchinson & Mason PLLC, *Mergers and Acquisitions Basics* (Hutchinson Law Group, Raleigh, N.C.), Nov. 2001, at 3, available at <http://www.hutchlaw.com/resources/docs/Merge%20and%20Acquisition%20Basics.pdf>.

stipulate the time period after closing during which a buyer may bring a claim based upon a representation and warranty set forth in the transaction agreement.<sup>135</sup> Second, indemnification provisions typically restrict the amount of damages available for any post-closing breach to a specified percentage of the purchase price.<sup>136</sup> Third, most indemnification provisions seek to preclude small claims by establishing so-called “deductibles” or “baskets,” which set a minimum dollar threshold below which a buyer’s losses do not qualify for reimbursement.<sup>137</sup> And finally, the exclusive remedy provision is designed to prevent a plaintiff from circumventing the foregoing limitations, by stipulating that the right of indemnification constitutes the only post-closing recourse available to either party for any alleged breach of the contractual representations and warranties.<sup>138</sup>

Accordingly, while contracting parties employ disclaimer-of-reliance clauses to limit their liability for extra-contractual representations, they include indemnification and exclusive remedy provisions to limit their liability for representations and warranties set forth within the written contract itself.<sup>139</sup> And if drafted broadly to cover actions arising in both contract and tort, an exclusive remedy provision can help protect a contracting party from extra-contractual liability in jurisdictions that permit transacting parties to premise fraud claims on the basis of contractual representations and warranties.<sup>140</sup>

So when the Delaware Court of Chancery determined in *ABRY* that the scope of the tightly drafted exclusive remedy provision was sufficiently broad to encompass both breach of contract and tort claims, the private equity buyer’s fraud action, based upon “false representations of fact embodied within the four corners of the [s]tock [p]urchase [a]greement itself,” seemed doomed to fail.<sup>141</sup> But after the buyer argued that the defensive provisions were unenforceable as a matter of public policy, Vice Chancellor Strine sought guidance from the “longstanding debate within American jurisprudence about society’s relative interest in contractual freedom versus [the need to establish] universal minimum standards of truthful conduct for contracting parties” to inform his ultimate decision in favor of the latter.<sup>142</sup> Indeed, although *ABRY*’s specific facts presented a question of first impression in Delaware,<sup>143</sup> courts have long wrestled with the propriety of imposing

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135. *See id.*

136. *See id.*

137. *See id.* With a basket, a party may recover all of its damages once the proven losses exceed the stipulated basket amount. With a deductible, by contrast, a party may recover damages only to the extent that its losses exceed the stipulated deductible amount. *See id.*

138. *See* Ben Adler, Stephen M. Besen & Carole Schiffman, *Fundamentals of Private Equity Investing II (Sell-Side)*, in PRACTISING L. INST., COURSE HANDBOOK: PRIVATE EQUITY FORUM (EIGHTH ANNUAL) 137, 145–48 (2007).

139. *See, e.g.,* *ABRY Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1052–53 (Del. Ch. 2006).

140. *See, e.g., id.* at 1055–56; *Formosa Plastics Corp. USA v. Presidio Eng’rs & Contractors, Inc.*, 960 S.W.2d 41, 47 (Tex. 1998).

141. *See ABRY*, 891 A.2d at 1056.

142. *Id.* at 1055.

143. For a thorough discussion of Delaware law on this topic, see Haas, *supra* note 37.

tort duties, rights, and remedies upon transacting parties that have contractually disclaimed their application.

## B. ENFORCEABILITY OF CONTRACTUAL DEFENSES TO TORT LIABILITY: DOES FRAUD VITIATE EVERY CONTRACT?

Courts in the late nineteenth and early twentieth centuries generally enforced clauses that disclaimed the existence of representations for which the seller refused to provide an express warranty where the complaining party premised its extra-contractual claim upon innocent, inadvertent, or negligent statements.<sup>144</sup> In other words, courts tended to give effect to provisions that waived, disclaimed, or excluded a buyer's remedies for misrepresentations that would only entitle the buyer to rescission, but not compensatory damages. And even though the common law gradually recognized negligent misrepresentation as a basis for recovery of compensatory damages,<sup>145</sup> courts remained favorably inclined toward the enforcement of waivers, disclaimers, and exclusion clauses that shielded a contracting party from extra-contractual liability for negligent statements.<sup>146</sup>

Decisions addressing the ability of contracting parties to disclaim liability for "fraudulent" representations, by contrast, were decidedly more negative. Indeed, influenced by the widely accepted legal maxim that "fraud vitiates everything it touches,"<sup>147</sup> courts often have rebuffed the efforts of contracting parties to avoid litigation over who said what to whom during pre-contract negotiations, holding that tort-based liability for fraudulent (including reckless) misrepresentations,

144. See, e.g., *J.B. Colt & Co. v. Clay*, 288 S.W. 745, 746 (Ky. 1926); *McCray Refrigerator & Cold Storage Co. v. Woods*, 58 N.W. 320, 322 (Mich. 1894); *Wilkinson v. Carpenter*, 554 P.2d 512, 514 (Or. 1976); *S. Morgan Smith Co. v. Monroe County Water Power & Supply Co.*, 70 A. 738, 739 (Pa. 1908).

145. See, e.g., *Doyle v. Chatham & Phenix Nat'l Bank of City of N.Y.*, 171 N.E. 574, 577 (N.Y. 1930) (allowing for damage claims in negligent misrepresentation actions); *D.S.A., Inc. v. Hillsboro Ind. Sch. Dist.*, 973 S.W.2d 662, 663 (Tex. 1998) (allowing for pecuniary loss damages in a negligent misrepresentation action but not benefit-of-the-bargain damages).

146. See, e.g., *Delta Airlines, Inc. v. Douglas Aircraft Co.*, 47 Cal. Rptr. 518, 521 (Ct. App. 1966) (enforcing a negligence disclaimer in a contract for the sale of an aircraft); *Perry v. Phila., B & W.R. Co.*, 77 A. 725, 726 (Del. Super. Ct. 1910) (highlighting that principles of freedom of contract support the enforcement of a knowing agreement to exempt a party to a contract from claims of negligence); *Melodee Lane Lingerie Co. v. Am. Dist. Tel. Co.*, 218 N.E.2d 661, 667 (N.Y. 1966) ("In the absence of statute, a contracting party could exempt itself from the consequences of its own ordinary negligence if the language so specifies."). See also *infra* note 166; 15 GRACE McLEAN GEISEL, CORBIN ON CONTRACTS § 85.18, at 455 (Joseph M. Perillo ed., rev. ed. 2003) ("The general rule of exculpatory agreements is that a party may agree to exempt another party from tort liability if that tort liability results from ordinary negligence.").

147. *ABRY*, 891 A.2d at 1059; see also *Danann Realty Corp. v. Harris*, 157 N.E.2d 597, 608 (N.Y. 1959); *Frizzell Constr. Co., Inc. v. Gatlinburg, L.L.C.*, No. 03A01-9805-CH-00161, 1998 WL 761840, at \*3 (Tenn. Ct. App. 1998), *aff'd*, 9 S.W.3d 79 (Tenn. 1989), *cert. denied*, 530 U.S. 1238 (2000); *Wintz v. Morrison*, 17 Tex. 372, 383 (1856); *S. Pearson & Son Ltd. v. Dublin Corp.*, [1907] A.C. 351, 362 (H.L.) (U.K.); *Dhillon v. Houston*, 1993 Carswell BC 2215, ¶ 13 (B.C.S. Ct.) (Can.), available at 1993 WL 1450828; *Opron Constr. Co. Ltd. v. Alberta*, [1994] 151 A.R. 241, ¶¶ 718-22 (Can.).

unlike tort-based liability for negligent or innocent representations, could not be contractually disclaimed.<sup>148</sup>

Interestingly, however, one influential English decision from the early twentieth century contemplated a distinction between the enforceability of contract clauses purporting to disclaim liability for one's own fraud, on the one hand, and the enforceability of contract clauses purporting to disclaim liability for the fraud of one's representatives or agents, on the other hand.<sup>149</sup> And there is also precedent that distinguishes standard disclaimer-of-reliance clauses from provisions that specifically inform one party to a contract that the agents of its counterparty have no authority to make any representations or warranties, suggesting that a seller could mitigate its exposure to extra-contractual fraud liability by obtaining an express acknowledgment from the buyer that the seller's agents do not have the authority to make representations on the seller's behalf.<sup>150</sup>

