'Busted Deals' and Damages: Court of Chancery Clarifies Who Can Recover 'Lost-Premium' Damages

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In October 2023, Chancellor Kathaleen St. J. McCormick of the Court of Chancery addressed an issue of first impression in *Crispo v. Musk*, C.A. No 2022-0666-KSJM, holding that "a provision purporting to define a target company's damages to include lost-premium damages [in a busted deal] cannot be enforced by the target company" and if "a damages-definition provision purports to define lost-premium damages as exclusive to the target … it is unenforceable."

The court's ruling arose in a "curious procedural context": the plaintiff's petition for a $3 million mootness fee. The plaintiff contended that his stockholder class action played a causal role in forcing Elon Musk's buyout of Twitter to close.

Amid the Twitter/Musk litigation, the plaintiff had filed suit seeking to specifically enforce the merger agreement as a third-party beneficiary and alleging that Musk breached his duties as a *de facto* controller of Twitter. Before the deal closed, the court dismissed nearly all of the plaintiff's claims, but left open the theoretical question of whether the merger agreement permitted stockholders to seek "lost stockholder premium" damages under the merger agreement (the Lost-Premium Provision) as third-party beneficiaries.

When the deal closed, concerns regarding lost-premium damages were eliminated. Accordingly, the court rejected the plaintiff's fee petition, stating the claim was not "meritorious when filed because plaintiff either did not have third-party beneficiary status or his third-party beneficiary status had not yet vested."

However, in rejecting the fee petition, the court provided a lengthy analysis that served as the framework for its novel holding on Lost-Premium Provisions. The court's analysis included:

- Delaware law considerations unique to stockholders claiming third-party beneficiary status.
- An overview of provisions that developed in the wake of the Second Circuit's *Con Ed* decision.
- An analysis of the enforceability of the Lost-Premium Provision.

Third-Party Beneficiary Status

"Delaware courts are reticent to confer third-party beneficiary status to stockholders under corporate contracts for a mix of doctrinal, practical, and policy reasons," the court explained. "One reason for this reticence [is that it] runs counter to Delaware's board-centric model." Granting stockholders "the concurrent right[] to enforce [a] contract alongside the company, risks unsettling the board-centric model by encroaching on the board's authority over litigation assets … [and] risks creating a path by which stockholders could readily circumvent the demand requirement, which has been carefully developed and fine-tuned over decades of jurisprudence," the court said.

It also noted that the practical considerations included "a proliferation of stockholder suits in a variety of commonplace scenarios."

"Merger agreements might be viewed as unique among corporate contracts because stockholders are, undeniably, the intended economic beneficiaries of those agreements," the court said. However, the "unique aspects of merger agreements" enhance the "need to recognize the contractual primacy of the board of directors in the sale context" because a board exercising its fiduciary duties "should not be constrained by the possibility that a multitude of individual stockholders might seek to sue a buyer directly under the merger agreement."

Thus, the court concluded that "no-third-party-beneficiaries provisions are arguably entitled to greater weight in the context of merger agreements."

Con Ed Provisions

The court then turned to *Consolidated Edison v. Northeast Utilities* (2d Cir. 2005), in which the Second Circuit held that stockholders lacked standing to sue the acquirer for breach of the merger agreement.

The Court of Chancery noted that the *Con Ed* decision "came as a surprise to M&A practitioners 'who believed that a merger premium (or some amount of shareholders damages) would be recoverable against a buyer such as *Con Ed* who wrongly terminates or breaches a merger agreement.'" The court identified three primary approaches that creative deal lawyers used to deal with Con Ed's fallout:

1. Expressly provide shareholders with third-party beneficiary status. But the court noted that "practitioners were wary of this approach for the same reasons that Delaware law is reticent to grant stockholder[s] third-party beneficiary status."
2. Make the target the agent for recovering damages on behalf of its stockholders. But the court noted "this approach rested on shaky ground … because there is no legal basis for allowing one contracting party to unilaterally and irrevocably appoint itself as an agent for a non-party for the purpose of controlling that party's rights."
3. Define damages that result from a breach to include the lost premium, which commentators have coined the "damages-definition" approach. This was the provision at issue in Twitter.

Enforceability of Lost-Premium Provisions

Addressing the "damages-definition" approach, the Court of Chancery stated that "[a] target company has no right or expectation to receive merger consideration, including the premium, under agreements that operate like the Merger Agreement," where "no stock or cash passes to or through the target" and "merger consideration is paid directly to the stockholders."

Accordingly, the court held that "a provision purporting to define a target company's damages to include lost-premium damages cannot be enforced by the target company." And to the extent a provision "purports to define lost-premium damages as exclusive to the target [] it is unenforceable." Thus, the court concluded that the Lost-Premium Provision at issue was "unenforceable unless the Merger Agreement conveys third-party beneficiary status to stockholders."

The court noted that it was possible "the parties took the risk that the provision would be unenforceable" because the parties chose language to exclude stockholders as third-party beneficiaries. However, the court noted that, despite being "facially reasonable," the interpretation failed to "satisfy the cardinal rule of contract construction that" a court should give effect to all provisions, if possible.

The court went on to state that another construction of the provision would "grant stockholders third-party beneficiary status that vest[s] in exceptionally narrow circumstances and for the limited purpose of seeking lost-premium damages" when specific performance is no longer available. But the court ultimately determined that it need not identify "which of these interpretations is most faithful to the parties' expectations" because, even if the plaintiff had third-party rights under the Lost-Premium Provision, they would not have vested.

Key Points

- Despite the odd procedural posture, this was an important, novel ruling on an issue of significance for corporate practitioners.
- Although the court's ruling on lost-premium damages is arguably *dicta* given that the issue of whether the merger agreement permitted stockholders to pursue lost-premium damages never ripened, it is still something that corporate practitioners should be considering. The court's stated view, were the issue to ripen in a future matter, is clearly that a target company is not able to seek such lost-premium damages, and that stockholders could have third-party standing to pursue such relief directly.
- Practitioners have expressed concern about the prospect of stockholders being deemed third-party beneficiaries to a merger agreement, including for lost-premium damages provisions. To date, practitioners have generally relied upon Delaware's board-centric model and jurisprudence that suggests stockholders would not be considered third-party beneficiaries to a merger agreement unless there is a clearly specified intent.
- The ruling arguably exposes a legal tension that may be explored in the future. Specifically, the court noted that, when a target corporation seeks lost-premium damages, it is considered an unenforceable "penalty" if only stockholders are entitled to receive a premium under a merger agreement. However, when discussing Delaware's board-centric model, the court noted that a board "manages the business and affairs of the corporation, which extends to litigation assets" and that "[d]eeming stockholders third-party beneficiaries of corporate contracts … risks unsettling the board-centric model by encroaching on the board's authority over litigation assets." Additional case law may develop about lost premium being treated as a litigation asset of the company.
- In all likelihood, we should expect corporate practitioners to make adjustments in the future to address the court's views and concerns.
    - The court offered at least one potential solution regarding the agency approach: "Perhaps corporate law could supply a solution here" by having the company adopt a "charter provision designating the company as the stockholder's agent for purpose of recovering lost-premium."
    - Along these lines, another option is a statutory fix. The Delaware Legislature could amend the Delaware General Corporation Law to expressly allow target corporations entering into a merger agreement to designate themselves as the stockholders' agent for purposes of obtaining lost premium. This would be consistent with Delaware's board-centric model and with merger practice over the past several decades.

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