Client Alert

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Delaware Court Addresses the Binding (or Not) Nature of Indemnification and Other Stockholder Obligations in Merger Transactions – *Cigna Health*

By David A. Lipkin, Michael G. O'Bryan, Robert S. Townsend and Charles C. Comey

The Delaware Chancery Court (in a decision by Vice Chancellor Parsons in late November) has held unenforceable against a stockholder, that had not agreed in advance to the terms of a merger agreement effecting the sale of the company, two commonly-used provisions in private M&A transactions: (a) a post-closing indemnity obligation, to the extent that it involved a risk of repayment of up to 100% of the stockholder's share of the merger consideration for an "indefinite" period of time; and (b) a broadly-worded stockholder release that was contained in a letter of transmittal sent to stockholders after the merger was consummated. The court accordingly ordered that the stockholder be paid its proceeds without having to agree to the indemnity or the release. *Cigna Health and Life Insurance Company v. Audax Health Solutions, et al*. (Del. Ch. Nov. 26, 2014).

Although *Cigna Health* leaves open as many questions as it answers, its invalidation of a portion of a frequently-used indemnity structure and the stockholder release means that private M&A practice will evolve as a result of this case. Prior to this decision, it was not uncommon to see these types of obligations implemented through the means of a post-closing letter of transmittal. We suggest below a number of practical techniques that may help to mitigate the impact of the *Cigna Health* decision.

BACKGROUND

Acquisitions of private companies by way of merger are typically conditioned on the target company stockholders agreeing to a number of important provisions, beyond the per share merger consideration, that directly impact the stockholders following the closing of the transaction. Since their operative effect is to allocate post-closing risk in the transaction, the enforceability of such provisions against the selling stockholders is critical for acquirors. At the same time, target company boards expect these provisions to be enforceable in a consistent manner across all (rather than just against certain) stockholders, and they want a deal structure that will help make the company attractive as a target to potential acquirors.

For example, the merger agreement for a private acquisition typically gives the acquiror a post-closing indemnification remedy for damages arising from the target's breach of its representations, warranties and covenants. The indemnity is commonly supported by an escrow or holdback of a portion of the merger consideration for an agreed period following closing. In addition, in the case of the target's fraud, breach of certain "fundamental" representations and warranties or breach of covenants, the acquiror may also be entitled (beyond the more limited escrow or holdback) to sue former stockholders directly for recovery of an agreed portion of the consideration paid to them at closing.

Similarly, merger agreements in private M&A transactions often require, as a condition to closing, that all or a specified portion of the target's stockholders execute a general release in favor of the acquiror and the target.

THE *CIGNA HEALTH* DECISION

Facts

Optum Services, Inc. agreed to acquire Audax Health Solutions, Inc. via a merger. Several Audax stockholders executed support agreements shortly after the merger agreement was signed, which served as written consents providing stockholder approval of the merger. The support agreement provisions included:

- an agreement to be bound by the provisions of the merger agreement, including those requiring indemnification of Optum and related parties (the indemnification obligation);
- the appointment of a third party as a stockholders' representative to administer the indemnification provisions (the stockholders' rep obligation); and
- a release of any claims against Optum and Audax (the release obligation).

The indemnification obligation required stockholders to repay to Optum up to 100% of the merger consideration received by them if Optum were damaged by breaches of certain representations and warranties of Audax or the selling stockholders in the merger agreement. While most of these representations and warranties survived for a limited post-closing period (18 or 36 months), a number of them, by their terms, survived indefinitely. Somewhat unusually, the agreement did not provide for an escrow or holdback of any portion of the merger consideration.

The merger agreement required each Audax stockholder to execute a letter of transmittal reasonably acceptable to Optum as a condition to receiving the per share consideration. The form of letter of transmittal in turn required that stockholders agree to the indemnification and stockholders' rep obligations (which were contemplated by the merger agreement) as well as the release obligation (which was not mentioned in the merger agreement).

Cigna, a significant preferred stockholder of Audax (with its shares valued at over $46 million in the merger) with a representative on the board of directors of Audax (and a significant competitor of the acquiror), did not sign a support agreement and did not vote in favor of the merger. Following the closing, Cigna refused to sign the letter of transmittal and demanded its share of the merger consideration, alleging in its lawsuit (a) that the indemnification obligation violated Section 251 of the Delaware General Corporation Law (DGCL), (b) that the stockholders' rep obligation was invalid since it was "inextricably entwined" with the indemnification obligation and (c) that the release obligation was unenforceable since it lacked consideration.

