Lies, Damn Lies, and Fraud Claims in M&A Transactions[1]

Delaware Chancery Court Rules in *ABRY Partners V, L.P. v. F&W Acquisition LLC et. al.*

In his recent decision in *ABRY Partners V, L.P. v. F&W Acquisition LLC, et. al.* ("*ABRY*"), Vice Chancellor Strine of the Delaware Court of Chancery addressed the circumstances in which a seller may contractually insulate itself in a purchase agreement from claims by the buyer for rescission and post-closing damages due to intentional misrepresentations concerning the business or assets being sold. The issue manifests itself in a number of interlocking (and often heavily-negotiated) provisions in purchase agreements, which purport to limit the liability of the seller by (1) making indemnification claims for misrepresentations of fact (including or excluding fraud claims) the sole and exclusive remedy of the parties with respect to the transaction; (2) imposing monetary caps on the seller's potential liability with respect to such indemnification claims; and (3) limiting the buyer's ability to make indemnification claims based on misrepresentations other than with respect to the representations expressly set forth in the purchase agreement.

Vice Chancellor Strine held that under Delaware law, "when a seller intentionally misrepresents a fact embodied in a contract – that is, when a seller lies," public policy compels the courts to disregard provisions of a contract that purport to eliminate certain remedies, including the remedy of rescission. In

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limiting the holding to intentional misrepresentations with respect to statements within the agreement, Vice Chancellor Strine also noted that Delaware courts will enforce provisions in contracts between sophisticated commercial parties that purport to limit a seller's liability if (1) the buyer's claim is based on contractual misstatements that were not intentionally made, or (2) the buyer's claim is based on extra-contractual misrepresentations (regardless of whether they were intentional) and the parties disclaimed reliance on extra-contractual statements.

The following looks at the background to *ABRY*, examines Vice Chancellor Strine's decision and related analysis, and highlights some of the key implications for buyers and sellers in M&A transactions.

The *ABRY* Decision - Background

ABRY involved an attempt by a sophisticated private equity firm, ABRY Partners ("Buyer"), to rescind, several months after the closing, its $500 million purchase of a portfolio company, F&W Publications ("F&W"), from another sophisticated private equity firm, Providence Equity Partners ("Seller"). The transaction was a result of an auction process and, as is common in many purchase agreements arising out of an auction process, the stock purchase agreement (the "Purchase Agreement") was very favorable to the Seller, though the Court characterized it as having been highly negotiated.

The Purchase Agreement contained numerous provisions designed to limit the Buyer's post-closing recourse against the Seller, including:

- The Buyer's promise that it did not rely upon any representations and warranties not contained in the Purchase Agreement and that none had been made, and that neither the Seller nor the Company would be liable for any extra-contractual representations or warranties, and a broad "merger or integration clause" (collectively, the "Non-Reliance Provisions").

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- Limitations on the Seller's liability for claims by the Buyer for breach of representations, warranties or covenants in the Purchase Agreement ("Indemnity Claims"), including a monetary cap (an "Indemnity Cap") of $20 million – 4% of the $500 million purchase price.
- The Buyer's agreement that the Indemnity Claims were to be the sole and exclusive remedy of the parties with respect to the transaction (the "Exclusive Remedy Provisions").

It is important to note that fraud claims were not excluded from the Exclusive Remedy Provisions. The Purchase Agreement also specifically delineated between the extensive representations and warranties made by F&W and the limited representations and warranties (such as title to the shares being sold) made by the Seller (as the private-equity sponsor of its portfolio company).[2] However, in an act critical to the court's analysis, the Seller provided as part of its closing deliverables, its certification to, among other things, the accuracy of the representations and warranties of F&W and the absence of any material adverse effect (a "MAE") on F&W.

Shortly following the transaction's closing, the Buyer began to identify a number of serious financial and operational problems that led it to conclude it had been defrauded by the Seller and F&W. Buyer alleged that Seller and F&W's management worked in concert to manipulate F&W's financial statements in order to fraudulently induce Buyer to purchase F&W at an excessive price. Buyer claimed that because of these manipulations, F&W's historical financial statements contained material misrepresentations and did not accurately reflect the company's financial condition, which constituted a breach of F&W's representations and warranties relating to the accuracy of its financial statements.

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[2] The Chancery Court appears to have ignored for purposes of its analysis a special purpose holding company, F&W Acquisition LLC, the direct owner of all of the outstanding shares of F&W. F&W Acquisition LLC was the "Seller" under the Purchase Agreement, while Providence Equity Partners was not party to the Purchase Agreement.

