

## RULE 10B-5 AND BUSINESS COMBINATION TRANSACTIONS

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### ABSTRACT

Parties to large business combination transactions are paradigmatically sophisticated, profit-maximizing entities. As such, they structure their transactions to be efficient, that is, to maximize the joint surplus of the transaction, as this creates the greatest opportunity for each to profit from the transaction. One of the greatest difficulties such parties face in maximizing the joint surplus of the transaction is the severe asymmetric information problem between the seller and the buyer regarding the business to be transferred (the target). The market has developed two main tools to overcome this problem. First, before the parties enter into a definitive agreement regarding a transaction, the seller provides the buyer with tremendous amounts of non-public information about the target business (due diligence). Second, in the definitive agreement, the seller makes extensive representations and warranties about the target, thus assuming liability if these factual statements about the target turn out to be false.

In order to price transactions as accurately as possible, sophisticated parties attempt to identify precisely the rights they acquire and the

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obligations they undertake in entering such transactions. By far, the cheapest way to do this is to limit those rights and obligations to those specified in the definitive written agreement, and so the intention of the parties is that the agreement between them should determine such rights and obligations completely. With respect to the rights and obligations created by contractual promises, that goal is easily attained (to the extent that any contract can ever be truly complete) by invoking the parol evidence rule by means of a properly drafted integration clause.

With respect to rights and obligations arising from representations, however, the development of the common law at the intersection of contract and tort has made the situation more complicated. Although the law has usually allowed parties to contract around actions for contractual misrepresentation, the situation was different with respect to fraudulent misrepresentations for a long time. Under the theory that fraud vitiates everything, contractual provisions purporting to limit remedies for fraudulent misrepresentations, including even extra-contractual misrepresentations, were long held unenforceable on public policy grounds. More recently, however, leading commercial jurisdictions like Delaware and New York have allowed sophisticated parties to agree that the only actionable representations will be those included in the definitive agreement, including with respect to actions for fraudulent inducement. This is accomplished by means of so-called “non-reliance clauses,” in which a party promises or represents that it is not relying on any representations by the counterparty except for those included in the definitive agreement.

Even some sophisticated parties are surprised to discover, however, that representations made not actionable at common law by non-reliance clauses may be actionable under Rule 10b-5, the general antifraud provision of the federal securities laws. At issue is Section 29(a) of the Securities Exchange Act of 1934, which declares void any agreement “binding any person to waive compliance with any provision” of the act or rules promulgated thereunder. The United States Court of Appeals for the Second Circuit has held that non-reliance clauses, at least between sophisticated parties, survive under Section 29(a), but the First and Third Circuits have held otherwise and have allowed Rule 10b-5 suits based on extra-contractual representations to proceed.

After reviewing the common law background regarding non-reliance clauses, this Article provides an economic analysis of the process by which sophisticated parties to business combination transactions deal with the severe information problem inherent in such transactions, that is, the fact that the buyer comes to the transaction knowing relatively little about the

target business, and certainly much less than the seller does. The process of dealing with this problem typically begins with the parties entering into a preliminary agreement, variously styled a confidentiality agreement or non-disclosure agreement, the primary purpose of which is to prevent the potential buyer from using confidential, non-public information about the target for any purpose other than evaluating a potential acquisition of the target. After such an agreement is signed, due diligence begins, and the seller gives the buyer access to large amounts of non-public information about the target business, including both written materials and information delivered orally in meetings and discussions between the agents of the parties.

Confidentiality or non-disclosure agreements virtually always include provisions in which the seller disclaims any representation that the information delivered in due diligence will be accurate or complete. This Article argues that such disclaimers, which neophytes often find surprising, are virtually necessary features of the situation. First, the written materials delivered in due diligence typically aggregate several tens of thousands of pages, and this information is usually drawn directly from the business records of the company, which were prepared for other purposes in other contexts. Since a rational business invests in the accuracy and completeness of its records only to the extent that the marginal benefit of doing so exceeds the marginal cost, a firm's business records will naturally contain a certain non-zero percentage of misstatements and omissions. A seller delivering such records in due diligence will thus know that they include such misstatements and omissions. Reviewing the records to identify and correct such misstatements and omissions, however, would be extremely costly and involve significant delay. Moreover, the oral discussions between agents of the seller and agents of the buyer often involve relatively junior personnel who lack a comprehensive understanding of the business and the potential transaction, and so there is a very large probability that such agents will sometimes make statements even in good faith that senior officers and transaction advisors would recognize as being untrue or misleading. Again, preventing or correcting such misstatements and omissions would be extremely costly and involve significant delays. Hence, with respect to both written and oral statements in due diligence, if the seller represented that all the information it delivered to the buyer was true and complete, that representation itself would almost inevitably be fraudulent. The seller would be virtually certain that what it was saying was false. Moreover, sophisticated buyers understand all this as well as the seller does. In disclaiming the accuracy and completeness of the due diligence materials, therefore, the seller is

merely saying what the seller and buyer already know is the case: that these materials will contain misstatements and omissions that the seller, at some senior level, would know to be misstatements or omissions.

Furthermore, sophisticated parties want to craft an efficient agreement, that is, one that divides rights and obligations precisely and allocates each right to the party that values it most highly and each obligation to the party that can bear it most cheaply. With respect to representations and warranties, this means that parties wish to include in the agreement only the efficient set of representations and warranties—that is, those that cost the seller less to make than they benefit the buyer to receive. Including any other representations will reduce the joint surplus and make both parties worse off. But, identifying the efficient representations and warranties requires comparing the cost of making the representation, which is known only to the seller, with the benefit of receiving the representation, which is known only to the buyer. That means that neither party, acting alone, can determine the efficient set of representations. Rather, the parties must act together, through bargaining, to identify the efficient set of representations. In addition, the cost to the seller and the benefit to the buyer of a given representation depends not only on its content (i.e., what it says about the target business), but also on the other provisions contained in the agreement of which it is a part, such as the indemnification provisions and closing conditions. Hence, it is impossible for parties to identify the efficient representations except by bargaining over them in the context of a definitive agreement. Since both parties understand this, neither party wants the information the seller delivers to the buyer in due diligence to form part of their agreement. Hence, as a counterpart to the seller disclaiming the accuracy and completeness of the due diligence materials, the buyer promises in the preliminary agreement that it will not rely on any statements by the seller except for the representations in the definitive agreement (promissory non-reliance clauses). When it enters into that agreement, the buyer then represents that it has fulfilled this promise and is relying only on the representations in the definitive agreement (representational non-reliance clauses).

In short, this Article argues that disclaimers, promissory non-reliance clauses, and representational non-reliance clauses are parts of an integrated system designed to produce an efficient set of representations and warranties as part of an efficient overall agreement between sophisticated parties. Since such parties come to the transaction wanting and expecting such a system, the clauses merely make express the understanding that participants in the market for corporate control already have. Even if such

clauses were not included in the relevant agreements, the economic realities of the situation make it such that no reasonable seller would understand itself to making enforceable representations in due diligence, and no reasonable buyer would rely on any such representations. Even if enforceability were limited to fraudulent misrepresentations, the result would be a severely inefficient process that would decrease the value to the parties of the potential transaction.

Against this understanding of the economic realities of the deal-making process, this Article then considers whether disclaimers and non-reliance clauses should be enforceable under Section 29(a). Arguing that Section 29(a) should be understood as preventing parties from tampering with the allocation of rights made by the federal securities laws, and relying on the economic analysis in the Article to show that no representations or warranties were ever made or received in due diligence and thus no rights created, the Article concludes that disclaimers and non-reliance clauses do not run afoul of Section 29(a). If the Supreme Court ever addresses the circuit split related to the enforceability of non-reliance clauses, it should adopt the view of the Second Circuit that such clauses are enforceable, at least as between sophisticated parties involved in business combination transactions.

INTRODUCTION.....538

I. COMMON LAW BACKGROUND AND NON-RELIANCE CLAUSES

    UNDER THE FEDERAL SECURITIES LAWS.....544

    A. The Intersection of Contract and Tort.....549

    B. The Treatment of Non-Reliance Clauses at Common Law .....560

        1. Delaware Law .....564

            a. *Abry Partners V, L.P. v. F.W. Acquisitions, LLC*.....565

            b. *RAA Management, LLC v. Savage Sports Holdings, Inc.* .....581

        2. New York Law.....586

    C. The Circuit Split: Enforceability of Non-Reliance Clauses in the Second Circuit, Un-Enforceability in the Third and First Circuits.....590

        1. The Second Circuit: *Harsco Corp. v. Segui*.....593

        2. The Third Circuit: *AES Corp v. The Dow Chemical Co.*.....597

        3. The First Circuit: *Rogen v. Ilikon Corporation*.....603

        4. Some Cases Not Mentioning Section 29(a) in the Seventh, First, and District of Columbia Circuits .....605

II. ECONOMIC ANALYSIS OF NON-RELIANCE CLAUSES .....607

    A. The Information Problem and its Solutions.....608

1. Due Diligence .....	609
a. The Vast Quantity of Information in Due Diligence .....	610
b. An Efficient Rate of Errors and Omissions in Due Diligence Information .....	614
c. The Costs of Avoiding Fraud: Diligence Materials.....	617
d. Meetings and Presentations in Due Diligence.....	621
e. The Costs of Avoiding Fraud: Oral Due Diligence .....	623
f. The Impossibility of Reasonable Reliance and the Function of Disclaimers .....	625
2. Discovering Efficient Representations and Warranties.....	628
a. Representations that Increase the Joint Surplus .....	628
b. In the Context of an Agreement .....	630
c. The Economic Function of Non-Reliance Clauses.....	632
3. An Efficient Process to Produce an Efficient Agreement....	634
III. NON-RELIANCE CLAUSES AND HOW THE CIRCUIT SPLIT ABOUT THE EFFECT OF SECTION 29(A) SHOULD BE RESOLVED.....	635
A. Section 29(a) As Non-Circumvention Provision and Disclaimers and Non-Reliance Clauses as Not Circumventing.....	639
B. Section 29(a) as Not Prohibiting Agreements About Which Representations Are Being Made .....	643
CONCLUSION.....	645

## INTRODUCTION

In any significant business combination transaction, the seller (or target) is a firm of substantial size. The acquirer is either another firm operating in the same or a related line of business, usually of larger and often of much larger size (a strategic buyer), or otherwise a private equity fund (a financial buyer). The parties to such transactions are thus paradigmatically rational, sophisticated, profit-maximizing parties.<sup>1</sup> To profit as much as possible from such transactions, such parties want to structure their transactions to assign rights to the party who values them most highly and obligations to the party that can bear them the most cheaply. This maximizes the joint surplus the transaction creates, which allows both parties to profit to the greatest extent possible. Central to this endeavor is identifying and specifying the rights the parties acquire and the

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1. The assumption is very much in favor of the neo-classical rationality assumption and against any competing behavioralist assumptions. *See infra* note 26.

obligations they undertake upon entering the transaction. By far, the cheapest and most effective way of doing this is to limit those rights and obligations to those specified in the definitive written agreement between the parties.<sup>2</sup> Unfortunately, the law makes this surprisingly difficult.<sup>3</sup>

Although the parol evidence rule,<sup>4</sup> which the parties invoke by means of an integration clause in the definitive agreement,<sup>5</sup> makes it simple for the parties to circumscribe the set of *promises* they make (and thus the contractual obligations for performing such promises that they take on) to those in the written agreement, the situation is not so simple with respect to the *representations* the parties make.<sup>6</sup> In part because of historical

2. See generally Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the “Entire” Deal?*, 64 BUS. L. 999 (2009) (proposing a series of defensive strategies to limit client exposure to tort liability arising from contractual obligations). Of course, whenever transaction costs are positive—which is to say, always in the real world—no contract is ever literally complete. The point in the text is that, because of their sophistication and experience, the costs that sophisticated parties face in attempting to make contracts complete are unusually low, and since the amounts involved in business combination transactions are usually very high, such parties can and will write contracts that are, generally speaking, highly complete—about as complete as contracts in the real world will get, even if these contracts are not literally complete.

3. West & Lewis, Jr., *supra* note 2, at 1018 (stating, “[T]he agreements governing sophisticated corporate transactions . . . often include a series of defensive provisions designed to ensure that the contract constitutes the exclusive source of contracting parties’ post-closing rights, obligations, and remedies.”).

4. See E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS §§ 7.2-7.3 (1990) (discussing parol evidence rule and related doctrines). As Judge Posner explains, “Drafters of contracts worry lest in the event of a dispute one of the parties ask the court to depart from the terms of the written contract on the ground that it is not the parties’ entire agreement.” *Extra Equipamentos E Exportacao Ltda. v. Case Corp.*, 541 F.3d 719, 723 (7th Cir. 2008). Hence, “If such a claim enabled the party making it to obtain a jury trial on the meaning of the contract, the contractual process would be riven with uncertainty. The law’s response to this problem is the parol evidence rule, which . . . forbids the introduction of evidence (whether oral or written) of what was said in the process of negotiating a contract to vary the terms of the contract that resulted from the negotiation, provided that the contract seems clear and complete.” *Id.*

5. See generally LOU R. KLING & EILEEN T. NUGENT, *NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS* (2017). As Judge Posner puts it, not content to rely on the parol evidence rule, “To make assurance doubly sure, parties to a written contract commonly include in it an ‘integration’ clause; for if they do not, the party resisting the invocation of the parol evidence rule can ask the judge to consider extrinsic evidence bearing on the question whether the parties really did intend the written contract to be the complete and final articulation of their agreement.” *Extra Equipamentos E Exportacao Ltda.*, 541 F.3d at 723; see also West & Lewis, Jr., *supra* note 2, at 1019 (discussing how most contracting parties will include merger [i.e., integration] clauses in their agreements to trigger the parol evidence rule).

6. See generally *Representations, Warranties, Covenants, Rights, and Conditions*,

accidents in the development of the common law, a breach of representation may support actions not only in contract, but also in tort, in particular for fraudulent inducement.<sup>7</sup> The problem thus becomes one of limiting obligations arising in tort.<sup>8</sup> The conventional solution in the market for corporate controls lies in an array of related contractual provisions, in both a preliminary agreement generally styled a confidentiality or non-disclosure agreement and the definitive agreement. The most important of these provisions is the so-called non-reliance clause, versions of which can appear in different forms in both the confidentiality agreement and the definitive agreement. In the former, the buyer promises that it will not rely on representations by the seller except for those as may eventually be contained in the definitive agreement; in the latter, the buyer represents that, in entering the definitive agreement, it has not relied on representations of the seller except for those actually contained in the definitive agreement.<sup>9</sup> Since reliance is an element of a fraudulent

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Practical Law Practice Note 9-519-8869, WESTLAW (2019) (providing background information on representations); FARNSWORTH ON CONTRACTS, *supra* note 4, at § 7.2.

7. See Section I.A.

8. As Judge Posner puts it, “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. Doctrine aside, all an integration clause does is limit the evidence available to the parties should a dispute arise over the meaning of the contract. . . . [I]t has nothing to do with whether the contract was induced, or its price jacked up, by fraud.” *Vigortone AG Products, Inc. v. PM AG Products, Inc.*, 316 F.3d 641, 644 (7th Cir. 2002).

9. For the most important articles on non-reliance clauses see generally Johnathan P. Altman, *Rule 10b-5 and Reasonable Reliance: Why Courts Should Abandon Focus on Non-Reliance Clauses*, 68 U. PITT. L. REV. 747 (2007); Allen Blair, *A Matter of Trust: Should No-Reliance Clauses Bar Claims for Fraudulent Inducement of Contract?* 92 MARQ. L. REV. 423 (2009); Elizabeth Cummings, *Balancing the Buyer’s Right to Recover for Precontractual Misstatements and the Seller’s Ability to Disclaim Express Warranties*, 76 MINN. L. REV. 1189 (1992); Kevin Davis, *Licensing Lies: Merger Clauses, the Parol Evidence Rule and Precontractual Misrepresentations*, 33 VAL. U. L. REV. 485 (1999); Jason R. Grove, *Non-Reliance Clauses and SEC Rule 10b-5: Defining the Boundaries of Corporate Transactions*, 56 CASE W. RES. L. REV. 1119 (2006); Steven M. Haas, *Contracting Around Fraud Under Delaware Law*, 10 DEL. L. REV. 49 (2008); Jeffrey M. Lipshaw, *Of Fine Lines, Blunt Instruments, and Half-Truths: Business Acquisitions Agreements and the Right to Lie*, 32 D.J.C.L. 431 (2007); David K. Lutz, *The Law and Economics of Securities Fraud*, 79 CHI-KENT L. REV. 803 (2004); Kabir Masson, *Paradox of Presumptions: Seller Warranties and Reliance Waivers in Commercial Contracts*, 109 COLUM. L. REV. 503 (2009); Robert Prentice, *Contract-Based Defenses in Securities Fraud Litigation: A Behavioral Analysis*, 2003 U. ILL. L. REV. 337 (2003); Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879 (1994); George J. Siedel, *The Double Liar Dilemma in Business Negotiations*, 17 STAN. J.L. BUS. & FIN. 1 (2011); Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 6 WASH. & LEE L. REV. 519 (1999); Joseph Wylie, *Using No-Reliance Clauses to Prevent Fraud-in-the-Inducement*



inducement claim,<sup>10</sup> a non-reliance clause, if taken at face value,<sup>11</sup> prevents a party from proving fraudulent inducement with respect to any representation not contained in the definitive agreement. Although courts were for a long time hostile to non-reliance clauses and their underlying purpose of limiting by contract claims sounding in fraud,<sup>12</sup> the courts in the leading commercial jurisdictions of Delaware and New York,<sup>13</sup> which especially value freedom of contract<sup>14</sup> and are committed to having

*Claims*, 92 ILL. B.J. 536 (2004).

10. *See, e.g.*, Prosser & Keaton on Torts, § 105 (explaining the elements of fraudulent inducement); Restatement (Second) of Torts, § 525 (stating justifiable reliance is an element of fraudulent inducement). This is also the law in Delaware and New York. *See e.g.*, *DCV Holdings, Inc. v. Conagra, Inc.*, 889 A.2d 954, 958 (Del. 2005) (holding that reliance is an element of fraudulent inducement under Delaware law); *Ambac Assur. Corp. v. Countrywide Home Loans, Inc.*, 31 N.Y.3d 569, 579-80 (2018) (holding that, in New York, the elements of common law fraud include justifiable reliance); *Banque Arabe et Internationale D'Investissement v. Maryland Nat'l Bank*, 57 F.3d 146, 153 (2d Cir. 1995) (stating that in New York, fraudulent misrepresentation requires that (a) the defendant make a material, false representation, (b) the defendant intended to defraud the plaintiff thereby, (c) the plaintiff reasonably relied upon the representation, and (d) the plaintiff suffered damages as a result of such reliance).

11. The text here is studiously ambiguous. The idea is that, if the buyer has kept its promise in the confidentiality agreement (for non-reliance clauses in such agreements) or has not breached its representation in the definitive agreement (for non-reliance clauses in such agreements), then it has not relied on extra-contractual representations, and so could not succeed in a claim for fraudulent inducement.

12. *See* Masson, *supra* note 9, at 504 (collecting cases indicating hostility towards non-reliance clauses).

13. The enforceability of non-reliance clauses in other jurisdictions varies. *See* West & Lewis, Jr., *supra* note 2, at 1023-28 (surveying case law across multiple jurisdictions). In particular, non-reliance clauses are generally unenforceable in California and Massachusetts. *See e.g.*, *Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Dev. Corp.*, 38 Cal. Rptr. 2d 783 (Cal. Ct. App. 1995) (holding non-reliance clause unenforceable in California); *Danzig v. Jack Grynberg & Assoc.*, 208 Cal. Rptr. 336 (Cal. Ct. App. 1984) (same); *Bates v. Southgate*, 3 N.E.2d 551 (Mass. 1941) (holding non-reliance clause unenforceable in Massachusetts). Texas makes the enforceability of non-reliance clauses turn on the particular aspects of the language used and the circumstances of the case. *See, e.g.*, *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51 (Tex. 2008) (holding that an agreement that clearly and specifically negates reliance on representations made outside the agreement would bar a claim for fraudulent inducement based on such representations).

14. As Chief Justice Strine has said, “[w]hen parties have ordered their affairs voluntarily through a binding contract, Delaware law is strongly inclined to respect their agreement, and will only interfere upon a strong showing that dishonoring the contract is required to vindicate a public policy interest even stronger than freedom of contract.” *Libeau v. Fox*, 880 A.2d 1049, 1056 (Del. Ch. 2005), *aff'd in pertinent part*, 892 A.2d 1068 (Del. 2006). Similarly, “the right to contract is one of the great, inalienable rights accorded to every free citizen. If there is one thing more than another which public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting.” *State v. Tabasso Homes*, 28 A.2d 248, 253 (Del. Gen. Sess. 1942). Again,

efficient commercial laws,<sup>15</sup> now give effect to non-reliance clauses, at least in transactions between sophisticated parties, and allow such parties to limit their obligations for breach of representations (whether in contract or in tort) in exactly the same way they allow them to limit their obligations for breaches of promises.<sup>16</sup> Accordingly, sophisticated parties, who regularly elect to have their contracts governed by Delaware or New York law,<sup>17</sup> now count on courts to honor their intentions in this regard.

Even sophisticated parties are sometimes surprised, then, when courts allow securities fraud suits under Rule 10b-5 to proceed when suits for common law fraud based on the same facts would be blocked by non-reliance clauses.<sup>18</sup> The different treatment arises primarily because of Section 29(a) of the Securities Exchange Act of 1934, which declares void any agreement “binding any person to waive compliance with any provision” of the federal securities laws.<sup>19</sup> The First<sup>20</sup> and Third Circuit Courts of Appeals<sup>21</sup> have held that Section 29(a) makes non-reliance clauses ineffective, even between sophisticated parties involved in business combination transactions.<sup>22</sup> The Second Circuit has held the opposite, however, and it has enforced non-reliance clauses to block suits under Rule 10b-5.<sup>23</sup> Remarkably, a number of other Circuit Courts of Appeals have enforced non-reliance clauses to block suits under Rule 10b-5 without

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“Delaware upholds the freedom of contract and enforces a matter of fundamental public policy the voluntary agreements of sophisticated parties.” *Cornell Glasgow LLC v. La Grange Prop., LLC*, No. N11C-05-016 JRS CCLD, 2012 WL 2106945, at \*8 (Del. Super. Ct. June 6, 2012).

15. According to Chief Justice Strine, Delaware “prides itself on having commercial laws that are efficient.” *Abry Partners V, L.P. v. F&W Acquisition, LLC*, 891 A.2d 1032, 1059-60 (Del. Ch. 2006).

16. See Sections I.B.1 and I.B.2.

17. See NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 15A.01 (discussing choice of law provisions in business combination agreements and indicating prevalence of Delaware and New York law in such choices).

18. See, e.g., *AES Corp. v. Dow Chemical Co.*, 325 F.3d 174 (3d Cir. 2003) (allowing a securities fraud suit under Rule 10b-5 to proceed despite the presence of non-reliance clause); *Rogen v. Illikon Corp.*, 361 F.2d 260 (1st Cir. 1966) (non-reliance clause did not bar Rule 10b-5 securities fraud suit).

19. Securities Exchange Act of 1934, Section 29(a), 15 U.S.C. § 78cc (2018).

20. *Rogen*, 361 F.2d at 264.

21. *AES Corp.*, 325 F.3d at 179.

22. Some scholars have agreed with this interpretation. See Altman, *supra* note 9, at 759 (“The Exchange Act requires parties to abstain from the sort of contracting embodied by the use of [non-reliance clauses.]”); Sachs, *supra* note 9, at 913 (agreeing with Altman’s argument).

23. See, e.g., *Harsco Corp. v. Segui*, 91 F.3d 337 (2d Cir. 1996) (holding that a non-reliance clause barred a securities fraud suit under Rule 10b-5).

considering the effect of Section 29(a).<sup>24</sup> This split among the federal Circuit Courts of Appeals creates considerable uncertainty for parties entering business combination transactions as to whether, contrary to the plain meaning of agreements between the parties, extra-contractual statements made by the seller are actionable.<sup>25</sup>

Part I of this Article provides background on some of the legal doctrines that have evolved at the intersection of contract and tort law and describes the treatment, under the common law of Delaware and New York, of non-reliance clauses. It then takes up the treatment of such clauses under the federal securities laws, especially Section 29(a), and describes the split in the federal circuits regarding the effectiveness of non-reliance clauses under that section. Part II contains the major contribution of this Article, which is a much more detailed economic analysis of the process whereby sophisticated parties exchange information in due diligence and determine which representations and warranties they will make in connection with a business combination transaction. In particular, Part II will show that non-reliance clauses are only one of a set of related contractual provisions that sophisticated parties use to structure the bargaining process in business combination transactions. That larger process includes other contractual provisions (primarily disclaimers) and conventions regarding due diligence that, in the aggregate, produce incentives for the parties to bargain to an efficient set of representations and warranties in the definitive agreement as part of an overall process of crafting a value-maximizing transaction. In light of the conclusions of Part II, Part III returns to the key issue of what effect Section 29(a) should have on such clauses and concludes that such clauses should be effective, at least in the context of complex business combination transactions between sophisticated parties. Finally, I offer some concluding remarks.

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24. See, e.g., *Rissman v. Rissman*, 213 F.3d 381 (7th Cir. 2000) (holding that a non-reliance clause barred a securities fraud suit under Rule 10b-5); *Jackvony v. Riht Financial Corp.*, 873 F.2d 411 (1st Cir. 1989) (non-reliance clause barred security suit); *One-to-One Enterprises, Inc. v. Caruso*, 848 F.2d 1283 (D.C. Cir. 1988) (non-reliance clause barred security suit).

25. There may be an extremely simple and elegant solution, however, that parties could adopt to avoid this uncertainty: parties could add to their choice of law and venue clauses a provision that any claims arising under the federal securities laws will be adjudicated by the federal courts sitting in New York, which, of course, falls within the Second Circuit and so would apply *Harsco Corp.*, under which non-reliance clauses in contracts between sophisticated parties are effective. West & Lewis, Jr., *supra* note 2, at 1031 n.212.

I. COMMON LAW BACKGROUND AND NON-RELIANCE CLAUSES  
UNDER THE FEDERAL SECURITIES LAWS

As noted above, the parties to large business combination transactions are paradigmatically sophisticated, rational,<sup>26</sup> profit-maximizing entities.<sup>27</sup> They are large corporations or private equity funds typically managed by extremely knowledgeable and experienced individuals chosen for their proven business and financial acumen, advised by expert legal counsel and

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26. Here, I set aside the idea that such parties are significantly affected by the biases or heuristics studied in behavioral economics. My reasons include not only profound skepticism about behavioral economics in general, *see, e.g.*, Mario J. Rizzo and Douglas Glen Whitman, *The Knowledge Problem of New Paternalism*, 2009 BYU L. REV. 905 (2009) (arguing that the various biases and heuristics identified in behavioral economics affect different persons to different degrees in different circumstances and so tend to offset each other); Charles R. Plott and Kathryn Zeiler, *The Willingness to Pay/Willingness to Accept Gap, the "Endowment Effect," and Subject Misconception and Experimental Procedures for Eliciting Valuation*, 95 AMER. ECON. REV. 530 (2005) (presenting empirical evidence that, when comprehensive protocols to exclude subject misconceptions are used, the endowment effect disappears); Lutz, *supra* note 9 (assessing the assumption of rationality from the behavioralist perspective); Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Economics' Equal Incompetence*, 91 GEO. J. L. 67 (2002) (criticizing the behavioralist perspective on rationality); Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165 (2003) (criticizing the cognitive psychological approach to the law and behavioral economics), but also an even more profound skepticism of behavioral economics as applied to sophisticated commercial parties. The agents who act for such parties are an elite group of individuals selected for the purpose, and they act in teams, with redundant checking and rechecking of their decisions. Authors who suggest that, because individuals are subject to heuristics and biases, organizations that are staffed by individuals are subject to such heuristics and biases too, *e.g.*, Robert Prentice, *Contract-Based Defenses in Securities Fraud Litigation: A Behavioral Analysis*, 2003 U. ILL. L. REV. 337 (2003), may as well say that, if each of ten soldiers in a firing squad has a ten-percent chance of missing the condemned man, the squad as a whole has a ten-percent of chance of missing the condemned man. I agree with David K. Lutz, who argues, in the specific context of non-reliance clauses in business combination transactions, that Prentice's assumptions are very unrealistic. *See* Lutz, *supra* note 9, at 842 (asking rhetorically why, if AES's managers can operate profitably a large international business, they could not comprehend the significance of a non-reliance clause that they had agreed to); *see also* Blair, *supra* note 9, at 466-67 (considering behavioral economic considerations in the context of non-reliance clauses and concluding that it is difficult to imagine sophisticated commercial parties suffering from biases that would lead them to agree to non-reliance clauses contrary to their interests); *id.* at 463 n.185 (stating that "[t]here is little research to suggest that firms suffer from cognitive biases. To the contrary, it is likely that firms tend to correct for cognitive biases due to market pressures, even if individuals in the firm suffer from them.").

27. I mean here not that all such parties literally *always* seek only to maximize value for themselves (such an absolute generalization would obviously be false), but merely that such parties do this so often that legal rules, which address what usually or normally happens, should be framed on the assumption that the parties are acting in the way indicated.

investment bankers, and highly motivated to maximize profits within the law. Such parties will almost always structure their transactions efficiently, that is, by dividing rights and obligations minutely and then allocating rights to the party that values them most highly and obligations to the party that can bear them most cheaply. This maximizes the joint surplus from the exchange and maximizes each party's opportunity to profit from the transaction. Such parties understand that, if the joint surplus arising from the allocation of rights and obligations in the contract is increased, then the price term, which divides this joint surplus between them, can be adjusted in a manner that makes both parties better off. Assuming other branches of the law prohibit business combinations that generate significant negative externalities (as, for instance, the antitrust laws prohibit combinations that substantially increase market power),<sup>28</sup> business combination transactions increase social welfare by increasing the welfare of the parties to the transaction more than they decrease the welfare of others. Hence, society has an interest in seeing that such transactions are structured efficiently.

Since the acquirer is a rational profit-maximizer, its interest in acquiring the target is limited to the value it can capture by owning the target.<sup>29</sup> This is true if the acquirer is a strategic buyer, who usually hopes to combine the target's business with its own existing business, capturing value from synergies as well as from the target's own cash flows, and it is true if the acquirer is a financial buyer, who hopes to improve the business of the target and then resell the company in the midterm at a substantial profit. For this reason, the price that the acquirer will pay in the transaction is highly dependent on what it comes to believe about the future cash flows of the target, their riskiness, and, in the case of a strategic buyer, the potential synergies between the target and its own existing business.

The process leading to a business combination transaction may begin in any number of ways, ranging from the acquirer approaching a target that previously had no intention to sell itself,<sup>30</sup> to a seller engaging an investment banker to approach potential buyers,<sup>31</sup> to an activist shareholder

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28. See generally Philip E. Areeda and Herbert Hovenkamp, Antitrust Law § 910 et seq. (2018).

29. But see Robert T. Miller, *Inefficient Results in the Market for Corporate Control: Highest Bidders, Highest-Value Users, and Socially-Optimal Owners*, 39 J. CORP. L. 71 (2013) (arguing that, in certain cases, an acquirer will pay more for a target than the present value of its future cash flows in order to prevent damage to its pre-existing business that would result if a competitor acquired the target).

30. See, e.g., *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009).

31. See, e.g., *In re Netsmart Tech., Inc. Shareholders Litig.*, 924 A.2d 171 (Del. Ch. 2007).

goads a reluctant board into a sales process.<sup>32</sup> But, however the process begins, there is a significant constant: one of the greatest difficulties that parties to business combination transactions face concerns the buyer's lack of information about the seller.<sup>33</sup> This problem has two aspects. On the one hand, it is a problem for both parties, as the buyer will not make an offer to purchase the company without a sufficient understanding of its business, and how much the buyer will offer will depend on how much it thinks the company is worth, which in turn depends on the information about the company the buyer possesses. Hence, both parties have incentives to create an efficient process whereby the buyer can acquire information from the seller about its business. To the extent that this information is positive (that is, supports a higher valuation of the seller's business), both sides have incentives for the seller to disclose the information to the buyer. On the other hand, the information problem is especially a problem for the buyer, for the seller will always have a better understanding of the business than will the buyer, and this asymmetry exposes the buyer to opportunistic behavior by the seller.<sup>34</sup> In particular, the seller has incentives to conceal negative information about the business, which the buyer has an incentive to ferret out. While obviously important, this aspect of the situation should not be exaggerated, for sellers also have partly countervailing incentives to disclose even negative information about the business. Sophisticated and experienced buyers will usually discover the information in any event (they tend to know where the pitfalls lie) and being straightforward about negative aspects of the business allows the seller to put its own construction on such information, to manage the buyer's expectations, and to build credibility by being forthcoming contrary to its own immediate interest. In general, therefore, the interests of the parties are closely, but not perfectly, aligned in favor of the seller disclosing information about the business to the seller.<sup>35</sup> The market has

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32. See, e.g., *In re PLX Tech. Inc. Shareholders Litig.*, C.A. No. 9880-VCL (Del. Ch. Oct. 16, 2018).

33. The text assumes a transaction in which the consideration is cash and thus in which one party is clearly the buyer, the other the seller. In transactions in which the consideration is stock or other securities of the buyer, in effect both parties are buyers and both parties are sellers. See generally NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 1.07. In such cases, the information problems—and the solutions thereto—are reciprocal, but this does not affect the analysis in this Article, and so without loss of generality I shall assume one party is the buyer and the other the seller.

34. Blair, *supra* note 9, at 432 (discussing asymmetric information problem and stating, “[b]uyers know little about the characteristics and qualities of sellers and their promised performances, including sellers’ propensities to act opportunistically.”).

35. There are odd occasional exceptions. For instance, in *In re IBP, Inc., Shareholders Litig.*, the seller, IBP, the nation’s leading producer of beef, was auctioning itself, and the

evolved tools and customs to deal with this information problem. The most important of these is the due diligence process.<sup>36</sup> That is, before the parties enter into a definitive agreement regarding the transaction, the seller provides the buyer with tremendous amounts of non-public information about the target. This typically involves the seller making available to the buyer (and its advisors and experts) tens of thousands of pages of information about the target in electronic data rooms, and further supplementing this information with in-person presentations, meetings, and on-site inspections of the properties and assets of the target business.<sup>37</sup>

Such disclosure to the buyer of non-public information about the target makes the seller vulnerable to various types of opportunistic behavior by the buyer, such as misappropriating the seller's trade secrets or other competitively sensitive information. To limit the possibility of such behavior, the seller typically makes such information available to the buyer only after the parties enter into a preliminary legal agreement, often styled a confidentiality agreement or non-disclosure agreement.<sup>38</sup> The key provisions in this agreement usually include promises by the buyer not to further disclose the non-public information that it receives from the seller, and not to use such information for any purpose other than evaluating the potential transaction with the seller.<sup>39</sup> Indeed, the buyer usually has its own

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bidders were Tyson, the nation's leading producer of chicken, and Smithfield Foods, the nation's leading producer of pork. 789 A.2d 14, 21 (Del. Ch. 2001). While Tyson was uninvolved in the beef business, IBP was also the nation's second largest producer of pork. *Id.* In providing the parties due diligence materials, IBP held back from both parties some competitively sensitive information, because, although it was willing to let Tyson see the information, it was not willing to let Smithfield do so. *Id.* at 33. To comply with its *Revlon* duties, IBP informed Tyson that it would make the information available to Tyson if Tyson so desired, but if it did so, it would also have to make the same information available to Smithfield. *Id.*

36. See NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at §§ 8.01-8.04 (explaining the purpose of due diligence, including the lawyer's role); CRAIG E. CHAPMAN, CONDUCTING DUE DILIGENCE (2004) (outlining the steps of the due diligence process); see also Blair, *supra* note 8, at 434 (discussing preliminary negotiations and the due diligence process).

