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Tips For Drafting M&A Agreements After Akorn

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It has been widely reported that the Delaware Court of Chancery's decision in Akorn v. Fresenius on Oct. 1, 2018, is significant in that the court, for the first time ever, found that a target company had suffered a "material adverse effect" (also known as a material adverse change, or MAC) between the signing and closing of a merger agreement, which entitled the acquirer to terminate the agreement. The 246-page opinion by Vice Chancellor J. Travis Laster is also significant, however, in serving essentially as a primer on how the court may interpret numerous standard provisions in merger agreements and in corporate contracts generally.

The court's strong emphasis in Akorn on looking to the plain language of the parties' agreement to resolve disputes between them, and the court's discussion of various provisions, should stimulate consideration of modifying the drafting of certain standard provisions. The provisions discussed by the court appear not only in merger agreements but also in most other types of corporate contracts, including financing agreements, commercial contracts, investment agreements, and others. Of course, whether a drafting change would be accepted by the counterparty, or even should be raised with the counterparty, will depend on the parties' respective negotiating strategies and leverage and the particular facts and circumstances.

Below, we provide practice and drafting points arising from the opinion. As the Akorn decision is being appealed to the Delaware Supreme Court, further explication of these points may be forthcoming.

Practice and Drafting Points

The Court Emphasized a Strongly Contractarian Approach

Throughout the opinion, the court emphasized that, given that Delaware is a "contractarian" jurisdiction, it will rely on the specific words of the merger agreement and will not "read in" concepts that the parties did not specifically provide for. The decision thus underscores the importance of ensuring that merger agreement provisions as drafted accurately reflect the parties' business understandings. Further, the decision highlights the need for any special issues or concerns relating to the company, the business, the industry or the transaction to

be expressly and specifically dealt with in the agreement. In Akorn, in finding that the acquirer had been entitled to terminate the merger agreement, the court stated that, notwithstanding the parties' mutual commitment to use reasonable best efforts to consummate the transaction, "they were not committing themselves to merge at all costs and on any terms. Instead, they were committing themselves to fulfill the contract they had signed ... which gave each of them the right to terminate under certain specified circumstances."

A MAC Is Whatever the Agreement Says It Is

There is no free-standing definition of a MAC; it is, simply, what the parties set forth in the agreement that it is. One important drafting consideration is whether the closing condition should be that there has been a MAC or, alternatively, should be that events or changes have occurred that reasonably would be expected to lead to a MAC. The key drafting consideration is the definition of a MAC (i.e., which events or changes would be included, and which would be excluded, from the definition). Parties can, but typically do not want to, define a MAC by setting forth a quantitative bright-line test — such as a decline in earnings before interest, tax, depreciation and amortization, or EBITDA, of at least X% or a loss of value in market capitalization of at least $X. Thus, parties must consider carefully the categories of events or changes, and any specific events or changes, that are to be considered, or that are to be excluded, when determining whether a MAC may have occurred. Particularly given the court's emphasis in Akorn on the specific words of the contract, parties should not necessarily rely on "standard" MAC definitions; rather, they should carefully review all of the general and specific risks that may be applicable prior to closing and decide which should be allocated to the target (i.e., expressly included in the MAC definition) and which should be allocated to the acquirer (i.e., expressly excluded from the MAC definition). Parties and their advisers should seek to ensure that the relevant risks have been identified and considered. Counsel should ensure that the wording accurately reflects the parties' intentions with respect to the allocation of risks. Of course, in all cases, whether a counterparty will accept the allocation to it of any particular risk is a matter of negotiation between the parties.

Drafting MAC Clauses — Industrywide Changes and Disproportionate Effects

Akorn underscores the importance for the target of excluding from the MAC definition changes reflecting industrywide (rather than company-specific) conditions. The court's discussion also highlights the importance for the acquirer of excepting from that exclusion industrywide conditions that have a disproportionate effect on the target. Parties may wish to treat separately and specifically certain issues where it might not be readily apparent whether they reflect industrywide or company-specific conditions (and, if industrywide, whether they may have a disproportionate effect on the target) — such as, for example, the emergence of new competition or certain regulatory changes. We note that other drafting issues include whether a disproportionate effect on the target would have to be "material" to be considered and whether the comparison should be stated to be with "peer companies" or with a specified list of companies.

Drafting MAC Clauses — "Known" Risks

Based on the court's discussion in Akorn, a target should consider seeking to exclude from the MAC definition changes arising from "known" risks — such as new competition or other risks generally known by industry insiders, as well as risks disclosed in due diligence, set forth on schedules to the merger agreement, and/or disclosed in the target's public filings. On the other hand, an acquirer may wish to specify that the MAC definition as written is applicable without regard to whether the factors included or excluded reflect risks that were "known" to the acquirer. In Akorn, the court observed (in a footnote)

that, in a survey of M&A agreements executed between June 1, 2016, and May 31, 2017, for deals valued at $1 billion or more, 28 percent of the agreements contained an MAE carveout for developments arising from facts disclosed to the buyer or in public filings.

General Exception for Items Disclosed

A seller may seek a general exception to all of the agreement's representations, covenants and/or closing conditions for items or information disclosed on any schedule or exhibit to the agreement, in public filings of the company, in materials provided in the data room, and/or otherwise disclosed to the buyer in writing. If a buyer agrees to this exception, the parties will want to ensure clarity as to whether post-signing developments with respect to any categories of (or specific) items or information disclosed would or would not be excluded from the exception.

