SCHOOL OF LAW
CASE WESTERN RESERVE
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Case Western Reserve Law Review

Volume 56 | Issue 4

2006

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Recommended Citation

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)

Available at: https://scholarlycommons.law.case.edu/caselrev/vol56/iss4/14

NOTES

NON-RELIANCE CLAUSES AND SEC RULE 10B-5: DEFINING THE BOUNDARIES OF CORPORATE TRANSACTIONS

INTRODUCTION

In merger and acquisition discussions, the purchase of a target corporation is the most significant transaction in that corporation's existence. The acquiring corporation's directors and managers are under tremendous pressure from their shareholders to increase shareholder market value.[1] Corporate combinations offer directors and managers the possibility of increasing shareholder market value through synergies.[2] During acquisition negotiations, the purchaser wants access to all potentially relevant documents. Different people, most of whom are lower-level employees or outsiders, not authoritative representatives of the seller, draft the documents. If the purchaser has a question, the seller may answer, but often the seller does not want to be bound for the accuracy of these documents except to the extent that the seller expressly says so.

Feeling the immense pressure from shareholders, directors and managers often rush into transactions, overpaying to their

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[1] Shareholder market value is the market value of the firm's outstanding common stock: market price × number of shares outstanding. RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 253 (2d ed. 1995).

[2] There are numerous motives for acquisitions, but:

> Synergies of various sorts – operating, financial, or managerial – are the most common explanation offered by the acquirer's managers for an acquisition. . . .
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> . . . .
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> . . . Operating synergy involves the prospect of improvements in the productive activities of the two companies. . . . Financial synergy concerns the potential value of reducing the variance of a company's earning by diversifying at the firm level, or replacing the external capital market with an internal market.

Id. at 258.

shareholders' detriment.[3] Once the purchaser realizes the overpayment, it may try to recover its loss by claiming that the seller misrepresented material facts. Even if underpayment occurs, the purchaser may still decide to seek return of part of the purchase price—an attempt to renegotiate an even better price after the fact. In these situations, the seller has a legitimate concern that the purchaser will claim reliance on a document that the seller never represented to be accurate.

A non-reliance clause (NRC) included in the final agreement is designed to avoid this threat by defining the boundaries of the transaction. An NRC provides that the purchaser is "relying solely on representations contained in the final written contract, thereby eliminating the possibility that an aggrieved party may plausibly claim reliance on any oral or written representations that are excluded from the final contract."[4] NRCs permit purchasers to rely on, and therefore sue under, only a specific list of representations and warranties contained in the final agreement.

Allowing parties to completely contract out of securities regulation by private agreement would facilitate fraud. To prevent this, section 29(a) of the Securities Exchange Act of 1934 provides that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."[5] The underlying concern of section 29(a) is "whether the agreement 'weakens [the] ability to recover under the Exchange Act.'"[6] Parties persistently push the limits of section 29(a). Courts must rule if NRCs: waive compliance of the 1934 Act; limit and define the boundaries of the transaction;[7] or neither.[8]

In *Harsco Corp. v. Segui*,[9] the U.S. Court of Appeals for the Second Circuit determined that an NRC did not "constitute a forbidden

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3 The two most cited reasons for overpayment are (1) optimism: managers successful in one business may be apt to overestimate their ability to run another business; and (2) Winner's Curse: in an auction, the person who overbids (overpays) wins. *See id.* at 295-97; Bernard Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 624-27 (1989).

4 David K. Lutz, Note, *The Law and Economics of Securities Fraud: Section 29(A) and the Non-Reliance Clause*, 79 CHI.-KENT L. Rev. 803, 804 (2004).

5 Securities Exchange Act of 1934 § 29, 15 U.S.C. § 78cc (2000).

6 Shearson/Am. Express Inc. v. McMahon, 482 U.S. 220, 230 (1987) (quoting Wilko v. Swan, 346 U.S. 427, 432 (1953), *overruled by* Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989)).

7 Harsco Corp. v. Segui, 91 F.3d 337, 343 (2d Cir. 1996).

8 If an NRC says, "Buyer agrees not to sue over any representation other than" X, then it is an attempted contractual modification (or limitation). If, however, an NRC says, "Buyer states that it has not relied on any representation other than" X, then it is a statement of fact.

9 91 F.3d 337.

waiver of compliance."[10] The NRC simply "define[d] the boundaries of the transaction."[11] In 2003, however, the Third Circuit held in *AES Corp. v. Dow Chemical Co.*[12] that enforcement of an NRC in a stock purchase agreement "to bar AES's fraud claims as a matter of law would be inconsistent with Section 29(a)."[13] The court held that a purchaser anticipatorily waives future claims based on fraudulent misrepresentations if the purchaser agrees never to claim reliance on representations not included in the final agreement.[14] The Third Circuit rejected the holding in *Harsco Corp.*, thereby creating a circuit split.[15]

This Note will examine the "reasonable reliance" element of Rule 10b-5 in the context of corporate transactions between sophisticated parties.[16] It will show that an NRC serves to avoid unwarranted Rule 10b-5 claims in connection with stock purchase acquisitions. This Note will argue that the Second Circuit was correct when it held that an NRC does not waive compliance of the 1934 Act; rather, an NRC defines the boundaries of the transaction.[17] An NRC is not a waiver but a statement of fact. NRCs do not bar plaintiffs from suing over false statements of material facts, but merely represent that the plaintiff has not relied on certain statements.

Part I of this Note will provide a background and historical perspective on the Securities Act of 1933 (1933 Act) and the 1934 Act. It will also discuss the requirements of scienter and reasonable reliance for Rule 10b-5 claims. Part II will argue that an NRC does not "weaken" a plaintiff's ability to recover under the Act; it simply narrows the scope of a seller's potential liability to a contractually agreed level. Part II will also analyze the circuit split concerning the effect of NRCs in federal securities fraud actions. Part III will argue that an NRC should establish a sophisticated party's non-reliance on representations and warranties not contained in the final agreement.

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10 *Id.* at 343.
11 *Id.*
12 AES Corp. v. Dow Chem. Co., 325 F.3d 174 (3d Cir. 2003).
13 *Id.* at 180.
14 *Id.* at 180-81.
15 Lutz, *supra* note 4, at 805.
16 *See* discussion *infra* Part I.A.
17 Harsco Corp. v. Segui, 91 F.3d 337, 343 (2d Cir. 1996).

I. SECURITIES FRAUD UNDER RULE 10B-5

A. The Securities Act of 1933 and the Securities Exchange Act of 1934

Congress enacted the 1933 and 1934 Acts to restore investor confidence and alleviate the mistrust created by the American stock market crash of 1929.[18] The 1933 Act is designed to "provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing."[19] The 1933 Act's principal objective is to promote full disclosure in securities offerings.

The 1934 Act is "intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges."[20] Section 10(b) of the 1934 Act makes it illegal for any person to employ deceptive or manipulative devices in the purchase or sale of marketable securities.[21] Both Acts recognize the need for public investment in the securities markets in order to increase employment and encourage economic growth and capital formation.[22] The 1934 Act granted the Securities and Exchange Commission (SEC) regulatory and enforcement authority.[23] With this authority, the SEC promulgated Rule 10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

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[18] *See* Eugene P. Caiola, *Retroactive Legislative History: Scienter Under the Uniform Security Litigations Standards Act of 1998*, 64 ALB. L. REV. 309, 311 (2000) ("The Securities Exchange Acts of 1933 and 1934 were written in response to the mistrust of the securities markets occasioned by the collapse of the stock market in 1929."); Michael P. Catina & Cindy M. Schmitt, *Private Securities Litigation: The Need for Reform*, 13 ST. JOHN'S J. LEGAL COMMENT. 295, 299 (1998) (discussing how Congress enacted the 1933 and 1934 Acts "to promote investor confidence and regulate the American stock market after the crash of 1929").

[19] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

[20] *Id.*

[21] Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(j) (2000); *see also* William S. Feinstein, *Securities Fraud: Pleading Securities Fraud with Particularity—Federal Rule of Civil Procedure 9(b) in the Rule 10b-5 Context:* Kowal v. MCI Communications Corporation, 63 GEO. WASH. L. REV. 851, 853 (1996) (stating that it is "unlawful to use deceptive or manipulative practices in the purchase or sale of marketable securities").

