

# Private Company Deal Alert: Fraud Disclaimers, “Threatened” Claims and Sandbagging in Delaware

## Client Alert

01.20.2016

In the last quarter of 2015, the Delaware courts issued three opinions and one oral ruling of importance to practitioners advising on private company transactions. Two of the opinions provide insight into the treatment of fraud claims in the acquisition context under Delaware law, especially the element of reliance, and how to successfully disclaim reliance on representations outside the acquisition agreement. The most recent opinion provides guidance on the meaning of “threatened” claims, a concept used in many indemnity provisions. Finally, the oral transcript ruling confirms the permissibility of “sandbagging” under Delaware law.

### *TRUEBLUE, INC. V. LEEDS EQUITY PARTNERS IV, LP: FAILURE TO ELIMINATE EXTRA-CONTRACTUAL FRAUD CLAIMS*

*TrueBlue* is a recent case out of the Complex Commercial Litigation Division of the Delaware Superior Court. That Court has, in recent years, decided a number of cases important to practitioners involved in private company deals. The *TrueBlue* case is a good reminder that, if parties want to limit fraud claims, they should include a clear anti-reliance provision in their acquisition agreement and be very careful concerning the scope of any fraud exception. The Court emphasized the importance of an “explicit and unambiguous” anti-reliance provision to cut off fraud claims based on extra-contractual representations. Fraud claims were found *not* to be cut off by the combination of a standard integration clause and a no-extra-contractual representations provision in which the buyer “acknowledge[d] and agree[d]” that the contractual representations superseded any other representations. The contractual provisions, the Court held, could not overcome plaintiff’s justifiable reliance on the extra-contractual misrepresentations at issue in the case.

The Court also found that a “fraud exception” provision stating that nothing in the contract would limit a claim for “actual fraud” was also enough to preserve extra-contractual fraud claims (and citing dicta in *Airborne v. SquidSoap* for the notion that drafters ought to specify whether the fraud claims they mean to preserve are based on the contract or are extra-contractual).

---

## Private Company Deal Alert: Fraud Disclaimers, “Threatened” Claims and Sandbagging in Delaware

---

### *PRAIRIE CAPITAL III, L.P. V. DOUBLE E HOLDING CORP.: ELIMINATION OF EXTRA-CONTRACTUAL FRAUD CLAIMS*

In *Prairie*, the Court of Chancery further refined some of the recent Delaware law regarding the viability of claims for fraudulent, extra-contractual misrepresentations under various provisions found in many acquisition agreements. Specifically, the Court offered guidance on the type of provision that will be effective to disclaim reliance on extra-contractual representations and on the interplay between a fraud carve-out in an exclusive remedy provision and the anti-reliance provision.

The dispute arose out of the sale by Prairie Capital Partners (the “seller”) of one of its portfolio companies to Incline Equity Partners, III, L.P. (the “buyer”) pursuant to a stock purchase agreement (the “SPA”). The seller brought suit against the buyer to compel the release of escrowed funds; the buyer filed counterclaims against the seller and certain directors and officers of the target company, including claims of fraud related to the target’s alleged falsification of invoices to inflate sales in the month before the closing of the sale. The fraud claims arose out of extra-contractual representations and omissions as well as specific representations in the SPA.

With regard to the seller’s motion to dismiss the fraud claims, the Court first found that the SPA’s “Exclusive Representations” and “Integration” clauses, in combination, foreclosed claims of fraud based on extra contractual misrepresentations. The buyer, relying on *Anvil Holding Corp. v. Iron Acquisition Company*, argued that the Exclusive Representations clause was insufficient to preclude justifiable reliance on extra-contractual representations because the buyer did not *affirmatively* disclaim reliance on representations made outside the SPA. The Court dismissed this argument, noting that it did not read *Anvil* as requiring a “specific formula” or the use of the words “disclaim reliance.” The Court did not find it problematic that the Exclusive Representations clause was an affirmative statement that the buyer was only relying on the representations and warranties in the SPA (as opposed to a statement that the buyer was not relying on representations made outside the SPA): “If a party represents that it only relied on particular information, then that statement establishes the universe of information on which that party relied. Delaware law does not require magic words.”