Over the last half of the twentieth century, courts began to recognize more broadly the freedom and sanctity of contract as considerations to be weighed against society's distaste for fraud.<sup>151</sup> Indeed, courts began to appreciate that the intrusion of tort-based principles into bargained-for contractual relationships may be "unwarranted."<sup>152</sup> After all, what policy justifies "such a radical shift from bargained-for duties and liabilities to the imposition of duties and liabilities that were expressly negated by the parties themselves when they decided to abandon their status as legal strangers and define their relationship by contract[?]"<sup>153</sup>

And in *ABRY*, Vice Chancellor Strine highlighted a series of additional arguments supporting the enforcement of liability limitations in transactions between

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148. See, e.g., *S. Pearson & Sons*, [1907] A.C. at 356 ("[N]o subtlety of language, no craft or machinery in the form of contract, can estop a person who complains that he has been defrauded from having that question of fact submitted to a jury."); see also *Isler v. Tex. Oil & Gas Corp.*, 749 F.2d 22, 23–24 (10th Cir. 1984) (applying New Mexico law); *Rio Grande Jewelers Supply, Inc. v. Data Gen. Corp.*, 689 P.2d 1269, 1271 (N.M. 1984); *Snyder v. Lovercheck*, 992 P.2d 1079, 1087–88 (Wyo. 1999).

149. See *S. Pearson & Sons*, [1907] A.C. at 353–54 ("Now it seems clear that no one can escape liability for his own fraudulent statements by inserting in a contract a clause that the other party shall not rely upon them. I will not say that a man himself innocent may not under any circumstances, however peculiar, guard himself by apt and express clauses from liability for the fraud of his own agents."); see also *Davis*, *supra* note 12, at 508 ("[I]t is critical to distinguish the primary responsibility of an agent who has made a false or negligent misrepresentation and the vicarious responsibility of the enterprise on whose behalf he acted."); *Masson*, *supra* note 12, at 514; RESTATEMENT (THIRD) OF AGENCY § 260 (2006); *HIH Cas. & Gen. Ins. Ltd. v. Chase Manhattan Bank*, [2003] 2 Lloyd's Rep. 61, 68 (H.L.) (U.K.). *But see Super-Cold Sw. Co. v. Willis*, 219 S.W.2d 144, 147 (Tex. Civ. App. 1949) (citing *James L. Hartsfield, Jr.*, Comment, *The "Merger Clause" and the Parol Evidence Rule*, 27 TEX. L. REV. 361, 369 (1949) and describing a "compromise rule" that will relieve the innocent seller from liability for damages based on its agent's misrepresentations, but allows the innocent buyer to rescind the contract); *Davis*, *supra* note 12, at 491 (citing *Super-Cold Sw. Co.*, 219 S.W.2d 144).

150. See *Goodyear Tire & Rubber Co. v. Chiles Power Supply, Inc.*, 7 F. Supp. 2d 954, 962 (N.D. Ohio 1998); *Overbrooke Estates Ltd. v. Glencombe Props. Ltd.*, [1974] 3 All E.R. 511, ¶ 1335 (U.K.).

151. See, e.g., *EA Grimstead & Son Ltd. v. McGarrigan*, No. QBENF 97/1641/C, 1999 WL 852482 (CA (Civ.) Oct. 27, 1999) (U.K.); *Vermont Teddy Bear Co., Inc. v. 538 Madison Realty Co.*, 807 N.E.2d 876, 879 (N.Y. 2004); *Wallace v. 600 Partners Co.*, 658 N.E.2d 715, 717 (N.Y. 1995); *W.W.W. Assocs. v. Giancontieri*, 566 N.E.2d 639, 642 (N.Y. 1990).

152. *Isler*, 749 F.2d at 23–24.

153. *Id.* at 23.



sophisticated business parties.<sup>154</sup> First, he noted, courts should permit businesses to “make their own judgments about the risk[s] they should bear and the due diligence they undertake, recognizing that such parties are able to price factors such as limits on liability.”<sup>155</sup> Second, he continued, “judicial decisions are not the only way that commercial norms of fair play are instilled,” for a party who “gets a rap as a fraudster” will pay a price in the marketplace.<sup>156</sup> Third, he observed, “there remains much harshness in the world,” and sophisticated private equity firms “are unlikely candidates to place at the head of the line for judicial protection.”<sup>157</sup> And fourth, “[p]ermitting a party to sue for relief that it has contractually promised not to pursue creates the possibility that buyers will face erroneous liability (when judges or juries make mistakes) and uncompensated costs (when they incur . . . costs . . . defending successfully against a contractually-barred claim . . .).”<sup>158</sup>

Even after acknowledging that “[Delaware] courts have said that . . . ‘fraud vitiates every contract,’” and that “‘no man may invoke the law to enforce his fraudulent acts,’”<sup>159</sup> Vice Chancellor Strine recognized that “[t]o fail to enforce non-reliance clauses is not to promote a public policy against lying.”<sup>160</sup> Instead, he recognized, “it is to 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 of the contract.<sup>161</sup> In such a “double liar scenario,” he conceded, “[t]o allow the buyer to prevail . . . is to sanction its own fraudulent conduct.”<sup>162</sup>

### C. SURVEY OF STATE APPROACHES TO THE ENFORCEABILITY OF LIABILITY DISCLAIMERS IN COMMON LAW TORT ACTIONS

In recognition of the foregoing, the *ABRY* court ultimately held that Delaware law only categorically forbids courts from enforcing an exclusive remedy provision to the extent that it purports to insulate a party from *its own deliberate* lies regarding representations and warranties actually set forth in the written agreement.<sup>163</sup> And, as we noted above, the Court of Chancery’s narrow opinion did not foreclose enforcement of contractual disclaimers of reliance to preclude fraud or

154. See *ABRY Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1061 (Del. Ch. 2006).

155. *Id.*

156. *Id.*; see also Blair, *supra* note 12, at 477–78.

157. *ABRY*, 891 A.2d at 1062.

158. *Id.*

159. *Id.* at 1061 (citing *Norton v. Poplos*, 443 A.2d 1 (Del. 1982); *Slessinger v. Topkins*, 40 A. 717 (Del. Super. Ct. 1893)).

160. *Id.* at 1058.

161. *Id.*

162. *Id.* (citing *MBIA Ins. Corp. v. Royal Indem. Co.*, 426 F.3d 204, 218 (3d Cir. 2006) (“The danger is that a contracting party may accept additional compensation for a risk that it has no intention of actually bearing. This prevarication may amount to a fraud all its own. . . . [T]he safer route is to leave parties that can protect themselves to their own devices, enforcing the agreement they actually fashion.”)).

163. *Id.* at 1063.

negligent misrepresentation claims premised upon purported lies told outside the four corners of a written agreement.<sup>164</sup>

Other states, by contrast, maintain an unwavering prohibition on the enforceability of disclaimer-of-reliance clauses, no matter the nature of the purported misrepresentation or the content of the defensive provision. Massachusetts courts, for example, following the Supreme Judicial Court's influential 1941 decision in *Bates v. Southgate*,<sup>165</sup> decline to give effect to contractual limitations on liability for fraudulent pre-contractual representations.<sup>166</sup> According to the *Bates* court, "the same public policy that in general sanctions the avoidance of a promise obtained by deceit strikes down all attempts to circumvent that policy by means of contractual devices."<sup>167</sup> Recognizing the "principle of the common law . . . that positive fraud vitiates every thing . . . incontrovertible as [such things] are on every other ground," the New Hampshire Supreme Court recently held that a specific contractual disclaimer did not preclude a party to the contract from establishing a fraudulent inducement defense.<sup>168</sup> And courts in Nevada,<sup>169</sup> Wisconsin,<sup>170</sup> Wyoming,<sup>171</sup> California,<sup>172</sup>

164. See *id.* For an alternative view, see generally Jeffrey M. Lipschaw, *Of Fine Lines, Blunt Instruments, and Half-Truths: Business Acquisition Agreements and the Right to Lie*, 32 DEL. J. CORP. L. 431 (2007) (proposing a default rule whereby a purported disclaimer-of-reliance provision would only be effective where (A) (i) the disputed extra-contractual representation conflicts with a contractual representation covering the same subject matter or (ii) the applicable contract is "wholly silent" on the subject matter of the extra-contractual representation and (B) the disclaimer provision is absolutely clear in disclaiming truthfulness in the contract-making process).

