The Metropolitan Corporate Counsel®

www.metrocorpcounsel.com

October 2013 © 2013 The Metropolitan Corporate Counsel, Inc. Volume 21, No. 10

Lies, Half-Truths, And Concealing Information: The Risks Of M&A Due Diligence

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Since the *Abry* case in 2006,[1] sellers in mergers and acquisition transactions have increasingly tried to structure Acquisition Agreements to effectively nullify buyers' common law fraud remedies. This trend, if taken to its extreme, would allow a seller to lie in diligence to induce a sale, and would provide a buyer with a remedy only if the lie was repeated in the Acquisition Agreement. In a recent case examining the implications of this trend,[2] the Delaware Court of Chancery identified three types of fraud that sellers could be liable for - misrepresentations (lies), half-truths, and actively concealing information - and provided useful guidance on each. It is expected that *Transdigm* will result in a change in the standard waivers that sellers will seek in Acquisition Agreements.

The Risk-Allocation Technology

Most sophisticated private Acquisition Agreements contain representations and warranties relating to the business being sold. Parties allocate the risk that representations and warranties are not true through complex indemnification provisions. In addition, buyers can rely on common law claims of fraud if they are defrauded in the Acquisition Agreement or in the sales process. In sophisticated M&A transactions, sellers utilize a variety of techniques to limit common law claims for fraud, including requiring the buyer to represent that: (1) it was provided with all information necessary for it to make the decision to purchase the business being acquired, and (2) it is not relying on any representations or warranties other than the ones contained in the Acquisition Agreement (the "Non-Reliance Representation").

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Transdigm

In *Transdigm*, during the due diligence period, the target's largest customer informed the target that it would be cutting its purchases from the target by 50 percent, and the target agreed to provide the customer with an across-the-board five percent price discount on the remaining purchases. These facts were not disclosed to the buyer. Post-closing disputes arose between the buyer and the seller, and the buyer asserted a variety of claims based on developments with the customer. The court's ruling on this dispute provides guidance as to permissible seller conduct and the proper crafting of Acquisition Agreement disclaimers.

Active Concealment and Lies

The buyer in *Transdigm* alleged that the seller had deliberately concealed the material facts regarding the developments with the customer and that such concealment constituted fraud. The court reiterated the five elements of fraud, the two most relevant here being: (1) deliberate concealment of material facts, and (2) the buyer's reliance.[3] The court found that the buyer had adequately pled details of the fraud to survive a motion to dismiss. The seller apparently argued that the buyer was not able to satisfy the reliance element of the fraud claim because of the Non-Reliance Representation, i.e., the buyer had represented that it hadn't relied on anything outside of the Acquisition Agreement, so it couldn't now claim fraud based on the undisclosed developments with the customer. In a key ruling for participants in the M&A process, the court rejected that argument.

The court found that because of the Non-Reliance Representation, the buyer could *not* have reasonably relied on representations and warranties not contained in the Acquisition Agreement.[4] In other words, if the seller had lied outright to the buyer in diligence (for example, by affirmatively stating that there were no issues with the largest customer), but that lie was not contained in the Acquisition Agreement, then the buyer would have no remedy.

However, the court held that the buyer had relied on the contractual representations and warranties and the pre-closing omissions of the seller (in not disclosing bad facts to the buyer), and that, since the Non-Reliance Representation did not disclaim reliance on pre-closing omissions, for purposes of a motion to dismiss, it could not say that the buyer's reliance was not reasonable.[5] While this might lead a seller to conclude that the standard Non-Reliance Representation should be expanded to include non-reliance on extracontractual omissions, it is unclear whether such a disclaimer would be effective, as the court reiterated the principle that Delaware law prohibits the use of

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contract disclaimers to release claims of fraud.

Half-truths

The buyer also alleged that the representation in the Acquisition Agreement that: *since 'Date X' there was no material adverse development with respect to customers* was a half-truth, as there were substantial material adverse developments prior to Date X. An actionable "half-truth" was defined by the Delaware Supreme Court as follows: *"although a statement or assertion may be facially true, it may constitute an actionable misrepresentation if it causes a false impression as to the true state of affairs, and the actor fails to provide qualifying information to cure the mistaken belief."*[6] In the leading case on half-truths, the Delaware Supreme Court found that while a representation regarding zoning classification was technically true, it was still actionable as the property was subject to substantial additional restrictions that had not been disclosed to the buyer and that undermined the zoning classification. In *Transdigm*, however, the Chancery Court found no "half-truth." The representation in the Acquisition Agreement was clear on its face, and gave no impression whatsoever as to what occurred prior to Date X. If the buyer had wished for coverage prior to Date X, it could have asked for it. [7] The Chancery Court was unwilling to disturb the risk allocation contained in the Acquisition Agreement and found no actionable half-truth.

The Lessons Of *Transdigm*

There are a number of key lessons from *Transdigm*:

- Delaware courts will respect the allocation of risk between sophisticated parties in an Acquisition Agreement, but for that allocation to be respected, the parties have to disclose what they know.
- Sellers should reexamine their standard Non-Reliance Representation to make sure that it covers extra-contractual omissions.
- Buyers should make sure that all critical diligence representations and omissions are reflected in the representations and warranties contained in the Acquisition Agreement.

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1 *Abry Partners V, L.P. v. F & W Acquisition, LLC*, 891 A.2d 1032 (Del. Ch. 2006).

2 *Transdigm Inc. v. Alcoa Global Fasteners, Inc.* (Del.Ch. May 29, 2013) ("*Transdigm*").

3 *Transdigm* at 6.

4 *Transdigm* at 8.

5 *Transdigm* at 8 (emphasis added).

6 *Norton v. Poplos*, 443 A.2d 1, 5 (Del. 1982).

7 *Transdigm* at 8 (emphasis added).