DELAWARE CORPORATE LAW BULLETIN

Chancery Court Denies Rescission of Merger Agreement Where "Indispensable" Company Stockholders Not Named as Parties to Litigation

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But refuses to dismiss unjust enrichment claim where buyer alleged fraudulent inducement notwithstanding exclusive remedy provision

INTRODUCTION

It is customary, when a private corporation with numerous stockholders is sold, for a representative to be appointed to act on behalf of the stockholders if a dispute arises post-closing with respect to a purchase price adjustment or indemnification claim. The representative may be one of the stockholders, perhaps the largest, or may be a professional organization established to perform these and related functions. A buyer clearly prefers to deal with a single individual or entity rather than to pursue individual claims against a large number of former stockholders.

What happens, though, when a buyer seeks a type of relief to address a dispute not contemplated by the acquisition agreement? May the buyer obtain the desired relief by suing only the representative, or must all stockholders be joined in the lawsuit?

The Delaware Court of Chancery ("*Chancery Court*") faced this issue in *Shareholder Representative Services LLC v. RSI Holdco, LLC*, C.A. No. 2018-0517-KSJM, 2019 WL 2207452 (Del. Ch. May 22, 2019) ("*Shareholder Services*"). Vice Chancellor Kathaleen St. J. McCormick, applying the Chancery Court's joinder test in connection with a buyer's action for rescission of a merger agreement, determined that company stockholders having a financial stake in the litigation, and not just their contractually appointed representative, must be named as parties. In so ruling, the Vice Chancellor found no merit in the buyer's contention that the representative was illegitimately seeking to use its status *both* as a "sword"—by seeking recovery on behalf of company stockholders for alleged breaches by buyer—and as a "shield"—by claiming it had no authority to defend the stockholders against rescission.

On the other hand, the Vice Chancellor refused to dismiss the buyer's unjust enrichment claim based on alleged fraudulent inducement. The Vice Chancellor was not persuaded by the representative's argument that the merger agreement provided for indemnity as buyer's exclusive remedy for breach.

I. FACTUAL BACKGROUND

A. Completed Merger Leads to Post-Closing Disputes

Radixx Solutions International, Inc. ("*Radixx*") "is a cloud-based provider of travel distribution and passenger service system software" to the airlines industry. In September 2016, a private equity firm acting through its affiliate RSI Holdco, LLC (collectively, "*Buyer*") acquired Radixx pursuant to an Agreement and Plan of Merger ("*Merger Agreement*"). The Merger Agreement, which was signed by each of Radixx's "more than one hundred stockholders" (collectively, "*Stockholders*"), appointed Shareholder Representative Services LLC ("*Representative*") to, among other things, represent the Stockholders in the resolution of post-closing disputes.

In accordance with the Merger Agreement, at closing Buyer withheld $9 million from the purchase price ("*Holdback*") to fund any post-closing indemnification or set-off claims asserted by Buyer. Buyer was required to repay the Holdback in March 2018, subject to any pending claims or set-offs. A few weeks before this deadline, Buyer presented Representative with a "Claim Certificate" alleging breaches of representations and warranties in the Merger Agreement and claiming indemnity for the related losses. Because these losses would "greatly exceed the $9,000,000 Holdback," Buyer asserted it would retain the Holdback. Representative objected, declaring the Claim Certificate "procedurally and substantively deficient." Representative also claimed Buyer had breached provisions of the Merger Agreement regarding taxes.

B. Litigation Ensues

On July 17, 2018, Representative brought suit in the Chancery Court, seeking return of the Holdback and claiming damages for breach of the tax-related provisions of the Merger Agreement. Buyer responded with three causes of action against Representative and five of the Stockholders ("*Company Holders*"). *First*, Buyer sought rescission, claiming it was fraudulently induced to enter into the transaction by material misrepresentations made to Buyer before signing. *Second*, Buyer claimed the Company Holders were unjustly enriched as a result of the fraudulent inducement. *Third*, Buyer claimed the Company Holders breached the Merger Agreement by (among other things) failing to pay various purchase price adjustments. Representative and

the Company Holders moved to dismiss the fraudulent inducement and unjust enrichment claims.