37. See Lipshaw, *supra* note 9, at 439 (discussing due diligence in the underlying transaction in *Abry Partners*).

38. See generally IGOR KIRMAN, M&A AND PRIVATE EQUITY CONFIDENTIALITY AGREEMENTS LINE BY LINE (2008); see also NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 1.04[1][a] (2017) (discussing confidentiality agreements and their role in the deal process).

39. See *Martin Marietta Materials Inc. v. Vulcan Materials Co.*, 68 A.3d 1208 (Del. 2012) (holding that a company that received information under a confidentiality agreement for the exclusive purpose of negotiating a transaction with the party providing the information breached the agreement when it used the information to launch a hostile tender offer). There are minor exceptions. For example, if the parties are significant competitors,

incentives to want the seller's confidential information to remain confidential: if the transaction goes through, the seller becomes a subsidiary of the buyer, and so any disclosure that hurts the seller will ultimately hurt the buyer.<sup>40</sup>

Information about the target business is valuable to the buyer, however, only to the extent that it is reliable. The reliability of the information that the buyer receives from the seller in due diligence can be enhanced in many ways, including by the buyer's independent efforts to verify it and the reputation costs that the seller may incur if the information proves false.<sup>41</sup> The most effective way for the seller to enhance the reliability of the information it conveys to the buyer, however, is to assume legal liability for inaccuracies or omissions in such information. As explained more fully below however, originally the seller's liability for such inaccuracies or omissions supported actions in tort, not contract. This historical accident in the development of the common law introduced a great deal of complexity. The key contractual tool for dealing with this

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sharing certain kinds of pricing and cost information could violate the antitrust laws. Similarly, if the target is worried that a competitor is not serious about acquiring the target, but merely wants to gain a competitive advantage over the target by learning confidential information about it, the target may be reluctant to share such information. See *In re IBP, Inc.*, 789 A.2d at 33 (discussing how a target corporation wanted to keep competitively sensitive information from a potential acquirer that was also a competitor).

40. For simplicity, the text presupposes that the consideration paid by the acquirer to the seller (or its shareholders) is cash. In such a transaction, the seller has no continuing interest in the business after the completion of the deal. If the consideration paid by the acquirer is its own stock, however, then the seller (or its shareholders) will hold such stock in what, after the completion of the transaction, is the combined company. In such cases, the seller will care about the condition of the combined business (and so the condition of its own business after closing) because this affects the value of the securities it receives in the merger. See generally Robert T. Miller, *The Economics of Deal Risk: Allocating Risk through Mac Clauses in Business Combination*, 50 WM. & MARY L. REV. 2007 (2008).

41. More accurately, the reputation costs for the individual employees and agents of the sellers tend to afford the buyer some basis for thinking the information disclosed is reliable. The seller itself, if the transaction closes, will cease to be an independent entity, and so in the sales process, it faces a last period problem. The same may be true for employees who will effectively retire as a result of the transaction, or otherwise become so personally wealthy that they can disregard any reputational interests. This is one reason that professional legal and financial advisors add value: by being consummate repeat players with comparatively little at stake in any one transaction, their behavior is much more sensitive to reputational concerns than that of their principles. See generally JOHN C. COFFEE, *GATEKEEPERS: THE ROLE OF THE PROFESSIONS AND CORPORATE GOVERNANCE* (2006). See also *Abry Partners V, L.P. v. F&W Acquisition, LLC*, 891 A.2d 1032, 1061 (Del. Ch. 2006) (“[j]udicial decisions are not the only way that commercial norms of fair play are instilled,” and “the nature of [the] market is still such that reputational factors are likely to be important.”).



complexity is the non-reliance clause: a promise by the buyer that it is relying only on the representations and warranties<sup>42</sup> in the definitive agreement, and thus not on the vast amount of information made available to it in due diligence.<sup>43</sup> The next section of this Part of the Article explains the relevant common law doctrines, the contractual provisions sophisticated parties use to contract around some of these in business combination transactions, and the judicial response such attempts have met in the leading commercial law jurisdictions of Delaware and New York.

#### *A. The Intersection of Contract and Tort*

In order to know whether a contract is worth making, the contracting parties need to ascertain and quantify the value of the rights they will acquire and the obligations they will incur under the contract. For sophisticated parties entering business combination transactions, those incentives are especially strong. The reason is that, given the very large amounts of money involved in such transactions, the transaction costs of making the contract complete (that is, specifying the rights and obligations of the parties in great detail) tend to be quite small by comparison and therefore worth incurring. In addition, these costs tend to be smaller for sophisticated parties than for others because the parties' sophistication and experience give them advantages in writing complete contracts. Agreements memorializing business combination transactions, therefore, tend to include elaborate divisions and allocations of rights and obligations. While no contract is ever literally complete, business combination agreements between sophisticated parties are among the most complete contracts encountered in the real world.

By far the cheapest way to make certain what the parties' rights and obligations are is to specify them explicitly in the written agreement. For this to work, however, the written agreement must contain the entire allocation of rights and obligations between the parties in the sense that whatever express agreements there really are between the parties, these

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42. NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at §§ 11.01-11.04; JAMES C. FREUND, ANATOMY OF A MERGER §§ 7.01-7.4 (1975). Representations and warranties are heavily negotiated. *See id.* at 229 (stating that, although there are "no known statistics on the subject," the author would "bet [his] briefcase that lawyers spend more time negotiating 'Representations and Warranties of the Seller' than any other single article in the typical acquisition agreement.").

43. *See* NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 1.06 (discussing the relationship between due diligence and representations and warranties).

express agreements are included in the written agreement.<sup>44</sup> If this is not the case, then any attempt to determine what the parties' rights and obligations actually are quickly devolves into difficult, expensive, and uncertain factual inquiries about who said what to whom in what context during the process of negotiating the contract. In the case of a business combination transaction, given the very large number of individuals involved for both parties — businesspeople, legal counsel, accountants, financial advisors, and other experts — and the typically long and complex negotiations leading to such transactions,<sup>45</sup> this inquiry is especially difficult, expensive, and uncertain. Procedurally, this factual uncertainty means that any lawsuit based on alleged extra-contractual promises or representations will likely be impossible to dismiss on the pleadings, will proceed to discovery and summary judgment, and perhaps even to trial to resolve disputed factual matters.<sup>46</sup> These procedural realities can lead unscrupulous plaintiffs to engage in opportunistic behavior, for even weak cases will have considerable settlement value for defendants.<sup>47</sup>

For these entirely familiar reasons, the common law has long responded to this problem with the parol evidence rule, which provides that

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44. The text refers to completeness of the agreement in the sense used by the parol evidence rule that there are no express agreements between the parties related to the transaction not memorialized in the agreement. As noted in the text, although business combination agreements are unusually complete, they are not (and cannot be) literally complete in the sense that contract theory uses the expression “complete”.

45. See e.g., NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 1.04[a][1] (discussing the transaction process); see also Davis, *supra* note 9, at 488-89 (discussing complex negotiations leading to business combination transactions).

46. *Abry Partners V, L.P. v. F&W Acquisition, LLC*, 891 A.2d 1032, 1058 (Del. Ch. 2006); see also Blair, *supra* note 9, at 465-66 (stating, that “[a] plaintiff alleging fraud stands a very good chance of surviving any pretrial efforts that a defendant might make to cut short the litigation,” and “[s]ellers faced with fraud claims . . . are likely to be forced to incur legal fees through a trial.”); Lutz, *supra* note 9, at 842 (discussing effects of not enforcing non-reliance clauses on litigation); Masson, *supra* note 9, at 513 (arguing that non-reliance clauses mitigate the potential hold-up problem arising from the expense and difficulty of dismissing opportunistic, non-meritorious suits based on allegedly fraudulent extra-contractual misrepresentations); West & Lewis, Jr., *supra* note 2, at 999 (stating, that “fraud and negligent misrepresentation claims have proven to be tough . . . easy to allege, hard to dismiss.”).

47. As Judge Posner has said in a related context, without some way to limit such suits, “sellers would have no protection against plausible liars and gullible jurors.” *Carr v. CIGNA Securities, Inc.*, 95 F.3d 544, 547 (7th Cir. 1996); see also Robert F. Quaintance, Jr., *Division of Opinion in the Colonies — “Non-Reliance Clauses,”* 7.4 M & A LAW 17, 18 (stating that if non-reliance clauses are not effective to block fraud suits based on extra-contractual representations, although “seller will likely still win” the suit, “seller may be forced to go through discovery which . . . can create significant incentive for seller to pay something and settle.”).

if a written agreement appears complete, courts will not consider extrinsic evidence (whether via other documents or oral testimony) about promises allegedly made during negotiations but not included in the written agreement.<sup>48</sup> From the point of view of sophisticated parties wanting to ensure that their written agreement is treated as the entire agreement between them, the only problem with the parol evidence rule is making sure that it will be applied. That problem is easily solved by including in the written agreement an integration clause: a provision expressly stating that the written agreement is the entire agreement between the parties and supersedes any other agreements, written or oral, that may have existed.<sup>49</sup> Unsurprisingly, therefore, business combination agreements between sophisticated parties virtually always include integration clauses.<sup>50</sup>

Nevertheless, the parol evidence rule and the integration clauses that invoke it have nearly universally been held not to affect which representations a party may have made for purposes of a fraudulent inducement claim.<sup>51</sup> Many commentators understand the reluctance of

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48. See FARNSWORTH ON CONTRACTS, *supra* note 4, at §§ 7.2-7.3 (discussing parol evidence rule and related doctrines); see also *Extra Equipamentos E Exportacao Ltda. v. Case Corp.*, 541 F.3d 719, 723 (7th Cir. 2008) (Posner, J) (explaining the parol evidence rule).

49. See *e.g.*, West & Lewis, Jr., *supra* note 2, at 1019 (stating that “most contracting parties include merger [i.e., integration] clauses in their agreements to trigger the parol evidence rule”).

50. *Id.*

51. See *Kronenberg v. Katz*, 872 A.2d 568, 593 (Del. Ch. 2004) (holding that although non-reliance clause can block fraud in the inducement claims, for a contract to bar such a claim it “must contain language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract’s four corners in deciding to sign the contract” and “a standard integration clause alone, which does not contain explicit anti-reliance representations and which is not accompanied by other contractual provisions demonstrating with clarity that the plaintiff had agreed that it was not relying on facts outside the contract, will not suffice to bar fraud claims.”); see also *Abry Partners V, L.P. v. F&W Acquisition, LLC*, 891 A.2d 1032, 1058 (Del. Ch. 2006) (stating that Delaware courts have not treated as non-reliance clauses “merger or integration clauses that do not clearly state that the parties disclaim reliance upon extracontractual statements”). See, *e.g.*, *Altman*, *supra* note 9, at 747 n.2 (stating that “an integration clause that specifically references representations and warranties would likely have an effect similar to that of a non-reliance clause, while a more customary reference only to ‘agreements and understandings’ probably would not”); *Blair*, *supra* note 9, at 436-438 (distinguishing simple merger clauses from non-reliance clauses and noting that merger clauses affect only claims arising in contract, not tort claims such as fraudulent inducement); *Cummings*, *supra* note 9, at 72-73 (stating that while some courts have allowed integration clauses to block suits sounding in tort based on extracontractual representations, other courts have concluded that an integration clause does not affect suits, such as fraudulent inducement, that sound in tort); *Davis*, *supra* note 9, at 489-490 (stating that courts commonly distinguish between integration clauses, which limit actions sounding in contract,

courts to read integration clauses as limiting which representations a party has made as being part of a general hostility by courts towards allowing the parties to limit contractually their liability in tort. While this is no doubt largely correct, there is in fact a good deal more going on. For one thing, integration clauses are clauses in contracts, and the parol evidence rule is a rule of contract law. Hence, from a formalistic, doctrinal point of view, neither an integration clause nor the parol evidence rule can operate to block a claim sounding in *tort*, which fraudulent inducement undoubtedly does.<sup>52</sup> Moreover, this formalistic distinction can be grounded in more than the arguably artificial categories of the common law, for fraudulent inducement (and, for that matter, the claim of contractual misrepresentation) is based not on the defendant's promises, but on his representations. Representations, of course, are not promises but declarative statements about present or past facts in being.<sup>53</sup> Why, however, should this difference matter? One possible answer is that, although it makes perfect sense for the parties to agree later about which

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and non-reliance clauses, which seek to limit actions sounding in tort); Haas, *supra* note 9, at 72-73 (discussing the rule in *Kronenberg* that, to block fraud suits based on extracontractual representations, the contractual language must clearly and unambiguously state that a party is not relying on such representations); Lutz, *supra* note 9, at 804 n.4 (noting the difference between "an integration clause, providing that all of the parties' earlier dealings and written agreements are integrated into the final agreement" and "a non-reliance clause, providing that the parties may not rely on any representations not contained in the final written agreement," and stating that although "[t]he effect of both clauses is substantially similar," nevertheless "[s]ome courts . . . have noted that an integration clause is less explicit in reference to reliance, and therefore may have less evidentiary value than a non-reliance clause to prove the lack of reliance."); Siedel, *supra* note 9, at 8 (stating that "[o]ften a clear distinction is not made between broad merger and integration clauses (which state that the writing represents the entire contract) and specific anti-reliance language"); West & Lewis, Jr., *supra* note 2, at 1018 (stating that "it is important to distinguish between an explicit disclaimer-of-reliance provision and a standard merger or integration clause").

52. See *Extra Equipamentos E Exportacao Ltde.*, 541 F.3d at 723 (explaining that, under the parol evidence rule, "evidence of what was said in the negotiations that led up to the signing of the [contract] would not be admissible - in a suit for breach of contract," but because "[t]he parol evidence rule is a rule of contract law, and a contract integration clause is a privately negotiated supplement to the rule," it follows that "neither the rule nor the clause prevents a disappointed party to the contract from basing a tort suit on proof that in the course of negotiations the other party made fraudulent misrepresentations."); see also Davis, *supra* note 9, at 490 (discussing how some courts have "held that the parol evidence rule is merely a rule of contract law that only bars actions that 'sound in contract', but cannot bar claims that sound in tort.").

53. See, e.g., FARNSWORTH ON CONTRACTS, *supra* note 4, at §§ 7.2-7.3. As we will see below, a warranty is a promise that a representation is true, and so if a warranty is breached, the breached-upon party has a remedy in contract — expectation damages to put him in the position he would have enjoyed had the warranted statement of fact been true. See *infra* notes 62-67 and accompanying text.

*promises* they are making to each other, it is not quite the same with which *representations* they have made. That is, if during preliminary negotiations, one party makes a promise to another, nothing prevents the parties from later agreeing to void this promise. The promisee can agree to relinquish whatever rights he acquired from the promisor under the promise. It is within the parties' power to unmake promises just as it is within their power to make them. But whether or not a party made a representation is a matter of past fact; technically speaking, if such a thing happened, the parties can no more agree that it did not happen than they can agree that the Civil War did not happen.<sup>54</sup> Hence, reading it literally, an integration clause that merely states that the writing containing it contains the entire agreement between the parties does not extinguish previously made representations the way it can extinguish previously made promises.

The way around this difficulty is for the party to whom representations may have been made to agree not to rely on any representations except those contained in the definitive agreement. While the parties cannot change the past facts about which representations were made, they can change their present behavior and not rely on certain representations other than those specified. This extra step about reliance, of course, is precisely the one taken in a non-reliance clause as distinguished from a mere integration clause.<sup>55</sup>

So, if the law allows parties, by means of the parol evidence rule and integration clauses, to limit the promises they undertake to those included in their written agreement, should the law not also allow parties by means of non-reliance clauses to limit the representations they are making to those

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54. Indeed, eminent theologians like Aquinas and Augustine have taught that even God cannot change the past. See, e.g., Thomas Aquinas, *De Aeternitate Mundi*, in OPERA OMNIA SANCTI THOMAE AQUINATIS, AQUINAS INSTITUTE (forthcoming), available in a prior version in ON THE ETERNITY OF THE WORLD, INTERNET MEDIEVAL SOURCEBOOK (Robert T. Miller trans., Fordham Univ. 1997), at <https://sourcebooks.fordham.edu/basis/aquinas-eternity.asp> [<https://perma.cc/7QTL-X7CE>] (stating, "God cannot make [contradictory] things come to be, for the assumption that such a thing exists immediately refutes itself. Nevertheless, if we allow that God can make such things come to be, the position is not heretical, though I believe it is false, just as the proposition that the past did not occur is false," about which Augustine says that "anyone who says 'if God is omnipotent, let him make what has happened not to have happened,' does not realize that he is saying, 'If God is omnipotent, let him make true things false insofar as they are true.'"). If God cannot change the past, so much less, therefore, may contracting parties do so, even sophisticated ones.

55. See *Extra Equipamentos E Exportacao Ltda.*, 541 F.3d at 724 (explaining that since a "suit for fraud can be a device for trying to get around the limitations [of] the parol evidence rule and contract integration clauses," "[n]o-reliance clauses serve a legitimate purpose in closing a loophole in contract law.").

included in their written agreement?<sup>56</sup> As explained more fully in Section B of this Part of the Article, in leading commercial jurisdictions such as Delaware and New York that sensible result is possible today, at least for sophisticated parties. For a long time, however, this was not the case, and the reason takes us back to the vagaries of the history of the common law.

As noted above, although actions based on a breach of promise always sounded in contract, actions based on the falsity of a representation originally sounded in tort. In particular, they were actions for deceit.<sup>57</sup> This matter of legal categorization had many important effects. One was that reliance (or reasonable reliance) by the plaintiff on the allegedly false representation was an element of the cause of action, for someone who does not rely on a false representation can hardly be said to have been *deceived* by it. This is quite different from the usual understanding in contract law. Even if, at the time the contract is made, one party does not believe the other will perform, the breached upon party still has a good claim for breach of contract when the breach occurs. A second effect concerned the measure of damages. That is, although the standard measure of damages in contract is expectation damages,<sup>58</sup> in tort the measure is compensatory damages.<sup>59</sup> In addition, in appropriate cases, tort claims can

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56. The parol evidence rule would presumably block an action for breach of warranty based on an extra-contractual statement, for such would in fact be an extra-contractual promise. Blair, *supra* note 9, at 434.

57. See West & Lewis, Jr., *supra* note 2, at 1009-10, who explain that “courts have not always recognized the distinction between tort-based misrepresentation claims and contracts-based warranty claims,” the distinction between which is discussed below. 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 and instead viewed these claims as grounded in deceit or fraud. 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. Even after courts began enforcing express warranties 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.” *Id.*; see also Masson, *supra* note 9, at 508 (stating “[w]arranty law grew out of tort actions for deceit, but eventually was recognized as a distinct part of contract law.”).

58. “Delaware courts historically have endorsed the concept of the ‘efficient breach’ of contract — a theory of contract law which urges expectation damages as a remedy in order to encourage a promisor’s breach where resulting profits to the promisor exceed the loss to the promisee.” *Cornell Glasgow LLC v. La Grange Properties LLC*, No. N11C-05-016, 2012 WL 2106945, at \*8 (Del. Super. Ct. Jun. 6, 2012).

59. See, e.g., *Harman v. Masonelian Int’l, Inc.*, 442 A.2d 487, 499 (Del. 1982) (stating, “[t]he damages available for deceit and fraudulent misrepresentation are generally limited to

support awards of punitive damages,<sup>60</sup> which are generally not available for contract claims, even when the breach of contract has been knowing and intentional. A third effect arose from the idea that if one party to a contract deceived another with respect to a fact at the time the contract was made, the deceived party's consent to the contract was not effectively given.<sup>61</sup> This is a large part of the meaning of the common law maxim that fraud vitiates everything.<sup>62</sup> On this theory, as a result of the misrepresentation, there never was an enforceable contract between the parties to begin with,

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those which are the direct and proximate result of the false representation and which represent the 'loss-of-the-bargain' or actual 'out-of-pocket' loss"). That is, the Delaware Supreme Court has also allowed the award in tort cases of what amount to expectation damages. Thus, "Delaware law recognizes two measures of damages both in cases of fraud or deceit," namely (a) "the benefit of the bargain rule," under which "the plaintiff recovers the difference between the actual and the represented values of the object of the transaction," and the aim of which "is to put the plaintiff in the same financial position that he would have been in if the defendant's representations had been true," and (b) "the other rule" which "gives the plaintiff the difference between what he paid and the actual value of the item," which is "the out of pocket measure, and is designed to restore the plaintiff to his financial position before the transaction occurred."). *Stephenson v. Capano Dev., Inc.*, 482 A.2d 1069, 1076 (Del. 1983). Naturally, "[i]f the fraud is gross, oppressive, or aggravated, or where it involves breach of trust or confidence, the plaintiff may recover punitive damages." *Id.* at 1076-77.

60. *Id.*; see also Blair, *supra* note 9, at 471 (discussing importance of punitive damages in actions for fraud).

61. The idea goes back to Aristotle, who thought ignorance of important facts made an agent's action less than voluntary. ARISTOTLE, *NICOMACHEAN ETHICS*, 3.1.1110-1111 (W.D. Ross, trans. 1999).

62. See *Pearson & Son Ltd. v. Dublin Corp.*, [1907] A.C. 351 (HL), 362 (appeal taken from Ir.) (stating that "fraud vitiates every contract and every clause in it"); *Bridger v. Goldsmith*, 143 N.Y. 424, 428 (1894) (stating that "a party who has perpetrated a fraud upon his neighbor may [not] . . . contract with him in the very instrument by means of which it was perpetrated, for immunity against its consequences, close his mouth from complaining of it and bind him never to seek redress. Public policy and morality are both ignored if such an agreement can be given effect in a court of justice. The maxim that fraud vitiates every transaction would no longer be the rule but the exception."); *United States v. Throckmorton*, 98 U.S. 61, 64 (1871) (stating "[t]here is no question of the general doctrine that fraud vitiates the most solemn contracts, documents, and even judgments."); see also *Danann Realty Corp. v. Harris*, 5 N.Y.2d 317, 323-33 (Fuld, J., dissenting) (arguing that the traditional view that fraud vitiates everything should make non-reliance clause unenforceable); Blair, *supra* note 9, at 426 (discussing the traditional view that fraud vitiates everything); West & Lewis, Jr., *supra* note 2, at 1021-22 (explaining that, historically, judicial "decisions addressing the ability of contracting parties to disclaim liability for 'fraudulent' misrepresentations . . . were decidedly more negative," and "influenced by the widely accepted legal maxim that 'fraud vitiates everything it touches,' 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, unlike tort-based liability for negligent or innocent representations, could not be contractually disclaimed.").

and so the appropriate remedy is therefore rescission (or, when rescission is not practicable, rescissionary damages).

The development of the common law at this intersection of contract and tort has varied considerably from jurisdiction to jurisdiction. Generally speaking, however, this development has resulted in essentially three possible causes of action that can be based on a false representation. First, at one extreme, there is an action that rests squarely within contract law: the action for breach of an express warranty. Here, the representation, which is a statement of past or present fact, is taken to be coupled with a promise that the statement is true (i.e., a warranty).<sup>63</sup> It is this promise that places breach of warranty firmly within the law of contracts. To prevail in such an action, the plaintiff party must prove, besides the existence of a contract and its own performance (or willingness to perform) thereunder, (a) that its contractual counterparty made a statement of fact, (b) that the counterparty promised that the statement was true, and (c) that the statement was false, which of course implies that the promise was breached.<sup>64</sup> There is no requirement that the party show it relied on the promise or the related statement of fact.<sup>65</sup> If the party can prove that the counterparty warranted the factual statement in question and the statement was false, then it is entitled, as in contract claims generally, to expectation damages for the breach. As Judge Learned Hand put it, “A warranty is an assurance by one party to a contract of the existence of a fact,” and “it amounts to a promise to indemnify the promisee for any loss if the fact warranted proves untrue.”<sup>66</sup> A claim for breach of an express warranty is

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63. As West and Lewis explain, “although some modern commentators disagree about whether there is a difference between ‘representations’ and ‘warranties,’ there is a very clear distinction between actions premised upon misrepresentations and actions premised upon breaches of express warranties.” West & Lewis, Jr., *supra* note 2, at 1008. “A claim based upon a breach of an express warranty . . . is premised upon one party’s specific contractual promise that a stipulated fact or set of facts is correct. 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.” *Id.* at 1008-09.

64. *Metropolitan Coal Co. v. Howard*, 155 F.2d 780, 784 (2d Cir. 1946); *see, e.g.*, *Rogath v. Siebenmann*, 129 F.3d 261 (2d Cir. 1997) (holding that in a suit for breach of express warranty, the plaintiff need prove only that the defendant made a statement and the statement was false); *CBS Inc. v. Ziff-Davis Publishing Co.*, 75 N.Y.2d 496 (N.Y. 1990); *Ainger v. Michigan Gen. Corp.*, 476 F.Supp. 1209 (S.D.N.Y. 1979), *aff’d* 632 F.2d 1025 (2d Cir. 1980).

65. *See CBS Inc.*, 75 N.Y.2d at 1001 (holding that “[t]he right to be indemnified in damages for [the warranty’s] breach does not depend on proof that the buyer thereafter believed the assurances of fact made in the warranty would be fulfilled”).

66. *Metropolitan Coal Co.*, 155 F.2d at 784.



thus a straightforward claim for breach of contract.<sup>67</sup> The only difference, which turns out to be a legally immaterial difference, is that the promise breached did not concern what the counterparty would do or not do, but whether a certain factual assertion was true. Since this action sounds in contract, and since it is based on a statement made by the counterparty, there can be no question but that such actions may be based only on representations made by the counterparty in the contract. If the underlying representation is not in the contract, then the promise that it is true cannot be in the contract either. Hence, the parol evidence rule will block an action for breach of express warranty based on representations not included in an integrated contract.

Second, at the opposite extreme, there is the action for fraudulent inducement, which rests squarely within tort law. Here, the plaintiff must prove that (a) the defendant falsely represented or omitted facts that the defendant had a duty to disclose; (b) the defendant knew or believed that the representation was false or made the representation with a reckless indifference to the truth (*scienter*); (c) the defendant intended to induce the plaintiff to act or refrain from acting; (d) the plaintiff acted in justifiable reliance on the representation; and (e) the plaintiff was injured by its reliance.<sup>68</sup> Such an action supports compensatory and, in an appropriate case, punitive damages. Some of the other differences from the contract claim are also clear. Though an element of any intentional tort, *scienter* is not an element of a breach of contract claim. Neither, as noted above, is reliance by the plaintiff or deception by the defendant. Naturally, the parol

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67. See *CBS Inc.*, 75 N.Y.2d at 1001 (stating “[t]he express warranty is as much a part of the contract as any other term.”).

68. RESTATEMENT (SECOND) OF TORTS, § 525 (AM. LAW. INST. 1977); see also *Abry Partners V, L.P. v. F&W Acquisition, LLC*, 891 A.2d 1032, 1068 (Del. Ch. 2006) (listing the elements of fraudulent inducement); *DCV Holdings, Inc. v. Conagra, Inc.*, 889 A.2d 954, 958 (Del. 2005) (elements of common-law fraud); *Barks v. Herzberg*, 206 A.2d 507, 508 (Del. 1965) (elements of common-law fraud). The law is essentially the same in New York. See, e.g., *Young v. Keith*, 112 A.D.2d at 626 (stating “[a] claim for fraud must allege a representation of a material existing fact, falsity, scienter, deception, and injury”); see also *Bridgestone/Firestone, Inc. v. Recovery Credit Services, Inc.*, 98 F.3d 13, 19 (2d Cir. 1996) (stating “[t]o prove fraud under New York law, a plaintiff must show that (1) the defendant made a material false representation, (2) the defendant intended to defraud the plaintiff thereby, (3) the plaintiff reasonably relied upon the representation, and (4) the plaintiff suffered damage as a result of such reliance.”); *Banque Arabe et Internationale D’Investissement v. Maryland Nat’l Bank*, 57 F.3d 146, 153 (2d Cir. 1995) (stating that in New York, fraudulent misrepresentation requires that (a) the defendant make a material, false representation, (b) the defendant intended to defraud the plaintiff thereby, (c) the plaintiff reasonably relied upon the representation, and (d) the plaintiff suffered damages as a result of such reliance.); see also *West & Lewis, Jr.*, *supra* note 9, at 1013 (discussing elements of common-law fraud).

evidence rule, being a rule of contract law, does not apply to claims of fraudulent inducement, even when the parol evidence rule is expressly triggered by an integration clause. As indicated above, this is the crucial point, for it leads to the invention and use of non-reliance clauses.

Finally, between the two extremes lies a third cause of action that is governed neither entirely by contract principles nor entirely by tort principles, although it is conventionally regarded as a contract claim: the action for contractual misrepresentation. To prove this cause of action, the plaintiff has to prove that (a) the defendant made a statement of fact, (b) that was false, (c) and material, and (d) on which the plaintiff actually and reasonably relied.<sup>69</sup> If the plaintiff succeeds, he is entitled to rescind the contract or, if rescission is impracticable, to collect rescissionary damages.<sup>70</sup> Clearly, contractual misrepresentation has some contract-like elements and some tort-like ones. Like actions in contract, it does not require a showing of scienter, but like actions in tort, it does require a showing of reliance.<sup>71</sup> The remedy it supports is not typical for either contract (expectation damages) or tort (compensatory damages) but a curious mixture of both tort and contract. It is contract-like in that it assumes that a party who consents to a transaction while mistaken about material facts does not consent effectively, and it is tort-like in requiring that the mistake arise from the action by the other party (the misrepresentation), albeit even an innocent one.<sup>72</sup> Finally, in another tort-

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69. RESTATEMENT (SECOND) OF CONTRACTS, §§ 162-164 (AM. LAW. INST. 1981); FARNSWORTH ON CONTRACTS, *supra* note 4, at §§ 4.12-4.13; *see, e.g.*, In re IBP, Shareholders Litig., 789 A.2d 14, 72 (Del. Ch. 2001) (listing elements of contractual misrepresentation under New York law); Kronenberg v. Katz, 872 A.2d 568, 593 (Del. Ch. 2004) (listing the elements of contractual misrepresentation).

70. *Id.*; *see also* West & Lewis Jr., *supra* note 2, at 1016-17 (stating that “[w]hile rescission is the only remedy available for a pre-contractual misrepresentation under contract law, a plaintiff may seek compensatory damages for the same misrepresentation under tort law.”).

71. Masson, *supra* note 9, at 508. Masson speaks of “warranty law,” but in context it is clear he means contractual misrepresentation, which he describes as “an area of contract law that retains some vestiges of tort law, such as reliance.” *Id.*

72. That is, if we really took seriously, for contract law purposes, Aristotle’s idea that a man who acts in ignorance does not act voluntarily, then, regardless of the source of the mistake, the party entering the contract less than voluntarily would be entitled to rescind. This is, of course, not the law. A unilateral mistake of fact without fault on the other side does not support an action to rescind the contract. *See generally* FARNSWORTH ON CONTRACTS, *supra* note 4, at §9.4 (stating that “courts have been reluctant to allow a party to avoid a contract for a mistake that was not shared by the other party”). To be clear, I am in no way criticizing these traditional contract doctrines; I am merely pointing out that the action for contractual representation, by including something like the notion that the mistake by one party must be caused by the (fault of the) other party has certain tort-like qualities.

like aspect, at least in some jurisdictions, actions for contractual misrepresentation, even though typically sounding in contract, may be based on a party's extra-contractual statements, even when the contract is fully integrated.

Although actions based on breach of an express warranty must be based on representations made in the agreement, actions for fraudulent inducement and contractual misrepresentation may be based both on statements made in the agreement and on extra-contractual statements. The problem for sophisticated parties attempting to determine and quantify the value of their obligations, therefore, becomes how to limit actions for contractual misrepresentation or fraudulent inducement to claims based on representations made in the agreement. It may seem that the problem admits of a simple solution: a clause in the agreement analogous to the integration clause, but providing that the only representations and warranties made are the ones contained in the agreement, and such representations and warranties supersede any others that may have been made previously. Such a clause, however, would likely be ineffective for several reasons. In addition to all the reasons courts have found for not honoring non-reliance clauses (of which, more below), there is the reason suggested above that representations are different from promises, which parties can agree to make and unmake as they please, because once a representation is made, the parties cannot by agreement change the past, as it were, and cause the representation not to have been made.<sup>73</sup> Thus, regardless of any purported agreement about which representations were made, there seems to be nothing to stop a party from proving that all the elements of a claim for contractual misrepresentation or fraudulent inducement, and so a clause analogous to an integration clause purporting to undo representations previously made is — or at least may seem to be — literally nonsense.

If the parties cannot agree that representations made were not made, what can they do to block actions based on contractual or fraudulent misrepresentations? As suggested above, the answer lies in the fact that both causes of action include as an element reliance on the alleged misrepresentation by the party to whom it was made. Unlike whether a certain event (one party's making a representation) in fact occurred in the past, whether or not a party relies in the present, as it enters into a contract, on a representation made to it by the counterparty in the past, is within the party's power. Hence, the party to whom a representation was made can agree that it is not relying on any representations by the counterparty other

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73. See *supra* notes 52-54 and accompanying text.

than those included in the written agreement, and this is the non-reliance clause that is at the center of this Article.<sup>74</sup> I now turn to the law's treatment of such clauses.

*B. The Treatment of Non-Reliance Clauses at Common Law*

Before considering the treatment of non-reliance clauses in particular jurisdictions, it is important to consider the different ways they may be thought to function. Now, grammatically, a non-reliance clause is a statement that the party is not relying on certain representations that may have been made by the counterparty. How this statement should be understood legally, however, is not straightforward. Indeed, depending on the context and the intentions of the parties, such a statement can be interpreted in at least five different ways, each of which would fulfill, at least to some extent, the intended general purpose of the clause of forestalling suits on the basis of extra-contractual representations. I consider the five possible interpretations in turn.

On the first interpretation, which I shall call the weak-evidentiary interpretation, the statement by the party that it is not relying on certain representations could be merely evidence, though not conclusive evidence, that the party giving the non-reliance clause did not rely on the relevant representations. If this interpretation is right, then the party giving the non-reliance clause would still be entitled to prove, by other evidence, that it did in fact rely on the relevant representations. As we shall see, this is how courts that are said to disregard non-reliance clauses usually understand them.<sup>75</sup> It is very difficult to see how this interpretation, which is the weakest of the four suggested here, is not correct as far as it goes — that is, correct in a way that does exclude some of the stronger interpretations from being true as well.

