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Chancery Court—Reiterating High Bar for Proving "MAE"—Requires Buyer to Honor Its Obligations Under Acquisition Agreement

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Utilizes Akorn standard in rejecting buyer's claim that fraudulent scheme by target executive triggered MAE; criticizes buyer's failure to use "commercially reasonable efforts" to address concerns

INTRODUCTION

Material Adverse Effect ("*MAE*") clauses are one of the cornerstones of acquisition agreements subject to a *delayed closing* (i.e., when the parties—for regulatory, corporate approval, financing, or other reasons—cannot sign and close on the same day). While specifics are highly negotiated—and differ from transaction to transaction—the purpose underlying all MAE clauses is *risk allocation*: to define the circumstances under which a buyer may terminate a binding acquisition agreement, without penalty, due to events which have caused, or can reasonably be expected to cause, a deterioration of the target business post-signing. Notwithstanding the prevalence of MAE clauses in acquisition agreements, they are rarely invoked, and even more rarely successfully so.

Any discussion of MAE must begin with the well-known decision of the Delaware Court of Chancery ("*Chancery Court*") in *In re IBP, Inc. S'holders Litig. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001) ("*IBP*"). In *IBP*, then-Vice Chancellor Leo E. Strine Jr. ordered a reluctant buyer experiencing a severe case of "buyer's regret" to complete its acquisition of a target company, even though the target had experienced a seasonal shortfall in earnings. *IBP* set a very high bar for any buyer (at least a strategic buyer) who wishes to walk away from a signed acquisition transaction due to a post-signing MAE. In fact, until 2018, the Chancery Court had not permitted any buyer to successfully invoke an MAE for the purpose of terminating an acquisition agreement.

Then in 2018, in *Akorn, Inc. v. Fresenius Kabi AG*, No. 2018-0300-JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018) ("*Akorn*"), Vice Chancellor J. Travis Laster allowed a buyer to utilize an MAE clause to terminate a merger agreement in the wake of post-signing developments which "substantially threaten[ed] the overall earnings potential of the target in a durationally-significant manner." Some interpreted *Akorn* as a sign, perhaps, of the Chancery Court lowering the *IBP* bar. However, the rationale and extremity of the decline in the target's business in *Akorn* belied that concern. In fact, Vice Chancellor Laster, channeling *IBP*, explained that "[a] buyer faces a heavy burden when it attempts to invoke a material adverse effect

clause." Further, "[a] short-term hiccup in earnings should not suffice; rather the [MAE] should be material when viewed from the longer-term perspective of a reasonable acquiror." Finally, this "longer-term perspective" is "measured in years rather than months." For a discussion of *Akorn*, see Robert S. Reder & Katie Clemmons, *Chancery Court—for the First Time—Releases Buyer from Obligation to Close due to Target MAE*, 73 VAND. L. REV. EN BANC 227 (2020).

The next important MAE-related decision, *Channel Medsystems, Inc. v. Boston Sci. Corp.*, No. 2018-0673-AGB, 2019 WL 6896462 (Del. Ch. Dec. 18, 2019) ("*Channel Medsystems*"), confirmed that *IBP* is alive and well and that the MAE bar remains high. In *Channel Medsystems*, the Chancery Court once again confronted a buyer's attempt to terminate a signed acquisition agreement on the basis of an MAE purportedly caused by a target company executive's fraud. Chancellor Andre G. Bouchard, quoting extensively from *Akorn*, determined that the buyer failed to establish an MAE and granted specific performance of the acquisition agreement to the target company.

I. FACTUAL BACKGROUND

A. Channel and BSC Sign a Merger Agreement

On November 1, 2017 ("*Agreement Date*"), Boston Scientific Corporation ("*Boston Scientific*" or "*BSC*") and Channel Medsystems, Inc. ("*Channel*"), "an early stage medical device company," entered into a merger agreement ("*Agreement*") calling for BSC "(i) to purchase immediately . . . preferred stock in Channel for approximately $5.6 million . . . ; and (ii) to acquire Channel's remaining equity for up to $275 million pursuant to a put-call structure." At the time, Channel had only one product, a medical device called Cerene ("*Product*"), which remained subject to Federal Drug Administration ("*FDA*") approval. That approval process continued over the course of the negotiation of the Agreement and thereafter following signing. BSC was not required to consummate the acquisition or honor the put-call until the FDA approved the Product, subject to an outside deadline of September 30, 2019.

