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Private Equity Alert

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Avoiding Extra-Contractual Fraud Claims in Portfolio Company Sales Transactions — Is "Walk-Away" Deal Certainty Achievable for the Seller?

Glenn D. West (gdwest@weil.com)

The duties that parties owe to one another in a commercial transaction are not necessarily limited to those imposed by the written agreement purporting to govern that transaction. Indeed, in addition to any statutory law that may be applicable, there are generally two separate bodies of common law in the United States that govern all commercial interactions—the law of contract, which generally seeks to honor the justifiable expectations of the parties to a written agreement based on the language used in that agreement; and the law of torts, which generally seeks to hold parties responsible for the breach of certain recognized standards of conduct that everyone is expected to observe.

Commercial certainty that a closed sales transaction will not continue to be subject to liability claims after the distribution of transaction proceeds to limited partners is a basic tenet of private equity deal practice. As a result, whenever possible, private equity deal professionals and their counsel seek to clearly limit post-closing liability for contractual representations to a specified survival period and for a specified amount (i.e., by specific bargained-for liability caps). Sellers and buyers factor these limitations on recourse into the price being paid. But to the surprise of many deal professionals, these bargained-for contractual limitations on liability may only be held to apply to contract-based claims and not to extra-contractual tort claims based on alleged fraud or misrepresentation. It is vital for private equity deal professionals and their counsel, therefore, not only to understand the various extra-contractual tort claims that can arise in a commercial transaction independent of the actual contract (and even based on that contract), but also to appreciate the potential means and ability of contracting parties (depending on the applicable state law) to avoid some or all of these extra-contractual claims by specific disclaimers in the written agreement.

The "Contortion" of Contract and Tort

Many contractual disputes in the United States include both claims based on breach of contract, as well as tort claims based on fraud or misrepresentation. Fraud and misrepresentation claims arising from contractual disputes are frequently based not only on the representations that are actually set forth in the executed contract, but also on the disclosures or omissions that occur in the negotiations or diligence process leading up to the execution of that contract. When a claim is brought in tort based on a commercial relationship established pursuant to a written agreement, the resulting intersection of contract and tort law can truly become "contorted."[1] Not only are there potential differences between the duties imposed by contract versus tort law, the remedies provided for the breach of the duties imposed by these two divergent bodies of law are somewhat different too; in a breach of contract case the court generally seeks to provide the non-breaching party the benefit of the bargain made, while in a tort case the court seeks to put the aggrieved party in the place that party would have been but for the wrongful act and, in certain exceptional cases, to actually punish the wrongdoer by awarding punitive damages in excess of the actual damages that were incurred. Under the law of contract, why or even how a contract was breached is usually not the issue because contracting parties are generally free to breach a contract for almost any reason provided they are prepared to pay the damages resulting from that breach. In the law of torts, however, why or how things happened appears to take on more relevance. [2]

Deliberate Lying is not the only form of Fraud or Misrepresentation

The law of torts is most commonly understood as involving the duty to refrain from intentionally or negligently injuring another person through one's actions or failure to act; i.e., don't punch anyone in the face and use due care when driving your car. In commercial transactions, those basic concepts are generally and imprecisely translated into a commercial "honor code" of sorts: "just don't commit fraud, i.e., don't lie, cheat or steal." Tort claims arising from commercial transactions, however, are not always limited to intentional or knowing "lies."

For instance, depending on the applicable state law, "fraud" may be established without proving a deliberate lie; all that may be required is proof that a representation was made "recklessly" and it was "relied upon" by the other party. Under the law of some states, a representation not actually known to be false may be considered reckless and rise to the level of fraud if it "is made without any knowledge of its truth, or if the person making the representation knows that he or she does not have sufficient information or a basis to support it, or if the maker realizes he or she does not know whether or not the statement is true."[3] In other words, statements made by or on behalf of a contracting party without sufficient information or diligence to ascertain their truth may constitute "fraud." Moreover, if you have sufficient information to ascertain a statement's validity (and you believe it to be true), but it nevertheless turns out to be false, you may not be liable for fraud, but you still may be liable in many states for the tort of "negligent misrepresentation."

