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Milbank

Corporate Governance Group

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DELAWARE COURT ASKED TO RESOLVE DISPUTE OVER STANDARD M&A CONTRACT TERMS

Court denies summary judgment where contract terms are ambiguous and conflicting and the parties' intent not clear from the record

It is interesting to note just how often courts are required to resolve disputes over the meaning of contract terms that lawyers and dealmakers take for granted. A lack of care and consistency in the drafting of contractual provisions that might be considered by some to be “boilerplate” – and therefore deserving of less attention than seemingly more substantive deal terms – can result in expensive and time-consuming litigation and, on occasion, unintended consequences.

One recent example is the decision of the Delaware Court of Chancery in *ClubCorp, Inc. v. Pinehurst, LLC*,¹ a case arising from a dispute over an indemnification agreement incident to a merger. Although this decision focuses on intermediate motions by the parties and the Court was not required to make determinations on the merits, several observations of the Vice Chancellor in allowing the case to proceed to trial warrant consideration and attention.

Background

ClubCorp, Inc. operates “various golf, country, and other clubs located throughout the United States” including, prior to 2006, the renowned Pinehurst Resort and Country Club in North Carolina. Prior to selling ClubCorp to Fillmore CCA Holdings, Inc. in 2006 in a transaction structured as a merger, ClubCorp’s founders formed an entity – which they named Putterboy, Ltd. – to acquire Pinehurst from ClubCorp. To address Fillmore’s understandable reluctance to become subject to “certain potential issues regarding tax and insurance matters” relating to Pinehurst, Putterboy entered into an Indemnification Agreement for the benefit of Fillmore and ClubCorp.

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¹ C.A. No. 5120-VCP (Nov. 15, 2011).

In December 2009, ClubCorp and Fillmore filed an action in the Court of Chancery seeking specific performance of Putterboy's obligations under the Indemnification Agreement. Subsequently, each of ClubCorp and Fillmore "merged with and into a new corporate entity, and the successors [sought] to continue to assert the original plaintiffs' contractual rights" by filing for a motion of substitution of parties. In addition to disputing whether ClubCorp and Fillmore gave timely notice under the Indemnification Agreement and whether the Indemnification Agreement covers the claims in question, Putterboy argued that these mergers "violated an anti-assignment provision of the Indemnification Agreement" and, as a result, "the successor entities cannot enforce their predecessors' rights under the Indemnification Agreement."

The Court's Analysis

The Court was faced with two motions brought by Fillmore and ClubCorp – one for substitution of the successor parties into which they had merged and the other for summary judgment with regard to the indemnification claims.

Substitution of Successor Parties

At the outset, the Court noted that under Delaware law:

"where an antitransfer clause in a contract does not explicitly prohibit a transfer of property rights by a merger, and where performance by the original contracting party is not a material condition and the transfer itself creates no unreasonable risks for the other contracting parties, the court should not presume that the parties intended to prohibit the merger."²

Thus, contracting parties are well-advised to explicitly include mergers in the list of transactions that trigger application of an anti-assignment provision.

A provision of the Indemnification Agreement entitled "*Assignment*" provides that the parties' "rights, interests or obligations" shall not "be assigned ... by operation of Law or otherwise, without the prior written consent of the other parties, and any attempt to make such assignment without such consent shall be null and void." The Court explained that "this language, taken in isolation, reasonably could be read as proscribing mergers absent prior written consent of the parties." A separate provision entitled "*Rights Cumulative*" provides, on the other hand, that "[t]he right of any indemnified party to the indemnification provided herein ... shall extend to such indemnified party's successors, assigns, heirs, and legal representatives." In the Court's view, this latter provision "[i]f read in isolation ... appears to allow successor entities of a merger to continue to enforce the original parties' rights under the Indemnification Agreement, thus presenting a direct conflict" with the anti-assignment clause.

Recognizing the "tension between the relatively clear language" of these two sections, the Court observed that "the Indemnification Agreement, read as a whole, is fairly susceptible to different interpretations regarding the effect of a merger on a party's rights thereunder." Next, the Court explained that although it "ordinarily would attempt to resolve the ambiguity by considering extrinsic evidence of the parties' intended meaning," neither party had offered such evidence to the Court. Accordingly, the Court exercised its "considerable discretion" over the substitution of successor parties by allowing them

² *Star Cellular Tel. Co. v. Baton Rouge CGSA*, 1993 WL 294847 (Del. Ch. Aug. 2, 1993).

to be “joined or added, rather than substituted,” for the purpose of establishing a record of the parties’ “actual intent as reflected in, for example, overt acts and statements pertaining to, or the context of, the contract’s formation.” This substitution was, however, “without prejudice to any party’s ability to argue at a later stage of the proceedings what effect, if any, the mergers have had on the ability of a particular Plaintiff to pursue its claims for indemnification.”