[22] Catina & Schmitt, *supra* note 18, at 299.

[23] *Id.* at 300.

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[24]

The Supreme Court repeatedly "describe[s] the 'fundamental purpose' of the [1934] Act as implementing a 'philosophy of full disclosure.'"[25] Section 10(b) and Rule 10b-5 reach a plethora of schemes aimed at defrauding investors.[26] This may have a "chilling effect" on companies, because they fear penalization in connection with stock purchase acquisitions.[27] To soften this effect, "both the judiciary and the legislature have begun to narrow the scope of section 10(b) and Rule 10b-5" in hopes of preventing "frivolous litigation or unfair results."[28] In *Blue Chip Stamps v. Manor Drug Stores*,[29] for example, the Supreme Court observed that, "[w]hen we deal with private actions under Rule 10b-5, we deal with a *judicial oak which has grown from little more than a legislative acorn*,"[30] and is "badly in need of pruning because of the potential overbreadth of its language."[31] The Supreme Court has subsequently "construed these provisions with more skepticism and has limited much of Rule 10b-5's potency."[32]

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24 17 C.F.R. § 240.10b-5 (2005).

25 Santa Fe Indus. v. Green, 430 U.S. 462, 477-78 (1977); *see also* Brendan J. McCarthy, Note, *"In Connection with": The Need for Limitation to SEC Rule 10b-5 in Dissemination of Misleading Information Cases*, 54 CASE W. RES. L. REV. 1347, 1350 (2004) ("Although protection of investors is of the utmost concern under the securities laws, [Rule] 10b-5 need not be so far reaching as to capture conduct that has a tangential connection to a securities transaction."); Bhavik R. Patel, Note, *Securities Regulation—Fraud—Rule 10b-5 No Longer Scares the Judiciary, but May Scare Corporate Defendants: The United States Supreme Court Switches Directions.* Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc., 532 U.S. 588 (2001), 25 U. ARK. LITTLE ROCK L. REV. 191, 197 (2002).

26 Patel, *supra* note 25, at 200.

27 Stock purchase acquisitions include both issuer repurchases and tender offer mergers.

28 Patel, *supra* note 25, at 200.

29 421 U.S. 723 (1975).

30 *Id.* at 737 (emphasis added).

31 Patel, *supra* note 25, at 200; *see also Blue Chip Stamps*, 421 U.S. at 737 (stating that Congress did not intend the "present state of the law").

32 Patel, *supra* note 25, at 201.

In a Rule 10b-5 claim, a plaintiff must show the defendant knowingly or recklessly[33] misrepresented or omitted a material fact[34] "in connection with the purchase or sale of any security"[35] and the omitted fact, or reasonable reliance[36] on defendant's misrepresentation, caused the plaintiff's injury.[37]

But, "[n]ot all misrepresentations . . . are actionable."[38] Courts distinguish "generally optimistic statements," considered "puffery" and immaterial as a matter of law, from specific statements, which can be actionable.[39] To plead an actionable misrepresentation a plaintiff must show that the misrepresented information is material.[40]

An NRC is irrelevant to omissions. In corporate transactions, the seller will always have unique or superior knowledge about its business.[41] This information will not be readily available to the purchaser if the seller does not disclose it.[42] Specific reliance is impossible under these circumstances. In *Affiliated Ute Citizens v. United States*,[43]

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[33] The United States Supreme Court held, in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), that scienter is required, but there are subsequent federal circuit court cases supporting the notion that a finding of recklessness will suffice to prove a violation of Rule 10b-5. *See* discussion *infra* Part I.B.2.

[34] *See* 17 C.F.R. § 240.10b-5(b) (2005); Joseph Conahan et al., *Securities Fraud*, 40 AM. CRIM. L. REV. 1041, 1044 (2003); *see also* TSC Indus. v. Northway, Inc., 426 U.S. 438, 450 (1976) (stating that materiality "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him"); Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988) (adopting the *TSC Industries* standard for materiality in cases brought under Rule 10b-5); Graham v. SEC, 222 F.3d 994, 1000 (D.C. Cir. 2000) (holding that substantive fraud is an essential element of a Rule 10b-5 proceeding).

[35] 17 C.F.R. § 240.10b-5(c); *see also* United States v. O'Hagan, 521 U.S. 642, 658 (1997) (requiring fraud "in connection with the purchase or sale of any security" as an element of a Rule 10b-5 action); McCarthy, *supra* note 25, at 1348 (noting that because fraud is a necessary element of a 10b-5 claim the plaintiff must prove the common law elements of fraud, "scienter, materiality, reliance, causation, and damages").

[36] *See* 17 C.F.R. § 240.10b-5; *see also* AES Corp. v. Dow Chem. Co., 325 F.3d 174, 179 (3d Cir. 2003) (stating that "[f]ederal law calls for the determination of reasonableness to be made on a case-by-case basis based on all of the surrounding circumstances"); Harsco Corp. v. Segui, 91 F.3d 337, 342 (2d Cir. 1996) (requiring reliance as a necessary element of a Rule 10b-5 action).

[37] *AES Corp.*, 325 F.3d at 178 (*quoting* Semerenko v. Cendant Corp., 223 F.3d 165, 174 (3d Cir. 2000)); Conahan et al., *supra* note 34, at 1044.

[38] Feinstein, *supra* note 21, at 855; *see also TSC Indus.*, 426 U.S. at 448 (discussing omissions based upon the "materiality" of the fact).

[39] Conahan et al., *supra* note 34, at 1048. *See generally* Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1707-15 (1998) (describing various situations in which courts have recognized the puffery defense).

[40] A fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important." Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988) (quoting *TSC Indus.*, 426 U.S. at 449).

[41] Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 SETON HALL L. REV. 70, 195 (1993).

[42] *Id.*

[43] 406 U.S. 128 (1972).

the Supreme Court articulated a presumption of reliance in nondisclosure Rule 10b-5 cases, stating that "positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision."[44] A plaintiff must show the information is material and the defendant had a duty to disclose the information—a "duty to speak."[45] However, *Affiliated Ute's* presumption of reliance is rebuttable,[46] and "must be confined to making proof of *specific* reliance on particular omissions unnecessary when the circumstances indicate that the plaintiff placed some *general* reliance upon the defendant's disclosing material information."[47] The presumption is "essentially a rule of judicial economy and convenience designed to avoid the impracticality of requiring that each plaintiff shareholder testify concerning the reliance element."[48]

A plaintiff can falsely allege an oral misrepresentation by the defendant, but it is much harder to falsely allege nondisclosure. Although, "positive proof of reliance is not required for recovery in a nondisclosure case, if the defendant is able to prove that there clearly was no reliance, nondisclosure cannot be said to be the cause of subsequent loss."[49] As long as the seller provides all disclosures in writing, it can produce these writings to rebut false omissions claims. But, what if the defendant hides materials during the plaintiff's due diligence[50] investigation and then produces these documents to refute the omissions claim? Should the allegation that the defendant hid materials be barred by an NRC? No. If the plaintiff proves the allegation, the court should resolve the claim as an omission and the plaintiff will have the presumption of reliance. If the defendant refutes the claim by proving disclosure, the NRC becomes relevant to determine the reasonableness of the plaintiff's reliance on the alleged misrepresentations. Since specific reliance is not required in claims predicated on omissions, an NRC does not bar such claims.

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44 *Id.* at 153-54, *cited with approval in* Biechele v. Cedar Point, Inc., 747 F.2d 209, 213 (6th Cir. 1984).

45 For a misrepresentation, the plaintiff must only prove the information is material. Feinstein, *supra* note 21, at 855-56 ("A duty to speak may arise from other federal securities laws, such as . . . registration of publicly offered securities . . . [or] inclusion of certain information in prospectuses. A duty to speak may also arise where the failure to update previously released information would cause the public to be misled by such inaccurate disclosures.").

46 *Biechele*, 747 F.2d at 214.

47 Vohs v. Dickson, 495 F.2d 607, 622 (5th Cir. 1974).

48 *Biechele*, 747 F.2d at 214 (quoting Panter v. Marshall Field & Co., 646 F.2d 271, 284 (7th Cir. 1981)).

