Chancery Court Provides Guidance on Post-Closing Fraud Claims by Buyer of Portfolio Company—Prairie Capital v. Double E

In a recent decision relating to the sale of a portfolio company by one private equity firm to another—*Prairie Capital v. Double E* (Nov. 24, 2015)—the court provided important guidance with respect to a buyer's ability to make post-closing fraud claims against a portfolio company's executives and its private equity fund sellers.

Significance of the decision

- **Reminder that representations and warranties in the sale agreement affect not only indemnity claims but fraud claims.** The decision serves as a reminder that, in a sale agreement that includes a typical non-reliance provision (i.e., a statement that the buyer has not relied on statements made or information provided outside the agreement), the representations and warranties set forth in the agreement will affect the extent to which the buyer can bring not only indemnity claims but also fraud claims.

- **Court lowers bar for effectiveness of non-reliance provisions.** At the same time, the court broadened its view as to the types of non-reliance provisions that would be effective in barring extra-contractual claims.

In *Prairie Capital,* the buyer had conditioned its offer on the portfolio company's meeting certain sales targets. The seller allegedly falsified the books and records and lied to the buyer in order to make it appear that the sales targets had been met. Notwithstanding the egregious factual context, at the pleading stage, the court ruled (consistent with its 2006 *Abry* decision) that, based on the non-reliance provision in the sale agreement, *the buyer could bring a fraud claim only to the extent that it was based on a breach of a representation and warranty set forth in the agreement*. Although most of the fraud claims made in *Prairie Capital* were not dismissed, the court's disposition of each claim was based on a detailed review of the representations in the agreement to determine whether, by their terms and the dates as of which they spoke, they covered the alleged fraudulent conduct.

Prairie Capital

Background. Funds sponsored by private equity sponsor Prairie Capital sold a portfolio company to an acquisition vehicle formed by funds sponsored by another private equity firm. Only the company's CEO and its CFO (neither of whom were otherwise affiliated with the sponsor) communicated directly with the buyer during the sale process and the representations and warranties set forth in the stock purchase agreement were made by the company. As is customary in dispositions of portfolio companies by sponsors, the principals of the sponsor were extensively involved in the sale process. The sale strategy emphasized a "growth story"; the buyer's due diligence focused on confirmation of the historical sales numbers; and the buyer expressly conditioned its final offer (and price increase) on the company's meeting its March sales target numbers. The sales updates delivered to the buyer through mid-March demonstrated numbers far off the target, but, at the end of March, the report showed that the target had just been met. Based on that information and the company's further assurances, the buyer signed and closed the transaction.

Fraud allegations. The company had disclosed to the buyer that, in the ordinary course, the company booked sales only after an ordered product was invoiced and shipped to the customer. The buyer alleged that, to meet the March sales target, the company had included in its accounts receivable "revenues" from the sale of products that were not yet invoiced or shipped and had not operated in the ordinary course in generating sale orders (calling people back from vacations and making other extraordinary efforts to meet the target numbers). The buyer also alleged that, prior to March, the company had been falsifying records (for example, shipping products to false addresses on the last day of a month) to maintain the appearance of an upward trend in revenues. The buyer sued the funds and the company's CEO and CFO for fraud and conspiracy to commit fraud (as well as claims for indemnification) with respect to alleged misrepresentations made both in the stock purchase agreement (the "contractual claims") and outside the agreement (the "extra-contractual claims").

Court's holding. At the pleading stage, the court ruled that, because the agreement contained an effective non-reliance provision (i.e., a statement that the buyer had not relied on information provided outside the sale agreement), the buyer was limited to making fraud claims that were based on misrepresentations in the sale agreement—notwithstanding an exclusive remedy provision with a fraud carve-out (i.e., a statement that indemnification would be the exclusive remedy for breaches of representations and warranties *other than in the case of fraud*). While the court concluded that most of the claims did constitute breaches of the representations in the agreement (and, accordingly, most of the claims were not dismissed), the court dismissed the claim that the audited financial statements were fraudulent, because the representation in the agreement relating to the audited financials statements did not cover the March 2012 or pre-March 2012 periods during which the alleged misconduct occurred. (The unaudited financial statement representation covered the March 2012 period, but not pre-March 2012.)

Key Points

- **Breadth of representations and warranties in a sale agreement has real consequences not only with respect to indemnification claims, but also fraud claims.** In *Prairie Capital*, the portfolio company allegedly falsified its books to show (contrary to the truth) that sales targets, on which the buyer had conditioned its offer, had been met. The court ruled that, even were that true, the buyer could not bring a fraud claim—because the non-reliance provision limited the buyer to claims based on the representations set forth in the agreement. The court interpreted the fraud carve-out in the agreement as eliminating indemnification as the exclusive remedy for any fraud claims *that could be made*, but *not* as broadening the basis on which the non-reliance provision permitted a fraud claim to be brought.

