FOLEY HOAG LLP

Published Article

Delaware Chancery Court Concludes Indemnification and Other Provisions of a Merger Agreement Are Not Enforceable Against Non-Consenting Stockholders

Written by John D. Hancock, Peter M. Rosenblum, Joseph J. Basile

January 20, 2015

In November, the Delaware Court of Chancery issued a decision that raises troubling questions about commonly used techniques in private company acquisitions and that, if not modified on appeal or through legislation, could alter the way in which companies approach certain merger transactions governed by Delaware law.

In *Cigna Health and Life Insurance Company v. Audax Health Solutions Inc. et al.*[i], the court was asked to consider the enforceability of three provisions of a merger agreement that are common to many transactions involving privately held targets: (1) indemnification of the buyer by the stockholders of the selling corporation, (2) a release of claims by the selling stockholders and (3) the appointment of a stockholder representative to negotiate and settle post-closing disputes with the buyer.

Vice Chancellor Parsons concluded that, in light of the manner in which the transaction had been structured, neither the full scope of indemnification nor the release of claims was enforceable against a stockholder that neither voted in favor of the merger nor agreed to these provisions by contract. The Vice Chancellor held that, on the basis of the factual and legal record before the court, he could not reach a decision on the issue of the appointment of the stockholder representative, although he did note that "the propriety of stockholder representatives under the [Delaware General Corporation Law] is the subject of active and ongoing debate."

Background

The case arose from the acquisition of Audax Health Solutions, Inc. by Optum Services, Inc., a member of the UnitedHealth group of companies and a direct competitor to Cigna, a substantial stockholder of Audax. The acquisition appears to have been structured as a typical reverse triangular merger, whereby a transitory subsidiary formed by Optum was merged into Audax, and Audax thereby became a wholly owned subsidiary of Optum. The merger agreement provided that stockholders of Audax would be entitled to receive payment for their shares upon surrender of the shares and delivery of an executed "letter of transmittal in form and substance reasonably acceptable to [Optum], pursuant to which, among other things, the [stockholders] shall make standard representations and warranties [and] agree with the provisions [of the merger agreement] (including the indemnification provisions…)".

The merger agreement appears to have contained fairly customary terms regarding indemnification and the appointment of a stockholder representative. The agreement provided that former stockholders of Audax would indemnify Optum, on a pro rata basis in accordance with their ownership interest, for (among other things) any breaches by Audax of the representations and warranties that it made in the merger agreement. For most representations and warranties, Optum could assert indemnification claims only for 18 months after the closing. For certain intellectual property representations and warranties, Optum could assert indemnification claims for up to 36 months after the closing. For certain "fundamental" representations and warranties, Optum could assert indemnification claims for an indefinite period. The opinion implies, but does not clearly state, that indemnification for certain representations was capped at an amount less than the purchase price. Regarding the stockholder representative, the merger agreement provided that the stockholder representative would be entitled to defend and settle any indemnification claims by Optum, and the stockholder representative's actions would be binding upon the former stockholders of Audax.

The merger agreement did not itself contain a release of claims by the stockholders of Audax.

In accordance with Delaware law, the merger agreement was first approved by the board of directors of Audax and then submitted for approval by stockholders. The merger agreement was subsequently approved by the written consent of holders of 66.9% of the shares entitled to vote. The written consents were provided in the form of "support agreements," which Cigna did not sign. The support agreements contained binding contractual commitments, including provisions whereby the stockholders executing the support agreements expressly agreed to (1) be bound by the terms of the merger agreement, including the indemnification provisions, (2) provide a broad release of claims against Optum and Audax and (3) appoint the stockholder representative.

Following the consummation of the merger, Cigna was provided with a letter of transmittal that required it to agree to the indemnification, release and stockholder representative obligations. Significantly, the letter of transmittal did not form part of the merger agreement and was not submitted to the stockholders for their approval. Cigna refused to sign the letter of transmittal on the basis that the indemnification, release and stockholder representative obligations were unlawful and demanded payment of its share of the merger consideration, amounting to approximately $46 million. Optum refused to pay, and Cigna filed suit.

Indemnification – The Parties' Contentions

Cigna contended that the indemnification obligations were unlawful on two grounds. First, Cigna argued that the indemnification obligations violate Section 251 of the Delaware General Corporation Law, which governs Delaware mergers of this kind. Second, Cigna argued that the indemnification obligations violate Section 102(b)(6) of the Delaware General Corporation Law, which provides that stockholders are generally not personally liable for the debts of a Delaware corporation absent a contrary provision in the certificate of incorporation.

