IN THE UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF WISCONSIN

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MBI ACQUISITION PARTNERS, L.P.,

OPINION AND ORDER

Plaintiff,

01-C-177-C

v.

THE CHRONICLE PUBLISHING COMPANY and RICHARD SUOMALA,

Defendants.

- -

This is a civil action for monetary relief in which plaintiff MBI Acquisition Partners, L.P., contends that defendants The Chronicle Publishing Company and Richard Suomala committed fraud and fraudulently induced plaintiff to enter into a contract when they failed to disclose the existence of a warehouse that was allegedly leased by defendants to store unprocessed returns, failed to provide accurate financial statements regarding the status of the unprocessed returns and represented expressly that the current level of unprocessed returns was consistent with historical levels. Plaintiff alleges five causes of action: (1) violation of Section 10(b) and 10(b)-5 of the Securities Exchange Act; (2) violation of Wis.

Stat. §§ 551.41 (uniform securities law-fraudulent practices: sales and purchase) and 551.59 (uniform securities law-general provisions: civil liabilities); (3) violation of Wis. Stat. § 100.18(1) (marketing; trade practices: fraudulent representations); (4) fraudulent inducement; and (5) violation of Rule 20(a) of the Securities Exchange Act. Subject matter jurisdiction is present. 28 U.S.C. § 1331. Supplemental jurisdiction is present over state law claims. 28 U.S.C. § 1367.

Presently before the court is defendants' motion to dismiss or, in the alternative, to strike plaintiff's claims pursuant to Fed. R. Civ. P. 12(b)(6) and 12(f), respectively. In their motion to dismiss, defendants contend that plaintiff cannot bring its claims because (1) the California choice-of-law provision contained in the purchase agreement bars plaintiff's Wisconsin statutory claims; (2) plaintiff is unable to show reasonable reliance; (3) the "survival," "entire agreement" and "representations and warranties " clauses contained in the purchase agreement bar claims of fraud that occurred outside the purchase agreement; and (4) portions of plaintiff's federal securities claims that rely on representations made outside the purchase agreement are barred because of the "survival" and "representations and warranties" clauses. Because I find that plaintiff has stated claims on which relief can be granted, defendants' motion to dismiss or to strike will be denied.

For the sole purpose of deciding this motion to dismiss, plaintiff's allegations in the complaint are accepted as true.

ALLEGATIONS OF FACT

Plaintiff MBI Acquisition Partners, L.P. is a holding company with its principal place of business in New York, New York. Defendant The Chronicle Publishing Company is a publishing and media holding corporation with its principal place of business in San Francisco, California. Defendant Richard Suomala is a citizen of Minnesota.

Before February 1, 2000, defendant Chronicle owned all of the issued and outstanding capital stock of MBI Publishing Company. Defendant Chronicle retained Donaldson, Lufkin & Jenrette to conduct an auction of MBI. On July 26, 1999, Donaldson, Lufkin & Jenrette invited plaintiff to participate in the auction process. Later that month, it delivered to plaintiff an offering memorandum containing information provided by defendant Chronicle. On August 27, 1999, plaintiff's representatives examined certain financial documents concerning MBI that MBI and defendant Chronicle had assembled at the offices of Donaldson, Lufkin & Jenrette in New York, New York. On September 9, 1999, plaintiff's representatives visited MBI's headquarters in Osceola, Wisconsin.

In early October 1999, plaintiff bid $46 million for MBI. Plaintiff arrived at this offering price by performing calculations that included a discounted cash flow analysis of MBI's operating cash flows based on the current and historical financial information that defendant Chronicle had provided. In late October 1999, defendant Chronicle gave plaintiff

