Bloomberg BNA

Mergers & Acquisitions Law Report™

DUE DILIGENCE

Financial Due Diligence and the Specter of Fraud in the Private M&A Context



By Michael M. Farhang, Aaron Bloom and Scott F. Meadow

Introduction

In the process of a private company sale, where do a seller's obligations to disclose adverse facts about the business begin and end, and how do contractual disclaimers affect these obligations? The buyer may believe itself entitled to receive all material information of which the seller is aware, while the seller may believe that it is only required to produce information specifically requested by the buyer and that a buyer's due diligence is responsible for determining what must be disclosed. The question may be complicated further where deal documents contain disclaimers that create questions about who bears the risk of reliance on inaccurate information. Resolving these questions is particularly important in sales of private companies where public information is limited and a buyer's financial diligence relies in great part upon the seller's representations about the current operations and future projections of its business. Such information will likely be central to the buyer's decision of whether to proceed with the purchase and at what price, and it may underpin pricing calculations derived from multiples of EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), discounted cash flows, or other formulas. Under these circumstances, a mutual and clear understanding of the respective obligations of the seller and the buyer can be important for creating sufficient trust between the parties to reach a close of the deal.

Michael Farhang is a partner in the Los Angeles office of Gibson Dunn & Crutcher LLP. He is a member of the White Collar Defense and Investigations and Securities Litigation Practice Groups, and handles general civil and criminal matters in the Litigation Department. Aaron Bloom is an associate in Gibson Dunn's Los Angeles office where he practices in the firm's Litigation Department. Scott Meadow is a Clinical Professor at the University of Chicago Booth School of Business, specializing in entrepreneurial finance and private equity, and particularly in the due diligence process.

The ramifications of dashed expectations about the true state of affairs at an acquired company can be significant and can lead to allegations of fraud, internal investigations, litigation, and even referrals to law enforcement. Several recent high-profile acquisitions involving public company and private equity buyers illustrate how this can unfold. In 2012, Hewlett-Packard Co.'s $11 billion acquisition of the U.K. software company Autonomy Corp. was followed by a write-down of close to 90 percent of the transaction's value after Hewlett-Packard received information about undisclosed accounting improprieties at the acquired company. In a public statement, Hewlett-Packard an-

nounced that the accounting problems appeared to have been a ''willful effort . . . to inflate the underlying financial metrics of the company'' that had a severe impact on HP's ability to fairly value Autonomy at the time of the deal.[1] HP announced that it had referred the matter to regulatory agencies in the U.S. and U.K.[2]

Similarly, Caterpillar Inc.'s $800 million acquisition of the Hong Kong mining machinery company ERA Mining Machinery Ltd. and its Chinese subsidiary Siwei in 2012 was followed later by nearly $580 million in noncash goodwill impairment charges and an announcement by Caterpillar that it had determined that the subsidiary's senior managers had engaged in accounting misconduct for several years prior to the acquisition.[3] Caterpillar stated that it was considering litigation to recover its losses from those responsible.[4]

In 2005, private equity firm Abry Partners' acquisition of F&W Publications (''F&W'') for $500 million from Providence Equity Partners was followed by claims of fraud during the acquisition process and protracted litigation between the parties.[5] Abry Partners alleged that it was defrauded by Providence Equity Partners and F&W's management about the financial condition of F&W leading up to the sale, and that F&W was actually worth roughly $400 million.[6] The claim was only settled when Providence Equity Partners agreed to repay Abry Partners part of the acquisition price in exchange for a minority stake in the company.[7]

In situations like these, understanding the precise contours of common law fraud liability applicable to private company transactions can guide the disclosure obligations of a seller and the diligence practices of a buyer so as to provide stability to the process. Common law fraud liability is a natural mechanism for balancing the respective interests of the buyer and seller and can help buyers and sellers navigate the deal and diligence process in a manageable way. Further, fraud principles can help both sides avoid an unworkable alternative, in which contract liability would remain as the only recourse for deception and agreements would need to be endless because every expectation would need to be stated specifically in writing to be valid.

