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M&A Report – Delaware Court of Chancery Narrows Enforceability of Con Ed Provision

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The Delaware Court of Chancery recently narrowed the enforceability of a "*Con Ed*" provision allowing a target company to seek lost stockholder premium as damages resulting from an acquiror's breach in a failed merger. In *Crispo v. Musk et al.*, Chancellor Kathaleen St. J. McCormick denied a stockholder-plaintiff's petition for a mootness fee related to the efforts of Twitter (now known as "X") to force Elon Musk to close their merger.[1] The Court held that Twitter stockholder Luigi Crispo lacked standing to seek lost premium damages from Musk under "two objectively reasonable interpretations" of the merger agreement's provision that includes the lost share premium as available target company damages (the "Lost-Premium Provision"). Specifically, the Court held that the Lost-Premium Provision was unenforceable by stockholders because (a) the merger agreement did not clearly confer third-party beneficiary status on stockholders to seek such lost premium damages directly, or (b) the stockholder's "implicit" limited rights to seek such damages under the Lost-Premium Provision had not vested when the complaint was filed because, at that time, Twitter was pursuing a claim for specific performance. In the course of determining the viability of the stockholder's claim, the Court also held that a Lost-Premium Provision that defines lost-premium damages as exclusive to the target (a "damages-definition approach") is unenforceable under Delaware law.

The first interpretation is reflective of the Court's conclusion that a damages-definition approach to *Con Ed* provisions is an unenforceable penalty under hornbook contract law; whereas, the second interpretation infers "exceptionally narrow circumstances" in which the damages-definition approach will be interpreted to confer third-party beneficiary status on stockholders. Under either interpretation, the practical effect of the Court's decision is to require M&A practitioners to reconsider how best to structure and negotiate merger agreement provisions that are intended to preserve significant damage claims resulting from a buyer breach that results in a failed deal.

Background

This case arose from Musk's attempt to terminate his acquisition of Twitter in July 2022. The company immediately sued to specifically enforce the merger agreement; Crispo also sued Musk for specific performance and damages. In October 2022, the Court largely dismissed Crispo's claims, holding, among other things, that Twitter stockholders lacked standing to specifically enforce the merger agreement. But it left open the possibility that the Lost-Premium Provision "conveyed third-party beneficiary status to stockholders claiming damages for breach of the [m]erger [a]greement." Musk and Twitter closed the deal on October 27, 2022.

Months later, Crispo claimed partial credit for the deal's consummation, and he petitioned the Court for a $3 million mootness fee. To be entitled to a mootness fee, Delaware law required Crispo to establish that his claim "seeking lost-premium damages was meritorious when filed." Crispo's petition teed up the question the Court had not reached in its prior decision—whether he had standing to seek his expectation damages from Musk

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as a third-party beneficiary under the merger agreement.

This question required the Court to reconcile the merger agreement's express disclaimer of third-party beneficiary rights with the Lost-Premium Provision, which purported to hold the buyer liable for "the benefits of the transactions . . . lost by the Company's stockholders . . . including lost stockholder premium."

Analysis

The Court looked to the range of approaches to Lost-Premium Provisions that emerged after *Consolidated Edison, Inc. v. Northeast Utilities* ("*Con Ed*")[2] to frame its analysis of the provisions at issue in *Crispo*. In *Con Ed*, the Second Circuit held that a merger agreement's blanket prohibition on third-party beneficiary rights deprived target-company stockholders of standing to sue the buyer for the lost share premium where a deal fails due to buyer breach. As noted by the Court in *Crispo*, M&A practitioners concerned that "*Con Ed* threatened a significant tool that a target might leverage to force a buyer to consummate a deal" drafted so-called *Con Ed* provisions that were "aimed to make clear that the parties to the contract intended for the buyers to be liable for lost stockholder premium in the event of a busted deal." In the wake of *Con Ed*, three variations of *Con Ed* provisions emerged: provisions (1) expressly granting stockholders third-party beneficiary status to pursue lost-premium damages claims directly against the buyer, (2) making the target the exclusive agent for recovering lost-premium damages on behalf of stockholders (the "exclusive agency approach"), or (3) at issue in *Crispo*, defining damages available to the target company to include the lost share premium (the "damages-definition approach").