a draft share purchase agreement that included disclosure schedules. On November 1, 1999, MBI began leasing a warehouse in which it stored returned product. On November 5, 1999, the parties entered into a purchase agreement whereby plaintiff agreed to pay defendant Chronicle $46 million for all of the outstanding stock of MBI. On November 8-12, 1999, plaintiff's representatives visited MBI's headquarters in Osceola and interviewed members of MBI's management, including defendant Suomala, MBI's chief financial officer, and Ann Eklund, MBI's vice president of operations. Plaintiff's representatives included David Straden and Stephen Walmsley, an employee of plaintiff's accounting and due diligence advisers, PriceWaterhouseCoopers, LLP. In these and subsequent interviews and communications about the business of MBI, defendant Suomala, Eklund and other officers and employees of MBI were acting not only as officers of MBI but as agents of defendant Chronicle in connection with defendant Chronicle's impending sale of MBI. During this visit, Walmsley and others reviewed financial records, including MBI's financial statements as of August 31, 1999, and MBI's general ledger.

Plaintiff's offering price for MBI was reduced subsequently by $4 million on a negotiated basis as a result of MBI's poor performance in October 1999. This poor performance lowered the forecast for MBI's performance for the full year ending December 31, 1999. In January 2000, plaintiff's representatives, including Straden, had numerous telephone conversations with defendant Suomala and representatives from defendant

Chronicle regarding MBI's higher than expected levels of accounts receivable. On January 24 and 25, 2000, plaintiff's representatives, including Walmsley, visited MBI's headquarters in Osceola again to check its inventory and accounts receivable. On February 1, 2000, defendant Chronicle sold all of the issued and outstanding capital stock of MBI to plaintiff for $42 million.

Through the disclosure schedules, defendant Chronicle represented that it had disclosed all material contracts to which MBI was a party, including leases for real property, and all real property sites at which MBI's assets were located. These representations were false because the disclosure schedules did not disclose the real property site (a warehouse) at which MBI stored returned product and they did not disclose the lease for this site. Defendant Suomala represented to plaintiff's representatives that the information contained in the financial documents provided to plaintiff reflected MBI's levels of sales returns accurately. This representation was false because the financial documents provided did not disclose that MBI had an additional $1 million in unprocessed customer returns and did not disclose facts about the existence of the warehouse containing unprocessed customer returns.

During the November 1999 visit, officers of MBI, including defendant Suomala and Eklund told Walmsley that (a) MBI's current inventory levels, including unprocessed customer returns, were consistent with MBI's historical levels; (b) MBI's Star Prairie Facility contained only slow moving inventory; and (c) MBI stored unprocessed customer returns

only at its Osceola warehouse and nowhere else. These representations were false because MBI's unprocessed return backlog level at that time was ten times higher than the return backlog level at year end 1998 and MBI stored unprocessed customer returns at the Star Prairie facility and at the undisclosed warehouse. In January 2000, plaintiff's representatives asked defendant Suomala and representatives of defendant Chronicle to explain why MBI's receivables were approximately $2 million higher than expected. Defendants offered explanations but failed to disclose that approximately $1 million of the receivables resulted from the backlog of customer returns that had not yet been processed and credited to customers.

During the January 2000 visit, Walmsley asked defendant Suomala and Eklund specifically whether MBI stored returns at any location other than its Osceola warehouse. Both Suomala and Eklund answered this question in the negative. After discovering seven to ten skids of returned product not included by MBI in its inventory count, Walmsley asked defendant Suomala and Eklund specifically whether MBI had any additional unprocessed returns. Suomala and Eklund represented to Walmsley that MBI did not. This statement was false because MBI had additional unprocessed returns at Osceola, the Star Prairie facility and the undisclosed warehouse. Defendant Chronicle made numerous representations and warranties to plaintiff in the purchase agreement, including that (a) MBI's financial statements were accurate; (b) all of MBI's tangible property, including its real property

leases, was disclosed; and (c) all of MBI's contracts, including its leases relating to all real property, were disclosed. These representations were false because MBI's financial statements misstated MBI's revenue and profit in that they did not disclose the $1 million in unprocessed returns or include the lease for the undisclosed warehouse.