In short, in an unpredictable market without a background set of rules beyond the four corners of the contract, buyers could never be convinced (and in turn would not be able to convince lenders and investors) that they had asked all the right questions and gotten all the right answers.

This article will address how common law fraud in two important jurisdictions governs the proper limits of seller disclosures in a way that due diligence and contract law alone cannot. It examines the current standards for fraud applicable to the due diligence process in two of the major states for private company sales—California and New York—as well as some additional issues presented by choice-of-law and disclaimer provisions in purchase agreements. The article discusses how fraud liability helps to balance disclosure obligations of the seller and diligence practices of the buyer in ways that make acquisitions more workable for both sides. At its heart, fraud liability is based on relatively universal concepts, and is a means of preventing a party from obtaining an undue advantage through deception based on a misrepresentation or silence when good faith requires expression.[8]

A Due Diligence Hypothetical

The following hypothetical example will illustrate some of the tensions between buyer and seller expectations about what information is fair game for disclosure in the due diligence process. Assume that the owners of a privately-held company have decided to sell their ownership interest, and have selected a prospective buyer. During due diligence, the buyer requests and receives via the sellers' electronic ''data room'' a company sales and margin forecast for the coming year. The buyer does not ask for more specific forecasts for particular customer accounts, although the buyer does request background materials relating to the share of revenues owing to the company's major customers.

Shortly before the sale's closing, the company's management prepares an internal forecast for sales to a major customer in one of the company's key industrial sectors showing that margins to this customer are projected to fall significantly over the next year. The company holds an operational meeting at which the negative customer forecast is discussed and an action plan for the next year is agreed upon. The specific customer margin forecast tends to undermine the overall revenue and profitability forecast already disclosed and upon which the buyer is relying to make the purchase and pricing decision, justify the acquisition to investors, obtain financing, and plan for future performance. The buyer does not seek, and the purchase agreement does not contain, contractual representations about margin forecasts. The sellers have, however, made affirmative representations that are arguably impacted by the internal customer forecast. Despite the lack of a specific request or a clear contractual obligation and given the

[1] *HP Issues Statement Regarding Autonomy Impairment Charge*, HP (Nov. 20, 2012), http://www8.hp.com/us/en/hp-news/press-release.html?id=1334263#.UnPvQPleY4k; *H-P Affirms Commitment to Autonomy*, Wall St. J. (Apr. 10, 2013 8:59 a.m.), http://online.wsj.com/article/SB10001424127887323741004578414193970038724.html.

[2] *HP Issues Statement Regarding Autonomy Impairment Charge*, HP (Nov. 20, 2012), http://www8.hp.com/us/en/hp-news/press-release.html?id=1334263#.UnPvQPleY4k.

[3] *Caterpillar Takes Action to Address Accounting Misconduct at Siwei, Its Recently Acquired Company; Misconduct Results in Fourth Quarter Non-Cash Charge of Approximately $580 Million and the Removal of Several Siwei Senior Managers*, Caterpillar (Jan. 18, 2013), http://www.caterpillar.com/cda/layout?m=393518&x=7&id=4326216&mode=noNav; Andrew Harris, *Caterpillar Board Sued Over ERA Mining Machinery Merger*, Bloomberg (Aug. 5, 2013 5:20 p.m.), http://www.bloomberg.com/news/2013-08-06/caterpillar-board-sued-over-era-mining-machinery-merger.html.

[4] *Caterpillar Takes Action to Address Accounting Misconduct at Siwei, Its Recently Acquired Company; Misconduct Results in Fourth Quarter Non-Cash Charge of Approximately $580 Million and the Removal of Several Siwei Senior Managers*, CATERPILLAR (Jan. 18, 2013), http://www.caterpillar.com/cda/layout?m=393518&x=7&id=4326216&mode=noNav.

