
The Enforceability of Transaction Indemnities Against Stockholders

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Post-closing indemnities for breaches of representations, warranties and covenants are common features of most transactions. They are often supported by an escrow or holdback of a portion of the consideration, and in cases of the target's fraud or breach of certain fundamental representations and warranties the acquirer is often entitled to sue the former stockholders of the target for recovery of an agreed upon portion of the consideration paid to them at closing. In *Cigna Health and Life Insurance Co. v Audax Health Solutions, et al.*, Del. Ch. Nov. 26, 2014, the court held a post-closing indemnity and release to be unenforceable against a stockholder that had not agreed in advance to the terms of a merger agreement.

Background

Optum Services, Inc. acquired Audax Health Solutions, Inc. in a merger transaction. The merger agreement required each Audax stockholder to agree to certain indemnities and provide a release of claims against Optum and Audax. Cigna, a shareholder of Audax with a representative on its board of directors, did not sign an indemnity agreement and did not vote in favor of the merger. Instead, it demanded its share of the merger consideration following the closing.

Court's Decision

The court held that the indemnification and release obligations were unenforceable against Cigna. The court reasoned that the indemnification obligation made it impossible to determine the merger consideration from the agreement, because the indemnification obligation placed all of the stockholders' merger consideration at risk and continued indefinitely. This resulted in the violation of a provision of Delaware law that is also common in the law of many other States. The court found the release to be unenforceable because the merger consideration vested as a matter of law when the merger was consummated.

Lessons to be Learned

As a result of the decision, parties engaged in M&A transactions are likely to seek joinders from stockholders, prior to closing, expressly agreeing to indemnities and releases negotiated by the parties. If less than all of the stockholders agree to the indemnities and releases, then the size and duration of the indemnification escrows and holdbacks might be increased. Stockholders who do approve deals may also be asked to pay for more than their pro-rata share of the indemnity obligations to make up for those stockholders not signing. In transactions involving earnouts and other forms of contingent consideration, offsets against post-closing payouts should be sought. Careful attention should also be paid to those representations and warranties that are to survive “indefinitely,” so that stockholders have exposure for an amount that is less than 100% of the merger consideration.