Plaintiff overvalued MBI on the basis of defendants' misrepresentations and omissions. If the $1 million in unprocessed returns had been reflected in MBI's financial documents, it would have had the effect of reducing its 1999 revenue by $1,039,000, reducing cash flow by $622,000, and would have revealed that MBI's cash flows and profits were in decline. The financial information defendants provided to plaintiff indicated that MBI's cash flows and profits were on the rise. Plaintiff paid $10.4 million more for MBI than it would have paid had it known MBI's true financial condition. Because of defendants' misrepresentations, plaintiff was misled into believing that MBI's revenue and cash flow were much higher than they were. The amount and value of MBI's unprocessed returns at year end 1999 totaled $1 million, a fact that defendants intentionally or recklessly failed to disclose and affirmatively misrepresented. Defendants made affirmative misrepresentations and failed to disclose facts to plaintiff for the purpose of inflating the sales price of MBI.

The purchase agreement contains the following clauses, among others:

"9.1 Survival. None of the representations and warranties of the Seller, the Company

and the Purchaser contained in this Agreement, or in any certificate, instrument or other document delivered by the Seller, the Company or the Purchaser pursuant to this Agreement or in connection with the transactions contemplated hereby, shall survive the Closing. None of the covenants and agreements of the Seller, the Company and the Purchaser contained in this Agreement, or in any certificate, instrument or other documents delivered by the Seller, the Company or the Purchaser pursuant to this Agreement or in connection with the transactions contemplated hereby, shall survive the Closing, except to the extent such covenants and agreements by their terms contemplate performance after the Closing. . . .

9.6 Entire Agreement. This Agreement, the Confidentiality Agreement and the related documents contained as Exhibits and Schedules hereto or expressly contemplated hereby contain the entire understanding of the parties hereto relating to the subject matter hereof and supersede all prior written or oral and all contemporaneous oral agreements and understandings relating to the subject matter hereof. The Exhibits and Schedules to this Agreement are hereby incorporated by reference into and made a part of this Agreement for all purposes.

9.7 Representations and Warranties Complete. The representations, warranties, covenants and agreements set forth in this Agreement, the Confidentiality Agreement and the Exhibits and Schedules hereto, constitute all the representations, warranties, covenants and agreements of the parties hereto and their respective shareholders, directors, officers, employees, affiliates, advisors (including financial, legal and accounting), agents and representatives and upon which the parties hereto have relied.

9.9 Governing Law. This Agreement will be governed by and construed and interpreted in accordance with the substantive laws of the State of California, without giving effect to any conflicts of law rule or principle that might require the application of the laws of another jurisdiction.

OPINION

A. Standards of Review

A motion to dismiss under Fed. R. Civ. P. 12(b)(6) will be granted only if "it is clear that no relief could be granted under any set of facts that could be proved consistent with the allegations" of the complaint. Cook v. Winfrey, 141 F.3d 322, 327 (7th Cir. 1998) (citing Hishon v. King & Spalding, 467 U.S. 69, 73, (1984)); Gossmeyer v. McDonald, 128 F.3d 481, 489 (7th Cir. 1997)). Moreover, in a Rule 12(b)(6) motion to dismiss, all plaintiff's well-pleaded facts are taken as true, all inferences are drawn in favor of plaintiff and all ambiguities are resolved in favor of plaintiff. Dawson v. General Motors Corp., 977 F.2d 369, 372 (7th Cir. 1992).

A district court may strike from any pleading "any insufficient defense or any redundant, immaterial, impertinent, or scandalous matter." Fed. R. Civ. P. 12(f). A motion to strike will be granted only in extreme circumstances where the challenged matter clearly has no bearing on the subject matter of the litigation and real prejudicial harm to the moving party is shown. Armstrong v. Snyder, 103 F.R.D. 96, 100 (E.D. Wis. 1984). Because defendants have failed to show that the claims at issue in this motion meet these criteria, defendants' motion to strike will be denied.

