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Post-Closing Liability Risks For Private Equity Firms

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Law360, New York (April 27, 2017, 12:04 PM EDT) --
Private equity firms selling portfolio companies engage in thoughtful — and sometimes contentious — negotiations to limit their post-closing liabilities. PE firms attempt to do this by employing one or more of the following: (1) making a holding company be the "seller," (2) having the holding company provide the substantive representations and warranties, (3) contractually setting a cap on liability, (4) requiring the buyer to disclaim reliance on extracontractual representations (whether or not made fraudulently), and (5) attempting to limit liability against third parties (such as employees of the PE fund or advisory company). But despite these and other protections, a seller's post-closing liability can be unknown and, more troubling, the PE firm can have direct liability. We look at one example — fraud-in-the-inducement claims — through the lens of the Delaware Superior Court's recent decision in ITW Global Investments Inc. v. American Industrial Partners Capital Fund IV LP, C.A. No. N14C-10-236 (Del. Super. Ct. March 6, 2017).[1]

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Facts Viewed From the Perspective of the Buyer

In this case, the buyer brought a fraud-in-the-inducement claim against the PE seller. Because the seller was trying to dismiss the claim on summary judgment without a trial, the court (as it does here) will look at any disputed facts in the light most favorable to the nonmoving party (here, the buyer). This standard puts a seller facing a fraudulent inducement claim at a disadvantage because it may be easy to create disputed facts.

The story behind the deal begins in 2011 when PE firm American Industrial Capital and its affiliates wanted to sell Brooks Instrument, one of the fund's portfolio companies. On Oct. 28, 2011, the buyer submitted an offer for $500 million. At the time of the offer, the target was expected to earn $13.5 million in revenue for October 2011 and $49 million in combined revenue for October, November and December. However, shortly thereafter, the PE seller learned that the target would not reach the October target.

During negotiations, the PE seller asserted that the October miss was the result of timing issues and reaffirmed the projection for the quarter by increasing the projections for November and December. However, post-closing, the buyer alleged that the target reached those increased projections because of “sham sales” to another portfolio company of the PE firm. According to the buyer’s allegations, there was a verbal understanding that the portfolio company could return the product and extend payment terms — facts that should have prevented Brooks from recognizing the associated revenue.

After receiving the November financial statements, buyer and seller entered into a purchase agreement on Dec. 13, 2011. The deal was for $425 million with a $75 million earnout.

First Dispute: Working Capital

After closing, the buyer proposed some changes to the working capital adjustment as a result of the alleged “sham sales.” The parties settled on a final adjustment with the seller paying the buyer $2,495,000. The parties executed a full release of claims related to the purchase price adjustment and agreed not to sue or bring any action against any other party relating to the released claims, “including, without limitation, pursuant to Article VIII of the Agreement.” Article VIII is the indemnification provision, which also had a fraud carveout.

The parties argued over whether the release covered the fraud-in-the-inducement claim. Ultimately, the court narrowly construed the release and concluded that it did not cover the fraud-in-the-inducement claim. The court interpreted the reference to the indemnification section as a reference to indemnification with respect to the working capital adjustment.

Limiting the Claims to the Four Corners of the Purchase Agreement

Delaware law distinguishes between representations made outside the purchase agreement (often called “extracontractual representations”) and those made within the purchase agreement. If a purchase agreement has a nonreliance clause (including an integration clause), then a buyer will not have a valid claim against the seller for misrepresentation of extracontractual representations. In the case at issue, the court found that the purchase agreement had an enforceable nonreliance clause.[2] Consequently, in order to successfully defeat the seller’s motion for summary judgment, the buyer had to point to intentional false statements of the representations in the purchase agreement itself.[3]

The buyer sought to do this in several ways. First, the buyer pointed to the material contracts representation that required a listing of each material contract to which Brooks was a party. The relevant clause provided for the listing of:

(viii) a Contract involving the obligation of [Brooks] to deliver products or services for payment in excess of $250,000 [...], other than sales orders entered into in the ordinary course of business.

Second, the buyer pointed to the representation that the financial statements for October and November had been prepared in accordance with generally accepted accounting principles (GAAP).

Although the seller had arguments that these were not misrepresentations because the contracts were entered in the ordinary course of business or that the financial statements did meet GAAP standards, the court found that there were genuine issues of material fact on these points and thus summary judgment was not appropriate.

Alleging “Knowledge” of the PE Firm

The key issue in the case was whether there were sufficient facts in dispute concerning the PE firm’s knowledge of the falsehood. In order for the PE firm (or other corporate parent) to be liable for the misrepresentations of its portfolio company, the buyer must show that the PE firm knew that the representations in the purchase agreement were false. In this regard, PE firms are at a disadvantage because courts may assume for the purposes of summary judgment that the close contact between the PE firm and the portfolio company means that the PE firm knows what is going on. For example, the court cites a precedent that references "numerous conference calls," "numerous revisions [to the management presentation]" and the fund being so involved that one or both partners "flew out to the Company's headquarters to rehearse the management presentation ..." While these actions sound like prudent management to a private equity participant, they will be viewed differently in hindsight once allegations of fraud are present and may be sufficient to create a disputed issue of fact.