Buyer also claimed that certain problems with the implementation of a book order fulfillment system constituted a MAE under the Purchase Agreement, and that both F&W and the Seller had breached the Purchase Agreement by failing to give Buyer the contractually required pre-closing notice of these problems and by misrepresenting in an officer's "bring-down" certificate delivered by the Seller at the closing that no MAE on F&W had occurred.

The Buyer argued that because the purchase price of F&W was based on a multiple of 10 times trailing 12-months EBITDA, the alleged misrepresentations and non-disclosures had resulted in payment of a grossly inflated purchase price. Specifically, the Buyer claimed that but for the alleged misrepresentations and non-disclosures, the purchase price of F&W – based on the negotiated 10 times EBITDA multiple – would have been closer to $400 million rather than the $500 million paid at the closing. The Buyer further claimed that it never would have closed at all had it known that F&W engaged in the alleged unethical business and accounting practices.

After learning of these problems, the Buyer asked the Seller to rescind the transaction and take back ownership of F&W. When the Seller refused, the Buyer sued for fraudulent inducement (both for rescission and for money damages in excess of the Indemnity Cap) and negligent misrepresentation. The Seller moved to dismiss the complaint for failure to state a claim, asserting that the contractual limitations on liability should be enforced and that the Buyer's sole remedy, if successful on the merits of its claim, should be limited to the $20 million Indemnity Cap. The Sellers argued that, given the sophisticated nature of the parties, there was no principled basis to override by judicial *fiat* the remedy specifically negotiated by the parties under the Non-Reliance, Indemnity Cap and Exclusive Remedy Provisions of the Purchase Agreement.

The Court held that the Buyer could pursue a claim for rescission notwithstanding the contractual limitation on remedies and damages. The Court found that the claims did not offend the Non-Reliance Provisions because the claimed fraudulent statements were within the Purchase Agreement itself, and did not invoke representations that were outside the Purchase Agreement and barred by the well-drafted integration clause. However, the Court held that it would offend Delaware public policy to enforce the Indemnity Cap and the Exclusive Remedy Provisions "if the Buyer can show either: 1) that the Seller knew that the Company's contractual representations and warranties were false; or 2) that the Seller itself lied to the buyer about a contractual representation and warranty."

For the Court, the key factor in favor of permitting the rescission claim to proceed, notwithstanding the contractual limitations, was its finding that the complaint alleged *intentional* fraud. In a different context in the opinion, Vice Chancellor Strine explained that a "lie" gives rise to the type of fraud that public policy will not allow to be avoided by contract.

> I use the plain word "lie" intentionally because there is a moral difference between a lie and an unintentional misrepresentation of fact. This moral difference also explains many of the cases in the *fraus omnia corrumpit* strain, which arose when the concept of fraud was more typically construed as involving lying, and thus it is understandable that courts would find it distasteful to enforce contracts excusing liars for the harm their lies caused.[3]

The Lessons of ***ABRY***

[3] For those who have not kept up with their Latin, *fraus omnia corrumpit* is explained as "fraud unravels all" or, more colloquially, "Once a contract is affected by fraud, all bets are off." (www.swarb.co.uk/lawb/genLegalLatin.shtml).

The *ABRY* decision answers under Delaware law the question of whether, and to what extent, a seller may contractually insulate itself from rescission claims or post-closing claims for damages by a buyer for misrepresentation, including even certain types of fraud. In addition, the decision has a number of important implications and lessons for both buyers and sellers in private M&A transactions, including the following:

Understanding "Boilerplate"

The fierce competition among private-equity funds in recent M&A auctions often has resulted in pro-seller purchase agreement terms and provisions. When deals are particularly "hot," sellers seek to impose limitations on the length and scope of the buyer's due diligence process.