B. Wisconsin State Law Claims

1. Choice-of-law provision

A district court is required to apply the laws of the state in which it sits to resolve conflict of laws questions. Klaxon Co. v. Stentor Electric Mfg. Co., 313 U.S. 487 (1941). The first step to resolving a conflict of law is identifying the type of case involved. Drinkall v. Used Car Rentals, Inc., 32 F.3d 329, 331 (8th Cir. 1994). In Krider Pharmacy v. Medi-Care Data Systems, 791 F. Supp. 221, 225 (E.D. Wis. 1992), the court held that "Wisconsin law governs the tort aspects of Krider's claims . . . because the choice-of-law provision in the sales agreement governs only the parties' contract rights." See also Smith v. Meadow Mills, Inc., 60 F. Supp. 2d 911, 914 (E.D. Wis. 1999) (holding that North Carolina choice-of-law provision "pertains only to the interpretation of the Agreement itself and not to the law surrounding successor liability in the context of tort actions").

Defendants contend that plaintiff's second and third causes of action, which are brought under Wisconsin statutory law, should be dismissed because the choice-of-law provision contained in the purchase agreement states that California law governs "without giving effect to any conflicts of law rule or principle that might require the application of the laws of another jurisdiction." Therefore, defendant contends that the choice-of-law rules, as set out in the purchase agreement, are also governed by California and not Wisconsin law. Plaintiff contends that the purchase agreement choice-of-law provision controls only contract

claims and not tort claims.

Plaintiff brought these claims under Wis. Stat. §§ 551.41 (uniform securities law-fraudulent practices: sales and purchase), 551.59 (uniform securities law-general provisions: civil liabilities) and 100.18(1) (marketing; trade practices: fraudulent representations). These fraud claims are tort actions and not breach of contract. See Jersild v. Aker, 766 F. Supp. 713, 714 (E.D. Wis. 1991) (noting plaintiffs filed "tort action alleging securities fraud" when plaintiffs filed under Wis. Stat. §§ 551.41, 551.59 and 100.18(1)). See also Werner v. Pittway Corp., 90 F. Supp. 2d 1018, 1033 (W.D. Wis. 2000) (noting plaintiff's claim for fraudulent misrepresentations under § 100.18(1) could fall within a continuing tort theory for statute of limitations purposes); Wilbur v. Keybank National Assoc., 962 F. Supp. 1122, 1132 (N.D. Ind. 1997) (holding that it is "well established that a claim for constructive fraud is a tort action"). Because these are tort claims, I find that the applicable choice-of-law rules are those of Wisconsin law and that Wisconsin law also applies to the substantive claims made by plaintiff.

2. Fraudulent misrepresentations inside the purchase agreement

As to the aspects of plaintiff's second, third and fourth claims that are contained within the purchase agreement itself, defendants argue that plaintiff is required to prove reasonable reliance on the alleged misrepresentations and that plaintiff cannot do so because

a finding of reasonable reliance would conflict with the terms of the purchase agreement's "survival," "entire agreement" and "representations and warranties" clauses. Plaintiff asserts that reliance is presumed because its claims are based on fraudulent omissions that contradict the purchase agreement.

In Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972), the Supreme Court found that the defendants had induced holders of stock "to dispose of their shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell." The Supreme Court reasoned that "[u]nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision." Id. at 153-54. See also Harsco Corp. v. Segui, 91 F.3d 337, 342 n.5 (2d Cir. 1996) (noting court holding in Affiliated Ute and recognizing total non-disclosure of material information as exception to requirement of proving reliance).

The "entire agreement" and "representations and warranties" clauses state that the parties have not relied on any representations other than those contained in the purchase agreement, but plaintiff alleges that numerous false representations were made inside the purchase agreement. For example, plaintiff alleges that the purchase agreement itself states that all financial statements are accurate (when they were not), all of MBI's real property

leased are disclosed (when they were not) and all contracts, including real property leases, are disclosed (when they were not). Notwithstanding a "no other representations or warranties" clause, the court held in Harsco that any representation within the purchase agreement itself can be the basis of a fraud action against the seller. Harsco, 91 F.3d at 344.

Because plaintiff alleges a material omission that a reasonable investor might have considered important, I find that plaintiff is not required to demonstrate reasonable reliance as an element of its state law claims. In addition, the "survival," "entire agreement" and "representations and warranties" clauses do not bar plaintiff from bringing claims of fraud based on misrepresentations made in the purchase agreement itself.

