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*Practice Group:*  
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## Private Company M&A: Post-Closing Purchase Price Adjustment Provisions: New Decision Holds Some Common Mechanics Unenforceable

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In private company acquisitions, it is common for the buyer to require that a portion of the merger consideration be set aside in escrow as an accessible source of funds to cover the buyer's post-closing indemnification claims relating to breaches of the target company's representations and warranties and other specified contingencies. However, the buyer might demand additional protection if its losses under such claims exceed the escrow amount by insisting upon collection of the full loss from the target company's stockholders. If the losses are significant and the indemnification obligations are uncapped or have a sufficiently high cap, this could require the target company's stockholders to return their full pro rata share of the merger consideration to the buyer.

Although the Delaware courts have previously upheld post-closing purchase price adjustments, a recent decision found common provisions unenforceable in certain circumstances. *Cigna Health and Life Insurance Co. v. Audax Health Solutions, Inc.*, C.A. No. 9405 (Del. Ch. Nov. 26, 2014) (V.C. Noble). In this case, the merger agreement and related Letter of Transmittal (the "LoT") required the target company's stockholders (1) to indemnify the buyer, up to their pro rata share of the merger consideration, for the target company's breaches of its representations and warranties, and (2) to release the buyer and its affiliates from any and all claims relating to the merger. The Court found these common provisions unenforceable under the facts in *Cigna*; accordingly, this decision has significant implications for other private company acquisitions by merger.

### I. Background

The plaintiff, Cigna Health and Life Insurance Co. ("Cigna"), a former preferred stockholder of defendant Audax Health Solutions, Inc. ("Audax"), sought some \$46 million in merger consideration arising from the acquisition of Audax by Optum Services, Inc. ("Optum"). Audax's stockholders approved the merger agreement by non-unanimous written consent. Pursuant to support agreements, consenting stockholders also agreed to: (1) to release any claims against Optum arising from the merger (the "Release"), (2) abide by the terms of the merger agreement, providing for their indemnification of Optum for Audax's breaches of its representations and warranties (the "Indemnification Obligations"), and (3) appoint Shareholder Representative Services, LLC, as the stockholders' representative (the "Appointment Obligations").

The merger agreement expressly conditioned receipt of the merger consideration by non-consenting stockholders on execution of the LoT, containing an agreement by the stockholders to be bound by the Indemnification Obligations. However, the form of the LoT

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sent to former Audax stockholders after closing required their consent to not only the Indemnification Obligations, but also to the Release and the Appointment Obligations. Cigna did not vote in favor of the merger agreement, did not execute a support agreement, and refused to sign the LoT, but demanded payment for its shares.

In this action, Cigna argued that the Release was unenforceable for lack of consideration for the LoT. Cigna also argued that the Indemnification Obligations violated the General Corporation Law of the State of Delaware (the “DGCL”) because they rendered (1) the amount of merger consideration indefinite (in violation of DGCL § 251, which requires merger agreements to set forth the cash, property, rights, or securities that stockholders are to receive as merger consideration), and (2) the stockholders liable for the target corporation’s debts (in violation of DGCL § 102(b)(6), which provides that stockholders are not liable for the corporation’s debts absent an explicit charter provision to the contrary). Finally, Cigna argued that the Appointment Obligations were unenforceable because they were intertwined with the unenforceable Indemnification Obligations. The Court resolved Cigna’s motion for judgment on the pleadings.

### II. Analysis

The Court held the Release unenforceable for lack of consideration because the stockholders’ right to receive the merger consideration vested at the effective time of the merger, and the stockholders could not be required to release claims post-closing absent additional consideration. (The Court relied on the language of DGCL § 251, which conditions a stockholder’s right to receive merger consideration after the effective time of the merger only upon the surrender of stock certificates.) The Court found the Release particularly troubling because Cigna was a holder of preferred stock and had a mandatory right to payment of some of the merger consideration under the certificate of designation governing its rights as a holder of preferred stock upon a merger.