49 *Id.* at 214-15.

50 Due diligence is an investigation or audit of the target corporation. During due diligence, purchasers attempt to confirm all material facts relating to the transaction.

B. Required State of Mind: Scienter: Ernst & Ernst v. Hochfelder[51] *and* Sundstrand Corp. v. Sun Chemical Corp.[52]

A plaintiff must "prove requisite intent in order to establish a violation of section 10(b) and Rule 10b-5."[53] A plaintiff must show the defendant acted with scienter.[54] Scienter[55] is the "central question in many garden variety fraud cases."[56] To resolve this issue, courts must inquire into the defendant's state of mind, which is often a complicated task.[57] Courts must infer the defendant's state of mind from its conduct.[58] The basis "of such inferences has proven to be, at best, an inexact science."[59]

Rule 8(a) of the Federal Rules of Civil Procedure (FRCP) requires plaintiffs to provide "a short and plain statement of the claim."[60] FRCP Rule 9(b) departs from Rule 8(a), requiring that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."[61] In 1995, however, Congress adopted the Private Securities Litigation Reform Act of 1995 (PSLRA)[62] to discourage frivolous claims.[63] The PLSRA adopted a heightened pleading standard requiring that:

> In any private action arising under this title in which the plaintiff may recover money damages only on proof that the

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51 425 U.S. 185 (1976).

52 553 F.2d 1033 (7th Cir. 1977).

53 Conahan et al., *supra* note 34, at 1049.

54 *E.g.*, *Hochfelder*, 425 U.S. at 193.

55 Scienter, Latin for "knowingly," is defined as:

> **1.** A degree of knowledge that makes a person legally responsible for the consequences of his or her act or omission; the fact of an act's having been done knowingly, esp. as a ground for civil damages or criminal punishment . . . . **2.** A mental state consisting in an intent to deceive, manipulate, or defraud. In this sense, the term is used most often in the context of securities fraud. The Supreme Court has held that to establish a claim for damages under Rule 10b-5, a plaintiff must prove that the defendant acted with scienter. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 S.Ct. 1375 (1976).

BLACK'S LAW DICTIONARY 1373 (8th ed. 2004).

56 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, 668 (1991).

57 *Id.*

58 *Id.*

59 *Id.*

60 FED. R. CIV. P. 8(a).

61 FED. R. CIV. P. 9(b).

62 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C. (1995)).

63 A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions To Dismiss Under the Private Securities Litigation Reform Act*, 2 J. EMPIRICAL LEGAL STUD. 125, 127 (2005).

> defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.[64]

The PSLRA requires plaintiffs to plead scienter with particularity, but "it remains unclear how much detail is required to meet that particularity standard."[65] NRCs serve the purpose of avoiding litigation, which is always expensive and unpredictable, especially when the central issue is the defendant's state of mind.

1. Scienter Defined: Ernst & Ernst v. Hochfelder

In *Ernst & Ernst v. Hochfelder*, defendant Ernst & Ernst was a Big Eight accounting firm retained by First Securities Company of Chicago, a small brokerage firm, to perform audits.[66] Plaintiffs, customers of First Securities, invested in a fraudulent scheme perpetrated by Leston B. Nay, president of First Securities with 92% ownership.[67] Nay carried on massive fraud for years by inducing the plaintiffs to invest their funds in "escrow" accounts. Nay converted these funds to his own use.[68] The plaintiffs sued First Securities and also Ernst & Ernst for "aid[ing] and abett[ing]" Nay's Rule 10b-5 violations.[69] The plaintiffs premised their suit against Ernst & Ernst on the accounting firm's "'failure' to conduct proper audits of First Securities."[70] The essence of their claim was that Ernst & Ernst failed to uncover the fraud even though there were a number of clues to the fraud, such as Nay's insisting on being the only one to open certain kinds of mail.[71] The plaintiffs, however, failed to suggest that Ernst & Ernst intended to defraud or mislead anyone relying on the audit.[72]

The Supreme Court "decisively resolved two issues for a Rule 10b-5 violation: negligence is not sufficient, and scienter is re-

[64] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 21D(b)(2), 109 Stat. 737, 747 (1995) (codified at 15 U.S.C. § 78u-4(b)(2) (1995)).

[65] Pritchard & Sale, *supra* note 63, at 131.

[66] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 188 (1976).

[67] *Id.* at 189.

[68] *Id.*

[69] *Id.* at 190.

[70] *Id.*

[71] *Id.*

[72] *Id.* ("[Plaintiffs] specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst."). In their response to interrogatories plaintiffs "conceded that they did 'not accuse Ernst & Ernst of deliberate, intentional fraud,' but merely with 'inexcusable negligence.'" *Id.* at 190 n.5.

quired."[73] The Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud."[74] The *Hochfelder* definition, sometimes considered narrow and stringent,[75] effectively deals with at least three different situations. First, it covers situations where a defendant misstates a material fact while knowing the statement is false. Second, if a defendant represents a material fact without any belief as to whether it is true, the defendant acted with scienter. Third, any false statement of knowledge by the speaker—i.e., the speaker states he knows a fact is true when the fact is uncertain—defrauds listeners to the extent of his knowledge thereby constituting scienter. What the *Hochfelder* definition does not resolve is whether a showing of recklessness satisfies scienter for the purposes of Rule 10b-5.[76]

2. *Recklessness:* Sundstrand Corp. v. Sun Chemical Corp.[77]

The *Hochfelder* Court stated that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act."[78] Many federal courts of appeals hold that recklessness satisfies scienter in Rule 10b-5 violations,[79] and adopt either the Seventh Circuit's definition of recklessness from *Sundstrand Corp. v. Sun Chemical Corp.*,[80] or a slight variation thereof.[81]

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[73] William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121, 145 (1997); *see also Hochfelder*, 425 U.S. at 201 ("[Section] 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.").

[74] *Hochfelder*, 425 U.S. at 193 n.12.

[75] *See* Johnson, *supra* note 56, at 673 ("The narrow definition of scienter, combined with the suggestion that reckless behavior might only be sufficient to establish liability under certain circumstances, suggests that *Hochfelder's* scienter requirement is stringent.").

[76] *See Hochfelder*, 425 U.S. at 193 n.12 (refusing to address whether reckless behavior is sufficient for civil liability under §10(b)).

[77] 553 F.2d 1033 (7th Cir. 1977).

[78] *Hochfelder*, 425 U.S. at 193 n.12.

[79] *See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-69 (9th Cir. 1990); Van Dyke v. Coburn Enter., 873 F.2d 1094, 1100 (8th Cir. 1989); Woods v. Barnett Bank, 765 F.2d 1004, 1010 (11th Cir. 1985); Hackbart v. Holmes, 675 F.2d 1114, 1117 (10th Cir. 1982); Sharp v. Coopers & Lybrand, 649 F.2d 175, 193 (3d Cir. 1981); Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961 (5th Cir. 1981); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979); Nelson v. Serwold, 576 F.2d 1332, 1337 (9th Cir. 1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir. 1978); *Sundstrand Corp.*, 553 F.2d at 1044.

[80] *See* Janas v. McCracken, 183 F.3d 970, 976 (9th Cir. 1999) (adopting the *Sundstrand Corp.* standard for recklessness); *Hackbart*, 675 F.2d at 1118 (same).

[81] *See* Broad v. Rockwell Int'l Corp., 642 F.2d at 961-62 (using the *Sundstrand Corp.* definition of recklessness to define "severe recklessness").

