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Delaware Reaffirms the Limits of Conditions Precedent to an Indemnification Claim in M&A Disputes


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The Delaware Supreme Court recently reversed and remanded the decision of the Chancery Court in *Thompson Street Capital Partners IV, L.P. v. Sonova Unites States Hearing Instruments, LLC* and provided a new framework to assess whether a condition precedent required by a merger agreement is excusable. While the case dealt specifically with a post-closing indemnification claim and the notice and evidence required to be delivered in support of such claim, the Delaware Supreme Court noted that the framework may extend to other conditions precedent not a material part of an agreed exchange among parties.

Pursuant to a 2022 merger agreement, Sonova United States Hearing Instruments, LLC (Sonova) acquired several businesses operated by Alpaca Group Holdings, LLC (Alpaca). The merger agreement set forth the terms by which Sonova could submit indemnification claims after the closing and seek recovery from the escrowed portion of the purchase price reserved for indemnification claims. Recovery was conditioned on Sonova's compliance with certain notice requirements in the merger agreement, including an obligation to provide Thompson Street Capital Partners IV, L.P. (Thompson), as the seller representative, a reasonably detailed description of the claim, the justification for the demand under the merger agreement with reasonable specificity, "all available material written evidence" of the claim, and an estimated amount of damages not later than 30 days after Sonova became aware of any such claim "provided that no delay on the part of" Sonova would relieve the parties from their indemnification obligations "except to the extent such delay actually and materially prejudices" the indemnifying party. The merger agreement further stated that Sonova "shall have no right to recover any amounts… unless [Sonova] notifies [Thompson] in writing of such Claim… on or before the Survival Date."

One day prior to the escrow release date, Sonova delivered an indemnification claim notice to Thompson and the escrow agent alleging improper and unlawful billing practices, in breach of the representations and warranties contained in the merger agreement. As part of the claim notice, Sonova alleged unquantified damages that exceeded the amount deposited in the indemnity escrow fund. Thompson sued for (a) declaratory judgment that the claim notice did not meet the requirements in the merger agreement, including because the claim did not include any material written evidence in support of the claim, let alone "all available" material written evidence as was required by the merger agreement and a (b) mandatory injunction requiring Sonova to execute a joint instruction letter to release the funds in the indemnity escrow fund. The Delaware Chancery Court found the claim notice sufficient and dismissed Thompson's claims.

On appeal, the Delaware Supreme Court held that the indemnification provisions in the merger agreement "clearly and unambiguously conditioned Sonova's right to recover on submission of a claim notice" in compliance with the terms of the merger agreement. In a *de novo* review, the Delaware Supreme Court found that (i) the lower court did not adequately focus on the merger agreement's claim notice requirements, (ii) the merger agreement made the claim notice requirements an express condition precedent for recovery under the indemnity escrow fund, and (iii) Sonova's noncompliance with the claim notice requirements was reasonably conceivable and on the record. Despite the clear failure of Sonova to comply with the condition precedent, and Delaware's status as a "contractarian state," the Delaware Supreme Court noted that Delaware common law "abhors a forfeiture" and therefore Sonova's noncompliance with the claim notice requirements may still be excused "if the timing [(*i.e.*, 30 days after Sonova became aware)] and specificity [(*i.e.*, description of the claim in reasonable detail, together with copies of all material evidence)] requirements were not material to the agreement and the noncompliance would result in a disproportionate forfeiture." Noting that the materiality and disproportionate forfeiture issues that would factor into the excusal analysis were not sufficiently developed on the record to make a determination on the issues, the Delaware Supreme Court reversed and remanded back to the Chancery Court.

To help guide the Chancery Court's decision, the Delaware Supreme Court created a comprehensive framework to address whether excusal of the merger agreement's claim notice requirements would be warranted.

According to the Delaware Supreme Court, before applying the framework, a court must first determine whether the language purporting to create a condition precedent is stated clearly and unambiguously. Where a condition precedent is found, the nonperformance of the condition precedent will result in a forfeiture of the rights in the conditioned obligation *unless* the condition is excused.

In assessing whether a condition precedent should be excused, a court's analysis should consider two prongs:

First, "whether the occurrence of the condition was a material part of the agreed exchange" and

Second, a balancing of "the risk to be protected with the amount to be forfeited."

The Delaware Supreme Court noted that the application of the second prong is dependent on the level of materiality. If "the occurrence of the condition is a material part of the agreement, then the proportionality analysis is not applied and the forfeiture cannot be prevented."

Looking to the Restatement (Second) of Contracts Section 241, the Delaware Supreme Court highlighted the following factors in determining whether the occurrence of a condition was a material part of the agreed exchange:

a. the extent to which the injured party will be deprived of the benefit which he reasonably expected;

b. the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;

c. the extent to which the party failing to perform or to offer to perform will suffer forfeiture;

d. the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances, including any reasonable assurances; and

e. the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

The Delaware Supreme Court further explained that materiality in the context of the Restatement (Second) of Contracts "rests to a large extent on the analysis of the requirement's purpose, [but] it also involves a consideration of the negotiations of the parties along with all other circumstances relevant to the formation of the contract or to the requirement itself."

On remand, if the trial court determines that the condition itself was not material, the proportionality/balancing prong should be used to "weigh the extent of the forfeiture by the obligee against the importance to the obligor of the risk from which he sought to be protected and the degree to which that protection will be lost if the nonoccurrence of the condition is excused." In other words, the court should consider (i) the gravity of the potential forfeiture against (ii) the importance of the risk the parties sought to protect against in negotiating the condition precedent, and whether that protection will be lost if the condition precedent is excused.

Thompson underscores Delaware's evolving application of equity in commercial contract enforcement. While Delaware will continue to enforce the terms of a contract in most cases, this decision serves as a reminder that rigid enforcement of contractual language may be set aside, including to prevent an inequitable consequence for an immaterial breach. By remanding back to the trial court and providing a framework of review, the Delaware Supreme Court stressed that the words of a contract are of critical importance and may cause a footfault to result in forfeiture of material rights – provided that the court must balance differing considerations. Going forward, parties seeking to ensure strict compliance with contractual requirements and those looking to provide a measure of flexibility should both carefully negotiate conditions precedent in M&A agreements.