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M&A ALERT

PRIVATE M&A PRACTITIONERS ADJUSTING MERGER STRUCTURES IN LIGHT OF *CIGNA V. AUDAX* DELAWARE CHANCERY COURT OPINION

Private M&A deal makers have begun to adjust to the Delaware Court of Chancery's cautionary opinion in *Cigna Health and Life Insurance Company* v. *Audax Health Solutions, Inc.* which held that: (i) stockholder releases of claims contained only in letters of transmittal that stockholders were required to execute to receive merger consideration, but not in the merger agreement itself, are unenforceable for absence of consideration; and (ii) post-closing indemnification obligations imposed upon stockholders that are unlimited in duration and that place at risk potentially all of the merger consideration received by a stockholder are unenforceable for running afoul of DGCL § 251(b)(5). In light of the decision, M&A practitioners have adapted merger structures to incorporate stockholder support obligations in documents outside of the merger agreement and are also encouraging the explicit allocation of merger consideration within the merger agreement to these support obligations.

THE *CIGNA* CASE

On February 10, 2014, a majority of Audax Health Solutions, Inc.'s ("**Audax**") board of directors approved the acquisition via reverse triangular merger (the "**Merger**") of Audax by Audax Holdings, Inc. ("**Holdings**") and Optum Services, Inc. ("**Optum**"). Holdings was a wholly-owned subsidiary of Optum that Optum formed as the acquisition vehicle to acquire Audax. On February 14, 2014, the Merger was approved by the written consent of 66.9% of Audax's stockholders who were entitled to vote. Those consenting stockholders gave their consent in the form of a support agreement ("**Support Agreement**"). The Support Agreement contained obligations imposed upon the consenting stockholders, including, *inter alia*:

- irrevocably and unconditionally releasing any claims that the stockholder ever had against Holdings or Optum, as well as their respective affiliates, employees, and agents (the "**Release Obligation**"); and

- agreeing to be liable to Holdings and Optum up to the *pro rata* amount of the merger consideration the stockholder received for breaches of Audax's representations and warranties in the Merger Agreement (the "**Indemnification Obligation**").

The terms of the Merger Agreement conditioned a stockholder's receipt of the merger consideration upon: (i) a surrender of the stockholder's shares of Audax in line with § 251(b)(5) of the General Corporation Law of the State of Delaware ("**DGCL**"); (ii) and the execution of a letter of transmittal ("**Letter of Transmittal**"). The Letter of Transmittal required that the stockholder surrender the stockholder's Audax shares and agree to each of the Release Obligation and the Indemnification Obligation. Importantly, the Release Obligation did not appear in the Merger Agreement, standing only in the Support Agreement and the Letter of Transmittal. Additionally, and of equal import, due to certain of Audax's representations and warranties in the Merger Agreement surviving indefinitely, the Indemnification Obligation also survived indefinitely. The Indemnification Obligation appeared in each of the Merger Agreement, the Support Agreement, and the Letter of Transmittal.

The Merger was subsequently consummated pursuant to DGCL § 251. Before the Merger, Cigna Health and Life Insurance Co. ("**Cigna**") owned 23,105,430 shares of Audax's Series B Preferred Stock. Cigna did not vote in favor of the Merger, did not execute a Support Agreement, and did not execute a Letter of Transmittal. Accordingly, Optum and Holdings refused to pay to Cigna its merger consideration. Cigna sued for declaratory relief, claiming that it was owed approximately $46 million pursuant to DGCL § 251 and the Merger Agreement.

PARTIES' ARGUMENTS

Cigna's primary contention was that the Release Obligation and the Indemnification Obligation each ran afoul of DGCL §251, which Cigna argued required the merger consideration to be paid upon the consummation of the Merger and the cancellation of Cigna's shares. In Cigna's view, payment of the merger consideration was a pre-existing duty imposed upon Optum and Holdings by DGCL § 251 and could not be the basis for a binding contract between the parties. Thus, the Release Obligation and the Indemnification Obligation were extraneous and indefinite obligations that could not be used as conditions precedent to Cigna's receipt of its merger consideration. Additionally, because Cigna had not signed the Support Agreement and as the Release Obligation was included not in the Merger Agreement, even if Cigna had signed the Letter of Transmittal, under which no consideration passed to a stockholder, the imposition of the Release Obligation upon Cigna must fail for lack of consideration.

In response, Optum and Holdings argued that the Indemnification Obligation is the economic equivalent of an escrow provision, and that there is no basis to aver that placing a portion of the merger consideration into escrow is prohibited by DGCL § 251. In addition, Optum and Holdings argued that the court must approach the definition of "merger consideration" as more than simply a cash payment to stockholders, but also as a "bundle of rights," such that the stockholders' acceptance of the Release Obligation and the Indemnification Obligation affected the price that Optum and Holdings were willing to pay for the Merger, thus affecting the total mix of consideration.