165. 31 N.E.2d 551, 558 (Mass. 1941).

166. Sweeney v. DeLuca, No. 042338, 2006 WL 936688, at \*5-6 (Mass. Super. Ct. Mar. 16, 2006). *But see* Sound Techniques, Inc. v. Hoffman, 737 N.E.2d 920, 924-25 (Mass. App. Ct. 2000) (holding that while a standard integration clause cannot bar a fraud claim based upon an excluded representation, such a provision may preclude a negligent misrepresentation action brought on the same basis), *review denied*, 742 N.E.2d 82 (Mass. 2001) (unpublished table decision).

167. *Bates*, 31 N.E.2d at 558.

168. Van Der Stok v. Van Voorhees, 866 A.2d 972, 976 (N.H. 2005).

169. See *Blanchard v. Blanchard*, 839 P.2d 1320, 1322-23 (Nev. 1992) ("waiver clauses cannot bar a misrepresentation claim").

170. See *RepublicBank Dallas, N.A. v. First Wis. Nat'l Bank of Milwaukee*, 636 F. Supp. 1470, 1473 (E.D. Wis. 1986) ("The Wisconsin Supreme Court has endorsed the position of the Restatement (Second) of Contracts that exculpatory clauses are unenforceable on public policy grounds where the alleged harm is caused intentionally or recklessly. There is ample Wisconsin case law in which this general principle has been applied to hold disclaimers of liability ineffective against claims of fraudulent misrepresentation. . . . [And] there is no Wisconsin authority which has limited the rule to cases involving consumers or parties of unequal bargaining power . . . nor is there any Wisconsin authority which suggests a different result depending upon the type or specificity of the disclaimer provision involved." (citations omitted)).

171. See *Snyder v. Lovercheck*, 992 P.2d 1079, 1086 (Wyo. 1999) ("[W]e decline to adopt the reasoning of [the New York Court of Appeals] in *Danann Realty Corp. [v. Harris]* (enforcing a specific disclaimer of reliance), and hold that [the plaintiff] is not precluded from asserting a claim for fraudulent misrepresentation by . . . the disclaimer clause.").

172. See, e.g., *Danzig v. Jack Grynberg & Assocs.*, 208 Cal. Rptr. 336, 342 (Ct. App. 1984) ("A party to a contract who has been guilty of fraud in its inducement cannot absolve himself from the effects of his fraud by any stipulation in the contract, either that no representations have been made, or that any right which might be grounded upon them is waived." (internal quotation marks omitted)), *cert. denied*, 474 U.S. 819 (1985); see also *Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Dev. Corp.*, 38 Cal. Rptr. 2d 783, 790 (Ct. App. 1995) ("The provision in [the relevant agreement] stating that no representations were made by the parties except as set forth in the agreement does not preclude appellants from proving fraud. Thus, the provision does not establish as a matter of law that

Missouri,<sup>173</sup> and Oregon<sup>174</sup> also appear unwilling to enforce even specifically crafted contractual limitations on liability for pre-contractual fraud.

But many states employ a less rigid approach, premising the enforceability of purported disclaimer provisions on the extent to which they supply evidence sufficient to negate the “reliance” element of fraud and negligent misrepresentation claims as a matter of law.<sup>175</sup> And in these states, the dispositive question is whether the language of the contract clearly evinces the signatories’ intent to disregard the representations upon which the complaining party grounded its claim.<sup>176</sup>

Accordingly, courts in these jurisdictions are generally reluctant to conclude that a general merger or integration clause, standing alone, is sufficient to preclude one contracting party from asserting a tort claim based upon the pre-contractual representations of its counterparty.<sup>177</sup> Rather, a merger or integration clause sim-

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any reliance by appellants on misrepresentations not contained in the contract was unreasonable.” (citations omitted)). *But see* *Applied Elastomerics, Inc. v. Z-Man Fishing Prods., Inc.*, No. C 06-2469 CW, 2006 WL 3251732, at \*6 (N.D. Cal. Nov. 8, 2006) (“Reliance on representations that contradict clear and unambiguous terms of an agreement is unjustified as a matter of law.”).

173. *See* *Hess v. Chase Manhattan Bank, USA, N.A.*, 220 S.W.3d 758, 767 (Mo. 2007) (“Missouri law holds that a party may not, by disclaimer or otherwise, contractually exclude liability for fraud in inducing that contract.”). *But see* *Luli Corp. v. El Chico Ranch, Inc.*, 481 S.W.2d 246, 256 (Mo. 1972) (holding disclaimer that was “positive, direct, and to the point, even of disclosing the source of the questioned representation,” was sufficient to preclude a rescission claim of purchaser).

174. *See* *Wilkinson v. Carpenter*, 554 P.2d 512, 514–17 (Or. 1976) (“[I]n this case the contract contained a clause specifically excluding any prior warranties and declaring that there had not been any representations made which induced defendants to purchase the property. Although such a clause will not preclude relief upon a showing of [a]ctual fraud, it does prevent defendants from relying upon any innocent misrepresentations as the basis for a suit for rescission [or damages].” (citation omitted)).

175. *See, e.g.*, *Student Mktg. Group, Inc. v. Coll. P’ship, Inc.*, 247 F App’x 90, 99 (10th Cir. 2007) (“We conclude that [the relevant agreement]’s waiver and integration clauses contain the kind of ‘specific language’ necessary to preempt [claimant’s] negligent misrepresentation claim as a matter of law.”); *Vigortone AG Prods., Inc. v. PM AG Prods., Inc.*, 316 F.3d 641, 644–45 (7th Cir. 2002); *Kronenberg v. Katz*, 872 A.2d 568, 590 (Del. Ch. 2004); *Head v. Head*, 477 A.2d 282, 288 (Md. Ct. Spec. App.), *cert. denied*, 483 A.2d 754 (Md. 1984) (unpublished table decision); *UAW-GM Human Res. Ctr. v. KSL Recreation Corp.*, 579 N.W.2d 411, 418–20 (Mich. Ct. App. 1998) (“[W]hen a contract contains a valid merger clause, the only fraud that could vitiate the contract is fraud that would invalidate the merger clause itself; i.e., fraud relating to the merger clause or fraud that invalidates the entire contract . . . . The various species of fraud alleged here all require reliance on a misrepresentation. Here, the merger clause made it unreasonable for plaintiff’s agent to rely on any representations not included in the letter of agreement.” (citations omitted)), *appeal denied*, 590 N.W.2d 66 (Mich. 1999) (unpublished table decision); *Danann Realty Corp. v. Harris*, 157 N.E.2d 597, 604 (N.Y. 1959); *LaFazia v. Howe*, 575 A.2d 182, 185–86 (R.I. 1990) (holding that specific merger and disclaimer clauses “regarding the very matter concerning which defendants now claim they were defrauded” prevent defendants from “successfully claiming reliance on prior representations”); *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51, 56–58 (Tex. 2008).

176. *See supra* note 175.

177. *See, e.g.*, *Vigortone AG Prods.*, 316 F.3d at 645; *Envtl. Sys., Inc. v. Rexham Corp.*, 624 So. 2d 1379, 1383 (Ala. 1993) (“[T]he law in this state renders an integration, or merger, clause ineffective to bar parol evidence of fraud in the inducement or procurement of a contract.”); *Formento v. Encanto Bus. Park*, 744 P.2d 22, 26–28 (Ariz. Ct. App. 1987); *Martinez v. Zovich*, 867 A.2d 149, 156 (Conn. App. Ct.) (“A claim that a seller’s intentional, reckless or negligent misrepresentations caused a buyer to enter into a contract for the sale of property is a valid cause of action, even if [the relevant contract] constituted the entire agreement between the parties.”), *cert. denied*, 876 A.2d 1202 (Conn. 2005); *R.D. Greenfield v. Heckenbach*, 797 A.2d 63, 76 (Md. Ct. Spec. App. 2002) (“[W]e hold that in a suit for negligent misrepresentation, where equitable relief is prayed, the existence of a general merger clause, standing alone, will not prevent the plaintiff from introducing evidence concerning pre-contractual

ply precludes a court from “threshing through the undergrowth” in search of oral terms of a contractual arrangement beyond those expressed in the four corners of the written agreement.<sup>178</sup> As a threshold matter, then, most courts hold that the parol evidence rule only bars a complaining party from introducing evidence of pre-contractual representations in contract actions, not tort actions.<sup>179</sup> Indeed, according to Judge Richard Posner of the U.S. Court of Appeals for the Seventh Circuit, “fraud is a tort, and the parol evidence rule is not a doctrine of tort law and so an integration clause does not bar a claim of fraud based on statements not contained in the contract.”<sup>180</sup> And few courts have held that the mere existence of a merger clause renders it unreasonable as a matter of law for a contracting party to rely on any representation not set forth in its written agreement.<sup>181</sup>