The Court found that the damages-definition approach used in the Lost-Premium Provision was inherently limited by the basic tenet of contract law rendering penalty provisions unenforceable as a matter of law. Because a target company has no entitlement to the share premium included in the merger consideration if the merger closes, any attempt to define target damages in a busted deal to include the "lost" premium would amount to a penalty, as such damages would exceed the target company's expectation damages. Since lost-premium damages could not be sought by the target company, the Court reasoned, the Lost-Premium Provision was "only enforceable if it grants stockholders third-party beneficiary status." But the Court found ample evidence that Twitter and Musk intended to deprive stockholders of such status. This "objectively reasonable interpretation" rendered the Lost-Premium Provision unenforceable as a whole.

Noting Delaware's "cardinal rule" for avoiding a contract interpretation that renders a negotiated provision meaningless, the Court concluded, in the alternative, that the Lost-Premium Provision could be interpreted as implicitly granting stockholders third-party beneficiary status that vests in "exceptionally narrow circumstances"—namely, where a deal has been terminated and specific performance is no longer available, and for the limited purpose of seeking lost-premium damages. The Court inferred this "exceptionally narrow circumstance[]" from various aspects of the parties' contractual scheme, including the drafters' choice of "a *Con Ed* approach that commentators identified as intended to eliminate stockholder interference with the target's ability to maximize its leverage under the [m]erger [a]greement" to pursue specific performance to force a closing. The Court concluded that "any third-party beneficiary status conferred on stockholders would not vest while the remedy of specific performance is still available." Because Twitter was pursuing specific performance of the merger agreement at the time Crispo filed his complaint, Crispo's right to seek lost-premium damages had not vested at that time and, thus, his lost-premium claim was not meritorious when filed.

Accordingly, Crispo lacked standing under either interpretation of the Lost-Premium Provision. The Court denied his petition for mootness fees and declined to determine which interpretation of the Lost-Premium Provision controlled.

Key Takeaways

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- In *Crispo*, the Court is unequivocal that a *Con Ed* provision "purporting to define a target company's damages to include lost-premium damages"—the so-called damages-definition approach—is an unenforceable penalty under hornbook contract law. Thus, unless the Court's "alternative" interpretation in *Crispo* is adopted by a court and a damages-definition approach is read to include an implicit, albeit limited, third-party beneficiary right for stockholders, the damages-definition approach appears not to be viable, at least in Delaware, unless the merger agreement also expressly confers third-party beneficiary status on stockholders to pursue lost-premium damages.
- The Court's decision seemingly endorsed the view that the exclusive agency approach to *Con Ed* provisions stands on questionable legal footing. Nonetheless, the Court did not directly pass upon this formulation. Moreover, practitioners may consider whether methods of express stockholder appointment of the target as agent for collection of lost-premium damages might be effective. In a footnote, the Court remarked that a "charter provision designating the company as the stockholder's agent for the purpose of recovering lost-premium damages after [a] failed sale" could provide a solution. For many already-public companies, however, this approach may not be practicable.
- *Crispo* creates uncertainty regarding the enforceability and scope of *Con Ed* provisions intended to benefit stockholders. Targets that want to leverage a *Con Ed* provision to compel a buyer to close should consider making the grant and scope of third-party beneficiary status express, rather than relying on a court to infer such an intent. This approach is likely to raise considerable issues for buyers, however, as they would potentially be subject to multiple stockholder suits, and likely will be difficult for sellers to negotiate successfully.
- After *Crispo*, practitioners may want to focus attention on reverse termination fees or liquidated damages provisions sized to approximate the share premium payable in the merger, which would have the benefit of side-stepping the issue of the lost share premium as an element of expectation damages. But this approach is not without risk. A court may determine that a reverse termination fee (or liquidated damages stipulation) of magnitude approximating the lost premium also constitutes a penalty to the extent it reflects a target company's receipt of the lost premium in another guise.
- In light of the uncertainty following *Crispo*, the Delaware General Assembly could consider amendments to the Delaware General Corporation Law that authorize the exclusive agency approach.

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[1] *Crispo v. Musk et al.*, -- A.3d --, 2023 WL 7154477, at *13 (Del. Ch. Oct. 31, 2023).

[2] 426 F.3d 524 (2d Cir. 2005).

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