DELAWARE CORPORATE LAW BULLETIN

Chancery Court Takes a Deep Dive into Imprecise Asset Purchase Agreement Language

*Robert S. Reder**

*Gabrielle M. Haddad***

**Professor of the Practice of Law at Vanderbilt University Law School. Professor Reder has been serving as a consulting attorney at Milbank LLP in New York City since his retirement as a partner in April 2011.*

***Vanderbilt University Law School, J.D. Candidate, May 2022.*

Vice Chancellor interprets imprecise, and somewhat unusual, contract language to permit buyer to terminate transaction

INTRODUCTION

Precise language and adherence to market conventions are crucial elements when negotiating and drafting commercial agreements. In *Dermatology Assocs. of San Antonio v. Oliver St. Dermatology Mgmt. LLC*, No. 2017-0665-KSJM, 2020 WL 4581674 (Del. Ch. Aug. 10, 2020), the Delaware Court of Chancery ("*Chancery Court*") was called upon to resolve a dispute between two sophisticated parties over imprecise language in their asset purchase agreement. Due to this imprecision, Vice Chancellor Kathaleen S. McCormick analyzed each and every word of the agreement, together with the circumstances underlying the negotiation process and various contract drafting conventions, to decipher the parties' intent. The Vice Chancellor's analysis reveals several instances in which the parties and, more likely, their legal counsel failed to follow drafting conventions that typically promote clarity in commercial agreements.

I. FACTUAL BACKGROUND

In 2016, Dermatology Associates of San Antonio and DermSA Management, Inc. (together, "*DermSA*" or "*Target*") entered into an asset purchase agreement with Oliver Street Dermatology Management LLC ("*Oliver Street*" or "*Buyer*") providing for the purchase by Buyer of Target's business (as subsequently amended, "*APA*"). Buyer, "a dermatology practice management organization . . . built through the acquisition of businesses that perform similar services," sought to expand its footprint in Texas by acquiring Target's successful "dermatology and cosmetic medicine practice" carried out at "three locations in the San Antonio area." In short, DermSA "presented a unique acquisition opportunity for Oliver Street."

A. Buyer Confronts Risk of Physician Departures

Throughout the APA negotiation process, which occupied most of 2016, Buyer sought to mitigate the risk that Target's physicians would resign upon completion of the acquisition. Target "employed sixteen physicians, . . . fourteen [of whom] were the company's primary revenue drivers." Each physician's employment agreement required physician consent to a sale of Target. As discussions over employment agreement amendments with Buyer proceeded, the physicians became concerned that noncompete covenants required by Buyer would limit their ability to pursue their practices not only in the vicinity of Target's

three San Antonio locations, but also "within eight miles of any Oliver Street practice."

Meanwhile, when one physician, a "key revenue producer," resigned from Target in September, Buyer pressed Target for a reduction in the negotiated purchase price and for other protections should the full complement of physicians not be available at the time of closing. Finally, in December, Buyer and Target agreed on a $16 million purchase price (consisting of $13 million in cash and $3 million in Buyer equity), reduced from the $23 million payment contemplated by a letter of intent signed by the parties in late January.

B. Key APA Provisions

Overall, while the APA was structured consistent with the M&A market's approach to acquisition agreements, certain provisions departed from what might be considered the norm.

First, Article 3 of the APA contained representations and warranties of Target concerning various aspects of its business. The preamble to Article 3 ("*Preamble*") stated, somewhat atypically, that the representations and warranties that followed were "true and correct *as of the date of this Agreement*." (Typically, such preambles do not contain the italicized language.) With respect to its physicians, Target represented and warranted to Buyer that, to Target's knowledge, none of the physicians intended to terminate employment with Target ("*Physicians Representation*").

Second, Section 7.1(c) of the APA gave Buyer the right to terminate " '[b]y notice given prior to or at the Closing,' for two disjunctive reasons: [1] if any condition in Section 1.6 . . . has not been satisfied as of the Closing Date *or* [2] if satisfaction of such a condition by the Closing Date is or becomes impossible." Contrary to common practice, the APA did not fix an outside date after which either party could terminate if the acquisition was not completed by that date (so long as the terminating party's breach did not trigger such failure).