Of particular focus in this litigation was the impact of the officer's certificate. A condition to closing was that the seller's representations be "brought down" to the closing date. The buyer argued that the presence of an officer's certificate distinguishes other precedent and makes the knowledge requirement inapplicable. However, the court rejected that argument and concluded that the buyer would have to prove that the PE fund knew of the misrepresentations.

The court cites "a wealth of circumstantial evidence relating to knowledge," such as the number communications between the directors of the target and the PE firm, the officer's certificate, the transactions with another portfolio company of the PE firm, and the PE firm's motive and opportunity to misrepresent facts. And as is often the case, the buyer was able to point to emails obtained in discovery that the buyer argues shows that the PE firm had knowledge of the misrepresentations. Ultimately, based on the facts viewed in the light most favorable to the plaintiffs, the court denied the PE firm's motion to dismiss.

Takeaways

Below are some lessons from the case. Of course, each negotiation is different and it may not be possible to adopt all of these suggestions in a given transaction, but we propose them as items to consider as a starting place. We begin with some lessons for PE sellers:

- ***Sell-Side Representations*** — Ideally, the PE firm would not give any representations. This can be accomplished by adding an extra holding company if necessary. But if the PE firm must make representations, the PE firm can try to break the sell-side representations into two categories — representations made by the seller (solely with respect to the seller itself) and representations made by the target. The objective would be that only the target would make the financial and operational representations. Although the seller can still be liable for the target's misrepresentations, by not making the representations directly, the buyer must prove the seller knew the representations were inaccurate (as opposed to the lower standard of reckless indifference, which would be applicable if the representations were made by the seller).

- ***Officer's Certificates*** — While customary, consider not providing for the delivery of "bring-down" officer's certificates if preparing the first draft of the purchase agreement. If the buyer requests an officer's certificate, try to get it signed by an individual who is not an employee of the PE firm. An officer's certificate signed by a representative of the PE firm is one factor that a court will consider to support a showing of knowledge. As mentioned above, consider adding a new holding company if necessary so that target management can sign one officer's certificate.

- ***Ordinary Course Carveout*** — Be cautious about relying on an ordinary course of business exception to avoid disclosing a contract. Ordinary course will be judged in hindsight.

- ***Working Capital Adjustments*** — Try to insert a provision that any adjustment the buyer proposes (or could have proposed) for the working capital adjustment cannot be raised later as an indemnification claim or otherwise. In this case, the purchase agreement did eliminate subsequent indemnification to the extent of a liability included in the closing working capital, but this formulation still gives the buyer a second bite at the apple if the buyer does not succeed with its argument at the working capital adjustment stage.

- ***Disclosure*** — Consider disclosing more rather than less. If the seller had disclosed details around the affiliate transactions, the buyer would not have had a fraud claim. We recognize, however, that there is a practical limit to what can be disclosed, and it may be difficult to achieve the appropriate balance in the midst of a difficult transaction.

And lessons for buyers:

- ***Affiliate Transactions*** — If the seller discloses an affiliate transaction pursuant to the "affiliate transaction" representation, push the seller to make representations regarding the terms of the sale (or include them in the material contracts representation). While the opinion did not address the affiliate transaction representation, a slide presented during oral arguments shows that the affiliate transaction schedule discussed price, but did not discuss any of the other terms.

- ***Ordinary Course Carveout* —** Consider defining "ordinary course of business" or, if that is not possible, qualifying the term with "consistent with past practice." In litigation, sellers take an expansive view of the term.

Conclusion

Even though PE funds generally do not make business or operational representations in purchase agreements, disgruntled buyers can try to tag the PE fund with liability. PE funds are particularly susceptible because of their deep pockets and because their business model involves a close working relationship with their portfolio companies. A PE fund can better protect itself by attempting to eliminate liability for all extracontractual representations (which Delaware permits) and by attempting to avoid any of its representatives from delivering a "bring-down" officer's certificate at closing. However, in the end, the PE fund may be liable for fraudulent inducement if the buyer can show that the PE fund knew a representation in the purchase agreement was false, so it is in the PE fund's best interest to make sure it does not know of any inaccuracies in the representations contained in the purchase agreement.

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[1] Facts have been simplified for ease of discussion.

[2] See ITW Glob. Invs. Inc. v. Am. Indus. Partners Capital Fund IV LP, C.A. No. N14C-10-236 (Del. Super. Ct. June 24, 2015).

[3] The purchase agreement also had a fraud carveout. However, because the decision does not turn on that carveout, we do not discuss it in this article.