With respect to the fraud carve-out to the exclusive remedy provision, the Court noted that while such a carve out allows the parties to pursue remedies outside the SPA’s indemnification framework when claiming fraud, it does not expand the universe of representations on which a party can base its fraud claim. The Court held that the universe of representations is set by the Exclusive Representations provision.

---

## Private Company Deal Alert: Fraud Disclaimers, “Threatened” Claims and Sandbagging in Delaware

---

Finally, the Court allowed certain fraud claims based on representations made in the SPA to survive the motion to dismiss, finding that the buyer adequately pleaded that the representations were false when they were made. The Court noted that even though the allegedly false representations in the SPA were made by the target company, the defendants - the private equity firm seller and individual directors and officers of the target - could be held accountable for such alleged misrepresentations.

### *REXAM INC. V BERRY PLASTICS CORP.: HIGH STANDARD FOR “THREATENED” CLAIMS*

The concept of “threatened” claims is critical in many indemnity regimes (for example, for purposes of releasing escrows at the end of the survival periods where the contract may allow release to be delayed if there are any actual or threatened claims). Historically, Delaware did not have much case law addressing the issue. In light of the *Berry Plastics* letter ruling, practitioners should be aware that Delaware law will require a strong showing of present intent to file a lawsuit before finding that a claim has been “threatened.”

In this letter ruling, the Court of Chancery interpreted the meaning of “threatened” for purposes of determining whether one party was excused from performing its contractual obligations. The issue arose out of an equity purchase agreement that contemplated the transfer of certain pension liabilities to the buyer. When PBGC, an administrative agency with ERISA oversight responsibility, raised issues about the transfer prior to closing of the sale, the parties worked out an agreement that would permit the buyer to elect to have the seller retain the pension liabilities if there was a “threatened legal or administrative action” with respect to the liabilities within six months of closing. PBGC sent a letter to the parties, one week after closing, advising: “While PBGC does not plan to initiate legal action against the [seller] at this time, we have not yet decided whether we will pursue this matter through the IRS and/or professional actuarial organizations.” The buyer took the position that the PBGC letter threatened legal action and relieved it from its obligation to take the pension liabilities. The Court disagreed and, relying on the 2014 *i/mx* decision of the Court of Chancery that also construed the term “threatened,” held that the letter reserved PBGC’s options but did not demonstrate any present intent to “press the issue.” The Court found that the letter did not constitute a threat and did not “suggest that [PBGC] would likely pursue the matter.”

### *NASDI HOLDINGS, LLC, ET AL. V. NORTH AMERICAN LEASING, INC., ET AL.: “SANDBAGGING” IN DELAWARE*

In this oral ruling, the Court of Chancery confirmed that Delaware is “what is affectionately known as a ‘sandbagging’ state,” i.e., a state that permits a contracting party to sue for breach of a representation notwithstanding the party’s knowledge that the representation was not true prior to closing. In certain jurisdictions, a breach of contract claim requires a showing of justifiable reliance on

## **Private Company Deal Alert: Fraud Disclaimers, “Threatened” Claims and Sandbagging in Delaware**

---

the representation to recover for its breach. There are a handful of cases that could be read to suggest that such a showing might be required in Delaware. Given Delaware’s general emphasis on freedom of contract, however, the Court’s guidance in *NASDI* should not be surprising to practitioners. In *NASDI*, the Court declined to dismiss a buyer’s counterclaim for fraudulent inducement, finding the allegations sufficient to support the buyer’s claim. The Court found that the fact that the buyer conducted due diligence did not foreclose its ability to bring a fraud claim. The Court instructed that “if you have allocated risk through representations and warranties, the fact that you may do due diligence doesn’t contravene the allocation of risk. We have the contract control, as opposed to a loose sense of what people may have known or not known, depending on the due diligence they conducted.”

*Copyright © Morris, Nichols, Arsh & Tunnell LLP. These materials have been prepared solely for informational and educational purposes, do not create an attorney-client relationship with the author(s) or Morris, Nichols, Arsh & Tunnell LLP, and should not be used as a substitute for legal counseling in specific situations. These materials reflect only the personal views of the author(s) and are not necessarily the views of Morris, Nichols, Arsh & Tunnell LLP or its clients.*

### **PRACTICE AREAS**

Corporate Counseling