Even if you are careful to make no statements at all, in many states there is a duty to speak under certain circumstances. If you fail to do so, that failure can also constitute fraud. This duty to speak generally arises where there is a "special relationship" between the parties (generally fiduciary in nature) or where there is "special knowledge" on the part of one of the parties that "could not have been uncovered by reasonable investigation and inquiry" by the other party.[4] While these misrepresentation-related tort claims can certainly include deliberate deceit, they are, in fact, not so limited.

In addition, the law of agency may impose personal liability on the officers of contracting entities for their individual participation in these torts despite the fact that their actions were taken solely within the scope of their authority and entirely for the benefit of the applicable contracting entity.[5] This exposure to personal liability may include private equity deal professionals acting in the capacity as officers of contracting entities.

Even steadfast and faithful personal observance of a limited "no lying" honor code by deal professionals, therefore, cannot provide the commercial certainty private equity exit transactions require. This is so because merely observing this "honor code" does little to ensure that the contract alone will govern the obligations owed by the parties, that the contracting parties will be the only persons exposed to liability or, most important, that a claim that the code was violated, however meritless, will be summarily dismissed by the court, rather than being tried to a jury with the attendant costs and the risk of an unjustified conclusion that the code had been broken. Indeed, tort claims can be made, and parties subjected to litigation, based on circumstances falsely suggesting actual knowledge of the untruth of a representation (or the existence of a material undisclosed fact) by the individual deal professional, or by one of the members of the management of the transferred portfolio company. Furthermore, as previously discussed, misrepresentation-related tort claims can be based, in some states, on recklessness or negligence, rather than intentional falsehoods.

Contractually Avoiding Extra-Contractual Claims

While there is a strong policy in the United States favoring "freedom of contract," there is also a strong and sometimes conflicting policy against allowing that freedom to be used to diminish or waive the minimum standards of conduct imposed by the common law of torts. Indeed, because tort law duties and remedies are extra-contractual in nature, there is a common misperception (even among some lawyers) that there is little one can do contractually to avoid the automatic imposition of these extra-contractual obligations and liabilities in the case of "fraud."[6] However, many (but not all) states do allow sophisticated parties to clearly and unequivocally limit their obligations to each other as set forth in their written agreement, including effectively limiting their liability for most types of tort-based fraud and misrepresentation claims.[7] New York, Delaware and Texas, for example, broadly permit sophisticated parties to limit remedies for contractual breach and to contractually disclaim the existence of or reliance on extra-contractual representations and non-disclosures, thereby defeating an essential element of any tort-based fraud or misrepresentation claim that could be premised on those representations or non-disclosures.[8]

Because of the "contortion" created by the dual duties imposed by tort and contract law, the fact that fraud is a broader concept than merely not lying, and the reality that it is not uncommon for meritless fraud claims to be filed, observing the "no lying" honor code, while always a good practice, is simply not enough to protect you from post closing tort-based fraud and misrepresentation claims that might exceed the contractual liability caps.

On the other hand, disclaimers that are part of "form" agreements and "mere boilerplate," particularly in contracts with unsophisticated parties, are frequently not enforced even in states that are otherwise favorably inclined toward the enforcement of these provisions. Similarly, certain courts have recognized that the following situations may constitute non-disclaimable fraud: (1) where a seller has knowledge that could not be discovered by a buyer in its review of available information had the buyer elected to do so; or (2) where a seller has specifically and knowingly denied that requested information existed to thereby deprive a buyer of its ability to bargain for an opportunity to review that information (as opposed to a situation where the seller admits the information exists but refuses to provide the buyer access to that information and the buyer proceeds with the transaction anyway as part of the bargain made).[9] Other states are even more limited in their willingness to permit contractual provisions to effectively eliminate extra-contractual tort claims based on misrepresentations or omissions, even in the case of sophisticated parties and specifically bargained-for provisions.[10] Moreover, even those states that broadly permit disclaimers of extra-contractual representations and non-disclosures, sometimes permit fraud-based claims (with attendant tort-based remedies) to be premised upon the specific contractual representations that are set forth in the written contract that otherwise limits the remedies for breach of those representations to certain defined caps.[11]

Suggested Guidelines

In light of the potential contortion of contract and tort law and the limitations on contractual freedom imposed in some states, the following guidelines are suggested for private equity deal professionals to consider in negotiating purchase and sale agreements respecting an exit transaction:

