

Contractual Fraud: ‘Too Much Dynamite’ Can Blow Enforceability

On August 12, 2021, Vice Chancellor Slight of the Delaware Court of Chancery, in *Online HealthNow, Inc. and Bertelsmann, Inc. v. CIP OCL Investments, LLC, et al* (Del. Ch. August 12, 2021), denied defendants’ (seller’s) motion to dismiss a buyer’s post-closing fraud claims arising from representations and warranties in a purchase agreement that allegedly were known to be false when made, noting that a seller may not use a limitation of liability clause in a contract obtained by fraudulent inducement to bar a buyer’s fraudulent contract claim.

BACKGROUND

During 2018, CIP Capital Fund, L.P. (“CIP Capital”), a private equity fund that indirectly owned CIP OCL Investments, LLC (“Seller”), initiated an auction process to sell OnCourse Learning Corporation (“OCL”). The auction process was managed by a “working group” (the “CIP Working Group”) that was comprised of representatives from CIP Capital’s financial advisor, representatives of CIP Capital (the co-managing partner and a vice president of CIP Capital) and the CEO and CFO of OCL. As part of the auction process, the representatives of CIP Capital directed the CIP Working Group to disclose certain categories of information only to certain bidders. CIP Capital and the Seller, the co-managing partner and vice president of CIP Capital and the CEO and CFO of OCL were all named as defendants (“Defendants”).

OCL sold its products through its website using an eCommerce system that was connected to OCL’s tax reporting software, and when properly used, this system would apply the appropriate state sales and use tax to a customer’s purchase at checkout. OCL discovered that it had not been using the tax reporting system properly as early as June 2015. In June 2018, OCL retained an outside accounting firm to investigate this misuse, which investigation determined that, between 2014 and 2018, OCL had failed to pay sales and use taxes on a significant portion of its revenues. The outside accounting firm informed the CIP Working Group of the magnitude of OCL’s sales and use tax liability on August 14, 2018.

On or about August 15, 2018, the CIP Working Group provided a bidder with information regarding OCL’s sales and use tax liability. This informed bidder estimated that OCL’s sales and use tax liability was between \$8 and \$9 million, and as a condition to the acquisition, the bidder proposed an escrow of \$15 million or a purchase price reduction based on the bidder’s final determination of the potential tax liability prior to the closing of the transaction. CIP Capital rejected the informed bidder’s proposals.

Bertelsmann, Inc. (“Buyer”), the winning bidder in the auction process, was not informed of OCL’s sales and use tax liability prior to the parties executing a Share Purchase Agreement (the “SPA”) on August 20, 2018, or following execution of the SPA and prior to the closing of the transaction (the “Closing”), which occurred on November 1, 2018. In the SPA, OCL represented, among other things, that (i) all tax returns had been duly and timely filed and were true, complete and correct in all material respects, (ii) OCL had no undisclosed liabilities and (iii) there were no material changes to OCL or its subsidiaries’ accounting policies and practices with respect to collections of accounts receivable. Buyer alleged that each of these

representations were knowingly false when made in order to fraudulently induce Buyer into executing the SPA. Also, the SPA contained customary provisions through which a seller limits liability for post-closing claims, including: (i) an “anti-reliance clause,” pursuant to which Buyer agreed that it did not rely on any representation or warranty by, or information from, Seller or OCL other than as expressly set forth in the representations or warranties of the Seller and OCL in the SPA, (ii) a “survival clause,” pursuant to which the parties agreed that none of the representations and warranties in the SPA survived the Closing and (iii) a “non-recourse provision,” pursuant to which the parties agreed that the SPA may only be enforced against the express SPA parties and not any other persons.

During the post-Closing purchase price adjustment process, Buyer uncovered the extent of “Defendants’ fraudulent scheme” and surmised that “OCL’s financial and accounting irregularities . . . resulted from Defendants’ intentional misrepresentations.”

Defendants sought dismissal of plaintiffs’ claim of fraudulent inducement through contractual fraud on two grounds: (i) plaintiffs failed to plead the claim with particularity, and (ii) the contractually bargained-for limitations of the SPA (*i.e.*, the survival clause, anti-reliance clause and non-recourse provision) shield Defendants from liability.

With respect to particularity, the Court noted that plaintiffs had identified the specific false representations and “satisfied the requirement to allege facts sufficient to support a reasonable inference that the representations were knowingly false” by alleging, among other things, that members of the CIP Working Group were informed of OCL’s sales and use tax liability prior to signing the SPA, which knowledge was imputed to CIP Capital and OCL.

Defendants’ primary argument was that the contractually bargained-for limitations of the SPA (*i.e.*, the survival clause, anti-reliance clause and non-recourse provision) expressly preclude plaintiffs’ claim. Defendants asserted that (i) the survival clause provides that the claims predicated on false representations and warranties expired at Closing and (ii) even if such limitation does not bar the claim, the anti-reliance and non-recourse provisions, together, bar the fraud claim against CIP Capital.

Vice Chancellor Slight rejected this theory, relying on the 2006 decision in *ABRY Partners V, L.P. v. F&W Acquisition LLC* (891 A.2d 1032 (Del. Ch. 2006)) and its progeny as dispositive. In *ABRY Partners*, then-Vice Chancellor Strine held that: “To the extent that the Stock Purchase Agreement purports to limit the Seller’s exposure for its own conscious participation in the communication of lies to the Buyer, it is invalid under the public policy of [Delaware].” Vice Chancellor Slight further relied on the prior holdings that (i) “a survival clause would not defeat an otherwise well-pled contractual fraud claim” and (ii) a non-recourse provision does not protect a third party from liability when it facilitated the target’s lies.

After determining that plaintiffs adequately alleged that CIP Capital knew about and facilitated the fraudulent misrepresentations in the SPA through its participation in the CIP Working Group, Vice Chancellor Slight denied Defendants’ motion to dismiss. Citing Delaware’s public policy against intentional fraud, he held that “a party cannot invoke provisions of a contract it knew to be an instrument of fraud as a means to avoid a claim grounded in that very same contractual fraud.”

OUR VIEW

The Court’s decision reaffirms that parties to a contract cannot “detonate all bona fide contractual fraud claims (discovered or undiscovered) with the stroke of their pens” and serves as an important reminder that, while Delaware strongly favors the enforcement of negotiated contracts, courts will not permit contractual limitations on liability to excuse intentional fraud, even if a purchase agreement includes a fraud carve-out. Accordingly, sellers and their representatives should be particularly careful with the level of disclosure in a sell-side process and provide all relevant information to bidders.

We welcome the opportunity to discuss any questions you might have regarding this case.

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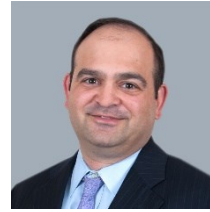
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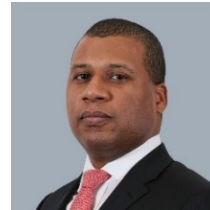
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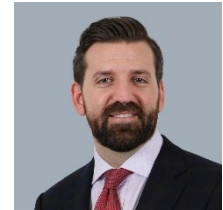
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