3. Fraudulent misrepresentations outside the purchase agreement

Defendants argue that any claims of misrepresentation brought under state law (the second, third and fourth claims) that occurred outside the purchase agreement should be dismissed or stricken because the purchase agreement contains an integration clause indicating that the agreement survives as evidence of the parties' representations. Plaintiff asserts that the contract language may prevent it from suing under contract law but does not prevent it from suing for the tort of intentional fraudulent conduct. Plaintiff also argues that the Wisconsin law that controls these claims does not allow such contract disclaimers to prevent actions in fraud.

In Astor Chauffeured Limousine v. Runnfeldt Inv. Corp., 910 F.2d 1540, 1545 (7th Cir. 1990), the Court of Appeals for the Seventh Circuit held that an integration clause did not prevent a plaintiff from pursuing securities and common-law fraud claims. In Astor, the plaintiff alleged that the written documents did not disclose the truth and that the defendant's oral statements contradicted the written statements. Id. Defendants try to differentiate the facts of this case from those in Astor, asserting that their integration clause ("entire agreement" and "representations and warranties" clauses collectively) is more substantial than the "wimpy" integration clause in Astor. In Astor, the integration clause stated "Entire Agreement. This Agreement constitutes the entire agreement between the parties, and may not be amended or supplemented except by written instrument executed by an authorized agent or officer of each of the parties hereto." Defendants argue that their integration clause "specifically provides that there are no other representations and that all representations expire at the time of closing." Dfts.' Reply Br. Mot. to Dismiss, dkt. #9, at 7-8. But the clause at issue in Astor implies that there can be no other representations because the agreement constitutes the entire agreement. Although representations expire at closing, misrepresentations amounting to fraud do not expire at the time of the closing because they are tort claims and are not governed by the contract terms. Plaintiff alleges that the purchase agreement stipulated that all real property leases were disclosed and all financial statements were accurate when, in fact, they were not. The integration clause does

not prevent plaintiff from claiming misrepresentations that occurred outside the purchase agreement in order to recover on its state securities fraud claims.

In Republicbank Dallas v. First Wisconsin Nat'l Bank, 636 F. Supp. 1470, 1473 (E.D. Wis. 1986), the court held contract disclaimers ineffective to bar intentional fraudulent misrepresentation claims. See also FS Photo, Inc. v. Picturevision, Inc., 61 F. Supp. 2d 473, 481 (4th Cir. 1999) (holding that party to contract may point to contract-inducing representations to prove claim); Hitachi Credit America Corp. v. Signet Bank, 166 F.3d 614, 630-31 (4th Cir. 1999) (holding that buyer may recover for fraudulent inducement even where "the contract contains specific disclaimers that do not cover the allegedly fraudulent contract-inducing representations"). In this case, plaintiff claims intentional or reckless misrepresentation. Because integration clauses are the functional equivalent of contract disclaimers, defendants cannot escape the conclusion that the integration clause does not bar plaintiff's state law claims.

Defendants assert further that these claims are actually breach of contract claims that plaintiff is merely labeling "fraud." Drawing all inferences in favor of the non-moving party as I must at this stage of the proceedings, I find that plaintiff's characterization of the facts as fraud does not fail to state a claim upon which relief may be granted. Accordingly, I find that in its claims for fraud, plaintiff may rely on defendants' contract-inducing representations in order to prove its claim. Defendants' motion to dismiss plaintiff's state

law claims occurring outside the purchase agreement will be denied.

C. Federal Claims: Anti-Waiver Provision of Securities Exchange Act

The anti-waiver provision of the Securities Exchange Act, § 29(a), states that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or any rule of an exchange required thereby shall be void." 15 U.S.C. § 78cc(a). Section 29(a) forbids enforcement of agreements that waive compliance with the provisions of the Securities Exchange Act. Shearson/American Express Inc. v. McMahon, 482 U.S. 220, 228 (1987). Section 29(a) focuses on whether the suspect provision "weakens [plaintiff's] ability to recover under the Exchange Act." Id. at 230 (citing Wilko v. Swan, 346 U.S. 427, 432 (1953)).

