

**DELAWARE CHANCERY COURT ENFORCES CONTRACTUAL RESTRICTIONS
ON BUYER'S REMEDIES IN STOCK PURCHASE AGREEMENT AND CONFIRMS
THAT RESTRICTIONS WILL NOT APPLY IN CASES OF ACTUAL FRAUD**

The recent ruling by Vice Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery (the “Court”) in *ABRY Partners V, L.P., et al. v. F&W Acquisition LLC, et al.* (“ABRY”) discussed the availability in the acquisition context of a rescission remedy where the purchase agreement provides that the exclusive remedy for breach thereof is monetary damages.

The Court concluded that “Delaware law permits sophisticated commercial parties to craft contracts that insulate a seller from a rescission claim for a contractual false statement of fact that was not intentionally made.” Conversely, a seller will not be protected from the possibility that the transaction would be rescinded if the buyer can prove the seller’s fraud.

Facts

- Providence Equity Partners (the “Seller”) indirectly owned F&W Publications (“F&W”), a portfolio company in the business of magazine publishing and book sales. The Seller sold F&W to another private equity firm, ABRY Partners (the “Buyer”), for approximately \$500 million through an auction process and pursuant to a customary Stock Purchase Agreement (the “SPA”).
- Shortly after the closing, the Buyer began to uncover a number of serious financial and operational problems with F&W. Additionally, the Buyer alleged that outside the context of the SPA, F&W had informed the Seller prior to closing that an important operational system of F&W was fully functional, yet the Buyer alleged that problems with the system were so pervasive that they constituted a material adverse effect under the SPA. Nevertheless, F&W did not give the Buyer pre-closing notice of the problems, and the Seller certified in an officer’s certificate delivered at closing that no material adverse effect had occurred prior to closing. The Buyer alleged that the Seller and F&W management, working in concert, schemed to manipulate F&W’s financial statements in order to fraudulently induce the Buyer into purchasing F&W at an excessive price.
- When the Buyer learned of the alleged improprieties, the Buyer asked the Seller to rescind the transaction and to take back ownership of F&W. The Seller refused to do so, and the Buyer consequently brought an action against the Seller for fraudulent inducement.

The Stock Purchase Agreement

- The Agreement contained a “non-reliance” provision (a “Non-Reliance Provision”) whereby the Buyer agreed that neither F&W nor the Seller made any representation or warranty to the Buyer except as expressly set forth in the Agreement and that neither F&W nor the Seller would be subject to any liability to the Buyer resulting from the Buyer’s use of or reliance on any extra-contractual information or material made available to the Buyer in connection with the sale of F&W, including information provided in data rooms and management presentations. Therefore, pursuant to the Agreement, the Buyer could not claim reliance on any alleged misrepresentations of the Seller or F&W not represented in the SPA itself or in an officer’s certificate (such as the allegedly misrepresented functionality of the operational system).
- The Agreement limited the Seller’s liability for misrepresentation to claims for damages in arbitration (“Indemnity Claims”) and capped the Seller’s liability at \$20 million. By its terms, the Agreement made an Indemnity Claim the exclusive remedy of the Buyer (an “Exclusive Remedy Provision”) for a misrepresentation by the Seller and barred any rescission claim of the nature pled by the Buyer. In addition, the Agreement stated that the Exclusive Remedy Provision was specifically bargained for and was reflected in the amounts payable to the Seller in connection with the sale.
- Lastly, the Agreement provided that Indemnity Claims be arbitrated in Massachusetts, but the SPA be “governed by, and construed in accordance with, the Laws of the State of Delaware, regardless of the Laws that might otherwise govern under applicable principles of conflicts of law.” The Buyer conceded that Delaware law should govern its contractual misrepresentation claim, but argued that Massachusetts law should govern its fraudulent misrepresentation claim. Presumably, Massachusetts law would have provided a more favorable outcome to the Buyer on certain of the issues.

The Court’s Decision

- The Exclusive Remedy Provision was held, by its express terms, to cover all claims for misrepresentation, whether innocent, negligent, reckless or fraudulent. However, as a matter of public policy, the Court refused to enforce the provision in the case of actual fraud.
- The Court held that the Buyer may obtain rescission (or full compensatory damages) only if it proves intentionally fraudulent conduct on the part of the Seller. This would require the Buyer to prove that “the Seller acted with an illicit state of mind, in the sense that the Seller knew that the representation was false and either communicated it to the Buyer directly itself or knew that [F&W] had.”

- The Court concluded that Delaware law would govern all claims relating to the Agreement, pointing to the fact that the parties specifically chose Delaware law to govern the contract. The Court also rejected the Buyer's proposed contractual misrepresentation/fraudulent misrepresentation dichotomy, making it clear that whether the claim is asserted as a contract claim, a tort claim or otherwise should not affect the governing law when the parties explicitly provide for disputes to be governed by the law of a chosen jurisdiction.

Lessons from ABRY

- The conventional wisdom that a private equity sponsor is generally unwilling to sue another private equity firm has been dispelled by this dispute. Whether this is an isolated situation or indicative of a trend remains to be seen.
- An intentional fraud claim trumps any contractual limitations on liability (such as a cap on damages), although the Court makes clear that the standard of proof for a fraud claim in Delaware is very high. The Court distinguished this case from cases involving unsophisticated parties or parties with disparate negotiating power. We can expect that Delaware will hold sophisticated parties to a high standard of proof, and will generally resist attempts to convert a mere misrepresentation claim (whether by negligence or gross negligence) to a fraud claim in order to avoid limitations on liability in the stock purchase agreement.
- Non-Reliance Provisions are important to sellers in that they will preclude a buyer from arguing that extra-contractual misstatements allegedly made by a seller, even if fraudulent, can provide a basis for recovery. These provisions are a necessary adjunct to standard "integration" or "entire agreement" clauses in order to effectively eliminate the possibility of a buyer's reliance on statements outside of the agreement.
- An Exclusive Remedy Provision, together with a Non-Reliance Provision, should protect a seller, even in cases of fraud, if the buyer was aware of a misrepresentation prior to closing and nonetheless elected to close. Nothing in the opinion suggests that such awareness would undermine the enforceability of an express indemnity for misrepresentations in the agreement.
- Although a private equity seller cannot protect itself against knowing misstatements, even when only communicated by the portfolio company being sold, the seller *can* protect itself against misrepresentations by the company that it is not aware are false.
- Delaware courts will enforce governing law provisions, and complaining parties cannot avoid such provisions, even if the claims are couched in tort or fraud.

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If you have any questions about the ABRY case, please contact Steven J. Gartner (sgartner@willkie.com, 212-728-8222), Michael A. Schwartz (mschwartz@willkie.com, 212-728-8267) or Roger D. Netzer (rnetzer@willkie.com, 212 -728-8249), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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