[5] *Abry Partners V, LP v. F&W Acquisition LLC*, 891 A.2d 1032, 1034-1040 (Del. Ch. 2006).

[6] *Id*.

[7] *Abry Partners Settles Lawsuit with Providence Equity Partners*, Boston Bus. J. (May 25, 2006 11:19 a.m.), http://www.bizjournals.com/boston/stories/2006/05/22/daily53.html.

[8] George Blum et al., *Fraud and Deceit: In General, Definitions and Types of Fraud*, 37 Am. Jur. 2d Fraud & Deceit § 1 (2013).

   ISSN 1098-4720

company's action plan to remedy the problems, are the sellers nonetheless obligated to turn this customer margin forecast over to the buyer prior to the acquisition? Or is the buyer stuck with the consequences of its failure to request either a forecast by customer or a contractual representation about the company forecasts?

Obligations Under Common Law Fraud Regimes: California Versus New York

As the respective technology and finance hubs of the U.S., California and New York represent two of the country's significant jurisdictions for private company acquisition activity. Their common law systems of fraud liability also provide examples of two slightly different approaches to balancing the expectations between buyer and seller of appropriate disclosure and due diligence. While California has a regime that appears to tip slightly in favor of buyers and New York has a regime that appears to tip slightly in favor of sellers, the common themes about disclosures obligations in both jurisdictions are significant enough to enable some overall conclusions about where the line of obligations consistently falls.

It should be noted that while intentional fraud may be the most readily applicable legal regime in the case of extracontractual acquisition-related claims, other statutory and common law claims (including federal and state securities fraud, breach of contract, rescission, negligent misrepresentation, etc.) may also be applicable in many cases as well. In addition, choice-of-law provisions in sales agreements may control which jurisdiction's law applies, though such provisions do not necessarily always control choice of law for extracontractual tort claims, as discussed below.

Choice-of-Law Provisions in Purchase Agreements. Purchase agreements typically contain a choice-of-law provision governing the law to be applied in case of disputes. However, although these choice-of-law provisions will likely govern the selection of law for claims arising under the contract, such as a breach of a representation or warranty or other provision, they may not always govern the choice of law for extracontractual tort claims, such as intentional fraud claims. Resolution of this question will generally depend on the precise language used in the choice-of-law clause. For example, under New York law, if the choice-of-law provision only governs disputes ''arising under'' the contract, tort claims arising from the overall relationship will generally fall outside the scope of that choice-of-law provision.[9]

If the choice-of-law provision does not govern the tort claim, the court will generally look to the forum state's general choice of law principles to determine what law controls.[10] Therefore, if the sales agreement has a venue clause that is broader than the choice-of-law clause, for instance covering all disputes ''between the parties,'' this choice of venue may end up being critical for more than just the setting of the litigation and can also affect which substantive law applies. Nonetheless, if the potentially applicable laws are different or conflicting, and if one state has a substantially greater interest in the outcome of the suit, that state's law will likely govern.[11]

California. The basic elements of a common law fraud claim in California are: (1) a misrepresentation, (2) knowledge of falsity, (3) intent to defraud, (4) justifiable reliance, and (5) resulting damages.[12] There are also four circumstances in which nondisclosure or concealment of a material fact may constitute a misrepresentation: (1) when the defendant is in a fiduciary relationship with the plaintiff; (2) when the defendant has exclusive knowledge of material facts not known to the plaintiff; (3) when the defendant actively conceals a material fact from the plaintiff; or (4) when the defendant makes partial representations, but also suppresses some material facts.[13] Of these, the last three may be applicable in the acquisition context.