On the second interpretation, the non-reliance clause could be treated as conclusive evidence that the party giving it did not rely on the relevant representations, and this would mean that the party would not have the opportunity to introduce other evidence to show that it really did so rely. If this strong-evidentiary interpretation is understood as implying that, as a factual matter, a party giving a non-reliance clause never or virtually never actually relies on the representations it says it did not rely upon, then this view seems very problematic. People — even sophisticated commercial

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74. See Masson, *supra* note 9, at 513 (stating, “reliance waivers developed out of tort law” and “were initially designed to provide protection against tort suits of fraud or misrepresentation in the formation of a contract.”).

75. See, e.g., AES Corp. v. The Dow Chemical Co., 325 F.3d 174, 179 (3d Cir. 2003).

parties — often say one thing and do another. It is hard to see, therefore, how we could give a written statement by a party that it is not relying on certain representations such conclusive effect without bringing in some other normative considerations (e.g., that the party to whom the writing is directed relies on it). This suggests a third way to understand a non-reliance clause.

On this third interpretation, the non-reliance clause has the exact same effect as the second interpretation (that is, it completely prevents the party giving the clause from proving reliance), but on this interpretation we view the clause not as evidence, whether conclusive or otherwise, of what the party giving it did but as an equitable estoppel<sup>76</sup> on certain future conduct by the party.<sup>77</sup> In other words, on this estoppel interpretation, it would, in the circumstances, be unfair to allow a party that gave a non-reliance clause to benefit itself and harm its contractual counterparty by attempting to prove the opposite of what the party affirmed in the non-reliance clause. As Justice Swayne put it in *Dickerson v. Colgrove*, a person, “who by his language or conduct leads another to do what he would not otherwise have done, shall not subject such person to loss or injury by disappointing the expectations upon which he acted.”<sup>78</sup> Presumably, the theory would be that, by stating it was not relying on extra-contractual representations, the party giving the non-reliance clause had led the counterparty to believe it would not sue counterparty on the basis of those representations, thus lulling the counterparty into not correcting any misstatements or omissions in those representations prior to the parties entering the transaction. Hence,

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76. See generally 2 JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE §§ 801-821 (4th ed. 1941); T. Leigh Anenson, *The Triumph of Equity: Equitable Estoppel in Modern Litigation*, 27 REV. LITIG. 377 (2008).

77. See *Bridger v. Goldsmith*, 143 N.Y. 424, 428 (1894). In this case, the contract between the parties contained a clause in which the seller disclaimed all relevant representations. *Id.* When the buyer later sued claiming that various extra-contractual representations by the seller were fraudulent, the seller defended claiming that the disclaimer was an equitable estoppel. This is nonsense, since the clause, which was a disclaimer by the seller, was not a representation of any kind at all by the buyer on which the seller could conceivably rely. *Id.* Not surprisingly, the court made quick work of this theory, stating that the seller “may, indeed, have relied upon [the disclaimer’s] force and efficacy to protect him from the consequences of his own fraud, but he certainly could not have relied upon the truth of any statement in it. A mere device of the guilty party to a contract intended to shield himself from the results of his own fraud, practiced upon the other party, cannot well be elevated to the dignity and importance of an equitable estoppel.” *Id.*

78. *Dickerson v. Colgrove*, 100 U.S. 578, 580 (1879); see also A TREATISE ON EQUITY JURISPRUDENCE, *supra* note 76, at 1645 (stating, “[t]he conduct must be relied upon, and be an inducement for the other party to act”).

the party giving the non-reliance clause must be equitably estopped from later bringing a cause of action on the basis of the counterparty's extra-contractual representations. Note that this interpretation is entirely consistent with the idea that the party actually did rely on the counterparty's representation, for regardless of whether it actually relied, in giving the non-reliance clause it causes the counterparty to change its position to its detriment, and so the estoppel will lie.

On each of these first three interpretations, nothing requires that the non-reliance clause be part of a legally enforceable agreement.<sup>79</sup> On the fourth interpretation, however, a non-reliance clause in a preliminary agreement can be understood (indeed, almost certainly has to be understood) as a promise about which representations the party will rely upon in entering into the definitive agreement. On this promissory interpretation, even if the party giving the non-reliance clause could prove it relied on extra-contractual representations of the counterparty and that these were false or fraudulent, in so proving it would prove that it had breached a contractual promise. Hence, if the party is entitled to damages for the falseness or fraudulence of the counterparty's extra-contractual representations, then the counterparty would, at least *prima facie*, be entitled to expectation damages to return it to the position it would have enjoyed had the party giving the non-reliance clause performed on its promise not to rely on extra-contractual representations. It seems we would have equal and offsetting damage awards, which is equivalent to making the extra-contractual representations not actionable. Note that, on the promissory interpretation, in contradistinction from the estoppel interpretation, since the counterparty's rights sound in contract and not in equity, it is irrelevant whether the counterparty relied on the non-reliance clause.

On a fifth and final interpretation, the non-reliance clause is a contractual representation and warranty made by the party in the definitive agreement. Analytically, nothing prevents the party giving the non-reliance clause from attempting to prove that it relied on extra-contractual representations by the counterparty, but, if it succeeds, it would thereby prove its own representation to the counterparty was false.<sup>80</sup> Assuming, as

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79. *Cf.* *Extra Equipamentos E Exportacao Ltde. v. Case Corp.*, 541 F.3d 719, 726 (7th Cir. 2008) (stating that, in a suit for fraudulent inducement, "the significance of the [non-reliance clause], which does not depend on its enforceability in contract law, is that its language and the circumstances of its negotiation render [the plaintiff's] reliance on [the defendant's] supposed oral misrepresentations unreasonable as a matter of law.").

80. *Compare with* Chief Justice Strine's double-liar argument in *Abrly Partners V, L.P. v. F&W Acquisition, LLC*, 891 A.2d 1032, 1058 (Del. Ch. 2006).

seems inevitable, that a party knows on which representations it was relying when entering the definitive agreement, in proving that its non-reliance representation to the counterparty was false, the party would be simultaneously proving that its non-reliance representation was also knowingly false. Thus, it would seem that, if the party proves that, the non-reliance clause notwithstanding, it relied on extra-contractual representations of the counterparty and thereby suffered harm, then the damages that the party collects from the counterparty in such a lawsuit would be harm to the counterparty arising from the party's misrepresentation to the counterparty about which representations of the counterparty it was relying upon in entering into the definitive agreement. In other words, as under the promissory interpretation, under this representational interpretation, the counterparty could recover equal and offsetting damages from the party based on the breach of the party's representation to it in the non-reliance clause.<sup>81</sup>

As we will see below, courts have not generally distinguished between these five possible interpretations. This is somewhat surprising, as some of the interpretations require that the clause appear in a particular kind of document, and naturally, in any particular case, the court will encounter a non-reliance clause only in the context of a particular document. Thus, the promissory interpretation is possible, and virtually required, if the non-reliance clause appears in a preliminary agreement. The representational interpretation is possible, and virtually required, if the clause appears in the

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81. Another question altogether is how non-reliance questions relate to misleading representations actually made or omissions from representations when the speaking party had a duty to speak. See generally Lipshaw, *supra* note 9, at 446 (discussing how *Abry Partners*, discussed below, and similar cases “went astray” by focusing on false representations rather than misleading representations or wrongful omissions). I would have thought that non-reliance clauses by their clear terms provide no benefit to the speaker who makes a representation that is true but misleading. See *Junius Construction Corp. v. Cohen*, 257 N.Y. 393 (1931) (holding that if the recipient of a representation may rely on it for its truth, he may also rely on its not being misleading). Additionally, questions of pure omissions when the party has an obligation to speak are handled not by non-reliance clauses but by the related but fundamentally different contractual provisions in so-called “big boy” letters. See Edwin D. Eshmoli, *Big Boy Letters: Trading on Inside Information*, 94 CORNELL L. REV. 133, 153 (2008) (discussing provisions in big boy letters); Grove, *supra* note 9, at 1124 (2006) (stating that “a [non-reliance clause] is irrelevant to omissions”); JOSEPH M. McLAUGHLIN, SIMPSON, THATCHER & BARTLETT LLP, BIG BOY LETTERS AND NON-RELIANCE PROVISIONS 1-2 (2012) (discussing the differences between non-reliance clauses and big boy letters); WACHTELL, LIPTON, ROSEN & KATZ, DISTRESSED MERGERS AND ACQUISITIONS 218 (2018) (indicating that acknowledgement by a sophisticated party that it is not relying on the insider-seller for information makes it more difficult to sustain a contention of justifiable reliance by that party). See generally Arnold S. Jacobs, *What is a Misleading Statement or Omission under Rule 10b-5?*, 42 FORDHAM L. REV. 243 (1973).

definitive agreement. The weak and strong evidentiary interpretations, as well as the estoppel interpretation, are possible regardless of the document in which the non-reliance clause appears, including documents that are not legally enforceable agreements. With these distinctions in mind, we turn to the treatment of non-reliance clauses in the leading commercial jurisdictions of Delaware and New York.

### 1. Delaware Law<sup>82</sup>

The Delaware Supreme Court and the Delaware Court of Chancery have had multiple occasions to consider agreements between parties to business combination transactions in which the seller disclaims, and the buyer promises not to rely on, any representations and warranties except for those in the definitive agreement between the parties, including with respect to representations by the seller allegedly made fraudulently.<sup>83</sup> For at least the past twenty years, the Delaware courts have consistently held that such agreements are enforceable against the parties in accordance with their terms.<sup>84</sup> The most important of these decisions are *Abry Partners V*,

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82. See *Abry Partners V, L.P. v. F&W Acquisition, LLC*, 891 A.2d 1032, 1046-1047 (Del. Ch. 2006) (noting that under Delaware law, the choice of law by contracting parties will govern not only the interpretation of their contract but also tort claims of fraudulent inducement to that contract). This is true generally. See West & Lewis, Jr., *supra* note 2, at 1004 n.24 (stating that a properly drafted choice of law clause can control the choice of law for tort claims arising from a transaction and citing cases).

83. See *Abry Partners V, L.P.*, 891 A.2d at 1064 (holding that a non-reliance clause would block fraud claims based on alleged extracontractual misrepresentations); *RAA Management LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107, 119 (Del. 2012) (affirming the lower court's dismissal based on an "unambiguous" non-disclosure agreement absolving the seller from intentional fraud); see also *Prairie Capital III, L.P. v. Double E Holding Corp.*, 132 A.2d 35, 50 (Del. Ch. 2015) (stating that "Delaware law enforces clauses that identify the specific information on which a party has relied and which foreclose reliance on other information"); *In re IBP, Inc., Shareholders Litig.*, 789 A.2d 14, 73 (Del. Ch. 2001) (holding that a non-reliance clause in a confidentiality agreement would block a fraudulent inducement action on the basis of extracontractual representations); *Great Lakes Chemical Corp. v. Pharmacia Corp.*, 788 A.2d 544, 556 (Del. Ch. 2001) (holding that under certain circumstances Delaware law "permits explicit contract disclaimers" to bar fraud claims). Despite the clarity of Delaware law on this point, the issue is often relitigated. See e.g., *Chyronhego Corp. v. Cliff Wight & CFX Holdings, Inc.*, No. 2017-0548-SG, 2018 WL 3642132, at \*11 (Del. Ch. July 31, 2018) (holding that fraud claims based on alleged extracontractual representations must be dismissed because of an anti-reliance provision in the definitive agreement).

84. For example, in *Great Lakes Corp. v. Pharmacia Corp.*, 788 A.2d 544, 552 (Del. Ch. 2001), the Delaware Court of Chancery held that a confidentiality agreement between sophisticated parties in which the seller disclaimed any representation as to the accuracy or completeness of information available to the seller would bar claims by the seller even for



*L.P. v. F.W. Acquisitions, LLC*,<sup>85</sup> a decision from the Court of Chancery by then Vice Chancellor and now Chief Justice Strine that contains the most elaborate analysis, and *RAA Management, LLC v. Savage Sports Holdings, Inc.*,<sup>86</sup> a decision from the Supreme Court by Justice Holland that adopted the reasoning of *Abry Partners*. I discuss them in turn.

*a. Abry Partners V, L.P. v. F.W. Acquisitions, LLC*<sup>87</sup>

In *Abry Partners*, the underlying transactions involved the sale of a portfolio company by one private equity fund to another.<sup>88</sup> In the agreement between the parties, the seller made various representations to the buyer, including about the financial statements of the company being transferred.<sup>89</sup> The agreement also contained provisions under which the seller indemnified the buyer for breaches of the representations contained in the agreement.<sup>90</sup> Moreover, such indemnification was the sole and exclusive remedy for breaches of representations, and the agreement capped the seller's liability at a relatively modest amount (\$20 million in an approximately \$500 million transaction).<sup>91</sup> After the transactions were closed, the buyer sued the seller, alleging that both contractual and extra-contractual representations about the financial condition of the company were fraudulent — that is, the plaintiff alleged not only that the representations were false but also that the seller knew they were false when the seller made them.<sup>92</sup> The buyer claimed damages in excess of \$100 million,<sup>93</sup> an amount well above the \$20 million cap on the seller's liability under the contractual indemnification provision.

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fraud. Then Vice Chancellor, now Chief Justice, Strine reached an identical conclusion in *In re IBP, Inc., Shareholders Litig.*, 789 A.2d 14 (Del. Ch. 2001). See generally Haas, *supra* note 9.

85. *Abry Partners V, L.P.*, 891 A.2d 1032 (Del. Ch. 2006).

86. 45 A.3d 107, 116-119 (Del. 2012).

87. *Abry Partners V, L.P.*, 891 A.2d 1032 (Del. Ch. 2006). For insightful discussions of *Abry Partners* and related cases in Delaware, see Lipshaw, *supra* note 9, at 446 (analyzing *Abry Partners* and arguing that non-reliance clauses should be effective to block suits based on extra-contractual representations that either conflict with contractual representations or are wholly additional to contractual representations but not to block suits based on the allegedly misleading-by-omission nature of contractual representations). See generally Blair, *supra* note 9; Haas, *supra* note 9; West & Lewis, Jr., *supra* note 2.

88. *Abry Partners V, L.P.*, 891 A.2d at 1035.

89. *Id.* at 1036.

90. *Id.* at 1041.

91. *Id.* at 1036.

92. *Id.* at 1051.

93. *Id.* at 1047.

It is important to understand precisely why the plaintiff framed its claims in the manner that it did. With respect to the representations in the agreement that the plaintiff claimed were false, the plaintiff could certainly have sued for breach of express warranty — that is, for breach of contract. Such a suit would have been much easier to win, primarily because it would not have required the plaintiff to prove scienter; the plaintiff would have needed to prove only that the representation, which was indisputably made, was false. A suit for breach of express warranty, however, would have availed the plaintiff little, for even if the suit succeeded, the plaintiff would have been bound by the provisions in the contract that limited its remedies for breach of contract to the relatively modest sum of \$20 million. Thus, the point of casting claims based on representations in the agreement as fraud claims (and taking on the additional significant burden of proving scienter) was in this case to avoid contractually agreed-upon limitations on damages for claims sounding in contract.<sup>94</sup> Although a plaintiff may not sue for both breach of contract and fraud with respect to the same alleged misrepresentation contained in the contract (as least when the damages would be duplicative),<sup>95</sup> the plaintiff has the option to choose which cause of action to bring.<sup>96</sup> Hence, not only did the agreement between the parties

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94. See *Abry Partners V, L.P.*, 891 A.2d at 1053-55; Lipshaw, *supra* note 9, at 433-43.

95. “The party asserting fraud must plead damages separate and apart from the alleged damages for breach of contract. The fraud damages must be more than a ‘rehash’ of the contract damages.” *AFH Holding Advisory LLC v. Emmaus Life Sciences, Inc.*, No. N12C-09-045 MMJ CCLD, 2013 WL 2149993, at \*13 (Del. Sup. Ct. April 18, 2013).

96. See *Abry Partners V, L.P.*, 891 A.2d at 1048 (stating, “a party aggrieved by fraud typically can seek to avoid a contract under the rubric of either contract or tort law.”); *id.* at 1054 (noting that, “[u]nder American law, buyers claiming to be victims of [fraudulent] representations have traditionally been able to seek to avoid a contract (or, in the alternative, recover damages) in either contract or tort.”). See generally RESTATEMENT (SECOND) OF CONTRACTS, § 471 com. A. But although the plaintiff may proceed on either theory, a party cannot recover on both theories for the same damages. See generally *McKenna v. Terminex International Co.*, No. 04C-02-022RBY, 2006 WL 1229674 (Del. Sup. Ct. March 13, 2006). Given the greater difficulty of proving fraud, this means that, unless they are seeking damages peculiar to the fraud claim (e.g., if compensatory damages exceed expectation damages or if the party is seeking punitive damages, which are not generally available for breach of contract claims), parties typically elect to sue on the contract claim. This leads to situations in which litigants who have what are essentially breach-of-contract claims attempt to bootstrap fraud claims by alleging, in effect, that the breach was intentional, or the party never intended to keep the breached promise. Such claims are routinely dismissed. See e.g., *Khushaim v. Tullow Inc.*, No. N15C-11-212-PRW, 2016 WL 3594752, at \*6 (Del. Sup. Ct. 2006) (stating, “fraud damages are a copy-and-paste recitation of [the] contract damages, replacing only the word ‘breaches’ with the word ‘fraud.’”); see also *Midland Red Oak Realty, Inc. v. Friedman, Billings & Ramsey & Co. Inc.*, No. Civ.A.04C05091CLS, 2005 WL 445710, at \*3 (Del. Super. 2005) (stating, “where an action is based entirely on a breach of the terms of a contract between the parties, and not on a violation of an independent duty

not prevent the plaintiff from suing for fraud based on representations made by the seller in the agreement, but, the court added, any contractual provision purporting to prevent suits for fraudulent inducement based on such representations would be void as contrary to the public policy of Delaware.<sup>97</sup>

With respect to its claims based on the representations not in the agreement, however, the plaintiff knew that, by its plain terms, the non-reliance clause to which it had agreed appeared to block such claims. Indeed, there was little doubt that the clause would block claims sounding in contract (that is, claims of contractual misrepresentation)<sup>98</sup> based on such extra-contractual representations. Thus, in alleging fraudulent inducement with respect to such representations, the plaintiff was hoping that, although the court would likely hold that a non-reliance clause blocks contract claims based on extra-contractual representations, it might reach a different result concerning fraud claims based on such representations. In other words, it might hold that the public policy of Delaware voided a non-reliance clause as to fraud claims based on extra-contractual representations

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imposed by law, a plaintiff must sue in contract and not in tort,” and “a breach of contract claim could not be bootstrapped into a fraud claim merely by adding the words ‘fraudulently induced’ or alleging that the contracting parties never intended to perform”).

97. *Abry Partners V, L.P.*, 891 A.2d at 1035 (stating, “[t]he public policy against fraud is a strong and venerable one that is largely founded on the societal consensus that lying is wrong.”). This is the virtually universal common law rule. *See e.g.*, RESTATEMENT (FIRST) OF CONTRACTS § 573 (AM. L. INST. 1932) (stating, “[a] provision in a bargain that fraud in its formation shall not be asserted is illegal.”).

98. The court does not go into the point, but claims for breaches of express warranty, which involve a breach of promise rather than of representation, would be blocked by the integration clause even more clearly than claims for contractual misrepresentation since the express warranty is a promise, and there is no doubt that which promises a party is making is governed by the integration clause. Thus, Williston says, “There is probably no more frequent application of the parol evidence rule than in cases in which one party asserts the existence of an oral warranty when there is a written contract, usually of sale or to sell goods,” but “if the writing contains a merger clause or a disclaimer stating that there is no warranty or none except what is contained in the writing,” then under the Uniform Commercial Code as under prior law “a parol warranty is ineffectual because it is contradictory and not merely in addition to the writing.” SAMUEL WILLISTON & RICHARD A. LORD, WILLISTON ON CONTRACTS § 33.33 (4th ed. 1990). To be clear, Williston is speaking about contract claims based on warranties, which are promises; the result with respect to claims of contractual misrepresentation or fraud, both of which are based on representations, will often be different. *See also* West & Lewis, Jr., *supra* note 2, at 2021 (stating, “[c]ourts 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,” as opposed to consciously false statements, and citing cases).

on the venerable common-law grounds as that fraud vitiates everything<sup>99</sup> or no one should be permitted to profit from his own wrongdoing.<sup>100</sup> Put yet another way, the plaintiff hoped that, just as Delaware does not allow parties to contract around liability for fraud with respect to representations in the agreement, perhaps it would also not allow parties to contract around liability for fraud with respect to representations not in the agreement.

While acknowledging the complexity of an area of law involving the intersection of contract and tort<sup>101</sup> and noting that courts have expressed many different views about the enforceability of a party's contractual promise to rely only on representations contained in the contract,<sup>102</sup> the court in *Abry Partners* held for the defendant. Regarding non-reliance clauses specifically, the court stated that Delaware law has consistently held "that sophisticated parties to negotiated commercial contracts may not reasonably rely on information that they contractually agreed did not form part of the basis for their decision to contract."<sup>103</sup> "A party cannot promise," the court held, "that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a 'but we did rely on those other representations' fraudulent inducement claim."<sup>104</sup>

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99. See *supra* note 62 and accompanying text.

100. *Riggs v. Palmer*, 115 N.Y. 506, 511 (1889).

101. See *Abry Partners V, L.P.*, 891 A.2d at 1048 (stating that, "[t]he relationship between contract and tort law regarding the avoidance of contracts on grounds of misrepresentation is an exceedingly complex and unwieldy one"); *id.* at 1054 ("American jurisprudence has never been able to achieve" "a clear division" "between the role of contract and tort law in addressing the consequences of false representations inducing the making and closing of contracts.").

102. *Id.* at 1056 ("There are several perspectives in American law regarding the extent to which a contract can define those representations of fact upon which the parties' decision to contract was based.").

103. *Id.* at 1057 (quoting *H-M Wexford LLC v. Encorp Inc.*, 832 A.2d 129 (Del. Ch. 2003)).

104. *Id.* at 1057. Although *Abry Partners* is the best known and most elaborately reasoned Chancery case on this issue, the *Abry Partners* court was not breaking new ground in Delaware law. See *Kronenberg v. Katz*, 872 A.2d 568, 593 (Del. Ch. 2004) (holding that although a non-reliance clause can block fraud in the inducement claims, for a contract to bar such a claim it "must contain language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract" and "a standard integration clause alone, which does not contain explicit anti-reliance representations and which is not accompanied by other contractual provisions demonstrating with clarity that the plaintiff had agreed that it was not relying on facts outside the contract, will not suffice to bar fraud claims."); *H-M Wexford, LLC*, 832 A.2d at 142-143 (dismissing fraud claims based on representations in a private placement memorandum when the fully-integrated purchase agreement excluded representations made in the memorandum and

Note that then-Vice Chancellor Strine here assumes, without further analysis, that the non-reliance clause at issue should be understood as a contractual promise in accordance with the fifth interpretation of non-reliance clauses given above. This made sense in *Abry Partners* because the clause was contained in an agreement entered into prior to the definitive agreement. It was part of a contract, but, since it related to the future, it could not be a representation; hence, it must have been a promise. Nevertheless, the then-Vice Chancellor does not treat the clause as a promise with complete consistency, for, if the non-reliance clause is a contractual promise, the plaintiff could conceivably prevail by arguing that it had breached its own promise. Perhaps it would have to suffer the legal consequences of that breach, but there is nothing impossible in the plaintiff admitting its breach and then arguing for its fraudulent inducement claims. The court does not even consider such a possibility. Rather, it tends to treat the non-reliance clause along the lines suggested in the third interpretation given above: it works an estoppel against the party giving it, preventing the party from pleading reliance.

The court also considered the argument that, by dismissing the plaintiff's fraud claim based on representations on which it had promised not to rely, it was encouraging or rewarding fraud. The court found this argument unpersuasive on the theory that, even if the seller lied to the buyer in some extra-contractual representations, the buyer lied to the seller when it said in the contract that it was not relying on any extra-contractual representations of the seller. "To fail to enforce non-reliance clauses," the court wrote,

is not to promote a public policy against lying. Rather, 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 the contract's four corners.<sup>105</sup>

Hence, for a plaintiff in such a case to succeed, "it proves itself not only a

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stating, "[t]he Court of Chancery has consistently held that sophisticated parties to negotiated commercial contracts may not reasonably rely on information that they contractually agreed did not form a part of the basis of the decision to contract"); In re IBP, Inc., Shareholders Litig., 789 A.2d 14, 72-74 (Del. Ch. 2001) (holding that buyer under a merger agreement could not reasonably rely upon extra-contractual representations made by the seller in due diligence when the confidentiality agreement between the parties provided that the buyer would not rely on representations of the seller except those included in the definitive written agreement).

105. *Abry Partners V, L.P.*, 891 A.2d at 1058.

liar but a liar in the most inexcusable of commercial circumstances—in a freely negotiated written contract.”<sup>106</sup> In other words, both allowing such claims and dismissing them may be thought to encourage lying, either by one party or the other, but allowing them encourages a worse sort of lying. On the plaintiff’s view, the case involves, as the court put it, a “Double Liar” problem, and the plaintiff is by far the worse of the two liars.<sup>107</sup> Hence, assuming there is a public policy against fraud, that policy is served, not disserved, by dismissing such claims.

This is a very attractive argument, and I think it is ultimately substantially correct, but note the subtle shift that it involves in how we understand non-reliance clauses. Earlier the court treated the non-reliance clause as a *promise* by the seller (the fifth interpretation above), but now, by saying the seller *lied* in giving the non-reliance clause, he is treating it as a representation (the fourth interpretation above), for only statements of fact are true or false (and so possibly lies). Promises, which can be kept or broken, are neither true nor false.<sup>108</sup> Now this shift may or may not matter

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106. *Id.* Here, Vice Chancellor Strine quotes Judge, now Justice, Alito: “[if] a contracting party may accept additional compensation for a risk that it has no intention of actually hearing,” such “prevarication may amount to a fraud all its own.” *MBIA Ins. Co. v. Royal Indemnity Co.*, 426 F.3d 204, 218 (3d Cir. 2005). Justice Alito thus seems to be the originator, or at least the inspiration, for the Double Liar argument. See West & Lewis, Jr., *supra* note 2, at 1023 (discussing the Double Liar argument and the MBIA case).

107. *Abry Partners V, L.P.*, 891 A.2d at 1058. See generally Siedel, *supra* note 9.

108. People sometimes speak of “lying promises,” on the theory that every promise includes an implicit representation by the promisor about the promisor’s state of mind, to wit, that at the time he makes the promise, he intends to keep it (even if this intention may later change). See generally IAN AYRES & GREGORY KLASS, *INSINCERE PROMISES: THE LAW OF MISREPRESENTED INTENTION* (2005) (discussing legal, philosophical and economic aspects of lying promises); see *Cornell Glasgow LLC v. La Grange Properties, LLC*, No. N11C-05-016 JRS CCLD, 2012 WL 2106945, at \*8 (Del. Sup. Ct. June 6, 2012) (“[E]ven if the defendants never intended to perform, their alleged scheme to breach the Development Agreement simply cannot give rise to an actionable claim for fraud or negligent misrepresentation”); see also *Tristate Courier and Carriage, Inc. v. Berryman*, No. C.A. 20574-NC, 2004 WL 835886 (Del. Ch. 2004) (holding that, although plaintiff proved that defendant had breached a contract between the parties, such a claim cannot survive as a fraud claim merely because the plaintiff alleges that the defendant never intended to perform). There are fascinating and complex legal doctrines about whether a lying promise can support a fraud claim or only a claim for breach of contract. In Delaware, the answer is the latter. There is a subtle exception, however. If the defendant makes an extra-contractual promise (so that an action for breach of contract on the basis of the defendant’s non-performance of the promise would generally be blocked by a full integration clause and the parol evidence rule), and the promise is a lying promise (that is, the defendant made the promise with no intention of performing), then the plaintiff may generally sue for fraudulent inducement on the basis of the implicit representation that the defendant intended to perform the extra-contractual promise. See *Iotex Comm. Inc. v. Defrieds*, No. 15817.1998, WL 914265, at \*6 (Del. Ch. 1998) (explaining “a false promise can support a claim for fraud

to the argument. That is, if, as in *Abry Partners*, the non-reliance clause is a promise in an earlier agreement about which representations the party making the promise will rely upon in entering into a later agreement, then

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only where that promise was ‘collateral or extraneous’ to the terms” of the contract.”). In New York, the rule is the same. The early case of *Sabo v. Delman*, 143 N.E.2d 906 (NY 1957) seems to hold that even a contractual promise, if the promisor makes it with no intention of keeping it, may be actionable as fraud on the theory that it implies a fraudulent representation about the present intention of the promisor, but later cases make it clear that the New York rule is the same as the Delaware rule. In *International Cabletel, Inc. v. Le Group Videotron Ltce.*, 978 F.Supp. 483 (S.D.N.Y. 1997) (Sotomayor, J.), Justice, then Judge, Sotomayor explains that, although it is well settled under New York that (a) a contract action cannot be converted into one for fraud merely by alleging that the contracting party did not intend to meet its contractual obligations, and (b) if a promise was made with a preconceived and undisclosed intention of not performing it, then it constitutes a misrepresentation of a material existing fact sufficient to support a fraud claim, *id.*, nevertheless, (c) “any apparent tension . . . has been reconciled through a rule, widely adopted by the state and federal courts, pursuant to which a false promise can support a claim of fraud only where that promise was ‘collateral or extraneous’ to the terms of an enforceable agreement in place between the parties.” *Id.* at 486-487; *see also D.S. America (East), Inc. v. Chromagrafx Imaging Systems, Inc.*, 873 F. Supp. 786, 795-796 (E.D.N.Y. 1995) (stating, “[w]hen the fraud claim is premised upon an alleged breach of contractual duties and the supporting allegations do not concern representations which are collateral or extraneous to the terms of the parties’ agreement, a course of action sounding in fraud does not lie,” and “[a]lthough a promise made with a preconceived and undisclosed intention of not performing it can give rise to a fraudulent inducement claim, the promise must be collateral or extraneous to the terms of the agreement, not merely a promise to perform under the express terms of the contract, even if made with no intention to abide by the stated intention.”); *McKernin v. Fanny Farmer Candy Shops, Inc.*, 176 A.D.2d 233, 234 (N.Y. App. Div. 1991) (holding, “[i]t is well settled that where . . . a claim to recover damages for fraud is premised upon an alleged breach of contractual duties and the supporting allegations do not concern representations which are collateral or extraneous to the terms of the parties’ agreement, a cause of action sounding in fraud does not lie.”); *Spellman v. Columbia Manicure Mfg. Co.*, 111 A.D.2d 320 (N.Y. App. Div. 1985) (reconciling *Sabo* with later cases holding that a promise in a contract made with no intention to perform does not support a fraud claim). According to Justice Sotomayor, the reason for this so-called Collateral Promise Rule is that allowing fraud claims for false promises made in the agreement “would be to undermine the predictability that is essential to contracting, the predictability which permits sophisticated entities to enter into transactions understanding both their responsibilities and the potential scope of their liabilities.” *Id.* at 489; *see also Bridgestone/Firestone, Inc. v. Recovery Credit Services, Inc.*, 98 F.3d 13, 20 (2d Cir. 1996) (“To maintain a claim of fraud . . . a plaintiff must either: (1) demonstrate a legal duty separate from the duty to perform the contract, . . . or (2) demonstrate a fraudulent misrepresentation collateral or extraneous to the contract . . . or (3) seek special damages that are caused by the misrepresentation and unrecoverable as contract damages.”); West & Lewis, Jr., *supra* note 2, at 1013-14 (discussing liability for lying promises under the laws of various states). Under Rule 10b-5, lying promises are actionable. *The Wharf (Holdings) Limited v. United International Holdings, Inc.*, 532 U.S. 588, 596 (2001). I am not aware of any important cases on non-reliance clauses involving the labyrinth of interesting side-issues raised by lying-promises.

the shift matters: if the party later relies on extra-contractual promises by the counterparty, it will breach its earlier promise, but it will not have told a lie, much less have committed a fraud. Even intentionally breaching a contract is very different from committing a fraud, and courts, including Delaware courts, are assiduous in stopping plaintiffs with breach of contract claims from transforming those claims into fraud claims by arguing that the breach was intentional and that an intentional breach is tantamount to fraud.<sup>109</sup> That argument consistently fails. Ironically, Chief Justice Strine here himself seems to slip into the fallacy of equating an intentional breach of contract with a fraud. Eliminate this false step, however, and the Double Liar argument breaks down: the party breaching the promise in the non-reliance clause may intentionally breach a contract, but the counterparty that made knowingly false extra-contractual representations committed a fraud. There is only one liar.<sup>110</sup>

Or, at least that is true if the one and only non-reliance clause at issue is a promise in a preliminary agreement not to rely on extra-contractual promises. Often enough, as we shall see, there are multiple non-reliance clauses involved in a single transaction. For example, besides the *promise* by the buyer in the preliminary agreement not to rely on extra-contractual representations in entering into the definitive agreement, there is often a *representation* by the buyer in the definitive agreement that, in entering that agreement, it is not relying on any such representations. That latter kind of non-reliance clause—one squarely within the fifth or representational interpretation—solidly supports Chief Justice Strine’s

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109. See, e.g., *Midland Red Oak Realty, Inc. v. Friedman, Billings & Ramsey & Co. Inc.*, Civ.A.04C05091CLS, 2005 WL 445710, at \*3 (Del. Sup. Ct. 2005) (stating “where an action is based entirely on a breach of the terms of a contract between the parties, and not on a violation of an independent duty imposed by law, a plaintiff must sue in contract and not in tort,” and “a breach of contract claim could not be bootstrapped into a fraud claim merely by adding the words ‘fraudulently induced’ or alleging that the contracting parties never intended to perform”).

110. There may be an exception if, in making in the preliminary agreement, the party promising not to rely on extra-contractual promises made the promise without the intention of keeping it—that is, the promise was a so-called “lying promise.” All promises come, some courts say, with an implicit representation that the party making the promise intends to keep it, and so lying promises are implicit misrepresentations. See *supra* note 107 above and sources cited therein. Although many courts, including Delaware courts, say that such lying promises are not actionable as frauds and the disappointed promisee is limited to suing for breach of contract, see generally *Cornell Glasgow LLC v. La Grange Properties, LLC*, No. N11C-05-016 JRS CCLD, 2012 WL 2106945 (Del. Super. Ct. June 6, 2010); *Tristate Courier and Carriage, Inc. v. Berryman*, No. C.A. 20574-NC, 2004 WL 835886 (Del. Ch. 2004), for purposes of the Double Liar argument, the party giving the non-reliance clause would certainly still be a liar.



