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[CHRISTOPHER CHUFF]

Hey everyone. My name is Chris Chuff. I'm a Partner in Troutman Pepper's Business Litigation Group. I specialize in complex corporate and commercial litigation, particularly in the Delaware Court of Chancery. I'm joined today by Taylor Bartholomew, an M&A corporate attorney from Troutman Pepper. Taylor, who also sits in Delaware, represents clients in a wide variety of public and private transactions, including, as relevant today, private equity deals. He also specializes in counseling clients in matters of Delaware corporate governance law. Last podcast, we talked about the drafting considerations that crop up in operating agreements of private equity portfolio companies and today we're gonna dive into drafting considerations in PE acquisitions, particularly the provisions in which parties can address fraud claims. Why don't you start out by kind of outlining the type of provisions that can be used to address fraud claims.

[TAYLOR BARTHOLOMEW]

Absolutely. So, as you know Chris, Delaware has a very well-developed body of case law around fraud, right. So, everybody knows what they're getting into. Sophisticated parties can contract for certain treatment in the acquisition agreement in respect of fraud. So, couple of things to keep in mind. So, in Delaware, fraud can include the, actually does under common law, include concepts of both intentional conduct and reckless conduct, right. So, in Delaware, the famous case on point is the *ABRY Partners* case. Right. And it says that fraud can actually be negotiated down to intentional fraud. In other words, what most practitioners call true fraud. And I'm using air quotes here. So, true fraud, right, is intentional fraud. It's not something I should have known or it's something I actually meant to defraud someone when I was making representations and warranties in the acquisition agreement, right. So that's a commonly used sell-side tactic to limit the universe of fraud claims. And I would also say at this point in time, it's fairly market, it's fairly well-accepted. Most buyers don't push back on a negotiated of fraud. And, in fact, it is expected that the seller will get that.

[CHRIS CHUFF]

That's one component.

[TAYLOR BARTHOLOMEW]

That's the definition of fraud. And then the other big point is anti-reliance provisions. Those have been getting a lot of air time. They used to get a lot more, but I'd like to think we don't get so much these days because it's fairly well settled, right. So, an anti-reliance provision for our listeners here, what it does is it disclaims any kind of representations outside of the four corners of the purchase agreement, right. So, as practitioners, we're worried about things like

if I'm on the sell side, what did management say, right, in a management presentation, what did the bankers upload to the data room, right. Anything can really be used against you on the sell side as a representation, right. Even if it was an oral representation. And there are cases to that effect. So Delaware says look, we're sophisticated parties, right, around the table. This is a negotiated transaction so we're going to allow the parties to cabin the universe of fraud claims again by saying you can limit the universe of fraud claims to contractual fraud only, so we're not worrying about those management presentation, you know, those things that were said by management during that management presentation. We're not worried about that thing that seller said on a call, right. Or we're not worried about anything that was uploaded to the data room. We are saying, if you care about this representation, then you need to write it down in words and put it in the representations and warranties article in the acquisition agreement. So Delaware draws a line and says everyone can agree that lying is bad, right, but we're going to say like these are the things in the agreement that we're willing to make legal representations on. That's where Delaware draws the line. They say, contractual fraud can never be disclaimed, but extra-contractual fraud that can be limited.

[CHRIS CHUFF]

And this one, this one is one that has a big impact on any subsequent litigation because as you pointed out, if there's an effective anti-reliance provision, then a plaintiff can only assert a contractual fraud claim. That means a lie contained within the contract itself. And so, that's a very limited universe of statements that are highly negotiated and have usually a bunch of qualifying language and so there's a lot more hoops to jump through. Whereas, if extra-contractual fraud has not been waived, it completely opens up the entire litigation to, as you said, everything said during contract negotiations. Every single document, every single sentence in every single document that's in the data room, which is usually gigs of data. Everything in management presentations. And so it's just, it exponentially increases the amount of statements that can be used against a company in connection with an acquisition. So this one is a really important one, particularly for the sellers. Now, does it make sense, Taylor, for a buyer to also negotiate for an anti-reliance provision? If so, when?

[TAYLOR BARTHOLOMEW]

That's a great question. It's become increasingly more common for buyers to get sued for extra-contractual fraud in more complex transactions. So my take is, if you're doing a deal with a roll-over component or an earn-out, or both, then the buy side should be seeking at the outset and anti-reliance provision in their favor. And as a negotiating point, it would just be I'm willing to give sell side an anti-reliance provision and that benefit so I should get the same. And the reason is, why do I say in the context of a roll-over investment or an earn-out, it's because those have more of a potential to trigger discussions between the parties that talk about the value of the enterprise going forward. About whether the earn-out will be paid. About the value of the equity that they're receiving, right. Any upside in the future? How successful the platform will be. Ultimately, the more complex your transaction, the more of a potential there is to have liability for extra-contractual statements. On the flip side, if it's a more simple transaction, I always like to advise that if the only thing you're doing at closing is paying the purchase price, and repping that you have the authority to do the deal and that you are an entity organized under Delaware law, there's really no benefit to an anti-reliance provision.