BSC was well acquainted with Channel before it signed the Agreement, having previously invested $8 million in Channel in return for "approximately 15% of Channel's equity." At the time of this earlier investment, BSC was granted the right to an observer on Channel's board of directors with "access to anything that was presented to the board."

B. Channel Discovers an Executive's Fraud

On December 29, Channel discovered that its Vice President of Quality ("*VP*") had falsified expense reports and other documents—some related to FDA approval—as part of a scheme to steal approximately $2.6 million from Channel. Channel immediately began an investigation and, on January 2, placed the VP "on leave and terminated his employment shortly thereafter." Ultimately, Channel referred the VP's "fraud to the Department of Justice for potential prosecution." The VP eventually went to prison and reimbursed Channel for his ill-gotten gains.

On January 11, 2018, Channel retained a healthcare and regulatory consulting firm ("*Consultant*") to "conduct an independent assessment of (i) Channel's investigation of [the VP]'s fraud, and (ii) 'Channel's quality system related to . . . operations.' " The Consultant presented a report of its findings to Channel ("*Investigative Report*"), which "concluded that (i) Channel officials were 'thorough' and 'earnest[ ]' in their investigation, 'open and forthcoming with information[,] and placed no restrictions' on [Consultant]'s access to information; (ii) [the VP] 'act[ed] in isolation'; and (iii) [the VP] 'was not directly involved in the collecting and reporting of clinical data.' " Perhaps most important, the Consultant found no evidence that the VP's "conduct 'affected the outcome of the clinical study [of the Product] or impacted safety and efficacy data from the study.' "

The Consultant was hired also "to advise [Channel] on its communications with the FDA, and in particular how best to provide the FDA with all relevant information about [the VP]'s misconduct." Channel, with the Consultant's guidance, contacted the FDA in late January and, during February, complied with the FDA's requests for document resubmission. Representatives of Channel and the Consultant then met with the FDA on March 16. At the end of this meeting, the FDA praised Channel's representatives, thanking them for their transparency and timeliness. In a follow-up call on April 18, the FDA informed Channel "that it 'ha[d] addressed all of FDA's concerns and that the agency appreciate[d] the company's transparency and timeliness.' "

Consistent with its approach with the FDA, Channel notified BSC of the fraud in early January. Both Channel and the Consultant spoke with BSC representatives "regularly . . . to update them on Channel's investigation." BSC expressed its appreciation for Channel's "continued transparency," and apparently "remained 'very supportive and reiterated Boston's interest in Channel.' " On March 6,

> the same day Channel received the [Investigative] Report, [Channel's CEO] provided a copy of the report to Boston Scientific and "suggest[ed] we schedule a call with the appropriate [subject matter experts] the week of the 19th to discuss the meeting with the FDA and to share updates as may be appropriate." No one from Boston Scientific responded . . . .

Thereafter, BSC continued to be nonresponsive. Channel, at a meeting on January 25, offered for BSC to contact it with any further questions, but "[d]uring the next three months, Boston Scientific never asked for any additional information relating to [the VP]'s conduct, Channel's remediation, or its communications with the FDA. Instead, teams of Boston Scientific personnel pressed forward with their work on the integration of Channel without apparent regard for [the VP]'s fraud."

After the March 16 meeting, the FDA advised Channel that the remainder of its investigation would consist of a routine inspection and evaluation process. Then, on April 18, the FDA "accepted Channel's remediation plan, which strongly signaled that [the VP]'s fraud would not be the cause of any failure of the FDA to approve the [Product] and which made the FDA's approval a distinct possibility."

C. BSC Terminates; Litigation Ensues

Only after the worst of the tumult had passed did BSC begin to show concern. On April 22, BSC advised Channel that it found the Investigative Report "extremely troubling" and "requested Channel's communications with the FDA." Although Channel reached out to BSC five times to arrange an in-person meeting or call, BSC did not respond.

After dodging any further communications with Channel, on May 11 ("*Termination Date*"), BSC suddenly terminated the Agreement, claiming that Channel had suffered an MAE as a result of "multiple" breaches of representations and warranties. Pointing to the Investigative Report to support its assertions, BSC claimed that none of the breaches were curable. In response, Channel filed a complaint with the Chancery Court on September 12 in which it asserted that BSC had improperly terminated the Agreement "without a valid basis" and demanded specific performance of the Agreement as the remedy.

