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PE Seller May Have Liability for Portfolio Company's Alleged Fraud in Concealing Steep Earnings Decline Post-Signing–Agspring

In *Agspring v. NGP* (July 30, 2020), the Court of Chancery declined to dismiss fraud claims against a private equity fund and officers of its portfolio company, Agspring LLC, in connection with the sale of Agspring to another private equity fund. At the pleading stage of litigation, the court found it reasonably conceivable that: (i) the portfolio company officers deliberately concealed from the buyer a steep decline in Agspring's earnings before and after the signing and closing in December 2015; (ii) as a result of the earnings decline, certain of Agspring's representations and warranties in the sale agreement and a related financing agreement were false when made; and (iii) not only the portfolio company officers, but also the PE-seller, knew or were in a position to know that the representations were false.

Key Points

- **The decision serves as a reminder that, in connection with the sale of a portfolio company, a PE-seller can be liable for fraudulent representations in an agreement even if it is not a party to the agreement.** In this case, the PE-seller *was* a party to the sale agreement but *not* to the related financing agreement. The court found that the seller faced potential liability for allegedly fraudulent representations in *both* agreements in light of the seller's extensive involvement in Agspring's business and in the sale process. We note that in the more typical context of a PE-seller *not* being a party to a sale agreement and claims being made for breaches of representations rather than fraud, a PE-seller should not face liability.

- **The court found it reasonably conceivable at the pleading stage that the "Material Contracts" and "Material Adverse Effect" representations in the sale agreement were false when made–based on the decline in earnings that began in the weeks leading up to the signing and closing and continued post-closing.** Although Agspring did not default on its material debt obligations until three years after the closing, the court found that the earnings decline may have put the company on a course that would lead to the default. Also, the court found that Agspring's "internal" downward revision of its annual earnings forecast by 48% (made shortly before the signing and not disclosed to the buyer) indicated that a Material Adverse Effect may have occurred.

- **Notably, the overall factual context was egregious.** The earnings decline was severe (with actual earnings at the fiscal year-end being less than $1 million as compared to the forecast just before signing of $33 million); the decline allegedly was deliberately concealed by Agspring's officers (including by the President's erasing information from his computer); and false reassurances allegedly were repeatedly provided to the buyer. It may be that, at the motion to dismiss stage, in the context of an egregious factual setting, the court will be skeptical that a PE-seller would not have known about a material change and its concealment.

Background. Agspring, which acquires, consolidates and operates grain elevators, was founded in 2012 by two individuals, who served as the CEO and President, respectively (together, the "Officers"). The Officers owned 2% of the membership interests. NGP X U.S. Holdings, L.P. (the "Seller"), a fund affiliated with private equity firm NGP Energy Capital Management, owned 98% of Agspring's membership interests and had provided almost all of Agspring's initial capital ($150 million). Agspring's five-member board was comprised of the two Officers and three persons who had been designated by the Seller. Although Agspring acquired numerous businesses from 2012 to 2014, in 2014 the Officers complained to Seller's Agspring board designees that more capital was needed for acquisitions and they recommended that the Seller exit its investment in Agspring. The Seller authorized the Officers to engage in a sale process and told them it would be seeking a two-times return on its initial investment. The Officers, the Seller and the Seller's Agspring board designees then began working to find a buyer to purchase Agspring for over $300 million.

In May 2015, American Infrastructure MLP Funds (the "Buyer") entered into a non-binding term sheet to acquire all of the Agspring membership interests for $325 million. Agspring shared with the Buyer its EBITDA forecast of $38 million for FY 2016. In July 2015, a price reduction to $320 million was agreed based on the Buyer's due diligence findings relating to actual and projected earnings. In November 2016, a further price reduction, to $295 million, was agreed after the Officers disclosed a decline in earnings of one of two key subsidiaries. At this time, there was a major decline in earnings of the other key subsidiary as well that was *not* disclosed. Also at this time, Agspring provided to the Buyer, and to certain investors providing transaction financing (the "Investors"), projections that forecasted EBITDA for FY 2016 of $33 million–but did not disclose that Agspring had "internally" revised the forecast down to $20 million.

In December 2015, the Purchase Agreement, for a sale of all the membership interests at a price of $295 million (the "Transaction"), was signed and, shortly thereafter, closed. The Investors provided financing through a preferred equity investment in the Buyer's acquisition subsidiary, as well as, pursuant to a Loan Agreement, $80 million in loans to Agspring. At the closing, the Officers rolled over their equity in Agspring (valued at $5.4 million); received cash payments totaling $7.5 million; and continued in their positions as CEO and President. The closing occurred just after the midpoint of Agspring's fiscal year 2016, which ended May 31, 2016. At the FY 2016 year-end, the Officers disclosed actual EBITDA of $702,000. Shortly thereafter, the Officers resigned. Agspring, which continued to struggle financially, was restructured in both 2017 and 2018.

