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Sellers Alleged Breach of Stock Purchase Agreement Did Not Excuse Buyer in M&A Transaction from Its Own Performance; Right of Set-Off Did Not Apply to Unliquidated Claims

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According to the Merriam-Webster Dictionary, the word “unliquidated” is defined as “not calculated or established as a specific amount.” The Post Holdings case (*Post Holdings, Inc., and Michael Foods of Delaware, Inc., v. NPE Seller Rep LLC*, C.A. No. 2017-0772 AGB [Del. Ch. Oct. 29, 2018]) shed light on how a party’s right of set-off was construed to have limited applicability. The case also showed how a party may be excused from its obligations under a contract.

Case Background

In this case, the buyer acquired all the shares of a target company from its shareholders (“the sellers”). The stock purchase agreement (SPA) in question provided that the sellers would indemnify the buyer after the closing for all liabilities that arose from “any inaccuracy in or breach of any representation or warranty made by [the target company] in or pursuant to the [SPA].”

The SPA also obligated the buyer and the target company (as a subsidiary of the buyer after the closing) to remit to the sellers, subject to a netting provision, certain tax refunds, and insurance proceeds for the pre-closing period promptly after their receipt.

Buyer’s Argument

After the transaction closed, the buyer allegedly discovered various misrepresentations that the sellers made during due diligence and in the SPA itself. The buyer filed a claim notice for indemnification under the SPA, but the sellers rejected the demand. In addition, the buyer had also received certain tax refunds and insurance proceeds that, per the terms of the SPA, were to be remitted to the sellers.

The buyer’s primary argument for why it was not required to remit the tax refunds and insurance proceeds is based on a theory of prior material breach. Specifically, the buyer asserted that because the sellers materially breached various representations and warranties in the SPA, the buyer is excused from any post-closing obligation to remit the tax refunds and insurance proceeds that otherwise may be owed under the SPA.

Sellers’ Argument

The sellers argued that the buyer cannot continue to retain the benefits of the SPA while simultaneously failing to perform its obligations under the SPA. In addition, they argued that the alleged breach of the SPA was not material, so the buyer's performance would not be excused in any event. The court addressed only the sellers' first argument because it believed that the sellers' first argument was dispositive.

Delaware Court Decision

Under Delaware law, which governs the SPA, a party may be "excused from performance under a contract if the other party is in material breach thereof." It is also well-settled, however, that a party may not refuse to perform its contractual obligations after a material breach while simultaneously retaining the benefits of a contract.

The court found that the buyer could only condition its nonperformance on the sellers' breach if the buyer did not subsequently continue performing under the SPA, or indicated an intent to do so by seeking benefits from the SPA.

The court also found that by the buyer making indemnification claims, the buyer clearly indicated "an intention to continue the contract." As such, the court found that as a matter of law the buyer must continue to be bound by the SPA, irrespective of whether the sellers materially breached the SPA.

The second issue in the case deals with the buyer's ability to offset the amount of any indemnification payment the sellers owe to the buyer, which argued that the amount of its indemnification claim exceeded the tax refunds and insurance proceeds.

The court addressed whether the buyer could use the netting provision in the SPA to avoid paying the sellers the tax refunds. The relevant provision of the SPA provided the ability for the buyer to offset an "*amount of any indemnification payment owed*" by the sellers. As the court pointed out, the provision allows the buyer to reduce the amount of the tax refunds to be remitted to the sellers by the amount of an "indemnification payment" that is "owed."

The court further noted that the provision does not provide for the buyer to net from such tax refunds the amount of its unliquidated claims for indemnification. As such, the court found that the netting provision did not allow the buyer to avoid remitting the tax refunds.

Lessons Learned

The court provided a valuable lesson for buyers in merger-and-acquisition transactions in that "the parties certainly could have created a contractual right to permit the buyer to net against a tax refund to be remitted to the sellers the amount of an indemnification *claim*." In other words, any right of set-off or netting provision could provide a right of set-off for unliquidated claims. In this case, the provision was drafted to apply to liquidated claims.