Consistent with the timeframe "Boston Scientific originally contemplated before signing the Agreement," on March 28, 2019, the FDA approved the Product. Ironically, this was "six months ahead of" the deadline fixed by the Agreement.

D. Key Agreement Provisions

Chancellor Bouchard's analysis (discussed below) centered on (i) how to analyze BSC's MAE-related allegations under the Agreement and (ii) the proper time frame for that analysis. This analysis focused principally on the following key, interrelated provisions of the Agreement:

1. Representations Condition
    - BSC's obligation to close was "subject to satisfaction of the condition that each of Channel's representations and warranties in the Agreement 'shall have been true and correct at the time originally made . . . except to the extent that the failure of any such representations and warranties to be true and correct does not have and would not reasonably be expected to have a Material Adverse Effect' on Channel" among other conditions ("*Representations Condition*").
2. Termination Provision
    - BSC had a right to terminate if the Representations Condition was not satisfied ("*Termination Provision*"), but only if the failure of any representations and warranties to be true and correct "'has or reasonably would be expected to have a Material Adverse Effect' on Channel."
3. Covenant to Use "[C]ommercially [R]easonable [E]fforts"
    - The Agreement required that "from the 'Agreement Date until the Effective Time,' Boston Scientific 'will take all further action that is necessary or desirable to carry out the purposes of this Agreement' and 'shall use its commercially reasonable efforts to take all such action and refrain from taking any actions which would be reasonably expected to frustrate the essential purposes of the transactions contemplated by the Agreement.' "
    - Further, to the extent that circumstances constituting an MAE existed prior to the Termination Date, the Agreement prohibited termination under the Termination Provision "for so long as the party that has experienced a Material Adverse Event continues to exercise commercially reasonable efforts to ameliorate or cure the circumstances giving rise to such Material Adverse Event."

4. "Material Adverse Effect"
    - Finally, the term "Material Adverse Effect," as used in the Representations Condition, the Termination Provision, and the "commercially reasonable efforts" covenant, was defined as "any change or effect occurring after the Agreement Date that, when taken individually or together with all other adverse changes or effects occurring after the Agreement Date, is materially adverse to the business, results of operations, assets or financial condition of" Channel. As is customary, the Agreement did not define "material" or "materially."

II. CHANCELLOR BOUCHARD'S ANALYSIS

According to Chancellor Bouchard, BSC's "lead argument is that it properly terminated the Agreement . . . based on certain representations in the Agreement that were inaccurate as of the date of the Agreement." To prevail on this argument, the Chancellor required BSC to "prove that: (i) one or more of the representations in the Agreement was inaccurate as of the Agreement Date and (ii) the failure of such representation(s) to be true and correct 'has or reasonably would be expected to have a Material Adverse Effect' on Channel." Based on his conclusions that BSC (i) did not validly terminate the Agreement and (ii) had not used "commercially reasonable efforts" in dealing with its concerns over the VP's fraud, the Chancellor awarded Channel specific performance.

A. Were Any of Channel's Representations and Warranties "Materially" Inaccurate?

Chancellor Bouchard pointed out that each of the Channel representations and warranties that BSC claimed was inaccurate "contains a materiality qualifier." As noted above, the Agreement did not define "the term 'material' or its variations (*e.g.*, 'in all material respects') for purposes of assessing the accuracy of the representations in the Agreement in their own right."

Conveniently for Chancellor Bouchard, when deciding *Akorn* the year prior, "Vice Chancellor Laster carefully studied the meaning of the term 'in all material respects' in a covenant in a merger agreement." In *Akorn*, the Vice Chancellor determined that "'in all material respects' requires only a 'substantial likelihood that the . . . fact [of breach] would have been viewed by the reasonable investor as having significantly altered the ["]total mix["] of information.' "

After reviewing a series of representations and warranties challenged by BSC, the Chancellor concluded that "Boston Scientific has proven by a preponderance of the evidence that [several of the] representations . . . were inaccurate at signing." However, this was the only issue on which BSC would prevail.