The Buyer and the Investors brought suit in April 2019, alleging that the Officers and the Seller had fraudulently concealed from them Agspring's dramatic decline in performance in the weeks leading up to the signing and the months after the closing. They sought damages of $150 million, claiming that Agspring's value at closing actually had been less than $145 million (while the purchase price paid was $295 million). Chancellor Bouchard rejected the motions to dismiss the claims against the Seller and the Officers (i) for fraud with respect to the representations in the Purchase Agreement (to which the Seller and the Officers were parties); and (ii) for aiding and abetting and civil conspiracy to commit fraud with respect to the representations in the Loan Agreement (to which the Seller and the Officers were *not* parties). The court also ruled that the statute of limitations was "equitably tolled."

Discussion

The Seller's potential liability for allegedly fraudulent representations in the Purchase Agreement and Loan Agreement. Typically, a PE fund selling a portfolio company is not a party to the sale agreement. In *Agspring*, the Seller *was* a party to the Purchase Agreement and the representations about Agspring were made by the Seller, the Officers and Agspring. The Seller was *not* a party to the Loan Agreement. Chancellor Bouchard held that, in light of the Seller's control of Agspring and its extensive involvement in the sale process, the Seller was potentially liable for fraudulent misrepresentations in *both* agreements. We note that in *Prairie Capital v. Double E* (2015), another decision involving the sale of a portfolio company from one PE firm to another, Vice Chancellor Laster held, on the same basis, that the PE-seller was potentially liable for its portfolio company's fraudulent representations in a sale agreement even though not a party to the agreement (an even though, in that case, there had been no direct communication between the seller and the buyer). (See here our memorandum, *Chancery Court Provides Guidance on Post-Closing Fraud Claims by Buyer of Portfolio Company*, Jan. 4, 2016.)

The possible falsity of the Material Contracts representation–because the earnings decline put the company on a course that ultimately would cause a debt default. In the Purchase Agreement, the Seller, the Officers and Agspring represented that, "to the knowledge of Agspring, no event has occurred or circumstance exists…[that may] result in a breach of or default under any Material Contract." Starting almost three years after the closing, Agspring failed to make payments on a debt obligation it had incurred in connection with an earlier acquisition (a promissory note, with a $22 million outstanding balance and annual $1.2 million interest payment, which was a "Material Contract" (the "Tubbs Note")). The plaintiffs alleged that the defendants should have known before closing that Agspring's steep financial decline, together with the incurrence of the additional $18 million of Transaction financing, would lead to a default under the Tubbs Note. First, the defendants contended that no event *had occurred* before closing that would indicate that Agspring would violate a loan covenant 34 months later. Second, the defendants argued (citing the court's 2018 *Edinburgh v. Education Affiliates* decision) that representations about projections cannot be actionable for fraud because it is not "knowable" whether revenues will be achieved. The court found it reasonably conceivable that the effect of Agspring's poor performance during the first six months of FY 2016 (known to the defendants and not disclosed), together with the incurrence of the Transaction financing (also known to them), "put [Agspring] on a downward spiral that would cause a default" under the Tubbs Note. Distinguishing *Edinburgh*, the court stated that, "although there [was] a forward-looking aspect to the [Agspring Material Contracts representation], the representation [was] rooted in Agspring's financial condition at the closing based on historical events, *i.e.*, events that had 'occurred' and were not only knowable, but allegedly known, at closing."

The possible falsity of the MAE representation. In the Purchase Agreement, the Seller, the Officers and Agspring represented that "there has not been any…Material Adverse Effect" on Agspring since May 31, 2015 (which was the end of Agspring's FY 2015). As is typical, "MAE" was defined to exclude a "failure or inability to meet any projections, forecasts or estimates of revenues or earnings" and there was a carve-out from the exclusion "to the extent that…the facts or circumstances giving rise to such failure or inability may themselves be deemed to constitute, or to be taken into account in determining whether there has been, a [MAE]." The court, with little discussion, stated that the plaintiffs' allegation that Agspring's performance over the first half of its FY 2016 "necessitated a reduction of approximately 47 percent of the Company's total FY16 EBITDA forecast" (from $38 million in M1y 2015 to $20 million in November 2015) was "sufficient to support a reasonable inference of an [MAE] at the pleadings stage."

The possible falsity of representations in the Loan Agreement. In the Loan Agreement, Agspring represented that its projections were prepared in good faith and that the company was solvent. The court found it reasonably conceivable that these representations were false; that the Officers knew as much when they caused Agspring to make them; and that, although the Seller was not a party to the Loan Agreement, based on its extensive involvement in Agspring's business and in the sale process, it may have aided and abetted or conspired to commit the alleged fraud.