California's fraud standards impose substantial disclosure obligations on the seller in a company sale. A private company acquisition often involves a significant information asymmetry, where the seller has vastly more information about the company than the buyer and the buyer can only learn that information if the seller provides it. In these circumstances, the seller likely has exclusive knowledge of many material facts not known to the buyer. Further, if the seller learns of a fact that it knows may be material, and then actively seeks to conceal this fact from the buyer, it may similarly be exposed to fraud liability.[14] Finally, if the seller makes affirmative material representations about the current or future financial state of the business, the seller must also disclose negative information that materially qualifies or undermines any positive representation.[15]

---

[9] *Fin. One Pub. Co. v. Lehman Bros. Special Fin., Inc.*, 414 F.3d 325, 335 (2d Cir. 2005) (''tort claims are outside the scope of contractual choice-of-law provisions that specify what law governs construction of the terms of the contract''); *Winter-Wolff Int'l, Inc, v. Alcan Packaging Food & Tobacco, Inc.*, 499 F. Supp. 2d 233, 240 (E.D.N.Y. 2007) (''[t]he contractual language 'arising hereunder' is not sufficiently broad to encompass tort claims'').

[10] *See* for example in California: *Wash. Mut. Bank, FA v. Superior Court*, 24 Cal. 4th 906, 915-16 (2001); *McCann v. Foster Wheeler, LLC*, 48 Cal. 4th 68, 87-88 (2010).

[11] *See* again for example in California: *McCann v. Foster Wheeler, LLC*, 48 Cal. 4th 68, 87-88 (2010) (holding that California examines the laws in the different potential jurisdictions, and if they are different, determines whose interest would be more impaired if its law were not used).

[12] *Small v. Fritz Cos., Inc.*, 30 Cal. 4th 167, 173 (2003) (laying out the elements of a fraud claim in California); *see also* CACI Civil Jury Instructions, Nos. 1900-1901 (laying out the elements of a fraud claim in California).

[13] *Bank of Am. Corp. v. Superior Ct.*, 198 Cal. App. 4th 862, 870-71 (2011); *Warner Constr. Corp. v. City of Los Angeles*, 2 Cal. 3d 285, 294 (1970); *see also* CACI Civil Jury Instructions, Nos. 1900-1901 (laying out the elements of a fraud claim in California).

[14] *Warner Constr. Corp. v. City of Los Angeles*, 2 Cal. 3d at 290-91, 294-95 (finding that where the contractor plaintiff presented evidence of intentional concealment by the City of Los Angeles of two ancient landslides at the construction site, this created a cause of action for fraudulent concealment).

[15] *Randi W. v. Muroc Unified Sch. Dist.*, 14 Cal. 4th 1066, 1082 (1997) (holding that defendants, ''having undertaken to provide some information regarding Gadams's teaching credentials and character, were obliged to disclose all other facts

California's tendency to favor requiring seller disclosures is also apparent in California's treatment of certain commonly-invoked seller arguments, for example, that the buyer was sloppy or negligent in its due diligence. Under California law, a seller generally cannot defend itself against intentional fraud claims by pointing to the buyer's sophistication or negligence during due diligence as a means of negating reliance. Indeed, the buyer's negligence in failing to discover the falsity of a statement is no defense when the seller's misrepresentation was intentional.[16] Moreover, an independent examination by a sophisticated buyer does not preclude reliance where the falsity is not clear from the examination, where the person making the representation has superior knowledge, or where the buyer fails to discover the truth because of deception by the seller.[17]

In sum, in a private company transaction, if the information available to the buyer is limited, California law can require that the seller turn over certain material facts independent of any specific request for those facts by the buyer in order to ensure the accuracy of related representations actually made to the buyer. In the specific hypothetical described above, prudence would therefore counsel that the customer margin report be disclosed to the buyer despite the fact that the buyer did not specifically ask for this type of report in its diligence.[18]

New York. Under New York law, fraudulent misrepresentation consists of four elements: (1) a material misrepresentation, (2) made with intent to defraud, (3) reasonable reliance on the misrepresentation, and (4) damages as a result of that reliance.[19] New York law also imposes an affirmative duty to disclose information when (1) a party has made a partial or ambiguous statement that constitutes a half-truth without additional information, (2) the parties stand in a fiduciary or confidential relationship with one another, or (3) one party has some superior knowledge that the other party cannot readily obtain and knows that the other is acting on the basis of mistaken knowledge.[20]

