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MERGERS & ACQUISITIONS

Enforcing a private company indemnity regime

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Whether a private company acquisition is structured as a stock sale or a merger, the parties will often include in their deals provisions that specify when a buyer can bring claims for breach of representations. These provisions often take the form of highly negotiated indemnification provisions in the deal documents. In a stock sale, the sellers are party to the agreement, so that they are directly bound by the indemnity provisions. That is not the case, however, in a merger; under Delaware law, the selling stockholders are not required to be a party to the merger agreement. Thus, it is important to consider how the indemnification regime will be enforced against stockholders of the seller corporation in a private corporation acquisition structured as a merger.

Escrows versus clawbacks

In many instances, an indemnification regime is enforced against stockholders of the seller corporation through the use of an escrow. So, for example, shares of a target corporation might be converted into the right to receive $10 per share, plus a *pro rata* share of any amount left in an escrow following the permitted period for bringing

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indemnification claims. In such instances, a merger agreement typically will provide for a 'stockholder representative' to resolve disputed indemnity claims on behalf of all sellers. Because Delaware law allows merger agreement provisions to be made dependent on 'facts ascertainable' outside the agreement, including determinations by a person or body, the amount available to seller stockholders at the end of the escrow period can be reduced by indemnification claims settled by the stockholder representative. Thus, the actions of the stockholder representative will be binding on the sellers either: (i) because those stockholders are directly party to the merger agreement (through signing the merger agreement itself or a joinder); or (ii) through drafting the merger agreement to make decisions of the stockholder representative a 'fact ascertainable' upon which the final merger consideration is determined.

An alternative method to enforce an indemnification regime against stockholders of the seller corporation is through payment of all merger consideration up front, but subjecting the paid merger consideration to a claw back. In this regime, shares of a target corporation would be converted into the right to receive the full merger consideration (say, e.g., $12 per share) *subject to* a contingent obligation to return amounts that may be due under the indemnification regime. Under the old saying "possession is nine-tenths of the law", a clawback regime generally is more favourable to selling stockholders than an escrow regime in that stockholders have the consideration in their hands sooner (and so do not have to discount the amount in escrow to account for the time value of money) and hold the res from which an indemnification regime will be enforced.

Market trends

In our experience, transaction planners often combine elements of an escrow and clawback. A common example is to provide for an escrow for indemnification claims based on a breach of representation or covenant and for that escrow to be an exclusive remedy for the buyer subject to certain exceptions, such as a working capital adjustment or claims for breaches of defined 'fundamental representations' (e.g., representations as to capitalisation and due authority and organisation). In that example, selling stockholders would be subject to a clawback for claims falling within the exception to the exclusive remedy provision.

A study released by the American Bar Association reflects that experience. The study analysed 136 publicly available acquisition agreements for transactions ranging in value from $17.2m to $4.7bn and completed in 2012 that involved private targets being acquired by public companies. According to that study, 55 percent of the reviewed transactions contained an escrow holdback as sole remedy subject to one or more exceptions (similar studies of transactions completed in 2010 and 2008 reported that percentage at 57 percent and 48 percent, respectively). A smaller percentage, 32 percent, provided for an escrow holdback as sole remedy with no exception (reported at 24 percent and 27 percent for transactions completed in 2010 and 2008, respectively). Smaller still was the percentage of deals that relied solely on a clawback – 11 percent in 2012, 14 percent in 2010 and 19 percent in 2008.

Recent judicial development

A 2014 opinion from the Delaware Court of Chancery (a trial court vested with jurisdiction to hear disputes over merger agreements) calls the practice of enforcing indemnity obligations through a clawback, at least in part, into question. The opinion, *Cigna Health & Life Insurance Company v. Audax Health Solutions*, involved a merger agreement calling for enforcement of an indemnity regime solely through a clawback. As a condition to receiving the merger

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consideration, the stockholders of the selling corporation were required to sign a letter of transmittal agreeing to be bound by the indemnification obligations. One stockholder refused and alleged that a clawback is impermissible under Delaware law because, among other things, a clawback would prevent determination of the actual value of the merger consideration.

On a motion for judgment on the pleadings, the Court issued what it described as a 'limited holding'. The Court held that the obligation to agree to an indemnification obligation of *unlimited duration* and *unlimited amount* would make the merger consideration undeterminable and thus invalid under Delaware law. The Court did not, however "reach the question of whether clawbacks are per se invalid" and, in fact, denied plaintiff's motion except to the extent plaintiff challenged indemnification obligations "that are not subject to a monetary cap and a time limit of 36 months or less" (leaving open for future determination the validity of clawbacks subject to such a cap on amount or duration). Similarly, although the Court likened a clawback of unlimited amount and duration to a "100% indefinite escrow pursuant to which the merger consideration would be released only after the buyer determined it would never make a claim under the Merger Agreement", the Court observed that "[t]he case law of this Court contains no indication that an escrow of a portion of the merger consideration, as a general matter, is invalid," and that a contrary view would be "unreasonable". Moreover, the Court repeatedly emphasised that it was not being called upon to decide the validity of temporally limited clawbacks tied to post-closing financial statements, such as working capital adjustments. That said, a troubling aspect of the Court's opinion was its observation, in *dicta*, that "[t]he propriety of stockholder representatives under the [Delaware General Corporation Law] is the subject of active and ongoing debate". To the contrary, the use of a stockholder representative seemed settled following a 2010 opinion from the Court of Chancery, *Aveta Inc. v. Cavallieri*.

Developments post-Cigna

Although the Court sought to issue a narrow ruling in *Cigna*, that opinion has proved unsettling to transaction planners, at least in the United States, where transactions tend to include at least some form of clawback for exceptions to an escrow as sole remedy. In light of *Cigna*, it may be difficult to rely on letters of transmittal and declarations in the merger agreement that "stockholders shall indemnify", in and of themselves, as a solid basis to obtain indemnification in excess of a holdback amount. As an alternative, the buyer may (and in our experience often will) ask significant stockholders to become a party to the merger agreement, or to sign a joinder, to provide indemnification through direct contract obligations. If having stockholders sign the merger agreement is not practicable, the buyer could consider making it a condition to closing the merger that joinders be obtained from a specified percentage of stockholders. In addition, if the selling stockholders are subject to a drag-along provision that requires them to agree to a transaction upon certain triggers, buyers could explore the triggering of such provisions. We also have received questions whether a merger agreement could provide an election – a stockholder could *choose* to receive all merger consideration up front if they agree to a clawback or merger consideration minus an amount placed in an escrow account if they do not agree to a clawback. Anecdotally, we have not seen that provision make its way into merger agreements.

Because *Cigna* is still recent, its ramifications are still working their way through the markets. Clearly, this is an area of law and drafting that awaits further developments. ■