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problems, which are not mentioned in the written contract.”); *Van Der Stok v. Van Voorhees*, 866 A.2d 972, 976 (N.H. 2005) (“We have held that neither a standard merger clause, nor the parol evidence rule, bars an action for fraud.” (citations omitted)); *Blanchard v. Blanchard*, 839 P.2d 1320, 1322–23 (Nev. 1992) (“[I]ntegration clauses do not bar claims for misrepresentation.”); *Travers v. Spidell*, 682 A.2d 471, 472–74 (R.I. 1996) (holding that general merger clause does not shield defendant from liability for fraud); *Slack v. James*, 614 S.E.2d 636, 640 (S.C. 2005) (“Neither the parol evidence rule nor a merger clause in a contract prevents one from proceeding on tort theories of negligent misrepresentation and fraud.”).

178. *Intntrepreneur Pub Co. (GL) v East Crown Ltd.*, [2000] 2 Lloyd’s Rep. 611, 611 (Ch. D.) (U.K.) (“[T]he purpose of an entire agreement clause was to preclude a party to a written agreement from threshing through the undergrowth and finding in the course of negotiations some chance remark or statement on which to found a claim as to the existence of a collateral warranty . . . .”); Andrew J. Bowen, *Threshing Through the Undergrowth: Entire Agreement Clauses and Unfair Contract Terms Act 1977*, S.L.T. 2004, 7, at 37, 37–38; Simon Mills & Lawrence Jacobson, *Entire Agreement and Non-Reliance Clauses*, 22 *COMPANY LAW*, 189, 189–91 (2001).

179. See, e.g., *Vigortone AG Prods.*, 316 F.3d at 644; *Downs v. Wallace*, 622 So. 2d 337, 340 (Ala. 1993) (“the parol evidence rule applies to contract actions, not actions in tort”); *Formento*, 744 P.2d at 26 (“The parol evidence rule is a rule of substantive contract law, and a claim of negligent misrepresentation sounds in tort. Therefore . . . a claim for negligent misrepresentation is governed by the law of negligence, and the parol evidence rule is inapplicable.” (citations omitted)). *But see* *Harrison v. Happy Day Ford*, No. 87-3911, 1988 WL 57688, at \*4 (9th Cir. Sept. 30, 1988) (“We find most persuasive the view that the parol evidence rule precludes consideration of any evidence of an oral promise inconsistent with the express terms of an integration, regardless of whether the claim is styled one of tort or contract.”).

180. *Vigortone AG Prods.*, 316 F.3d at 644.

181. See, e.g., *Wylie*, *supra* note 127, at 4 (citing *Harrison*, 1988 WL 57688, at \*4 (“the presence of an integrated agreement precludes any right to rely on an inconsistent promise”); *Props. Unlimited, Inc. v. Cendant Mobility Servs.*, No. 01 C 8375, 2002 WL 31155107 (N.D. Ill. Sept. 26, 2002), *appeal dismissed*, 384 F.3d 917 (7th Cir. 2004); *UAW-GM Human Res. Ctr. v. KLS Recreation Corp.*, 579 N.W.2d 411, 418–20 (Mich. Ct. App. 1998), *appeal denied*, 590 N.W.2d 66 (Mich. 1999) (unpublished table decision)). *But see* *Star Ins. Co. v. United Commercial Ins. Agency, Inc.*, 392 F. Supp. 2d 927, 929–30 (E.D. Mich. 2005) (“The Michigan courts have said that, as it pertains to representations regarding additional agreements or contractual terms, a party would not be justified in relying on them where there is a merger clause. . . . Yet, a party could still justifiably rely on representations made by another party regarding things outside the scope of the contractual terms. . . .”); *Downs*, 622 So. 2d at 340 (“[T]his Court has never held that a [general] integration clause renders a party’s reliance on oral representations unjustifiable, or unreasonable, as a matter of law.” (footnote omitted)); *Keller v. A.O. Smith Harvestore Prods., Inc.*, 819 P.2d 69, 74 (Colo. 1991) (“[Defendant] contends that these provisions constitute a waiver by the [plaintiffs] of any claim that requires proof of reliance on statements made . . . prior to the formation of the purchase agreements. . . . We disagree. . . . A contract provision purporting to prohibit a party to the contract from asserting a claim of negligent misrepresentation must be couched in clear and specific language.” (citations omitted)); *Norton v. Poplos*, 443 A.2d 1, 6–7 (Del. 1982).

But in contrast to a general merger or integration clause, courts in many jurisdictions are willing to enforce provisions that clearly demonstrate that the complaining party intentionally and unequivocally waived its right to rely on the extra-contractual representation upon which it based its claim.<sup>182</sup> In New York, for example, it is well-settled that a specific disclaimer clause stipulating that a plaintiff did not rely on the very representations that formed the basis for its fraud claim can “[destroy] the allegations in [the] plaintiff’s complaint that the agreement was executed in reliance upon [the] contrary oral representations,” and justify dismissal of the tort action as a matter of law.<sup>183</sup> Indeed, the New York State Court of Appeals has stated, “to hold otherwise would be to say that it is impossible for two businessmen dealing at arm’s length to agree that the buyer is not buying in reliance on any representations of the seller as to a particular fact.”<sup>184</sup> Importantly, although there is some conflicting authority,<sup>185</sup> the New York rule most reliably “operates where the substance of the disclaimer [provision] tracks [i.e., identifies] the substance of the alleged misrepresentations.”<sup>186</sup> So a general clause that merely requires each party to agree that it is not relying on any extra-contractual representation may not suffice.<sup>187</sup> The law in Alabama,<sup>188</sup> Kansas,<sup>189</sup> and Rhode Island<sup>190</sup> appears to be similar.

Delaware courts appear to effectuate anti-reliance clauses more broadly.<sup>191</sup> Under the Delaware Supreme Court’s holding in *Kronenberg v. Katz*, for a contract

182. See, e.g., *Tranched Sys. Ltd. v. Versyss Transit Solutions, LLC*, No. 07C-08-286 WCC, 2008 WL 948307, at \*3 n.14 (Del. Super. Ct. Apr. 2, 2008); *Miles Excavating, Inc. v. Rutledge Backhoe & Septic Tank Servs., Inc.*, 927 P.2d 517, 517–18 (Kan. Ct. App. 1997); *Head v. Head*, 477 A.2d 282, 288 (Md. Ct. Spec. App.), cert. denied, 483 A.2d 754 (Md. 1984) (unpublished table decision); *Dannann Realty Corp. v. Harris*, 157 N.E.2d 597, 601–03 (N.Y. 1959); *LaFazia v. Howe*, 575 A.2d 182, 185–86 (R.I. 1990); *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51, 60–61 (Tex. 2008) (interpreting *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171 (Tex. 1997)).

183. *Dannann*, 157 N.E.2d at 599.

184. *Id.* at 600.

185. See, e.g., *Citibank, N.A. v. Plapinger*, 485 N.E.2d 974, 977 (N.Y. 1985).

186. *Mfrs. Hanover Trust Co. v. Yanakas*, 7 F.3d 310, 316 (2d Cir. 1993) (quoting *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 735 (2d Cir. 1984)).

187. See, e.g., *Yanakas*, 7 F.3d at 316 (holding that contract provision did not bar fraudulent inducement claim where clause “di[d] not specifically disclaim reliance on any oral representation concerning the matter as to which plaintiff now claims he was defrauded” (internal quotation marks omitted)).

188. See, e.g., *Envlt. Sys., Inc. v. Rexham Corp.*, 624 So. 2d 1379, 1384 & n.7 (Ala. 1993) (holding that “the existence of a general disclaimer clause in [the relevant agreement] does not, as a matter of law, preclude [the plaintiff] from justifiably relying on alleged [pre-contractual oral representations],” but noting that “the [relevant disclaimer] does not specifically disclaim the very representation [the plaintiff] alleges to be the foundation for fraud”).