### Double Liar argument.

All this is not to say, however, that *Abry Partners* should have turned out other than it did if the only non-reliance clause at issue was the promissory one in a preliminary agreement. As explained above,<sup>111</sup> even if the counterparty is liable for fraud, the party is liable for breach of contract, and the damages should offset. Unless, that is, since we have only one liar and not two, the public policy against fraud prevents the counterparty from collecting on the contract. That would seem to make a very great deal turn on the apparently technical point of whether, besides a non-reliance clause in the form of a promise in the preliminary agreement, the parties also included another non-reliance clause in the form of a representation in the definitive agreement. The lesson, therefore, would seem to be that the best practice is to include both forms of non-reliance clauses, the promissory form in the preliminary agreement and the representational form in the definitive agreement. In one sense, the former is obviously more important, since it structures the entire due diligence process and makes it clear from the beginning that the parties are agreeing that the buyer will not rely on any representations made by the seller in due diligence that the seller does not repeat in the definitive agreement. The latter, however, is what we need to correctly ground the Double Liar argument, which is the most powerful answer to the argument that enforcing non-reliance clauses somehow licenses fraud. In other words, the promissory non-reliance clause in the preliminary agreement does the heavy-lifting in structuring an efficient deal-making process (on which see Part II below), but the representational non-reliance clause in the definitive agreement does the heavy-lifting in the policy area, ensuring that the non-reliance clauses—both of them—are given legal effect.

However all of this may be, the court in *Abry Partners* makes another important point about claims of fraud based on extra-contractual representations by the seller—to wit, the judicial error rate in adjudicating such claims will be abnormally high. “Courts are not perfect in distinguishing meritorious from non-meritorious claims of fraud,” the court wrote, and so permitting “fraud claims based on statements that buyers promised they did not rely upon subjects sellers to a greater possibility of wrongful liability.”<sup>112</sup> Especially because those statements are often

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111. See *supra* note 79 and accompanying text.

112. *Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032, 1058 (Del. Ch. 2006); *Cf. Blair, supra* note 9, at 470 (stating, “[s]ellers faced with fraud claims . . . face the unpredictability of the legal system. Specifically, sellers run the risk that courts will not be able to distinguish accurately between representations that were fraudulent and representations that were merely inaccurate or puffery”); *Davis, supra* note 9, at 502-503

allegedly oral rather than in a writing, “there is often an evidentiary issue about whether the supposedly false statement was uttered.”<sup>113</sup>

This is an important point. Consider two fraud claims, one based on representations in the contract and one based on representations outside the contract. For the claim based on the representation in the contract, there is no doubt that the seller made the statement, that it is material (why else include it in the contract?), and that the buyer relied on it. The possible sources of judicial error concern only whether the statement is indeed false and whether the seller made the statement with the requisite scienter (that is, knowing it was false and intending to induce the buyer to rely on it to his detriment). Assume that the judicial error rate (both for false positives and false negatives) is 10%. Ignoring transaction costs, that makes the expected value to the plaintiff of a non-meritorious suit equal to 10% of the damages that would be due if the suit were meritorious. For the claim based on a representation outside the contract, the possible sources of judicial error are much more numerous; they include whether the seller really made the statement, whether it was material, whether the buyer relied on it, and whether the seller had the requisite scienter. But because of the difficult evidentiary problems associated with extra-contractual statements, especially oral ones, assume (conservatively, in my view) that the judicial error is only half again the rate in cases where the representations are in the contract—that is, 15% (both for false positives and false negatives). Ignoring transaction costs, that makes the expected value to the plaintiff with a non-meritorious suit equal to 15% of the damages that would be due if the suit were meritorious.<sup>114</sup> As usual, plaintiffs with weak cases prefer rules of law that are difficult to apply and result in high rates of judicial error, for this increases the value of their claims.<sup>115</sup> The perverse incentive

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(explaining that sellers may want non-reliance clauses in their agreements because “they might fear that courts are unable to determine accurately whether parties have behaved negligently or fraudulently”); West & Lewis, Jr., *supra* note 2, at 999 (discussing that “fraud and negligent misrepresentation claims have proven tough to define, easy to allege, hard to dismiss, and highly susceptible to the erroneous conclusions of judges and juries”).

113. *Abry Partners V, L.P.*, 891 A.2d at 1058.

114. Of course, the same assumptions imply that plaintiffs with meritorious suits have a lower chance of winning their cases when the judicial error is higher (assuming the same error rate obtains for false positives and false negatives). Ignoring transaction costs, allowing the cases with the higher error rate to go forward does not affect the overall distribution of wealth between plaintiffs and defendants, but it does shift wealth from plaintiffs with meritorious suits to plaintiffs with non-meritorious ones. Hence, if we consider not just individual cases but the incentive effects of one legal rule as compared to another, the argument against allowing cases with high rates of judicial error becomes stronger.

115. See Robert T. Miller, *RMBS Push-Back Litigations and the Efficient Allocation of*

effects of such rules are evident.<sup>116</sup>

Finally, as noted above, although the court in *Abry Partners* held that Delaware law permits sophisticated commercial parties to “allocate the risk of factual error freely as to any error where the speaking party did not consciously convey an untruth,”<sup>117</sup> nevertheless it also held that Delaware law does *not* permit a party to exculpate itself for fraud. That is, although the parties may agree as to which representations are being made, with respect to the representations that they agree are made, the party making the representations will be subject to liability for fraud regardless of any contractual provision to the contrary. To the extent that an agreement “purports to limit the seller’s exposure for its own conscious participation in the communication of lies to the buyer, it is invalid under the public policy of this State.”<sup>118</sup>

Some commentators have criticized this aspect of the decision, arguing that all the efficiency rationales that support the position that sophisticated parties may agree as to which representations are being made also support the position that such parties may agree on the legal consequences of fraud in the making of such representations.<sup>119</sup> Indeed, even Chief Justice Strine was somewhat uneasy about this aspect of the

*Endogenous Risk Over Time*, 34 REV. OF BANKING AND FIN. L. 255, 300 (2015) (stating, “with the passage of time, determining disputed issues becomes much more difficult (that is, more costly) because documents are lost, memories fade, and witnesses become unavailable. This means that the error rate in such cases will rise, and the costs of investigating and disputing issues will rise as well”).

116. As West and Lewis note, unscrupulous parties can also make a claim based on allegedly fraudulent extra-contractual misrepresentations to use as a bargaining chip in what is really a purely contractual dispute. See West & Lewis, Jr., *supra* note 2, at 999 (stating, “[t]he mere threat of a fraud or negligent misrepresentation claim can be used as a bargaining chip by a contracting party attempting to avoid a contractual deal that it made”); see also Blair, *supra* note 9, at 468-469 (stating that allegations of fraud based on extra-contractual representations “impose significant costs on a seller and thus give a buyer leverage that it can use after contract formation to renegotiate the terms of the deal in its favor”).

117. *Abry Partners V, L.P.*, 891 A.2d at 1035.

118. *Id.* at 1035. The *Abry Partners* court also stated, however, that a party could, by agreement with the counterparty, exculpate itself for negligent, grossly negligent, or even reckless misstatements or omissions. *Id.* at 1063-1064. The prohibition arising from public policy reaches only intentional or conscious misstatements or omissions.

119. See Blair, *supra* note 9, at 425 n.5 (describing *Abry Partners*’s distinction between fraudulent representations in the contract and extra-contractual fraudulent representations as “suspect”); Lipshaw, *supra* note 9, at 434 (citing criticisms of *Abry Partners* on this score); Siedel, *supra* note 9, at 16 (questioning the moral basis for treating fraudulent representations differently depending on whether they are made within or without the four corners of the contract).

decision.<sup>120</sup> He says in a footnote that there is a “residual double liar problem” in cases where a buyer promises not to sue for fraud on the basis of misrepresentations in the contract but later does so.<sup>121</sup> In that case, even though both parties are liars, the law favors the buyer and allows him to sue for fraud even though if he promised not to do so—the opposite of the result in the usual Double Liar problem related to extra-contractual representations and non-reliance.<sup>122</sup>

It is important to see precisely what is at issue here. Both with suits based on fraudulent misrepresentations in the contract purportedly

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120. *Abry Partners V, L.P.*, 891 A.2d at 1064 n.85.

121. *Id.* After confessing its uneasiness with the distinction, Chief Justice Strine provides three reasons to support it. First, he says that a typical non-reliance clause is much more specific than an exclusive remedies provision that does not expressly mention limitations on suits for fraud even if the provision is correctly interpreted to include such limitations—a rationale that applied on the facts in *Abry Partners* but would clearly not apply if the contract had expressly mentioned limitations on remedies in fraud suits. Second, Chief Justice Strine says that “it is . . . not unrealistic to assume that the contracting parties knew that there were public policy limitations that would come into play” that could limit the seller’s ability to exculpate itself for fraud. Siedel suggests that this argument is circular: contractual limitations on fraud suits should be unenforceable because courts often hold such limitations to be unenforceable. Siedel, *supra* note 9, at 16. Third, if courts decline to enforce non-reliance clauses, they would subject sellers to a great deal of uncertainty and opportunism by buyers as the parties argue over which extra-contractual representations were made, but there are no equivalent deleterious effects arising from declining to enforce contractual limitations on fraud—an argument that seems correct as far as it goes. In my view, however, the Chief Justice underestimates the importance of his second argument: rightly or wrongly, many transactional lawyers think that contracts exculpating a party for fraud will be unenforceable. See NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 15.02[4] (stating that transactional lawyers may agree to provisions carving out fraud from exclusive remedies provisions because “they may believe, erroneously, that the parties cannot agree among themselves so as to exclude any fraud claims.”). That this view is erroneous, however, is not quite true; the law varies by jurisdiction, but the rule announced in *Abry Partners* is not at all unusual. See West & Lewis, Jr., *supra* note 2, at 1021-1028 (surveying the case law across states).

122. Actually, there is likely *not* a Double Liar Problem, for although the seller allegedly made a fraudulent representation, the buyer merely *promised* not to sue for fraud or promised to accept certain limitations on suits for fraud and now is breaching that promise. We have one lie and one breach of promise, which are quite different things. The analogy would be to a case in which the only non-reliance clause was a promissory one (i.e., there was no representational non-reliance clause). The only way to get to two liars in the case imagined is to assume that the promise not to sue for fraud was a lying promise, a promise made with no intention of its being kept. Chief Justice Strine alludes to this issue when he says the buyer’s “decision to later renege on [the relevant contractual] promise suggests that it was untruthful in making the promise in the first instance.” *Abry Partners V, L.P.*, 891 A.2d at 1064 n.85. In reality, though, breaching a contractual promise does not make it probable that the promise was a lying promise, though this is always possible.

circumscribed by other contractual provisions and with suits based on extra-contractual representations purportedly blocked by non-reliance clauses, there is a contractual provision that affects a suit for fraudulent misrepresentation, but there the similarity ends. In the usual situation involving non-reliance clauses, we have an allegedly fraudulent representation outside the contract together with a contractual provision in which the buyer promises or represents that it is not relying on the relevant representation. The strict analogy to this would be a case in which we had an allegedly fraudulent misrepresentation in the contract together with a contractual provision in which the buyer promises or represents that it is not relying on the representations in the contract (or, perhaps, promises not to sue for fraud). *This* situation, to my knowledge, has not appeared in the case law, and it is not hard to see why it does not occur in practice. For one thing, the representation would (at least usually) also be a warranty, and so the buyer could sue for breach of an express warranty regardless of whether it relied on the particular representation. Since breach of an express warranty is so much easier to prove than fraud, the buyer would normally not even want to sue for fraud. For another thing, if the gist of the agreement between the parties is that the representations in the contract are not actionable in any way, even in fraud, then why bother negotiating page after page of representations and write them into the agreement? If the representations are not actionable, then rational parties would never incur the costs of putting them in the contract in the first place.

Indeed, when parties negotiate representations and put them into the contract, they do so because they are meant to have some legal effect. There is no strict analogy to the usual case involving non-reliance clauses where the agreement between the parties is precisely that that these extra-contractual representations shall have no legal effect at all. The contractual provisions relevant to fraudulent misrepresentations in the contract are *not* clauses that, if effective, would wholly block suits for fraudulent misrepresentation based on contractual representations. Rather, the contractual provisions relevant to fraudulent misrepresentations in the contract are, as was the case in *Abry Partners* (and every other case of which I am aware),<sup>123</sup> limitations on *remedies* for breaches of representations (e.g., caps on damages). With fraudulent representations in the contract, the question is not whether the defrauding party shall be liable for its fraud; the question is whether the contract may limit the damages for

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123. See West & Lewis, Jr., *supra* note 2, at 1021-28 (providing a broad survey of cases in which provisions relevant to fraudulent misrepresentations in the contract are caps on damages).

fraud.<sup>124</sup>

Once this is clear, I think there are good grounds for distinguishing between cases involving fraud suits based on extra-contractual representations blocked by non-reliance clauses and cases involving contractual limitations on remedies for fraud based on representations in the contract. The difference is this: if we take non-reliance clauses seriously—that is, if we take non-reliance clauses to mean that the buyer has really not relied on extra-contractual representations, which is the conclusion argued for in Part II below—then there *never was any fraud* in the cases involving non-reliance clauses.<sup>125</sup> That is, if the arguments in Part II are correct, the usual scenario is *not* one in which a seller intentionally makes false representations to the buyer before the contract is signed, the buyer relies on them, and then, at the last minute, the seller bamboozles the buyer into agreeing that he is relying only on representations in the contract. *That* situation does indeed look like one in which the seller is attempting to exculpate itself by contract for its own fraud.<sup>126</sup> As shown in Part II,

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124. Someone may say that a contractual provision making representations in the contract not actionable is merely the limiting case of contracts that restrict remedies for breaches of representations. This is technically true, but in context the point is captious. If the parties incur significant transaction costs of negotiating representations and writing them into the contract, then these costs will generally be less than the discounted value of any damages the buyer may collect, which means that any cap on damages will be a nontrivial amount.

125. To be clear, the argument in the text depends on the conclusion of Part II below that non-reliance clauses merely make express what sophisticated, value-maximizing parties involved in business combination transactions have already agreed to—that the buyer is in fact not relying on any representations of the seller except for those included in the definitive agreement between the parties.

126. Such cases, I suggest, would virtually invariably involve a non-sophisticated party as the victim, and in such cases the non-reliance clause would likely *not* be enforced. See e.g., *Harsco Corp. v. Segui*, 91 F.3d 337, 344 (2d Cir. 1996) (distinguishing *Rogen* on the facts and concluding that, unlike in *Rogen*, there was nothing in *Harsco* “that indicates that [the plaintiff] was duped” into waiving its rights”); *Keller v. A.O. Smith Harvestore Products, Inc.*, 819 P.2d 69 (Colo. 1991) (allowing negligent misrepresentation suit based on extracontractual representation to proceed despite the presence of a full integration clause in a case where the plaintiffs were individuals engaged in farming); see also *Abry Partners V, L.P.*, 891 A.2d at 1035 (holding that “Delaware law permits sophisticated commercial parties to craft contracts that insulate a seller from a rescission claim for a contractual false statement of fact that was not intentionally made.”); *id.* at 1061 (distinguishing older cases that did not enforce contractual limitations on fraud claims as “involv[ing] the protection of a relatively unsophisticated party or a party lacking bargaining clout who signs a contract with a boilerplate merger clause” from the transaction in *Abry Partners* where the court would “respect the ability of sophisticated businesses . . . to make their own judgments about the risk they should bear and the due diligence they undertake, recognizing that such parties are able to price factors such as limits on liability”); *MBIA Insurance Corp. v. Royal Indemnity Co.*, 426 F.3d 204, 218 (3d Cir. 2005) (applying Delaware law and stating that

however, in a typical business combination transaction, even before the seller begins delivery of due diligence information to the buyer, the seller and buyer agree that the seller is *not* making any representations as to the accuracy or completeness of the information delivered (because both parties know that that information *will* contain misstatements and omissions),<sup>127</sup> and, moreover, the parties understand that it would reduce the joint surplus of the transaction and make them both worse off if anything the seller says to the buyer other than the negotiated representations in the definitive agreement were treated as a representation upon which the buyer might rely. In the typical case in which non-reliance clauses are used in business combination transactions, therefore, even if a buyer intentionally lies to a seller in due diligence, the context makes this lie non-fraudulent because both the buyer and the seller understand perfectly well that the buyer will not rely on it. Hence, in typical cases involving non-reliance clauses, *there is no fraud* (even if, occasionally, there are some deliberate lies), but in typical cases involving contractual limits on remedies for fraud, there is *always fraud*, for if there were no fraud, the question of limitations on remedies for fraud would not arise. There is, therefore, all the difference in the world between the two cases: one *never* involves fraud, and the other *always* involves fraud.

And that is quite sufficient to explain the different treatment the two kinds of cases receive at law. From a moral point of view, while enforcing

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“when sophisticated parties have inserted clear antireliance language” into an agreement, Delaware courts “will enforce it to bar a subsequent fraud claim.”); *H-M Wexford LLC v. Encorp Inc.*, 832 A.2d 129, 142 n.18 (Del. Ch. 2003) (stating that the Delaware Court of Chancery has “consistently [held] that sophisticated parties to negotiated commercial contracts may not reasonably rely on information that they contractually agreed did not form a part of the basis for their decision to contract”); *In re IBP, Inc., Shareholders Litig.*, 789 A.2d 14, 72 (Del. Ch. 2001) (before holding that a non-reliance clause would be enforced, noting that “it is important to place [the court’s] . . . analysis in some context. The negotiations between IBP and Tyson did not take place between a world-wise, globe-trotting capitalist with an army of advisors on one side, and Jethro Bodine, on the other. Instead, two equally sophisticated parties dealt with each other at arms’ length with the aid of expensive and highly skilled advisors.”).

127. *But see* Quaintance, *supra* note 47, at 21-22, who thinks it cuts in favor of *not* enforcing the non-reliance clause in *RAA Management, LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107 (Del. 2012) that the clause was contained in a preliminary agreement, not the definitive one. Quaintance does not explain why this should be so, and I cannot imagine a reason for this view. Surely warning someone ahead of time not to rely on information yet to be produced generates a more sympathetic case for enforcement than allowing the buyer to think he can rely on the information he is receiving until it comes time to negotiate the definitive agreement, at which point the issue of a non-reliance clause is sprung for the first time.

non-reliance clauses in the usual case does *not* involve allowing a person to exculpate himself for his own fraud, enforcing limitations on damages for fraud obviously does. In the former case, the court does not help a fraudster; in the latter, it does. If the legal system wants to uphold standards of honest dealing in commercial transactions, it should enforce non-reliance clauses, not refuse to enforce them.<sup>128</sup> Likewise, if the legal system wants to uphold standards of honest dealing in commercial transactions, it should *not* enforce contractual limitations on fraud suits.

What about economics? It may seem that, if sophisticated parties have agreed to limit remedies for fraud, then this must be efficient, and so courts should enforce the such provisions in accordance with their terms. I think there are two answers to this. First, even if enforcing such provisions is efficient as between the contracting parties, such enforcement may involve negative external effects that make enforcing the provisions inefficient. That is, a legal system that helps fraudsters in this way may reasonably be perceived as valuing commercial honesty less than society generally does, and this will tarnish the reputation of that legal system, with negative effects for many parties beyond the contracting parties in the particular case. In other words, if Delaware allowed parties to exculpate themselves for fraud or even to limit the liability to which they may be exposed for fraud, this would harm the reputation of Delaware law and the Delaware courts,<sup>129</sup> which would hurt not only the State of Delaware but also all those sophisticated commercial parties who value Delaware as the venue of choice for settling business disputes. If we take account of these external effects, it is no longer clear that enforcing contractual limitations on remedies for fraud is efficient. Hence, even on purely economic grounds, there may well be good reasons for Delaware to hold unenforceable any contractual provisions purporting to limit remedies for fraud.

Second, Chief Justice Strine comes to the heart of the matter when he says in *Abry Partners* that the “public policy against fraud is a strong and venerable one that is largely founded on the societal consensus that lying is wrong.”<sup>130</sup> That is, even if it is efficient, including when we take account

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128. Again, always assuming we are considering business combination transactions (or similar transactions) between sophisticated parties. See *infra* Part II.

129. See *Bank of the United States v. Owens*, 27 U.S. 527, 528 (1829) (stating “no court of justice can in its nature be made the handmaid of iniquity. Courts are instituted to carry into effect the laws of a country, how can they then become auxiliary to the consummation of violations of law?”); see also *Siedel*, *supra* note 9, at 9 (stating that “the principal reason” for “the policy behind the rule that courts do not enforce illegal contracts” is “protection of the reputation of the judiciary”).

130. *Abry Partners V, L.P.*, 891 A.2d at 1035.



of external effects, to allow parties to agree by contract what should happen if one party defrauds the other, efficiency is not the only value at stake in a legal system. Indeed, efficiency is an ersatz normative concept intentionally devised by economists,<sup>131</sup> the intelligent application of which depends on the fulfillment of various conditions,<sup>132</sup> and when what is efficient and what is moral diverge, only an efficiency fanatic refuses to see that there are powerful reasons (though not necessarily conclusive ones in all cases) for the law to do what is moral rather than what is efficient. In most commercial settings, the preconditions of using the concept of efficiency in a normative way are usually easily fulfilled because most of the preferences of everyone affected can usually be very plausibly quantified in dollars. Society's preference for promoting honest dealing, however, is not plausibly quantified in dollars, and so this may be an unusual instance in the realm of business law where the concept of efficiency is not readily applicable.

b. *RAA Management, LLC v. Savage Sports Holdings, Inc.*<sup>133</sup>

In *RAA Management, LLC v. Savage Sports Holdings, Inc.*, the target company was conducting a sales process in which potential bidders, including RAA, a private equity firm, were given access to confidential information about the target pursuant to a non-disclosure agreement.<sup>134</sup> As is typical in such cases,<sup>135</sup> the agreement provided that the target was making no "representation or warranty, express or implied, as to the accuracy or completeness" of the materials made available to RAA and that the target "will not have any liability to" RAA "or any other person resulting from" RAA's evaluation of the materials.<sup>136</sup> In addition, the agreement also contained a provision stating, "Only those representations or warranties that are made to the purchaser in the Sale Agreement when,

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131. The original papers are NICHOLAS KALDOR, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549 (1939); JOHN HICKS, *The Foundations of Welfare Economics*, 49 *ECON. J.* 696 (1939); and TIBOR SCITOVSKY, *A Note on Welfare Propositions in Economics*, 9 *REV. ECON. STUD.* 77 (1941); see also DAVID D. FRIEDMAN, *PRICE THEORY* 434-454 (1990) (providing a modern treatment of the value of efficiency).

132. The most important of these conditions is that the parties involved can reasonably and realistically quantify, in dollars, their preferences regarding the possible outcomes. See *id.* In many commercial contexts, this condition is easily satisfied; in many other kinds of contexts, it is not, and in some contexts even suggesting that it could be fulfilled would be plainly absurd.

133. *RAA Management, LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107 (Del. 2012).

134. *Id.* at 109-110.

135. See *supra* notes 6-11 and accompanying text.

136. *RAA Management, LLC*, 45 A.3d at 110.

as and if it is executed, and subject to such limitations and restrictions as may be specified [in] such a Sale Agreement, shall have any legal effect.”<sup>137</sup>

Before considering the facts that gave rise to the dispute, notice that none of those provisions are, on their face, a non-reliance clause—that is, none expressly says that RAA will not rely on extra-contractual representations. The last quoted provision, stating, “[o]nly those representations or warranties that are made to the purchaser” in the definitive agreement “shall have any legal effect,” may reasonably be thought to amount to a non-reliance clause. After all, why else would representations outside the definitive agreement have no legal effect, unless it was because RAA was not relying on them? The Delaware Supreme Court obviously took this clause (or the other clauses mentioned above, or all of them in conjunction) as amounting to a standard non-reliance clause, which is certainly a reasonable view.

The other provisions in the preliminary agreement—the ones stating that the seller was making no “representation or warranty, express or implied, as to the accuracy or completeness” of the materials made available to RAA and that the seller “will not have any liability to” RAA based on RAA’s evaluation of the materials— are provisions we have not encountered before in our review of the case law. These are *disclaimers*, not non-reliance clauses, and although applying them in accordance with their terms may have the *same effect* as an enforcing a standard non-reliance clause, it is obvious that disclaimers and non-reliance clauses are different things. The disclaimer says, in effect, that the seller is making no representations when speaking to the buyer in due diligence; a standard non-reliance clause says that, although the seller makes all manner of representations to the buyer in due diligence, the buyer is not relying on those representations. In fact, confidentiality agreements typically include both disclaimers *and* non-reliance clauses, although, as I said already and we shall see further below, the Delaware Supreme Court in *RAA* does not seem to make much of a distinction between the two kinds of clauses.

Now, I noted above that one reason courts may historically have been reluctant to allow parties to contractually limit their liability arising from representations in contradistinction from promises was that while parties can by agreement unmake promises as easily as they make them, they cannot by agreement change the past fact about whether a representation was made or not. Here, however, we have a disclaimer *in a preliminary agreement*, made *before* the seller delivers any information to the buyer or

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137. *Id.*

otherwise speaks to the buyer. Does it make sense, generally speaking, for one person to deliver information to another without thereby endorsing it or otherwise taking responsibility for its accuracy or completeness? Clearly, it does. I can present you with a copy of a madman's diary<sup>138</sup> without raising any inference that I agree with the views expressed therein, and this is especially the case if, before I give you the book, I expressly say that I do not necessarily agree with anything asserted therein.<sup>139</sup> Whether this makes sense, or should be respected by the law, in the particular context of the delivery of information in due diligence by the seller to the buyer in connection with a business combination transaction is another matter. However, since the Delaware Supreme Court does not distinguish the disclaimers in the agreements in *RAA v. Savage Sports* from a standard non-reliance clause, I shall leave this topic for now and return to it in Part II, where we consider how disclaimers and non-reliance clauses work together to structure an efficient deal-making process.<sup>140</sup>

To return to *RAA*, however, the case arose because RAA contended that the target had represented to it that the company had no material liabilities not recorded on its financial statements, but that in the course of reviewing the materials made available to it in due diligence, RAA discovered that there were several such liabilities, a fact that, according to RAA, caused it to abandon any interest in acquiring the target.<sup>141</sup> RAA sued, claiming that, when the target represented to it that the company had no unrecorded material liabilities, it knew that this statement was false and the company made the false statement for the purposing of inducing RAA to at least consider purchasing the company.<sup>142</sup> According to RAA, the target was thus liable to it in fraud for the costs RAA incurred in its due diligence investigation, an amount that aggregated over \$1.2 million.<sup>143</sup> Thus, at issue in the case were (a) whether the provisions in the non-disclosure agreement quoted above applied to fraudulent misrepresentations (and not just innocent or negligent ones),<sup>144</sup> and (b) if

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138. See generally NIKOLAI GOGOL, *The Diary of a Madman*, in *THE DIARY OF A MADMAN, THE GOVERNMENT INSPECTOR, AND SELECTED STORIES* (Ronald Wilks trans. 2006) (providing a fictional example of a diary written by a madman).

139. Gottlob Frege, *Begriffsschrift* § 2, in *FROM FREGE TO GÖDEL: A SOURCE BOOK IN MATHEMATICAL LOGIC, (1879-1931)* (Jean van Heijenoort, 1967) (discussing the logical distinction between asserting a proposition and merely calling someone's attention to it or proposing it for consideration).

140. See *infra* Part II.

141. *RAA Management, LLC*, 45 A.3d at 111.

142. *Id.*

143. *Id.*

144. *Id.* at 112-13.

so, whether disclaimers of liability for fraudulent misrepresentations and non-reliance clauses related thereto were unenforceable as being contrary to public policy.<sup>145</sup>

Justice Holland, writing for the Delaware Supreme Court, quickly concluded that the agreement unambiguously referred to all forms of misrepresentations and therefore applied to fraudulent misrepresentations as well as innocent and negligent ones.<sup>146</sup> Turning to the more difficult question of whether disclaimers apply to even fraudulent misrepresentations, Justice Holland reviewed the reasoning in *Abry Partners* and adopted it wholesale.<sup>147</sup> In particular, Justice Holland quoted then-Vice Chancellor Strine's analysis of the Double Liar problem and adopted it as the position of the Delaware Supreme Court. He concluded, "In accordance with the *ratio decidendi* of *Abry Partners*, RAA's claim must be barred by the non-reliance and waiver provisions" in the non-disclosure agreement.<sup>148</sup>

Like the Chancery Court in *Abry Partners*, the Delaware Supreme Court also went on to consider policy rationales relevant to the question of disclaiming liability for fraud. Quoting from the decision of the Court of Appeals for the Second Circuit in *Warner Theatres Associates, Ltd. v. Metro Life Insurance Co.*, the court observed that disclaimers of liability and non-reliance clauses serve not only to shield a party from liability but also to "avoid lawsuits, or at least lawsuits that cannot be quickly dismissed."<sup>149</sup> That is, if non-reliance clauses are legally effective, any claim by the buyer based on allegedly fraudulent statements or omissions made in due diligence will be immediately dismissible under Rule 12b-6 on the basis of the non-reliance clause. If such clauses are not effective, then such claims will, in general, not only survive a motion to dismiss but will not even be resolvable by summary judgment.<sup>150</sup> That is, such claims will

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145. The agreement included a choice-of-law clause providing that New York law would govern disputes related to the agreement. The Delaware Supreme assumed without deciding that New York applied, but it expressly noted that "the outcome would be the same under Delaware law." *Id.* at 112.

146. *Id.* at 112.

147. *Id.* at 116-17.

148. *Id.* at 117.

149. *Id.* at 118 (quoting *Warner Theatres Associates, Ltd. v. Metro Life Insurance Co.*, 149 F.3d 134, 137 (2d Cir. 1998)).

150. See Lutz, *supra* note 9, at 842 (describing how plaintiffs may avoid summary judgement or a motion to dismiss because of factual uncertainty regarding whether the plaintiff reasonably relied on a representation by the defendant); see also Blair, *supra* note 9, at 469-70 ("[A] plaintiff alleging fraud stands a very good chance of surviving any pretrial efforts that a defendant might make to cut short the litigation," and "Sellers faced with fraud claims . . . are likely to be forced to incur legal fees through a trial . . .").

almost always raise disputed issues of material fact, thus preventing their disposition on summary judgment. This means that a defendant faced with such a suit has to incur the significant costs of discovery and perhaps trial. Moreover, as noted in *Abry Partners*, claims based on allegedly fraudulent statements or omissions made in due diligence (especially oral ones) are subject to a high error rate. These factors combine to endow even quite unmeritorious suits with considerable settlement value.

All this suggests a simple but powerful economic argument in favor of making non-reliance clauses effective. For, from economic point of view, the question has become one of relative costs. If disclaimers and non-reliance clauses are not enforceable, the seller bears the cost of non-meritorious post-closing suits based on allegedly fraudulent extra-contractual statements and omissions. If such clauses are enforceable, the buyer bears the cost of being duped by fraudulent extra-contractual statements and omissions. But this second cost can be avoided by the buyer taking the precaution of ensuring that all representations that are material to it are included in the definitive agreement. Since the parties are already going to negotiate such an agreement, and since such an agreement typically includes a vast array of representations covering all aspects of the target's business, the cost to the buyer of making sure that all the representations material to it are included in the definitive agreement is normally quite low. Hence, the efficient solution to the problem is for the cost to the seller of non-meritorious suits to be eliminated by making disclaimers and non-reliance clauses enforceable, and for the cost to the buyer of being duped by fraudulent statements and omissions in due diligence to be avoided by the buyer's taking appropriate precautions by negotiating a complete set of representations in the definitive agreement. By placing the risk on the cheapest cost avoider, this solution maximizes the joint surplus from the transaction and so makes both parties better off. I will formulate a much more elaborate version of this argument in Part II below.

## 2. New York Law<sup>151</sup>

Although New York long declined to enforce non-reliance clauses,<sup>152</sup> that changed in 1959 when the state's highest court, the New York Court of Appeals, reversed course in *Danann Realty Corp. v. Harris*.<sup>153</sup> In *Danann Realty*, the underlying transaction was a sale of a lease for a building. After the transaction was consummated, the buyer sued, affirming the contract, but seeking damages for fraud based on alleged misrepresentations, supposedly made orally by the seller outside the contract, concerning the operating expenses and profits of the lease.<sup>154</sup> As the court saw it, the key issue was whether the buyer could "establish . . . reliance upon the representations,"<sup>155</sup> given that the contract provided that the seller "has not made and does not make any representations as to the physical condition, rents, leases, expenses, operation or any other matter or thing affected or related to the [building], except as . . . specifically set forth" in the agreement and the buyer "expressly acknowledges that no such representations have been made" and was "not relying upon any statement or representation not embodied in this contract."<sup>156</sup> In the other words, the contract contained a disclaimer by the seller of extra-contractual representations and a representational non-reliance clause by the buyer (it also included a standard integration clause).<sup>157</sup> After noting that an integration clause, by itself, would not operate to bar a fraud claim based on extra-contractual representations,<sup>158</sup> the court held that, in this case, the

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151. See generally Masson, *supra* note 9, at 503 (discussing the evolution of New York Law on the issue of non-reliance clauses).

152. See e.g., *Bridger v. Goldsmith*, 143 N.Y. 424, 428 (1894) (stating that "a party that has perpetrated a fraud upon his neighbor may [not] . . . contract with him in the very instrument by means of which it was perpetrated, for immunity against its consequences, close his mouth from complaining of it and bind him never to seek redress."); *Crowell-Collier Pub. Co. v. Josefowitz*, 5 N.Y.2d 998 (1959) (holding that a disclaimer by the seller in the agreement did not bar buyer's suit for fraud based on alleged extra-contractual misrepresentations); see also Masson, *supra* note 9 at 504 (citing *Danann Realty Corp. v. Harris*, 5 N.Y.2d 317 (1959) as a case in which the court changed the default rule regarding reliance waivers).

153. 5 N.Y.2d 317 (1959). The majority maintains that the decision in *Danann Realty* is consistent with prior New York law, but the vigorous dissent by Judge Fuld demonstrates that this is clearly not correct. See Masson, *supra* note 9, at 504 (agreeing that *Danann Realty* was an important departure from prior law).

154. *Danann Realty Corp.*, 5 N.Y.2d at 319.

155. *Id.*

156. *Id.* at 320 (emphasis deleted).

157. *Id.* at 319.

158. The court cited *Sabo v. Delman*, 3 N.Y.2d 155 (1957) and reiterated "the fundamental principle that a general merger clause is ineffective to exclude parol evidence

buyer “has in the plainest language announced and stipulated that it is not relying on any representations *as to the very matter as to which it now claims it was defrauded.*”<sup>159</sup> That is, the *Danann* court held that the particularity of the non-reliance clause mattered: the buyer had represented it was not relying on extra-contractual representations about expenses and profits, and now it was suing alleging misrepresentations about specifically these issues. Noting that the “plaintiff’s officers read and understood the contract” and “they were aware of the provisions by which they aver that plaintiff did not rely on . . . extra-contractual representations,”<sup>160</sup> the court held that the buyer would be held to the terms of the agreement and its claims of fraud based on allegedly fraudulent extra-contractual representations would be dismissed.

