

Secondary Fraud Claims Against a Non-Party to M&A Deal Allowed to Proceed Under Delaware Law



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On June 27, 2024, in *Matrix Parent, Inc., et al. v. Audax Management Company, et al.*, the Delaware Superior Court denied Audax's motion to dismiss, allowing to proceed H.I.G. Capital's fraud claims in connection with its March 2022 purchase of a majority stake in Mobileum, Inc. from a holding company controlled by Audax.

H.I.G. contends that a 2021 Confidential Information Memorandum (CIM) provided by seller's banker and other diligence materials fraudulently misstated certain financial metrics and projections, including EBITDA, revenue and bookings and that such misstatements induced H.I.G. to enter into the stock purchase agreement (SPA) and acquire Mobileum. H.I.G. alleged that under Audax's "guidance, Mobileum: (1) improperly accelerated its revenue recognition by acting as if it had performed more work than it had; (2) covered up its improper revenue acceleration by creating, but not sending, invoices for work that had not been done; and (3) recorded "sham" bookings from artificial entities, knowing that the bookings would not lead to revenue."

As part of its motion to dismiss, Audax noted that, as is customary, the SPA (a) disclaimed reliance on any representations outside of the SPA, including the CIM and other due diligence materials, (b) included an integration clause stating that the SPA acts as the final agreement between the parties, superseding prior agreements and (c) included provisions limiting the liability of and enforcement against persons who are not parties to the SPA.

While recognizing that the alleged fraudulent misstatements first arose as part of the projections presented in the CIM and that in the SPA H.I.G. disclaimed reliance on statements in the CIM, the Court found that H.I.G.'s fraud claims were based "solely on the falsity of express contractual representations." H.I.G. alleged that Audax perpetuated a fraud and breached at least seven representations in the SPA, including relating to (a) financial statements, (b) maintenance of books and records, (c) absence of changes, (d) accuracy of tax returns, (e) compliance with laws and (f) the bona fide nature of accounts receivable. Noting that its role at the present stage was "not to distill the representations that can support a viable fraud claim from those that cannot," the Court found that H.I.G. "raised a fair inference that the SPA contained false representations." Therefore, the Court stated that it had no reason to assess the first two SPA provisions cited by Audax, as they were not in dispute: (i) that H.I.G. disclaimed reliance on extra-contractual representations and (ii) that the SPA supersedes all prior agreements.

As to H.I.G.'s agreement not to bring claims against Audax, as an affiliate of the buyer entity, and other non-parties, although the SPA prohibited H.I.G. from bringing against Audax even secondary fraud claims for aiding and abetting fraud and civil conspiracy, the Court found "that under Delaware law, the terms of a fraudulently procured contract cannot exempt from liability entities that were knowingly complicit in the fraud, including entities that aided, abetted, or conspired to commit such fraud."

As will be relevant as the case proceeds, under the SPA, "fraud" was defined as follows:

“intentional and knowing common law fraud under Delaware law in the representations and warranties set forth in this Agreement, any Contribution Agreement and the certificates delivered pursuant to Section 2.02(f)(i) and Section 2.03(d)(i). A claim for Fraud may only be made against the Party committing such Fraud. “Fraud” does not include equitable fraud, constructive fraud, promissory fraud, unfair dealings fraud, unjust enrichment, or any torts (including fraud) or other claim based on negligence or recklessness (including based on constructive knowledge or negligent misrepresentation) or any other equitable claim.”

Recognizing that the SPA requires actual and not constructive fraud, the Court found that H.I.G. met the heightened pleading standard imposed by Delaware Superior Court Civil Rule 9(b) for fraud claims, namely that H.I.G. has plead with particularity “the time, place, and contents of the false representations; the facts misrepresented; the identity of the person(s) making the representation; and what that person(s) gained from making the misrepresentation.”

The Court did not disagree with Audax’s contention that H.I.G. will have to prove scienter at trial, *i.e.*, that Audax committed actual, intentional fraud but distinguished this from the “position to know” standard applicable for pleading purposes. As was espoused in *lotex Communications, Inc. v. Defries*, a central element of a fraud allegation is that the defendant was in a position to know of the fraud, namely that the defendant “knew as a fact (and failed to disclose) something about the state of mind of [an affiliate] and others during the period of negotiation of the Agreements.”

Although H.I.G.’s fraud claims against Audax have been allowed to proceed by the Court, the outcome of the litigation, or whether the parties will ultimately settle the dispute, remains to be seen.

Audax, which retained a minority stake in Mobileum through a limited partnership agreement with H.I.G., countersued claiming essentially that H.I.G. mismanaged Mobileum after the sale and “ran what was a high-performing business into the ground.”

The outcome of the trial – *i.e.*, whether or not Audax conspired to perpetrate fraud – will be highly dependent on the facts and evidence presented. At this stage of the litigation, the Court held H.I.G. sufficiently pled facts that, if true, could lead to the conclusion that Audax controlled Mobileum and conspired to perpetrate a fraud against H.I.G.

Of note, the decision highlights the Court’s unwillingness to allow parties to “contract-around” Delaware law in order to limit recourse against non-parties to an agreement, at least in so far as such parties commit actual fraud.