# M&A Hotline

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## POST-ACQUISITION INDEMNITY DOES NOT COVER FUTURE EVENTS HOLDS DELAWARE CHANCERY COURT

In a recent landmark ruling, Walter A. Winshall v. Viacom International Inc.[1], the Delaware Court of Chancery has explained the scope of the indemnity provisions after an acquisition. Broadly, the Court has ruled that that in the absence of a clear language in the transactional documents to the contrary, the shareholders of the acquired company are not liable to indemnify the acquirer against any future claims.

### THE TRANSACTION

In 2006, Viacom International, Inc.("**Acquirer**") entered into a merger agreement ("**Merger Agreement**") with the shareholders of Harmonix Music Systems, Inc. ("**Seller**") to acquire Harmonix Music Systems, Inc. ("**Acquired Company**"), a company engaged in the business of making music themed video games. As per the terms of the agreement, in consideration of the shares of the Acquired Company, the Acquirer was required to pay a lump sum amount in cash to the Sellers and an earn out based on the Acquired Company's earnings in two subsequent years. The parties also entered into a separate agreement ("**Escrow Agreement**") wherein the parties agreed to deposit a certain portion of the lump sum amount into an escrow. The escrow amount was to be used inter alia to fine tune the final purchase price and any unexpected costs associated with the transaction, and also to indemnify the Acquirer for certain losses that included the losses arising out of the breach of representations and warranties in the Merger Agreement. The escrow amount was required to be dispersed to the Sellers, eighteen months after the date of closing, with the consent of the Acquirer and the Seller.

### THE DISPUTE

In 2008, three days before the eighteen months deadline set out in the Escrow Agreement, the Acquirer wrote to the representative of the Sellers informing him of the three claims against the Sellers for violation of the intellectual property with respect to one of the theme games, Rock Band, that was being developed by the Acquired Company at the time of the acquisition and stating that it may seek indemnification for losses on the grounds of alleged breaches of representation and warranties set out in the Merger Agreement. In its letter, the Acquirer also reserved the right to seek indemnification for any other future claims brought by third parties. Thereafter, almost three months after the eighteen months deadline, the Acquirer furnished another notice to the Sellers of a fourth claim. In the meantime, the Acquirer without informing the Sellers went ahead and defended the claims and in the process incurred substantial costs as legal fees.

The dispute triggered when four months after the end of the eighteen month escrow period, the Sellers demanded the release of the escrowed funds and in response the Acquirer refused to release the escrowed funds on the ground that the same needs to be adjusted against the indemnity amount owed by the Sellers in relation to the four claims. It is in light of this that the Sellers approached the Chancery Court seeking an order requiring the Acquirer to release the escrowed funds.

### RELEVANT CONTRACTUAL TERMS

The dispute revolved around the interpretation of certain representation and warranties covenants in the Merger Agreement and the terms of the Escrow Agreement. The Merger Agreement contained a standard clause that the Sellers would indemnify the Acquirer "against any or all loses" arising out of the "breach of any representation or warranty" ("**Indemnity Clause**"). Specifically, the Acquirer relied on three representations made in the Merger Agreement, first, that the Acquired Company had adequate rights in the software used in the games as is necessary for the current use ("**Software Representation**"), second, the manufacture or use of any current game does not infringe any third party rights ("**Operation of Business Representation**") and third, that there was no pending or threatened claim against the Acquired Company to the knowledge of the Acquired Company or its officers ("**Litigation Representation**"). The Acquirer was required to bring the indemnification claims for breaches of any or all the three representations within a period of eighteen months.

### DECISION OF THE CHANCERY COURT

The Chancery Court adjudicated in favour of the Sellers primarily on the ground that there was no breach of representations and that Sellers had no obligation to pay the Acquirer's defense cost in the absence of any such breach.

- Sellers Obligation to Indemnify: The Acquirer had argued that the Sellers were responsible for paying the defense costs as per the Indemnity Clause if the allegation of the claim at issue fell within the scope of the representation and warranty. The Court relying on the principle rule for interpretation of commercial contracts i.e. the contract must be interpreted literally held that as per the Indemnity Clause the Sellers obligation to indemnify depended on the existence of the breach of a representation or warranty. The Court also reasoned that if the intent of the parties was

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to cover the defense costs of the Acquirer incurred against any claim that involved an alleged breach of the representations, the same must have been expressly provided for in the Merger Agreement. The Court further stated that such an interpretation in the absence of an express language would lead to a peculiar situation were the Sellers would have to defend the Acquirer against frivolous claims.

- No Breach of Representations and Warranties: The Court applying the basic principles of interpretation of contracts that the words in a contract must be given its plain meaning and the contract should be interpreted in such a manner that all the words in a contract are given meaning to, came to the conclusion that the Sellers had not breached any of the three representations viz. the Software Representation, the Operation of Business Representation or the Litigation Representation.

The court relying on the words "current use" in the Software Representation ruled that the provision only covered the use of the intellectual property rights as on the date of the acquisition and cannot be interpreted to apply to any violation of intellectual property rights after the date of the acquisition. This finding was strengthened by the fact that the game in question, Rock Band, was only in the process of being developed by the Acquired Company on the date of the acquisition and the final version, against which the four claims were made by third parties, was only completed by the Acquired Company after the Sellers had exited. Thus, the court reasoned that the Sellers cannot be responsible for a claim against a product that was not finally developed under the control and supervision of such Sellers.

In addition, the Court, refuting the contention of the Acquirer, held that the use of the words "current game" in the Operation of Business Representation clearly demonstrated that the representation only covered those games that were used in the conduct of the business as on the date of the acquisition and not the games that were being developed at the time of acquisition but was only ready for use after the acquisition.

## RELEVANCE IN THE INDIAN CONTEXT

In India, like other countries, indemnity clauses forms one of the key "open issues" in the negotiation process for any M&A or private equity transaction. In recent years due to the fluid legal environment, the negotiation around indemnity clauses has intensified further. The Indian Contract Act[2] that provides the enabling framework for indemnity clauses defines a contract of indemnity as contract by which one party promises to save the other from loss caused to the other by the conduct of the promisor himself, or the conduct of any other party. The Indian Courts have acknowledged that the provision in the Indian Contract Act does not encompass the entire law on indemnification.[3] Thus, reliance on precedents such as the present one is of significant importance, especially, when several indemnity clauses have not been tested in Indian courts.

The other important take away from the present ruling is that an indemnity clause should be as clear and specific as possible in order to avoid future litigation. In case the parties wish to cover a specific future event, it is advisable that the same is incorporated in the transactional documents expressly.

– Ankit Mishra & Simone Reis
You can direct your queries or comments to the authors

[1] C.A. No. 6074-CS (Del. Ch. Dec. 12, 2012)

[2] Indian Contract Act, 1872, s. 124

[3] Gajanan Moreshwar Parelkar v. Moreshwar Madan Mantri, AIR 1942Bom302; The New India Assurance Company Ltd. v.The State Trading Corporation of India Ltd., unreported, Special Civil Application No. 22891 of 2006




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