THE COURT'S RULING

The court held that both the indemnification obligation and the release obligation were unenforceable, for the reasons set forth below.

Indemnification Obligation. The court held that the indemnification obligation, to the extent it was "indefinite" in duration and put at risk the stockholder's entire purchase price, violated Section 251 of the DGCL, which requires merger consideration to be determinable from the merger agreement. Under Section 251, merger consideration can be determinable from "facts ascertainable" outside of the merger agreement, but only if "the manner in which such facts shall operate … is clearly and expressly set forth in the agreement." Here, the court noted, a stockholder might never know the value of its merger consideration, since the indemnification obligation (a) placed potentially all of the stockholder's merger consideration at risk, and (b) continued indefinitely. The court rejected the acquiror's argument that the indemnification obligation was economically equivalent to an escrow structure (which the court said was "widely understood to be permissible" under Delaware law).[1]

The court did "not address whether such a price adjustment that covers all of the merger consideration may be permissible if time-limited, or whether an indefinite adjustment period as to some portion of the merger consideration would be valid." Rather, the court held only that the combination of these factors present in this case violated Section 251.

Release Obligation. Cigna argued that the release was unenforceable, since the merger consideration vested as a matter of law under the DGCL when the merger was consummated, and there was no other stated consideration for the release. The court agreed, and held the release unenforceable, noting also that the merger agreement "provided no indication to stockholders that they might have to agree to a release, let alone the sweeping release called for in the Letter of Transmittal" and rejecting the acquiror's argument that the release was "part and parcel of the overall consideration."

EFFECT ON PRIVATE COMPANY M&A PRACTICE

The *Cigna Health* decision carries implications for both acquirors and targets in private company acquisitions. For practitioners who had previously assumed that indemnity, release and similar post-closing stockholder obligations could be effectively implemented through a post-closing letter of transmittal, the effect on existing practice will be most significant. Following *Cigna Health*, we expect that more companies engaged in private M&A, particularly on the buy-side, will want to consider techniques including the following to mitigate the impact of the decision:

- Securing joinders expressly agreeing to the merger terms from as many stockholders as possible prior to closing, as a condition to closing, or by using a stock purchase structure in lieu of a merger.
- Increasing the size and duration of indemnification escrows and holdbacks, to mitigate against the possibility that indemnification recovery beyond these sources will not be fully available.
- Similarly, in deals that have earnouts and other forms of contingent consideration, providing expressly for offset rights against post-closing payouts (on the basis that offsets are more akin to an escrow/holdback than a right to recover consideration previously paid).
- Considering requiring stockholders that do approve the deal to pay for more than their *pro rata* share of indemnity obligations, to make up for those not signing.
- Providing in the acquisition agreement that fewer (if any) representations and warranties survive "indefinitely" and more survive for a fixed time period, and limiting the total indemnity exposure to an agreed percentage of the total merger consideration that is less than 100% of the merger consideration.

[1] The court's ruling that the indemnification obligation was unenforceable effectively mooted Cigna's claim with respect to the stockholders' rep obligation (the court also stated that the stockholders' rep obligation had been inadequately briefed to enable it uphold Cigna's challenge).

- Ensuring that all required stockholder releases and other post-closing stockholder obligations are specified with particularity in the merger agreement, and stating in the merger agreement that the purchase price is in consideration for and based on the acquiror's expectation of the enforceability of these obligations.
- Relying on other risk mitigation measures, such as purchasing representation and warranty insurance, or conducting additional due diligence.
- On the sell-side, increasing use of "drag-along" provisions in corporate charters and stockholder agreements, in order to minimize the percentage of the stockholder base whose separate approval is required for terms of a future acquisition.
- Limiting the authority of the stockholders' representative to the administration of the escrow or holdback provisions (as distinguished from the indemnity provisions that contemplate a recovery of merger consideration previously paid).

We would be pleased to discuss the *Cigna Health* decision or any of the other matters described in this Client Alert with our existing clients and other interested parties.

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