Client Alert

December 2014

Delaware Court Rules on Indemnity Imposed on Non-Signatory Stockholders in Private Company M&A

On November 26, 2014, the Delaware Court of Chancery issued a significant ruling with important implications for private company M&A transactions. The litigation, *Cigna Health and Life Insur. Co. v. Audax Health Solutions, Inc.*, was brought by a former target stockholder that did not vote in favor of a cash-out merger.[1] The stockholder refused to sign a letter of transmittal that contained a release of claims and appointment of a stockholders' representative. The stockholder also objected to post-closing indemnity obligations that were imposed by the merger agreement on all stockholders (including non-signatories).

First, the court refused to enforce the release contained in the letter of transmittal. The court held that the release was not supported by consideration because it was not expressly contemplated in the merger agreement. "Because the Release Obligation is a new obligation Defendants seek to impose on [the stockholder] post-closing," Vice Chancellor Parsons wrote, "and because nothing new is being provided to [the stockholder] beyond the merger consideration to which it became entitled when the Merger was consummated and its shares were canceled, I find that there is no consideration for the Release Obligation in the Letter of Transmittal."

Second, the court refused to enforce the indemnification obligations imposed on the non-signatory stockholder through the merger agreement. Although Section 251(b) of the Delaware General Corporation Law ("DGCL") allows the terms of a merger agreement to be "made dependent upon facts ascertainable outside of such agreement," the court held that the merger consideration was not sufficiently determinable as required under the DGCL. The court based its conclusion on the fact that the indemnity, though limited to certain types of claims, survived "indefinitely" and was capped at the merger consideration received by the stockholder. "[D]espite literally complying with the 'facts ascertainable' provision of Section 251(b)," the court explained, "the value of the merger consideration *itself* is not, in fact, ascertainable, either precisely or within a reasonable range of values."

The court denied the stockholder's motion for judgment on the pleadings on a third claim, which challenged the appointment of the stockholders' representative, finding that the record on that issue was not fully developed.

Cigna is an important case for private company M&A transactions where the number of target stockholders makes a stock purchase agreement impractical. Here are a few initial take-aways on an opinion that will continue to be scrutinized by practitioners:

- The court did not address whether the release would have been enforceable if included in the merger agreement. The court also did not address other approaches for obtaining a release. For example, a release in a letter of transmittal could be supported by separate consideration,

[1] *Cigna Health and Life Insur. Co. v. Audax Health Solutions, Inc.*, C.A. No. 9405-VCP (Del. Ch. Nov. 26, 2014).

such as offering stockholders the option to receive an additional payment or a mutual release of claims from the company if they grant the release.

- The court did not rule broadly that imposing indemnification obligations on non-signatories to a merger agreement is unenforceable under the DGCL. In fact, the court stated that its opinion with respect to the indemnification obligations focuses only on "the fact that certain aspects of [the indemnification obligations] are not limited in terms of (1) the amount of money that might be subject to a clawback and (2) time." The opinion thus leaves open that a more limited survival period and cap could suffice. Still, cautious buyers will continue to require as many stockholders as possible (and certainly the key stockholders) to sign the merger agreement or a support agreement.

- Vice Chancellor Parsons went out of his way to indicate that this was a "limited holding" that did not address "escrow agreements, nor does it rule on the general validity of post-closing price adjustments requiring direct repayment from the stockholders."

- M&A parties can be expected to explore additional ways to allocate risk when a private company is widely held. For example, stockholders might be offered a choice to receive a higher per share price if they agree to a post-closing indemnity or a lower per share price with limited or no post-closing obligations. In addition, representation and warranty insurance has become increasingly popular in recent years, particularly in transactions where financial sponsors seek limited post-closing exposure.

- M&A parties should keep in mind Vice Chancellor Laster's 2010 decision in *Aveta Inc. v. Cavallieri*, 23 A.3d 157 (Del. Ch. 2010), which found that certain post-closing price adjustments to be determined through a stockholders' representative were permissible under Section 251(b). Still, the precise contours of a stockholders' representative's authority have not been fully defined by the courts, and *Cigna* declined to rule on this issue.

Contacts

Steven M. Haas
shaas@hunton.com

Michael C. McCann
mmccann@hunton.com