The Deal

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DELAWARE RESURRECTS MATERIAL ADVERSE EFFECT CLAUSE

Sponsored: Cahill Gordon & Reindel attorneys discuss why an October ruling focused on the clause offers an important opportunity for dealmakers to reassess how they approach MAEs specifically and conditions to closing more broadly.

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Imagine, reaching signing day on a transaction: the successful public roll-out, the headlines, the champagne and the congratulatory handshakes.

And then, the deal falls apart when the conditions to closing are not met.

For dealmakers, that is the fuel which feeds nightmares.

Now, the Delaware Court of Chancery has resurrected the Material Adverse Effect (MAE) clause, which many experts had long considered dead, as a means of walking away from a signed-up deal. Where most contract terms are highly specific, the MAE is, in the Court's words, a general backstop "protecting the buyer from the occurrence of unknown events" that threaten earnings over the long haul.

While successful MAE challenges will remain rare, the Court's October ruling offers an important opportunity for dealmakers to reassess how they approach MAEs specifically and conditions to closing more broadly.

Background

The MAE clause has long been found in M&A agreements, but many dealmakers and their legal advisors considered it inoperable. The Delaware courts set a powerful precedent in 2001 when they placed a heavy burden on those who bring MAE cases. That case involved a merger between Tyson Foods and IBP, in which Tyson argued that a 64% decrease in IBP's first quarter earnings constituted an MAE. The Court disagreed, writing that "a short term hiccup in earnings will not suffice."

Additional rulings in Delaware reinforced this finding, including the 2008 Hexion case where the Court found no MAE where the financial performance of the target, Huntsman, suffered due to "macroeconomic challenges" presented by rapidly increasing oil and natural gas prices and unfavorable foreign exchange rates.

As a result, for over a decade, legal advisors have warned buyers that invoking an MAE was a fool's errand.

Then last month, the MAE was brought back to life with a lightning bolt. The Delaware courts ruled in Akorn, Inc. v. Fresenius Kabi AG, and found the buyer, Fresenius, had validly terminated its merger agreement due to MAEs at the target, Akorn.

Details of the Akorn case

Fresenius agreed to acquire Akorn, but between signing and closing, significant financial losses and a host of regulatory compliance issues arose at Akorn. Fresenius moved to terminate the agreement, and Akorn turned to the Delaware courts, hoping to compel Fresenius to close the deal.

Instead, the Court sided with Fresenius. In fact, the Court found two MAEs and also that Akorn breached its duty to operate in the ordinary course of business.

First, the Court found a general MAE based on the magnitude of Akorn's financial downturn, its durational significance and a disproportionate decline compared to industry peers. After signing, Akorn's performance "dropped off a cliff," according to the Court. The firm suffered year-over-year declines in Ebitda of 86% and in operating income of over 100%. The MAE would be enough for Fresenius to refuse to close the deal, but not to terminate the agreement, so the Court turned to analyzing Fresenius' other claims.

Second, the Court found a regulatory-related MAE at Akorn, citing "overwhelming evidence of widespread regulatory violations and pervasive compliance problems." The Court reasoned that compliance with the FDA's regulatory requirements was an essential part of Akorn's business. Yet, FDA regulatory requirements centered on data protection and integrity were not met. Further, it was alleged Akorn misled the FDA on these issues. In reaching its conclusion, the Court stressed the time it would take to correct these issues and their significant financial impact.

The Court also found that Akorn's handling of these non-compliance issues amounted to an incurable breach of Akorn's obligation to continue operating in the ordinary course of business. The Court made clear that either of these failures was sufficient grounds to terminate the agreement.

Lessons for dealmakers

While the facts of the case made for an exceptionally narrow ruling, there are a few essential warnings dealmakers should heed:

This case is not an open-door invitation to litigate MAEs. The Court noted that the Delaware court has correctly criticized previous buyers who brought MAE cases as a result of, "second thoughts after cyclical trends or industrywide effects negatively impacted their own businesses." The Court made clear that successful MAE cases will remain few and far between.

Carefully allocate risks in the contract. The Court noted, "The typical MAE clause allocates general market or industry risk to the buyer, and company-specific risks to the seller," while the seller can negotiate carve-outs, exclusions and exceptions to exclusions in the MAE. These steps reallocate to the buyer any categorical risks or specific matters that may arise after signing. Buyers, of course, should weigh such carve-outs carefully as part of the negotiation of the merger agreement.

Extensive due diligence is still the best protection. To be clear, even the best due diligence cannot always account for misrepresentations or misdeeds of the seller, as was the case in the Akorn dispute. Nonetheless, potential buyers have the most power during the negotiation of the merger agreement. While many fear losing momentum at this high-stakes moment, uncovering problems early, before signing, saves headaches later.

Access covenants are key. The Court noted that, "Under the Merger Agreement, Fresenius had bargained for a right of reasonable access to Akorn's officers, employees, and information." Utilizing this access, Fresenius learned the extent of the regulatory problems related to Akorn's data integrity. Access to books, records and key personnel must be a focus of both buyers and sellers during negotiation.

Understand rights and duties related to an "efforts clause" or "hell or high water" clause. The Akorn case included an efforts clause in which Fresenius agreed to take "all actions necessary" to secure antitrust clearance. But, the Court suggested that where negotiating parties want to require specific divestitures or take on specific conditions of regulatory approvals, the language of the merger agreement should reflect such specificity. Further, the Court noted that hell or high water clauses may be diluted if the buyer has control over the strategy for regulatory approvals; although in this case the Court did not find that dilution to be dispositive.

While this case represents the first Delaware court finding of an MAE, the more important lesson for dealmakers is clear: Delaware courts expect sophisticated parties to craft complex merger agreements with the help of expert legal counsel - and the terms of those contracts will guide the Court's decisions, so dealmakers must negotiate them carefully and wisely.

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