- Remember that "fraud" can be a broader concept than deal custom may suggest. Accordingly, you should avoid agreeing to broadly exclude "fraud" from an exclusive remedy provision that limits claims under a contract to indemnification up to a specified dollar threshold. First, you may be inadvertently converting a breach of contract claim arising from a contractual representation into a tort claim. Second, depending on the jurisdiction, fraud may include actions that are less egregious than deliberate lying. Lastly, fraud claims may be lodged against you or your selling entity based on the actions of your officers and agents. If you want to exclude "lies" or willful and intentional breaches of representations from the indemnity cap do so, but make certain you know whose "lies" or willful and intentional breaches you are covering and seek to maintain the exclusivity of contractual, as opposed to tort-based, remedies for all breaches of those representations.

- Where there is more that one state's law that may properly be selected to govern your agreement, make sure your counsel selects the state with the most favorable "freedom of contract" approach to the effective elimination of tort claims by disclaimer in a written agreement.
- Having properly selected a favorable state's law to govern your agreement, make certain that the choice of law provision covers tort claims "arising from or related to" the agreement and is not limited to just the terms of the contract, as are most traditional choice of law clauses.[12]
- Because "reliance" is an essential element of tort-based fraud and misrepresentation claims, have the buyer clearly and unequivocally disclaim reliance upon any information provided or statements made outside the four corners of the written agreement. With respect to the representations that are set forth in the written agreement, make it clear that the buyer has not generally relied on those representations except for the limited purpose of the contractual indemnification specifically set forth in the agreement. In other words, don't allow the fact that the contractual representations are a carve-out from the disclaimer of reliance clause inadvertently convert a contract claim for breach of a contractual representation into a tort claim. After all, bargained-for contractual representations are merely contractual risk allocation devices among sophisticated parties, not sworn affidavits as to the facts represented. Indeed, contractual representations are actually just agreements to indemnify the buyer for losses that may be sustained if the representations turn out to be untrue.
- Provide the buyer with full access to all information necessary to diligence the portfolio company; and make sure that the buyer represents that it is satisfied with the access that has been granted and that the buyer has not been denied access to any information that it specifically requested.
- In exchange for assurance that the seller's liability is fixed by the terms of the contract, consider assuring the buyer that its ability to assert and collect when there is an actual breach of a bargained-for contractual representation will not be subject to "sandbagging" claims by the seller. If the bargain is to make the contract the only law governing the transaction, and thereby relieve the seller from the potential vagaries of tort law, it is only fair and consistent to remove those vagaries for the buyer as well—make it clear that no alleged knowledge of the potential inaccuracy of a contractual representation on the part of the buyer (and corresponding lack of "reliance" by the buyer) will relieve the seller from honoring its indemnity obligations as expressly limited by the agreement.
- Always include a "non-recourse" or "no personal liability" provision that provides that the named contracting entities are the only persons with any exposure for claims under or "arising from or related to the contract" (expressly including both tort and contract claims).[13]

The goal in private equity exit transactions is to contractually cap post closing exposure to a specified amount for a specified period and to avoid extra-contractual tort claims being made at all or, if they are made, having the best possibility for obtaining their dismissal prior to any trial on the facts before a jury. Because of the "contortion" created by the dual duties imposed by tort and contract law, the fact that fraud is a broader concept than merely not lying, and the reality that it is not uncommon for meritless fraud claims to be filed, observing the "no lying" honor code, while always a good practice, is simply not enough to protect you from post closing tort-based fraud and misrepresentation claims that might exceed the contractual liability caps. It is critical, therefore, that everything that can be contractually done within the constraints of applicable state law, be done to thereby avoid extra-contractual tort claims that can exceed the seller's bargained-for limits of liability.

As a result of the public policy limits on parties' contractual freedom imposed by the courts in certain states, it may not be possible to completely eliminate by contract all extra-contractual fraud and misrepresentation claims that might be lodged against you by a disappointed buyer. Observing these guidelines, however, can assist in evaluating the risks and assuring that as much contractual deal certainty as can be obtained is obtained.

1 The term "contort" has been used by the courts to describe claims that are based both on contract and tort law. *See, e.g., Erlich v. Menezes*, 21 Cal.4th 543, 551 (Cal. 1999); *Cass v. Stephens*, 156 S.W.3d 38, 68 (Tex. App.—El Paso 2004, pet. filed). The term was apparently first coined by Professor Grant Gilmore in his book The Death of Contract (1974).