- **A buyer can circumvent the agreed limitations on indemnification by reframing a breach of representation claim as a fraud claim.** The decision serves as a reminder that, when there *is* a breach of a contractual representation, a buyer can circumvent the agreed caps, deductibles, timeframe, and procedural restrictions agreed by the parties with respect to indemnification by reframing the breach claim as a fraud claim.

- **A well-plead fraud claim (although it may be difficult to prove at trial) will generally not be easily dismissed at the pleading stage of litigation.** 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. At the pleading stage of litigation, the court must assume that all facts alleged by the claimant are true. In *Prairie Capital*, the court noted 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 decision broadens the types of non-reliance provisions that the court will regard as effectively barring extra-contractual fraud claims.** The decision confirms that a well-drafted provision stating that the buyer has not relied on statements made by the seller outside the sale agreement will be respected by the court and will preclude a buyer from making a fraud claim that is based on extra-contractual statements. The court indicated that, contrary to what has been suggested in some precedent, no "magic words" are required to make a non-reliance provision effective, so long as the provision clearly indicates the parties' intention that the buyer disclaims reliance on extra-contractual statements.

- **A private equity fund owner can be held accountable for fraudulent statements made to a buyer by the portfolio company.** The decision confirms that a private equity sponsor's extensive involvement in the sale of a portfolio company can result in the sponsor's funds being potentially liable for fraudulent representations made to the buyer—even if all of the direct communication with the buyer was by the portfolio company executives and the representations in the agreement were made by the portfolio company. Notably, in *Prairie Capital*, the two partners of the private equity firm sponsor who served on the portfolio company's board (one of whom was also the President and Secretary of the portfolio company) were alleged not only to have been extensively involved in the sale process but to have known about, participated in, sanctioned, and even possibly to have "orchestrated," the fraud. It is unclear to what extent the court would consider the sponsor as potentially accountable for the portfolio company's fraudulent misrepresentations if the sponsor had been extensively involved in the sale process but had *not* necessarily known about the fraud.

Practice Points for Buyers

- **Importance of the breadth of the sale agreement representations and warranties.** Based on *Prairie Capital*, the representations and warranties set forth in the sale agreement, as defined by the qualifiers and dates included in the representation, will affect not only a buyer's ability to bring indemnification claims but also its ability to bring fraud claims. We note that, in any case in which the truth of certain specific information is particularly key to the buyer's determination to enter into the transaction (such as, in *Prairie Capital*, the truth of the Company's having met the March sales target), a buyer should consider whether it could better ensure that the information is precisely covered if it made that information the subject of a separate representation (without the qualifications, dates or other limitations applicable to a broader representation).

- **Fraud claims will not be subject to the limitations on indemnification set forth in the sale agreement.** It should be kept in mind that, to the extent a buyer can bring a fraud claim for a misrepresentation of the seller, the claim will not be subject to the caps, deductibles, baskets, timeframes or procedural restrictions set forth by the parties in the sale agreement with respect to indemnification for breaches of representations.

- **Consider seeking to include a fraud carve-out not only in the exclusive remedy provision but also in the non-reliance provision.** In response to the court's interpretation in *Prairie Capital* of the fraud carve-out clause in the exclusive remedy provision, a buyer should consider seeking to include a fraud carve-out not only in the exclusive remedy provision but also in the non-reliance provision. The double carve-out would make it clear that the parties intend not only to eliminate indemnification as the exclusive remedy for a fraud claim, *but also* to override the non-reliance provision's bar to extra-contractual fraud claims.

- **Indemnification claim should be drafted to cover the specific claim.** Consistent with the court's trend in recent years, the court rejected the concept of a "placeholder" indemnification claim. The court rejected a claim that was supported by allegations in the pleadings but had not been described in the indemnification notice provided under the agreement. "To permit the Buyer to treat a notice relating to claims about March 2012 as a placeholder for later asserted claims regarding earlier time periods would contravene the [indemnification] notice requirement [that requires 'reasonable notice of the claim']," the Vice Chancellor wrote. Buyers making indemnification claims should provide specific support in the indemnification notice and not rely on being able to make more specific allegations in litigation pleadings.

Practice Points for Sellers

- **Importance of the breadth of the sale agreement representations and warranties.** As discussed, the breadth of the representations in the sale agreement will affect not only a seller's potential liability for indemnification claims, but also for fraud claims.

- **Sellers must consider what to do when projections provided to buyers become inaccurate at a later stage in the sale process.** Although not the situation present in *Prairie Capital*, the decision serves as a reminder that, even when fraudulent conduct is not at issue, during what can be an extended sale process, the selling parties may come to have knowledge that the projections provided to the buyer at an earlier stage have become inaccurate. The decision underscores the importance of considering the appropriate timing, form, and extent of disclosure to the buyer of this type of development.