The alleged concealment of the earnings decline. The court found it reasonably conceivable that, from the weeks leading up to the signing through seven months after the closing, the Officers made numerous statements "to perpetuate the myth" that the "artificially inflated forecast they provided" shortly before closing "remained achievable when they knew otherwise." Further, the destruction by one of the Officers of information on the company computer that he took with him when he resigned (accomplished through a "factory reset" which made the erased information irretrievable) "st[ood] out as a deliberate effort" to conceal information.

The Seller's involvement in Agspring's business and the sale process–such that it may have been in a position to know that Agspring's representations were false. The court found the plaintiffs' allegations "far more than sufficient" to support an inference that the Seller had been extensively involved in Agspring's business and the sale process such that the Seller would have been "in a position to know when it signed the [Purchase Agreement] the knowable reality underlying the alleged falsity of the [Material Contracts and MAE representations] that was concealed from Plaintiffs, *i.e.*, that Agspring's financial results had declined dramatically over the prior six months necessitating material reductions to its forecast for the 2016 fiscal year, which severely threatened Agspring's earnings and imperiled its ability to service its debt after the closing." Specifically, the Seller allegedly: (i) controlled Agspring; regularly received financial information from Agspring; and was contractually obligated to advise Agspring concerning financings and acquisitions; (ii) negotiated two price reductions directly with the Buyer (as a result of pre-signing earnings declines that *were* disclosed to the Buyer); and provided "specific feedback to improve Agspring's consolidated financial statements" and "encouraged Agspring employees to modify financial documents that were later disclosed to [the Investors] so that [Agspring] would look more attractive to potential investors"; (iii) "understood that attaining a specific EBITDA was essential to the [Buyer's] value proposition and to secure financing" for the Transaction and that "maintaining consistent financial projections and a positive outlook was key to getting the deal closed"; and (iv) "constantly communicated with [the Officers] during the sale process," including "push[ing] [them] to close the deal as [Agspring]'s forecasts worsened, stating in November 'need a close now,' and calling, texting, and emailing [the Officers] constantly in December 2015."

The tolling of the statute of limitations. First, the court held that the Buyer was not "on notice inquiry" of possible fraud until the Officers resigned after disclosing the fiscal year-end results. Second, the court ruled that the statute of limitations was tolled, with respect to the Officers, under the "fraudulent concealment" doctrine–which stops the limitations "clock" from running while there was "actual artifice…intended to put a plaintiff off the trail of inquiry." The court concluded that the Officers' concealment of the earnings decline constituted such an artifice and pointed to the Officer's alleged destruction of information on his computer as "stand[ing] out as a deliberate effort to impede the investigation they inferably knew was coming." Third, the court stated that the statute also was tolled with respect to the Officers under the "equitable tolling" doctrine–which stops the limitations clock from running while a plaintiff was "reasonably relying on the competence and good faith of a fiduciary." This doctrine applied because "all of the concealment occurred while [the Officers] continued to serve as [officers and thus were] fiduciaries of Agspring." The court (citing the Delaware Supreme Court's 1976 *Laventhol* decision) rejected the defendants' argument that equitable tolling applies only to claims of wrongful self-dealing. Fourth, the court ruled that tolling applied to the Seller to the same extent as it did with respect to the Officers because it was reasonably conceivable that the Seller "knowingly engaged in a conspiracy with [the Officers] to make the fraudulent misrepresentations." The court stated that those who conspire to defraud with fiduciaries who enrich themselves should be bound by the same standard for statute of limitations purposes as the fiduciaries themselves–even if, as the defendants asserted in *Agspring*, the concealment by the fiduciaries occurred after the alleged conspiracy with them had ended.

Practice Points

- **A private equity fund selling a portfolio company should be mindful that, depending on the circumstances and the terms of the sale agreement, it can be held accountable for fraudulent misrepresentations made in an agreement, even if not a party to the agreement.** As highlighted in both *Agspring* and *Prairie Capital*, a PE fund that is extensively involved in the portfolio company's business and sale process (as is typical) may be liable for fraudulent representations made by the portfolio company in the sale agreement or related agreements–even if (as is also typical) the seller is not a party to the agreement. We note that, in both *Agspring* and *Prairie Capital*, the PE fund also allegedly knew about, participated in, sanctioned, and (in *Prairie Capital*) even possibly orchestrated, the fraud. It is unclear to what extent the court might consider a PE fund to be potentially accountable for its portfolio company's fraudulent misrepresentations if the fund had been extensively involved in the business and the sale process but clearly had *not* known about the fraud. As noted above, it may be that, at the motion to dismiss stage, in the context of an egregious factual setting, the court will be skeptical that a PE-seller would not have known about a material change and its concealment.