Indemnification Claims

The Court next turned to the actual indemnification claims of ClubCorp and Fillmore for various tax and insurance matters allegedly relating to Pinehurst and its acquisition by Putterboy. As a general matter, the Court found that ambiguities in the applicable provisions of the Indemnification Agreement required the consideration of extrinsic evidence that had not been provided by the parties as part of the record. Thus, the Court denied summary judgment to ClubCorp and Fillmore. Some of the Court’s observations in reaching this conclusion are certainly worthy of note:

- o *Failure to Give Timely Notice.* Section 4 of the Indemnification Agreement provides that a party seeking indemnity must give notice to that effect within 30 days after determining that the claim exists, but that the failure to do so does not constitute a waiver of the claim “except to the extent the Indemnifying Party is materially prejudiced by such failure, and then only to the extent of such prejudice.” Although ClubCorp and Fillmore did not give their indemnity notice within the requisite 30-day period, the Court placed the burden of establishing that such failure “caused [Putterboy] prejudice in some material respect” as the indemnifying party. Because Putterboy failed to present any evidence to this effect, the Court allowed the indemnity claims to proceed.
- o *General vs. Specific Provisions.* In addition to bringing its claim for indemnification of certain taxes under the provision of the Indemnification Agreement dealing explicitly with tax matters, ClubCorp and Fillmore sought relief under Section 1, “a general loss provision requiring Pinehurst and Putterboy to indemnify ClubCorp ‘from all any all Losses from, or included in, . . . the Pinehurst Transaction Claims.’” Even though the Indemnification Agreement’s definition of “Losses” does not specifically include taxes, ClubCorp and Fillmore argued that “a tax liability falls within the contractual definition of a ‘Loss.’” They also argued that taxes are contemplated by use of the term “Pinehurst Transaction Claims”, which is defined broadly by the Indemnification Agreement to include “Actions”, which in turn is defined to include “claims and charges” by governmental entities.

The Court was not sympathetic with this approach, explaining that only by “considering each of these defined terms in the aggregate” could ClubCorp and Fillmore argue that this provision is not ambiguous. Ultimately, the Court was not persuaded by this “Russian matryoskha doll of defined terms,” relying instead on the rule of interpretation which requires that “[s]pecific language in a contract controls over general language, and where specific and general provisions conflict, the specific provision ordinarily qualifies the meaning of the general one.” In particular, the Court found that ClubCorp’s and Fillmore’s argument as to the applicability of the general loss provision “is undercut by the presence of a more specific provision in the Indemnification Agreement . . . which expressly provides for indemnification of taxes . . . on a more limited basis . . .” Even if the former provision also were applicable, the latter provision “would be the narrower of the two provisions and, therefore, control.” On this basis, the Court denied summary judgment on this aspect of the indemnity claim.

- o *Meaning of Undefined Term.* Another of ClubCorp's and Fillmore's tax claims depends on the meaning of the term "Pinehurst Entities." The Indemnification Agreement does not include a definition of "Pinehurst Entities," but does provide that undefined terms have their meanings set forth in the Merger Agreement relating to Fillmore's acquisition of ClubCorp. The Court observed, however, that "Pinehurst Entities" also is not defined in the Merger Agreement but is defined in the Purchase Agreement relating to the purchase of Pinehurst by Putterboy, and in a manner favorable to ClubCorp's and Fillmore's claims. Because the evidence presented was not sufficient to establish the parties' intention to incorporate this definition into the Indemnification Agreement, however, the Court also denied this aspect of ClubCorp's and Fillmore's summary judgment motion.

Conclusion

It is too soon to tell which of the parties' interpretations of the disputed provisions of the Indemnification Agreement will prevail at trial. Because the outcome is uncertain, the parties may very well decide to settle. At this point, both sides probably regret not having provided more precision in the drafting of their arrangements.

There clearly are improvements, alluded to by the Court, that could have avoided this uncertainty. For instance, the inclusion of the term "permitted" before the term "successors" in the "*Rights Cumulative*" section would have negated any conflict with the "*Assignment*" provision. Similarly, the dispute over whether tax losses were intended to be covered by the general indemnity provision would not have arisen had taxes been specifically included or excluded. Finally, the use of defined terms that are defined only in separate, although related, agreements will frequently lead to confusion. These are all matters which careful drafting can address. In the absence of such precision, however, it is very difficult to predict how a court will react.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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