II. VICE CHANCELLOR MCCORMICK'S ANALYSIS

Vice Chancellor McCormick noted the high standard for dismissal of Buyer's claims. Thus, dismissal was not warranted unless she found Buyer "could not recover under any reasonably conceivable set of circumstances susceptible of proof." The Vice Chancellor proceeded to address the motions to dismiss in turn.

A. Rescission

In response to Buyer's request for rescission of the transaction and return of the merger consideration, Representative countered that *all* the Stockholders—not just the Company Holders named by Buyer—were "indispensable to a request for rescission." To resolve this dispute, the Vice Chancellor turned to Chancery Court Rule 19, which sets forth "a multi-step test" to determine "whether absent persons are necessary or indispensable to pending litigation." According to Rule 19(a), she "must determine whether an absent party should be party to the litigation" and if so, determine "whether joinder is feasible." To decide if a person is "necessary," Rule 19(a) states that a person should be joined if "the person claims an interest relating to the subject of the action and is so situated that the disposition of the action in the person's absence may . . . as a practical matter impair or impede the person's ability to protect that interest . . . ." If joinder of a "necessary" person is not feasible, the rule establishes a "balancing test" for determining whether "the action can equitably proceed without the absent party" or should be dismissed.

Buyer argued joinder of the Stockholders was not necessary because Representative would "fully represent the interests" of the Stockholders in contesting rescission. According to the Vice Chancellor, this argument "misses the mark." Because its authority under the Merger Agreement was contractually "limited to matters relating to or under the four corners of that agreement," Representative had no authority "to defend a claim for rescission, reach into the pockets of each [Stockholder], or otherwise compel each [Stockholder] to return the consideration" paid in the merger if rescission were granted.

In fact, Vice Chancellor McCormick found the tests provided in Chancery Court Rule 19 were "easily met." Because all Stockholders received merger consideration, they had "interests relating to the

subject of the action," that is, "rescission of the merger." And ordering rescission of the Merger Agreement in a proceeding in which all Stockholders do not have the opportunity to participate "may impair or impede their ability to protect their interests."

Vice Chancellor McCormick then determined joinder would be feasible in light of the fact that Buyer had previously named the Stockholders in litigation over purchase price adjustments under the Merger Agreement. Accordingly, the Vice Chancellor dismissed Buyer's request for rescission, albeit "without prejudice to permit them to join the currently-unnamed [Stockholders] as third-party defendants."

B. Unjust Enrichment

With respect to Buyer's unjust enrichment claim, Representative contended "the Merger Agreement governs the parties' relationship and provides an adequate remedy . . . ." In response, Vice Chancellor McCormick observed that when "a contract comprehensively governs the parties' relationship, then it alone must provide the measure of the plaintiff's rights and any claim of unjust enrichment will be denied." On the other hand, she wrote, "where the claim is premised on an allegation that the contract arose from wrongdoing," such as fraud, "the contract itself is not necessarily the measure of [the] plaintiff's right[s] . . . ." In essence, because Buyer's unjust enrichment claim "challenged the validity of the Merger Agreement" itself, the Vice Chancellor did not believe dismissal was compelled by the Merger Agreement's exclusive remedy provision.

Finally, the Vice Chancellor addressed Representative's argument that Buyer's unjust enrichment claim should be dismissed because it sought restitution from Stockholders for the alleged wrongdoing of Radixx. Citing Delaware Supreme Court precedent, the Vice Chancellor pointed out that Delaware allows for restitution even when those—such as the Stockholders—who benefit from wrongdoing are not themselves the wrongdoer. In short, "'[r]estitution serves to deprive the defendant of benefits that in equity and good conscience he ought not to keep, even though he may have received those benefits honestly in the first instance . . . .' "

CONCLUSION

Shareholder Services resolves potential ambiguity surrounding proper joinder when a stockholder representative is acting on behalf of stockholders of an acquired company. In an action for rescission of the

transaction, those stockholders must be named as third-party defendants notwithstanding the representative's authority to resolve certain disputes on behalf of the stockholders. Vice Chancellor McCormick's opinion also clarifies that a contractual exclusive remedy provision does not preclude an unjust enrichment claim challenging the validity of the agreement itself, even when restitution is sought from stockholders not charged with individual wrongdoing.