A number of private M&A studies conducted by financial advisors and others in the industry show the increasing prevalence of these provisions in recent transactions. For example, representations and warranties are more narrowly drawn, survival periods for representations and warranties are becoming shorter, indemnity caps are lower, non-reliance and exclusive remedy provisions (even for fraud claims) are more commonplace and 10b-5 and accuracy of disclosure type representations from sellers are the exception rather than the norm. To increase their likelihood of being the "winning" bidder in M&A auctions, many private M&A buyers have been willing to accept these limitations on recourse against the sellers and other seller-oriented provisions. The *ABRY* Stock Purchase Agreement included a number of provisions on the extreme pro-seller end of the spectrum. For example, fraud was not carved-out from the Exclusive Remedy

Provisions and language was included that the indemnification provisions were "specifically bargained for and reflected" in the purchase price.[4]

Sometimes clients view these provisions as mere "boilerplate" having less significance than the primary business terms. Buyer's counsel needs to focus its client on the implications of these provisions, the risks the client will assume by agreeing to them, and that courts will be reluctant to "undo" what the parties specifically bargain for, except in the case of the most egregious types of fraud. Vice Chancellor Strine appropriately noted that parties bargain for the degree of risk they are willing to assume and the allocation of risk is reflected, in part, in the price that they are willing to offer or accept. Clients must avoid the temptation to dismiss these provisions as so much "boilerplate" if they are to make informed business decisions about whether to accept such post-closing limitations.

Fraud and Exclusive Remedy Provisions

ABRY makes clear that contractual liability limitations for fraud claims based on misrepresentations outside of the agreement will be enforced under Delaware law and will bar claims for rescission. It is equally clear under *ABRY* that contractual limitations on fraud claims based on the "four corners" of the agreement will not be enforceable under Delaware law. Consequently, the express inclusion or exclusion of fraud claims from exclusive remedy provisions has meaningful consequences if a fraud claim is brought with respect to the transaction.

Understanding Who is Doing What to Whom

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[4] See, e.g., the study conducted by the American Bar Association's M&A Market Trends Subcommittee of the Committee on Negotiated Acquisitions released in March 2006 (the "ABA Study") which found that in deals closed in 2004, only 15% failed to carve out fraud from the provision for indemnification as the exclusive remedy.

ABRY illustrates the importance, for transactions in which both a portfolio company and a seller are involved, of giving careful consideration to which of these parties will be making the representations and warranties, delivering bring-down certificates and providing or back-stopping the indemnification remedies. Buyers will want both the seller and the portfolio company to make the representations and warranties, both for indemnification claims and, more importantly, for fraud and misrepresentation claims. The *ABRY* Purchase Agreement – as is increasingly customary – carefully delineated between the representations and warranties of F&W and the Seller. However, this distinction became irrelevant when the Seller signed and delivered an officer's certificate certifying as to the accuracy not only of *its* representations and warranties, but also to the accuracy of *F&W's* representations and warranties. Vice Chancellor Strine found that the blurring of the F&W/Seller delineation opened the door for fraud and rescission claims against the Seller, as opposed to limiting the Buyer to the sole remedy of breach of representation claims subject to the Indemnity Cap. The decision might have been different if Seller's bring-down certificate had applied only to its own representations and warranties (none of which were alleged to have been breached or misrepresented) and an officer of F&W had delivered a separate bring-down certificate covering F&W's representations and warranties. If the Seller and F&W had provided separate bring-down certificates, it is unclear whether the Buyer would have been able to point to any contractual misrepresentations made by the Seller to serve as the basis of Buyer's fraud claims.

Involvement with Portfolio Company Management

The *ABRY* decision suggests that increased interaction with, and oversight of, a portfolio company by a private equity sponsor is likely to make it more difficult for the private equity sponsor to insulate itself from liability for

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misrepresentations by the portfolio company. In *ABRY*, Vice Chancellor Strine noted that F&W had its own key managers who had no prior affiliation with the Seller (the management was inherited when the Seller acquired F&W from the prior owner) and that the Seller may have had less familiarity with the company and its operations than did F&W's management.

Vice Chancellor Strine's decision was influenced substantially by the blurring of the distinction between F&W and the Seller because of the Seller's closing certification. However, it also appears to have been influenced, at least in part, by the Seller's relative lack of involvement in the management of F&W. His decision may have been different if the private equity sponsor had selected its own management team or replaced the inherited management with its own managers after it purchased the business. Therefore, although there often are compelling business reasons for private equity sponsors to hand-pick management teams, replace management teams with affiliated persons or increase the monitoring of portfolio companies' operations and performance, doing so may make it more difficult for the sponsors to avoid having managers' more intimate knowledge of the portfolio company attributed to them, and to insulate themselves from liability for the company's misrepresentations. Finally, private equity sponsors should be aware that any knowledge obtained by its principals, employees, or agents – including when those persons serve as officers or directors of portfolio companies – is likely to be attributable to the firm as a whole and could support a buyer's claim that the private equity seller had knowledge of a misrepresentation made by the portfolio company in a purchase agreement, or otherwise.