2 *See generally* Michael Dorff, *Attaching Tort Claims to Contract Actions: An Economic Analysis of Contort*, 28 Seton Hall L. Rev. 390 (1997); Thomas C. Galligan, *Contortions along the Boundaries between Contracts and Torts*, 69 Tul. L. Rev. 457 (1994).

3 37 Am. Jur.2d Fraud and Deceit § 120 (2005).

4 *Cronus Offshore, Inc. v. Kerr McGee Oil & Gas Corp.*, 369 F. Supp. 2d 848, 858 (E.D. Tex. 2004), aff'd, 133 Fed. Appx. 944 (5th Cir. 2005); *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 872 A.2d 611, 629 (Del Ch. 2005); *Greenberg Taurig of N.Y., P.C. v. Moody*, 161 S.W.3d 56,

77-79 (Tex. App.—Houston [14th Dist.] 2005, no pet.) (applying New York law); *Chase Manhattan Bank v. New Hampshire Ins. Co.*, 749 N.Y.S.2d 632, 645 (N.Y. App. Div. 2002).

5 This concept of agency law and the guidelines for protecting yourself from personal exposure for these claims is the subject of a companion article in this *Alert*—"Protecting the Deal Professional from Personal Liability for Contract-Related Claims."

6 Part of the reason for this misperception is the assumption that in securities transactions (i.e., stock sales), non-reliance clauses will not preclude statutory securities fraud claims. This assumption, however, does not appear to be borne out by the case law. *See, e.g., Harsco Corp. v. Segui*, 91 F.3d 337, 343 (2d Cir. 1996); *see also* David K. Kutz, Note, *The Law and Economics of Securities Fraud: Section 29(A) and the Non-Reliance Clause*, 79 Chi-Kent. L. Rev. 803 (2004).

7 *See, e.g., Cerabio LLC v. Wright Med. Tech., Inc.*, 410 F.3d 981, 989-90 (7th Cir. 2005) (applying Wisconsin, Tennessee and Delaware law).

8 *See, e.g., Dannan Realty Corp v. Harris*, 157 N.E.2d 597 (N.Y. 1959); *Harsco Corp.*, 91 F.3d at 345; *Aetna Cas. & Sur. Co. v. Aniero Concrete Co., Inc.*, 404 F.3d 566, 584 (2d Cir. 2005) (applying New York law); *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171 (Tex. 1997); *Steinberg v. Brennan*, No. CIV. A. 3:03-CV-0562, 2005 WL 1837961 (N.D. Tex. July 29, 2005) (applying Texas law); *MBIA Ins. Corp. v. Royal Indem. Co.*, 426 F.3d 204 (3rd Cir. 2005) (applying Delaware law).

9 *See, e.g., DynCorp v. GTE Corp.*, 215 F. Supp. 2d 308, 319-23 (S.D.N.Y. 2002).

10 Massachusetts, for example, appears to permit disclaimers directed at negligent misrepresentations but not those directed at fraudulent misrepresentations. *Compare Bates v. Southgate*, 31 N.E.2d 551 (Mass. 1941) *with Sound Techniques, Inc. v. Hoffman*, 737 N.E.2d 920, 924 (Mass. App. Ct. 2000).

11 *See Abry Partners V, L.P. v. F&W Acquisition LLC*, No. CIV. A. 1756-N, 2006 WL 358236 (Del. Ch. Feb. 14, 2006) (creating a Delaware limited public policy exception to parties' contractual freedom to otherwise limit liability for breaches of contractual representations with respect to "deliberate lying," but declining to create such an exception with respect to any other type of misrepresentation); *Benchmark Elecs., Inc. v. J.M. Huber Corp.*, 343 F.3d 719 (5th Cir. 2003) (recognizing that Texas law, in contrast to New York law, may allow fraudulent inducement claims to be premised on the representations that are set forth in the contract). New York appears to have an aversion to allowing breach of contract claims to be converted into tort claims for any reason, but some cases have nevertheless held that misrepresentations of "present facts," as opposed to misrepresentations about future actions, can form the basis of a fraud claim, even if based solely on representations actually set forth in the contract. *See Great Earth Int'l Franchising Corp. v. Milks Dev.*, 311 F. Supp. 2d 419 (S.D.N.Y. 2004).

