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The Tie that Binds: Enforceability of Merger Provisions Against Non-signatory Shareholders

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The Predicament

One challenge encountered in M&A deals is how to bind all shareholders of the target company to all deal terms. For private companies with few shareholders, this is not much of a challenge. However, many private companies have accumulated a wide group of shareholders. Companies may have sold stock in financings, granted employees incentive equity, and issued equity to other third parties.

The challenge arises on account of an acquirer's insistence on a structure facilitating a timely closing, the acquisition of all ownership interests in the target, and a "price adjustment" via shareholder indemnity if the target's condition is not as represented. Structuring the deal as a stock purchase from many shareholders requires corralling numerous shareholder signatories to a complex purchase agreement and potentially contending with holdout or missing shareholders. An asset acquisition mitigates these risks, but may not be feasible due to tax, regulatory, or other reasons.

A work-around is to structure the deal as a statutory merger whereby a majority, but not necessarily all, of the shareholders vote to approve the merger resulting in acquisition of 100% ownership of the target company. However, state merger statutes typically only provide for conversion of the target's shares into *rights* to cash or other property; the statutes do not expressly provide for the target's shareholders to be subject to post-closing *obligations,* such as indemnification for breaches of the target's representations in the merger agreement.

Many acquirers have addressed this by requiring that, in order for the target company's shareholders to receive the merger consideration, they sign an expanded letter of transmittal which commits shareholders to post-closing obligations.

The Judicial Response

Two years ago, the Delaware Chancery Court, in *Cigna Health and Life Insurance Company v. Audax Health Solutions, Inc.*, called into question this approach. Cigna was a shareholder of Audax Health Solutions which was acquired by merger by Optum Services. The merger was approved by almost 67% of the Audax shareholders, but not Cigna. Cigna refused to sign the letter of transmittal which would have obligated it, among other things, to release claims against the purchaser and to indemnify the purchaser for the target's breach of the representations and warranties in the acquisition agreement. When the purchaser refused to pay Cigna its merger consideration, Cigna sued, asserting that requiring it to agree to these provisions violated Delaware law.

The Court agreed. It noted that the flexibility provided by the Delaware merger statute is not unlimited, and, by structuring the deal as a statutory merger and not a stock purchase, the purchaser made a choice requiring it to comply with the statute. The Court noted that the requirement of a release by the target company's shareholders was not even mentioned in the merger agreement. Once the merger was consummated, Cigna was entitled to the merger payment by law, and the release was an unenforceable new requirement not supported by legal consideration. The Court noted that to hold otherwise would enable buyers to impose any number of new obligations on shareholders as a condition to receiving merger consideration.

In contrast, the requirement that the target shareholders agree to be responsible for indemnification obligations was in the merger agreement. However, the Court held that the indemnification obligations were so broad that the merger consideration's value was not reasonably ascertainable and therefore violated statutory requirements. The Court noted that, while many representations terminated after 18 months, certain representations continued for a longer period with "fundamental representations" surviving indefinitely. Moreover, at least some of the indemnification obligations were not subject to an aggregate cap on liability. The fact that, years later, the entire merger consideration could be "clawed back" made the merger payment improperly indefinite.

The Court distinguished an unlimited claw back from a permissible escrow provision in which a portion of the merger consideration is put aside to satisfy claims for breaches of target company representations. It also distinguished a prior case addressing balance sheet based post-closing price adjustments, which are frequently contained in deals.

The Take-Away

The take-away from C*igna* is not that statutory mergers are no longer appropriate to acquire companies with numerous shareholders; to the contrary, statutory mergers remain an effective, and preferred, structure. The take-away is that the flexibility provided by statutory mergers is not unlimited and one must play within the rules. Fortunately, there remains a range of techniques to do so:

▶ Pre-sale planning is important. For instance, a "drag-along" provision in a shareholder agreement requiring shareholders to abide by the wishes of majority owners and agree to be bound by indemnity provisions or other obligations is valuable. Dialogue by management with the shareholder base prior to a transaction can set expectations and reduce conflict.
▶ Shareholders remain free to sign support agreements containing post-closing obligations. Buyers may require a requisite percentage of shareholders signing support agreements as a condition of the deal.
▶ Shareholder votes may be procured by written consents which also contain agreements to support post-closing obligations.
▶ Escrows to secure breaches of representations and warranties remain a viable tool.
▶ Representation and warranty insurance may also be available when the target resists an escrow or the acquirer insists on claw back provisions.
▶ Including post-closing obligations in the merger agreement and not just the letter of transmittal is wise, as are time limitations and dollar caps for all representations and warranties. Also, consider providing separate consideration for releases and other obligations.

The bottom line is that, properly planned, a statutory merger remains an effective acquisition vehicle.

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