Cigna challenged the indemnification obligations under Section 251 on the basis that certain of the obligations were not limited in terms of either time or the amount of money that might have to be returned, causing ongoing uncertainty regarding the value of the merger consideration, since it could be reduced at any time through additional indemnification claims. Cigna argued that the merger agreement therefore did not satisfy the requirement of Section 251(b)(5) of the Delaware General Corporation Law that every merger agreement state "the cash, property, rights or securities … which the holders of such shares are entitled to receive." The merger agreement failed to meet this requirement, Cigna argued, because the ultimate value of the merger consideration was not "ascertainable *either precisely or within a reasonable range of values*" (emphasis added).

Optum made two principal counterarguments. First, Optum argued that the indemnification obligations were a normal purchase price adjustment mechanism substantially similar to escrow agreements, which the Vice Chancellor admitted are "widely understood to be permissible." In an escrow arrangement, the parties typically agree to deposit a portion of the merger consideration, frequently in the range of 5% to 15%, with an escrow agent for an agreed period of time; the escrow agent then disburses escrow funds to the buyer for valid claims made during the escrow period and pays to stockholders any funds to which they are entitled at the end of the escrow period (or following resolution of all disputed claims). Second, Optum argued that the indemnification provisions were specifically authorized by Section 251(b), which provides that "any of the terms of the [merger agreement] may be made dependent upon facts ascertainable outside of such agreement, provided that the manner in which such facts shall operate upon the terms of the agreement is clearly and expressly set forth in the [merger agreement]. The term 'facts' … includes … the occurrence of any event, including a determination or action by any person or body, including the corporation." According to Optum, the purchase price was, in fact, ascertainable through the application of the dispute resolution mechanisms set forth in the merger agreement – through either a negotiated resolution between Optum and the stockholder representative or, failing that, a judicial determination.

Indemnification – The Court's Analysis

Vice Chancellor Parsons conceded that, in *Aveta Inc. v. Cavallieri*,[ii] the Chancery Court had previously found certain post-closing purchase price adjustments valid under Section 251(b). In that case, the adjustments included an earn-out, an adjustment based on the target's financial statements and a potential clawback. He noted, however, that it did not appear that the clawback was at issue in that case, and therefore *Aveta* could not necessarily be relied upon as validating a clawback. The Vice Chancellor was clearly concerned about the potentially unlimited nature of the indemnity obligations in the Audax merger agreement. He found Optum's escrow analogy unpersuasive; he describes the indemnification obligations as the equivalent of "a 100% indefinite escrow pursuant to which the merger consideration would be released only after the buyer determined that it would never make a claim under the [merger agreement]," which he characterized as "hard to fathom."

Vice Chancellor Parsons found the indemnification obligations in the Audax merger agreement distinguishable from *Aveta* on the basis that, in contrast to a limited duration clawback of only a portion of the purchase price, the Audax indemnification put all of the merger consideration potentially at risk for an indefinite period of time. He ultimately agreed with Cigna's argument that the indemnification obligations – to the extent that they were uncapped in amount and unlimited in duration – violated Section 251(b)(5) of the Delaware General Corporation Law because it left the stockholders "unable to determine what they are receiving as merger consideration." Instead, the court held, Section 251 requires every merger agreement to set forth "determinable merger consideration." While acknowledging that stockholders may agree, through contractual arrangements, to bear the types of risks contemplated by the indemnification obligations, he concluded that "such a post-closing price adjustment cannot be foisted on non-consenting stockholders."

The Vice Chancellor expressly stated that his holding was a limited one. The opinion noted that the court was not addressing the general validity of either escrow agreements or clawbacks. Further, the opinion stated that the court was not addressing whether a purchase price adjustment that covers all of the merger consideration would be permissible if limited in duration or whether an adjustment that is unlimited in duration would be permissible if capped at only a portion of the merger consideration. Rather, the Vice Chancellor invalidated only the portion of the indemnification obligations in the Audax merger agreement that covered the entirety of the merger consideration for an indefinite period of time. The court expressly declined to rule on the enforceability of any portion of the indemnification obligations that were either subject to a monetary cap or limited in duration.