Sandbagging and Fraud

The *ABRY* decision underscores that Delaware public policy considerations prohibit a Buyer from seeking rescission or recovering damages for fraud in excess of contractual limitations if (1) the purchase agreement had exclusive remedy provisions that applied to fraud claims and had non-reliance provisions, (2) the Buyer was aware of misrepresentations prior to closing and had the contractual right to terminate, but (3) the Buyer nonetheless elected to close (so-called "sandbagging"). The opinion does not address whether, in the absence of a provision that precludes an indemnity claim by the buyer for breaches known by the buyer before closing (a so-called "anti-sandbagging" provision), such a Buyer may seek indemnification after closing for misrepresentations that it was aware of at closing.

An Unanswered Question: What Is "Fraud"?

Vice Chancellor Strine concluded that to enforce a contractual provision exonerating a party from *intentional* fraud – *i.e.*, "lying" – would offend public policy. In securities and M&A law, however, fraud is also generally understood to encompass reckless misconduct, including both affirmative misrepresentations and omissions. The Court stated that it did not believe that "it would be immoral for the Seller and Buyer to allocate the risk of intentional lies by the [Portfolio] Company's managers to the Buyer. Such an allocation of risk does not permit the *Seller* to engage in consciously improper conduct itself …." [*Emphasis added*].

ABRY arose on a motion to dismiss the complaint, and the factual allegations of the complaint are necessarily deemed to be true. What will the proof ultimately be at trial? Will the contractual limitations be enforced if the Seller's portfolio manager disregarded information that contradicted the Company's representations when he blithely signed the certificate? Perhaps Vice Chancellor Strine's moral demarcation is drawn in the right place, but it must be

recognized that the marker is not fixed and immutable; another court of equity may place it elsewhere.

Delaware Choice of Law and Jurisdiction

ABRY also highlights the importance of contractual choice of law, jurisdiction and venue provisions. Although Delaware remains the jurisdiction-of-choice for entity formation and merger agreements involving Delaware entities, many stock and asset purchase agreements are governed by New York law, the law of another state where one or both of the parties is physically located or the law of a state or jurisdiction chosen for some other reason, such as neutrality. Vice Chancellor Strine's decision again demonstrates why Delaware is selected as a governing law and preferred forum. The decision reflects a sophisticated sensitivity to deal considerations. The Court of Chancery's willingness to decide *ABRY* on an expedited schedule and the relative certainty (under Delaware law) of Vice Chancellor Strine's rule is likely to reinforce the disposition of clients and their attorneys to select Delaware as the governing law for acquisition agreements, and Delaware for jurisdiction and venue.

Potential Benefits of Indirect Ownership of Portfolio Companies

Although F&W was indirectly wholly-owned by investment funds managed by Providence Equity Partners (a private investment firm that manages investment funds), neither Providence Equity Partners nor the various investment funds were a party to the *ABRY* Stock Purchase Agreement or provided any sort of guarantee to the Buyer. As a result, none of them made any representations to, or had any privity of contract with, the Buyer.

The *ABRY* decision collapses all of these entities together and does not address why the Buyer's recourse was not limited to the special purpose

subsidiaries of the investment funds of Providence Equity Partners that *were* parties to the Stock Purchase Agreement. It is unclear why the separate existence of these entities was not respected by the Vice Chancellor, particularly given that the very sophisticated Buyer could have bargained to include a guarantee by such parties of the Seller's obligations under the Stock Purchase Agreement.

Conclusion

A cynic might describe the lesson of *ABRY* as "don't lie, but if you must lie, don't lie about matters covered by your representations in the contract." A more accurate lesson would be, as the Seller of a portfolio company, carefully maintain your distance and recognize the distinctness and limits of your knowledge compared to company management; then, consider the implications of contractual limitations on liability, because Delaware courts will enforce sufficiently broad contractual provisions in purchase agreements governed by Delaware law, unless the buyer can prove that the seller committed fraud (or knew of a fraud committed by the underlying portfolio company owned by the seller) with respect to an express representation made to the buyer in the agreement." In *ABRY*, Vice Chancellor Strine balanced the often-competing goals of establishing a body of commercial law that is efficient (in part by permitting sophisticated parties to freely allocate risk, including the risk of "lying"), and the public policy against fraud. The decision seems to be based, at least in part, on his view that there is no economic efficiency to reward parties who "lie."