Besides the requirement that the non-reliance clause mention with particularity the subjects of extra-contractual representations on which the buyer is not relying, the opinion in *Danann* is notable for another reason as well. That is, it anticipates—and arguably even improves upon Chief Justice Strine’s Double Liar Argument. For, the court says, because the buyer “made a representation in the contract that it was not relying on specific representations not embodied in the contract, while, it now asserts, it was in fact relying on such oral representations,” the buyer thus “admits . . . that it is guilty of deliberately misrepresenting to the seller its true intention.”<sup>161</sup> This, of course, sounds very much like the Double Liar Argument. But, the court continues, “To condone this fraud would place the purchaser in a favored position,”<sup>162</sup> and the court cites, without further explanation, the famous case of *Riggs v. Palmer*,<sup>163</sup> in which the New York Court of Appeals refused to allow an heir under a will who had murdered the testator to receive the legacy to which he was otherwise entitled. Although it is not entirely clear why the *Danann* court cites *Riggs v. Palmer*,<sup>164</sup> the court seems to be citing the case for the proposition that “all

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to show fraud in inducing the contract.” *Danann Realty Corp.*, 5 N.Y.2d at 320.

159. *Id.* (emphasis added).

160. *Id.* at 321.

161. *Id.* at 323.

162. *Id.*

163. *Riggs v. Palmer*, 115 N.Y. 506 (1889).

164. *Danann Realty Corp.*, 5 N.Y.2d at 323 (citing *Riggs v. Palmer* 115 N.Y. at 511-12). On page 511, the *Riggs* court is discussing the equitable interpretation of statutes, which is plainly not relevant to the issues in *Danann*. At the very bottom of page 511, however, the *Riggs* court moves to a new topic, which, as quoted in the text, is that all laws *and contracts* may be controlled in their operation by fundamental maxims of the common law, such as that no one shall be permitted to profit from his own fraud. This discussion continues onto page 512, where the court gives several examples, such as *Mutual Life Ins. Co. of New York v. Armstrong*, 117 U.S. 591 (1886), in which the United State Supreme Court held that

contracts may be controlled in their operation and effect by general, fundamental maxims of the common law,” such as that “[n]o one shall be permitted to profit by his own fraud, or to take advantage of his own wrong, or to found any claim upon his own iniquity, or to acquire property by his own crime.”<sup>165</sup> In other words, the *Danann* court sees the buyer, who represented that he was not relying on extra-contractual representations of the seller but did in fact rely on such representations, as a fraudster, and under the common-law principle that no one shall be permitted to profit by his own fraud, it would dismiss his suit. But, in contradistinction to the Double Liar Argument, the *Danann* court does *not* see the seller as a fraudster. Why not, if the seller did, as the buyer alleges, make lying representations to the buyer outside the contract? I think the only answer, which goes beyond the Double Liar Argument and adumbrates much that I will have to say in Part II, is that even if the seller did lie to the buyer outside the contract the seller did not commit *fraud* because the buyer agreed not to rely on such representations, and reliance is an element of fraud. By contract, the seller presumably *did rely* on the buyer’s representations in the contract, and so the buyer, but not the seller, would be a fraudster. If this is correct, then the *Danann* court likely understood the issues surrounding non-reliance clauses more deeply than any other court to consider them.

However this may be, the requirement in *Danann* that the non-reliance clause mention with specificity the matters treated in extra-contractual representations on which the buyer is not relying did not long survive in New York. After lower courts chipped away at the requirement,<sup>166</sup> the Court of Appeals reconsidered it in *Citibank v. Plapinger*.<sup>167</sup> That case centered on a guarantee that the guarantors represented was “absolute and unconditional” but which, they later claimed, was fraudulently induced by certain oral, extra-contractual representations by the guaranteed party.<sup>168</sup>

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a beneficiary under a life insurance policy who had murdered the individual whose life was insured would be not be permitted to collect the insurance proceeds. See *Riggs*, 115 N.Y. at 512 (holding that the murderer “forfeited all rights under [the insurance policy] when, to secure its immediate payment, he murdered the assured” because it “would be a reproach to the jurisprudence of the country if one could recover insurance money payable on the death of the party whose life he had feloniously taken.”).

165. *Riggs*, 115 N.Y. at 511.

166. See *Barnes v. Gould*, 83 A.D.2d 900 (N.Y. App. Div. 1981); *Galvatron Indus. Corp. v. Greenberg*, 96 A.D.2d 281 (N.Y. App. Div. 1983); see also *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729 (2d Cir. 1984) (holding that an action for fraud based on extra-contractual representations cannot be maintained where the plaintiff contractually disclaimed reliance and had access to all relevant information).

167. *Citibank, N.A. v. Plapinger*, 66 N.Y.2d 90, 95 (1985).

168. *Id.* at 93-94.



Summarizing the holding in *Danann* as, “the rule that fraud in the inducement vitiates a contract [is] . . . subject to exception where the person claiming to have been defrauded has by his own specific disclaimer of reliance upon oral representations himself been guilty of deliberately misrepresenting [his] true intention,”<sup>169</sup> the Court of Appeals noted that *Danann* “has been criticized as . . . likely to result in verbose merger clauses.”<sup>170</sup> Suggesting a distinction between specifically negotiated non-reliance clauses and ones not specifically negotiated, the court stated that, although “it cannot be said, as in *Danann*, that the defendants have ‘in the plainest language announced and stipulated that [they were] not relying on any representations as to the very matter . . . as to which [they] now [claim they were] defrauded,’ nevertheless ‘following extended negotiations between sophisticated business people,’ the defendants agreed to a guarantee that they ‘proclaimed . . . to be ‘absolute and unconditional.’”<sup>171</sup> This, the court held, was legally sufficient. “It is unrealistic in such circumstances to expect an express stipulation that the defendants were not relying” on the particular representation they claimed to rely upon “when they themselves have denominated their obligation unconditional . . . .”<sup>172</sup>

The lesson from *Citibank*, therefore, seems to be that a non-reliance clause, even one that is completely general, will be enforced if it is part of a negotiated agreement between sophisticated parties. Although some subsequent New York cases continue to consider the specificity of the non-reliance clause,<sup>173</sup> others have followed in the path of *Citibank* and largely dropped the specificity requirement. Thus, noting that the “specificity requirement is further relaxed when the contracting parties are ‘sophisticated business people,’ and the disclaimer clause [in the case at hand] was the result of negotiations between [such parties],”<sup>174</sup> the court in *Aniero Concrete Co., Inc. v. New York City Const. Authority* held that a sophisticated party would be bound by a non-reliance clause even though it did not mention specifically the subject matter of the extra-contractual representations by which the plaintiff claimed the defendant had fraudulently induced it into the contract at issue.<sup>175</sup> Perhaps not surprisingly, the Delaware courts have taken *Citibank* at face value and

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169. *Id.* at 94.

170. *Id.* at 95 (internal citations omitted).

171. *Id.* at 95.

172. *Id.*

173. See e.g., *Warner Theatre Assoc. v. Metropolitan Ins. Co.*, No. 97-9552, 1997 WL 685334 (S.D.N.Y. Nov. 4, 1997) (considering the specificity of language in an agreement).

174. *Aniero Concrete Co. v. New York City Const. Auth.*, No. 94 CIV. 9111, 1997 WL 3268, at \*7 (S.D.N.Y. Jan. 3, 1997).

175. *Id.* at \*8.

held, when applying New York law, that non-reliance clauses in negotiated agreements between sophisticated parties are enforceable in accordance with their terms.<sup>176</sup> If this is correct, then, as Justice Holland noted in *RAA v. Savage Sports*, the New York rule is the same as the Delaware rule.<sup>177</sup>

*C. The Circuit Split: Enforceability of Non-Reliance Clauses in the Second Circuit, Un-Enforceability in the Third and First Circuits.*<sup>178</sup>

We have seen so far that the virtually universal practice in the market for corporate control is for the seller to require that potential purchasers enter into a confidentiality agreement prior to receiving due diligence materials from the seller.<sup>179</sup> Furthermore, such confidentiality agreements routinely include both disclaimers by the seller of any representations about the accuracy or completeness of the materials made available to the buyer and promises by the buyer not to rely on any representations of the seller except for those that are ultimately set forth in the definitive acquisitive agreement between the parties.<sup>180</sup> We have also seen that the leading commercial law jurisdictions of Delaware and New York have held that such disclaimers and non-reliance promises are enforceable against sophisticated parties in accordance with their terms to block suits against the seller on the basis of extra-contractual representations, even when the allegation is that the seller made such extra-contractual representation fraudulently in order to induce the buyer into the agreement.<sup>181</sup>

Against this background, it might seem inevitable that similar disclaimers and non-reliance clauses would have the same effect against fraud claims brought under Rule 10b-5 as they do against common law fraud claims. Such is indeed the law in the Second Circuit,<sup>182</sup> but the rule is

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176. See, e.g., *In re IBP, Inc., Shareholders Litig.*, 789 A.2d 14, 73 n.178 (citing *Citibank* as holding that “specific contractual agreement that representations outside of contract were not relied upon foreclosed fraud in inducement claim”).

177. See *RAA Management, LLC v. Savage Sports Holdings, Inc.*, discussed above in Section I.B.1.b, where, when it had to decide whether a non-reliance clause was enforceable, the Delaware Supreme Court assumed without deciding that New York law applied but expressly noted that “the outcome would be the same under Delaware law.” 45 A.3d 107, 112 (Del. 2012.)

178. On the specific topic of the circuit split, see generally Altman, *supra* note 9; Grove, *supra* note 9; Lutz, *supra* note 9; Quaintance, *supra* note 47; West & Lewis, Jr., *supra* note 2, at 1003 n.2.

179. See *supra* notes 35-40 and accompanying text.

180. *Id.*

181. See Sections I.B.1 & I.B.2.

182. *Harsco Corp. v. Segui*, 91 F.3d 337, 342 (2d Cir. 1996).

otherwise in the First<sup>183</sup> and Third Circuits.<sup>184</sup> The source of the disagreement is Section 29(a) of the Securities Exchange Act of 1934 (the Exchange Act). This innocuous-sounding provision reads its entirety as follows, “Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.”<sup>185</sup> Generally speaking, this is an entirely unremarkable non-circumvention provision designed to protect investors from sharp practices in which bad actors would trick them into waiving compliance with the securities laws, thus defeating the whole purpose of the statutory scheme. As with so many provisions in the federal securities laws, however, although this provision may be eminently sensible in the context of protecting retail investors against securities professionals, nevertheless the provision becomes problematic in the context of securities transactions between sophisticated parties advised by expert counsel.<sup>186</sup> In the case of non-reliance clauses in business combination transactions, the problem is obvious: a non-reliance clause may well seem to be a “condition, stipulation, or provision binding” the buyer “to waive compliance with” Rule 10b-5, thus making misrepresentations that are not actionable at common law (because of the non-reliance clause) actionable under federal law.<sup>187</sup>

Taking the question in abstraction from any more detailed context, it is at least plausible that non-reliance clauses are void under Section 29(a). In a richer context like that described above, however, this argument becomes considerably less plausible. In any case, as indicated above, the United States Circuit Courts of Appeals for the Second Circuit, which

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183. *Rogen v. Illikon Corp.*, 361 F.2d 260, 266 (1st Cir. 1966).

184. *AES Corp. v. Dow Chemical Co.*, 325 F.3d 174, 179 (3d Cir. 2003).

185. Securities Exchange Act of 1934, Section 29(a), 15 U.S.C. § 78cc (2018).

186. *See Lutz, supra* note 9, at 805 (arguing that the split between the circuit courts “stands for a much more fundamental and widespread problem,” which concerns what assumptions “should drive legal analysis and rulemaking” and “[w]hat values are served by regulating the securities industry”).

187. Reasonable reliance is an element of an action under Rule 10b-5 just as it is an element of an action for common law fraud. *See Basic v. Levinson*, 485 U.S. 224, 247 (1988) (reliance is an element of a Rule 10b-5 fraud action); *see also Kennedy v. Josephthal & Co.*, 814 F.2d 798, 804 (1st Cir. 1987) (listing and discussing factors to be considered in determining whether a purchaser or seller of securities reasonably relied on the defendant’s alleged misstatement); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972) (noting that in a Rule 10b-5 action based on an allegedly misleading omission, the investor need not show actual reliance on the omission but, only that a reasonable investor would find the omitted information to be important in making an investment decision); *Lutz, supra* note 9, at 808-809 (discussing reasonable reliance and the *Kennedy* factors).

includes New York, and the Third Circuit, which includes Delaware, have been divided over this issue for at least fifteen years, with the First Circuit aligned with the Third. Adding to the confusion, other Circuits, including the Seventh and the District of Columbia Circuit, have considered the enforceability of non-reliance clauses without reference to the effect of Section 29(a) and held them to be enforceable. Regrettably, the Supreme Court has not acted to resolve the circuit split. The next three subsections consider the relevant cases in detail.<sup>188</sup>

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188. In the famous case of *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), Jordan resold to his employer, Duff & Phelps, shares acquired in connection with his employment and later sued under Rule 10b-5 claiming that the corporation should have disclosed to him the possibility that the corporation could soon be acquired at a price well above the sales price. The case is thus very similar to *Rogen v. Illikon Corp.*, but unlike *Rogen* the court more accurately understood the situation as one involving a duty to disclose, rather than non-reliance on an allegedly false representation. Judge Easterbrook writes, “We may assume that duties concerning the timing of disclosure by an otherwise-silent firm also may be the subject of contract. Section 29(a) of the Securities Exchange Act of 1934 . . . forbids waiver of the provisions of the Act,” including Rule 10b-5. *Id.* at 436. But “a provision must be applicable to be ‘waived,’ and the existence of a requirement to speak is a condition of the application” of Rule 10b-5 “to a person’s silence during a securities trade. The obligation to break silence is itself based on state law . . . and so may be redefined to the extent state law permits.” *Id.* As M. Todd Henderson points out, in their famous dueling opinions in the case, “one thing upon which [Judge] Easterbrook and [Judge] Posner agree is that the parties could, through contract, waive any duties to disclose; they simply disagree about whether Jordan did so in this case.” M. Todd Henderson, *Deconstructing Duff and Phelps*, 74 U. CHI. L. REV. 1739, 1754 (2007). “This is a pretty remarkable leap,” Henderson says, “as it seems to run afoul of the ban on waivers found in . . . the securities laws.” *Id.* (citing Securities Exchange Act of 1934, Section 29(a)). Henderson thinks that “the view that the securities laws are waivable (to some extent) by contractual definition of rights at the state law level is more readily accepted after *O’Hagan*, but when Posner first suggested it in *Duff and Phelps*, it was a radical notion.” *Id.* at 1755. I am not sure this is quite right, at least if Posner is correct (which I think he is) that the duty to speak arises under state fiduciary law, not Rule 10b-5, and the former may be modified by agreement. *Id.* at 445. See *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 445 (7th Cir. 1987), (Posner, J., dissenting) (stating “Rule 10b-5 forbids ‘fraud or deceit’ in the sale or purchase of corporate securities,” but Jordan “does not argue that Duff and Phelps made any misleading statements.” Rather, the gist of the complaint is that the company’s “omission to tell Jordan that he should think twice about quitting since the company might soon be sold at a price that would increase the value of Jordan’s stock by almost 30-fold.”). In any event, although *Duff and Phelps* recognizes the importance of Section 29(a), the fact that the case is about non-disclosure of material facts rather than non-reliance on matters actually disclosed, it is not ultimately relevant to the question of the effectiveness of non-reliance clauses.

1. The Second Circuit: *Harsco Corp. v. Segui*<sup>189</sup>

In *Harsco Corp. v. Segui*, the Second Circuit Court of Appeals considered claims for, among other things, Rule 10b-5 securities fraud arising out of a business combination transaction.<sup>190</sup> The buyer, Harsco, had acquired all of the outstanding equity securities of Multiserv, a Netherlands corporation, and subsequently Harsco sued various former officers and shareholders of Multiserv alleging that various extra-contractual representations they made were fraudulent in violation of Rule 10b-5.<sup>191</sup> The district court below had dismissed the plaintiff's claims on the basis of a disclaimer in the acquisition agreement,<sup>192</sup> and on appeal the Second Circuit understood "the central issue" in the case to be "whether parties who negotiate at arm's length for the sale and purchase of a company can define the transaction in a writing so as to preclude a claim of fraud based on representations not made, and explicitly disclaimed, in that writing."<sup>193</sup>

The Second Circuit began its analysis by noting that reasonable reliance by the plaintiff is an element of a Rule 10b-5 claim.<sup>194</sup> The agreement between the parties, however, contained not only a standard merger clause but also a disclaimer in which the seller disclaimed any representations or warranties except those expressly set forth in the agreement.<sup>195</sup> The defendants argued that these provisions made reasonable reliance by the buyer on any extra-contractual representations impossible.<sup>196</sup> The buyer disputed the correct interpretation of the

189. 91 F.3d 337 (2d Cir. 1996).

190. *Harsco Corp. v. Segui*, 91 F.3d 337, 341 (2d Cir. 1996); *see also* Citibank, N.A. v. Itochu Int'l Inc., No. 01CIV.6007(GBD), 2003 WL 1797847, at \*3 (S.D.N.Y. Apr. 4, 2003) (applying *Harsco Corp. v. Segui* to hold that a non-reliance clause in a securities purchase agreement between sophisticated parties barred fraud claims based on extra-contractual representations).

191. *Harsco Corp.*, 91 F.3d at 341.

192. *Harsco Corp. v. Bowden*, No. 94CIV.6191(LMM), 1995 WL 152523, at \*4 (S.D.N.Y. Apr. 5, 1995), *aff'd sub nom.* *Harsco Corp. v. Segui*, 91 F.3d 337 (2d Cir. 1996). Hence, *Harsco*, which is universally understood to concern non-reliance clauses, actually turns on the legal effect of a disclaimer. This is yet another instance of courts and scholars running together disclaimers, promissory non-reliance clauses, and representational non-reliance clauses.

193. *Harsco Corp.*, 91 F.3d at 339. The district court dismissed the common law claims along with the Rule 10b-5 claims. *Harsco*, 1995 WL 152523, at \*6. The Second Circuit also affirmed this ruling. *Harsco Corp.*, 91 F.3d 337, 339 (2d Cir. 1996).

194. *Harsco Corp.*, 91 F.3d at 342 (stating, "[t]he general rule is that reasonable reliance must be proved as an element of a securities fraud claim").

195. *Id.*

196. In this respect, the argument is similar to that adopted by the Delaware Supreme

contractual language, but its chief argument was that, even if the provisions meant what the seller claimed, then they were void under Section 29(a) of the Exchange Act. Since the buyer apparently conceded that, if the disclaimer made reliance on extra-contractual representations unreasonable, its claims on the basis of such representations had to fail, the issue quickly narrowed to whether Section 29(a) permitted the parties to agree that the only representations actionable under Rule 10b-5 would be those made in the agreement.

The court began its consideration of Section 29(a) by considering the only Supreme Court case to construe that provision, *Shearson/American Express, Inc. v. McMahon*.<sup>197</sup> In that case, a securities broker and its client had entered into an agreement that required the client to arbitrate any claims against the broker, including claims that the broker had violated provisions of the Exchange Act or rules or regulations promulgated thereunder.<sup>198</sup> Later, the client argued that the arbitration clause in the agreement violated Section 29(a) because Section 27 of the Exchange Act grants the district courts of the United States exclusive jurisdiction to adjudicate cases involving violations of the securities laws.<sup>199</sup> Therefore, the argument went, enforcing the arbitration clause would amount to the plaintiff waiving compliance with Section 27 in violation of Section 29(a). This argument did not prevail, and the Supreme Court held in *Shearson/American Express* that Section 29(a) did not invalidate agreements to arbitrate violations of the securities laws.<sup>200</sup>

The relevance of *Shearson/American Express* to the problem in *Harsco* is unclear. In holding that agreements to arbitrate claims concerning violations of the securities laws are not voided by Section 29(a), *Shearson/American Express* may be read to suggest that extremely broad readings of Section 29(a) are incorrect. On the whole, however, the many significant factual differences between disclaimers and non-reliance clauses in agreements between sophisticated parties involved in a business combination and arbitration clauses in agreements between brokers and their (often unsophisticated) clients are so great that it is perilous to infer

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Court in *RAA*, where Justice Holland treated disclaimers not obviously equivalent to a non-reliance clause as their functional equivalent. *RAA Management LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107, 119 (Del. 2012).

197. 482 U.S. 220 (1987); see also Lutz, *supra* note 9, at 810-811 (discussing the relevance of *Shearson/American Express* to the issue of the effectiveness of non-reliance clauses); Grove, *supra* note 9, at 1131 (discussing the *Shearson/American Express* opinion that Section 29(a) only prohibits waiver of substantive obligations of the Exchange Act.).

198. *Shearson/American Express*, 482 U.S. at 222-226.

199. Securities Exchange Act, Section 27(a), 15 U.S.C. 78aa (2018).

200. *Shearson/American Express*, 482 U.S. at 220.

much at all from *Shearson/American Express*. Indeed, in considering the effect of *Shearson/American Express* on the question before it, the Second Circuit did little more than note that the Supreme Court had stated that Section 29(a) “forbids . . . enforcement of agreements to waive ‘compliance’ with the provisions of the statute”.<sup>201</sup> It is hard to see how this gloss to Section 29(a) significantly adds to its content.

But in its analysis of the relevance of *Shearson/American Express*, the Second Circuit also stated that “the question here boils down to whether” the disclaimers in the agreement “weaken Harsco’s ability to recover” under Rule 10b-5 “in a way that § 29(a) prohibits.”<sup>202</sup> That qualification, of course, contains the whole issue, for the court readily conceded that, by limiting the universe of representations on which Harsco could bring Rule 10b-5 actions to those set forth in the agreement, there was obviously a clear sense in which the agreement “weaken[ed] Harsco’s ability to recover” under the Exchange Act.<sup>203</sup> Nevertheless, “in the circumstances of this case,” the court said, “such a ‘weakening’ does not constitute a forbidden waiver of compliance.”<sup>204</sup> In explaining why this was so, however, the court merely repeated some of the facts in the case: “there is a detailed writing developed via negotiations among sophisticated business entities and their advisors,” and this writing “defines the boundaries of the transaction.”<sup>205</sup> All of this is indisputably correct, but its relevance to whether Section 29(a) should be interpreted to require that parts of that writing be void is left entirely unexplained.

Little more emerges from the balance of the *Harsco* opinion. In distinguishing *Rogen v. Ilikon Corp.*,<sup>206</sup> a First Circuit case holding that Section 29(a) voided a non-reliance clause and discussed more fully below,<sup>207</sup> the Second Circuit emphasized that, in *Harsco*, the parties were both sophisticated entities and that they negotiated at arm’s length.<sup>208</sup> The result of that negotiation was an agreement containing extensive representations and warranties that were enforceable (including under Rule 10b-5) and that “protected [] Harsco’s substantive rights.”<sup>209</sup> In the court’s

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201. *Harsco Corp. v. Segui*, 91 F.3d 337, 343 (2d Cir. 1991) (quoting *Shearson/American Express*, 482 U.S. 220, 228 (1987)).

202. *Id.* (emphasis added).

203. *Id.*

204. *Id.*

205. *Id.*

206. 361 F.2d 260 (1st Cir. 1966); see also *Lutz*, *supra* note 2, at 811 (agreeing that *Rogen* should be distinguished from *Harsco* on the facts).

207. See Section I.C.2.

208. *Harsco Corp.*, 91 F.3d at 344.

209. *Id.*

view, the “analysis becomes a question of degree and context,” and “in different circumstances (e.g., if there were but one vague seller’s representation) a ‘no other representation’ clause might be toothless and run afoul of § 29(a).”<sup>210</sup> In other words, it seems that the court was holding that if sophisticated parties negotiate a sufficiently large set of representations, then a disclaimer of any extra-contractual representations will be enforceable.

Now, such a rule is in keeping with the spirit of the federal securities laws in at least two important ways. First, it relies on a vague standard the application of which depends on the court’s appraisal of the totality of the facts and circumstances.<sup>211</sup> Second, it allows sophisticated parties, who can “fend for themselves”<sup>212</sup> and who do not “need the protection of the Act,”<sup>213</sup> to arrange their own affairs without governmental inference. It is worth pointing out, however, that when the securities laws make exceptions to general rules for sophisticated parties, the exceptions are invariably from such rules as the registration requirement under Section 5 of the Securities Act, not the general antifraud provisions such as Rule 10b-5.<sup>214</sup> That potentially important difference goes unnoticed in the *Harsco* opinion.

The rest of the *Harsco* opinion is not especially convincing. For example, if the key factor is the sophistication of the parties, why should sophisticated parties be permitted to limit the representations on which Rule 10b-5 claims are brought to those in the agreement only if the representations in the agreement are very extensive? Sometimes, sophisticated parties wish to agree to a sale without representations and warranties—a sale, in transactional law jargon, “as is, where is.”<sup>215</sup> The Second Circuit expressly says, however, that in such a case disclaimers and non-reliance clauses may be void under Section 29(a). The idea seems to be that the federal securities laws protect parties on a sliding scale based on their level of sophistication. That is, the securities laws protect

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210. *Id.*

211. Compare *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) (holding that availability of the exemption in Section (4)(a)(2) from the registration requirements of the Securities Act of 1933 depends on the totality of the facts and circumstances of the challenged transaction).

212. *Id.* at 125.

213. *Id.*

214. For example, Regulation D provides certain safe-harbor exemptions from the registration requirement of Section 5 of the Securities Act, but Rule 500(a) states that transactions effected in accordance Regulation D “are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws.” 17 C.F.R. § 230.500(a) (2016).

215. The facts in the Third Circuit case discussed below essentially fit the bill; the subject transaction was essentially “as is, where is.” *AES Corp. v. Dow Chemical Co.*, 325 F.3d 174, 177 (3d Cir. 2003). See *supra* note 183 and accompanying text.



unsophisticated parties completely, and so any contractual limitation on which representations made to such parties may support a Rule 10b-5 action will be void. The securities laws protect sophisticated parties much less, and so contractual limitations on which representations made to them may support a Rule 10b-5 action will generally be enforceable. Nevertheless, since the securities laws protect even sophisticated parties to some extent, the limitation on representations made to sophisticated parties cannot be complete. This schema has some surface plausibility, but only the most naïve view that, no matter what, a buyer is better off with more representations rather than fewer could possibly justify such a position. In any event, it is clear that, while the result in *Harsco* seems right, the reasoning is inadequate.<sup>216</sup>

## 2. The Third Circuit: *AES Corp v. The Dow Chemical Co.*

The facts in *AES Corp. v. The Dow Chemical Co.*<sup>217</sup> are very similar to those in *Harsco*. As in *Harsco*, one sophisticated business entity negotiated with another for the purchase of all the outstanding stock of a corporation. In particular, when Dow Chemical decided to sell one of its subsidiaries, it engaged the investment banking firm Morgan Stanley to manage the sales process.<sup>218</sup> Morgan Stanley made available to interested parties, including the ultimate purchaser, AES, certain information about the company being sold, but such information was delivered pursuant to a confidentiality agreement in which such parties (a) acknowledged that the seller was making no representations or warranties about the accuracy or completeness of the information being delivered, (b) agreed that the seller would have no liability arising from any errors or omissions in such information, and (c) promised that they would rely only on such representations and warranties as were included in the definitive agreement

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216. In *Citibank, N.A. v. Itochu International, Inc.*, No. 01 Civ. 6007(GBD), 2003 WL 1797847 (S.D.N.Y. 2003), a federal district court in the Second Circuit followed *Harsco* and further held that, because of the common law doctrine that parties may not contractually limit their liability for fraud and because Section 29(a) the Exchange Act makes waivers of rights under the federal securities laws void, a buyer of securities could sue for Rule 10b-5 securities fraud on the basis of the representations a seller made to the buyer in the agreement without being bound by the exclusive remedies provision contained in the agreement. Indeed, the court expressly held that a contractual limitation on fraud claims based on alleged misrepresentations in the agreement would be void under Section 29(a). *Id.* The rules in *Harsco* and *Itochu* thus exactly parallel those under Delaware law as set forth in *Abry Partners* and *RAA*.

217. *AES Corp. v. The Dow Chemical Co.*, 325 F.3d 174 (3d Cir. 2003).

218. *Id.* at 175.

related to the sale and purchase of the target company.<sup>219</sup> In other words, the confidentiality agreement contained both disclaimers and a promissory non-reliance clause.

Eventually, AES and Dow entered into a definitive agreement under which AES acquired the stock of the target company. That agreement contained certain minimal representations by Dow, including with respect to its due organization and authority to enter into the agreement, a lack of conflicts between the agreement and any court orders by which Dow was bound or any contracts to which Dow was a party, and the absence of any fees due to brokers related to the transaction.<sup>220</sup> Dow did not make any representations or warranties about the qualities of the business being transferred,<sup>221</sup> and the agreement also contained a provision under which Dow disclaimed any representations or warranties except for those set forth in the agreement.<sup>222</sup> After the closing of the transaction, AES sued Dow alleging that various extra-contractual representations made by Dow's representatives during the due diligence process and the negotiation of the transaction were fraudulent under Rule 10b-5.

Much like the Second Circuit in *Harsco*, the Third Circuit began its analysis of the plaintiff's claim by reciting the elements of a Rule 10b-5 action,<sup>223</sup> emphasizing that the reasonable reliance element "requires a showing of a causal nexus between the misrepresentation and the plaintiff's injury, as well as a demonstration that the plaintiff exercised the diligence that a reasonable person under all the circumstances would have exercised to protect his own interests."<sup>224</sup> Noting that the defendant argued that the plaintiff could not prove the reasonable reliance element of its case because of the disclaimers and non-reliance clauses in the confidentiality agreement and the disclaimers in the acquisition agreement, the court moved on to

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219. *Id.*

220. *Id.* at 177.

221. The sale was thus, in effect, a sale "as is, where is." See *infra* note 215. A sale of a business "as is, where is" between such parties is certainly unusual. I asked Herbert L. Zarov, who represented Dow before the Third Circuit why the representations were so abbreviated, but he could throw no light on the subject. It seems that it never occurred to the court in *AES* that it could have distinguished the case from *Harsco* on this basis and not have placed itself in direct conflict with the Second Circuit. See *Quaintance*, *supra* note 47, at 24 (arguing that the Third Circuit could have distinguished *Harsco* on several grounds, including the extent and specificity of the representations and warranties the sellers made).

222. *AES Corp.*, 325 F.3d 174 at 174.

223. To wit, the plaintiff must prove that the defendant made a misstatement or an omission of a material fact, with scienter, in connection with the purchase or sale of a security, upon which the plaintiff reasonably relied, which such reliance was the proximate cause of the plaintiff's injury. *Id.* at 178.

224. *Id.*

consider the effect of Section 29(a) of the Exchange Act on those contractual provisions.

The court held that enforcing disclaimers and non-reliance clauses to foreclose Rule 10b-5 actions on the basis of extra-contractual representations “would be inconsistent with Section 29(a).”<sup>225</sup> The court’s reasoning, however, is very curious. Its primary argument is that, since reliance is an element of a Rule 10b-5 fraud claim, “if a party commits itself never to claim that it relied on representations of the other party to its contract, it purports anticipatorily to waive any future claims based on fraudulent misrepresentations of that party,” whether the promise covers all representations the party made or just those made outside the agreement.<sup>226</sup> This, of course, is transparently mistaken. The various different clauses in the confidentiality agreement and the definitive agreement do different things, but none of these is a promise by the buyer *not to claim* in the future that it relied on certain statements by the seller—as if the idea were that the buyer was indeed relying on those statements but promised not to assert this later in litigation. Of the various provisions in the agreements, the only one that is clearly a *promise* about what the buyer will do is a promise in the confidentiality agreement that, in entering into the definitive agreement, it will not rely on any extra-contractual representations of the seller.<sup>227</sup> Some of the other provisions may be read as *representations* by the buyer about which representations by the seller it is relying upon in entering into the definitive agreement.<sup>228</sup> But nowhere is there a promise *not to sue*.

It is true that the covenant not to assert certain claims that the Third Circuit mistakenly believes exists in the agreements and the actual provisions in those agreements may require the same outcome in certain kinds of lawsuits, but that does not make them legally equivalent. This is apparent from a large body of caselaw in which the difference between similarly worded covenants and representations makes an important legal difference. For example, a roofer replaces the roof on a homeowner’s house under a contract that says that the roof will not leak for ten years.<sup>229</sup>

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225. *Id.* at 180.

226. *Id.*

227. That is, the relevant provision in the confidentiality agreement should be read in accordance with the fifth interpretation of non-reliance clauses given above. See Section I.B.

228. That is, such provisions can be read in accordance with the fourth interpretation of non-reliance clauses given above. See Section I.B.

229. See *Cunningham v. Frontier Lumber Co.*, 245 S.W. 270, 270 (Tex. Civ. App. 1922) (guaranteeing that a roof would give satisfaction for ten years); see also Chris Williams, *The Statute of Limitations, Prospective Warranties, and Problems of Interpretation in Article Two of the UCC*, 52 GEO. WASH. L. REV. 67, 68 (1983) (describing the analogous issue

If this is a covenant, the roofer is promising that, if the roof leaks at any time in the ten-year period following the date of the contract, the roofer will repair it (or pay for the homeowner to do so). If the language in the contract is a representation, it is a statement, definitively true or definitively false, once and for all, on the date of the contract about the quality of workmanship and materials used (i.e., whether they are such as to withstand leaks from ordinary wear and tear for ten years). Suppose the statute of limitations for a claim sounding in contract is six years, the roof leaks in the seventh year, and the roofer refuses to provide the homeowner with any remedy. Whether the homeowner has a claim under the contract depends critically on whether the language in the contract contains a covenant or a representation. If it was a covenant, then the homeowner has a good claim, for the roofer breached the covenant only in year seven when he failed to repair the roof. If the language in the contract is a representation, however, the homeowner's claim is barred by the statute of limitations, for if the representation was false, it was false when made, which means that the breach of contract occurred on the date contract was made, more than six years in the past.

In the context of the federal securities laws, the difference between the buyer's promise not to claim a violation of Rule 10b-5 and a representation that the buyer did not rely on extra-contractual representations is even more important. The former would, presumably, violate Section 29(a). The non-reliance representation, however, is clearly different. For, in all manner of securities transactions, sellers demand representations from buyers as part of their efforts to comply with particular provisions of the securities laws. For example, under Rule 506(b) of Regulation D, an issuer may sell securities without registering them under Section 5 of the Securities Act if, among other things, each of the purchasers of the securities is an "accredited investor" within the meaning of Rule 501(a).<sup>230</sup> Thus, in an effort to comply with Rule 506(b), sellers routinely require that, in the agreement under which the securities are sold, the buyer represents to the seller that it is an accredited investor.<sup>231</sup> By reasoning like that in the Third Circuit's opinion in *AES*, this representation should be taken to be

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under Article 2 of the Uniform Commercial Code).