In *Sundstrand*, plaintiff, Sundstrand Corporation sued defendant, Standard Kollsman Industries (SKI).[82] Henry W. Meers, a director of SKI, allegedly misrepresented the financial status of SKI. Sundstrand claimed it relied on Meers' misrepresentations to purchase the shares of SKI. Later, the SKI shares became worthless.[83]

The Seventh Circuit defined recklessness for the purposes of federal securities fraud violations as:

> [C]onduct [that] may be defined as a highly unreasonable omission, 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.[84]

Under the *Sundstrand* definition, "the risk of misleading buyers 'must be actually known' or sufficiently obvious that the reasonable man would know of it, and 'the omission must derive from something more egregious than even 'white heart/empty head' good faith.'"[85]

This is consistent with congressional goals. In Rule 10b-5 claims, courts must focus on the challenged conduct's danger to innocent investors, rather than other tangential concerns, such as the fairness of the bargain. Allowing recklessness to satisfy scienter permits plaintiffs to bring federal securities fraud actions against all parties guilty of "an extreme departure from the standards of ordinary care."[86] This is within the original intent of Congress.[87]

C. Reasonable Reliance

Courts have not established a bright line rule for determining reasonable reliance as a matter of law. Instead, courts look to a number of factors: plaintiff's expertise and sophistication in financial and security matters; the existence of a long-standing business or personal relationship; plaintiff's access to relevant information; the existence of a fiduciary relationship; defendant's concealment of the fraud;

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[82] SKI merged with and into Sun Chemical Corporation at the close of 1972 so the amended complaint named Sun Chemical rather than SKI as defendant. *Sundstrand Corp.*, 553 F.2d at 1036 n.1.

[83] Johnson, *supra* note 56, at 689 (noting that Meers was also managing partner of an underwriter trying to promote the merger and that the merger fell apart when Meers's misrepresentations came to light).

[84] *Sundstrand Corp.*, 553 F.2d at 1045 (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976)).

[85] Caiola, *supra* note 18, at 314.

[86] *Sundstrand Corp.*, 553 F.2d at 1045 (quoting *Franke*, 428 F. Supp. 2d at 725).

[87] *See* discussion *supra* Part I.A.

plaintiff's opportunity to detect fraud; whether the plaintiff initiated or sought to expedite the stock transaction; and the specificity or generality of the misrepresentations.[88]

This balancing test creates tremendous "uncertainty in contractual dealings and forces the parties to encounter litigation on the other end of the deal . . . by requiring an *ex ante* balancing and individual determination of the factors listed above."[89] This significantly increases transaction costs and inefficient outcomes.[90] Parties often try to contract out of this uncertainty by private agreement. NRCs obviate balancing and lower transaction costs by "determin[ing], by agreement, the rule governing the judicial interpretation of the contract."[91]

Reckless conduct cannot satisfy reasonable reliance;[92] rather, a plaintiff must exercise the "appropriate diligence or due care"[93] that a "reasonable person would have exercised to protect his own interests."[94] This protects potential defendants by requiring plaintiffs to conduct a reasonable investigation prior to purchasing or selling securities, and furthers both the PSLRA's and FRCP's efforts to limit vexatious litigation by requiring actual substance to plaintiffs' claims.

Courts question reasonable reliance in at least two situations.[95] The first is when the "plaintiff relied on oral or written representations that are contradicted by the offering memorandum or prospectus."[96] The second is when the "plaintiff relied on oral or written misrepresentations . . . that were not included in the final written agreement, and the contract contained an NRC."[97] The second situation exists because the parties want to limit the seller's representations to the "four corners" of the final contract by including an NRC.[98] The goal of the clause is to preclude "an aggrieved party from claiming reliance on any representations that are not included" in the final written agreement.[99]

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88 Kennedy v. Josephthal & Co., 814 F.2d 798, 804 (1st Cir. 1987) (citing Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516-17 (10th Cir. 1983)).

89 Lutz, *supra* note 4, at 810.

90 *Id.*

91 *Id.*

92 *Kennedy*, 814 F.2d at 805.

93 Straub v. Vaisman Co., 540 F.2d 591, 597 (3d Cir. 1976) (describing policy considerations behind requiring a limited duty of diligence from 10b-5 plaintiffs).

94 Lutz, *supra* note 4, at 808.

95 *Id.*

96 *Id.*; *see also Kennedy*, 814 F.2d at 801 (affirming summary judgment against plaintiffs who claimed to have relied on broker's employee's misrepresentations despite contradictory language in offering memorandum); Zobrist v. Coal-X, 708 F.2d 1511, 1514 (10th Cir. 1983) (holding that a purchaser's reliance on oral representations was unjustified when offering memorandum contradicted them).

97 Lutz, *supra* note 4, at 808.

98 *Id.*

99 *Id.*

Courts generally hold that cases in the first situation are not, as a matter of law, sustainable under Rule 10b-5 because reliance cannot be reasonable.[100] The second situation—when a plaintiff relies "on oral or written misrepresentations . . . not included in the final written agreement"[101]—created a circuit split.[102]

II. NON-RELIANCE CLAUSES AND SIMILAR CONTRACTUAL PROVISIONS: THE CASE LAW

An NRC raises two major issues. First, does an NRC prevent a Rule 10b-5 claim, or is it merely a factor in determining whether the plaintiff's reliance was reasonable?[103] Second, does an NRC violate section 29(a) by limiting or weakening the plaintiff's ability to recover?[104] An NRC's effect varies among federal courts of appeals.[105]

A. The Securities Exchange Act of 1934: Section 29(a)

The Supreme Court in *Shearson/American Express Inc. v. McMahon*[106] "opined that section 29(a) only proscribes waiver of the Exchange Act's *substantive* obligations."[107] This includes reasonable reliance. Section 29(a) is primarily concerned with whether a stipulation in an agreement, voluntary or not, "waive[s] compliance with [a] provision" of the 1934 Act.[108] The Court added that, "[s]ection 29(a) is concerned, not with whether brokers 'maneuver[ed customers] into'

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[100] In *Kennedy*, 814 F.2d at 798, defendant told the plaintiffs the investment was safe but the memorandum disclosed the high degree of risk involved with the transaction. The plaintiffs executed documents acknowledging the risks and were barred from a Rule 10b-5 action because there was no reasonable reliance. In *Zobrist*, 708 F.2d at 1511, defendant told plaintiffs the investment was a "sure thing," but the memorandum disclosed the high degree of risk involved with the transaction. Plaintiffs were barred from a Rule 10b-5 action because reasonable reliance could not be established. *See* Lutz, *supra* note 4, at 808-09 (providing a brief discussion of both *Kennedy* and *Zobrist*).

[101] Lutz, *supra* note 4, at 808.

[102] *Compare* AES Corp. v. Dow Chem. Co., 325 F.3d 174 (3d Cir. 2003) (holding an NRC invalid and a violation of Section 29(A)), *with* Harsco Corp. v. Segui, 91 F.3d 337 (2d Cir. 1996) (holding an NRC valid and therefore barring suit under section 10(b) and Rule 10b-5).

[103] Lutz, *supra* note 4, at 810.

[104] *Id.*

[105] *See* Mark Betzen & Richard Meamber, *Rule 10b-5 and Related Considerations in Acquisition Agreements*, METROPOLITAN CORP. COUNS., Aug. 2004, at 10, *available at* http://metrocorpcounsel.com/pdf/2004/August/10.pdf (describing the circuit split discussed *infra* Part II.B).

[106] 482 U.S. 220 (1987).

[107] Marc I. Steinberg, *Securities Arbitration: A Decade After* McMahon*: Better for Investors than the Courts?*, 62 BROOK. L. REV. 1503, 1508 (1996); *see also McMahon*, 482 U.S. at 228 ("By its terms, § 29(a) only prohibits waiver of the substantive obligations imposed by the Exchange Act.").

[108] *McMahon*, 482 U.S. at 230 (quoting Securities Exchange Act of 1934 § 29(a), 15 U.S.C. § 78cc (2000)).

an agreement, but . . . whether the agreement 'weaken[s] their ability to recover under the [Exchange] Act.'"[109]

An NRC does not "weaken" a plaintiff's ability to recover under the Act; it simply limits a defendant's liability to a negotiated level. Parties make numerous representations during negotiations of acquisitions. A purchaser may not always express the importance of a representation. After the parties execute the agreement containing an NRC, if the purchaser realizes the seller has omitted a material fact relied upon, the purchaser may not have a Rule 10b-5 claim. The seller could argue that the NRC waives possible Rule 10b-5 claims, but the purchaser can easily avoid this fate by reading the final agreement and either refusing to sign the NRC or by not relying on the excluded documents. If a statement is material, the purchaser can insist that the statement be included in the agreement. Moreover, in corporate transactions, the parties are sophisticated, represented by counsel, and have the opportunity to negotiate representations and warranties.[110] The purchaser can still challenge the validity of the NRC under traditional contract theory, specifically unconscionability.[111]

B. Section 29(a): Circuit Split

In 1966, the First Circuit, in *Rogen v. Ilikon Corp.*,[112] reversed the trial court's summary judgment in favor of the defendants and held that a contractual provision similar to an NRC did not waive compli-

[109] *Id.* (first alteration added) (quoting Wilko v. Swan, 346 U.S. 427, 432 (1953), *overruled by* Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989)).