As in California, a seller under New York law generally must disclose those material facts that the buyer can only learn if the seller provides them, and also must disclose any negative facts that may materially qualify positive representations about the business actually made to the buyer. However, under New York law, the buyer must also prove, by clear and convincing evidence, that its reliance on the seller's alleged misrepresentation and conduct surrounding the transaction was reasonable.[21] In making the reasonableness determination, New York looks to the buyer's sophistication, independent inquiry, and access to the information.[22] As one court has noted, under New York law the ancient principle of *caveat emptor* is still ''alive and well.''[23] In New York, unlike in California, a sophisticated buyer who fails to conduct adequate due diligence may jeopardize its ability to bring a later fraud claim based on a misrepresentation or omission by the seller unless it can prove that the information was particularly within the seller's knowledge and that it was not ''on guard'' about the true facts, or that the seller made false statements in response to the buyer's request for the information.[24] Nonetheless, in the case of the hypothetical above, assuming that the customer margin information was material and not otherwise disclosed or accessible to the buyer in another form, and the seller knew the buyer would rely on the now-inaccurate forecast information previously disclosed, disclosure would still be advisable notwithstanding the absence of a particularized diligence request.

---

which 'materially qualify' the limited facts disclosed''); *Cicone v. URS Corp.*, 183 Cal. App. 3d 194, 201-02 (1986) (holding that ''one who is asked for or volunteers information must be truthful, and the telling of a half-truth calculated to deceive is fraud'')..

[16] *Alliance Mortg. Co. v. Rothwell*, 10 Cal. 4th 1226, 1239-40 (1995); *Seeger v. Odell*, 18 Cal. 2d 409, 414 (1941); *French v. Constr. Laborers Pension Trust*, 44 Cal. App. 3d 479, 486 (1975).

[17] *Arthur L. Sachs, Inc. v. City of Oceanside*, 151 Cal. App. 3d 315, 323 (1984); *Blackman v. Howes*, 82 Cal. App. 2d 275, 279 (1947).

[18] *Randi W.*, 14 Cal. 4th at 1082-84 (holding that where defendants offered general and unreserved praise of a teacher's character in a letter of recommendation, they were obligated to complete the picture by disclosing the material facts regarding charges and complaints of the teacher's sexual improprieties, despite no evidence of specific requests for this information).

[19] *Swersky v. Dreyer & Traub*, 219 A.D.2d 321, 326 (1996); *Wall v. CSX Transp., Inc.*, 471 F.3d 410, 415-16 (2d Cir. 2006) (quoting *Bridgestone/Firestone, Inc. v. Recovery Credit Servs., Inc.*, 98 F.3d 13, 19 (2d Cir. 1996)).

[20] *Brass v. Am. Film Techs., Inc.*, 987 F.2d 142, 150-152 (2d Cir. 1993); *Aetna Casualty & Surety Co. v. Aniero Concrete Co.*, 404 F.3d 566, 582 (2d Cir. 2005); *Bank of Am. v. Bear Stearns Asset Mgmt.*, 2013 WL 4734495, at *10 (S.D.N.Y., Sept. 3, 2013).

[21] *Abrahami v. UPC Const. Co., Inc.*, 224 A.D.2d 231, 234 (1996); *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 500 F.3d 171, 181 (2d Cir. 2007).

[22] *Abrahami*, 224 A.D.2d at 234 (holding that sophisticated plaintiffs have a duty to exercise due diligence and conduct an independent appraisal of the risk they were assuming); *Rodas v. Manitaras*, 159 A.2d 341, 342-43 (1st Dep't 1990) (holding that a party cannot claim fraud when it is its own lack of due care which is responsible); *Emergent Capital Inv. Mgmt., LLC v. Stonepath Grp., Inc.*, 343 F.3d 189, 195-96 (2d Cir. 2003) (holding that sophisticated parties are held to a higher standard and that a party which has been put on notice of the existence of material facts which are not documented must protect itself by insisting that this representation be included in the final agreement); *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 500 F.3d at 181 (where the misrepresentations relate to matters peculiarly within the other party's knowledge ''the wrong party may rely on them without further investigation'').