230. Rule 506(b) allows the seller to sell to up to 35 non-accredited investors as well, but in any sizeable private placement of securities, the purchasers are virtually always all accredited investors. *See* Rule 506(b)(2)(ii) and Rule 501(e); 17 CFR 230.506(b)(2)(ii); 17 CFR 230.501(e).

231. *See* Section 4(a)(2) and Regulation D Private Placements, Practical Law Practice Note 8-382-6259 (explaining the required representations as to accredited investor status under Regulation D).

equivalent to a promise by the investor not to claim later in litigation that it is not an accredited investor. That promise would then be equivalent to the buyer's waiving the protection of Section 5 of the Securities Act, because by promising not to claim to be anything other than an accredited investor, the buyer effectively makes it impossible for itself to argue that the seller sold securities to it outside the safe-harbor of Rule 506(b) and so in violation of Section 5. Given the ubiquity of buyers' representations in agreements for the sale of securities, and given that some of the SEC's own rules require that buyers obtain such representations from sellers,<sup>232</sup> it seems manifestly absurd that a representation from a buyer which, if true, negates an element of a possible cause of action under the securities laws should be understood to be a waiver of protection under those laws in violation of Section 29(a).

Indeed, at this point the difference between a waiver void under Section 29(a) and a representation that, if true, would negate an element of a potential claim under some provision of other of the securities laws should be clear. That is, when sophisticated parties are negotiating a sale and purchase of securities, they do so in light of the securities laws, attempting to structure their transaction in order to comply with those laws. For example, to fit the transaction into a certain safe harbor, it is usually the case that certain factual preconditions must be met (e.g., in a Rule 144A transaction, each of the purchasers must be a qualified institutional buyer within the meaning of the rule).<sup>233</sup> Ensuring that these preconditions are met is often beyond the control of the seller; rather, it requires coordinated action between the seller and the buyer. The seller, who is at risk of violating the law if the assumed factual preconditions are not actually fulfilled, secures the cooperation of the buyer in a legally binding way by requiring the buyer to make certain legally-binding representations to it in the relevant agreement. This is not an effort to evade the law or waive compliance with it; it is an effort to comply with particular provisions of the securities laws. The same is true with representations from the buyer regarding which representations and warranties it is relying on. By settling that matter, the seller knows in which representations it must invest resources to ensure that they are true in order not to violate Rule 10b-5. Hence, the representation from the buyer about which representations it is relying on is not a waiver of compliance with the law. It is a tool to establish the facts about the transaction in order that the seller can take

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232. See, e.g., 17 CFR §230.147 and 17 CFR §230.147A, which relate to intrastate offerings, require the seller to obtain from each purchaser a representation that the purchaser is a resident of the state to which the offering is confined.

233. 17 CFR §230.144A.

precautions to comply with the law.

To return to the Third Circuit's opinion in *AES*, after noting that its holding agreed with that of the First Circuit in *Rogen v. Ilikon*,<sup>234</sup> the court states that, although the disclaimers and non-reliance clauses in the agreement between the parties were void in violation of Section 29(a), nevertheless they would retain evidential value concerning whether the buyer in fact relied on extra-contractual representations.<sup>235</sup> That is, the buyer's declaration in the non-reliance clause "alone, or in conjunction with other evidence, may establish an absence of reliance and, when unrebutted, may even provide a basis for summary judgment in the defendant's favor."<sup>236</sup> The court thus adopted the minimal, evidentiary interpretation of the non-reliance clause.<sup>237</sup> Unlike in *Harsco*, however, the Third Circuit held that the non-reliance clause could not establish reliance as a matter of law entitling the defendant to prevail on a Rule 12(b)(6) motion to dismiss.<sup>238</sup> In other words, the court declined to adopt the conclusive-evidentiary or estoppel interpretations.

Finally, the Third Circuit acknowledged that its holding in *AES* was directly contrary to that of the Second Circuit in *Harsco*, but the court stated it found "*Harsco's* reasoning unpersuasive."<sup>239</sup> Conceding that "there may be economic efficiency in allowing private parties the freedom to fashion their own bargains,"<sup>240</sup> the court insisted that "Congress has made a decision to limit that freedom when it comes to anticipatory

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234. 361 F.2d 360 (1st Cir. 1966), which is discussed below in Section I.C.3.

235. *AES Corp. v. Dow Chemical Co.*, 325 F.3d 174, 180 (3d Cir. 2003). In other words, the *AES* court understand non-reliance clauses in accordance with the first interpretation thereof given above. See I.B.

236. *Id.* at 180.

237. See Lutz, *supra* note 9, at 815 (noting that the rule in *AES* makes non-reliance clauses one more factor in an already uncertain many-factor balancing test of whether the plaintiff's reliance on the alleged misrepresentation was reasonable). As Lutz correctly says, one way to understand non-reliance clauses is that they reduce uncertainty and limit the costs of litigation by settling, *ex ante*, which representations it is reasonable for the buyer to reply upon (those in the agreement) and which it is not (any other representations). *Id.* at 816-821. Altman, however, argues that this approach is incoherent: he thinks that the reasonability of a party's reliance on extra-contractual representations depends on the enforceability of non-reliance clauses. See Altman, *supra* note 9, at 756. Altman is surely right to the extent that, if such clauses are enforceable, then relying on extra-contractual representations in the presence of such a clause is unreasonable, but if such clauses are not enforceable, it is not incoherent to treat them as (non-conclusive) evidence of non-reliance—i.e., the evidentiary interpretation of such clauses identified above. See Section I.B.

238. *AES Corp.*, 325 F.3d 174, at 180-181.

239. *Id.* at 183.

240. *Id.*

waivers of Exchange Act claims.”<sup>241</sup> This, of course, merely refers back to the argument above that equates a representation negating an element of a potential cause of action under the securities laws with an anticipatory waiver of that claim. It does little to touch the reasoning in *Harsco*. The opinion in *AES* does not seriously engage with that in *Harsco*, and, like the opinion in *Harsco*, its reasoning is murky. The losing defendant in *AES* filed a petition for certiorari, but the Supreme Court declined to hear the case.<sup>242</sup>

### 3. The First Circuit: *Rogen v. Ilikon Corporation*

The earliest case to consider the effect of Section 29(a) on disclaimers and non-reliance clauses was *Rogen v. Ilikon Corporation*,<sup>243</sup> which the Third Circuit cited in *AES* and which the Second Circuit distinguished in *Harsco*. In *Rogen*, an individual, one of the founders and a former president and director of the corporation at issue, along with some of his family,<sup>244</sup> resold stock to the corporation pursuant to an agreement that included a clause in which the sellers represented “they are fully familiar with the business and prospects of the corporation, are not relying on any representation or obligation to make full disclosure with respect thereto, and have made such investigation thereof as they deem necessary.”<sup>245</sup> The second clause here includes a representational non-reliance clause.<sup>246</sup> When the sellers later became aware of several matters that led them to believe that the value of the stock was higher than the contract price, they sued the corporation, alleging that the corporation had violated Rule 10b-5 by failing to disclose these matters before entering the contract. The corporation defended on the ground that the plaintiffs could not prove reasonable reliance.

The First Circuit stated that “the available evidence of non-reliance is

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241. *Id. Cf. Sachs, supra* note 9, at 913 (1994) (arguing that, even when the buyer voluntarily agrees to a non-reliance clause, it ought not be enforced because “the voluntariness of the agreement is irrelevant” under Section 29(a)).

242. *Dow Chemical Co. v. AES Corp.*, 540 U.S. 1068, 1070 (2003).

243. *Rogen v. Ilikon*, 361 F.2d 260 (1st Cir. 1966).

244. *Id.* at 262.

245. *Id.* at 262.

246. As Kevin Douglas has pointed out to me, the other clauses in the quoted language appeared aimed at other problems, such as contracting around a duty to disclose information, whether under Rule 10b-5 or pursuant to a fiduciary duty the corporation would owe to its shareholders when transacting to repurchase their shares. Since the plaintiff’s suit involves a Rule 10b-5 action, however, these other complex issues may be ignored for our purposes. In any event, *Rogen* has come to be understood as a case about non-reliance clauses, regardless of what other issues were in fact in play in the case.

impressive,” mentioning, among other things, the fact that the plaintiff “signed an agreement in which he specifically acknowledged his full familiarity with the ‘business and prospects’ of [the corporation], his non-reliance on any duty to disclose, and his having made all necessary investigation.”<sup>247</sup> This seems to adopt implicitly the evidentiary interpretation of the non-reliance clause at issue. Still, the court thought that the evidence was not sufficient to support judgment as a matter of law,<sup>248</sup> and so it was not adopting the conclusive-evidentiary interpretation.

At this point, the court turned to the effect of Section 29(a) on the non-reliance clause in the agreement. Stating that it was aware of no other judicial treatment of Section 29(a),<sup>249</sup> the court recognized that a representation of non-reliance “is not, in its terms, a ‘condition, stipulation, or provision . . . bidding [plaintiff] to waive compliance’ with the Exchange Act.”<sup>250</sup> Presumably, the First Circuit was here alluding to the point, explained above, about the difference between a representation that, if true, would negate an element of a cause of action under the securities laws and a promise not to bring such an action. The court continued, however, by saying that “on analysis, we see no fundamental difference between saying, for example, ‘I waive any rights I might have because of your representations or obligations to make full disclosure’ and ‘I am not relying on your representations or obligations to make full disclosure.’”<sup>251</sup> On this basis, the First Circuit declined to allow the defendant to prevail as a matter of law on the basis of the non-reliance clause, because to do so “would have gone far toward eviscerating Section 29(a).”<sup>252</sup>

But, contrary to what the court thought, there is a fundamental difference between saying “I am not relying on your representations” and “I waive my rights to bring a claim based on your representations.” They are alike in that, if given effect, both will defeat a Rule 10b-5 claim, but that is about the only way the two are alike. As indicated above, the purpose of the representation is that it helps the parties comply with the law: one party gives the representation to another as part of structuring a transaction to comply with the law. The purpose of waiver, if such a waiver was ever given, would be to proceed with a transaction in violation of the law in a way designed to evade the consequences of the law. What

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247. *Rogen*, 361 F.2d 260, at 267.

248. *Id.* at 267-268.

249. *Rogen v. Illikon*, 361 F.2d 260 (1<sup>st</sup> Cir. 1966), antedates *Shearson/American v. McMahon* 482 U.S. 220 (1987) by over twenty years.

250. *Rogen*, 361 F.2d 260, at 268.

251. *Id.*

252. *Id.*



the *Rogen* court, like the *AES* court, missed was that complying with the securities laws often requires cooperation and coordination between the parties, and contractual representations are an important means of such cooperation and coordination. Make those representations unenforceable, and you merely make it harder for the parties to comply with the law.<sup>253</sup>

#### 4. Some Cases Not Mentioning Section 29(a) in the Seventh, First, and District of Columbia Circuits

Strangely, there are also several cases in which Circuit Courts of Appeals have considered factual situations like those in *Harsco*, *AES*, and *Rogen* but in which Section 29(a) is not discussed. The cases include *One-to-One Enterprises, Inc. v. Caruso* in the District of Columbia Circuit,<sup>254</sup> *Jackvony v. Riht Financial Corp.* in the First Circuit,<sup>255</sup> and *Rissman v. Rissman* in the Seventh Circuit.<sup>256</sup> That is, in each of these cases, the court had to consider whether a plaintiff may proceed on a Rule 10b-5 claim

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253. Regarding the law in the First Circuit, see also the discussion below in Section I.C.4 of *Jackvony v. Riht Financial Corp.*, 873 F.2d 411 (1<sup>st</sup> Cir. 1989). Yet another way of understanding the argument of the First and Third Circuits is to see the courts as applying the principle that, in interpreting the federal securities laws, substance should trump form—that is, arrangements or actions that have the same effect should be afforded the same treatment under the law. Since a waiver of compliance with Rule 10b-5 and a non-reliance clause have the same effect, they should be treated the same way under the law; since the former would be voided by Section 29(a), so too would the latter. The opposing position relies on something like the Independent Legal Significance Doctrine in Delaware corporate law. See *Hariton v. Arco Electronics, Inc.*, 188 A.2d 123 (Del. 1963) (holding that although a sale of assets accomplished the same result as a merger it is governed exclusively by the sale-of-assets statute); R. Franklin Balotti and Jesse A. Finkelstein, *Delaware Law of Corporation and Business Organizations*, 3d. ed. (2018) § 10.8. That is, it would attend closely to the legal forms adopted and give them their proper effect without regard to whether that effect was one that could be achieved in other ways as well. It is no accident, of course, that the Independent Legal Significance Doctrine in Delaware law is designed to serve the interests in clarity and certainty of sophisticated parties to business combination transactions, whereas the substance-over-form approach common in the federal securities laws is designed to protect retail investors from the depredations of market professionals. One way of viewing the entire problem of the treatment of non-reliance clauses under the federal securities laws is to see the issue as arising from the mismatch between the law's solicitude for retail investors on the one hand and efficient bargaining between sophisticated commercial parties on the other.

254. *One-to-One Enterprises, Inc. v. Caruso*, 848 F.2d 1283 (D.C. Cir. 1988).

255. *Jackvony v. Riht Financial Corp.*, 873 F.2d 411 (1<sup>st</sup> Cir. 1989)

256. *Rissman v. Rissman*, 213 F.3d 381 (7th Cir. 2000). Others have noted the oddness of these cases failing to discuss Section 29(a). See Lutz, *supra* note 9, at 813-814 (noting the relevance of Section 29(a) to *One-O-One* and *Rissman*); Sachs, *supra* note 9, at 911 (citing *One-O-One* and stating that some Rule 10b-5 decisions upholding non-reliance clauses disregard Section 29(a)).

based on extra-contractual representations when the agreement between the parties contained a clause in which the plaintiff represents that it is not relying on any representations other than those contained in the agreement. In each case, the court held that the non-reliance clause should be given effect and dismissed the plaintiff's Rule 10b-5 claim. Nevertheless, in each of case, the court never considered the possibility that Section 29(a) of the Exchange Act renders the non-reliance clause unenforceable, presumably because the plaintiff's counsel never raised the issue.

That such an oversight happened in the Seventh Circuit or District of Columbia cases is surprising but understandable: it amounts to the plaintiff's lawyer failing to discover an on-point precedent, albeit it from a different circuit and so of merely persuasive authority, that could have won the case for his client. Still, that the same thing happened three times in three different Circuit Courts of Appeals is remarkable, especially since all three of the cases involved were decided long after *Rogen* and one of them was decided years after *Harsco* as well. It is even more remarkable, however, that one of the cases, *Jackvony v. Riht Financial*, was heard in the First Circuit, the same circuit that decided *Rogen*. In other words, the plaintiff's counsel in *Rogen* appears to have failed to find a precedent decision in the very circuit hearing the case that would have required the court to rule in his client's favor. That may well have been legal malpractice. It is astonishing, however, that, not only did the plaintiffs' attorneys in all three cases fail to discover the relevant precedents, but so too did the judges themselves (and their clerks) on *three* different Circuit Courts of Appeals, including the judges on the First Circuit who failed to discover the precedent of their own court. The only thing even more astonishing than this is who were the judges authoring the relevant opinions. In *Rissman v. Rissman* in the Seventh Circuit, the judge writing the opinion was Judge Frank Easterbrook. In *One-o-One Enterprises v. Caruso* in the District of Columbia Circuit, the judge was Judge, now Supreme Court Justice, Ruth Bader Ginsburg. In *Jackvony v. Riht Financial* in the First Circuit, the judge was Judge, now Supreme Court Justice, Stephen Breyer.

However this may be, the fact remains that although each of these cases holds that non-reliance clauses will be given effect to defeat a Rule 10b-5 claim, since none of them considers the issue of whether non-reliance clauses are enforceable under Section 29(a), the precedential effect of these cases for that critical question is low. Since this crucial issue was never presented to these courts, the most that can reasonably be inferred from these decisions is that these courts found the policy rationales for making non-reliance clauses enforceable strong. The Third Circuit,

however, also allowed that there was a strong efficiency argument for this view, and it nevertheless held that Congress, in enacting Section 29(a), decided for other reasons that non-reliance clauses should be unenforceable. There would be nothing inconsistent if the courts that decided *Rissman v. Rissman*, *One-o-One Enterprises v. Caruso*, and *Jackvony v. Riht Financial* were to reach the same conclusion if, at some point, they were presented with the relevant argument under Section 29(a).

## II. ECONOMIC ANALYSIS OF NON-RELIANCE CLAUSES

The balance of this Article formulates an argument for making non-reliance clauses between sophisticated parties involved in a business combination enforceable under Section 29(a). That argument proceeds in two stages. The first, which is contained in Part II, is an argument, already foreshadowed above, that enforcing non-reliance agreements is efficient.<sup>257</sup>

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257. Most scholars who have considered the problem have reached this conclusion. See Blair, *supra* note 9, at 423 (arguing that non-reliance clauses should generally be enforceable because, for sophisticated parties, they generally serve important contractual purposes); Davis, *supra* note 9, at 507 (arguing that enforcing non-reliance clauses “may permit certain parties to minimize the costs of transacting through agents”); Grove, *supra* note 9, at 1144 (arguing that non-reliance clauses should constitute “conclusive proof of a sophisticated party’s non-reliance on any representation or warranties not contained in the final negotiated agreement” because non-reliance clauses “efficiently define [] the boundaries of the transaction and preclude [] fraudulent Rule 10b-5 claims in corporate acquisitions”); Lipshaw, *supra* note 9, at 451 (allowing that “the primary basis for justifying the contractual disclaimer of reliance on the truthfulness of assertions is that this provision, when used, is efficient, promoting predictability and certainty,” but arguing for limits on the effects of non-reliance in blocking suits based on misleading representations and omissions); Lutz, *supra* note 9, at 803 (arguing for the rule in *Harsco* over that *AES* on efficiency grounds, including that enforcing non-reliance clauses reduces uncertainty, litigation, and transaction costs); Masson, *supra* note 9, at 523 n.129 (2009) (stating, “Of course, between sophisticated parties, one would assume that [a non-reliance] clause only exists because it is a bargained-for clause in the contract, and so nonenforcement . . . contradicts common ideas of efficiency.”); SIEDEL, *supra* note 9, at 19 (stating that the rule in *Abry Partners V, L.P. v. F&W Acquisition, LLC*, 891 A.2d 1032 (Del. Ch. 2006) that non-reliance clauses in agreement between sophisticated parties will be enforced meets Delaware’s goal of having efficient commercial laws). But there are contrary views. See Altman, *supra* note 9, at 747 (arguing that non-reliance clauses violate Section 29(a) and should always be unenforceable); Sachs, *supra* note 9, at 879 (arguing that, under the influence of the law and economics literature, courts have wrongly begun enforcing merger clauses and other contractual provisions that are contrary to the regulatory, pro-security buyer policy and intent of the federal securities laws). In a very closely-argued article, Kevin Davis argues that the essential issue concerns the seller’s imperfect ability to monitor the statements of its agents, and “once we take into account that most disclaimers of liability are actually disclaimers of vicarious rather than primary liability, it becomes possible to formulate a rule of

The analysis given here, however, will be far more elaborate than previous arguments, whether in the case law or in the scholarly literature.<sup>258</sup> The second stage, which appears in Part III below, is an argument that, in part because of the efficiency of the buyer's relying on only those representations by the seller in the definitive agreement between the parties, no potential buyer in a business combination transaction could reasonably rely on the accuracy or completeness of any representations by the seller other than those in the definitive agreement. In other words, *even in the absence of a non-reliance clause*, extra-contractual representations in a business combination transaction should not be actionable under Rule 10b-5. Hence, a non-reliance clause does not in any way reduce the rights of a buyer in such a transaction or weaken the protections the securities laws afford the buyer. The function of the clause is to make express what would otherwise be implicit and so to prevent opportunistic behavior by the buyer—to wit, lying after the transaction closes about which representations the buyer relied upon. Since a non-reliance clause neither waives compliance with Rule 10b-5 (nor any other provision of the federal securities laws) nor reduces the buyer's rights under those laws but merely makes it clearer what those rights are, non-reliance clauses in business combination transactions do not violate Section 29(a) of the Exchange Act.

*A. The Information Problem and its Solutions.*

As noted above, the deal process for a business combination transaction begins with the parties facing a serious problem about information. That problem has two aspects. On the one hand, the buyer lacks information about the business to be transferred that both parties would prefer the buyer to have. On the other, the seller has vastly more information about the target than the buyer will ever have and so may potentially use this information opportunistically to exploit the buyer—a conventional asymmetric information problem.

The first aspect of the information problem is a concern for both parties, as how much the buyer will pay to acquire the business obviously depends on the buyer's assessment of the business, which in turn depends

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enforceability which often, though not always, reconciles principles of respect for individual autonomy, morality, and efficiency." Davis, *supra* note 9, at 487.

258. See e.g., Lipshaw, *supra* note 9, at 435 (arguing that "in focusing on fraudulent affirmative representations," the analysis may "fall [] short of (1) recognizing the fundamental aspect of deceptive promising in a complex deal, namely the half-truth, (2) articulating an appropriate doctrinal principle to address it, or (3) capturing the social and linguistic context that makes the deceptive half-truth so insidious").

on what information the buyer has about the business and how reliable the buyer takes that information to be. With respect to positive information, at least, the buyer's incentives and the seller's incentives are clearly aligned. With respect to negative information about the target, the situation is more complex and involves the asymmetric aspect of the problem as well. Clearly, negative information about the target will reduce the amount the buyer will pay, and the buyer has strong incentives to ferret out this information lest it overpay for the target. For exactly the same reason, the seller has strong incentives not to disclose such information. Still, sellers also have countervailing incentives to bring even negative information about the target to the buyer's attention. For one thing, being sophisticated and experienced parties, buyers are likely to discover such information in any event, and so straightforward disclosure of negative information allows the seller to control the timing and manner of its disclosure and to build credibility by revealing information that it has a motive to conceal. For another, sophisticated buyers tend to know, in a general way, where the likely pitfalls concerning a business lie, and if the seller is not straightforward about problems and difficulties in the target business, the seller will often assume the worst, which could lead it to offer a price even lower than accurate negative information would suggest. Thus, while their relative weight will vary considerably with the circumstances, sellers, as well as buyers, tend to have incentives favoring disclosure of even negative information about the target.

The primary tools developed in the market for dealing with this information problem are two: due diligence, and representations and warranties. As shown below, these two tools are part of an integrated, rational system to deal with the information problem inherent in business combination transactions. Another part of this system is the array of contractual provisions the parties typically employ: disclaimers and promissory non-reliance clauses in confidentiality agreements and representational non-reliance clauses in definitive agreements. In my view, the inadequacy of prior accounts of the economics of non-reliance clauses flows from a failure to see such clauses as part of an overall system that functions to mitigate the information problem and ultimately produce an efficient definitive agreement.

### 1. Due Diligence

Early in the deal process, perhaps even before making contact with the target, buyers will have studied carefully all publicly available information about a target. Such information is universally regarded as meager,

however, compared to the non-public information about the target that the seller itself possesses.<sup>259</sup> Hence, long before the parties enter into a definitive agreement regarding the transaction, the seller provides the buyer with tremendous amounts of this non-public information. But disclosing to the buyer such information makes the seller vulnerable to various types of opportunistic behavior by the buyer. For instance, an acquirer who is also a competitor could gain access to the seller's trade secrets or other competitively sensitive information, decline to proceed with a transaction, and then use the seller's information to compete more effectively against it.<sup>260</sup> To limit the possibility of such behavior, the seller typically makes any non-public information available to the buyer only after the parties enter into a confidentiality agreement or non-disclosure agreement.<sup>261</sup> The key provisions in this agreement include promises by the buyer not to further disclose the non-public information that it receives from the seller and not to use such information for any purpose other than evaluating the potential transaction with the seller. As we have seen, these agreements also typically include two separate provisions relevant to the problem of extra-contractual representations: (a) a disclaimer, in which the seller disclaims making any representations or warranties as to the accuracy or completeness of the information provided in due diligence, and (b) a non-reliance clause, in which the buyer promises not to rely on any information provided in due diligence but only on the seller's representations and warranties, if any, made in the definitive agreement between the parties. Although courts and commentators have generally assimilated these two provisions, as we shall see they actually perform independent (and independently important) functions.

*a. The Vast Quantity of Information in Due Diligence*

Now, the first thing to understand about the information a seller provides in due diligence is that the quantity of information involved is

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259. Indeed, Martin Lipton, the inventor of the poison pill, once commented that the greatest impediment to hostile takeovers is not the poison pill but the acquirer's inability to access the internal information of the target about its business. See also Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L. J. 621, 659-662 (2003) (discussing the asymmetrical information problem in hostile takeovers).

260. This is a key allegation in *Cigna Corp. v. Anthem, Inc.*, C.A. No. 2017-0109-JTL, currently pending in the Delaware Court of Chancery. See the redacted, public version of Cigna's complaint at <https://new.reorg-research.com/data/documents/20170406/58e6665f7b943.PDF> [<https://perma.cc/PXQ9-A66Z>].

261. NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at §§ 9.01-9.05.

utterly enormous.<sup>262</sup> A sense of the quantity and variety of information involved can be gleaned by reviewing the standard due-diligence requests lists of major law firms representing clients in business combination transactions. Such lists typically include requests for, with respect to both the seller and each of its subsidiaries, (a) organizational documents, such as certificates of incorporation, bylaws, limited liability company agreements, partnership or limited partnership agreements, shareholder agreements, voting agreements, voting trust agreements, and shareholder rights plans, as well as all minutes of meetings of the boards of the directors for the last three years and a complete organizational chart for the seller; (b) financial information, including all audited and unaudited financial statements for the last three years, all correspondence between the seller and its auditors, information about all material contingent liabilities and off-balance arrangements of the seller, all budget and financial projections prepared in the last three years and information about how actual results compared with such budgets and projections, and all documents related to the seller's indebtedness, including loan agreements, credit facilities, indentures, note or bond purchase agreements, private placement memoranda or other offering documents for securities of the company, hedging agreements, swaps, letters of credit, guarantees, and pledges and promissory notes, along with a schedule of all mortgages, security interests, liens, or encumbrances on any of the seller's properties; (c) a list of all real property owned by the company, along all deeds, mortgages, appraisals, title reports or policies, surveys, and leases; (d) a list of all real properties leased by the seller, along with all leases, renewals, amendments, estoppel certificates, and similar documents; (e) a list of all personal property owned or leased by the seller, including copies of leases related thereto; (f) a list of all intellectual property owned by the seller, including trademarks, service marks, copyrights, and patents, along with all assignments or licenses related to intellectual property, all applications filed with the Patent and Trademark Office or the Copyright Office and all correspondence related thereto, and all cease and desist letters sent or received by the seller, as well as a description of all non-patented proprietary information or trade secrets material to the seller's business; (g) documents related to the seller's compliance with the Sarbanes-Oxley Act of 2002 (SOX), especially in regard to the seller's internal controls over financial reporting and disclosure controls and procedures under Section 404 of SOX; (h) all

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262. NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 15A.01; Grove, *supra* note 9, at 1119 (stating, "During acquisition negotiations, the purchaser wants access to all potentially relevant documents.").

contracts material to the seller or its business, including all capital leases, sale-leaseback documents, joint venture or collaborative agreements, confidentiality or non-disclosure agreements, contracts with customers or suppliers, contracts related to acquisitions or dispositions of a material amount of assets, contracts indemnifying any other party or guaranteeing any obligation of any other party, all contracts with any government or governmental authority, and all contracts limiting the seller's right to compete in any market or to solicit customers or employees in any market; (i) an organizational chart for employees of the seller and all its business units, along with all employment agreements, change of control agreements, severance agreements, collective bargaining agreements or union agreements, a list of all pending Equal Employment Opportunity Commission, Department of Labor, unfair labor practice or similar actions, copies of all employee benefit plans (along with applicable IRS determination letters and most recent annual reports on Form 5500 related thereto), all stock option, bonus or incentive compensation plans, copies of all deferred compensation, retirement, pension, or profit-sharing plans; (j) all contracts between the seller and any affiliate, subsidiary, employee, director, officer, shareholder, or creditor of the seller; (k) documents related to ongoing or threatened litigations to which the seller is a party, including all complaints, answers, and related documents, and all audit response letters of the seller for the last five years, as well as any settlement agreements or consent decrees binding on the seller; (l) all material government licenses or permits held by the seller, all governmental or regulatory approvals received by the seller in the last five years, all compliance reports or similar filings made by the seller with any government agency or authority; (m) all environmental permits, notices of violations, studies or reports received by the seller or related to any real property in which the seller has an interest, including all notices or other documents related to the seller's potential liability under CERCLA; (n) all federal, state, local and foreign tax reports filed by the seller in the last three years, all tax-sharing agreements or other agreements related to the payment of taxes, all correspondence with any taxing authority that has jurisdiction over the seller, information regarding all net-operating losses or built-in losses of the seller, all revenue rulings or tax opinions sought or obtained by the seller in the last three years, and all property, payroll, excise, sales and use, withholding, Social Security or similar tax returns or reports filed by the seller in the last three years; (o) copies of all insurance policies of the seller, including with regard to general liability, products liability, personal injury liability, workers compensation, directors and officers liability, and key man, along with an insurance run for the last five



years; (p) information regarding the seller's information systems, including all assignments and licenses related thereto, as well information regarding cybersecurity measures, including all reports received from experts or consultants related to cybersecurity; and (q) all information and documents related to the seller's compliance with anti-corruption and anti-money laundering laws, including the Foreign Corrupt Practices Act, know-your-client laws, the USA Patriot Act, and all regulations or rules of the Office of Foreign Assets Control.<sup>263</sup>

Note too that this extremely long list is derived from *generic* due diligence request lists. Depending on the nature of the seller, there will certainly be additional requests for information about particularly important aspects of the seller's business—e.g., much more extensive requests for information regarding environmental matters for a seller engaged in an environmentally sensitive business such as petroleum production, or for information about real estate matters for a real estate investment trust that owns and operates shopping malls, or for information about anti-money laundering and know-your-client matters for a commercial bank.

Nowadays, due diligence information is typically placed in an electronic data room to which potential buyers are granted access. Intralinks, the leading provider of data room services for parties involved in business combination transacts, reports that the average quantity of information that a seller in a business combination transaction uploads to a data room is 50,000 pages.<sup>264</sup> For transactions involving larger targets, however, the quantity of information can vastly exceed this figure, aggregating hundreds of thousands or even millions of pages of data. Moreover, the information made available in electronic data rooms is further supplemented by presentations by officers and advisors to the seller, in-person meetings between representatives of the buyer and the seller (often meetings down to the line-manager level, as well as meetings between various kinds of specialists—e.g., human resources, tax, accounting, information technology, etc.), and even on-site visits by representatives of the buyer to inspect the seller's properties and assets. Indeed, in one recent transaction, when a private equity purchaser was conducting due diligence on a potential target, more than 460 individuals associated with the purchaser accessed the target's electronic data room,

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263. See generally NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 8.03 (providing a sample due diligence checklist); Public Mergers and Acquisitions Due Diligence Checklist, Practical Law Checklist 4-382-9194.

264. Email from Brian Hwang, Director, Strategic Business Development at Intralinks, Inc. to Robert Miller, Professor, University of Iowa College of Law (on file with the author).

and approximately 40 of the purchaser's employees and agents rented a hotel ballroom to hold meetings with about 20 employees of the target.<sup>265</sup> In cases considering the effect of non-reliance and similar provisions, courts often marvel at the length of the representations and warranties included in definitive agreements. The court in *Harsco*, for instance, remarks on the twenty-two pages of such representations and warranties.<sup>266</sup> The *average* quantity of information a data room related to a business combination transaction is more than *two-thousand times* this amount. The sheer quantity of the information produced in due diligence, especially in relation to the length of the representations that parties make in definitive agreements, should make it perfectly obvious (as, indeed, it is obvious and unquestioned among participants and their advisors in business combination transactions) that the seller is most certainly not representing and warranting the accuracy and completeness of this vast array of information. Indeed, no one in his right mind could imagine that a seller was making 50,000 pages of representations and warranties to the buyer, covering in minute detail every imaginable aspect of the business it is selling. In fact, in one recent Delaware case, Vice Chancellor Laster regarded it as practically a *reductio ad absurdum* of a party's position in litigation that this position implied that a representation in a merger agreement would be qualified by all the information the seller had produced in due diligence.<sup>267</sup>

*b. An Efficient Rate of Errors and Omissions in Due Diligence Information*

Furthermore, not only the quantity but also the quality of the information produced in due diligence makes it unthinkable that the seller is representing and warranting the accuracy and completeness of such information. For, with extremely limited exceptions, the immense amount of information that the seller makes available to the buyer is not specially prepared by the seller for inclusion in the data room and delivery to the

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265. *Dell, Inc. v. Magnetar Global Event Driven Master Fund, Ltd.*, 177 A.3d 1, 13 (Del. 2017).

266. *Harsco Corp. v. Segui*, 91 F.3d 337, 345 (2d Cir. 1996).

267. *Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), at \*80 ("As Akorn's counsel candidly conceded during post-trial argument, a regime which holds that a buyer cannot assert a breach of an MAE-qualified representation if the buyer learned or could have learned about aspects of the risk covered by the representation during due diligence turns an MAE-qualified representation into the functional equivalent of a scheduled representation that schedules everything provided in due diligence.").

buyer. On the contrary, the vast majority of the information placed in the data room consists of business records of the seller generated in the ordinary course of business.<sup>268</sup> For example, employee handbooks and information about the company's benefit plans are typically prepared to explain to employees, who are generally not themselves sophisticated investors or experts in employment law, the benefits such employees receive under those plans. They may not include information that an acquirer, who may have to assume such plans as part of a business combination transaction, would care about, such as the costs of such plans to the company. Similarly, financial projections included in the financial information in the data room may have been prepared as aspirational documents to motivate employees entitled to various forms of incentive compensation, not to predict with the greatest possible accuracy the future performance of the company. Or again, when a buyer asks for all environmental studies related to the company's properties, the seller may respond by placing all such studies in its possession in the data room, including a Phase I environmental study related to one of its properties that, the seller knows, became contaminated with hazardous waste only recently and long after the date of the study. In other words, given the immense amount of information buyers request and sellers deliver, the seller necessarily supplies huge amounts of raw data drawn directly from its business records, the production of the material often being delegated to relatively junior employees who merely follow directives to deliver certain kinds of information and who do not exercise any meaningful judgment about whether the information being delivered provides a true and complete picture of the relevant aspect of the seller's business in the context of a potential transaction between the seller and the buyer.

