

ALERT MEMORANDUM

Private Equity Buyer Permitted to Walk From Deal Based on Capitalization Representation Breach

June 5, 2023

In a May 29, 2023 opinion by the Delaware Chancery Court addressing a claim by sellers for specific performance under a merger agreement following buyer's termination for breach of the capitalization representation, the court found that sellers breached the capitalization representation under the merger agreement based on the post-signing discovery that a former employee held phantom equity in a subsidiary of the target company. Despite buyer's concession that the financial value of the former employee's interest in the subsidiary was "minor relative to the deal value,"¹ the court concluded that buyer was entitled to terminate the merger agreement since the capitalization representation was brought down flat at closing (and not subject to any *de minimis* or materiality qualifier).

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

New York

Matthew Salerno

+1 212 225 2742

msalerno@cgsh.com

John Kupiec

+1 212 225 2160

jkupiec@cgsh.com

Jessica Cymbaluk

+1 212 225 2272

jcymbaluk@cgsh.com

¹ *HControl Holdings LLC v. Antin Infrastructure Partners S.A.S.*, C.A. No. 2023-0283-KSJM, memo. op., at *4 (Del. Ch. May 29, 2023).

clearygottlieb.com



© Cleary Gottlieb Steen & Hamilton LLP, 2023. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

Background and Decision

In December 2022, following a competitive process, affiliates of Antin Infrastructure Partners S.A.S (“buyer”) entered into a merger agreement to acquire a group of privately held broadband companies, known as OpticalTel.² Sellers selected buyer as the preferred bidder even though it was not the highest bidder in the process based off its belief that buyer provided greater deal certainty for sellers relative to the other bidders.³

Leading up to signing, buyer’s counsel was unable to fully verify the capitalization table of OpticalTel, which led buyer to negotiate a number of protective measures under the merger agreement,⁴ including: (1) changing the deal structure from an equity purchase to a merger in an effort to minimize the risk associated with post-closing claims from unknown equity holders, (2) sellers providing buyer with an uncapped indemnity for third-party claims relating to breaches of the capitalization representation and (3) providing a closing condition that the fundamental representations, including the capitalization representation, were to be true and correct in all respects at closing. Shortly following signing, claims by two former employees of OpticalTel arose. One claim was by Rafael Marquez who claimed an ownership interest in an OpticalTel subsidiary based on a 2004 Software Development Agreement.⁵ Marquez, whom the court describes as a “skilled shakedown artist,”⁶ then engaged in a “campaign of disruption [that] stirred up other potential capitalization issues,”⁷ including a claim from Wajid Iqbal, who asserted he held options, warrants and a 5% interest in another OpticalTel entity.⁸ Although the court considered the Iqbal claim, other claims by buyer and counter-claims by sellers, those claims were all rejected by the court. The court’s opinion ultimately hinged on the claim by Marquez under the 2004 Software Development Agreement and on whether Marquez’s claim resulted in a breach of the

capitalization representation that gave buyer the right to terminate.

The 2004 Software Development Agreement provided that “HControl [an OpticalTel subsidiary] shall pay” to Marquez \$3,000 per month for his services and a “5% ownership of HControl Corporation to be distributed upon a liquidation event.”⁹ Sellers claimed that this arrangement did not entitle Marquez to any equity interest in the subsidiary and instead provided Marquez with “something akin to a distribution right or contingent value right,”¹⁰ whereas buyer claimed that this arrangement granted Marquez an equity interest in the relevant subsidiary.¹¹ The court, placing significant weight on the phrase “shall pay”—which the court concluded is typically used in contracts to describe a cash payment and not an issuance of equity—concurred with sellers’ interpretation that the arrangement provided Marquez with a contingent right to payment upon a liquidation.¹² However, the court concluded that this right constituted “phantom equity,” an unsecured contractual right that has the economic characteristics of equity.¹³ Even though the defined term “Equity Securities” did not capture “phantom equity,” the capitalization representation itself contained a representation from sellers that there was no outstanding phantom equity at HControl.¹⁴ Accordingly, the court concluded that the capitalization representation was not true and correct in all respects and that buyer was entitled to terminate the merger agreement.¹⁵

Sellers also argued that buyer failed to use its reasonable best efforts to consummate the merger as required under the terms of the agreement and thus was precluded from terminating as a result of sellers’ breach.¹⁶ The court disagreed and cited a litany of steps that buyer took to consummate the deal—even after learning of the Marquez and Iqbal claims—as well as steps that buyer took to resolve the Marquez and Iqbal claims prior to termination.¹⁷

² *Id.* at 1.