12 *See Hughes v. LaSalle Bank, N.A.*, No. 02 CIV. 6384 (MBM), 2006 WL 620654, at *8 (S.D.N.Y. March 13, 2006); *Benchmark Elecs., Inc.*, 343 F.3d at 726; *Kuehn v. Childrens Hosp., Los Angles*, 119 F.3d 1296, 1302 (7th Cir. 1997).

13 For examples of provisions addressing some of the issues identified in these guidelines see Glenn D. West & Sarah E. Stasny, *Corporations*, 58 SMU L. Rev., 719, 723-727(2005).

Protecting the Deal Professional from Personal Liability for Contract-Related Claims

Glenn D. West (gdwest@weil.com)

Private equity deal professionals should know the basic U.S. contract signing rule: "Always sign a contract or letter agreement only on behalf of the entity intended to be made a party and never individually." While this rule sounds fairly straight-forward, each year a surprising number of contract-related cases arise in which claims are made against individuals purportedly acting solely on behalf of limited liability entities. These cases arise in two circumstances: (1) direct contractual claims asserting that the individual signatory intended to be personally bound by the contract and was not signing merely in a representative capacity on behalf of the named limited liability entity;[1] and (2) extra-contractual claims alleging a misrepresentation regarding or a failure to disclose information respecting the subject matter of the contract.[2] Given the fact that private equity deal professionals inevitably serve as officers of numerous acquisition vehicles and portfolio companies, it is critical that the means of becoming exposed to personal liability in that capacity be fully understood and avoided.

Understanding Basic Agency Law

While nothing prevents a representative of a limited liability entity from adding her personal liability to a contract otherwise intended to reflect the obligation of that limited liability entity,[3] private equity deal professionals seldom deliberately do so. To understand how a private equity deal professional may nonetheless unintentionally become personally liable under such a contract requires some basic knowledge of agency law.

An officer or other representative of a limited liability entity is considered an agent of her "principal"—the limited liability entity. To avoid personal liability, the common law generally requires that an agent clearly disclose that she is acting in a representative capacity and to clearly identify the principal on whose behalf she is acting. If she fails to do so, the party with whom she is dealing is free to assume that the putative agent is actually acting on her own behalf.[4] For example, many deal professionals would be surprised to learn that the following signature line may only be deemed to identify who Sarah Deal Professional is, as opposed to clearly and unequivocally limiting the capacity in which she signed:

____

Sarah Deal Professional
President, Private Equity LLC.

Adding the word "as" in front of "President" and "solely on behalf of" in front of "Private Equity LLC" would be required to make the capacity in which she is signing clear. When signing letter agreements and closing certificates this nuance can sometimes be overlooked. The better approach is to consistently use the following formulation for all signatures on behalf of corporations or other limited liability entities:

Private Equity LLC
By: ____________
Name: Sarah Deal Professional
Title: President

Suggested Guidelines for Document Review and Execution to Avoid Direct Personal Liability on the Contract

Protecting yourself from unintended exposure to personal liability on contracts intended to be entered into solely on behalf of a limited liability entity, simply requires you to strictly follow these basic rules:

- Your representative capacity should be clearly set forth on the signature page of every contract, certificate or letter agreement you execute—that means listing only the name of the limited liability entity intended to be the actual party to the contract, with your signature, name and title only included after the express designation "by" immediately under the name of the limited liability entity.
- Personal pronouns, such as "we," "my" or "I," as well as the term "the undersigned" should be avoided in the operative contract, certificate or letter agreement, unless these terms are followed by language clearly designating on whose behalf the person or persons involved are acting. In other words, make sure that the only named party to the contract is expressly limited to the specific limited liability entity intended to be the sole obligor on whose behalf you are acting.
- Finally, we also suggest that the contract or letter agreement expressly include a "no personal liability" or "non-recourse" provision to hopefully provide an ultimate blocker to any creative claims that may be made against you personally by an unhappy counter-party looking for leverage.

Vigilantly observing these simple rules will help you avoid being named in or aid in you being promptly dismissed from a lawsuit based upon contractual obligations that were intended to be limited only to a particular entity.