189. See, e.g., *Miles Excavating, Inc. v. Rutledge Backhoe & Septic Tank Servs., Inc.*, 927 P.2d 517, 517–18 (Kan. Ct. App. 1997) (distinguishing *Edwards v. Phillips Petroleum Co.*, 360 P.2d 23, 28 (Kan. 1961), in which the court held that disclaimer precluded the plaintiff’s action for fraud) (“[*Phillips* is] distinguishable, since both cases involved disclaimers specific to the matter about which the plaintiff claimed to have been defrauded.”). But see *Mid Continent Cabinetry, Inc. v. George Koch Sons, Inc.*, No. 87-1248-C, 1991 WL 177961, at \*4–5 (D. Kan. Aug. 9, 1991) (“Plaintiff may bring a claim of fraud based on the same representations that were otherwise disclaimed as express warranties.”).

190. See, e.g., *LaFazia v. Howe*, 575 A.2d 182, 185–86 (R.I. 1990) (holding that specific merger and disclaimer clauses “regarding the very matter concerning which defendants now claim they were defrauded” “prevent defendants from successfully claiming reliance on prior representations”).

191. See, e.g., *MBIA Ins. Corp. v. Royal Indem. Co.*, 426 F.3d 204, 218 (3d Cir. 2006); *Tranched Sys. Ltd. v. Versyss Transit Solutions, LLC*, No. 07C-08-286 WCC, 2008 WL 948307, at \*3 n.14 (Del. Super. Ct. Apr. 2, 2008).

to bar a fraud in the inducement claim, “the contract must contain language that, when read together, can be said to add up to a clear anti-reliance clause by which the plaintiff . . . contractually promised that it did not rely upon statements outside the contract’s four corners in deciding to sign the contract.”<sup>192</sup> In contrast to New York law, then, Delaware courts may be more willing to enforce general disclaimers of reliance that do not specifically reference the extra-contractual representation upon which the tort plaintiff premised its claim.<sup>193</sup> Indeed, in its *MBIA Insurance Corp. v. Royal Indemnity Co.* decision, authored by then-judge, now-Justice, Samuel Alito, the U.S. Court of Appeals for the Third Circuit predicted that “when sophisticated parties [insert] clear anti-reliance language in their negotiated agreement[s], and when that language, *though broad*, unambiguously covers the fraud that actually occurs, Delaware’s highest court will enforce it to bar a subsequent fraud claim.”<sup>194</sup>

Texas courts have generally employed a more formulaic approach to the enforceability of reliance disclaimers.<sup>195</sup> In *Schlumberger Technology Corp. v. Swanson*, the Texas Supreme Court held that the language of a contract “and the circumstances surrounding its formation determine whether [a purported] disclaimer of reliance is binding.”<sup>196</sup> Under this “language and circumstances” inquiry, the Texas Supreme Court has recently emphasized the following factors as most significant in a court’s decision to enforce or decline to enforce a contentious disclaimer: (i) whether terms of the contract “were negotiated, rather than boilerplate,” and whether, “during negotiations, the parties specifically discussed the issue which has become the topic of the subsequent dispute”; (ii) whether the “complaining party was represented by counsel”; (iii) whether the parties “dealt with each other in an arm’s length transaction”; (iv) whether the parties were “knowledgeable in business matters”; and (v) whether the language of the purported disclaimer was “clear.”<sup>197</sup> So while New York and Delaware courts focus primarily (but not exclusively)<sup>198</sup> on the language of a non-reliance provision, Texas courts tend to accord more weight to exogenous considerations, including the sophistication of the contracting parties and even the visual prominence of the contentious clause.<sup>199</sup>

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192. 872 A.2d 568, 593 (Del. Ch. 2004).

193. See, e.g., *id.*; *MBIA*, 416 F.3d at 218; *Transched Sys.*, 2008 WL 948307, at \*3; *Progressive Int’l Corp. v. E.I. Dupont de Nemours & Co.*, No. 19209, 2002 WL 1558382, at \*5 (Del. Ch. July 9, 2002).

194. 416 F.3d at 218 (emphasis added).

195. See *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51, 60–61 (Tex. 2008).

196. 959 S.W.2d 171, 179 (Tex. 1997).

197. *Forest Oil*, 268 S.W.3d at 60–61 (interpreting *Schlumberger*, 959 S.W.2d at 181). The *Forest Oil* court highlighted the fact-specific approach articulated in *Schlumberger* by noting that the holding “should not be construed to mean that a mere disclaimer standing alone will forgive intentional lies regardless of context. We decline to adopt a *per se* rule that a disclaimer automatically precludes a fraudulent-inducement claim, but we hold today, as in *Schlumberger*, that ‘on this record,’ the disclaimer of reliance refutes the required element of reliance.” *Id.* at 61.

198. See, e.g., *Citibank, N.A. v. Plapinger*, 485 N.E.2d 974, 977 (N.Y. 1985).

199. See, e.g., *id.*; *Netknowledge Techs., L.L.C. v. Rapid Transmit Techs.*, No. 3:02-CV-2406-M, 2007 WL 518548, at \*4 (N.D. Tex. Feb. 20, 2007), *aff’d*, 269 F. App’x 443 (5th Cir. 2008).

## V. DRAFTING AGREEMENTS TO MAXIMIZE THE LIKELIHOOD THAT THE CONTRACT ALONE WILL GOVERN YOUR CLIENT'S RIGHTS, OBLIGATIONS, AND LIABILITIES

It follows from the foregoing discussion that a contracting party's susceptibility to extra-contractual liability depends upon three primary factors: (i) the breadth of the tort remedy afforded contract signatories under the governing state law; (ii) whether, and to what extent, the law of the jurisdiction chosen to govern the applicable written agreement permits transacting parties to disclaim tort liability by contract (both for extra-contractual representations and for representations and warranties set forth in the written agreement); and (iii) if the law of the jurisdiction chosen to govern the written agreement permits contracting parties to disclaim tort liability by contract, the stringency of the standards that courts of the relevant jurisdiction apply to examine the enforceability of purported disclaimer provisions.

### A. CHOICE OF LAW

Because subtle jurisprudential differences among states can dispositively determine whether a contracting party is ultimately exposed to contract-related tort liability,<sup>200</sup> the boilerplate "choice-of-law" provision buried in the "miscellaneous" section of most stock and asset purchase agreements may ultimately dictate the effectiveness of the highly negotiated indemnification mechanics and damage caps, as well as the prudence of any related purchase price adjustments.

#### 1. The Lessons of *Benchmark Electronics, Inc. v. J.M. Huber Corp.*

A 2003 decision from the U.S. Court of Appeals for the Fifth Circuit illustrates the importance of the contractual choice-of-law provision in this context.<sup>201</sup> In *Benchmark Electronics, Inc. v. J.M. Huber Corp.*, Benchmark Electronics, Inc. ("Benchmark"), a Texas corporation with its principal operations in Texas, brought suit against J.M. Huber Corporation ("Huber") for breach of contract, fraud, and negligent misrepresentation on the basis of (i) statements that Huber made before Benchmark agreed to purchase one of Huber's subsidiaries and (ii) express contractual warranties set forth within the applicable stock purchase agreement itself.<sup>202</sup> Importantly, the choice-of-law provision in the stock purchase agreement stipulated that the "[a]greement [would] be governed by, and construed in accordance with, the internal laws of the State of New York."<sup>203</sup> The Fifth Circuit

200. See *Berry v. Indianapolis Life Ins. Co.*, No. 3:08-CV-0248-B, 2009 WL 804163, at \*14–18 (N.D. Tex. Mar. 26, 2009) (discussing differences between Wisconsin, Texas, and California law regarding the effectiveness of disclaimer-of-reliance clauses).

201. *Benchmark Elecs., Inc. v. J.M. Huber Corp.*, 343 F.3d 719 (5th Cir.), modified by 355 F.3d 356 (5th Cir. 2003).

202. *Id.* at 722–24.