Now, since accuracy and completeness are costly, no rational business invests in making its business records perfectly accurate and complete. Rather, firms invest in accuracy and completeness only to the point that the marginal benefits of accuracy and completeness exceed the costs, and where this point is depends on the purpose for which the particular business

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268. See Grove, *supra* note 9, at 1119 (suggesting that, in responding to requests for information from a potential buyer, “[d]ifferent people, most of whom are lower-level employees [of the seller] or outsiders [i.e., outside advisors], not authoritative representatives of the seller, draft the documents,” and “the seller does not want to be bound for the accuracy of these documents.”). Oftentimes, this is correct, as sellers do sometimes produce documents specifically drafted to answer due diligence inquiries from buyers, and especially on relatively minor or technical matters, these documents may be produced by the kinds of individuals Grove indicates. Because sellers could (and often do) keep tight control over documents specifically produced for buyers, I think the problem Grove identifies, though undoubtedly real, is less important than those mentioned in the text.

records were originally created. An airline, for instance, will invest more in the accuracy and completeness of the maintenance records of its aircraft than in those of the records of its price changes and promotional discounts. Thus, large portions of the information a seller produces in due diligence will have a positive error rate. Accordingly, no rational seller would ever represent that the materials it delivers in due diligence are accurate and complete, for every rational seller already knows that any such representation would be false. Indeed, since the seller knows that any such representation would be false making the representation would be fraudulent. Or, it would be, except for the fact that buyers in business combination transactions are themselves sophisticated parties who understand all this perfectly well and treat due diligence materials accordingly.<sup>269</sup> In other words, buyers, as well as sellers, understand the nature of the materials they are reviewing in due diligence and appreciate that these certainly contain errors and inaccuracies.

Making matters even worse, the seller does not usually produce due diligence materials all at once. Rather, since some materials are easier to assemble than others, and since some materials are more important to potential buyers than others, sellers tend to produce due diligence materials in stages, delivering groups of documents into the data room over time. In addition, the deal-process usually takes weeks or months, and so information that did not exist at the beginning of the process (for instance, financial statements covering periods concluded only after the data room is

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269. Which answers what one commentator regards as the “core puzzle” of non-reliance clauses: “why would any rational party in an arms-length contract ever agree to a provision limiting or eliminating her recovery in cases when the other party intentionally lies to her?” Blair, *supra* note 9, at 428-429. As explained in the text, the answer is, in short, that if the buyer wants due diligence materials, those materials will contain inaccuracies and omissions that the seller, in a real sense, knows are inaccuracies and omissions, but that correcting these inaccuracies and omissions in the due diligence materials is extremely costly and more costly than solving the problem by negotiating representations and warranties in the definitive agreement for which the seller will assume liability. *See id.* at 476-479 (arguing that buyers agree to non-reliance clauses because (a) agreeing to non-reliance clause will lower the purchase price for the buyer, (b) the buyer may think that the risk of fraud by the seller is low, and (c) the buyer may believe that extra-legal sanctions are sufficient protections against fraud); Davis, *supra* note 9, at 503 (discussing the possibility that extralegal sanctions may suffice to protect buyers); Masson, *supra* note 9, at 513 (arguing that there are several legitimate reasons parties may agree to a non-reliance clause, including (a) mitigating the potential hold-up problem arising from the expense and difficulty of dismissing opportunistic, non-meritorious suits based on allegedly fraudulent extra-contractual misrepresentations; and (b) mitigating the agency problem, in which sellers find it difficult to monitor which representations their agents make and for which the seller may be liable in fraud, while noting that, in exchange for the non-reliance clause, the seller may reduce the purchase price.).

opened) may be added to the due diligence materials as they are created and become available. Often, sellers will deliver, at a later date, information that updates or supersedes information delivered at an earlier date. For example, an earlier draft of financial statements for a recent interim period may be replaced by a later, revised and updated draft. Similarly, some of the information in a data room relates to moving targets: for instance, a list of the company's real and leased properties may well change during the course of the buyer's due diligence investigation as the seller acquires some properties, disposes of others, and enters into new leases concerning yet others. Since the due diligence materials reflect virtually all aspects of the seller's business, and since that business continues during the perhaps months-long process during which the buyer conducts due diligence on the seller, naturally some information in the data room will become stale and will, in some cases (but not necessarily all), be superseded by information later added to the data room.

*c. The Costs of Avoiding Fraud: Diligence Materials*

The standard economic argument against fraud is that it is a form of rent-seeking: the fraudster invests real resources in deceiving the victim in order to transfer value from the victim to himself.<sup>270</sup> Correlatively, avoiding fraud is said to be costless because, although a person making a representation would have to invest resources in order to know if the representation is actually true, a person knows costlessly whether *he believes what he is saying is true*, and since avoiding fraud only involves avoiding making representations a person believes to be false, a person can avoid committing fraud costlessly.<sup>271</sup>

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270. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 139 (8th ed. 2011) (stating "The lie is different [from merely not disclosing information acquired by investing resources]. The liar makes a positive investment in manufacturing and disseminating misinformation. This investment is wasted from a social standpoint, so naturally the law does not reward him for his lie."). Lies are also different from negligent misrepresentations, because the activity that involves making negligent misstatements is itself usually social valuable, and punishing negligent misrepresentations thus runs the risk of reducing the level of that activity below the optimum level. By contrast, since it is a form of rent-seeking, "the optimal amount of fraud is zero," and judges need not worry about over-detering it. *Ackerman v. Schwartz*, 947 F.2d 841, 847 (7th Cir. 1991).

271. See Davis, *supra* note 9, at 498 n.55 ("Economists typically assume that the main cost of avoiding misrepresentations is the cost of verifying one's statements before making them. This in turn implies that so long as *scienter* is an essential element of fraud and is defined as knowledge of the falsity of a statement, it should be costless for a person to avoid making a fraudulent misrepresentation."); Paul G. Mahony, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 647 (1992) (referring to the argument

This analysis is very plausible if we imagine two principals negotiating face-to-face, communicating orally, which is often the paradigm factual situation imagined by the common law. That is, when one individual speaks face-to-face with another individual, he normally does costlessly know his own state of mind in the way this analysis presupposes.<sup>272</sup> It should be apparent, however, that this argument immediately breaks down if applied to the seller's production of information to the buyer in due diligence.<sup>273</sup> As we saw above, in due diligence information is transferred wholesale from the seller's business records to the buyer, and that information will certainly contain a non-trivial number of misstatements and omissions. Generally speaking, the information is transferred without any review by anyone associated by the

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that "It should be costless for defendants to avoid intentional falsehoods (they need only decide not to lie)"; see also M. JOHN STERBA, *LEGAL OPINION LETTERS: A COMPREHENSIVE GUIDE TO OPINION LETTER PRACTICE* § 12.17 (3rd ed. Supp. 2017) ("it is costless to avoid intentional falsehoods—all that is needed is that the fraudfeasor avoid reckless misconduct or decide not to lie"); Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2184 (observing that it is commonly "assumed that fraud's traditional scienter requirement ensures that regulated parties can costlessly avoid liability."); Cf. RESTATEMENT (SECOND) TORTS, § 552 com. A (AM. LAW INST. 1977) (contrasting, "honesty," which "requires only that the maker of a representation speak in good faith and without consciousness of a lack of any basis for belief in the truth or accuracy of what he says," with the care required to avoid negligent misstatements. "Unlike the duty of honesty, the duty of care to be observed in supplying information for use in commercial transactions implies an undertaking to observe a relative standard, which may be defined only in terms of the use to which the information will be put, weighed against the magnitude and probability of loss that might attend that use if the information proves to be incorrect.").

272. But perhaps not always. The analysis assumes that, in epistemic logic, if I know that P, then I know that I know P (that is, in the standard formalism of epistemic logic,  $K(P) \rightarrow KK(P)$ ), and if I do not know P, then I know that I do not know P (that is,  $\neg K(P) \rightarrow K(\neg K(P))$ ). These are Axioms (4) and (5) in Lemmon's well-known nomenclature in modal logic. See generally E.J. LEMMON, *AN INTRODUCTION TO MODAL LOGIC* (1978). Whether they hold in all cases, or even generally, for individual knowing agents is not obvious. In particular, Axiom (5) is a strong assumption. See generally J.J. Meyer, *Epistemic Logic*, in *THE BLACKWELL GUIDE TO PHILOSOPHICAL LOGIC* (L. Goble, ed. 2001).

273. See Davis, *supra* note 9, at 487 (emphasizing "the lack of congruence between the reality of modern contracting behavior, in which transacting through agents is typical, and legal analyses, both doctrinal and theoretical, which appear to be predicated on the assumption that face-to-face bargaining in the norm."). Some scholars do not agree. See Altman, *supra* note 9, at 760 (indicating that, "[s]urely if a party is one-hundred percent honest in its dealing leading up to a sale, and those dealings are well recorded, it has nothing to fear should the other party challenge it in court."). The burden of the current and succeeding subsections is to show that this is not correct—that avoiding liability for fraud (let alone avoiding situations in which a party could be sued for fraud with enough plausibility to produce a suit with significant settlement value) is in fact extremely costly in the context of a typical business combination transaction.

seller, certainly not by senior personnel or anyone else in a position to detect and correct apparent (let alone real) misstatements and omissions.

So why then not require the buyer to review the diligence materials before delivering them to the seller, not to remove all actual misstatements and omissions but just to remove all the statements and supply all the omissions that the seller *believes* should be corrected—that is, to correct the materials enough to ensure they are not fraudulent? The answer is that even this kind of review and correction of the materials would be an immensely costly undertaking. We know this to a certainty because, in some contexts, parties do undertake to produce information that they expect will be held to a Rule 10b-5 standard of accuracy, and producing such information turns out to be extremely costly. The most obvious example is the representations and warranties in the definitive agreement, but others include registration statements in securities offerings, filings under the Exchange Act, and certain other documents used in securities offerings,<sup>274</sup> and producing such documents is known to be a long, slow process, absorbing considerable resources, including extensive labor by businesspeople and legal counsel. To take a close analogy to the present case, in Rule 144A securities offerings,<sup>275</sup> it is customary for the issuer's counsel<sup>276</sup> to review the offering memorandum under which the securities are sold and deliver to the purchaser a so-called negative assurance or Rule 10b-5 letter in which the counsel states that, based on its review of specified documents and its participation in discussions and meetings relating to the securities offering, nothing has come to its attention that has caused it to believe that the offering memorandum either contains any untrue statement of a material fact or omits to state any material fact necessary in order to make the statements in the offering memorandum, in light of the circumstances under which those statements were made, not misleading.<sup>277</sup> Before issuing such a letter, it is standard practice in the

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274. As Freund puts it, “It is [the seller’s lawyer’s] job to cross-examine seller’s business people on their disclosures [in the representations and warranties and related disclosure schedule], just as he would do if he were preparing a prospectus.” ANATOMY OF A MERGER, *supra* note 42, at § 7.2.2.

275. See generally LLOYD S. HARMETZ, MORRISON & FOERSTER, WHAT IS RULE 144A? (2009), available at <http://media.mofo.com/docs/pdf/FAQRule144A.pdf> [<https://perma.cc/D79Z-8JAZ>] (regarding Rule 144A transactions); Purchase Agreement: Rule 144A/Regulation S Offering of Non-Convertible Debt (US Issuer), Practical Law Standard Document 1-517-6951.

276. Bond counsel (the law firm selected by the placement agent to represent the interests of the purchasers, who are usually not definitively determined until almost immediately before the purchase agreement is executed) undertakes a similar review. See generally *id.*

277. Purchase Agreement: Rule 144A/Regulation S Offering of Non-Convertible Debt

industry for the law firm to prepare, for its internal purposes, a version of the offering memorandum in which every factual assertion in every sentence is checked, with footnotes added to support each assertion. Since the offering memorandum is usually more than one hundred pages long, this is a significant undertaking, and it is typical for counsel to charge the client an additional seven-figure fee for a negative assurance letter. In fact, this fee (along with a similar fee for a similar service from the bondholders' counsel) are among the more important cost factors affecting Rule 144A offerings. If the cost of a negative assurance letter for a hundred-page offering memorandum is, say, \$5 million, then the cost for a similar review of fifty thousand pages of diligence materials could easily reach \$2.5 billion.

The lesson here is that, contrary to what may be the case in the common-law paradigm of two individuals negotiating face-to-face, the costs to the seller of detecting and remedying statements it believes are false (not just actually false statements) in the diligence materials in a significant business combination transaction are very high.<sup>278</sup> This is a

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(US Issuer), Practical Law Standard Document 1-517-6951.

278. This argument in this and other sections of this Part considers the costs of avoiding statements that the seller knows are false. In fact, the problem is much more acute because the scienter requirement under the common law and Rule 10b-5 is generally satisfied not only if the speaker knows the statement made is false but also if the speaker makes the statement recklessly, that is, with reckless disregard of its truth or falsity. Although *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) left open the question of whether recklessness suffices for a Rule 10b-5 claim, the lower federal courts have generally held that it does. See e.g., *Ackerman v. Schwartz*, 947 F.2d 841, 847 (7th Cir. 1991) (holding recklessness is sufficient to establish liability under Rule 10b-5); *Broad v. Rockwell International Corp.*, 642 F.2d 929, 961 (5th Cir. 1981) (holding that recklessness satisfies the scienter requirement for Rule 10b-5); *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977) (holding that reckless behavior constitutes scienter for civil liability for a Rule 10b-5 claim); *Hoffman v. Estabrook & Co.*, 587 F.2d 509, 516 (1st Cir. 1978) (assuming that recklessness will support an action for a 10b-5 claim). See generally Samuel W. Buell, *What is Securities Fraud?* 61 DUKE L. J. 511 (2011); Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667 (1991). If it is costly for a seller to ensure that its statements are not knowingly false, it is obviously much more costly to ensure that they are not recklessly so, especially given that some of the interpretations of recklessness adopted by lower federal courts involve no subjective component but seem equivalent to objective gross negligence. For example, in the Seventh Circuit, recklessness requires conduct that is "highly unreasonable, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it," *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (1977), which makes it sound as if reckless requires a subjective consciousness of wrongdoing, similar to, for example, an oversight breach under Delaware corporate law.



crucial fact, and it has very important consequences. In particular, it opens the question of how the parties can most cheaply deal with the costs of such misstatements and omissions—whether by action by the seller, action by the buyer, or some form of joint action.

*d. Meetings and Presentations in Due Diligence*

Furthermore, as noted above, beyond the written due diligence materials that the seller provides the buyer, sellers and buyers typically arrange for an extensive series of meetings between their representatives to allow the seller to make presentations to the buyer and to allow the buyer to ask questions of the seller. Some of these meetings will involve senior officers of the parties accompanied by their financial, legal, or accounting advisors. At such meetings, the most high-level and important matters will be discussed. But many of the due diligence meetings will involve more junior representatives of the party meeting to discuss more particular matters. For example, relatively junior lawyers from the parties' respective general counsels' offices specializing in intellectual property may meet to review patents held and patent applications filed by, the seller. Similarly, information technology professionals from the two companies may meet to discuss how the two companies' respective information systems could be combined if the transaction is concluded. Especially if the companies operate in the same or similar industries, line managers may meet with their counterparts to discuss relevant business operations. Representatives of the buyer may visit some of the seller's facilities and speak with relatively junior employees such as plant managers, shop forepersons, employees who are union officials, and so on. The conversations had in such meetings will generally not be recorded in any form. At best, the only records of what was said at many such meetings will be handwritten or similar notes of one participant in the meeting.

There are several important consequences of this. First, representatives of the seller speaking to the buyer will in many cases be relatively junior employees. This means they may lack a comprehensive view of the company, and, moreover, they may not be familiar with

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*See e.g.*, Stone v. Ritter, 911 A.2d 362 (Del. 2006) (noting that oversight liability requires a failure to act in good faith). Unfortunately, however, the court in Sundstrand went on to say that “the risk of misleading buyers must be actually known or sufficiently obvious that the reasonable man would know of it,” which sounds rather like ordinary negligence even though the court clearly thought that ordinary negligence would not suffice; *see also* West & Lewis, Jr., *supra* note 2, at 1013-1016 (explaining that “fraud is not limited to deliberate lying” and discussing claims of negligent misrepresentation).

business combinations generally or the potential transaction between the parties in particular. As a result, they may very well, in perfect honesty, make misstatements of facts or omit to state material facts, in their dealings with the representatives of the seller. Second, because so many conversations between representatives of the seller and those of the buyer take place in particular contexts among specialists, many of the statements made will be perfectly true in the context in which they are made—that is, against the background of expert knowledge and implicit qualifications apparent to experts in the field who had participated in a particular meeting or conversation. Removed from that context, however, such statements may well be false or misleading. The upshot of this is that representatives of the seller will say many things to representatives of the buyer that may well be true, in the particular context in which they are said, that would not be true if removed from that context—the context being very hard or impossible to reproduce after the fact. Third, agents of the seller may have incentives to prevaricate, whether because they perceive doing so to be in the interests of the seller or even contrary to the interests of the seller but in their own interests.<sup>279</sup> For all these reasons, just as in the written due diligence materials sellers place in data rooms, misstatements and omissions in the oral communications between representatives of the buyer and those of the seller are virtually inevitable, including misstatements and omissions that the seller, acting through its senior officers or experts, would recognize as misstatements and omissions.

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279. Davis argues that in business transactions between sophisticated parties, the seller often faces high costs of monitoring its agents, who may have incentives to make fraudulent representations to the buyer. On this basis, he argues that it is not immoral to allow the seller to escape vicarious liability for the wrongdoing of its agents, especially if the buyer is better able to detect their frauds than the seller. Davis, *supra* note 9, at 497-501. This is a perceptive and persuasive argument, and it complements many of the arguments in this article. I find less persuasive, however, Davis's arguments that buyers are, in a meaningful percentage of cases, able to detect fraud by the seller's agents more cheaply than could the seller itself. Given that buyers are virtually entirely dependent on the seller and its agents for information, buyers would seem especially poorly placed to detect fraud. In any case, I would suggest that overzealous or self-seeking agents are not the primary source of misstatements, even knowing misstatements, by sellers in due diligence in a business combination transactions (Davis does not suggest otherwise; he is not focused on business combinations but commercial transactions more broadly where, for instance, salespeople may have incentives to exaggerate the qualities of the firm's goods when trying to induce customers to buy.). Much more important in business combinations is the sheer volume of information made available to buyers and the fact that such information has been prepared for use in quite different contexts and for quite different purposes and so, from the point of view of a buyer of the company, may contain inaccurate or misleading statements. See Section II.A.1.

*e. The Costs of Avoiding Fraud: Oral Due Diligence*

Could the seller monitor the oral communications of its various agents as they interact with agents of the buyer in due diligence in order to prevent or correct fraudulent misstatements by such agents? In some sense, yes, but the costs of doing so would be extremely high.<sup>280</sup> In essence, every oral communication would have to be vetted ahead of time or monitored in real time by agents of the seller with sufficient knowledge of the business and sufficient legal expertise to ensure that every statement made met a Rule 10b-5 standard for accuracy and completeness. This could be done, but it would convert informal meetings and discussions between businesspeople into the something more like depositions, with the speaker formulating each answer after consulting with a variety of other people in the company and legal counsel. Besides the direct costs involved, mostly in the form of legal fees, the indirect costs in the form of management's time and delay in reaching an agreement with the seller (which comes with all manner of consequential costs, such as damage to the business when it is perceived to be in play, defections of employees and customers, leaks about the transaction or its terms to the market, and so on) would be immense. Once again, as with written diligence materials, we see that the simple paradigm in which a party can costlessly avoid making fraudulent misstatements or omissions breaks down, and, in fact, the costs of avoiding such misstatements and omissions becomes very high.<sup>281</sup>

There is another reason, applicable to both written materials placed in

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280. Davis, *supra* note 9, at 511-512; see also Grove, *supra* note 9, at 1119, 1143 (stating that "a seller cannot possibly know all information disclosed by its employees [orally] or prove the non-existence of an alleged oral statement"). In a related context, Judge Easterbook has said, "If such a claim of oral inconsistency [i.e., the plaintiff's claim that the defendant or its agents made oral representations at variance with the written disclosure related to a securities transaction] were enough, sellers' risk would be greatly enlarged. All buyers would have to pay a risk premium to cover this extra cost of doing business."). *Acme Propane, Inc. v. Tenexco, Inc.*, 844 F.2d 1317, 1322 (7th Cir. 1988). See generally Eric Rasmussen, *Agency Law and Contract Formation*, 6 AM. L. & ECON. REV. 368 (2004).

281. Davis, whose account centers on how enforcing non-reliance clauses can minimize the costs of transacting for entities that act through agents, argues that agents often have positive incentives to lie to the counterparty in order to conclude a sale of the business. Davis, *supra* note 9, at 503. There are certainly situations in which this is true, as when the seller is selling only a division, not the whole company, and its agents will receive bonuses or other forms of incentive compensation if the sale is completed. In other situations, however, as when the seller is selling the entire company and the seller's agents expect that they will soon be employees of the buyer, their loyalties can swing away from the seller to the buyer, and in such cases their incentives are to be extremely forthcoming, even revealing matters that the seller has instructed them to keep secret.

data rooms but especially relevant to oral statements, that avoiding fraudulent misstatements and omissions is difficult and costly. That reason is that the matters on which the seller is speaking are in many cases inherently extremely complex.<sup>282</sup> To be true and not misleading, therefore, many statements about such matters may have to be very carefully phrased and elaborated qualified. For example, in the merger agreement at issue in *In re IBP Shareholders Litigation*, as in virtually all business combination agreements,<sup>283</sup> the seller represented to the buyer that, since a certain date, the target company had not suffered a material adverse effect.<sup>284</sup> This sounds simple enough, but the representation is clearly denying that certain changes in the state or condition of the company has occurred, and so the establishment of the baseline for any subsequent comparison is crucial to the meaning of the representation, and as Vice Chancellor, now Chief Justice, Strine explained, the representation created a very complex baseline against which to measure changes. In fact, the representation stated that no material adverse effect had occurred relative to the condition of the company as set forth in a set of financial statements dated as of a specific date, as adjusted by disclosures in a Form 10-K and three subsequent Forms 10-Q filed after that date, as further adjusted by disclosures made in the definitive agreement.<sup>285</sup> Without this elaborate baseline, a statement by the seller that the company had not suffered a material adverse effect may well be false and indeed knowingly false. Because of the complexity of the matters being discussed, crafting a statement that is literally true turns out to be a difficult and costly business. The sheer complexity of the matters being discussed, therefore, creates an additional and independent reason why contrary to what many have thought', avoiding lying is not, in the context of a business combination

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282. See Blair, *supra* note 9, at 434 (stating, “[p]arties or one of their agents . . . may make assertions that appear to mean one thing in one context and seem to mean something quite different in a later context.”).

283. NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 11.04[9].

284. Of course, “Material Adverse Effect” was itself a very carefully defined term, *In re IBP, Inc., Shareholders Litig.*, 789 A.2d 14, 65 (Del. Ch. 2001) which makes the argument in the text even stronger. See Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007 (2008) (discussing clauses common in definitions of “material adverse change” or “material adverse effect”).

285. See *In re IBP, Inc.*, 789 A.2d at 66 (where the court states, “Taken together, these provisions can be read to require the court to examine whether a MAE has occurred against the December 25, 1999 condition of IBP as adjusted by the specific disclosures of the Warranted Financials and the Agreement itself.”). The “Warranted Financials” included “IBP’s 1999 10-K and its 10-Qs for the first three quarters of 2000.” *Id.* at 43.

transaction, always costless.<sup>286</sup>

*f. The Impossibility of Reasonable Reliance and the Function of Disclaimers*

To summarize, then, the materials that the seller produces to the buyer in due diligence include an enormous amount of written materials, generally tens of thousands or, in larger transactions, even hundreds of thousands of pages. A large part of this information is drawn directly from the business records of the seller that were prepared in the ordinary course of business and so not for the purpose of providing a potential buyer with an accurate and complete description of the seller's business. In fact, since a rational business invests in the accuracy and completeness of its business records only to the point that the marginal cost of doing so equals the marginal benefit, and since the marginal benefit of accuracy and completeness is generally much lower in contexts arising in the ordinary course of business than in the context of representations to be made by the seller to the buyer in a business combination transaction, both the seller and the buyer can be certain that the business records contained in the seller's due diligence materials contain some misstatements of material facts as well as some omissions that make other statements made in the materials materially misleading. The same is true of the oral communications between representatives of the seller and those of the buyer. Finally, since the buyer's due diligence review will extend over a period of weeks or months, the materials produced by the seller are necessarily always a work in progress, with some materials becoming inaccurate or incomplete as the seller's business develops and market conditions change. Hence, the due diligence materials are not a fixed body of statements but an evolving mass of information, with new materials being added as they become available and some older materials being superseded.

I suggest that anyone familiar with due diligence reviews in business combination transactions could not reasonably believe that the seller was representing and warranting that every statement in this tremendous, evolving, fluid mass of information was accurate and complete. The primary reason is that such a state of affairs is a manifest impossibility. Hence, any such representation would be not only false but obviously false,

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286. See Lipshaw, *supra* note 9, at 435 (arguing that "in focusing on fraudulent affirmative representations," the analysis may "fall [] short of (1) recognizing the fundamental aspect of deceptive promising in a complex deal, namely the half-truth, (2) articulating an appropriate doctrinal principle to address it, or (3) capturing the social and linguistic context that makes the deceptive half-truth so insidious").

and any seller who gave such a representation would be committing fraud. Buyers understand this as well as sellers. This, if correct, explains the true nature of the disclaimers we find in confidentiality agreements: when the seller says it makes no representation or warranty as to the accuracy or completeness of the information it delivers to the seller, the contractual disclaimer is merely making explicit what both parties to the contract already know. Disclaimers exist not so much to put the buyer on guard (the buyer already knows there will be errors and omissions in the due diligence materials) nor to alter the rights and obligations between the parties (on the facts, because reliance would be so unreasonable the buyer should not have a good case for misrepresentation, whether contractual or fraudulent, based on statements in due diligence), but to forestall opportunistic lawsuits by a buyer when it may be difficult for the seller to prove *ex-post*, to judges and jurors unfamiliar with the relevant market practices, facts that the buyer and seller would both readily admit *ex-ante*.<sup>287</sup>

Now, someone may wonder just what the seller is doing in delivering all this information to the buyer if the seller is not in effect saying that the information is true and complete. Put another way, if the information that the seller delivers to the buyer in due diligence is not reliable, what good is it?

The answer to this question begins from the observation that it is not only possible but extremely common in human life for one person to call another person's attention to a proposition without asserting the proposition himself.<sup>288</sup> It is even more common for a person to deliver information without thereby assuming legal liability for its accuracy and completeness. Although creating legal liability for the seller is not one of them, there are in fact several important purposes achieved in due diligence. First, in due diligence, the seller can inspect the business and form his own conclusions about it. When a physical object is being sold, a seller may allow the buyer to inspect the object in order to form his own opinions about it. With a business, the analogue is allowing the seller to inspect the books and records of the company (as well as inspect the physical assets, which, as noted above, is usually also done in due diligence). Although the seller allows the buyer to inspect the books and records of the company, it does not thereby commit itself to saying that every statement made in those

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287. There are other reasons that a buyer could not reasonably rely on certain statements made by a seller in due diligence. *See e.g.*, Blair, *supra* note 9, 434 (noting that sellers "often puff their products or services" and "sometimes over-opportunistically predict their capacity or willingness to perform"). These reasons seem to me relevantly minor compared to the reasons identified in the text.

288. *See* FREGE, *supra* note 139, at § 2.

books and records is accurate and complete.

Or, to take a particularly important example, buyers are naturally intensely interested in any financial projections for the company that management may have prepared.<sup>289</sup> When the seller delivers a set of financial projections, however, no one thinks that the seller is representing and warranting that the projections will, in fact, be achieved. Precisely because they are *projections* sophisticated businesspeople understand not only that any number of factors could cause them not to be achieved but also that, for this and other reasons,<sup>290</sup> no rational seller would ever represent and warrant that such projections would actually be achieved.<sup>291</sup> Nevertheless, seeing management's best estimate prepared not for sales purposes but in the ordinary course of business, of the future cash flows of the company is extremely valuable information for a buyer trying to value the company. Something analogous is true for due diligence materials generally. Even treating them for what they are—basically, the books and records of the company and the unfiltered and possibly unreliable opinions of its personnel—the information a buyer gets in due diligence, appropriately discounted to reflect its degree of reliability, is very valuable to the buyer.

This reference to discounting is important. The question of the seller's liability for misstatements or omissions in the diligence materials is an all-or-nothing thing: either the seller has liability, or it does not.<sup>292</sup> But the question of the reliability of the seller's statements in due diligence is not all-or-nothing. The buyer can, and certainly does, assign to each such statement whatever subjective probability it thinks is appropriate in light of the facts and circumstances as the buyer understands them. That probability would be higher if the seller was liable for misstatements and omissions, lower if the seller is not, but even in that latter case it will

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289. See *supra* Section II.A.1.a.

290. If the seller promised (since it relates to the future, it is a promise, not a representation we are considering) that the projections would be achieved, it would in effect be guaranteeing the future financial success of the business. Since, after the sale, the buyer and not the seller controls the business, the buyer could adopt a high-risk, high-return strategy for the business, benefiting greatly if the strategy worked out but being protected from its failure by the guaranteed return promised in the projections if it did not. The misalignment of incentives and resulting inefficiencies here are manifest.

291. In rare cases, seller will make representations and warranties about financial projections in the definitive agreement. When they do so, the customary representation states that the projections were prepared by the company's managers in good faith and on a reasonable basis, but that no representation is made as to whether they will actually be fulfilled.

292. See generally Saul Levmore, *Probabilistic Recoveries, Restitution, and Recurring Wrongs*, 19 J. OF LEGAL STUDIES 691 (1990).

generally be very much greater than zero, and this means that the information is valuable to the buyer in evaluating the transaction.

There is an even more important purpose, however, in the seller's making available to the buyer information that both parties understand will contain inaccuracies and omissions. For, as indicated above, due diligence is part of an efficient process for reaching an efficient transaction. Buyers will use information acquired in due diligence *in order to negotiate representations and warranties in the definitive agreement*. In other words, buyers do not really need the seller to assume legal liability for the accuracy and completeness of all of the statements contained in diligence materials because the buyer and the seller will later negotiate, on the shared basis of information contained in the diligence materials, which representations and warranties the seller will actually make and the buyer will actually rely on. To that topic, I now turn.

## 2. Discovering Efficient Representations and Warranties

As I noted at the outset, the parties to large business combination transactions are sophisticated, rational profit-maximizers who will structure their transactions efficiently, that is, by dividing rights and obligations minutely and then allocating rights to the party that values them most highly and obligations to the party that can bear the associated costs most cheaply.<sup>293</sup> They do this to maximize the joint surplus from the exchange and so maximize each party's opportunity to profit from the transaction, allocating the joint surplus through the price term. This point applies as much to representations and warranties as to any other provision in the contract between the parties.

### *a. Representations that Increase the Joint Surplus*

Now, prior to the sale of the target, the seller bears all the risks associated with owning the target, and after the sale, the buyer bears these risks. Representations and warranties in the agreement shift some of these risks back to the seller, for if the statement about the business in the representation turns out to be false (or knowingly false), then the seller is liable to the buyer. Hence, each representation that the seller makes creates a benefit for the buyer and generates a cost for the seller. It may thus seem that the buyer would want the seller to make as many representations as possible and the seller would want to make as few representations as

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293. *See supra* Introduction.



possible—and, indeed, this is the case, if we hold all other terms of the agreement, including the price term, fixed. In the real world, however, these other terms are not irrevocably fixed prior to the time the parties enter into a definitive agreement. The result of this is that the simple picture suggested above—buyers want more representations, sellers less—is not correct. Rather, because both parties want to maximize the joint surplus of the transaction, ex-ante both parties want the seller to make all and only the *efficient* representations, that is, those that increase the joint surplus because the benefit to the buyer of receiving the representation exceeds the cost to the seller of making it.<sup>294</sup>

The first thing that follows from this is that neither the buyer nor the seller wants the seller to represent and warrant all the thousands or millions of statements included in the due diligence materials. Given that sellers generally have low information costs related to facts about the target business, there are many matters for which the cost to the seller of making a representation is less than the benefit to the buyer of receiving one, but this is not universally true.<sup>295</sup> In fact, the vast body of statements contained in due diligence materials inevitably includes a huge number of statements with respect to which the benefit to the buyer of having a representation would exceed the cost to the seller of making the representation.<sup>296</sup> Furthermore, identifying the efficient representations requires comparing the benefit to the buyer of receiving the representation, which is known to the buyer alone, with the cost to the seller of making the representation, which is known to the seller alone. Hence, neither party acting alone can identify the efficient representations; rather, identifying the efficient representations

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294. Ex post, of course, when all the other terms of the agreement are fixed, the buyer wants to the seller to have made as many representations as possible, and the seller wants to have made as few representations as possible. This point determines the incentives of the parties in any post-closing litigation and is reflected in the fact that, in the non-reliance cases, the buyer is arguing that a certain representation was made, and the seller is arguing that no such representation was made (or, if made, is not actionable).

295. On the length of representations and warranties and the myriad matters about which seller customarily make representations, see ANATOMY OF A MERGER, *supra* note 42, at § 7.1.3, (sagely counseling selling clients that “the purchaser is entitled to full disclosure—even if that means a lot of work for seller in dishing up the facts.”); see also NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 11.04 (discussing representations about corporate organization and existence, good standing as a foreign corporation, subsidiaries, due authorization of the agreement, required approvals, financial statements, undisclosed liabilities, absence of material adverse changes, litigation, compliance with law, environmental matters, title to assets, taxes, employee benefit plans and matters, and accuracy of disclosure).

296. Cf. ANATOMY OF A MERGER, *supra* note 42, at § 7.1.1 (stating that “representations constitute a systematic smoke-out of the data about the seller that buyer feels is important”).

requires cooperation between the buyer and the seller. How is this cooperation effected? Clearly, it takes the form of bargaining over which representations the seller will make and the buyer will receive.

Now, for the bargaining process to achieve the intended result of identifying the efficient representations, both parties need to understand in great detail the business being transferred. The seller, of course, already understands the business.<sup>297</sup> The buyer, however, does not, but it must quickly come to do so in order to bargain intelligently with the seller about which representations to include in the agreement. This brings us back to due diligence. The purpose (or, at least, one purpose) of the seller's delivering so much information to the buyer is not for the seller to represent and warrant that such information is accurate and complete but to enable the buyer to bargain effectively against the seller in order that the parties, working together by bargaining, may identify the efficient representations, which the seller will then make to the buyer in the definitive agreement. Due diligence is not the making of representations and warranties; it is a necessary condition for the parties being able to negotiate efficient representations and warranties.

*b. In the Context of an Agreement*

There is another critically important reason why the set of efficient representations can be determined only in the course of bargaining towards a definitive agreement. For, the benefit to the buyer of receiving a representation and the cost to the seller of making that representation both depend not only on the content of the representation (that is, the factual statement it embodies) but also on the other provisions included in the definitive agreement of which it is a part. For example, business combination agreements involving private company targets typically provide that the seller will indemnify the buyer for breaches of the seller's representations and warranties in the agreement,<sup>298</sup> but such agreements

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297. What the seller might not understand (or understand fully), however, is what aspects of the business are important to the buyer. Due diligence is not a one-way street: although it begins with sellers delivering vast quantities of information to buyers, buyers ask questions and request additional information about issues that are important to them. As Freund puts it, the process of negotiating representations "forc[es] the seller to focus on significant aspects of his business, in a way he has probably never previously attempted, in order that important information can be formally transmitted to the purchaser." ANATOMY OF A MERGER, *supra* note 42, at § 7.1.1.

298. NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 15.01; see ANATOMY OF A MERGER, *supra* note 42, at § 7.1.1 (explaining the relationship between representations and indemnification provisions); West & Lewis, Jr.,

also typically limit this contractual remedy (which is usually the exclusive remedy, except in cases of fraud) by making it subject to deductibles (or baskets)<sup>299</sup> and a cap.<sup>300</sup> The same set of representations and warranties are more valuable to the buyer and more costly to the seller if the indemnification deductibles are low and the cap high; conversely, the representations are less valuable to the buyer and less costly to the seller if the indemnification deductibles are high and the cap low.

Or again, in agreements related to public companies (which typically omit indemnification provisions),<sup>301</sup> one of the most important functions of the representations is to establish a closing condition for the buyer.<sup>302</sup> The typical condition is that the representations made by the seller at the time the agreement is signed must still be true, to some standard or other, at the time of closing. For instance, the standard, which is commonly called a bring-down, could be that the representations remain true in all material respects, or that the representations remain true except for such failures to be true as would not have a material adverse effect on the company.<sup>303</sup> How valuable a representation is to the buyer, and how costly to the seller, in terms of its effect on the buyer's obligation to close the transaction will thus depend on the nature of the bring-down. The same set of representations will be more valuable to the buyer and most costly to the seller if the bring-down standard requires only that the representations be

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*supra* note 2, at 1019 (“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.”) (emphasis in original).

299. A basket is a clause that provides that the indemnifying party will not be liable to the indemnified parties until the aggregate value of all claims for indemnity exceed a certain stated amount, but once the claims exceed that amount the indemnifying parties are liable for the entire amount of all such claims (not the entire amount of such claims less the stated amount, which is a conventional deductible as in a consumer insurance policy). *See* NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 15.03[1].

300. *Id.* at § 15.03[1].

301. *See* ANATOMY OF A MERGER, *supra* note 42, at § 5.3.1 (explaining why acquisitions of targets that are public companies typically do not include indemnification provisions).

302. *Id.* at § 7.1.1 (explaining that one function of representations and warranties is to interact with the closing condition so that negative information about the target discovered after signing and before closing may result in a breach of representation and failure of the closing condition that the representations remain true at closing). NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 14.02[1]-[3].

303. *See* NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at §§ 14.02[1]-[3]. The text ignores the so-called double-materiality problem, *id.* at § 14.02[[3], but including it merely complicates the exposition without advancing the argument.

true in all material respects; the representations will be less valuable to the buyer and less costly to the seller if the bring-down standard requires only that the representations not be breached in a manner resulting in a material adverse effect.

Therefore, to determine which representations are efficient, not only must the parties work together to compare the benefit to the buyer of receiving the representation to the cost to the seller of making it, but they must also do this in the context of an overall agreement, for only in such a context can this comparison sensibly be made.<sup>304</sup> In other words, the *only* way for the parties to identify the set of efficient representations is to bargain over which representations will be included in the definitive agreement. Hence, value-maximizing parties would not want the seller to make any representations except for those negotiated with the buyer in the context of the definitive agreement.

*c. The Economic Function of Non-Reliance Clauses*

But if, for the reasons given above, sophisticated parties, who want to maximize the value of the joint surplus, would not want the seller to make, or the buyer to receive, any representations except for those in the definitive agreement, then the economic function of non-reliance clauses becomes apparent. Just as with disclaimers of the accuracy and completeness of the diligence materials, non-reliance clauses merely make express what sophisticated, value-maximizing parties involved in business combination transactions have already agreed to. The ultimate purpose of non-reliance clauses is to identify and include in the agreement all and only the efficient representations. They are tools for facilitating the creation of efficient agreements.

Negotiated representations in real business combination agreements demonstrate this process at work. For example, buyers naturally want information about contracts between the target business and its customers. If cost were not an issue, the buyer would want to see *all* of the contracts between the seller and buyer. Suppose that, in due diligence, the seller makes many of these contracts available to the buyer. From this and other aspects of due diligence, the buyer learns that the number of such contracts is extremely large (say many thousands), the dollar amounts of such

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304. As Kling and Nugent put it, "It is important for lawyers to bear in mind that an acquisition transaction is an interactive process in which the acquisition agreement serves as both a template which reflects matters which are of significance to the parties and as a 'road map' of how the parties get from deal concept to consummation." NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 1.06.

contracts tend to be low relative to the value of the deal, and almost all such contracts are terminable by customers for any reason or no reason on 30 days notice. Nevertheless, there are a relatively small number of contracts in which the dollar values are higher and the termination provisions less friendly to the buyer (perhaps, for example, because delivering the unusually large quantity of goods and services under these agreements requires special investments by the company). On this basis, the buyer requests that the seller represent that a schedule attached to the definitive agreement contain a list of all the agreements the seller has with its customers that (a) obligate the customer to pay at least \$1 million in the next twelve months, or (b) the customer may not terminate on less than 180 days notice.<sup>305</sup> The seller, who still knows its customer contracts better than the buyer, replies that the number of such agreements will still be very large, and so assembling the list requested and ensuring that it is complete and up to date would be very costly. The seller counteroffers to produce a list of all the agreements it has with costumers (a) under which the customer is obligated to pay at least \$2 million in the next twelve months, or (b) under which the customer is obligated to pay at least \$1 million in the next twelve months and which the customer may not terminate on less than 180 days notice. The seller knows that, with these changes, the list will not be difficult to produce (perhaps querying its software for this list is easy, while querying it for the list the buyer wanted impossible). The change makes little difference to the buyer and may in itself convey valuable information (for example, because it makes clearer to the buyer which kinds of contracts by the company require special investments in order for the company to perform on them). The parties thus agree that the seller will make the representation in the language proposed by the seller. The parties are here effectively trading off the costs of the seller in making the representation (including the potential liability for inaccuracy) against the benefits to the buyer of receiving the representation.<sup>306</sup>

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305. *Cf.* NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at §§ 1.06 (stating that in the discussion of the relationship between due diligence and representations and warranties, “a party may well ask for a specific representation and warranty on a certain topic because its investigation of the business being acquired has convinced it that such a topic is particularly important to that business or has made it aware of a specific problem or concern as to which it wants the added comfort of a specific representation.”).

306. *Cf.* NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, *supra* note 5, at § 1.06 (stating, “The scope of a buyer’s due diligence may also (unwittingly, perhaps) form the basis of the ‘definition’ of materiality in the representations,” because, for example, “if the seller wishes to limit its representations as to contracts by providing that it is being made as to contracts for sales in excess of a certain dollar volume, the dollar

### 3. An Efficient Process to Produce an Efficient Agreement

The relationship between the two tools to solve the information problem inherent in business combination transactions—due diligence and the representations and warranties in the definitive agreement—thus finally comes into focus. Both the seller and buyer understand that the purpose of the seller’s making so much information available to the buyer in due diligence *is not for the buyer to rely on it*. Indeed, even the *AES* court understood that “a buyer who relies on seller-provided information without seeking to verify it has not acted reasonably.”<sup>307</sup> Rather, as contemplated by the confidentiality agreement, the parties go into the due diligences process with the expectation that, after the buyer has concluded its investigation of the company, the buyer and the seller will negotiate which representations the seller will make in the definitive agreement. The purpose of the buyer’s due diligence investigation (or, at least, one such purpose) is to make this negotiation possible. *Negotiating* the representations is critically important because, since both parties want to reach an agreement that maximizes the joint-surplus of the transaction, the parties in particular want the agreement to contain all and only the representations that benefit the buyer more to receive than they cost the seller to make. Identifying these representations, however, requires a comparison of the benefit the representation confers on the buyer, which is known only to the buyer, and the cost to the seller of making the representation, which is known only to the seller. Moreover, these benefits and costs depend not only on the content of the representation but also on other provisions in the agreement, such as the indemnification provisions and the closing conditions that are keyed to the representations. Hence, the only way to determine which representations are efficient is for the parties to negotiate about the representations in the context of a definitive agreement. Since both parties clearly understand this from the beginning of the transaction process, the confidentiality agreement, which is executed before the process begins, typically provides that the only representations and warranties the seller will make will be those contained in the definitive agreement, and the buyer agrees to this by promising that it will not rely on any representations by the seller except for representations in the definitive agreement.

Hence, it becomes apparent why non-reliance clauses are efficient.

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amount chosen by the parties may well mirror the dollar amount reflected in the agreements the buyer has examined in its due diligence process.”)

307. *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 181 (3d Cir. 2003).

Indeed, they are efficient in two senses. On the one hand, they are efficient because they facilitate and structure a process of information sharing and negotiation needed to reach an agreement containing an efficient set of representations. On the other hand, they are efficient because they exclude from the transaction only representations that were not efficient, representations that the parties omitted from their agreement precisely because the cost of including them would have exceeded the benefit of doing so. The representations that non-reliance clauses make unenforceable are precisely the ones that the parties not only *have not* agreed to (this is obvious) but also *would not* have agreed to.<sup>308</sup>

### III. NON-RELIANCE CLAUSES AND HOW THE CIRCUIT SPLIT ABOUT THE EFFECT OF SECTION 29(A) SHOULD BE RESOLVED

The argument above shows that, in the context of a business combination transaction, sophisticated parties know that (a) the information the seller makes available to the buyer in due diligence will have a positive error rate and so will contain a non-trivial number of misstatements and omissions, (b) that if every statement in the information the seller makes available to the buyer in due diligence were treated as an enforceable representation, the result would be an agreement containing a vast number of inefficient representations, thus reducing the joint surplus of the transaction and making both the seller and the buyer worse off, and (c) both parties expect *and find it in their interest* to determine the efficient set of representations in negotiating the final definitive agreement. Sophisticated parties know all these things not only because they are sophisticated and can be counted upon to know what is in their own best interests but also because these matters are so well understood in the market for corporate control that they have become embodied in customary market practices.

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308. The argument in the text is really an unusual application of the Coase theorem. Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960). In the more usual situation, the argument goes that, because transactions costs were high, a gap exists in a contract between the parties; had transaction costs been zero (or low), the parties would have agreed to a particular provision, because, in the context of their agreement, that provision would have been efficient. *See e.g.*, *Katz v. Oak Industries, Inc.*, 508 A.2d 873, 880 (Del. Ch. 1986). The argument in the text is that, because transaction costs are low and because a certain provision does *not* appear in the contract between the parties, that provision would *not* have been efficient in the context of the agreement between the parties. These two arguments are applications of the two conditionals that, together, are logically equivalent to the biconditional in the Coasean claim that, if transaction costs between the parties negotiating an agreement are zero, then a provision will be included in the agreement if, but only if, it is efficient in the context of the agreement.

One convincing proof of this is that the contractual clauses giving effect to these market practices—disclaimers by the seller of any representations as to the accuracy and completeness of the information in the due diligence materials and non-reliance clauses by buyers representing or promising that they are relying on no representations of the seller except those included in the definitive agreement—are boilerplate provisions in model confidentiality agreements published by such organizations as the American Bar Association<sup>309</sup> and the New York City Bar Association.<sup>310</sup>

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309. See ABA, *Confidentiality Agreement*, in MODEL STOCK PURCHASE AGREEMENT 83 (2d ed. 2010) (providing “Neither party to this letter agreement . . . has made or will make any representation or warranty, express or implied, as to the accuracy or completeness of the Evaluation Material,” “neither [party] shall have any liability to the other party hereto . . . from the use of the Evaluation Material or any errors therein or omissions therefrom,” and “[e]ach party hereto also agrees that it is not entitled to rely on the accuracy or completeness of any Evaluation Material and that it shall be entitled to rely solely on such representations or warranties regarding the Evaluation Material or the subject matter thereof as may be made in any definitive agreement” related to the transaction.). Compare, Sachs, *supra* note 9, at 909 (worrying “whether it is reasonable to expect investors to ferret out a merger clause from a voluminous offering document of considerable complexity.”). Such concerns are understandable in the contexts that Sachs appears to have in mind—namely, situations involving a sophisticated party dealing with a retail investor, not two sophisticated parties dealing with each other, which is the focus of this article. As I emphasized at the outset, the argument here concerns business combination transactions (and by analogy some similar complex corporate transactions) in which both parties are highly sophisticated and in which all competent transactional lawyers would expect to see disclaimers and promissory non-reliance clauses in confidentiality agreements and representational non-reliance clauses in definitive agreements. In quite different contexts, like those Sachs has in mind, the appropriate outcomes of cases could be quite different. Others who have considered the problem of enforcing non-reliance clauses have usually had sophisticated parties in mind, though not necessarily only in the context of business combination transactions. See also Blair, *supra* note 9, at 428 n.17 (distinguish situations involving sophisticated parties from those involving “consumer contracts or contracts involving radically disparate bargaining power.”); Masson, *supra* note 9, at 528 (discussing how New York law distinguishes between agreements between sophisticated commercial parties and consumer contracts when determining whether to enforce non-reliance clauses); West & Lewis, Jr., *supra* note 2, at 1033 (“Contracts made between sophisticated parties, represented by counsel, who freely decided after extensive negotiations to allocate risk in a carefully crafted written agreement are fundamentally different from the adherence contracts made by consumers who buy cars, rent jet skis, or sign consents allowing their children to participate in rafting excursions.”). Kevin Davis’s account, which is focused on how enforcing non-reliance clauses can minimize the costs of transacting through agents, would seem to apply to any parties, whether sophisticated or not, who transact through agents. Davis, *supra* note 9, at 507.

310. See Model Form of Non-Disclosure Agreement § 4, Corporation Law Committee of the New York City Bar Association (2015), available at [https://www.nycbar.org/pdf/report/New\\_York\\_City\\_Bar\\_Association\\_Model\\_Form\\_of\\_Non-Disclosure\\_Agreement\\_2015.pdf](https://www.nycbar.org/pdf/report/New_York_City_Bar_Association_Model_Form_of_Non-Disclosure_Agreement_2015.pdf) [<https://perma.cc/29Z3-K392>] (“Buyer acknowledges and agrees that: (a) no representation or warranty, express or implied, is made by the Company or any of its Representatives as to



Under these circumstances, no reasonable seller understands itself to be making representations to the buyer when it makes available to the buyer due diligence materials. For exactly the same reasons, no person in the position of the buyer could reasonably understand that, in making available to it information in due diligence, the seller was making representations to it. No reasonable buyer would expect the seller to make representations that both parties know are not true and complete.

Furthermore, both parties understand perfectly well that there is a process—namely, the negotiation of the definitive agreement—whereby they will work out the set of efficient representations and that the buyer will make such representations to the seller if, but only if, they actually enter into an agreement to effect a business combination. Therefore, even in the absence of an agreement embodying a non-reliance clause, sophisticated parties involved in a business combination transaction cannot reasonably understand the seller to be making representations to the buyer in the information provided the buyer in due diligence, and so, even in the absence of a non-reliance clause, a seller cannot reasonably rely on any putative extra-contractual representations.<sup>311</sup> This brings us to the true function of non-reliance clauses: by making express in a legally binding way an efficient arrangement for the discovery and negotiation of efficient representations in the definitive agreement, non-reliance clauses prevent one party (the buyer) from taking opportunistic advantage of the other party (the seller).<sup>312</sup> That is, in due diligence the seller makes available to the buyer certain information about the target, some of which the parties know will almost inevitably include misstatements and omissions. The parties understand and agree from the beginning, however, that this information

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the accuracy or completeness of any of the Evaluation Material; and (b) Buyer shall be entitled to rely only on those representations and warranties that are expressly set forth in any definitive written agreement that is hereafter executed and delivered by both Buyer or its Affiliate and the Company in connection with the Transaction . . . . Except as may be expressly set forth in a Definitive Transaction Agreement, none of the Company or any of its Representatives shall have any liability to Buyer or any of its Representatives on account of the use of any Evaluation Material by Buyer or any of its Representatives or any inaccuracy therein or omission therefrom”). In the interest of full disclosure, the author notes that he is the current chairman of the New York City Bar Association’s Corporation Law Committee, which was responsible for drafting the model agreement, and was a member of that committee in 2015 when the model agreement was published.

311. Recall that even the *AES* court understands that “a buyer who relies on seller-provided information without seeking to verify it has not acted reasonably.” *AES Corp. v. The Dow Chemical Co.*, 325 F.3d 174, 181 (3d Cir. 2003).

312. See *Rissman v. Rissman*, 213 F.3d 381 (7th Cir. 2000) (stating written non-reliance clauses protect parties from “the vagaries of memory and the risks of fabrication”).

will not be treated as representations by the seller;<sup>313</sup> rather, sharing the information facilitates the negotiating of such representations in the definitive agreement. By engaging in this sharing, however, the seller makes itself vulnerable to a later lying claim by the buyer that the seller induced the buyer into the transaction by making fraudulent representations to it in due diligence. The way to prevent such opportunistic behavior is a non-reliance clause, a promise (in a preliminary agreement) and a representation (in a definitive agreement) by the buyer that it is not relying on information disclosed in due diligence. A more complete representation would state that the buyer understood that the information it received from the seller in due diligence contained errors and omissions, probably a great many of them, and that both the seller and the buyer, knew this, and knew that each other knew this, but that the buyer and seller both believed the seller's making such information available to the buyer on these terms was in their common interest.<sup>314</sup>

From all this, it should be clear that any interpretation of Rule 10b-5 that imposes liability on sellers in business combination transactions for misstatements and omissions in due diligence materials would result in great inefficiencies in the market for corporate control. In my view, the argument for this conclusion is overwhelming.<sup>315</sup> But, as explained above

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313. *Cf.* Grove, *supra* note 9, at 1121 (holding that a “[non-reliance clause] is not a waiver but a statement of fact”).

314. Compare the language in big boy letters, which typically includes provisions that one party is or may be in possession of material, nonpublic information about the securities that are the subject of the sale and purchase and that the counterparty is aware of this fact but does not desire that the party with such information disclose it. *See, e.g.*, WACHTELL, LIPTON, ROSEN & KATZ, *supra* note 81, at 1 (discussing typical provisions in big boy letters); McLAUGHLIN, *supra* note 81, at 2 (discussing the differences between non-reliance clauses and big boy letters); Eshmoli, *supra* note 81, at 153 (noting preclusion of reasonable reliance in big boy letters).

315. Readers insufficiently impressed with efficiency rationales may still worry about the moral aspects of a system that, on rare occasions, allows one sophisticated party to intentionally lie and escape liability therefor. The answer to this, I think, is twofold. First, given the nature of the system, any lies the seller may tell pre-contractually are almost certainly immaterial (which means that, though lies and perhaps fraud, they would not support any meaningful damages), for if they concern significant matters, they would be incorporated in the seller's representations in the definitive agreement, and as such they would be actionable (indeed, actionable in contract and not merely in fraud). Getting the efficient representations (and only the efficient representations) into the definitive agreement is, after all, the point of the system. But no system is perfect, and there will occasionally be lies that go unpunished at law. This is hardly surprising since any enforcement mechanism is expensive to operate, which means that the marginal benefit of reducing the incidence of the kind of conduct to be suppressed down to zero (usually) eventually exceeds the marginal cost. The only thing surprising in this case is that the optimal enforcement system has been almost completely privatized by the market

in Part I, the issue faced by courts in determining whether disclaimers and non-reliance clauses will be given effect in accordance with their terms is not one of merely interpreting Rule 10b-5. Practically every court that has viewed the question merely in these terms<sup>316</sup> has concluded that disclaimers and non-reliance clauses should be given effect, but the more difficult question of statutory interpretation concerns whether Section 29(a) of the Exchange Act makes such contract terms unenforceable as a matter of federal law. To that final question, I now turn.

*A. Section 29(a) As Non-Circumvention Provision and Disclaimers and Non-Reliance Clauses as Not Circumventing*

By its terms, Section 29(a) is a non-circumvention provision. That is, its purpose is to prevent the parties engaged in securities transactions governed by the Exchange Act from agreeing by contract that certain rights allocated by the federal securities law to one party will be retransferred to the other party. Those rights undoubtedly include rights under Rule 10b-5, which are essentially rights not to be defrauded by material misstatements or misleading omissions. Hence, under Section 29(a), an agreement that a representation otherwise actionable under Rule 10b-5 will not be actionable—a transfer of a certain right from the buyer to the seller—is unenforceable. So far, so good.

But *which rights the buyer has* under Rule 10b-5 to transfer depends on *which representations the seller previously made to the buyer*. That is, before a contractual provision can violate Section 29(a) by transferring rights from one party to another, the party transferring those rights must

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participants, but even that is not surprising when we remember we are dealing with very sophisticated parties involved in very high-stakes transactions. An answer to the argument that lying is immoral and should be punished that does *not* work, I think, is that, while some lies are immoral, not all are (e.g., the famous case of lying to the Nazis to protect the Jews hiding in the attic). Blair, *supra* note 9; *see generally* SISSELA BOK, LYING (1999). One may well think that lies to save lives, divert evildoers or madmen from their pernicious ends, or safeguard privacy are morally permissible, but that does nothing to show that lies about the subject matter of a contract being negotiated between potential contracting parties are permissible. Chief Justice Strine is certainly correct when he says that lies in such a context are among the most inexcusable kinds of lies. *Abry Partners V, L.P. v. F&W Acquisition, LLC*, 891 A.2d 1032, 1058 (Del. Ch. 2006). When Blair argues that “fraud is not categorically unreasonable” because “there are other social goods that can, in proper circumstances, offset the need to impose liability for fraud,” Blair, *supra* note 9, at 464, I think he is confusing fraud, the optimal level of which is zero, and reducing the incidence of fraud to zero by enforcement action, which is very likely not optimal.

316. *See supra* Section I.C.3 on the cases in the First, Seventh, and District of Columbia Circuits.

actually have those rights. In this case, the rights in question would be rights the party has because the other party has made certain false or misleading representations to it. Hence, before a party *has* any rights that could be transferred in violation of Section 29(a), the other party must have made to the party a false or misleading representation.<sup>317</sup>

Now, as the argument above has shown, as typically used in the market for corporate control, disclaimers and non-reliance clause do *not* reallocate rights from the seller back to the buyer. That is, we do not have a situation in which the seller has made false or misleading representations to the buyer in due diligence on which the buyer could have reasonably relied, thus acquiring a certain kind of right—a cause of action under Rule 10b-5—which such right is then transferred to the seller by contract. That is nothing like what occurs. As we saw, even in the absence of disclaimers and promissory non-reliance clauses in the preliminary agreements and representational non-reliance clauses in the definitive agreement, the market realities of business combination transactions ensure that rational, profit-maximizing parties involved in such transactions would not want, and to not understand, sellers to be making representations and buyers to be receiving them in the due diligence process. Rather, in pursuing an efficient and value-maximizing transaction, both sellers and buyers want only the representations that they negotiate in the definitive agreement to have any legal effect. The disclaimers and non-reliance clauses they employ do not change their understanding of how rights and obligations are being allocated. They merely memorialize this understanding to prevent ex post opportunistic defalcations.

Another way to grasp this point is to consider the temporal relationships between the creation of the relevant contractual provisions and the alleged misrepresentations in due diligence. That is, if we had a process in which a seller makes representations to the buyer on which the buyer, in the circumstances, could reasonably rely, and then, when the parties are negotiating the definitive agreement, the seller slips into the agreement a clause in which the buyer represents that it is relying on no representations of the seller except for those contained in the definitive agreement, we would indeed have a very problematic situation. For one thing, the seller would have made representations on which the buyer likely did reasonably rely, and so the contractual provision in the agreement would be transferring by contract rights that the buyer had acquired under

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317. Lutz, *supra* note 9, at 846 (arguing that because it would be unreasonable for a buyer to rely on extra-contractual representations in a business combination transaction, non-reliance clauses do not waive existing rights but merely make explicit the fact that reliance on extra-contractual representations was unreasonable).

federal law (or, at least, rights the buyer would acquire once the parties entered into a binding agreement and that was a sale and purchase of securities). For another, the representation that the buyer would give stating that it is not relying on extra-contractual representations would likely be false when given. Similarly, if the provision in the definitive agreement were a disclaimer, in which the seller disclaims making any representations or warranties except in the definitive agreement, the disclaimer is likely a false representation when made: it is simply not true, as a matter of fact, that the seller had made no representations except those in the contract. Given the implausibility of these contractual provisions, such provisions would likely best be understood as waivers of rights already accrued, and in that case the correct result is no doubt that such provisions are void under Section 29(a).

But, as explained above, this scenario bears no resemblance to what actually occurs in the market for corporate control. There, as we saw, what typically happens—and what the parties from the beginning of the process understand will happen—is that at the very outset, *before due diligence begins*, the parties enter into a preliminary agreement in which the seller disclaims any representations as to the accuracy or completeness of the due diligence materials and the buyer promises not to rely on any of those materials in entering into the definitive agreement. At this point, *before the seller has made any representations to the buyer*, the buyer of course has no rights under Rule 10b-5, for there are no representations with respect to which such rights could accrue. Thus, disclaimers and promissory non-reliance clauses in preliminary agreements cannot possibly be transferring rights in violation of Section 29(a). At most, they are controlling the creation of such rights that, absent these contractual provisions, the subsequent behavior of the parties might cause to accrue. But even that is not the case, because, as we saw, the disclaimers and promissory non-reliance clauses are really only memorializing the only reasonable understanding of the market realities at issue. Hence, it is clear that such provisions in the preliminary agreement do not violate Section 29(a).

Subsequently, in the definitive agreement, the parties typically include a representation by the buyer stating that it has not relied on any extra-contractual representations of the seller. Clearly, this representation does not run afoul of Section 29(a) either. For, in giving the representation, the buyer is merely representing that it has performed on its promise in the preliminary agreement, and it would be nonsense if the earlier contractual promise and its fulfillment did not violate Section 29(a) but a mere subsequent representation by the party that it fulfilled these obligations somehow did. The representational non-reliance clause in the definitive

agreement is a statement that certain rights never accrued; unless false when given, it does not attempt to transfer rights but rather confirms that certain rights were never created in the first place.<sup>318</sup>

Therefore, disclaimers and promissory non-reliance provisions in preliminary agreements and representational non-reliance provisions in definitive agreements are not devices that, individually or in the aggregate, transfer rights created by Rule 10b-5 or other provisions of the federal securities laws. Such contractual provisions are thus not void under Section 29(a). Indeed, so far from being devices for transferring rights created under federal law, these contractual provisions are integral parts of a process of determining which representations the seller will make and the buyer will receive—that is, they help the parties identify the efficient set of representations. Such contractual provisions thus in no way “weaken [the buyer’s] ability to recover under the Exchange Act.”<sup>319</sup>

Someone might object that this argument, which places great weight on the difference between a representation never having been made and a representation having been made and then negated by contract, is excessively formalistic. I think that objection misses a crucial point. As I emphasized several times, it is not so much the contractual provisions that allocate and reallocate rights here; it is the underlying market realities themselves. Given the quantity and nature of due diligence materials and the economic interests of the parties in negotiating efficient representations only as part of a definitive agreement, no reasonable seller understands itself as making representations in due diligence, and no reasonable buyer understands itself as receiving such representations. Giving effect to disclaimers and non-reliance provisions is thus emphatically not formalistic; it is just the opposite: it is to give effect to realities in the marketplace. If there is any unrealistic formalism here, it is to apply Rule 10b-5 in literal accordance with its terms but in ways that would seem patently absurd and unreal to businesspeople involved in the transaction.

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318. *Cf. Grove, supra* note 9, at 1143 (concluding that non-reliance clauses do “not waive compliance with 1934 Act” but “merely affect [] the question of whether there is a Rule 10b-5 violation in the first place. One cannot waive a right one does not have.”).

319. *Shearson/American Express v. McMahon*, 482 U.S. 220, 231 (1987); *see also Grove, supra* note 9, at 1131 (discussing the relevance of *Shearson/American Express* to the issue of the effectiveness of non-reliance clauses).

*B. Section 29(a) as Not Prohibiting Agreements About Which Representations Are Being Made*

Above I suggested that Section 29(a) should be understood as prohibiting any transfer of rights that parties obtain under the Exchange Act, including Rule 10b-5, and I argued that disclaimers and promissory non-reliance clauses and representational non-reliance clauses in definitive agreements do not work any such transfer. But it seems clear that Section 29(a) does not even prohibit *all* transfers of accrued rights under Rule 10b-5.

Consider the following example. Suppose that the parties enter into a binding agreement for the sale and purchase of securities that includes several representations by the seller about the securities being transferred and the underlying business. After the agreement is signed but before the transaction is closed, the parties renegotiate the deal in important respects, amending the agreement to change the price of the securities and the quantity sold; they also make extensive changes to the seller's representations in the agreement, deleting some, adding others, and modifying yet others. The amended agreement includes a full integration clause that expressly states that the amended agreement supersedes the original amendment, and it also contains a representational non-reliance clause in which the buyer represents that, in entering into the amended agreement, it is relying on no representations or warranties of the seller except for those set forth in the amended agreement. After the transaction as specified in the amended agreement closes, the buyer sues the seller under Rule 10b-5 alleging that certain representations made by the buyer were false or misleading, including (a) some alleged extra-contractual representations that appeared in neither the original nor the amended agreement, and (b) some representations that appeared in the original agreement but were deleted from the amended agreement.

Courts such as the First and Third Circuit would say that Section 29(a) voids the representational non-reliance clause as to the extra-contractual representations, which allows the plaintiff's suit to proceed with respect to these claims (of course, whether the plaintiff will succeed in proving reasonable reliance is another matter). But what of the claim based on the representations that had been included in the original agreement but were removed when the parties agreed to the amendment? It is patently absurd to say that the buyer can sue on those representations. Why? Obviously, because in entering into the amended agreement, the buyer expressly agreed that such representations would no longer be part of the agreement. No reasonable interpretation of Section 29(a) would make it impossible for

parties to amend an agreement in a way that deletes a representation that had previously been part of the deal. But if, without offending Section 29(a), a seller can make a representation in a legally binding agreement, something that obviously causes rights to accrue to the other party under Rule 10b-5, and then by agreement with the buyer remove that representation from the agreement so that the buyer may no longer rely upon it and so no longer sue on the basis of it under Rule 10b-5, why cannot the parties agree to do exactly the same thing with respect to a representation *that was never part of the agreement in the first place*? Even more, why can they not do so with respect to a statement that, even before it was made, the seller disclaimed, and the buyer promised not to rely upon? There are no good answers to these questions. If Section 29(a) allows representations made in legally binding agreements to be voided by the agreement of the parties, it must also allow the parties to agree in the first instance which representations will be included in their agreement. Its reasoning may have been inadequate, but the Second Circuit was essentially correct when it held in *Harsco* that nothing in Section 29(a) prevents sophisticated parties from agreeing as to which representations the buyer makes. Section 29(a) does prevent the parties from agreeing that Rule 10b-5 will not apply to representations one party makes to another, but it does not prevent the parties from agreeing which representations they want to make and receive.<sup>320</sup>

When the Supreme Court finally resolves the split between the Second Circuit and the First and Third Circuits regarding the enforceability of disclaimers and non-reliance clauses under Section 29(a) of the Exchange Act, it should hold that, at least as between sophisticated parties engaged in business combination transactions in the market for corporate control, such provisions should be enforceable in accordance with their terms.<sup>321</sup>

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320. See Davis, *supra* note 9, at 496 (discussing whether non-reliance clauses amount to retractions of prior fraudulent representations and concluding that “the most satisfying approach seems to be to say that if a misrepresentation has been retracted in the clearest possible language it should not be considered to have induced entry into a subsequent contract.”).

321. See Grove, *supra* note 9, at 1145 (pointing out that, even apart from the merits of such a result, making non-reliance clauses in agreements between sophisticated parties enforceable would further the Supreme Court’s announced policy of keeping the scope of the private right of action under Rule 10b-5 narrow); see, e.g., *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 167 (2008) (referring to “the narrow dimensions we must give to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.”).



## CONCLUSION

Anyone familiar with the due diligence process has to be impressed with the vast quantities of information involved and recognize the inevitability that such information will, in some respects, be inaccurate and incomplete. There is usually, moreover, a mad rush on the part of the seller to produce such information, and an equally mad rush on the part of the buyer to review it. On the other hand, the representations included in a definitive agreement are often negotiated word by word by senior counsel with the involvement of various senior officers from the company and other expert advisors, and at some point counsel will typically insist that the relevant business people review the representations (and many schedules qualifying them) word by word and sentence by sentence to check their accuracy and completeness. The contrast between the level of care involved in the diligence materials and the representations could not be starker. Anyone who has witnessed this firsthand cannot help but see why both parties want the buyer to rely on the representations in the agreement and nothing else. In other words, if non-reliance clauses did not exist, they would have to be invented.

In this regard, I remind the reader of the commonly-heard argument that anyone can avoid making a fraudulent statement at zero cost because he knows, immediately and costlessly, before he opens his mouth, whether he believes that the statement he is about to make is true. As I indicated above, this is likely correct in the vast majority of cases when one individual human being is speaking to another, which is the paradigm situation presupposed by the common law. It is emphatically not true, however, when one large organization delivers tens of thousands, hundreds of thousands, or even millions of pages of information to another, or when their various agents meet and discuss such material. In that context, it turns out that avoiding fraud—and not just lying or mistaken claims of fraud brought after the fact by disappointed or opportunistic buyers—is actually very costly.

What emerges from the contrast is that common law judges developed a set of rules that were very likely efficient at a time when face-to-face negotiations between individual human beings were the norm. Perhaps such situations still are the norm, but, however this may be, the rules of the common law undoubtedly assume that the transactions costs faced by the parties are the kinds of costs typically faced by individual human beings dealing with other individual human beings. We have today—and have had for a long time—to consider as well quite different kinds of parties interacting in quite different kinds of contexts, contexts where the relevant

transaction costs may be materially different from those of individual human beings interacting with other individual human beings. In such cases, the market usually supplies a fix in the form of agreements that vary the common law rule, replacing it with a rule that responds to the different cost structures the parties actually face. Thus, forms of deal technology arise to create efficient rules for parties for whom the common law rules would be inefficient. Common law judges, like the judges on the Delaware Court of Chancery and the Delaware Supreme Court, usually see such things for what they are and allow the parties to make rules appropriate for their situation. In other words, they enforce the relevant agreements.

Difficulties arise, however, when legislatures make rules of wide applicability that do not allow for adaption to the vastly different situations and cost structures that parties who come within the rule actually face. This is the underlying problem with Section 29(a). Congress enacted this provision with one class of case in mind, presumably a kind that it thought common at the time, back in 1934. Fortunately, the text of Section 29(a) is sufficiently open-textured to allow federal courts to find that disclaimers and non-reliance clauses of the kinds typically used in business combination transactions are enforceable. But this is more a matter of good luck than anything else. If Congress had said something slightly different, reaching the socially-desirable result may have been impossible. The lesson is one of the omnipresent danger of writing an inflexible rule for a complex and evolving world.