[110] Amanda K. Esquibel, *The Finality of Buyout Agreements in the Close Corporation Context: What Recourse Remains for Aggrieved Sellers?*, 53 RUTGERS L. REV. 865, 899 (2001).

[111] An aggrieved purchaser may be able to prevail under contract and the doctrine of unconscionability by providing specific evidence to a court for its determination. Unconscionability is defined as:

> **1.** Extreme unfairness. . . . **2.** The principle that a court may refuse to enforce a contract that is unfair or oppressive because of procedural abuses during contract formation or because of overreaching contractual terms, esp. terms that are unreasonably favorable to one party while precluding meaningful choice for the other party.
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> . . . .
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> ***procedural unconscionability.*** Unconscionability resulting from improprieties in contract formation (such as oral misrepresentations or disparities in bargaining position) rather than from the terms of the contract itself.
>
> . . . .
>
> ***substantive unconscionability.*** Unconscionability resulting from actual contract terms that are unduly harsh, commercially unreasonable, and grossly unfair given the existing circumstances.

BLACK'S LAW DICTIONARY, *supra* note 55, at 1560-61 (citations omitted).

[112] 361 F.2d 260 (1st Cir. 1966).

ance with section 29(a).[113] Upon further analysis, however, the court concluded that the fundamental effect was the same and if the court were to "hold that the existence of th[e] provision constituted the basis (or a substantial part of the basis) for finding non-reliance as a matter of law, [the court] would have gone far toward eviscerating Section 29(a)."[114] The court saw "no fundamental difference between saying . . . '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.'"[115]

Then in 1996, the Second Circuit held in *Harsco Corp. v. Segui* that an NRC is not a forbidden waiver of compliance.[116] The agreement was valid and enforceable to insulate the seller from liability. Following *Harsco Corp.*, federal circuits agreed with its reasoning until the Third Circuit, in *AES Corp. v. Dow Chemical Co.*, ruled such a clause invalid under section 29(a).[117] To date, the Supreme Court has denied certiorari to resolve the issue.[118]

1. NRC Valid: Second Circuit: Harsco Corp. v. Segui

Thirty years after the *Rogen* court held that an NRC provision is void because otherwise it would eviscerate section 29(a),[119] the *Harsco Corp.* court distinguished its facts to reach a different conclusion. In *Harsco Corp.*, plaintiff Harsco Corporation purchased MultiServ. In the purchase agreement (Agreement), MultiServ made express representations, and Harsco expressly waived reliance on any outside representations. Harsco later sued various former officers and shareholders of MultiServ for alleged violations of Rule 10b-5. Harsco claimed Multiserv made several misstatements during due diligence regarding projected developments and business activities.

The Agreement between Harsco and MultiServ was sixty-plus, single-spaced pages.[120] Section 2.04 of the Agreement contained MultiServ's "Representations and Warranties."[121] Section 2.05

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[113] *Id.* at 268-69. *But see* Jackvony v. RIHT Fin. Corp., 873 F.2d 411, 417 (1st Cir. 1989) (diverging from the *Rogen* court's reasoning and holding that the plaintiff could not establish reasonable reliance when the alleged misrepresentations were not in the final written agreement).

[114] *Jackvony*, 873 F.2d at 417.

[115] *Id.* (footnote omitted).

[116] 91 F.3d 337, 343 (2d Cir. 1996).

[117] AES Corp. v. Dow Chem. Co., 325 F.3d 174 (3d Cir. 2003).

[118] *See id.*, *cert. denied*, 540 U.S. 1068 (2003).

[119] Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966).

[120] *Harsco Corp.*, 91 F.3d at 340.

[121] Harsco's complaint only cited section 2.04 of the Agreement but nowhere in the complaint did Harsco draw the court's or MultiServ's attention to any specific portion or passage of section 2.04. Section 2.04 was fourteen single-spaced pages, consisting of seventeen subsections

specifically disclaimed any representations not in the Agreement. It provided that MultiServ:

> [S]hall not be deemed to have made to [Harsco] any representation or warranty other than as expressly made by [MultiServ] in Sections 2.01 through 2.04 hereof . . . . Without limiting the generality of the foregoing, and notwithstanding any otherwise express representations and warranties made by [MultiServ] in Sections 2.01 through 2.04 hereof . . . , [MultiServ] make[s] no representation or warranty to Purchaser with respect to:
>
> > (a) any projections, estimates or budgets heretofore delivered to or made available to [Harsco] of future revenues, expenses or expenditures, future results of operations, [etc.]; or
> >
> > (b) any other information or documents made available to [Harsco] or its counsel, accountants, or advisors with respect to [MultiServ], except as expressly covered by a representations and warranty contained in Sections 2.01 through 2.04 hereof.[122]

Along with the NRC, the Agreement contained a standard merger clause, providing that the Agreement, "contain[ed] the entire agreement between the parties hereto with respect to the transactions contemplated by this Agreement and supersedes all prior arrangements or understandings with respect thereto."[123] The Agreement granted Harsco fourteen days to conduct "confirmatory due diligence."[124] If during this period Harsco learned that any of MultiServ's representations

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and numerous sub-paragraphs, containing numerous topics relating to MultiServ's representations. MultiServ's representations included the capitalization of MultiServ, MultiServ's financial statements, MultiServ's liabilities, the ownership and condition of MultiServ's assets, MultiServ's litigation exposure, taxes, contracts, and environmental matters. *Id.*

[122] *Id.* at 342-43 (last alteration in original).

[123] *Id.* at 343 (referring to section 7.02 of the Agreement).

[124] Section 1.04 of the Agreement explained the "confirmatory due diligence":

> [P]urchaser and its accountants, consultants and advisers shall be permitted . . . to review the premises, facilities, books and records and Contracts of [MultiServ], and to conduct interviews with Senior MultiServ Officers . . . regarding the business, operations, financial condition and results of operations of [MultiServ], for the purpose of confirming the accuracy of the representations and warranties of the [sellers] contained in Article II hereof.

Id. at 340-41 (alteration in original).

were false, Harsco could terminate the deal without penalty.[125] After finishing due diligence, Harsco completed its purchase of MultiServ, paying cash totaling $216 million and assuming approximately $164 million in MultiServ debt.[126]

The court rejected Harsco's arguments that sections 2.05 and 7.02 contravened section 29(a) of the 1934 Act.[127] The court focused on whether Harsco's Rule 10b-5 claim was so weakened by the NRC and merger clause that section 29(a) prohibited it.[128] The court acknowledged that "[t]here can be no question that the Agreement 'weakens' Harsco's ability to recover under the Act," since the Agreement "outlines, with great specificity, the representations and warranties that Harsco agreed to rely upon—and not rely upon—in purchasing all of MultiServ's outstanding stock."[129] However, "in the circumstances of this case such a 'weakening' does not constitute a forbidden waiver of compliance."[130] The Second Circuit stressed that "there [was] a detailed writing developed via negotiations among sophisticated business entities and their advisors. That writing . . . defines the boundaries of the transaction. Harsco brings this suit principally alleging conduct that falls outside those boundaries."[131] The court essentially held that, with no lack of bargaining power, Harsco purchased fourteen pages of MultiServ's representations and did not waive Rule 10b-5 claims but simply limited its claims to the representations in the Agreement.[132]

The Second Circuit limited its holding by stating that the "analysis becomes a question of degree and context. . . . In different circumstances (e.g., if there were but one vague seller's representation) a 'no other representations' clause might be toothless and run afoul of § 29(a). But not here."[133]

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[125] *Id.* at 341.

[126] *Id.*

[127] *Id.* at 343.

[128] Memorandum from Tashlik, Kreutzer, Goldwyn & Crandell P.C., *Securities Fraud Claims in Stock Purchase Transactions* (Aug. 19, 2003), http://www.tkgclaw.com/maug19.html.

