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Delaware Court Addresses Claims Arising From Hackers' Theft of Merger Consideration

After hackers targeted law firm emails and stole a portion of the merger consideration, the Delaware Court of Chancery found it was "reasonably conceivable" that an M&A buyer could be liable for not ensuring final payment reached target company shareholders.

On April 1, 2022, the Delaware Court of Chancery (the Court) issued an opinion in *Sorenson Impact Foundation v. Continental Stock Transfer & Trust Company*, a case brought by target company shareholders in a merger transaction after hackers posing as the shareholders successfully redirected a portion of the merger consideration to the hackers instead of the shareholders. The out-of-pocket shareholders sued the buyer, the target company (which survived the merger as a wholly owned subsidiary of the buyer), and the paying agent responsible for remitting payment of the merger consideration to the target's shareholders under a customary paying agent agreement with the buyer.

Vice Chancellor Glasscock, considering the defendants' motions to dismiss at the pleading stage:

- allowed breach of contract claims against the buyer to proceed on the grounds that it was "reasonably conceivable" (the relevant standard at the pleading stage) that the buyer had breached the merger agreement by not ensuring that final payment reached the shareholders;
- dismissed all claims against the paying agent due to lack of personal jurisdiction; and
- dismissed claims that the buyer was vicariously liable for the paying agent's breach of contract on grounds that Delaware law only recognizes vicarious liability for an agent's tortious conduct.

Background

The *Sorenson* case concerns the acquisition of Graduation Alliance, Inc. (the Target) by Tassel Parent Inc., a subsidiary of funds managed by a private equity firm (the Buyer). In connection with the transaction, the Buyer entered into a paying agent agreement (the PAA) with Continental Stock Transfer & Trust Company (the Paying Agent) to engage the Paying Agent to send the merger consideration delivered by the Buyer to the Target's shareholders. After the Sorenson Impact Foundation and James Lee Sorenson Family Foundation (together, the Sorenson Entities) properly tendered their securities in the Target to the Paying Agent along with a letter of transmittal directing the Paying Agent to wire their

merger consideration to a bank in Utah, hackers intercepted emails between the Sorenson Entities and legal counsel on the transaction (the Law Firm) and, posing as the Sorenson Entities, asked the Law Firm to direct payment instead to a bank account in Hong Kong in the name of HongKong Wemakos Furniture Trading Co. Limited.

In accordance with the terms of the PAA, prior to closing of the merger, the Buyer sent the Paying Agent a schedule of all the Target shareholders entitled to receive the merger consideration. The PAA required the Paying Agent to examine all letters of transmittal as well as the share certificates submitted to it by the shareholders to ascertain that they were properly completed. If the share certificates or letters of transmittal were not properly completed or if some other irregularity existed, the Paying Agent was required to consult with the Buyer. The Paying Agent could waive such irregularities, but only with the Buyer's written consent. In addition, the form letter of transmittal that the shareholders completed required that any shareholder requesting payment in a name other than the name on its stock certificate properly endorse the certificate and have the signature "medallion guaranteed" by a qualified guarantor.

When the Law Firm instructed the Paying Agent to revise the Sorenson Entities' letter of transmittal to make a payment to the bank in Hong Kong in the name of HongKong Wemakos, the Paying Agent discussed the issue with the Law Firm and offered the Law Firm three options: (i) provide the medallion guarantee; (ii) provide the Paying Agent with a letter of instruction from the Sorenson Entities including hold harmless language for the benefit of the Paying Agent and waive the medallion guarantee requirement; or (iii) change the name on the payment schedule to the HongKong Wemakos name. The Law Firm chose the last option, and the Paying Agent made the payment to the account in the name of HongKong Wemakos, resulting in the Sorenson Entities not receiving the merger consideration to which they were entitled.

Analysis

Buyer May Be Liable for Not Ensuring Payment to Target Shareholders

The Court, noting that "the amended Complaint pushes the Court to the limits of the leniency inherent in the modern doctrine of notice pleading," overcame two significant hurdles to reject the Buyer's motion to dismiss the Sorenson Entities' breach of contract claims.

First, the Court observed that the Sorenson Entities did not plead that the Buyer had breached the terms of the merger agreement but instead alleged that the Buyer had breached the terms of the letter of transmittal by failing to obtain a medallion guarantee in circumstances where it was required to do so. The Court noted that the Buyer was not a party to, and had not signed, the letter of transmittal and that the Court had previously held in *Cigna Health and Life Insurance Company v. Audax Health Solutions, Inc.* that letters of transmittal are not contracts. Nevertheless, the Court stated that in the context of pleading a breach of contract claim in Delaware, a plaintiff can make out a sufficient claim if the complaint contains "a short and plain statement of the claim showing that the pleader is entitled to relief," and that "specific facts need not be pled in order to make out an 'actionable claim,' and assessment of the stated claim should be 'liberally construed' so long as the defendant has 'fair notice' of the claim." Applying that forgiving standard, the Court found that the complaint gave sufficient notice to the Buyer that it was being sued for a failure to pay the merger consideration in violation of the merger agreement for the breach of contract claim to survive a motion to dismiss.

Second, the Court acknowledged that the merger agreement did not explicitly require the Buyer to make a payment of the merger consideration to the Sorenson Entities. Instead, it merely required the Buyer to pay the merger consideration to the Paying Agent, which the Buyer had done. However, notwithstanding

the plain text of the merger agreement, the Court held that it was "reasonably conceivable" (the applicable standard at the pleading stage) that the merger agreement "read holistically" could be interpreted to require the Buyer "to do more than make a payment to its agent, that is, to ensure payment to the 'entitled' shareholders."