[CHRIS CHUFF]

Yeah, agreed. Okay, so if you're a buyer, if you're looking at all cash deal, all cash at closing, no earn-out, no roll-over, you might want to try to negotiate for no anti-reliance provision on either side and at the end of the day, cause there's really not that much protection for buyer with such a provision because, you know, the buyers not really make much representations, they're just saying, I'll pay you this for your business. But where you have either maintaining roll-over equity or there's an earn-out, there's more of an incentive, more risk for the buyer and they should think about getting a mutual anti-reliance provision rather than a one-way.

[TAYLOR BARTHOLOMEW]

That's exactly right. And of course in actual practice, the difficulty can be responding to counsel on the other side who may not be necessarily keyed in to these concepts. So then it's always the interesting question of, well, I'm on the buy side, they're on the sell side, they haven't put in an anti-reliance provision, do I need to put in one, right? And I think that's really a discussion with your client as to the riskiness of not including one, right.

[CHRIS CHUFF]

Right.

[TAYLOR BARTHOLOMEW]

Generally speaking, and correct me if you think this is off base Chris, but I think generally speaking, it's always more risky for sell side to not have an anti-reliance provision, as opposed to the buy side going without one.

[CHRIS CHUFF]

So, I completely agree with that. And, you know, obviously generalities are dangerous and every situation is different but generally speaking, if I'm on the buy side and the sell side doesn't put an anti-reliance provision in, I'm probably staying silent on that because there's more risk to the seller than there is to the buyer. I think even probably in those complicated deals but that's a question. So I think I would stay silent. And then if the seller eventually raised, then I would probably insist on it being mutual but I agree there's a lot more risk for fraud claims typically against sellers than there is for buyers.

[TAYLOR BARTHOLOMEW]

And it's worth noting that, I mean, like I mentioned in the definition of fraud, an anti-reliance provision, especially on the sell side, very well accepted. Definitely a market approach. No party should really have hesitation over that. It's really, the reaction is always, if you think something is important, write it down in a representation and I'll tell you if I can make it. That's ultimately the response. If anybody ever has any hesitation on what an anti-reliance provision is, it's really just, I can't control what my employees say. I can't control what the banker says, so let's write it down and review it together and shake hands on it.

[CHRIS CHUFF]

Got it. Alright. So, we got, so far we have how to address fraud in acquisition agreements, the first thing is the definition of fraud and the big negotiating point is whether, one of the big negotiating points is, whether we're going to allow fraud claims based on recklessness only, or whether it has to be intentional. And then the second is whether an anti-reliance provision is gonna be included and whether it's mutual or one-way. Are there any other provisions that parties should be thinking about when address fraud claims?

[TAYLOR BARTHOLOMEW]

Absolutely. It actually, the first one that comes to mind is the anti-reliance provision itself. And to make sure that it's draft appropriately. What do I mean by that? I mean, often times I see drafts of acquisition agreements from say an auction context. Sell side serves up an auction draft. We look at it. We review and unfortunately for the seller, they have included an anti-reliance provision in the seller representations that says something to the effect of buyer is not relying on any representations other than these representations set forth in Article 3, or something like that. Delaware law has made it clear, as you are aware Chris as well, that the anti-reliance provision needs to be from the perspective of the aggrieved party for it to be effective. So in other words, in this context, the auction draft would have had to have a reciprocal anti-reliance provision in the buyers' reps that says the buyer is acknowledging that the seller is not making any representations outside of the four corners of this agreement for that to be effective. So, if you're on the sell side, just be aware that that anti-reliance provision has to actually be acknowledged by the buyer. It cannot just be the sell side saying this is my representation and I'm not making any other representations. That's not enough. It has to be from the other side.

[CHRIS CHUFF]

Right.

[TAYLOR BARTHOLOMEW]

That's very important.

[CHRIS CHUFF]

Yeah. So to put it in context, buyer brings fraud claim. If you have a statement in the contract that says seller is only making these reps and no others, that's not going to be enough to get rid of extra-contractual fraud claim. What you need is a statement that says something to the effect that buyer is only relying on the reps in this contract and no others. Because it has to be from the perspective of the aggrieved party. Did I get that right?

[TAYLOR BARTHOLOMEW]

That's exactly right.

[CHRIS CHUFF]

And then, any other drafting considerations regarding anti-reliance provisions? If not, what other provisions should be looking at to address fraud? Alright, anything else on anti-reliance?