Having invalidated the indemnification obligations under Section 251(b)(5), the Vice Chancellor declined to rule on Cigna's argument that the indemnification obligations were also invalid under Section 102(b)(6). He noted the facial appeal of Cigna's argument that, absent express authorization to the contrary, no corporation should be able to enter into a contract with a third party – such as a buyer – that exposes its stockholders to liability. Yet he goes on to say that, in the context of a merger, the court should look to Section 251 for guidance, rather than Section 102(b)(6), on the basis of the general interpretive principle that specific provisions should prevail over more general provisions. While the Vice Chancellor does not draw out the implications of this discussion, it appears to be an effort to lay the groundwork for a possible later holding that an indemnification obligation that is reasonably bounded in amount and in time might be enforceable. If the court were to accept Cigna's argument that Section 102(b)(6) applies, then presumably no indemnification obligation would be enforceable against a non-consenting stockholder, no matter how light. It seems the court has decided to leave that issue for another day.

The Release of Claims

The court's analysis of the enforceability of the release of claims is more straightforward. Cigna argued that, under Section 251 of the Delaware General Corporation Law and the terms of the merger agreement, Optum was legally obligated to pay it the merger consideration to which it was entitled and that the letter of transmittal was unenforceable because it lacked separate, independent consideration. Essentially, Cigna argued, payment of the merger consideration was a pre-existing legal duty, and Optum could not permissibly force stockholders to make additional concessions as a condition to its obligation to fulfill that duty. Cigna further argued that it did not matter whether any of these obligations were also stated in the merger agreement; because the obligations violated Section 251, they were unenforceable whether expressed in the merger agreement or in the letter of transmittal. Optum responded by arguing that the "bundle of rights" that stockholders were entitled to receive – including the merger consideration – were subject to the terms and conditions of the merger agreement, including the obligation to deliver a letter of transmittal in a form acceptable to Optum.

The Vice Chancellor rejected Optum's argument for two reasons. First, to accept Optum's argument would be to permit buyers to impose a wide range of potentially onerous obligations on stockholders as a condition to payment. Second, the release was not mentioned in the merger agreement. The Vice Chancellor was unpersuaded by Optum's argument that stockholders should be bound by obligations not previously disclosed to them in the merger agreement. He held that, because the release was a "new obligation," it was not supported by separate consideration and was therefore unenforceable.[iii]

The opinion appears to leave open the possibility that, had the release been included in the merger agreement and had it been sufficiently narrowly tailored to the transaction – rather than the "sweeping release" contained in the letter of transmittal – the release might be considered to be supported by sufficient consideration and therefor enforceable, at least as to stockholders consenting to the merger. Because of the importance of enforceable releases to many buyers, we anticipate that merger parties will experiment with alternative structures until the Delaware courts provide clearer guidance.

Implications

Until the reach of this decision is clarified, buyers seeking enforceable merger agreement provisions regarding indemnification, releases of claims and the appointment of a stockholder representative should seek counsel before structuring transactions similar to the arrangements in Audax. Read expansively, the decision could mean that the inclusion of indemnification or other forms of purchase price adjustment that make it too difficult for stockholders to ascertain the ultimate value of the merger consideration at the time they are asked to approve the terms of the merger would render the adjustment unenforceable.

Although the court implies that an indemnification obligation will be enforceable if it allows stockholders to ascertain the merger consideration "within a reasonable range of values," the court's opinion provides no specific guidance regarding what this range might be. Presumably, the court would validate limited indemnification and escrow arrangements that fall within reasonable and customary ranges for transactions of this type and are limited in duration. The court also appears to express a high degree of comfort with escrow arrangements and indemnification obligations to which stockholders voluntarily agree by contract. Parties seeking to negotiate indemnification arrangements that go beyond these general norms should be certain to consult with counsel in order to increase the likelihood that alternative arrangements will be respected by the courts.

---

i. C.A. No. 9405-VCP, 2014 Del. Ch. LEXIS 244 (Del. Ch. Nov. 26, 2014).↩

ii. 23 A.2d 157 (Del. Ch. 2010).↩

iii. The court's reasoning is such that even basic letters of transmittal – which typically contain representations by the stockholder regarding ownership and other basic matters – might no longer be enforceable, particularly if the letter of transmittal does not form part of the merger agreement approved by stockholders.↩

RELATED PRACTICES

- Business Counseling

This communication is intended for general information purposes and as a service to clients and friends of Foley Hoag LLP. This communication should not be construed as legal advice or a legal opinion on any specific facts or circumstances, and does not create an attorney-client relationship.

United States Treasury Regulations require us to disclose the following: Any tax advice included in this document was not intended or written to be used, and it cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code.

Attorney advertising. Prior results do not guarantee a similar outcome. © 2017 Foley Hoag LLP. All rights reserved.