[23] *Brass*, 224 A.D.2d at 150.

[24] *See, e.g.*, *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 500 F.3d at 181 (where the misrepresentations relate to matters peculiarly within the other party's knowledge ''the wrong party may rely on them without further investigation''); *Keywell Corp. v. Weinstein*, 33 F.3d 159, 164 (2d Cir. 1994) (finding that a sophisticated buyer with access to an environmental report was not sufficiently on notice of the true facts about illegal waste disposal such that it was precluded from claiming justifiable reliance where the defendants' misrepresentations during due diligence may have influenced the plaintiff's investigation); *but see Harsco Corp. v. Bowden*, , 1995 WL 152523, at *1-2, 7 (S.D.N.Y. 1995) (holding that where a sophisticated purchaser agreed to a due diligence period of 17 days, did not complain and went through with the purchase despite not receiving access to certain of the seller's key personnel, and then disclaimed reliance, it could not reasonably rely on vague information it alleged was withheld during due diligence).

   ISSN 1098-4720

Disclaimers. How does a contractual disclaimer affect the question? Assume that various of the deal documents also contain contractual language requiring the buyer to generally disclaim reliance on the accuracy of information disclosed in due diligence as a condition to receiving information from the seller.

A buyer's agreement to disclaimers of reliance during due diligence can assume central importance in a later fraud claim based on the seller's misrepresentations or failure to disclose material facts. In private company acquisitions, a seller will often seek to have the buyer disclaim reliance on some or all representations by the seller, either as a condition to receipt of promotional materials, or in written agreements relating to the transaction. A buyer's purported disclaimer of reliance on extracontractual representations can arise, for example, at the outset of the transaction in a confidentiality agreement entered into with the seller or seller's agent as a condition to receipt of the confidential information memorandum (typically referred to as a ''CIM''), in a letter of intent signed by the buyer to gain exclusivity with the seller in anticipation of a final deal, or in a final purchase agreement effecting the sale. The disclaimer can range from a blanket acknowledgement that the seller makes no representation or warranty of the accuracy of any information outside the final purchase agreement to a specific disclaimer of reliance on particular facts, such as any alleged representation by the seller relating to financial projections or other descriptive financial information provided by the seller.

In California, buyers' disclaimers of reliance on representations generally do not impact the disclosure burdens of the seller (or a buyer's showing of reliance) when analyzed in cases of intentional fraud. Under California Civil Code § 1668, disclaimers purporting to apply to fraudulent conduct are void and unenforceable, and therefore cannot preclude the justifiable reliance element of a common law fraud claim.[25] However, one California case has held that where other evidence supported the buyer's lack of justifiable reliance, the buyer's agreement to a disclaimer could be used as additional evidence of the buyer's lack of reliance and justifiable reliance.[26] So in the hypothetical above, assuming that intention fraud is shown, the contractual disclaimer will not absolve the seller of liability.

In New York, to the contrary, a buyer's disclaimer of reliance can potentially preclude the buyer's justifiable reliance on the seller's misrepresentation or omission, but only if (1) the disclaimer is made sufficiently specific and applicable to the particular type of information either misrepresented or not disclosed and (2) the alleged misrepresentation did not concern facts ''peculiarly'' within the seller's knowledge.[27] A sufficiently specific disclaimer clause in a final written purchase agreement, *i.e.,* a disclaimer provision aimed at precisely the subject matter of the alleged misrepresentation, can sometimes defeat a fraud claim.[28] By contrast, a general merger clause that simply limits the agreed-upon terms of the sale to the terms in the final written purchase agreement will not on its own, without some additional specific disclaimer clause in the same agreement, preclude justifiable reliance.[29]