No Personal Jurisdiction Over Paying Agent

The Court granted the Paying Agent's motion to dismiss for lack of personal jurisdiction. The Sorenson Entities asserted that, although the Paying Agent was neither a party to the merger agreement nor a signatory to the letter of transmittal, the forum selection clauses in those documents (both of which required litigation in Delaware) could be imputed into the PAA because the PAA attached the letter of transmittal as an exhibit, and the letter of transmittal in turn attached the merger agreement as an exhibit.

The Court rejected the Sorenson Entities' arguments because (i) the PAA did not specifically incorporate the forum selection clauses by reference or otherwise provide an "explicit manifestation of intent" to incorporate the forum selection clauses and (ii) the PAA contained a provision expressly denying that the Paying Agent was bound by any provisions of the merger agreement.

The Court also found that the Paying Agent did not have sufficient minimum contacts with the state of Delaware by virtue of providing services in connection with the merger of two Delaware corporations for the state to assert jurisdiction through its long-arm statute, and Delaware had no special interest in adjudicating a dispute over a "commonplace commercial contract" such as the PAA.

No Vicarious Liability for an Agent's Breach of Contract

The Court dismissed the Sorenson Entities' claims that the Buyer was vicariously liable for the Paying Agent's breach of the PAA on the grounds that under Delaware law, while a principal may be vicariously liable for *torts* committed by its agent, a principal cannot be liable for its agent's breach of contract or other non-tortious conduct. Although the Sorenson Entities did plead that the Paying Agent had committed the tort of negligence, the Sorenson Entities did not allege that the Buyer was vicariously liable in connection with that conduct. The Court implied that had the Sorenson Entities pleaded that the Buyer was vicariously liable for the Paying Agent's negligence, a vicarious liability claim may have survived a motion to dismiss.

Unjust Enrichment Claims

The Sorenson Entities also pleaded unjust enrichment claims against both the Buyer and the Target. Under Delaware law, unjust enrichment occurs where there is "(1) an enrichment, (2) an impoverishment, (3) a relation between the enrichment and impoverishment, (4) the absence of justification and (5) the absence of a remedy provided at law." While the Court noted that "it is difficult to see how Buyer can have liability apart from breach of contract here," it nevertheless "bow[ed] under the weight of precedent," citing the Court's recent decision in *Lockton v. Rodgers* (holding that the absence of justification prong can be satisfied by other claims brought by the plaintiffs) to decline to dismiss the unjust enrichment claims.

Status After the Ruling

As a result of the ruling, the Sorenson Entities' claims against the Paying Agent were dismissed, while their claims against the Buyer for breach of contract and claims against both the Buyer and the Target for unjust enrichment were permitted to proceed. The Court declined to rule on the Buyer's and the Target's motion to dismiss for failure to join the Law Firm as a necessary party, requesting that argument on that motion be supplemented to consider the additional question of whether the Paying Agent is a necessary party.

Implications

Sorenson highlights the need for M&A practitioners to be aware that sophisticated hackers who are familiar with the standard payment mechanics of merger transactions are looking to exploit the process of transmitting funds from the paying agent to shareholders. These hackers prey upon law firm associates, paying agent employees, and other individuals who are tasked with coordinating closing payment logistics, often in great volume and under significant time pressure. The plaintiffs in *Sorenson* argued that the defendants' actions were influenced by a "time crunch," and noted that the Law Firm did not consult with what it believed were the Target shareholders before giving the final instruction to the Paying Agent to change the name in the PAA payment schedule.

While all parties to an M&A transaction and their counsel and other advisors should do everything possible to ensure that protections are in place to prevent hackers from infiltrating their systems in the first place, ultimately individual practitioners must remain vigilant even in the haze of a time-crunched closing process for potential red flags, such as last-minute changes to payment instructions or letters of transmittal or failures to observe protective technical requirements, such as the need for a medallion guarantee.

Additionally, *Sorenson* puts M&A buyers on notice that their obligations may not end with payment to a paying agent. Indeed, the Court found that it was "reasonably conceivable" that the merger agreement in this case required the Buyer to ensure ultimate payment to the Sorenson Entities (despite the lack of any direct language to that effect). Buyers (and their counsel) may be obliged to see that payments ultimately reach shareholders, especially when potential irregularities arise or deviations from the express processes in transaction documents are considered.

While M&A practitioners and their clients can view paying agent agreements as technical form documents with little practical significance, *Sorenson* proves that their these documents' terms can have important implications when unforeseen circumstances arise or in the event that increasingly sophisticated bad actors succeed in infiltrating a transaction. Buyers and paying agents should consider including language in their paying agent agreements and letters of transmittal entitling them to rely on the information provided by shareholders unless precise steps are taken to revise the letter. Doing so could lessen the perceived pressure to accommodate what appear to be last-minute changes from entitled shareholders.

Further, parties should not assume that Delaware courts will read into agreements choice of law or forum clauses that are not included in the agreements or incorporated by reference simply because there are significant Delaware contacts in other aspects of a transaction. If the parties' goal is to ensure that Delaware law and venue (or that of another jurisdiction) prevail, they should expressly include choice of law and forum clauses in paying agent agreements or expressly incorporate by reference the choice of law and forum clauses in the merger agreement or the letter of transmittal to ensure that the paying agent can be joined in any litigation that arises. Terms contained in an exhibit or attachment to an agreement will not be imputed into that agreement unless there is an "explicit manifestation of intent" for those terms to be incorporated.

Finally, *Sorenson* serves as a reminder that under Delaware law a principal (such as a party to an M&A transaction) can be held liable for the negligence or other tortious conduct of an agent (such as a paying agent), but not for an agent's breach of contract.

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