

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

PENpoints

A recent Delaware decision points to steps a buyer of a private company via a merger can take to ensure that certain post-closing obligations are enforceable against target stockholders.

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*, the court held that two separate attempts to impose obligations on non-signatory stockholders in a private company merger were unenforceable. First, it 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. The court 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 merger consideration actually received by each stockholder, 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, 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.

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

gations against all stockholders, a stock purchase may not be practical in every private company acquisition 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 structuring, drafting and negotiating process to ensure that the parties best position themselves for an optimal outcome on enforceability questions, particularly around the delicate issues of risk allocation involving indemnification, purchase price adjustment provisions and general releases.

If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

Daniel E. Wolf, P.C.
<http://www.kirkland.com/dwolf>
 +1 212-446-4884

David B. Feirstein
<http://www.kirkland.com/dfeirstein>
 +1 212-446-4861

Joshua M. Zachariah
<http://www.kirkland.com/jzachariah>
 +1 212-446-6450

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Before the Clouds Roll In – Advantages of Board Actions on a “Clear Day”

Recent Delaware cases challenging a so-called “defensive measure” taken by a board of directors — such as forum selection, advance notice and fee-shifting bylaws — highlight that courts will give more deference to directors’ judgment if the board’s decision is made on a “clear day,” i.e., before any actual threat exists. To learn more, see our recent [M&A Update](#).

PENnotes

42nd Annual Securities Regulation Institute Coronado, California January 26-28, 2015

Hosted by Northwestern Law, the 42nd Annual Securities Regulation Institute will take place in Coronado, California. One of the most visible and highly regarded securities and corporate law conferences in the country, the Securities Regulation Institute reaches prominent attorneys from both firm and in-house practices. Kirkland partner Robert Khuzami will be a panel member for the Enforcement and Criminal Investigations session. Click [here](#) for more information.

Harvard Business School’s 21st Annual Venture Capital and Private Equity Conference Boston, Massachusetts February 1, 2015

Kirkland is a sponsor of Harvard Business School’s 21st Annual Venture Capital and Private Equity Conference. This season’s conference will be held on February 1, 2015, on campus in Boston. The conference will bring together industry professionals, students, alumni and faculty to share their knowledge and experiences on today’s private equity and venture capital environment. Click [here](#) for more information.

14th Annual Beecken Petty O’Keefe & Company Private Equity Conference Chicago, Illinois February 20, 2015

The Chicago Booth Private Equity Conference (PEC) is an annual event that brings together financiers, students and entrepreneurs to network and share insights into the dynamics of investing in a constantly changing economy. This year’s conference is themed “Return Realization: Positioning and Timing the Ideal Exit,” and Kirkland partner Bruce Ettelson will moderate a panel.

10th Annual Stern Private Equity Conference New York, New York February 27, 2015

Kirkland is a sponsor of New York University’s 10th Annual Stern Private Equity Conference. This season’s conference will be held on February 27, 2015 at the Kimmel Center in New York. The conference will provide a forum for industry leaders to discuss the opportunities and risks of today’s private equity and venture capital environment.

Columbia Business School’s 21st Annual Private Equity and Venture Capital Club Conference New York, New York March 6, 2015

Kirkland is a sponsor of Columbia Business School’s 21st Annual Private Equity & Venture Capital Conference. This season’s conference will be held on March 6, 2015, in New York. The conference will focus on the emerging challenges and opportunities facing the private equity and venture capital industries in the coming year.

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Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013 and 2014 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland & Ellis was named "Law Firm of the Year" in Mergers and Acquisitions Law by U.S. News Media Group and Best Lawyers in their 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance's* 2014 Legal Awards, "Law Firm of the Year in North America: Fund Formation" at Private Equity International's 2013 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012 and 2013*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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EDITORS

Jack S. Levin, P.C.
 Margaret A. Gibson, P.C.
 Norbert B. Knapke II

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To subscribe to *KirklandPEN*, please email
kirklandpen@kirkland.com
 +1 (312) 862-3356

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