Nonetheless, despite the greater force of disclaimers under New York law, even a specific disclaimer in New York will not necessarily preclude a buyer's fraud claim if the alleged misrepresentation concerned facts peculiarly within the seller's knowledge.[30] For example, in *DIMON Inc. v. Folium Inc.*, 48 F. Supp. 2d 359 (S.D.N.Y. 1999), the court relied on allegations that the buyer could not have uncovered the well-concealed accounting fraud prior to the sale in denying a motion to dismiss where an extremely sophisticated buyer had signed a specific disclaimer of reliance on representations other than those made in the stock purchase agreement.[31] New York courts are also less willing to bar fraud claims as a result of a disclaimer where there is no evidence that the agreement was the product of any real negotiations between the parties,[32] which may often be true in the case of the form confidentiality agreements signed or promotional materials routinely received at the beginning of transactions. The general disclaimer in the hypothetical above will therefore likely not eliminate liability in the case of intentional fraud both because it is insufficiently specific and because the information withheld concerns operational facts that only the seller knows.

---

[25] CAL. CIV. CODE § 1668; *see also McClain v. Octagon Plaza, LLC,* 159 Cal. App. 4th 784, 794-95 (Cal. Ct. App. 2008) (explicit disclaimer of reliance does not preclude justifiable reliance on defendants' representations for intentional and negligent misrepresentation claims); *Manderville v. PCG & S Grp., Inc.*, 146 Cal. App. 4th 1486, 1500 (Cal. Ct. App. 2007) (''It is well-established in California that a party to a contract is precluded from contracting away his or her liability for fraud or deceit based on intentional misrepresentation''); *Blankenheim v. E.F. Hutton & Co.*, 217 Cal. App. 3d 1463, 1472-73 (Cal. Ct. App. 1990) (a contract that attempts to exempt a party from liability for his own positive assertions, made in a manner not warranted by the information, is against the policy of the law and void).

[26] *Hinesley v. Oakshade Town Ctr.*, 135 Cal. App. 4th 289 (Cal. Ct. App. 2005) (holding that where the buyer disclaimed any reliance on certain representations by the seller and then failed to ask any questions about the alleged representations or put forward any evidence of the reliance on the alleged representation, the buyer's justifiable reliance failed as a matter of law).

[27] *Danann Realty Corp. v. Harris*, 5 N.Y.2d 317, 319-23 (1959) (holding that a specific disclaimer defeats reliance); *Grumman Allied Ind., Inc. v. Rohr Ind., Inc.*, 748 F.2d 729, 734-36 (2d Cir. 1984); *see also Steinhardt Grp., Inc. v. Citicorp*, 272 A.D.2d 255, 257 (1st Dep't 2000) (holding that a disclaimer that was not sufficiently specific did not preclude reliance).

[28] *See, e.g.*, *Grumman Allied Ind., Inc.*, 748 F.2d at 735 (holding that a disclaimer precluded reliance because ''the substance of the disclaimer provisions tracks the substance of the alleged misrepresentations, notwithstanding semantical discrepancies'').

[29] *Mfrs. Hanover Trust Co. v. Yanakas*, 7 F.3d 310, 315 (2d Cir. 1993) (''a general merger clause is ineffective . . . to preclude parol evidence that a party was induced to enter the contract by means of fraud'').

[30] *DIMON Inc. v. Folium, Inc.*, 48 F. Supp. 2d 359, 368 (S.D.N.Y. 1999) (holding that where the facts are peculiarly within the seller's knowledge, a specific representation is not sufficient to defeat reliance); *Steinhardt Grp.*, 272 A.D.2d at 257 (2000) (''[A] purchase may not be precluded from claiming reliance on misrepresentations of facts peculiarly within the seller's knowledge, notwithstanding the execution of a specific disclaimer.'')

[31] *DIMON Inc.*, at 367-72.

[32] *Mfrs. Hanover Trust Co.*, 7 F.3d at 317 (noting that one factor in why a disclaimer could not defeat reliance was that it was not the result of any negotiations between the parties).