- **A seller must consider whether a post-signing decline in earnings implicates representations made in the sale agreement.** In *Agspring*, the court viewed the severe earnings decline as potentially rendering false not only the representation that no MAE had occurred, but also the representation that no event had occurred that would cause a default under a Material Contract.

- **A seller must consider what to do when, during the sale process, projections (or any other material information) provided to the buyer earlier in the sale process no longer reflects current expectations with respect to the business.** Even when fraudulent conduct or falsity of an express representation in the sale agreement is *not* at issue, selling parties may come to have knowledge during the course of the sale process (especially if it is lengthy) that projections (or other information) provided to the buyer at an earlier stage may have become inaccurate. Some contracts expressly provide that a seller must inform the buyer if it becomes aware of a representation having become materially inaccurate. Even if a contract does not so provide, even if the seller is not a party to the agreement, and even if there is no specific representation that will be breached, material information should be provided to the buyer. A seller should consider with legal counsel the appropriate timing, form, and extent of disclosure of this type of development. While disclosure in this situation may well lead to renegotiation of the price (or even potentially termination of the deal), it will mitigate the risk of fraud claims, as well as the risk of reputational damage (which could impede a firm's ability to sell portfolio companies or otherwise conduct business in the future).

- **Buyers should conduct careful due diligence prior to signing and closing.** Due diligence should be conducted by a buyer not only before signing but also to confirm the continued accuracy of representations prior to closing; and should carefully consider whether to close if all of its information requests have not been fully answered. Pre-closing due diligence should be conducted even if there are indemnification rights and/or R&W insurance. It should be noted that sell-side R&W insurance generally does not cover fraud claims. Buyers should seek to obtain through the acquisition agreement appropriate rights to information between signing and closing. A buyer should consider seeking a right to access to the company's CFO, accounting staff, and outside accountants. To avoid claims being time-barred, a buyer should not delay investigation of suspected concealment of information. When a buyer becomes aware of declining revenues, whether before or after signing, it should promptly seek out a full explanation and supporting information and then monitor the situation.

- **A well-plead fraud claim based on a misrepresentation in an agreement may not necessarily be easily dismissed at the pleading stage of litigation (although it is often difficult to prove at trial).** A claim for fraud requires (i) a false representation, (ii) the defendant's knowledge of or belief in its falsity or the defendant's reckless indifference to its truth, (iii) the defendant's intention to induce action based on the representation, (iv) reasonable reliance by the plaintiff on the representation, and (v) causally related damages. Although fraud claims must be plead with particularity, the court pointed out in both *Agspring* and *Prairie Capital* that, in the context of a fraud claim based on a written representation in a contract, once the claimant identifies a false statement for which the defendant is accountable, satisfaction of the remaining elements of fraud generally can be "reasonably inferred" at the pleading stage. The court explained in *Agspring* that "[t]his is because the plaintiff can readily identify who made what representations, where and when, because the specific representations appear in the contract."

- **Sellers may want to consider provisions that might mitigate the risk associated with post-closing fraud claims.** We note that post-closing fraud claims span a continuum—from those that are made by a buyer who was "duped" into agreeing to a transaction based on a seller's false representations that were apparently knowingly made, to those made by a buyer who simply has "buyer's remorse" and bases fraud claims on representations that turned out to have been false but were innocently (or possibly negligently) made. While not at issue in *Agspring,* some purchase agreements expressly "carve out" fraud from the provision stating that indemnification is the sole remedy for misrepresentations. Sellers should also consider an express carve-out for fraud from the provision stating that the buyer cannot rely on any statements other than those expressly made in the agreement. Sellers might also consider seeking to include less common provisions (to the extent permissible under state law) that would, for example, contractually limit the parties against which fraud claims could be made, the timeframes for making them, the subject matters to which they could relate, and/or the responsibility for payment of the fees and expenses incurred in defending them unless the buyer prevails in the litigation.

- **Parties should pay special attention to the drafting of a "Material Adverse Effect" definition.** Unusually, the MAE in Agspring provided that an MAE "has not occurred." A buyer will want the definition to include that nothing has occurred that would be expected to lead to an MAE. Also, an MAE definition typically is drafted to exclude any failure or inability of the company to meet projections, forecasts, or estimates of revenues or earnings. A buyer will want to state expressly that this exclusion will not preclude consideration of the factors that gave rise to that failure or inability to the extent that they otherwise may themselves constitute or contribute to an MAE.

- **Indemnification of portfolio company executives.** Given the potential of liability for portfolio company executives for fraudulent misrepresentations in a sale process, indemnification provisions in the company's charter and/or executive employment agreements should be reviewed to ensure that they reflect the parties' intentions with respect to indemnification of executive officers therefor.

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This Briefing is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this Briefing, please call your regular Fried Frank contact or an attorney listed below:

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