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KIRKLAND **M&A UPDATE**

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Slipping Away? – Enforceability of Obligations Against Non-Signatories in Private Mergers

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A recent Delaware decision in Cigna provides important guidance on simple yet important steps that buyers of private companies using a merger structure can take to more effectively impose certain post-closing obligations on stockholders who do not sign agreements to support the deal.

While a stock purchase involves entering into an agreement with each stockholder of a target company, creating an avenue to bind each selling stockholder to terms such as indemnification obligations, non-compete clauses and general releases, in a merger structure direct contractual relationships are only established with those target stockholders who may sign a written consent or voting agreement to support the merger. This leaves buyers facing the challenge of how to impose these post-closing obligations on stockholders who do not consent or sign a voting agreement ("non-signatory stockholders").

In *Cigna*, VC Parsons held that two separate attempts to impose obligations on non-signatory stockholders in a private company merger were unenforceable. First, he invalidated an attempt to force such a stockholder to agree to a general release of the buyer via a requirement to sign a letter of transmittal in order to receive its merger consideration. By law, the stockholder was already entitled to its merger consideration by virtue of the merger closing and so there was no consideration flowing to the stockholder signing the letter of transmittal rendering its new terms unenforceable. Because the release only appeared in the letter of transmittal and not the merger agreement, it could not be enforced against the non-signatory stockholder.

The Court separately addressed whether terms could be included in the merger agreement (where there is clear consideration to stockholders – the merger payment) as a way of binding non-signatory stockholders. VC Parsons held that certain indemnification obligations sought to be imposed on all stockholders via the merger agreement ran afoul of DGCL §251(b)(5), which requires a merger agreement to state clearly what consideration each stockholder would receive for its shares. Given that indemnity obligations relating to breaches of "fundamental representations" survived indefinitely and were only capped at the pro rata merger consideration received by stockholders, a stockholder could never definitively ascertain the consideration being received in connection with the merger. Therefore such a non-consensual imposition of indemnification obligations, even though a term of the merger agreement, was not enforceable against the non-signatory stockholder.

The *Cigna* decision points to steps that buyers can take to avoid this outcome of questionable enforceability in a private merger structure:

1. Do not seek to first impose post-closing obligations on target company stockholders via a letter of transmittal because they are likely unenforceable against non-signatory stockholders.

2 As noted in prior Delaware cases (such as *Aveta*), an escrow/holdback of a portion of the merger consideration to satisfy representation and warranty indemnity obligations or a purchase price adjustment (as compared to indemnification where a stockholder is required to pay back a portion of already-received merger consideration) is the most effective means of imposing these post-closing recourse obligations on non-signatory stockholders.

3. If indemnification is sought to be imposed via the merger agreement (either in lieu of or as a supple-

ment to an escrow), indemnification of limited duration and/or capped amount is more likely to be enforced against non-signatory stockholders because of its outcome being more reasonably ascertainable.

4. A possible blended approach could impose an escrow obligation under the merger agreement unless the non-signatory stockholders agree pre-closing to a replacement indemnification obligation (in which case the escrow would not be required).

5. If enforceability of a post-closing obligation against a specific non-signatory stockholder is essential to the buyer, parties should consider whether they are comfortable relying on enforceability arising out of their inclusion in the merger agreement and/or as a condition to acceptance by the stockholders of the merger consideration, or instead whether to require separate consensual agreements with specific stockholders as a condition to signing or closing.

While stock purchase agreements provide greater certainty to a buyer for enforcement of post-closing obligations against all stockholders, a stock purchase may not be practical in every case, even private company acquisitions, because of the need to obtain consent from each and every stockholder to fully acquire the target. Any number of fact patterns – including large stockholder bases, shares held by a wide group of current or even former employees, or shares held by "friends and family" – can force parties to use a merger structure where, with approval of the requisite percentage of shares (usually a majority), the parties can effect a purchase of 100% of the target shares even without the explicit agreement of some minority.

Although the decision to proceed with a merger structure is usually driven by considerations of practicality or expediency, the recent *Cigna* decision serves as an important reminder of the potential resulting limitations on the enforceability of post-closing obligations against non-signatory stockholders. Care should be taken during the drafting and negotiating process to ensure that the parties best position themselves for an optimal outcome on enforceability questions, especially around the delicate issues of risk allocation involving indemnification, purchase price adjustment provisions and general releases.

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