Due Diligence Is Not an Antidote to Fraud. Although California and New York (and other states) attempt to promote stability in the market by striking mutually acceptable balances between the obligations of sellers and buyers through fraud liability, it is significant that neither jurisdiction depends exclusively (or even significantly) on the buyer's diligence process to strike this balance.

Effective due diligence can play a meaningful role in promoting stable transactions by creating a sense of common purpose for buyer and seller in a couple of important ways. First, in most private acquisitions, there will be a significant imbalance between the level of knowledge that the target company has about itself and the level of knowledge that the most astute buyer in the sector will have about the target company. Therefore, one goal of due diligence is for the buyer to sufficiently understand and validate the underlying economics of the company to permit an informed decision of whether to purchase the company and at what price. Second, and just as importantly, the buyer can use the due diligence process to create a sense of common cause between the buyer and the target company, by working collaboratively with the company's management team to adequately understand the company's operations, challenges, and goals. Ultimately, the buyer will likely be in a close relationship with the target company for some period of time, and therefore will need to have a relationship of trust wherein they work together effectively to improve the business.

To accomplish these goals, a buyer's diligence typically includes a number of steps, including, among others, developing an initial investment thesis for the target company, conducting a detailed internal investigation into the target company, its management, and its market, customers, competitors, and suppliers, evaluating and understanding the actual and forecasted financial information provided by the target company, creating a financial model to arrive at an appropriate purchase price, and ultimately finalizing the investment thesis and determining whether the deal makes sense and should proceed.

An outside buyer's due diligence would not normally be designed to uncover intentional misrepresentation or concealment of material facts. In many private company transactions, the seller is in exclusive control of most or all of the critical information about the company's operations. Although a buyer can often obtain industry data and forecasts, it may not be able to acquire company-specific information unless that information is provided by the seller. Therefore, all parties are served if the seller supplies the buyer with all of the management reports used to manage the business. It is then incumbent on the buyer to read and digest the complete set of documents supplied by the seller.

Common law fraud liability can protect a buyer from having to rely on either the due diligence process or contract liability as the exclusive means of preventing deception. In the absence of circumstances that alert the buyer to potential fraud, case law discussing fraud claims does not typically impose an obligation upon a buyer of a private company with limited public information to assume that the seller is concealing information that would materially qualify its representations. In short, effective due diligence cannot be expected to uncover misrepresentations or deceptive ''half-truths'' made by the seller when the seller is the only knowledgeable source of the full scope of relevant information. In addition, the application of fraud liability means that a buyer does not have to incorporate every representation that goes to the heart of the deal into the final contract in order to justifiably rely upon it.

Although a final purchase agreement will often address certain critical representations, a stable market requires that the parties believe that there is legal recourse to a set of fraud principles protecting the buyer outside of the written agreement in certain ways as well. Otherwise, negotiations over the representations and warranties would overwhelm the diligence process and transactions would be extremely difficult to accomplish.

Conclusion

Although effective buyer diligence can and should play a meaningful role in a transaction, it is not an antidote to fraud, and cannot be relied on to uncover concealed information in situations where the seller has exclusive control of most or all of the critical information about the company's operations. Therefore it is in the best interest of fairness that the seller supply the buyer with all of the management reports utilized to manage the business from the time of ''exclusivity'' until closing.

The issue of a seller's duty to disclose has particular significance in private company acquisitions, as in such circumstances common law fraud principles can operate to protect a buyer from having to rely on the due diligence process as the exclusive means of preventing fraud. Common law fraud liability, therefore, provides a natural mechanism for avoiding an untenable alternative in which the fight over the representations and warranties in the final purchase agreement would consume the sales process, and contractual disclaimers do not generally usurp this role. Buyers and sellers must be able to work within a clear and reasonable common understanding of what disclosure is required. The common law of fraud can deliver needed stability to the market by providing guidance on the disclosure obligations of a seller and the diligence practices of a buyer.

   ISSN 1098-4720