- **Although the court ruled that the effectiveness of a non-reliance provision will not depend on the use of "magic words," previously judicially endorsed formulations should be employed to avoid the issues that arose in *Prairie Capital*.** The court upheld the effectiveness of the non-reliance provision in *Prairie Capital* despite the fact that the provision was not formulated as the court in past precedent had suggested would be required. Nonetheless, issues relating to the effectiveness of a non-reliance provision should be mitigated if, as the court has previously required, the provision includes (i) words specifically stating that the buyer *has not relied* on extra-contractual statements; and (ii) a specific reference to non-reliance not only on misrepresentations but also on "omissions or the concealment of material information."

- **Consider seeking to incorporate into the sale agreement the court's interpretation of the fraud carve-out in *Prairie Capital.*** A seller should consider seeking to include in the agreement a statement of the parties' intention that the fraud carve-out in the exclusive remedy provision affects only the remedy that is available if a fraud claim otherwise can be made and does *not* expand the basis on which a fraud claim can be made—in other words, consistent with how the court interpreted the fraud carve-out in *Prairie Capital*, that the carve-out is intended to eliminate indemnification as the exclusive remedy for a fraud claim but does *not* override the non-reliance provision's bar to extra-contractual fraud claims.
- **Other agreement 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 (as alleged in *Prairie Capital*) was "duped" into agreeing to a transaction based on 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 possibly negligently or even innocently made. Sellers seeking to mitigate the risk of post-closing fraud claims might consider (to the extent permissible under state law) seeking to (i) contractually limit the persons and entities against which any claims (including fraud claims) could be made, and (ii) provide for alternative arrangements for the payment of fees and expenses incurred in defending a fraud claim unless the buyer prevails in the litigation.
- **Representations and warranties insurance.** We note that the trend has been toward private equity sellers increasingly relying on representations and warranties insurance to cover their potential liability for breaches of representations and warranties. When R&W insurance is employed, a seller should seek to have the insurance coverage mirror to the extent possible the seller's indemnity obligations under the sale agreement. Importantly, sell-side insurance generally does not cover fraud claims, and the seller is required to certify to the insurance company that, to its knowledge, the representations and warranties set forth in the agreement are true and correct. A seller should keep in mind that any fraud claim by the insurance company would, of course, be unaffected by limitations on indemnification or fraud carve-outs set forth in the sale agreement.
- **Indemnification of portfolio company executives.** As the court discussed in *Prairie Capital,* the portfolio company officers through whom the portfolio company makes fraudulent misrepresentations can be held accountable for the company's fraud. 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 for this potential liability.

* * *

Authors:

Aviva F. Diamant

Christopher Ewan

David J. Greenwald

Robert C. Schwenkel

David L. Shaw

Peter L. Simmons

Steven J. Steinman

Gail Weinstein

This memorandum 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 memorandum, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

New York

Jeffrey Bagner	+1.212.859.8136	jeffrey.bagner@friedfrank.com
Abigail Pickering Bomba	+1.212.859.8622	abigail.bomba@friedfrank.com
Andrew J. Colosimo	+1.212.859.8868	andrew.colosimo@friedfrank.com
Aviva F. Diamant	+1.212.859.8185	aviva.diamant@friedfrank.com
Steven Epstein	+1.212.859.8964	steven.epstein@friedfrank.com
Christopher Ewan	+1.212.859.8875	christopher.ewan@friedfrank.com
Arthur Fleischer, Jr. *	+1.212.859.8120	arthur.fleischer@friedfrank.com
Peter S. Golden	+1.212.859.8112	peter.golden@friedfrank.com
David J. Greenwald	+1.212.859.8209	david.greenwald@friedfrank.com
Mark Lucas	+1.212.859.8268	mark.lucas@friedfrank.com
Tiffany Pollard	+1.212.859.8231	tiffany.pollard@friedfrank.com
Philip Richter	+1.212.859.8763	philip.richter@friedfrank.com
Steven G. Scheinfeld	+1.212.859.8475	steven.scheinfeld@friedfrank.com
Robert C. Schwenkel	+1.212.859.8167	robert.schwenkel@friedfrank.com
David L. Shaw	+1.212.859.8803	david.shaw@friedfrank.com
Matthew V. Soran	+1.212.859.8462	matthew.soran@friedfrank.com
Steven J. Steinman	+1.212.859.8092	steven.steinman@friedfrank.com
Gail Weinstein *	+1.212.859.8031	gail.weinstein@friedfrank.com

Washington, D.C.

Jerald S. Howe, Jr.	+1.202.639.7080	jerry.howe@friedfrank.com
Brian T. Mangino	+1.202.639.7258	brian.mangino@friedfrank.com

* Senior Counsel