203. *Id.* at 727 (emphasis added) (internal quotation marks omitted).

interpreted the foregoing clause narrowly and held that it only encompassed claims arising from “the construction and interpretation of the contract” and not from Benchmark’s claims of fraud and misrepresentation, which were, by definition, tort claims outside of the contract.<sup>204</sup>

Because the stock purchase agreement included a provision pursuant to which Benchmark specifically disclaimed reliance on statements not expressly warranted in the parties’ contract, the Fifth Circuit concluded that the fraud and negligent misrepresentation claims that Benchmark based upon Huber’s pre-contractual representations were not actionable as a matter of New York contract law.<sup>205</sup> Indeed, applying New York law to determine the validity of the disclaimer provision, the court held that the “specificity” of what Huber warranted in the agreement “preclude[d] Benchmark, a sophisticated business entity, from claiming reliance upon other *pre-contractual* representations covering the same subjects.”<sup>206</sup>

But since the choice-of-law provision did not also encompass *tort* claims arising out of or related to the agreement, the Fifth Circuit determined that Texas law, and not New York law, would dictate whether the fraud claim that Benchmark based on Huber’s express contractual warranties was actionable.<sup>207</sup> And because Texas law (like Delaware law) permits fraud and negligent misrepresentation claims “even if the representations on which those claims are [premised] are otherwise set forth in a contract,”<sup>208</sup> the court vacated the district court’s grant of summary judgment in favor of Huber with respect to the warranty-based tort actions, permitting Benchmark to pursue tort damages, including exemplary damages, for the inaccuracy of Huber’s *contractual* warranties.<sup>209</sup>

*Benchmark*, then, teaches us that the breadth of the choice-of-law provision may drastically impact our clients’ exposure to extra-contractual liability.<sup>210</sup> Indeed, had the choice-of-law provision in that case been drafted with sufficient breadth to cover contract-related *tort* actions, the Fifth Circuit likely would have dismissed all of Benchmark’s claims, since New York law, unlike Texas and Delaware law, does not generally permit contracting parties to ground fraud or misrepresentation claims on *contractual* misrepresentations.<sup>211</sup>

204. *Id.*

205. *See id.*; *see also* West & Nelson, *supra* note 88, at 816–18.

206. West & Nelson, *supra* note 88, at 817 (quoting *Benchmark*, 343 F.3d at 729) (emphasis added).

207. *See Benchmark*, 343 F.3d at 728.

208. West & Nelson, *supra* note 88, at 817.

209. *Benchmark*, 343 F.3d at 728. Under Texas law, this is possible under the theory that such contractual warranties were simply restatements of the pre-contractual representations or “factual predicates” that induced the formation of the contract.

210. *See Benchmark*, 343 F.3d at 726 (interpreting narrowly a choice-of-law clause as applying only to the construction of the agreement and not to any potential tort claims between the parties); *see also* Kuehn v. Childrens Hosp., 119 F.3d 1296, 1302 (7th Cir. 1997) (noting that a specific choice-of-law provision expressing the parties’ intent to apply a particular state law to torts, as well as to contractual claims, would prevent the uncertainty of the application of another state’s laws in a dispute); *Karnes v. Fleming*, No. 4528223, 2008 WL 4528223, at \*4 (S.D. Tex. July 31, 2008) (holding that a narrow contractual choice-of-law provision in only some of the contracts giving rise to a class action was not broad enough to prevent the court from engaging in a thorough common-law choice-of-law analysis).

211. *See* West & Nelson, *supra* note 88, at 817.



## 2. Drafting Effective Choice-of-Law Provisions

Accordingly, consider the following suggestions when negotiating and drafting choice-of-law provisions<sup>212</sup>:

- Recognizing that some states afford broader tort remedies to contract signatories, and that a choice-of-law provision that names the state law to be used in the interpretation of an agreement may not also determine the state law that governs tort claims that arise in connection with that agreement, carefully review, and, if necessary, expand the scope of, the choice-of-law provision to maximize the likelihood that a court will apply the chosen state's law to both contractual and extra-contractual claims; and
- To the extent that you can, under applicable conflict of laws principles, choose among several states' laws to govern your contractual relationship, ensure that the chosen state permits sophisticated transacting parties the maximum flexibility in contractually limiting prospective tort liability since some jurisdictions, like Massachusetts, New Hampshire, Nevada, Wisconsin, Wyoming, California, Missouri, and Oregon, may unequivocally decline to enforce disclaimer-of-reliance provisions to preclude fraud claims, no matter the nature of the purported misrepresentation or the content of the defensive clause.

We have set forth in the Appendix a model "Governing Law" provision, which incorporates the foregoing recommendations.

### B. DRAFTING EFFECTIVE "ENTIRE AGREEMENT," DISCLAIMER-OF-RELIANCE, AND RELATED PROVISIONS

Once you have selected the law of the best available state, ensure that the language of your agreement clearly and unequivocally demonstrates that your counterparty has knowingly waived its right to rely on, or bring suit on account of, the specific representations that could form the basis of a tort claim, whether or not such representations are set forth in the written agreement.<sup>213</sup> And though some jurisdictions, like Delaware, may generally enforce disclaimer provisions without extensive indicia of specificity, it is important to remember that even in

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212. For earlier versions of these suggestions authored or co-authored by Mr. West, see West, *supra* note 12 at 4; West & Bodamer, *supra* note 19, at 13; and West & Obi, *supra* note 19, at 19. In stock deals and to the extent permissible under applicable choice-of-venue principles, it may also be prudent to include a "choice-of-venue" provision to ensure that any resulting securities fraud claims would be litigated in a federal circuit, like the Second or Seventh Circuit, that is amenable to enforcing disclaimer-of-reliance clauses to preclude actions brought under section 10(b) of the Exchange Act at the motion to dismiss stage. See *supra* notes 21–22 and accompanying text.

213. Clarity in drafting is critical so that a court is truly required to ignore the parties' express agreement in order to allow a tort-based claim to proceed. In deciding that a general disclaimer of reliance on pre-contractual representations "does not operate to exclude remedies for pre-contractual misrepresentations," the court in *Thomas Witter Ltd. v. TBP Indus. Ltd.*, [1996] 2 All E.R. 573 (Ch. D.) (U.K.), noted, for example, that "if a clause is to have the effect of excluding or reducing remedies for damaging untrue statements then the party seeking that protection cannot be mealy-mouthed in his clause . . . . He must bring it home that he is limiting his liability for falsehoods he may have told." For more on this point, see Lipshaw, *supra* note 164, at 457.

these states, some courts apply more stringent criteria than may be the governing rule. Accordingly, consider the following suggestions:

- Be sure to include a merger provision that stipulates the exclusivity of the agreement *and* a provision disclaiming both the existence of, and any reliance upon, any other representations or warranties, oral or written, so as to reinforce the acknowledgment of the buyer that it has waived its right to rely on extra-contractual representations;
- Be sure that the disclaimer-of-reliance provision stipulates the specific (though non-exclusive list of) extra-contractual representations on which your counterparty has agreed not to rely;
- Document the arm's-length negotiations by which the counterparty agreed to incorporate the merger and disclaimer provisions as important bases of the bargain;
- Ensure that the agreement stipulates the sophistication of the buyer as a business player and the competence of its legal counsel;
- Whenever possible, have the company being sold, rather than the selling stockholder, actually make the representations and warranties even though the selling stockholders are agreeing to indemnify the buyer contractually for their breach and disclaim the making of any representations and warranties by that selling stockholder;
- Make sure that any language suggesting the counterparty has relied upon the specific representations that are set forth in the written contract is subject to the exclusive remedy provision, so that only the agreement provides remedies for their breach (not tort law). In addition, include a provision making clear that all representations and warranties contained in the agreement are contractual in nature only, regardless of whether they were made to the counterparty pre-contract and were relied upon by the counterparty in entering into the agreement;
- Obtain a specific acknowledgment from the counterparty that no officer, employee, agent, or other person acting or purporting to act on behalf of your client has any actual or apparent authority to make any representation, warranty, assurance, or covenant that is not specifically set forth in the written agreement and subject to the limited remedies bargained for therein—and that the buyer has not relied upon any such person;
- Be certain to include express language specifying that no officers or agents of either contracting party shall have any personal liability (whether in contract or in tort) with respect to the negotiation, execution, delivery, or performance of the agreement or any misrepresentations made in connection therewith;
- To be consistent in your position that only the agreement governs the relationship between the buyer and seller, do not ask buyers to agree to anti-sandbagging clauses.<sup>214</sup> Asking the buyer to agree to an anti-sandbagging

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214. For more information on anti-sandbagging clauses and why they are inappropriate, see generally West & Shah, *supra* note 47.