The Court also agreed with Cigna that the Indemnification Obligations were unenforceable because they rendered the value of the merger consideration indeterminable in violation of DGCL § 251. Under DGCL § 251(b), merger consideration may be subject to adjustment post-closing based on facts ascertainable outside the merger agreement (i.e., the target company breaches its representations and warranties and causes the buyer a determined amount of damages) *if* the manner in which such facts will affect the amount of merger consideration is “clearly and expressly set forth in the agreement of merger.” In this case, the Court held that the merger agreement complied textually with DGCL § 251(b) but ultimately left the true value of the merger consideration undeterminable due to two factors: (1) some of the Indemnification Obligations survived closing of the merger indefinitely, and (2) potentially all merger consideration to be received by the target company’s stockholders was subject to recoupment.

The Court declined to decide whether the Indemnification Obligations violated the DGCL by effectively making the corporation’s stockholders liable for the corporation’s debts. Audax’s certificate of incorporation did not contain a provision making its stockholders liable for Audax’s breaches of its representations and warranties. The Court also declined to decide Cigna’s claims relating to the Appointment Obligations, which it found had not been properly presented in Cigna’s briefing.

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### III. Practical Implications

A buyer might avoid enforceability issues with releases in letters of transmittal by incorporating them into the merger agreement through contingent payment provisions and the “facts ascertainable” language of DGCL § 251. For example, the merger agreement might specify that the target’s stockholders have a right to receive some additional amount of merger consideration if, and only if, at least some specified percentage of the target’s stockholders sign letters of transmittal containing a release—“a fact ascertainable outside the merger agreement.” In such a case, the stockholders merely possess a contingent right to receive that additional specified amount of merger consideration and the releases in the letters of transmittal should not be unenforceable for lack of consideration under the reasoning of *Cigna*.

As for post-closing indemnification provisions, although the Court held certain post-closing indemnification obligations unenforceable, the Court expressly limited its findings to cases where *all* of the merger consideration is subject to an *open-ended* clawback. Thus, if the merger agreement had put some, but not all, of the merger consideration at risk of clawback or if the indemnification clawback had been temporally limited, the Court might have reached a different result. Indeed, the Court denied *Cigna*’s motion for judgment on the pleadings as to the indemnification obligations that were subject to a monetary cap and limited in duration (in this case, to 36 months). Based on the decision in *Cigna*, buyers should consider including both monetary caps and temporal limitations to stockholder indemnification obligations.

As a practical matter, a merger agreement that provides that certain indemnification claims survive indefinitely could not be enforced beyond the applicable statute of limitations period (or comparable limitations period applied by analogy by a court of equity). Under a recent amendment to Delaware law, the parties to a contract may expressly provide by agreement for a statute of limitations period of up to 20 years. Thus, putting an express contractual survival period on all claims for breaches of representations and warranties and indemnification serves the dual purpose of satisfying Delaware law on statutes of limitations and addressing one of the *Cigna* court’s concerns.

Alternatively, the parties to a merger agreement could enter into separate indemnity agreements or joinder agreements with the target company’s stockholders that contain open-ended indemnification obligations; however, the target company’s stockholders cannot be forced to sign a separate indemnity agreement or joinder agreement.

Other alternatives include structuring the transaction as a stock sale or an asset sale. The DGCL does not require that any consideration payable to stockholders in such transactions be ascertainable or be paid to the stockholders upon delivery only of their stock certificates. (In fact, there is no provision in the DGCL governing payment of consideration to stockholders in connection with stock sales or asset sales.)

In addition, a merger agreement that subjects the entire amount of the merger consideration to an escrow or other holdback to satisfy indemnification claims appears to be a legally viable, although likely impractical, path.

While the Court ultimately found that the unlimited and uncapped indemnification obligations violated DGCL § 251, the true concern seemed to be that the merger agreement and the LoT were contracts of adhesion—effectively forcing stockholders to agree to give back merger

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consideration at some undetermined time in the future. This concern could be ameliorated by structuring any post-closing payments as mere contingent rights to receive merger consideration.

Although the Court did not address plaintiff's challenge to the stockholders' representative appointment provisions, *Aveta Inc. v. Cavallieri*, C.A. No. 5074-VCL (Del. Ch. Sept. 20, 2010) held that stockholders are bound by the actions of the stockholders' representative appointed pursuant to a merger agreement to handle disputes regarding earn-outs, other post-closing adjustments, or indemnification claims irrespective of whether the stockholders approved or signed the deal documents. However, the decision in *Cigna* suggests—by referring to stockholder representative provisions as the subject of an “active and ongoing debate”—that this issue may not be settled.

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