B. Did the Inaccuracies Cause an "MAE"?

1. "MAE" vs. "Material"

Because, as is customary, the Agreement defined "MAE" in terms of a "material adverse effect" but did not define "material," BSC urged the Chancellor to apply again the construct of "materiality" that he employed to determine whether Channel's representations and warranties were inaccurate to his determination of whether those inaccuracies caused an MAE. The Chancellor dismissed this argument as "devoid of merit." Rather, "the concept of 'Material Adverse Effect' and 'material' are analytically distinct, even though their application may be influenced by the same factors." Again falling back on *Akorn*, the Chancellor explained that "[i]n the absence of such a definition, Delaware courts applying MAE clauses . . . have held that the 'effect should "substantially threaten the overall earnings potential of the target in a durationally-significant manner." ' "

2. "Reasonably Be Expected"

Significantly, both the Representations Condition and the Termination Provision were triggered not only by an event which already had caused an MAE, but also by one which would "reasonably be expected to have" an MAE. According to Chancellor Bouchard, the "'reasonably be expected to' standard"—like the entire MAE analysis—"is an objective one." While "future occurrences" can be taken into account, "a mere risk of an MAE cannot be enough." "There must be some showing that there is a basis in law and in fact for the serious adverse consequences prophesied by the party claiming the MAE."

While the phrase "reasonably be expected" is an "inherently forward-looking concept," the Chancellor noted that the Agreement was "silent on what time frame the court should consider" in assessing whether an MAE had occurred. This raised "two temporal issues" requiring the Chancellor to choose time frames appropriate under the Agreement:

- ***Temporal Issue #1***: Determining "what date the court should look to in assessing whether there was a reasonable expectation

that an MAE would occur at some point in the future." Chancellor Bouchard explained that "the logical time to test whether a party had an objective right to terminate under [the Termination Provision] is to examine the facts and circumstances *when the party actually took action to terminate*" (emphasis added). Thus, "the most sensible way to read the Agreement is to consider, as of the [T]ermination [D]ate, whether there was a reasonable expectation of an MAE."

- ***Temporal Issue #2***: Determining "at what point in time, as of that date, an MAE 'would reasonably be expected' to occur." The Chancellor adopted Channel's position that the Termination Provision "requires Boston Scientific to prove, as of termination, that any inaccuracies in Channel's representations were such that an MAE would reasonably be expected as of the time of the anticipated closing." Because the parties expected FDA approval of the Product "in the first quarter of 2019," the anticipated closing was "in April or May of 2019."

In sum, Chancellor Bouchard concluded, "Boston Scientific has the burden to prove that, as of the [T]ermination [D]ate, the inaccurate representations in the Agreement would reasonably be expected to have a Material Adverse Effect on Channel around the time the parties[ ] expected the merger to close."

3. Did BSC Prove an MAE?

Having established the legal and temporal framework for his analysis, Chancellor Bouchard turned to the linchpin issue: did BSC offer evidence sufficient to prove that the inaccuracies in Channel's representations and warranties "'reasonably would be expected to have a Material Adverse Effect' on Channel," thereby justifying BSC's purported termination of the Agreement? At the outset, the Chancellor found that BSC's termination notice assertions "flew in the face of many facts known to Boston Scientific when it terminated the Agreement[,] . . . most significantly, the FDA's acceptance of Channel's remediation plan for premarket approval" of the Product.

To support his ultimate conclusion "that Boston Scientific has not proven that, as of the termination date, the inaccurate representations would reasonably be expected to have a Material Adverse Effect *at any future point in time*" (emphasis added), the Chancellor examined both "the qualitative and quantitative aspects of the evidence of an MAE that Boston Scientific offered at trial":

- ***Qualitative Aspects***: Because BSC could no longer argue that the VP's fraud jeopardized FDA approval of the Product, it

"shifted its strategy" to claim that, notwithstanding FDA approval, BSC would (i) have to go "all the way back to the beginning" of the design and approval process before it could market the Product in "good faith," and (ii) be faced with "products liability litigation, competitive harm, and future regulatory action" once it did go to market. The Chancellor rejected all of these claims, generally viewing them as "highly speculative," inconsistent with BSC's conduct in the past, and tainted by BSC's decision "to terminate the Agreement without taking any number of actions one reasonably would have expected [BSC] to take before making such a consequential decision," such as conferring with Channel and the Consultant, retaining outside consultants of its own, quantifying costs, and compiling a written record. As noted below, the Chancellor was quite suspicious of BSC's motivations.