³ *Id.* at 8.

⁴ *Id.* at 13-15.

⁵ *Id.* at 1.

⁶ *Id.*

⁷ *Id.* at 2.

⁸ *Id.*

⁹ *Id.* at 18-19.

¹⁰ *Id.* at 56.

¹¹ *Id.*

¹² *Id.* at 61.

¹³ *Id.* at 62.

¹⁴ *Id.* at 11.

¹⁵ *Id.* at 4.

¹⁶ *Id.* at 45.

¹⁷ *Id.* at 90-91.

There is an implication in the court's opinion that buyer was just using the capitalization representation breach as a pretext for terminating the merger agreement and that the real reason for buyer's termination may have been reputational concerns about Marquez and a loss of trust in the OpticalTel management team.¹⁸ This implication is reinforced by buyer's admission that the losses resulting from the breach of the capitalization representation were small compared to the deal value, combined with the fact that buyer was entitled to a full indemnity from sellers for the capitalization issues.¹⁹ The court, however, pointed to the negotiating history and noted that sellers tried three times to impose a materiality qualifier in the capitalization representation closing condition, and, all three times, buyer insisted that the capitalization representation should be brought down flat.²⁰ The court concluded that dispute over buyer's motives are beside the point²¹ and buyer was entitled to the benefit of its specifically negotiated bargain.

Takeaways:

- **Closing Certainty:** Historically, capitalization representations—like all other “fundamental” representations—were typically brought down “flat,” as is the case in this merger agreement. In the increasingly heated M&A market of the last several years, it has become more common for fundamental representations to be brought down subject to a *de minimis* exception or even a materiality exception. Whether the outcome in this case would have been different if the bringdown were subject to a *de minimis* exception is unclear, given buyer's admission that the amounts involved were immaterial in the context of the total deal value, but it seems clear that the court would have ruled differently had the capitalization representation been brought down subject to a materiality exception. Parties to acquisition agreements should carefully consider the impact on closing certainty of these different standards, which are often viewed as mere “legal points.”
- **Importance of diligence:** While the claims by Marquez and Iqbal only surfaced post-signing, buyer identified in diligence discrepancies in the capitalization of the company which they were unable to resolve by signing. The issues identified during buyer's diligence review enabled buyer to negotiate strong protections under the merger agreement, including both the “flat” closing condition bringdown and a full indemnity for breaches of the capitalization representation. Ultimately, this provided buyer with optionality to either terminate once the Marquez claim surfaced or close the deal and receive indemnification from sellers. Particularly in the context of an auction where merger agreement provisions tend to be quite seller-favorable, a robust diligence process pre-signing can provide buyers with the bargaining leverage they need to include appropriate safeguards in the transaction documentation for specifically identified issues (rather than hypothetical risks).
- **Buyer Compliance:** Sellers' counter-claim that buyer failed to use reasonable best efforts to consummate the merger illustrates another important point for buyers to be mindful of in these situations. Virtually all acquisition agreements include a prohibition on a buyer's ability to terminate the agreement if such buyer is also in material breach of the agreement that results in a failure of a closing condition to be satisfied. As a result, for a buyer who may want to walk away from a transaction, it is important for the buyer to strictly comply with all of its obligations under the agreement until the buyer has actually validly terminated the agreement.
- **Boilerplate Language Can Matter:** Although the court did not decide whether Marquez's rights under the 2004 Software Development Agreement fell within the confines of the definition of “Equity Securities” in the merger agreement, the opinion highlights the importance of having robust boilerplate language. Such definitions of “Equity Securities” generally

¹⁸ *Id* at 36, 81.

¹⁹ *Id* at 4, 35-37, 81.

²⁰ *Id* at 92.

²¹ *Id* at 37.

contain a litany of interests and derivative securities, such that it could have picked up the claim at issue here, but unlikely did in this instance. This could have been an issue for buyer, but—fortunately for buyer—the “catch all” language in the text of the capitalization representation itself captured the economic rights claimed by Marquez and gave buyer the benefit of the “flat” bringdown in the closing condition. It may have been better to capture this type of interest more directly, but the “boilerplate” language assisted buyer in obtaining appropriate protections in this instance.

...

CLEARY GOTTLIB