ANALYSIS

The Chancery Court first addressed Cigna's contention that the Letter of Transmittal (and thus the Release Obligation) is an unenforceable contract because it lacked separate, independent consideration. On this issue, relying on § 251(b)(5), which conditions a stockholder's right to receive merger consideration only upon the surrender of that stockholder's stock certificates, the court held the Release Obligation unenforceable for lack of consideration because the stockholders' right to receive the merger consideration vests at the effective time of the merger, and stockholders cannot be required to release claims post-closing without additional consideration.

In other words, because the Release Obligation was not contained in the Merger Agreement, and because the right to receive the merger consideration for the stockholder's shares of the target company vests upon consummation of the merger, the Release Obligation was a new, post-closing obligation unsupported by consideration. The court was also careful to specifically address Optum's and Holdings's "bundle of rights" argument, ultimately rejecting its rationale because under the circumstances of the *Cigna* case, the blanket acceptance of that argument would permit buyers to

impose upon stockholders boundless additional terms in documents ancillary to the Merger Agreement as pre-conditions to payment of the merger consideration.

The court also sided with Cigna on the Indemnification Obligation issue. The court held that the Indemnification Obligation, to the extent it was not subject to any monetary cap and was open-ended in temporal duration, violated DGCL § 251, and as such, was void and unenforceable.

Specifically, the court found that the Indemnification Obligation's limitless nature 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 a merger agreement 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 instance, although the court found that the Merger Agreement complied textually with DGCL § 251(b), the Merger Agreement left the true value of the merger consideration indeterminate for two reasons: (i) first, certain indemnification obligations survived indefinitely; and (ii) second, potentially all merger consideration was subject to clawback.

Indeed, the court found that the stockholders "may never know" the exact value of the merger consideration because the stockholder is forced to discount indefinitely the value of the merger consideration that was nominally received at the time of the Merger based on the possibility that some or even all of it may need to be returned to Optum and Holdings for any of Audax's breach of the representations and warranties. According to the court, such a situation contravenes DGCL § 251(b)'s requirement that a merger agreement state "the cash, property, rights or securities of any other corporation or entity which the holders of such shares are to receive."

The court was careful to note, however, that a stockholder may still contractually agree to an indefinite indemnity obligation, such as in a support agreement, but in Cigna's case, as a non-consenting stockholder, it could not have such an obligation "foisted" upon it. Further, although DGCL § 251 specifically contemplates some adjustments to purchase price, the court stated that post-closing price adjustments that could require individual stockholders to repay a portion of their merger consideration had an "uncertain" status under Delaware law to the extent such adjustments restricts a stockholder from ascertaining the real value of what the stockholder receives at a merger closing.

Finally, the Court stated that its opinion expressly did not concern escrow agreements nor does it rule on the general validity of post-closing price adjustments requiring direct repayment from the stockholders. As a result, the court left open the issue of whether such post-closing price adjustments are permissible under DGCL §251(b) if restricted in time or as to a portion of the merger consideration.

STRUCTURING FUTURE TRANSACTIONS

In light of the *Cigna* decision, M&A practitioners have addressed the enforceability issues with releases customarily found in letters of transmittal by incorporating the releases into support agreements and other separate instruments like the Support Agreement mentioned by the Chancery

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Court in *Cigna*. In these separate agreements, the releases find consideration outside of the merger consideration demanded by DGCL § 251(b) because these agreements are direct contractual undertakings between the acquiror and the target stockholder; the merger agreement, on the other hand, as noted by the *Cigna* court, remains a contract solely between the acquiror and the target company.

Alternatively, buyers in merger transactions can avoid enforceability issues with releases by incorporating the releases into the merger agreement through contingent rights provisions. For instance, the merger agreement may be drafted to provide that the target's stockholders have a right to receive some supplementary amount of merger consideration if a certain percentage of the target's stockholders sign letters of transmittal or some separate agreement containing the desired release. Under this framework, a specified value and amount of consideration is attributable directly to the release, thus avoiding the pitfalls with Optum's and Audax's "bundle of rights" argument in *Cigna* and preventing the releases in the letters of transmittal and separate agreements from being held unenforceable for lack of consideration under the reasoning of *Cigna*.

With regard to post-closing indemnity provisions, a similar approach may be taken as those for releases. 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 to alleviate consideration concerns. Alternatively, the indemnities may be fashioned as contingent rights to payment that may be realized upon the target company's stockholder's execution of an indemnity agreement or some other indemnification instrument. If, however, the indemnification obligation remains in the merger agreement in the form of a clawback, the *Cigna* case makes clear that only some of the merger consideration should ever be at risk of clawback, and the amount of time during which a clawback may occur must be temporally limited.

This M&A ALERT is intended to keep readers current on developments in corporate law, and is not intended to be legal advice. If you have any questions, please contact Michael Ecker at 215.851.8507 or mecker@eckertseamans.com; John Pauciulo at 215.851.8480 or jpauciulo@eckertseamans.com; Tyler Smith at 215.851.8526 or tsmith@eckertseamans.com, or any attorney with whom you have been working.

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