- ***Quantitative Aspects***: While recognizing that "[t]here is no bright-line test for determining an MAE based on quantitative considerations," the Chancellor seemingly had little trouble concluding that BSC "failed to demonstrate any material decline in Channel's value" relating to the inaccurate representations and warranties or otherwise. In this connection, the Chancellor fully discounted the testimony of an expert retained by BSC, criticizing him for (i) relying on BSC's unsubstantiated assumption that it could not begin to market the Product for "two to four years," (ii) incorporating "merger synergies" into his analysis, which "flies in the face of this court's uniform approach to valuing a target on a standalone basis in determining whether an MAE has occurred," and (iii) "uncritically accept[ing] an assumption for remediation costs that Boston Scientific provided to him." Accordingly, "Boston Scientific failed to provide any quantitative evidence of a reasonably expected MAE."

C. Did BSC Use "[C]ommercially [R]easonable [E]fforts"?

In challenging BSC's purported termination of the Agreement, Channel also claimed that BSC "breached its obligation to use 'commercially reasonable efforts' [ ] to consummate the merger." Consistent with *Akorn* and other Delaware precedent, Chancellor Bouchard discerned the meaning of "commercially reasonable efforts" under the Agreement with reference to concepts of "reasonable best efforts" and "good faith." Thus, he concluded that "Boston Scientific's 'utter failure to make any [meaningful] attempt to confer with [Channel] when [Boston Scientific] first became concerned with [the

Investigative Report], both constitutes a failure to use reasonable best efforts to consummate the merger and shows a lack of good faith.' "

In this connection, Chancellor Bouchard showed considerable skepticism of BSC's motives for terminating the Agreement, citing "contemporaneous evidence that Boston Scientific was looking for a way out of its deal with Channel due to growing concerns that [the Product] would be difficult to market and that the proposed transaction was complicating a potential divestment of part of Boston Scientific's business." While this seeming case of buyer's remorse was not sufficient in and of itself to justify Channel's claim that BSC failed to use "commercially reasonable efforts," it did lend

> credence to and corroborates other robust facts demonstrating that Boston Scientific did not fulfill its obligations to engage with Channel in a commercially reasonable manner to vet any concerns it may have had about the findings in the [Investigative] Report and to keep the transaction on track thereafter. To the contrary, Boston Scientific simply pulled the ripcord.

D. Channel Granted Specific Performance

Lastly, Chancellor Bouchard turned to the ultimate relief sought by Channel: requiring that BSC specifically perform its obligations to complete the transaction. Due to (i) the "irreparable harm" Channel would suffer if BSC were allowed to walk away from the transaction, (ii) the "clear and convincing evidence demonstrat[ing] that the equities weigh in Channel's favor" ("Channel itself was a victim of [the VP]'s fraud . . . [and] acted in good faith" while BSC "will obtain the essence of what it bargained for . . . an FDA-approved" Product), and (iii) BSC's failure to use "commercially reasonable efforts" after being apprised of the VP's fraud, the Chancellor granted Channel the typically extraordinary remedy "of specific performance requiring Boston Scientific to close" the transaction.

CONCLUSION

The Chancery Court historically has deferred to deals struck by sophisticated parties in their agreements and consistently refused to grant relief to parties complaining of changed circumstances or unforeseen risks. Invocation of an MAE requires a strategic buyer to establish an actual, durationally significant, adverse effect on the target. Otherwise, the Chancery Court will not look favorably on a buyer's attempt to evade its contractual obligations. This is particularly the case where a buyer—like BSC—stonewalls the target rather than engaging to mitigate unfortunate circumstances when it was reasonably practicable to do so.

Akorn, rather than straying from Chancery Court precedent, reiterated that the occurrence of a circumstance worthy of an MAE is rare. In *Channel Medsystems*, Channel's ability ultimately to win FDA approval of the Product, coupled with BSC's suspect motivations and lack of good faith cooperation, rendered Boston Scientific's MAE claim even weaker than it otherwise might have been.

In any event, invoking an MAE-based termination usually should not be a reluctant buyer's first line of attack. Instead, the Chancery Court will require some degree of effort on the part of the buyer to cooperate with the target in order to dispel suspicion that buyer's remorse was the actual motivating factor.