[129] *Harsco Corp.*, 91 F.3d at 343.

[130] *Id.*; *see also* Lutz, *supra* note 4, at 812 ("The clause at issue in *Harsco* is a more typical use of an NRC than the contract addressed in *Rogen*, because the *Harsco* contract contained specific representations on which the buyer was entitled to rely while not disclaiming disclosure obligations, while the *Rogen* contract disclaimed any obligation to disclose and contained no representations on which the purchaser was entitled to rely.") (citations omitted).

[131] *Harsco Corp.*, 91 F.3d at 343; *see also* Lutz, *supra* note 4, at 812 (noting that "the court distinguished the contract at issue in *Rogen* by observing that there, the contract did not contain a provision similar to an NRC, and was formed amid a disparity of bargaining power that allowed the purchaser to be 'duped' into forfeiting his rights") (citing *Harsco Corp.*, 91 F.3d at 344).

[132] *See* Memorandum from Tashlik Kreutzer, Goldwyn & Crandell P.C., *supra* note 128; Betzen & Meamber, *supra* note 105, at 10.

[133] *Harsco Corp.*, 91 F.3d at 344.

2. *Subsequent Litigation: The Aftermath of* Harsco Corp. v. Segui

In *Rissman v. Rissman*,[134] the Seventh Circuit followed *Harsco Corp.*, holding that an NRC in a stock-purchase agreement "precludes any claim of deceit by prior representations."[135] In *Rissman*, the plaintiff sold his interest in a corporation to his brother, the defendant, who already owned two-thirds of the corporation. The purchase agreement contained clauses providing that the parties did not rely on any oral statements. After the defendant later sold the corporation, the plaintiff still sued, claiming he relied on defendant's oral statements that he would never sell the corporation.[136] In holding the NRC valid,[137] the court stated, "[t]he principle is functionally the same as a doctrine long accepted in this circuit: that a person who has received written disclosure of the truth may not claim to rely on contrary oral falsehoods."[138]

3. *NRC Invalid: Third Circuit:* AES Corp. v. Dow Chemical Co.

After *Harsco Corp.* and *Rissman*, the question concerning the effect of NRCs in federal securities fraud actions seemed settled.[139] A majority of federal circuit courts weighing in on the issue had held that NRCs should bar Rule 10b-5 claims based on alleged extra-contractual representations.[140] The Third Circuit, however, in *AES Corp. v. Dow Chemical Co.*, later ruled that an NRC in a stock purchase agreement cannot bar a purchaser's Rule 10b-5 claim.[141]

Defendant Dow Chemical Company (Dow) solicited buyers for its subsidiary Destec Energy, Inc (Destec).[142] Prior to solicitation, Dow hired Morgan Stanley to perform a valuation of Destec. AES Corpo-

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134 213 F.3d 381 (7th Cir. 2000).

135 *Id.* at 384.

136 *Id.* at 382.

137 The court, however, failed to mention section 29(a), which is crucial to the proper determination of NRCs.

138 *Rissman*, 213 F.3d at 384 (citing Carr v. CIGNA Sec., Inc., 95 F.3d 544 (7th Cir. 1996); Assocs. in Adolescent Psychiatry, S.C. v. Home Life Ins. Co., 941 F.2d 561, 571 (7th Cir. 1991)).

139 Lutz, *supra* note 4, at 814.

140 *See Rissman*, 213 F.3d at 383 (holding an NRC valid but failing to mention or interpret section 29(a)); Harsco Corp. v. Segui, 91 F.3d 337 (2d Cir. 1996) (holding an NRC valid upon analysis of section 29(a)); Jackvony v. RIHT Financial Corp., 873 F.2d 411 (1st Cir. 1989) (diverging from the reasoning of *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966), but not overruling *Rogen*); One-O-One Enterprises, Inc. v. Caruso, 848 F.2d 1283, 1287 (D.C. Cir. 1988) (holding "silence in a final agreement containing an integration clause—in the face of prior explicit representations—must be deemed an abandonment or excision of those earlier representations"; however, the court failed to mention or interpret section 29(a)).

141 AES Corp. v. Dow Chem. Co., 325 F.3d 174 (3d Cir. 2003); *see also* Memorandum from Tashlik, Kreutzer, Goldwyn & Crandell P.C., *supra* note 128.

142 Destec Energy, Inc. has since changed its name to Dynegy Power Corporation.

ration sought to acquire Destec's international operations, which it operated through a subsidiary named Destec Engineering, Inc. (DEI).[143] DEI possessed one asset: a "contract to design and construct a power plant in the Netherlands."[144]

AES purchased certain assets of Destec, including all of DEI's capital stock. Following the acquisition, AES brought a Rule 10b-5 suit against Dow and Destec for securities fraud in connection with the sale of DEI to AES. AES claimed that Dow misrepresented the predicted completion date of the Dutch power plant and its potential profit. AES claimed that because of these material misrepresentations, DEI incurred a $70 million loss instead of $31 million profit.[145]

In order to receive a confidential offering memorandum on behalf of Destec, AES signed a confidentiality agreement with Destec's financial advisor. In this agreement AES acknowledged that "neither [Destec], nor Morgan Stanley [Destec's Investment Banker] or its affiliates, nor [Destec's] other Representatives, nor any of [Destec's] or [Morgan Stanley's] respective officers, directors, employees, agents or controlling persons . . . make any express or implied representation or warranty as to the accuracy or completeness of the Information."[146] AES agreed that "no such person will have any liability relating to the Information or for any errors therein or omissions therefrom," and that it is "not entitled to rely on the accuracy or completeness of the Information and that [AES] will be entitled to rely solely on any representations and warranties as may be made to [it] in any definitive agreement with respect to the Transaction."[147]

The offering memorandum contained the alleged misrepresentations. Like the confidentiality agreement, the offering memorandum stated "[o]nly those particular representations and warranties which may be made to a purchaser in a definitive agreement, when, as, and if executed, and subject to such limitations and restrictions as may be specified in such definitive agreement, shall have any legal effect."[148] Dow and Destec, however, gave information to AES and other potential bidders in several other ways, such as presentations; mailing documents directly to potential bidders and making other documents

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[143] *See* Michael Coddington, *Non-Reliance Clauses—They Are Not Get-Out-of-Jail-Free Cards*, FAEGRE & BENSON LLP, http://www.faegre.com/articles/article_print.aspx?id=1120 (last visited Apr. 4, 2006) (summarizing *AES Corp.*).

[144] *AES Corp.*, 325 F.3d at 175.

[145] *Id.* at 177.

[146] *Id.* at 176 (first two alterations in original).

[147] *Id.*

[148] *Id.*

available at Destec's facilities in Houston, Texas; and distributing a computer model to value Destec's assets.[149]

AES was only interested in the international assets of Destec, but Dow sought to sell all of Destec. As a result, AES and NGC Corporation submitted a joint bid for all of Destec. Dow accepted their offer that broke the transaction into two steps. First, NGC purchased all of the stock of Destec from Dow pursuant to a Merger Agreement by and among Dow, Destec, and NGC. Second, AES purchased all of the international assets of Destec, including all of DEI's capital stock, from NGC pursuant to an Asset Purchase Agreement between AES and NGC.

Both the Merger Agreement and the Asset Purchase Agreement contained NRCs. Section 4.6 of the Merger Agreement provided, "[e]xcept for the representations and warranties contained in this Article IV, neither Dow nor any other person makes any other express or implied representation or warranty on behalf of Dow."[150] Article IV of the Merger Agreement consisted of two pages of representations and warranties, but contained no representation or warranty about the Dutch plant.[151] Section 3.4 of the Asset Purchase Agreement stated, "except for the representations and warranties contained in this Article III, neither NGC nor any other person (as defined in the Merger Agreement) makes any other express or implied representation or warranty on behalf of NGC."[152] The definitive Asset Purchase Agreement included over twenty single-spaced pages of representations and warranties, but like the Merger Agreement, it contained no representation or warranty with respect to the Dutch plant.[153] However, AES, during its due diligence investigation, received information regarding DEI and the Dutch plant through Destec's presentations, on-site visits, and review of certain documents in a data room.[154]

In addition to the NRC, the Merger Agreement included a standard merger clause similar to the merger clause reviewed by the Second Circuit in *Harsco Corp.* It provided that, "[t]his Agreement and the Confidentiality Agreement, and certain other agreements executed by the parties hereto as of the date of this Agreement, constitute the entire agreement and supersedes [sic] all prior agreements and under-

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149 *Id.* at 176-77.

