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Five Keys to Analyzing A Material Adverse Effect

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While parties to large purchase or merger transactions typically include Material Adverse Effect (MAE) clauses in their agreements, there is little by way of detailed parameters in the law for what establishes such a material adverse effect. The clause can be used in various contexts but, in general, its purpose is to shift certain risks between the parties, providing buyers with a mechanism to avoid closing on a transaction if there is a significant enough change in the business of the target or underlying assets.

Although there is no one definitive benchmark to establishing an MAE, parties to purchase or merger transactions with New York or Delaware choice of law provisions, which underlie a substantial amount of commercial litigation, can find some guidance from a recent decision on MAE-related claims.

In December, the law regarding MAE clauses was advanced considerably by the Delaware Supreme Court's decision in *Akorn v. Fresenius Kabi AG,* which marked the first Delaware state court case upholding a buyer's right to terminate a merger agreement on the basis of an MAE.

In 2017, Fresenius Kabi AG agreed to purchase Akorn, Inc. for $4.3 billion, with closing between the two pharmaceutical companies to occur approximately one year later. Two days before the closing, Fresenius refused to close on the grounds that Akorn: (1) suffered an MAE, (2) made misrepresentations related to FDA regulatory compliance that would be expected to result in an

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MAE, thus constituting the failure of a Bring-Down Condition, and (3) breached an operating covenant to conduct its business in the ordinary course of business from signing until closing. Akorn filed suit in Delaware Chancery Court seeking specific performance.

The Chancery Court found an MAE had occurred, that there was a failure of the Bring-Down Condition because Akorn's regulatory compliance representations were inaccurate and would reasonably be expected to result in an MAE, and that Akorn failed to conduct its business in the ordinary course. The Supreme Court affirmed these findings, effectively making the 246-page Chancery Court opinion a primer on MAE clauses.

In *Akorn,* Chancellor Laster relied on the standard established by seminal Delaware cases that an MAE must "substantially threaten the overall earnings potential of the target in a durationally significant manner." Unfortunately, there are no hard lines for establishing such a material, long-term impact. For example, the Delaware Chancery Court has found a decline in the target's EBITDA of 3 percent did not constitute an MAE, while in *Raskin v. Birmingham Steel*, the Chancery Court noted that a 50 percent decline in earnings over two consecutive quarters likely constituted an MAE.

In New York, in *Pan Am Corp. v. Delta Air Lines*, the U.S. District Court for the Southern District of New York found an MAE based upon a three-month period of sharp declines in business performance, while in *Katz v. NVF Co*., a decision by the Appellate Division of the NY Supreme Court, the parties agreed that a loss in the target's earnings of $6,347,000, compared with positive earnings of $2,105,000 in the prior year, constituted an MAE

As noted in *In re IBP Shareholders Litigation* (which was actually decided under New York law), there is sparse authority in New York on this topic. But the limited authority is in line with Delaware law, in that an MAE must be based upon a significant decline in a target's business. Given the similarities between Delaware and New York law, there are several important takeaways in either jurisdiction that can be drawn from the authority that exists on MAE claims.

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Certain relevant market benchmarks in analyzing an MAE. Several benchmarks may be used to help assess whether an MAE has occurred. Although no one benchmark may be dispositive, the court in *Akorn* looked to "intuitive" benchmarks, such as a 20 percent decline in a target's value, to the extent this is likely material to a reasonable buyer. Such a benchmark finds parallels in the business and the markets more broadly.

For example, a bear market by definition occurs when stock prices fall 20 percent from their peak. The court in *Akorn* also cited to studies finding that where parties use collars or bands in deals with stock considerations to delineate acceptable fluctuations in value, they typically use upper and lower bounds of 10 percent-20 percent.

The *Akorn* decision also cited to a 40 percent decline in a target's business performance as evidence of an MAE, citing the treatise *Negotiated Acquisitions of Companies, Subsidiaries and Divisions*, in which the authors point to courts finding a 40 percent or more decline in profits as being material. While a 40 percent decline is not a bright line rule (see, e.g., the discussion of *IBP* below), such a decline, using a variety of financial metrics, such as earnings per share, EBITDA, operating income, and revenue, may provide relevant evidence of an MAE.

Again, while no hard threshold may be required to establish an MAE definitively, drawing from various benchmarks in these ways is the kind of analyses courts have undertaken.

Expert testimony regarding an MAE claim. In *IBP*, the lack of credible expert testimony was detrimental to the buyer's claims of an MAE in court. For example, in *IBP*, a quarterly decline of 64 percent was not considered an MAE, without further analysis demonstrating that the causes of the decline would be durationally significant.

By contrast, the court in *Akorn* gave great weight to expert testimony used by Fresenius to support an MAE finding. For example, the Chancellor accepted expert testimony tracking third-party analysts' reports that Akorn's business was suffering from a durationally significant effect. Thus, while not mandatory, expert evidence may be helpful in assessing and demonstrating to a court both the size of any decline and the long-term impact on the target's business.

Courts may take into account evidence of the motives of a party relying on an MAE. In *IBP*, the Chancery Court believed the buyer attempted to manufacture an MAE to escape the merger, and failed to communicate its concerns with the target. While not determinative, the court seemed to give great weight to these facts in rejecting the MAE claim. In *Akorn*, the court did not perceive Fresenius as suffering from buyer's remorse; rather, the court concluded that the evidence was consistent with a buyer that fully planned to close and was complying with its contractual obligations. Therefore, a party with an MAE concern may want to ensure that its own house is clean, *i.e.*, that its actions are consistent with the underlying agreement and that it is communicating its concerns with the target in a timely manner.

Materiality is both qualitative and quantitative. In some instances, parties use MAE language as a qualifier for representations made at the time of entering into an agreement, and which must still be in effect at closing. If the representations made were inaccurate to a degree that reasonably would be expected to result in an MAE, the buyer can refuse to close and terminate the agreement. In such cases, courts have assessed the magnitude of the deviation between the represented conditions and the actual conditions, both in quantitative and qualitative terms. Regarding the quantitative significance, a court again may rely on expert evidence to determine the financial impact the inaccurate representations have on the target's value or business. For example, a court may analyze the price tag on remedial efforts required as a result of the inaccuracies.

A court also may assess the impact of the inaccuracies on a target's value, potentially using the 20 percent benchmark noted above to determine materiality. Qualitatively, a court may rely on expert testimony to assess whether, for example, the inaccuracies would be thought to have a serious impact on the target's ability to conduct its business going forward. In *Akorn,* the Chancellor noted that Akorn was in "persistent, serious violation of FDA requirements with a disastrous culture of noncompliance," while representing its regulatory compliance to Fresenius.

Consider specificity in drafting MAE clauses, including any carve-outs. As a risk-shifting mechanism, when drafting MAE clauses, parties may wish to draft the language of any MAE clause, including any carve outs, with a high degree of specificity. For example, if a seller would like to exclude material changes resulting from known risks from the MAE definition, such a carve out should be specifically included in the agreement. Absent clear carve outs, a court may be less likely to imply exceptions that should have otherwise been included had the parties been more specific.

What is clear from the case law surrounding MAE analyses is that each analysis is and will remain fact specific. Sellers and buyers in merger agreements should be aware of the guidelines above, whether in Delaware, New York or elsewhere.