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MERGERS AND ACQUISITIONS

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Do We Have a Deal? A Groundbreaking Court Decision May Impact MAE Issues

By Megan E. Harmon

Businesses pursuing a merger or acquisition transaction may want to consider the important issues of material adverse effect (MAE) presented in the recent decision of *Akorn, Inc. v. Fresenius Kabi AG*. Parties to a deal should take into account how the questions raised by this case could potentially affect the way transactions are structured.

The *Akorn* decision comes at a time when the number of merger and acquisition deals has been riding high. Many experts continue to be cautiously optimistic that the M&A pace will continue through 2019. With interest rates remaining relatively low, active financial and strategic buyers with cash on hand, and aging baby boomers retiring, businesses are changing hands at record levels. So it remains a good time to sell or buy.

Once you have decided to pursue a transaction, when do you know that you have a real deal? While many things can derail a transaction, the parties should each have an understanding of what conditions or events can happen between signing the deal and closing that give either party the right to call it off. In a typical transaction, the parties agree to a purchase price and then negotiate at great length the representations and warranties related to the business. Only after these provisions are in place do the parties negotiate conditions precedent to closing, sometimes without more than a cursory understanding of what these conditions really mean.

Whether you are on the buy side or the sell side, you must be aware of the significance and meaning of material adverse effect and the various conditions to closing. Often the business people and their lawyers are not on the same page about what changes may occur between signing the deal and closing that would "compel" the parties to close or permit a buyer to "walk away". A typical condition to closing found in purchase agreements essentially says that between the signing of the deal and closing, no circumstance or event occurred that would have an MAE on the business of the seller or its financial condition, and sometimes the provision may even refer to the seller's prospects. The parties may negotiate certain items that are not considered an MAE, such as a change in law, change in general market conditions, or the terms of the deal being disclosed for obtaining regulatory approval or other consents. These exceptions say – "You can't call an MAE if these conditions occur." Pretty simple. However, often what is a "material" adverse effect or change may not be spelled out with sufficient detail and thus left open to interpretation. Here is where your average business person and the courts may diverge. A matter that would be deemed materially adverse in the eyes of a business person is rarely seen as such by the courts.

Lately there has been a lot written about the *Akorn v. Fresenius* decision of the Delaware Chancery Court, which was recently affirmed by the Delaware Supreme Court. For the first time, both Courts found there was a material adverse effect on Akorn's business, justifying the buyer to terminate the merger agreement.

The *Akorn* decision involved a multi-billion dollar merger, which is probably one reason why this termination was litigated. Often when there is a material change in circumstances or events, the parties either

negotiate a change to the purchase price or mutually agree to walk away. Nevertheless, business people and transaction practitioners should be aware of this case and its potential impact on the circumstances that could qualify as an MAE.

Courts in Pennsylvania, Delaware, and other states routinely hold businesses to contracts by rationalizing that the terms of such deals were negotiated by sophisticated parties. Courts assume the parties know the risks inherent in the market and their businesses. The courts are thus loath to second guess the business judgement of the parties to a transaction. On issues of material adverse effect, the courts most often defer to the written word of the contract. When there is not specific direction, courts are reluctant to determine what is material outside the written terms of the purchase agreement. Short term dips in value, earnings, or prospects usually do not arise to an MAE.

Akorn v. Fresenius offers insight into how courts may make an exception to these strict MAE conventions. The *Akorn* decision painstakingly details (in over 200 pages) the facts in this case and the financial and regulatory issues involved. Among other factors, the historical dip in the value of Akorn was precipitous, and most business people would have said obviously there was a material adverse effect. However, even given the dramatic circumstances in this case, the Delaware Chancery Court required hundreds of pages of analysis to reach a finding of MAE due to the cause, degree, and duration of these issues. What is noteworthy about this case is not only that the Delaware Courts found for the first time that there was a material adverse effect, but also the wide difference in perception as to what is material between common business judgment versus legal interpretation.

In light of the *Akorn* decision parties to a merger or acquisition, both business people and their lawyers, should consider taking great care in detailing in the purchase agreement what would constitute an MAE and not risk leaving it to the courts to determine materiality for a particular transaction. Drafters should not rely on a general MAE clause and hope the parties can work it out. Spell out with clear and precise language what activities, events, or circumstances would result in an MAE, including variations in financial performance, market conditions, or regulatory compliance issues. The key is to define with specificity what would permit the buyer to walk away from the deal and, short of that, what would compel the buyer to close. For instance, if EBITDA drops 5%, 10% or 20%, what happens? What if there is a loss of a significant customer? If certain consents are not obtained, must the deal still go forward?

If at all practicable, consider structuring the transaction as a simultaneous sign and close. This allows the buyer to have ultimate flexibility related to due diligence, changes in financial or market conditions, other outside influences, and the timing of the transaction. Of course this gives no comfort to a seller that they have a deal. And in a seller's market this structure is not always possible. Regulatory approvals may also bear on whether this structure can serve as an alternative.

Well-developed business plans and due diligence can also establish what are MAE triggers, and good drafting can make precise hurdles for the condition to closing. Good communication between counsel and the business development team can also help establish what potential events or changes could impact the transaction and give the buyer the ability to close or walk away. *Pro forma* assumptions should be woven into the closing conditions to the extent possible. A rush to closing is not always in the buyer's best interest.

Typically courts perceive MAE as a buyer's remorse issue. The judge from the Delaware Chancery Court in *Akorn* emphasized this point in the precedent-setting decision, stating:

> "In prior cases, this court has correctly criticized buyers who agreed to acquisitions, only to have second thoughts after cyclical trends or industry-wide effects negatively impacted their own businesses, and who then filed litigation in an effort to escape their agreements without consulting with the sellers. In these cases, the buyers claimed that the sellers had suffered contractually defined material adverse effects under circumstances where the buyers themselves did not seem to believe their assertions. This case is markedly different. . . . The parties agreed to pro-

> visions in the Merger Agreement that addressed those [MAE] events, and Fresenius properly exercised its rights under those provisions."

Each purchase and sale is different. The parties should clearly understand what commits each side to the deal and what permits them to walk or renegotiate the deal. This could include the consent of a key customer or employee, assumption of certain liabilities, or adjustment to the purchase price. The conditions to closing and the MAE should not rely solely on general terms, but set forth specific language and factors that lessen the need to make conjectures or interpret what is "material". Know what you are facing when you enter into to a purchase agreement, what conditions get you to the closing table, and what may let either party walk away.

For details, see *Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018–0300–JTL, Court of Chancery of the State of Delaware (Oct. 1, 2018), affirmed by Supreme Court of Delaware, No. 535 (Dec. 7, 2018). (https://courts.delaware.gov/Opinions/Download.aspx?id=279250; https://courts.delaware.gov/Opinions/Download.aspx?id=282110). ◆

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