150 *Id.* at 177.

151 *Id.*

152 *Id.*

153 The Subcommittee on Recent Judicial Developments, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 59 BUS. LAW. 1521, 1522 (2004).

154 *Id.*

standings (written and oral), among the parties with respect to the subject matter hereof."[155]

AES alleged "that Dow knew specific facts about" Destec and DEI "that contradicted the representations [Dow] made prior to and during [AES's] due diligence."[156] Furthermore, AES contended that Dow was involved in a "scheme to defraud" AES by concealing the true state of the Dutch plant and frustrating AES's due diligence efforts by causing false and misleading information to be provided by Destec and Destec employees.[157]

The Third Circuit held that "enforcement of the [NRCs] to bar AES's fraud claims as a matter of law would be inconsistent with Section 29(a)."[158] If a purchaser "commits itself never to claim that it relied on representations of the other party to its contract, it purports anticipatorily to waive any future claim based on the fraudulent misrepresentations of that party."[159] The Third Circuit agreed with the First Circuit's conclusion in *Rogen* that an NRC will not always preclude Rule 10b-5 fraud liability, even for a sophisticated buyer.

Both courts, however, indicated that NRCs might be either evidence that a party did not rely on extra-contractual representations, or evidence of the unreasonableness of the party's reliance.[160] Determining reasonableness involves a case-by-case analysis of all relevant circumstances, including the use of an NRC, and applying the reasonable reliance standard set forth in *Straub*.[161] The court acknowledged that "a buyer in a non-reliance clause case will have to show more to justify its reliance than would a buyer in the absence of such a contractual provision,"[162] especially in cases involving an NRC negotiated between sophisticated parties.[163] The court, however, failed to

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155 *AES Corp.*, 325 F.3d at 177 (alteration in original) (quoting the Merger Agreement).

156 *Id.*

157 *Id.* at 178.

158 *Id.* at 180.

159 *Id.* ("The same is true if the commitment is more limited, e.g., a promise not to claim reliance on any representation not set forth in the agreement. The scope of the anticipatory waiver is more limited, but it is nevertheless an anticipatory waiver of potential future claims under Rule 10b-5.").

160 Betzen & Meamber, *supra* note 105, at 10.

161 *See AES Corp.*, 325 F.3d at 181-82 (remanding to the district court for further discovery regarding the reasonableness of AES's reliance); The Subcommittee on Recent Judicial Developments, *supra* note 153, at 1523 (citing five non-exclusive factors set forth in *Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976), which courts have used to determine the reasonableness of a party's reliance: "(i) whether a fiduciary duty existed between the parties; (ii) whether the plaintiff had an opportunity to detect the fraud; (iii) the sophistication of the plaintiff; (iv) the existence of a long-standing business or personal relationship; and (v) 'the plaintiff's access to the relevant information'").

162 *AES Corp.*, 325 F.3d at 181.

163 *See id.*; The Subcommittee on Recent Judicial Developments, *supra* note 153, at 1523; *see also* Coddington, *supra* note 143 (adding that "cases where sophisticated parties have nego-

explain what would constitute enough evidence to overcome the presumption that any reliance would be unreasonable.

Consequently, even though the First and Third Circuits have taken a more liberal approach, the use of an NRC may materially impair the ability of a plaintiff to claim a Rule 10b-5 violation based upon representations and warranties not contained in the final agreement.[164]

III. DEFINING THE BOUNDARIES OF CORPORATE TRANSACTIONS

Aimed at investor protection, the 1934 Act recognizes the need for public investment in the securities markets in order to increase employment, and encourage economic growth and capital formation.[165] Congress's concern is to protect investors and the integrity of and public confidence in securities markets.[166] Congress seeks "to protect investors from fraudulent practices in securities markets [and] encourage the rapid dissemination of financial information which may have an impact on the value of a security."[167]

The Supreme Court in *Hochfelder* established that scienter is required for a Rule 10b-5 violation;[168] therefore, an NRC serves a purpose only when the defendant makes a false statement with scienter. *Harsco Corp.* and *Rissman*, however, do not permit claims based on fraudulent inducement.[169] An NRC negates a purchaser's reliance, thus destroying a necessary element for a fraud claim.[170] The effect

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tiated a contract with a non-reliance clause . . . will often be appropriate candidates for summary judgment").

[164] Betzen & Meamber, *supra* note 105, at 10.

[165] Catina & Schmitt, *supra* note 18, at 299.

[166] *See* THE COMM. ON BANKING AND CURRENCY, REGULATION OF SECURITIES, S. REP. NO. 73-47, at 1 (1933), *reprinted in* 1 FED. BAR ASS'N SEC. LAW COMM., FEDERAL SECURITIES LAWS, LEGISLATIVE HISTORY 1933–1982, at 89 (1983) ("The purpose of this bill is to protect the investing public."); *see also supra* Part I (discussing the purposes of the 1933 and 1934 Acts).

[167] Carlos J. Cuevas, *The Misappropriation Theory and Rule 10b-5: Deadlock in the Supreme Court*, 13 J. CORP. L. 793, 797 (1988).

[168] *See* Kuehnle, *supra* note 73, at 145 ("The *Hochfelder* opinion decisively resolved two issues for a Rule 10b-5 violation: negligence is not sufficient, and scienter is required."); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976) (providing that "§ 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone").

[169] *Harsco Corp.* and *Rissman* are not the only two cases negating fraudulent inducement claims. All cases allowing NRCs to bar reasonable allowance negate fraudulent inducement. Fraudulent inducement, or "fraud in the inducement" is defined as:

> Fraud occurring when a misrepresentation leads another to enter into a transaction with a false impression of the risks, duties, or obligations involved; an intentional misrepresentation of a material risk or duty reasonably relied on, thereby injuring the other party without vitiating the contract itself, esp. about a fact relating to value.

BLACK'S LAW DICTIONARY, *supra* note 55, at 686.

[170] Palmieri, *supra* note 41, at 148.

"is not to exculpate one of fraud, but rather to negate the reliance element of a fraud claim (and the result is said to be that, obviously, without reliance, there is no fraud)."[171] An NRC would bar a claim under Rule 10b-5 that a defendant induced a plaintiff to agree to the NRC while knowing that there were materially false statements in documents excluded under the NRC.

At first glance, this may seem contrary to congressional goals, specifically investor protection. However, an acquisition of a business is far different from a transaction on the New York Stock Exchange[172] or NASDAQ.[173] In corporate transactions, the purchaser is not an investor in the usual sense, but rather the purchaser of an entire business. Unlike many public investors, the purchaser is typically a large, sophisticated company advised by counsel.

In all acquisitions, purchasers recognize that they should know the following information about the target's business:

> (1) The financial history of the business, including its past stability, growth, and diversity of operations;
>
> (2) The profit and loss statements, balance sheets, and tax returns;
>
> (3) Tax and audit history;
>
> (4) Contracts and other agreements;
>
> (5) Credit history;
>
> (6) Good will, including reputation or prestige of business and ownership of trade or band names.[174]

In stock transactions, the purchaser should also be aware of the corporation's history by thoroughly reviewing its articles of incorporation, certificate of incorporation, by-laws, minute books, and registrations

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[171] *Id.* at 148 n.331.

[172] The New York Stock Exchange is "the world's leading and most technologically advanced equities market . . . . A broad spectrum of market participants, including listed companies, individual investors, institutional investors and member firms, create the NYSE . . . market." New York Stock Exchange, About the NYSE, http://www.nyse.com/Frameset.html?displayPage=/press/1134733534152.html (last visited Apr. 11, 2006).

[173] The NASDAQ is "the largest U.S. electronic stock market. With approximately 3,300 companies, it lists more companies and, on average, trades more shares per day than any other U.S. market." NASDAQ, *FactSheet 2005*, (2004), http://www.nasdaq.com/about/CorporateFact Sheet 2004.pdf.