Personal Liability for Fraud and Misrepresentation

Avoiding personal liability for extra-contractual claims requires even greater vigilance than protecting oneself from direct contractual claims. Merely because an agent is acting in a representative capacity on behalf of a disclosed principal does not relieve the agent of personal liability for the wrongful acts committed by the agent in the scope of that agency. That rule is fairly easy to appreciate when the wrongful act is an automobile accident resulting from an employee's (i.e., an agent's) negligence in driving a company car on company business. The common law recognizes that both the employee driver (agent) and the company employer (principal) are jointly and severally liable for the resulting damages caused—the employee because she owes a duty to the public to drive with due care and the principal because of the rule that generally requires the principal to answer for certain actions taken by the agent in the scope of the agency. When the alleged wrongful act is "negligent misrepresentation" or "fraud" arising out of the negotiation of a purchase and sale agreement, however, many deal professionals are surprised to learn that these same legal principals can impose personal liability on the officers of the limited liability entities that are the only contractually named parties to that purchase and sale agreement (without the need to "pierce the veil" or allege the limited liability entity was an "alter-ego" of an individual).[5]

"Negligent misrepresentation" and "fraud" are both extra-contractual claims that arise from a breach of duties imposed by the common law, as opposed to a breach of duties proscribed by contract. Both are considered "wrongful acts" and the fact that you are acting solely as a representative of a limited liability entity when an alleged misrepresentation is made by you concerning the company being sold

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by your seller entity (or when you are acting on behalf of the buyer, concerning the financing that is available to the buyer entity) will not relieve you of personal liability for any resulting damages arising from the other party's reliance on that misrepresentation.

Suggested Guidelines for Avoiding Personal Liability for Fraud and Misrepresentation

Many lawyers erroneously take the position that there is actually nothing contractual you can do to avoid extra-contractual "tort" claims, particularly those claims based on "fraud." This is not true in all states, nor as a general principle respecting all extra-contractual claims. As to individual representatives of the contracting entity, the way to maximize your chances of avoiding these claims is to insist that the contracting entity follow the suggested guidelines in our companion article in this Alert: "Avoiding Extra-Contractual Fraud Claims in Portfolio Company Sales Transactions—Is "Walk-Away" Deal Certainty Achievable for the Seller?"

Today's private equity deal professionals are required to be diligent in an increasing number of areas. Because plaintiffs will certainly seek out deep pockets when a transaction has gone bad, taking appropriate precautions to avoid personal liability should be no exception.

1 *See, e.g., Savoy Record Co. v. Cardinal Export Corp.*, 203 N.E.2d 206 (N.Y. 1964); Mencher v. Weiss, 114 N.E. 2d 177 (N.Y. 1953); *BBTOD, Inc. v. FTS Int'l, Inc.*, 807 NYS.2d 379 (N.Y. App. Div. 2005); *Taylor-Made Hose, Inc. v. Wilderson*, 21 S.W.3d 484 (Tex. App.—San Antonio 2000, pet denied).

2 *See, e.g., Ennis v. Loiseau*, 164 S.W.3d 698, 707-08 (Tex. App.—Austin 2005, no pet.); Epinosa v. Rand, 806 NYS.2d 186 (N.Y. App. Div. 2005); *Ray-Tek Servs., Inc. v. Parker*, 831 N.E.2d 948, 958 (Mass. App. Ct. 2005).

3 *See News Am. Mktg., Inc. v. Lepage Bakeries, Inc.*, 791 N.Y.S.2d 80, 82 (N.Y. App. Div. 2005); *Austin v. Dunnan & Strong*, 761 S.W.2d 115, 116 (Tex. App.—Houston [14th Dist.] 1998, no pet.).

4 For a more complete discussion of some of these legal principals and some recent cases involving corporate officers being exposed to personal liability as a result of the application of these principles *see* Glenn D. West, *Corporations*, 54 SMU L. Rev. 1221, 1231-1233 (2001); Glenn D. West and Brandy L. Treadway, *Corporations*, 55 SMU L. Rev. 803, 816-818 (2002); Glenn D. West and Adam D. Nelson, *Corporations*, 57 SMU L. Rev. 799, 802-809 (2004).

5 *See* West & Treadway, *supra* note 4, at 811-816.

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