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PERSPECTIVE

## Fake shipments test acquisition agreement

By Marc Boiron

In *Prairie Capital III, L.P. v. Double E Holding Corp.*, the Delaware Court of Chancery analyzed several clauses that commonly are included in acquisition agreements among private companies. The court gave practical guidance on the effects of a disclaimer of reliance provision in a stock purchase agreement on claims based on extra-contractual statements and omissions.

After months of seeking and negotiating with bidders to purchase Double E Parent LLC, a portfolio company of Prairie Capital Partners, private equity funds sponsored by Prairie Capital, received an offer in February 2012, from Incline Equity Partners to purchase all of Double E's stock for \$26.5 million. Incline made its offer contingent upon Double E meeting its monthly sales targets through the closing of the transaction, which was scheduled for the end of March 2012.

In mid-March, Double E was not on track to meet its sales target for the month. To reassure Incline that Double E would meet its target, Double E provided Incline with shipment forecasts showing that sufficient product would be shipped by the end of the month to meet its sales target.

Double E's management had informed Incline that, in accordance with GAAP, revenue was recognized from pending orders only after Double E manufactured and shipped the product and billed the customer for it. To meet the March sales target, Double E's employees were told to review the order pipeline and to manufacture and ship items that could be shipped in March. Moreover, Double E's employees generated and backdated false shipment entries to make it appear as if certain products had shipped and then produced false invoices and booked revenue in Double E's accounts receivable. The employees' actions resulted in approximately \$650,000 of fabricated sales.

In reliance on Double E's fabricated information, Incline signed the stock purchase agreement on April 4,

2012, and purchased all of Double E's stock for \$27 million.

The stock purchase agreement contained standard representations and warranties regarding the absence of any changes outside of the ordinary course of business, accounts receivable, financial statements and undisclosed liabilities and compliance with laws. In addition, the stock purchase agreement contained an independent investigation provision, which stated, in part: "In making its determination to proceed with the Transaction, the Buyer has relied on (a) the results of its own independent investigation and (b) the representations and warranties of the Double E Parties expressly and specifically set forth in this Agreement, including the Schedules." The same provision stated that the representations and warranties in the stock purchase agreement were the sole and exclusive representations and warranties made to Incline in connection with the transaction. A customary integration clause also was included in the stock purchase agreement.

In connection with a suit filed by the sellers' representative to compel the release of funds from an escrow account established as part of the transaction, Incline intervened and asserted several claims, including, among others, fraud against Prairie Capital and Double E's management based on extra-contractual statements and omissions and specific representations in the stock purchase agreement. The court granted the defendants' motion to dismiss the fraud claim as it related to extra-contractual statements and omissions, but denied it as related to most of the specific representations in the stock purchase agreement.

With respect to Incline's allegations of fraud based on extra-contractual misrepresentations, the court concluded that the independent investigation and integration clauses of the stock purchase agreement barred fraud claims based on extra-contractual misrepresentations. Incline argued that the independent investigation provision failed to expressly disclaim reliance as required under Delaware prece-

dent. The court rejected the argument, finding that the provision represented Incline's reliance only upon the representations and warranties in the stock purchase agreement. The court noted that "Delaware law does not require magic words." When the independent investigation and integration clauses were combined, they created a clear anti-reliance clause.

The court also rejected Incline's argument that the independent investigation provision did not bar fraud claims based on extra-contractual omissions. The court explained that, in an arm's length negotiation, the seller has no affirmative duty to disclose information. Therefore, the seller's affirmative duty to disclose information arises only out of representations it makes. Where an agreement limits the scope of information on which the buyer may rely to representations in the agreement, the buyer cannot argue that the seller is liable for fraud because it failed to provide extra-contractual information.

Incline relied on *Transdigm Inc. v. Alcoa Global Fasteners, Inc.* to support its argument that Double E would have needed to specifically disclaim extra-contractual omissions in the stock purchase agreement to avoid a claim of fraud based on extra-contractual omissions. *Transdigm* held that a fraud claim existed based on extra-contractual omissions because the buyer failed to disclaim such omissions. Here, the court disagreed with the holding in *Transdigm* because a "magic word like 'omissions'" is not required, and the independent investigation provision was extended to extra-contractual omissions.

The court analyzed Incline's various arguments based on the representations contained in the stock purchase agreement. The court concluded that Incline sufficiently pled that Double E made false representations in the absence of changes outside of the ordinary course of business and accounts receivable representations and certain financial statement representations but that claims based on other financial statement representations and on the

compliance with laws representations were insufficient to plead that they were false.

After finding that Double E knew it had made false statements with respect to the specific representations in the stock purchase agreement and that Incline reasonably relied on Double E's false representations and suffered causally related damages, the court denied Double E's motion to dismiss as to the fraud claim based on those representations.

The court's analysis in *Prairie Capital* is informative for planning private acquisitions in several respects. First, a provision in an acquisition agreement that identifies specific information on which a party has relied and forecloses reliance on other information is enforceable under Delaware law, even if the provision does not use the phrase "disclaim reliance." Nonetheless, relying on a formulation of a reliance disclaimer that Delaware courts have upheld is prudent practice. Second, a reliance disclaimer under Delaware law that does not specifically reference extra-contractual omissions may successfully disclaim reliance on extra-contractual omissions. However, in light of *Transdigm*, best practice is to specify that a reliance disclaimer applies both to express representations and to omissions of the seller. Lastly, a buyer's due diligence requests should be broad. Although a seller has no obligation to provide information that is not requested, if the information is requested and the seller does not provide it, then a fraud claim may arise. A seller that receives a broad due diligence request either should explicitly refuse to provide information that it does not desire to provide or provide full and candid information.

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