EXERCISE

FRAUD CARVE-OUTS

Background

You recently represented the selling stockholders in an acquisition that closed a few months ago. One of your colleagues just passed along a notice from buyer's counsel indicating that the buyer believes your client committed fraud in connection with the deal. The notice alleges the following:

1. The statements that form the basis for the buyer's fraud claim were made by the target company's CFO during a negotiation session and separately by the target company in a representation made in the stock purchase agreement;
2. The CFO, who was also a selling stockholder, allegedly stated during the negotiation session that an employment discrimination lawsuit had settled for $500,000;
3. In reality, the settlement had not yet been finalized when the CFO made this statement, and the lawsuit was formally settled for $3.5 million after the deal closed;
4. At the time the CFO made the statement, a settlement agreement for $500,000 had been drafted, but it was never entered into;
5. The stock purchase agreement also contained a representation from the target company that there was no outstanding litigation against the target company involving claims of more than $100,000;
6. The buyer claims that both the CFO's statement and the written representation can form the basis of a fraud claim and all of the seller's stockholders can be held liable for the alleged fraud notwithstanding the $2 million cap on indemnification.

Delaware law is the governing law of the stock purchase agreement. The agreement also includes a No-Reliance clause, an indemnification cap of $2 million, and an Exclusive Remedies provision stating that the rights and remedies in the Indemnification section are the only ones available if there's a breach of the written reps and warranties. The stock purchase agreement also includes a fraud carve-out in both the No-Reliance clause and in the Exclusive Remedy provision, which simply says "except in the case of fraud." Your client tells you that the reason for the CFO's statement was that he overheard the General Counsel of the target discussing the settlement and understood it was a done deal, and he was so excited to hear it he never followed up with the GC or anyone else to confirm that it was actually settled. He also supervised the preparation of the schedules to the stock purchase agreement and left the lawsuit off the schedules to the litigation representation because he had honestly believed at the time that the litigation had in fact been settled. The CFO, who is now acting as the selling stockholders' representative wants to know what her and the other selling stockholders' exposure for a fraud claim could be and why.

Instructions

Come prepared to discuss the following:

- Would the indemnification cap and the Exclusive Remedies provision limit the buyer's recovery to $2 million?

- Would the No-Reliance clause protect the sellers against a tort-based or uncapped indemnification claim based on the CFO's statement? If the fraud carve-out was a carve out only to the Exclusive Remedy provision and not to the No-Reliance clause, would that affect your answer?
- Would the CFO's belief in the statement's truth at the time it was made protect the CFO and the other seller stockholders against a tort-based or uncapped indemnification claim based on "fraud?" And does that belief similarly protect the CFO and the other selling stockholders from a fraud claim premised upon the written representation regarding outstanding litigation contained within the stock purchase agreement?
- Assuming there's a valid claim for fraud based on the CFO's actions, is the CFO the only selling stockholder with potential exposure to a tort-based or uncapped indemnification claim based on the alleged fraud or do all the selling stockholders have this exposure?
- Is the fraud carve-out that was included in the agreement broader, narrower, or equal in scope to any judicially imposed fraud carve-outs that would be applied?