clause subjects the buyer to the very uncertainties about extra-contractual claims of “knowledge” that the seller is seeking to avoid;

- Try to avoid agreeing to deliver a “bring-down certificate” in which officers assert the continued truthfulness of the contractual representations made in the agreement because a court could view the “certification” as the officers’ personal verification of the accuracy of the representations (that could generate another tort-based inducement claim). There are other means of making clear that the representations and warranties are remade at the closing for the sole purpose of the indemnification provisions; and
- Never undo all of the above by agreeing to exclude “fraud,” “willful misconduct,” “gross negligence,” or any other tort-related claims from the exclusive remedies provision of your agreement.<sup>215</sup> Remember, “fraud” is not limited to deliberate lying, and can even be based on innocent misrepresentations (i.e., “equitable fraud”). If your counterparty insists on a “fraud exclusion,” limit the exclusion to “intentional fraud committed with actual knowledge by the Seller Knowledge Persons [a defined group limited to persons from whom you obtained certificates indicating that they had no current actual knowledge that any representation made in the agreement was false] with respect to the specific representations and warranties set forth in Article [ ] only.” And make certain that the effect of such an exclusion is not to convert a contract claim into a tort claim, but to eliminate the applicability of the deductibles and caps as to those breached representations that were, in fact, “intentionally fraudulent.”<sup>216</sup>

A series of model defensive provisions that reflect the recommendations outlined above are set forth in the Appendix.

## VI. CONCLUSION

It has been said that “[t]he [common] law is the enforcement of common sense: or, at any rate, it should be.”<sup>217</sup> Contracts made between sophisticated parties, represented by counsel, who freely decided after extensive negotiation to allocate risk in a carefully crafted written agreement, are fundamentally different from the adhesion contracts made by consumers who buy cars, rent jet skis, or

215. See *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, No. 02 Civ. 7689, 2005 WL 832050, at \*3 (S.D.N.Y. Apr. 12, 2005) (“express carve-out for causes of action arising from fraud renders [exclusive remedies provision] meaningless” if action is based on claim of fraud); Glenn D. West & Benton B. Bodamer, *Corporations*, 59 SMU L. REV. 1143, 1166 n.149 (2006). Also, remember that the term “fraud” not only encompasses intentional fraud, but also “equitable” (i.e., negligent and even innocent misrepresentation) and “reckless” fraud. Of course, a lawyer’s ethical obligations demand that he or she not counsel or assist a client in conduct that the lawyer knows is fraudulent (in this case meaning “conduct that is fraudulent under the . . . law of the applicable jurisdiction and has a purpose to deceive”). See MODEL RULES OF PROF’L CONDUCT R. 1.0(d), 1.2(d) (2008).

216. For earlier versions of some of these suggestions authored or co-authored by Mr. West, see generally West, *supra* note 12, at 3; West & Bodamer, *supra* note 19, at 10–11; West & Obi, *supra* note 19, at 16–18.

217. *S.C.M. (U.K.) Ltd. v. W.J. Whithall & Son Ltd.*, [1971] 1 Q.B. 337, 344 (U.K.). See also *Thornton v. Micrografx, Inc.*, 878 F. Supp. 931, 938 (N.D. Tex. 1995) (“The Court refuses to leave its common sense at the courthouse steps . . .”).

sign consents allowing their children to participate in rafting excursions.<sup>218</sup> It is also common sense that there is a material difference between the risk of physical harm to person or property occasioned by a product or activity and the risk of economic loss occasioned by an arm's-length business transaction.<sup>219</sup>

As one commentator has noted, “tort duties arise to protect individuals unable to protect themselves from the unscrupulous actions of others.”<sup>220</sup> More specifically, “[t]ort law . . . governs the relationship between a [buyer] and a [seller], where it is impractical or impossible . . . to negotiate the terms of a sale or each party’s duty to the other.”<sup>221</sup> But where sophisticated parties contract pursuant to comprehensive written agreements intended to outline the specific extent of their respective obligations and liabilities, contract law alone should be sufficient to protect them. Indeed, that is why early courts adopted the “economic loss” rule—to prevent contracting parties from compensating for their failure to bargain for a specific warranty by bringing their claim in tort instead of contract.<sup>222</sup> To allow tort claims to maintain a “parasitic”<sup>223</sup> existence within the “host” of a contractual relationship that disclaims the application of tort law to that contract “render[s] warranties duplicative, at best, and marginalize[s] the risk/benefit allocation subsumed in the contractual terms on which the transaction actually, but may not otherwise have, occurred.”<sup>224</sup>

To create exceptions to contractual freedom in business agreements between sophisticated parties based on theories of fraud, and sometimes negligence, “disregards the memorializing function and sanctity of contracts and invites slippery-slope, second-guessing forays into the equities of contractual dealings.”<sup>225</sup> Fraud and negligent misrepresentation claims have proven to be hard to define, easy to allege, hard to dismiss on a threshold, pre-discovery motion, difficult to disprove without expensive, lengthy litigation, and highly susceptible to the erroneous conclusions of judges and juries.<sup>226</sup> And ironically, it may be the one alleging

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218. For a discussion of the law applicable to exculpatory clauses in contracts for which the risk of physical harm is present, see John G. Shram, Note, *Contract Law—The Collision of Tort and Contract Law: Validity and Enforceability of Exculpatory Clauses in Arkansas*, *Jordan v. Diamond Equipment*, 2005 WL 984513 (2005), 28 U. ARK. LITTLE ROCK L. REV. 279 (2006).

219. See *Murphy v. Brentwood Dist. Council*, [1991] A.C. 398, 487 (H.L.) (U.K.) (“The infliction of physical injury to the person or property of another universally requires justification. The causing of economic loss does not.”), quoted in *Perre v. Apand Pty Ltd.* (1999) 198 C.L.R. 180, 209 (Austl.).

220. Barton, *supra* note 65, at 1797.

221. *Id.* (quoting *Detroit Edison Co. v. NABCO, Inc.*, 236 F.3d 236, 240 (6th Cir. 1994)) (ellipses and alterations in original).

222. See *supra* note 72 and accompanying text.

223. See *Spartan Steel & Alloys Ltd. v. Martin & Co. (Contractors) Ltd.*, [1973] Q.B. 27, 34 (U.K.) (referring to a disputed doctrine called “parasitic damages,” the court noted that “[t]hey are said to be ‘parasitic’ because, like a parasite, in biology, they cannot exist on their own, but depend on others for their life and nourishment”).

224. *Maxcess, Inc. v. Lucent Techs., Inc.*, No. 6:04-cv-204-Orl-31DAB, 2005 WL 6125471, at \*7 (M.D. Fla. Jan. 5, 2005), *aff’d*, 433 F.3d 1337 (11th Cir. 2005).

225. *Id.* at \*8.

226. See, e.g., *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51, 60 (Tex. 2008) (“[a]fter-the-fact protests of misrepresentation are easily lodged”); *Santanna Natural Gas Corp. v. Hamon Operating Co.*, 954 S.W.2d 885, 890 (Tex. App. 1997) (“[f]raud “is an elusive and shadowy term”).

the fraud that is the actual “fraudster”—not the person against whom the fraud is alleged.

Despite the repugnancy of seemingly sanctioning what is conveyed by the common (although not necessarily legal) understanding of the term “fraud,” courts should focus instead on the nature of the bargains that parties make and the identity of the parties who make them. It is a “fundamental principle of contract law . . . [that] parties must be able to confidently allocate risks and costs during their bargaining without fear that unanticipated liability may arise in the future, effectively negating the parties’ efforts to build these costs into the contract.”<sup>227</sup> Freedom to contract, and the sanctity of contracts freely made, should remain a strong policy preference. Tort law should not interfere with business agreements made by sophisticated parties, particularly those involving business entities dealing through multiple agents, at least in cases where the parties have expressly excluded its application.<sup>228</sup>

As business lawyers, however, we must remain aware of the fact that there is, at present, a divergence of opinion on these issues among the common law judges who decide business-related disputes throughout the United States. And unless courts uniformly reconcile these conflicting views, business lawyers must advise their clients that the state law they choose to govern their particular agreement may dictate the certainty and predictability that they can expect from their contracts in the event that their counterparty alleges fraud or some other tort-based claim. This unpredictability runs against the very fabric of the common law because “the effectiveness of the law is seriously diminished when legal practitioners believe they cannot confidently advise what the law is.”<sup>229</sup> But, for now at least, the answer to the question that we posed in the subtitle of this article remains: “It depends”—on both the clarity of the language in written agreements and the willingness of courts to enforce those agreements as written.