Establishing an MAE at Trial

To establish whether the as-represented condition of a company compared to its actual condition constitutes an MAE, the parties should present evidence as to both quantitative and qualitative factors. With respect to the former, the parties should present evidence indicating whether the quantitative "valuation hit" resulting from the discrepancy is "material" from the point of view of a long-term investor (based on, for example, what valuation criterion the acquirer or others (a) used initially to value the target and/or (b) generally apply to reporting material acquisitions or other changes under Regulation S-K or Item 7 thereof).

MAE in the Context of a Financial Buyer

As noted, the court observed (in a footnote) that commentators have suggested that the requirement of "durational significance" may not apply when evaluating whether a MAC occurred in the context of a buyer who is "a financial investor with an eye to a short-term gain." The court cited a Tennessee Chancery Court decision finding that "two quarters of bad performance would be material to a buyer in a highly leveraged transaction." Accordingly, a financial buyer, in evaluating whether a MAC has occurred, should consider whether (and if appropriate should make the case that) the relevant time period for "durational significance" should be shorter than in the case of a strategic buyer.

Drafting Ordinary Course of Business Covenants

The court's discussion in Akorn highlights that parties may wish to consider to what extent the ordinary course covenant in the merger agreement requires operation of the business in the ordinary course consistent with the target's own past practices and to what extent it requires operation of the business in the ordinary course that would be expected of a hypothetical similarly situated company. Akorn also underscores that parties should consider whether there are any particular actions that should be specified in the agreement as actions that the target must (or need not) take to comply with the ordinary course covenant. A target should consider whether there are events that would arise as to which it would not be readily apparent what the "ordinary course of business" would be — for example, in the case of natural disasters, whistleblower activity or other kinds of extraordinary events — and whether these should be excluded from the general "ordinary course" requirement.

Drafting an Access Right

Based on Akorn, a target may wish to seek to specify contractual limitations on the scope, timing and

use of an access right — for example, stating that the access right can be used only to verify the satisfaction of conditions to the agreement, can be invoked only within a specified short time frame prior to the closing date, and will be available only to specified persons. On the other hand, an acquirer may wish to seek to specifically confirm that the right is broad in scope — and, for example, includes a right to investigate any issues that arise between signing and closing and a right to use outside counsel and experts in any such investigations.

Drafting Efforts Obligations

The court suggests in Akorn that, without further definition, all efforts standards could, in practice, impose a similar obligation (i.e., to take all reasonable steps to solve problems and consummate the transaction). Parties should consider expressly setting forth (in a disclosure schedule or otherwise) any specific actions that must (or that need not) be taken to meet the efforts standard included in the agreement. Where parties agree on a "best efforts" standard or "hell or high water" commitment, they should consider whether they intend this standard to require even actions that are not "commercially reasonable" (or to reflect the highest possible level of efforts that is judicially sustainable) — and, if so, they should expressly so provide.

Drafting Materiality Standards

Parties should consider that the court may view a provision that a representation or covenant shall be true or complied with "in all material respects" as a lower standard for materiality than a provision that any inaccuracies or noncompliance have (or reasonably would be expected to have) an MAE. Parties should also take into account the fact that the court may view a materiality standard in a bring-down condition, together with a materiality standard in the underlying representation or covenant, as the equivalent of just a single level of materiality. If the parties intend otherwise, they should expressly state so. Parties should ensure that, where, as is usual, different materiality standards are utilized in different provisions, the provisions, when read together, accurately reflect the parties' intentions.

Applicability of Efforts to Close When Considering Whether There Is a Right to Terminate

An acquirer that is considering whether it has the right to terminate the merger agreement should consider to what extent it may or may not be required to continue with efforts to close the transaction. In Akorn, the court emphasized that, even after the acquirer began to evaluate its termination rights, it continued to communicate with the target, to problem-solve, to pursue regulatory approvals and to proceed with integration planning. The appropriate extent of efforts to close after the possibility of a right to terminate has been identified will depend on the agreement language and the specific facts and circumstances. If an acquirer decides to terminate, the record should reflect that the desire to terminate is not based on general "buyer's remorse" but on specific factors that, under the merger agreement, provide a right of termination.

Regulatory Commitment and Control of the Regulatory Strategy

Based on Akorn, merger agreement parties may wish to consider increased specificity in provisions granting control to one of the parties of the strategy to obtain regulatory approval. For example, the parties may wish to provide specifically the time frame for delay that would be impermissible in connection with adopting a new strategy for obtaining regulatory approval.

Drop-Dead Date and Opportunity to Cure

Akorn serves as a reminder that parties should consider the interrelationship between the drop-dead date and a right of the target to cure condition failures. It should be clearly specified whether the opportunity to cure applies only if the breach is curable by the drop-dead date (in which case a termination right could be exercised by the acquirer before the drop-dead date if the breach is not curable) or whether the opportunity to cure is in all cases available to the target until the drop-dead date (in which case a termination right could be exercised by the acquirer only at the drop-dead date).

Termination Right Subject to the Terminating Party Not Being in Breach

The right of a party to terminate a merger agreement typically is subject to the party itself not being in breach of the agreement. The standard for that breach should be carefully considered so that a termination right is not defeated unless the breach has a material impact. For example, in Akorn, the acquirer could not terminate if it was then in "material breach" of "any" of its covenants or representations in the agreement. This drafting arguably could be viewed as setting a low standard for defeating the acquirer's right to terminate — that is, even if a nonmaterial covenant were materially breached, the right to terminate would be lost. For a clearly higher standard, consideration should be given to referencing "material breach of a material covenant or representation."[1]

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[1] For an in-depth summary of the background of the case and the key points, holdings, and discussion and analysis in the opinion, please see Fried Frank M&A/PE Briefing, dated Oct. 23, 2018.