

Channel Reinforces that Akorn is the Ceiling not the Floor for MAE Terminations

by Layne T Smith and Brian Burke

2018's landmark decision *Akorn, Inc. v. Fresenius Kabi AG* marked the first time that the Chancery Court upheld a buyer's use of a Material Adverse Effect (MAE) clause to terminate a merger agreement. However, the Court's reasoning in the case suggested that the favorable ruling was based on the particularity of the facts and that the general standard for successfully invoking such a clause remains high. The Court's recent decision in *Channel Medsystems v. Boston Sci. Corp* confirms the continuation of that high standard and reaffirms the Delaware Court's stance that the MAE clause cannot be invoked to alleviate the effects of "buyer's remorse" or undesirable business decisions.

Background

On November 1, 2017, Channel and Boston Scientific entered into an agreement and plan of merger. Shortly after entering into this agreement, Channel's Vice President of Finance discovered that, the company's Vice President of Quality had falsified documents as part of a self-enrichment scheme that netted him around \$2.5 million. An investigation into the scheme revealed that a number of the falsified documents had been sent to the FDA as part of Pre-Market Approval (PMA) for one of the company's products.

Channel immediately launched an internal investigation, fired the Vice President of Quality, quickly began remediation action, hired a third party company to assess their facilities, informed the FDA of the falsification, and informed Boston Scientific of the situation. The FDA found Channel to be highly cooperative and after a thorough investigation, which pushed back Channel's original PMA timeline by a few months, the FDA approved the PMA. The delay had no effect on the original closing date, however, Boston Scientific argued that the fraud rendered a number of the representations and warranties inaccurate, thereby triggering the MAE clause of the merger agreement, and opening the door for a buyer termination.

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The Court's Decision

In its analysis, the Court first addressed whether or not the representations and warranties were materially inaccurate. The Court engaged in this analysis because the language in the representations and warranties used materiality qualifiers and did not include a materiality scrape provision. A materiality scrape provision is an agreement between the parties to ignore the materiality qualifiers in favor of an over-all MAE standard. To determine materiality, the Court relied on the “total mix” standard used in *Akorn*, which asks whether there is a substantial likelihood that a reasonable investor would view the information or action as having significantly altered the total mix of information.

Based on that standard, the Court determined that the inaccuracies caused by the fraud were material. However, the Court concluded that, even though material, the inaccuracies did not rise to the height of causing a Material Adverse Effect. In its reasoning, the Court reaffirmed the standard for MAE found in *Akorn* and prior cases which states, that for a buyer to invoke a MAE clause to avoid its obligation to close, the buyer must show, that the MAE is material when viewed from the long-term perspective. The important consideration being whether there has been an adverse change in the target's business that is consequential to the company's long-term earning power measured in years rather than months.

Along with reaffirming this high MAE standard, the Court offered an important clarification to the temporal ambiguity created by the “reasonably be expected” language often found in MAE clauses. Similar to *Akorn*, the MAE clause in Channel stated that: “...each of the representations and warranties of Channel contained in [the] Agreement ... shall have been true and correct at the time originally made... except to the extent that the failure of any such representation and warranties to be true and correct does not have and would not *reasonably be expected* to have a Material Adverse Effect on Channel.”

The phrase “reasonably be expected” suggests a future looking standard, but does not specify at what point during the merger the buyer's reasonable expectation of a future breach should be measured, nor does it spell out how far in the future that expectation can be projected. The Chancery Court clarified that the expectation of material breach should be measured at the moment *when the buyer actually terminates* the merger agreement, as opposed to the date when the inaccuracies were discovered. In Channel, as the party seeking to terminate, Boston Scientific had the burden of showing a reasonable expectation of a future Material Adverse Effect when the termination notice was given. Since Channel was able to rectify its issue with the FDA and still gain PMA well before notice was given, the Court found that Boston Scientific failed in meeting its burden. This clarification can provide helpful guidance for sellers thinking of invoking the clause or buyers trying to analyze whether an MAE has occurred.

Conclusion

Channel v. Boston Scientific reaffirms that despite the Chancery Court's decision in *Akorn* in 2018, the bar for invoking a MAE clause to terminate a merger agreement is still

high. Material inaccuracies in the representations and warranties are not enough to trigger a Material Adverse Effect. Rather, the buyer must show that at the time of termination that there is a future expectation of a long-term adverse effect on the earning power of the target business.