[TAYLOR BARTHOLOMEW]

Not on anti-reliance but I did want to address one specific thing regarding who is making the reps in the purchase agreement. And this is really coming out of a recent case, I think from last year, that addressed fraud and specifically a walk-away deal construct. So, deal lawyers, for our listeners out there right, who aren't deal lawyers, know this argument very well. If I'm on the sell side, I will draft the acquisition agreement such that the company is a party and the company is making reps. Now, the obvious problem on the buy side to that argument, or to that drafting nuance, is that I am acquiring the company, right. So if the company is making the reps, then the argument is well, how do I pursue claims for fraud if the company is the one that is making the reps in the purchase agreement. And not, for instance, the sellers. So for years and years and years, parties have been arguing over who should make the reps, right. And it's always been viewed as the company makes the reps on the sell side, right. That's a sell side favorable position. And then if you're on the buy side, you change that to say the sellers and the company jointly and separately are making the reps. Or the sellers jointly and separately are making the reps. Again, under the theory that we're going to chase the sellers for fraud, right. Because they are the ones making the statement. Now, I alluded to the fact earlier that Chancery is very commercial, right. That's why Chancery is so good at what it does. So, in recent cases, Chancery has made it clear that it doesn't really matter who's making the reps, right. It doesn't matter what we say in the acquisition agreement because while Chancery will read that and interpret it, there is a rule regarding fraud, right. So the rule is if there's a member of management or a seller who's actively involved in the business and who actively participates in the making of the reps and the preparation of disclosure schedules, then ultimately, a buyer is going to be able to bring fraud claims against that party. Regardless of the fact that what the lead in to the article of the reps and warranties says.

[CHRIS CHUFF]

Got it. Now, if there is an anti-reliance provision, and you bring an extra-contractual fraud claim against the management, or is it still limited to solely to contractual fraud claims? Meaning fraud claims arising out of statements within the contract itself?

[TAYLOR BARTHOLOMEW]

Solely arising out of contractual representations and warranties.

[CHRIS CHUFF]

Right. So the anti-reliance provision bars the claims no matter who the defendants are and they have to go through a contractual fraud claim rather than an extra-contractual fraud claim. That is if there's an anti-reliance provision.

[TAYLOR BARTHOLOMEW]

Correct. And breaking it down. A simple, perhaps too simple example, if we had an acquisition agreement that said the company is making the reps and then we had a series of customary representations on the financial statements, post-closing it comes out that the sellers were cooking the books so to speak, the old argument would have been, well there's no liability for sellers, right, because they didn't make the representations about the financial statements being, you know, true, correct and complete in all respects. Now, it's very clear that we could pursue claims against the sellers for fraud for cooking the books. Because they actively participated in negotiating the reps, making the reps, preparing the disclosure schedules. And they've been actively involved in the business.

[CHRIS CHUFF]

Interesting. Okay. Alright, so we have the definition of fraud. We have anti-reliance provisions. We have the, you know, who is making the reps and non-recourse provisions. Any other provisions that typically address fraud, or are those the main ones?

[TAYLOR BARTHOLOMEW]

Actually, you bring up a great point with non-recourse provisions. So, typically on the buy side, when we represent private equity firms and their portfolio companies, we often put in the acquisition agreement a provision called a non-recourse provision. And what that provision says is that it's really only the parties to the agreement that can be on the hook for any kind of legal liability. And the point of it is to say, look, you can't really go all the way to the top, to the private equity fund or the firm itself because they're not actually party to the agreement. Delaware courts have repeatedly said that a non-recourse provision is completely ineffective to shield parties that participated in fraud from liability regardless of that ruling I constantly see drafts, and I'm probably guilty of it myself, of putting in non-recourse provisions. But practitioners should definitely know, for our listeners out there, that non-recourse provisions aren't really worth the paper that they're written on.

[CHRIS CHUF]

Got it. Okay. So, what I'm gathering here is that basically, in general terms, a party can contractually seek to modify its exposure to post-closing fraud claims by bargaining for limits on what information the buyer's relying up, through anti-reliance provisions. When the buyer may bring a claim, through survival provisions. Who among the sellers may be held liable, and then how much the buyer may recover if it proves its claim through caps, floors, and other damages limitations. But, all of that is limited by Delaware public policy preventing the elimination or limiting of intentional, contractual fraud claims. That is, an intentionally fraudulent statement about a provision within the contract itself, right. For those claims, you can't limit the when. The who, what, when, where and why. Is that right?

[TAYLOR BARTHOLOMEW]

That's exactly right. It boils down to there being a public policy against lying on paper, right. It's not, do your diligence and whoever bury the claim better, right, it wins the day. That's not what it is in Delaware. If we make contractual reps, we need to conduct the business by

those reps, right. We need to operate as if those reps are true because otherwise it's not worth anything. That's how Delaware goes.

[CHRIS CHUFF]

Right. Cause those are the fundamental underpinnings of the deal. I mean, that's literally what the parties agreed upon. And so, you can't get rid of, again, intentional lies about those things. So that covers everything on, kind of on my outline. We hit the fiduciary duty waivers, the exculpatory provisions, the indemnification provisions, how to address fraud in acquisition agreements. Is there anything that we didn't cover specific to PE deals that you think we ought to address?

[TAYLOR BARTHOLOMEW]

No. I think we've covered everything pretty comprehensively. So I just wanted to thank you for having me and thanks for the time.

[CHRIS CHUFF]

Absolutely. I also wanted to thank our listeners. And I hope you found our conversation insightful today as we progress further into 2022, consistently recognized as a top-tier national practice, Troutman Pepper's corporate attorneys regularly handle multi-million and multi-billion dollars transactions. The firm has particular expertise in the private equity and private funds services. We advise clients on matters from fund formation, to acquisitions, investment and exit transactions. For more information about Troutman Pepper and our Private Equity Group, please visit troutman.com.