

DELAWARE SUPREME COURT DECISION COULD IMPACT POST-CLOSING INDEMNIFICATION RIGHTS IN M&A DEALS

Parties to mergers, acquisitions and other corporate transactions have long relied on the Delaware courts' predictable interpretation and enforcement of contracts as written. Recently, the Delaware Supreme Court (the "Court") has signaled a potential change of course in its decision in *Thompson Street Capital Partners IV, L.P. v. Sonova United States Hearing Instruments, LLC* ("Thompson Street Capital"). Drawing on public policy arguments outside the four corners of the merger agreement at issue in the case, the Court suggests that lower courts may excuse an indemnified party's failure to strictly adhere to agreed-upon claim notice requirements if such requirements are immaterial to the parties' broader agreement and if such failure would lead to a disproportionate forfeiture. This shift from historical contractarianism could complicate the allocation of risk between bargaining parties going forward.

BACKGROUND

The claim in *Thompson Street Capital* involves a dispute over the buyer's compliance with indemnification notice requirements contained in a merger agreement ("Merger Agreement"). The Merger Agreement provided for an indemnity escrow account to serve as the buyer's sole source of recovery in the event of a post-closing breach of the seller parties' representations and warranties and defined a survival period during which the buyer—as the indemnified party—would be required to deliver notice of any indemnification claim arising during such period.

While administration and release of the indemnity escrow fund was, in part, subject to the terms of an integrated escrow agreement, the Merger Agreement made clear that the buyer would have no right to recover if it did not notify the seller parties' representative of the indemnification claim in the manner set forth in the Merger Agreement. These indemnification claim notice requirements included, among other requirements, that the notice (i) be delivered no later than 30 days following the date on which the buyer became aware of the claim; (ii) include copies of "all material written evidence" of the claim; and (iii) include an estimate of damages (to the extent practicable).

Following the closing, the buyer suffered an indemnifiable loss and delivered notice thereof one business day prior to the end of the survival period outlined in the Merger Agreement, alleging improper billing practices that led to the buyer incurring unquantified damages. The seller filed a complaint in the Delaware Court of Chancery seeking (i) a declaratory judgment that the indemnification claim notice failed to meet the timing and specificity requirements set forth in the Merger Agreement; and (ii) specific performance or a mandatory injunction requiring the buyer to release the contents of the indemnity escrow fund to the appropriate parties. More specifically, the seller alleged that the buyer knew of the circumstances leading to its claim for indemnification for longer than 30 days and failed to provide the seller with the written materials in the buyer's possession that would support the claim.

In granting the buyer's motion to dismiss, the Court of Chancery found that the seller failed to plead a claim for relief because the buyer's notice of claim for indemnification did not comply with the Merger Agreement. The seller then appealed to the Court.

THE COURT'S ANALYSIS

The seller's argument in *Thompson Street Capital* is that the buyer failed to meet the indemnification notice criteria set forth in the Merger Agreement and, in doing so, forfeited its right to be indemnified by the seller.

Siding with the buyer, the Court held that a party's nonfulfillment of a condition precedent may be excused if enforcing the terms of the agreement would lead to a disproportionate forfeiture, unless such condition was a material part of the agreed exchange. The Court acknowledged that excusing a party's noncompliance with the terms of a contract creates a tension in Delaware's contract law, recognizing that while Delaware is a contractarian state, common law generally disfavors forfeitures. The resulting guidance to the Court of Chancery included a recommendation that the court evaluate whether the notice conditions were material to the parties' agreement and, if not, whether the resulting forfeiture would be proportionate. Notably, if the notice conditions are material to the agreement, then no proportionality analysis is required to enforce such conditions.

In *Thompson Street Capital*, the Court ultimately found that the materiality and disproportionate forfeiture issues that factor into an excusal

analysis were insufficiently developed in the record. The Court reversed and remanded back to the Court of Chancery for further analysis with respect to questions of materiality, and if necessary, disproportionate forfeiture. The lower court's application of the prescribed test for a potential excusal is likely to signal to contracting parties in Delaware which type of language courts will be looking for to assess materiality in the future.

PRACTICAL TAKEAWAYS

- Parties to M&A transactions governed by Delaware law should be aware that Delaware courts may be open to **excusing** noncompliance with certain conditions precedent in transaction agreements.
- To help ensure transaction agreements are interpreted as written, parties should consider adding provisions to the agreement's indemnification and survival provisions that explicitly state that the conditions precedent to the parties' rights to indemnification, including applicable notice requirements, are **material to the agreement**.
- Parties should also consider whether similar edits should be made elsewhere in the transaction agreement.

If you have questions or would like additional information about this topic, please contact:

- **Bobby Hamill** at (919) 447-4970 or rhamill@hallrender.com;
- **Alec Mercolino** at (919) 447-4962 or amercolino@hallrender.com; or
- Your primary Hall Render contact.

Special thanks to Keri Edwards, Summer Associate, for her assistance in the preparation of this article.

Hall Render blog posts and articles are intended for informational purposes only. For ethical reasons, Hall Render attorneys cannot—outside of an attorney-client relationship—answer specific questions that would be legal advice.