Defendants have moved to dismiss only those portions of the first and fifth federal securities claims that rely on representations made outside the purchase agreement. Specifically, defendants argue for dismissal of allegations that "low-level employees of MBI Publishing allegedly made inaccurate statements about the company's inventory." Dfts.' Reply Br., dkt. #9, at 11. From the allegations, I assume that defendants are referring to defendant Suomala, the chief financial officer, and Eklund, the vice president of operations, neither of whom appear to be "low-level" employees. In any event, defendants contend that the anti-waiver provision of § 29(a) is not violated by the purchase agreement clauses, which

disclaim reliance on any representations made outside the purchase agreement.

Plaintiff argues that the "survival" and "representations and warranties" clauses are void insofar as they violate the § 29(a). Moreover, plaintiff asserts that if the purchase agreement clauses are not void under § 29(a), its federal claims under the Securities Exchange Act would be wholly eliminated. As defendants point out, this seems to be an overstatement because plaintiff would still have an opportunity to prove its federal securities claims based on misrepresentations made inside the purchase agreement. Nevertheless, the question is whether the clauses will "weaken" plaintiff's ability to recover.

Defendants argue that this court should consider the fact that both parties to the purchase agreement are sophisticated and that they mutually negotiated the terms of the purchase agreement. In Harsco Corp. v. Segui, 91 F.3d 337, 343 (2d Cir. 1996), the court found that the contested agreement was "a detailed writing developed via negotiations among sophisticated business entities and their advisors. That writing . . . defines the boundaries of the transaction. [The plaintiff] brings this suit principally alleging conduct that falls outside those boundaries." Although the facts suggest that the parties share a high level of sophistication and mutually negotiated the purchase agreement, in Shearson, 483 U.S. at 230, the Supreme Court held that "[i]f a stipulation waives compliance with a statutory duty, it is void under § 29(a), whether voluntary or not." Therefore, sophistication of the parties or voluntariness based on mutual negotiation is only part of the equation; the

court must also determine whether the disclaimer clauses violate the anti-waiver provision of the Securities Exchange Act.

In Harsco the court found for the defendant. With respect to the § 29(a) claim, the court was persuaded by its due diligence investigation, stating that "[i]f [the plaintiff] had been unable to confirm the truth of the representations [in the purchase agreement] during the due diligence period, [it] could have terminated the deal." Harsco, 91 F.3d at 344. The court went on to conclude that "there is nothing in the complaint or the Agreement that indicates that [the plaintiff] was duped into waiving the protections of the securities law." Id. In this case, plaintiff alleges that it attempted to confirm the truth of the purchase agreement representations but was assuaged with false answers. In short, plaintiff alleges it was duped. According to plaintiff's complaint, from the date of the signing of the purchase agreement, Nov. 5, 1999, until the closing of the stock purchase, Feb. 1, 2000, plaintiff visited MBI several times and made specific inquiries about the status of the returns and accounts receivable, to which defendants responded with misrepresentations. For example, plaintiff alleges that it specifically asked Eklund and defendant Suomala whether the company had any additional unprocessed returns and was falsely told it did not. Plt.'s Cpt., dkt. # 2, at 5-7, 9.

If plaintiff could not rely on these representations made outside the purchase agreement, its ability to recover would be weakened. Accordingly, I find that § 29(a)

renders the "survival" and "representations and warranties" clauses void as to the federal securities claims. Therefore, defendants' motion to dismiss those portions of the first and fifth claims that rely on representations made outside the purchase agreement will be denied.

ORDER

IT IS ORDERED that the motion of defendants The Chronicle Publishing Company and Richard Suomala to dismiss or, in the alternative, to strike plaintiff's claims pursuant to Fed. R. Civ. P. 12(b)(6) and 12(f), respectively, is DENIED.

Entered this 6th day of September, 2001.

BY THE COURT:

BARBARA B. CRABB
District Judge