CORPORATE FINANCE/M&A - USA

Opinion provides guidance on interpretation of contractual provisions relating to fraud-based claims

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Introduction

On November 24 2015 Vice Chancellor Laster issued an informative opinion on a motion to dismiss allegations of fraud under Delaware law in *Prairie Capital v Incline Equity Partners*.(1)

The case involved a sponsor-to-sponsor sale of Prairie Capital's portfolio company Double E Company to Incline Equity Partners. Incline alleged that the chief executive officer and chief financial officer of the company (with Prairie Capital's knowledge and approval) committed fraud by fabricating sales to achieve certain financial targets that Incline required to close the acquisition. Incline also made an indemnification claim and sought to recover $500,000 held in escrow for indemnification obligations. Although the vice chancellor's opinion was made only on a motion to dismiss, the opinion provides useful guidance for drafting and negotiating fraud provisions and serves as an important reminder of the importance for buyers and sellers to clearly define the scope of potential fraud-based claims.

Decision

The key takeaways from the opinion are as follows:

- Extra-contractual representations – there are no magic words when it comes to clearly establishing non-reliance. The purchase agreement had an exclusive representations and warranties clause (stating that the buyer disclaimed any representations and warranties outside the agreement) and an integration clause, but did not have a non-reliance clause (ie, that the buyer has not relied on any representations outside of the agreement). The vice chancellor found that the combination of the exclusivity and integration clauses created a "clear anti-reliance clause" (even in the absence of a non-reliance clause) and he noted that "[t]ransaction planners can limit their risk by using tested formulations, but they do not need to employ magic words". As a result of determining that an anti-reliance clause existed, the vice chancellor dismissed any extra-contractual claims based on fraudulent misrepresentations.
- Extra-contractual omissions – exclusive representation provisions could bar claims for fraudulent omissions or concealments beyond the four corners of the contract. Incline argued that the exclusive representation provision should not bar claims for fraudulent omissions or concealments outside of the contract. The vice chancellor, however, noting how a misrepresentation claim can easily be flipped into an omission claim, held that a valid disclaimer of extra-contractual representations will also bar claims of extra-contractual omissions. The vice chancellor noted that this holding may conflict with *TransDigm Inc v Alcoa Global Fasteners, Inc*(2) "[t]o the extent that *TransDigm* suggests that an agreement must use a magic word like 'omissions'". Given that this may not be settled law, practitioners should consider still using the word 'omissions' or other language that clearly indicates that the seller is not making "any representation as to the accuracy or completeness" of the

information provided.

- Exclusive remedies – courts will likely read provisions relating to fraud taken as a whole. Incline also argued that the exclusion of fraud in the indemnification provisions' exclusive remedies provision should permit it to make an extra-contractual fraud claim. However, the vice chancellor determined that the exclusion of fraud meant only that the indemnification provisions are not the exclusive remedy in respect of fraud, but did not expand the universe of claims for fraud that can be made – in other words, he found that fraud claims were preserved, but could be based only on the representations and warranties in the agreement, because Incline had waived reliance (an essential element of a fraud claim) on anything outside the agreement.
- Claims against non-parties (directors, officers and controlling sponsor) – directors' and officers' and secondary liability claims with a basis in fraud are possible. Prairie and the officers of the company argued that they should not be liable because the representations in the agreement were made by the company and not by the officers or Prairie, but at the motion to dismiss stage the vice chancellor rejected this argument and permitted Incline to continue to pursue:
  - the fraud claims against the officers of the company based on the company's representations and warranties because an "officer actively participating in the fraud cannot escape personal liability on the ground that the officer was acting for the corporation"; and
  - the secondary liability claims (eg, aiding and abetting) against Prairie due to Prairie's involvement in the sale process and knowledge of the fraudulent behaviour.

As a result, the claims for fraud based on representations and warranties in the agreement itself and certain contractual claims for indemnification were permitted to proceed past the motion to dismiss stage of litigation.

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Endnotes

(1) *Prairie Capital III, LP v Double E Holding Corp*, CA No 10127-VCL (Del Ch November 24 2015).

(2) Del Ch May 29 2013.

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