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227. *Vanderbeek v. Vernon Corp.*, 50 P.3d 866, 871 (Colo. 2002).

228. See *Davis*, *supra* note 12, at 529–30.

229. *Perre v. Apand Pty Ltd.* (1999) 198 C.L.R. 180, 215 (Austl.).

APPENDIX  
MODEL PROVISIONS<sup>230</sup>

*Governing Law.*<sup>231</sup> This Agreement, and all claims or causes of action (whether in contract or tort) that may be based upon, arise out of or relate to this Agreement, or the negotiation, execution or performance of this Agreement (including any claim or cause of action based upon, arising out of or related to any representation or warranty made in or in connection with this Agreement or as an inducement to enter into this Agreement), shall be governed by the internal laws of the State of [\_\_\_\_\_].<sup>232</sup>

*Entire Agreement.* This Agreement contains the entire agreement of the parties respecting the sale and purchase of the Company and supersedes all prior agreements among the parties respecting the sale and purchase of the Company. The parties hereto have voluntarily agreed to define their rights, liabilities and obligations respecting the sale and purchase of the Company exclusively in contract pursuant to the express terms and provisions of this Agreement; and the parties hereto expressly disclaim that they are owed any duties or are entitled to any remedies not expressly set forth in this Agreement. Furthermore, the parties each hereby acknowledge that this Agreement embodies the justifiable expectations of sophisticated parties derived from arm's-length negotiations; all parties to this Agreement specifically acknowledge that no party has any special relationship with another party that would justify any expectation beyond that of an ordinary buyer and an ordinary seller in an arm's-length transaction. The sole and exclusive remedies for any breach of the terms and provisions of this Agreement (including any representations and warranties set forth herein, made in connection herewith or as an inducement to enter into this Agreement) or any claim or cause of action otherwise arising out of or related to the sale and purchase of the Company shall be those remedies available at law or in equity for breach of contract only (as such contractual remedies have been further limited or excluded pursuant to the express terms of this Agreement); and the parties hereby agree that neither party hereto shall have any remedies or cause of action (whether in contract or in tort) for any statements, communications, disclosures, failures to disclose, representations or warranties not set forth in this Agreement.

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230. See Glenn D. West & W. Benton Lewis, Jr., *Corporations*, 61 SMU L. REV. 743, 764–65 (2008); West & Bodamer, *supra* note 19, at 11–15; West & Obi, *supra* note 19, at 18–21; Glenn D. West & Sarah E. Stasny, *Corporations*, 58 SMU L. REV. 719, 723–27 (2006). Highlighting the model provisions in boldface font or all capital characters may maximize their respective effectiveness. It is important to note, however, that the authors do not believe that including all of these provisions is critical to accomplishing the protection they seek. Rather, these provisions are, in many cases, deliberately duplicative. The business lawyer, with knowledge of the law in the applicable jurisdiction, should adapt and modify accordingly.

231. Note that choice of forum and jury trial waiver provisions may confer additional protections against extra-contractual liability.

232. This provision appears in West & Stasny, *supra* note 230, at 724. Interestingly, the court in *ABRY* suggests that Delaware courts, unlike the Fifth Circuit and other courts, would enforce a choice-of-law provision that was limited to the interpretation and enforcement of the contract so that the contractual choice would also govern tort claims arising out of that contract. See *ABRY Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1047–48 (Del. Ch. 2006).

*Nature of Representations and Warranties.*<sup>233</sup> All representations and warranties set forth in this Agreement are contractual in nature only and subject to the sole and exclusive remedies set forth herein. No Person is asserting the truth of any representation and warranty set forth in this Agreement; rather the parties have agreed that should any representations and warranties of any party prove untrue, the other party shall have the specific rights and remedies herein specified as the exclusive remedy therefor, but that no other rights, remedies or causes of action (whether in law or in equity or whether in contract or in tort) are permitted to any party hereto as a result of the untruth of any such representation and warranty.

*Non-Reliance of Buyer.* Except for the specific representations and warranties expressly made by the Company or any Selling Stockholder in Article [ ] of this Agreement, (1) Buyer acknowledges and agrees that (A) neither the Company nor any Selling Stockholder is making or has made any representation or warranty, expressed or implied, at law or in equity, in respect of the Business, the Company, the Company's Subsidiaries, or any of the Company's or its Subsidiaries' respective businesses, assets, liabilities, operations, prospects, or condition (financial or otherwise), including with respect to merchantability or fitness for any particular purpose of any assets, the nature or extent of any liabilities, the prospects of the Business, the effectiveness or the success of any operations, or the accuracy or completeness of any confidential information memoranda, documents, projections, material or other information (financial or otherwise) regarding the Company or any Company Subsidiary furnished to Buyer or its representatives or made available to Buyer and its representatives in any "data rooms," "virtual data rooms," management presentations or in any other form in expectation of, or in connection with, the transactions contemplated hereby, or in respect of any other matter or thing whatsoever, and (B) no officer, agent, representative or employee of the Selling Stockholder, the Company or any of the Company's Subsidiaries has any authority, express or implied, to make any representations, warranties or agreements not specifically set forth in this Agreement and subject to the limited remedies herein provided; (2) Buyer specifically disclaims that it is relying upon or has relied upon any such other representations or warranties that may have been made by any Person, and acknowledges and agrees that the Company and the Selling Shareholders have specifically disclaimed and do hereby specifically disclaim any such other representation or warranty made by any Person; (3) Buyer specifically disclaims any obligation or duty by the Seller, the Company or any Selling Stockholder to make any disclosures of fact not required to be disclosed pursuant to the specific representations and warranties set forth in Article [ ] of this Agreement; and (4) Buyer is acquiring the Company subject only to the specific representations and warranties set forth in Article [ ] of this Agreement

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233. Ideally, a stock or asset purchase agreement would not contain a separate section that stipulates the "representations and warranties" upon which the transaction was predicated. Instead, what we typically refer to as "representations and warranties" would be identified (and listed) as "indemnifiable matters" for which the seller would be obligated to indemnify the buyer, subject to the limitations set forth in the indemnification section. As much as we would like to see this change in convention, we are not optimistic that business lawyers are ready for such a change.

as further limited by the specifically bargained-for exclusive remedies as set forth in Article [ ].

*Non-Recourse.* No past, present or future director, officer, employee, incorporator, member, partner, stockholder, Affiliate, agent, attorney or representative of the Company, the Selling Stockholders or any of their respective Affiliates shall have any liability (whether in contract or in tort) for any obligations or liabilities of the Company or the Selling Stockholders arising under, in connection with or related to this Agreement or for any claim based on, in respect of, or by reason of, the sale and purchase of the Company, including, without limitation, any alleged non-disclosure or misrepresentations made by any such Persons.

*Exclusive Remedies.* Following the Closing, the sole and exclusive remedy for any and all claims arising under, out of, or related to this Agreement, or the sale and purchase of the Company, shall be the rights of indemnification set forth in Article [ ] only, and no person will have any other entitlement, remedy or recourse, whether in contract, tort or otherwise, it being agreed that all of such other remedies, entitlements and recourse are expressly waived and released by the parties hereto to the fullest extent permitted by law. [Notwithstanding the foregoing, the parties have agreed that if the Buyer can demonstrate, by clear and convincing evidence, that a material representation and warranty made by the Company or the Selling Stockholder in this Agreement was deliberately made and known to be materially untrue by any of the Seller Knowledge Parties, then the Deductible shall not apply and the Cap shall be increased to the Purchase Price with respect to any resulting indemnification claim under Section [ ].] The provisions of this Section [ ], together with the provisions of Sections [ ], [ ], and [ ], and the limited remedies provided in Article [ ], were specifically bargained-for between Buyer, the Company and the Selling Stockholders and were taken into account by Buyer, the Company and the Selling Stockholders in arriving at the Purchase Price. The Company and the Selling Stockholders have specifically relied upon the provisions of this Section [ ], together with the provisions of Sections [ ], [ ], and [ ], and the limited remedies provided in Article [ ], in agreeing to the Purchase Price and in agreeing to provide the specific representations and warranties set forth herein.