[174] Palmieri, *supra* note 41, at 193 (citing FRANK L. BRUNETTI & STANLEY J. YELLIN, BUSINESS ACQUISITIONS ¶¶ 201.2(B)-(E), 201.4(A), (E) (1987)).

to transact business.[175] Additionally, the purchaser will be subject to all the target's liabilities, so it should know all the threatened and outstanding litigation, debts, contracts, leases, insurance, licenses, pension plans, and agreements.[176]

Preliminary negotiations begin the courtship between parties in corporate transactions and "[i]f a meeting of the minds occurs, the parties are said to have reached an 'agreement in principle' on the transaction."[177] Once the parties reach an agreement in principle,[178] they begin intense investigations of each other's affairs, hoping to negotiate a definitive merger agreement.[179]

Parties to acquisitions "spend more time negotiating 'Representations and Warranties of the Seller' than any other single article in the typical acquisition agreement."[180] Purchasers view representations as:

> useful as a device to obtain the maximum degree of disclosure about the acquired business prior to the purchaser undertaking a binding commitment to make the acquisition. In other words, representations constitute a systematic smoke-out of the data about the seller which the buyer feels is important. . . . This focusing aspect of representations can often alert the purchaser to questionable areas for more detailed investigation, and may even provide ammunition for use in renegotiating the price or other terms of the deal.[181]

During due diligence, this information is sought out by the purchaser or its attorneys and accountants.[182] This fact significantly lessens the need for statutory protection. Corporate purchasers have the financial ability and sophistication to investigate the target completely; this demands *Harsco Corp.*'s application of section 29(a).

Section 29(a) provides a rule that parties must be able to rely on in drafting acquisition agreements.[183] Section 29(a) is not violated "[a]s long as the party is not seeking to 'opt out' of regulation, or binding

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[175] *Id.* at 193-94 (citing BRUNETTI & YELLIN, *supra* note 174, ¶¶ 201.2-201.2(B)).

[176] *Id.* at 194 (citing BRUNETTI & YELLIN, *supra* note 174, ¶ 203.1).

[177] GILSON & BLACK, *supra* note 1, at 1014-15 (stating that the agreement in principle "reiterates the parties' mutual intent to merge at a stated (or formula) price, which is made expressly subject to the negotiation and execution of a definitive acquisition agreement," along with their respective boards', creditors', and regulatory authorities' approval).

[178] An agreement in principle can be oral or it can be in a writing known as a "letter of intent."

[179] GILSON & BLACK, *supra* note 1, at 1014.

[180] JAMES C. FREUND, ANATOMY OF A MERGER 229 (1975).

[181] *Id.* at 230.

[182] Palmieri, *supra* note 41, at 193.

[183] *See* Lutz, *supra* note 4, at 839 (describing the rule as one upon "which parties should be able to rely").

the other party to waive their rights under the Act."[184] An NRC does not waive compliance with the 1934 Act; it merely affects the question of whether there is a Rule 10b-5 violation in the first place. One cannot waive a right one does not have, and one does not have the right to rely unreasonably and then expect compensation under Rule 10b-5. Given the parties' level of sophistication, section 29(a) demands strict application, forbidding only express waivers of the rights afforded under the 1934 Act. This offers parties certainty in their contractual agreements.

The 1934 Act "is regulation intended to supersede 'the philosophy of *caveat emptor,*' whereas traditional contract law promotes bargaining free of regulation."[185] NRCs barring claims of reasonable reliance offer parties specifically defined boundaries. This bar does not reinstate the philosophy of *caveat emptor*. In these situations, purchasers cannot bring Rule 10b-5 claims if the seller omits the alleged misrepresentation from the final agreement, but purchasers can still sue for misrepresentations in the final agreement. This limitation compels purchasers to make certain all significant representations are included.[186] If not, purchasers can insist that they be included, or the purchaser can refuse to sign the NRC. This result furthers the Supreme Court's desire to limit the potency of Rule 10b-5 and does not revert to *caveat emptor*.

The Third Circuit in *AES Corp.* acknowledged that NRCs "reflect the fact that the seller was unwilling to vouch for the accuracy of the information it was providing and the fact that the buyer was willing to undertake to verify the accuracy of that data for itself."[187] The court added that, "a buyer who relies on seller-provided information without seeking to verify it has not acted reasonably. . . . For this reason, cases involving a non-reliance clause in a negotiated contract between sophisticated parties will often be appropriate candidates for resolution at the summary judgment stage."[188] In other words, a purchaser cannot prove reasonable reliance when a negotiated contract contains an NRC; the purchaser has no viable Rule 10b-5 action.[189] Even after

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[184] *Id.* at 839.

[185] Margaret V. Sachs, *Freedom of Contract: The Trojan Horse of Rule 10b-5*, 51 WASH. & LEE L. REV. 879, 880 (1994) (citation omitted); *see also* Palmieri, *supra* note 41, at 119 ("Although caveat emptor is still followed in execution sales, tax sales, and judicial sales, the doctrine has been rejected in security sales . . . .") (citations omitted).

[186] Purchasers have the duty to make sure all significant representations are included in the agreement before signing. This may create an incentive for sellers to keep certain representations out of the contract in hopes of an oversight by the purchaser, but this is not a realistic concern considering the purchaser's level of sophistication.

[187] AES Corp. v. Dow Chem. Co., 325 F.3d 174, 181 (3d Cir. 2003).

[188] *Id.*

[189] Lutz, *supra* note 4, at 840.

stating the proper effect of an NRC, the court was "unwilling . . . to hold that the extraction of a non-reliance clause, even from a sophisticated buyer, will always provide immunity from Rule 10b-5 fraud liability."[190] Instead, the court held that an NRC violates section 29(a) and is invalid as a *per se* bar to a plaintiff's reasonable reliance claim.[191]

The *AES Corp.* court did not negate all effects of an NRC; rather, it transformed the NRC into another factor in the already complex balancing test.[192] The court concluded that an NRC should count as a factor concerning the reasonableness of reliance, but this, too, weakens a plaintiff's ability to recover under Rule 10b-5.

By failing to give NRCs the proper effect, courts increase parties' transaction costs in acquisitions.[193] Parties can no longer reduce their negotiations to one final definitive agreement defining the boundaries. Instead, every document and oral statement the purchaser receives or reviews or allegedly receives, whether given to it by an authoritative representative of the seller or not, can be a basis for a Rule 10b-5 claim. The Seventh Circuit stated in *Acme Propane, Inc. v. Tenexco, Inc.*[194] that:

> [a] seller who fully discloses all material information in writing should be secure in the knowledge that it has done what the law requires . . . . Otherwise even the most careful seller is at risk, for it is easy to claim: "Despite what the written documents say, one of your agents told me something else." If such a claim or oral inconsistency 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.[195]

This invites fraud and frivolous Rule 10b-5 litigation since a seller cannot possibly know all information disclosed by its employees or prove the non-existence of an alleged oral statement.

Courts must adopt the rule that an NRC establishes conclusive proof of a sophisticated party's non-reliance on any representations or warranties not contained in the final negotiated agreement. An NRC efficiently defines the boundaries of the transaction and precludes fraudulent Rule 10b-5 claims in corporate acquisitions.

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190 *AES Corp.*, 325 F.3d at 181.
191 *Id.* at 180.
192 *Id.* at 181.
193 Lutz, *supra* note 4, at 840.
194 844 F.2d 1317 (7th Cir. 1988).
195 *Id.* at 1322.

CONCLUSION

The Supreme Court desires to limit the application and potency of Rule 10b-5. NRCs offer sophisticated parties the ability to define the boundaries of their transactions. The effect of an NRC seemed settled until the Third Circuit decided *AES Corp.* A strict application—forbidding only express waivers of the 1934 Act—is the best approach in the context of a corporate transaction. Given the parties' level of sophistication, intensity of investigations, and emphasis on negotiating representations and warranties, an NRC efficiently allocates the risks and liabilities. After negotiations, if the purchaser is still not satisfied with the agreement, it has the ability to renegotiate or refuse to sign the agreement. An NRC effectively limits fraudulent Rule 10b-5 claims in corporate transactions.

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