Third, rather than specifying a date for consummating the transaction, the APA provided "that performance 'shall take place at a closing [("*Closing*")], effective as of 12:01 a.m. EST . . . on a date to be *mutually agreed* by the parties [("*Closing Date*")].' " Further, the APA "obligated the parties to 'use commercially reasonable efforts to cause the Closing Date to be not earlier than January 10, 2017 and not later than January 31, 2017.' "

Fourth, Section 1.6 of the APA set forth the conditions to the parties' obligations to close, two of which became the focus of the parties' eventual dispute. The *first*, Section 1.6(b)(1), required that Target

secure consents from several landlords ("*Landlord Consents*"). The *second*, Section 1.6(i), commonly known as a "Bring-down Provision," required that Target's "representations and warranties . . . shall be true and correct in all material respects as of the Closing Date with the same effect as though made at and as of such date" ("*Bring-Down Condition*").

C. Oliver Street Gets "[C]old [F]eet"

By late January 2017, two additional physicians indicated they would resign. This "gave Oliver Street cold feet about the deal." In fact, once Oliver Street assessed "the financial impact of the physicians' resignations," it "determined that it needed a 'path out.' " That path focused on Buyer's belief that Target would be unable to secure the Landlord Consents. And to add to Target's burden, Buyer sought to fix Closing for the earliest possible date.

To that end, on January 23, Buyer requested that the Closing Date be set for February 1. Although the APA called upon the parties to use "commercially reasonable efforts" to close between January 10 and January 31, the parties had not yet set a date. For its part, Target "was resistant to further delay" and, after initially emailing its assent, almost immediately withdrew that acceptance, claiming its email was sent accidentally. Consequently, the parties never "mutually agreed" on a particular Closing Date as contemplated by the APA.

D. Buyer Terminates; Litigation Ensues

Buyer continued to press for a renegotiation of the APA to account for the physicians' departures, but Target rejected any further changes. As a result, Buyer decided to treat January 31—the last day referenced in the APA's definition of Closing Date—as the Closing Date and, at 5 a.m. on February 1, delivered a notice of termination to Target. When Target's counsel replied the next day "that termination was wrongful," Buyer countered that Target had failed to "satisfy contractually-required conditions," including obtaining the Landlord Consents. After further negotiations "for a transaction and amicable resolution" failed, on September 15 Target brought suit in Chancery Court claiming Buyer had breached the APA by "failing to close the sale on January 31, 2017, and by delivering an ineffective Notice of Termination on February 1, 2017."

II. VICE CHANCELLOR MCCORMICK'S ANALYSIS

At the outset, Vice Chancellor McCormick observed that Target's claim centered on whether, *first*, Buyer gave timely notice of termination and, *second*, whether Buyer had adequate grounds for termination. The *first* question focused on the relevant deadlines both for closing and for giving notice of termination, while the *second* addressed whether failure of the closing conditions provided a basis for termination.

A. The Deadlines

Target argued that Buyer's termination notice was not timely because it was not given "prior to the relevant deadline," which Target argued was January 31. Buyer countered that the deadline under the APA literally was "the 'Closing,' which never occurred." Thus, the deadline had not passed. Further, Buyer argued that Target's failure to satisfy either the Landlord Consents condition or the Bring-Down Condition by the deadline justified Buyer's giving notice of termination.

The Vice Chancellor acknowledged the "irony of the parties' positions . . . that the two deadlines at issue"—the deadline for giving notice of termination and the deadline for satisfying closing conditions—"are one in the same [deadline] under the plain language of the . . . APA." In short, because the APA required Buyer "to deliver notice of termination 'prior to or at the Closing,' . . . the 'Closing' is the latest [possible] date for both providing notice of termination and satisfying the closing conditions."

Crucially, however, the APA "does not set a firm date for the Closing." Rather, as the Vice Chancellor explained, "the parties were required to 'mutually agree[ ]' " on the Closing Date and to use "commercially reasonable efforts" to close by January 31, 2017. Because the parties never achieved a "meeting of the minds," the Closing Date neither was agreed upon nor occurred. In response to Target's argument that the APA's plain language nevertheless implied a January 31 Closing Date, the Vice Chancellor explained that the parties' use of the phrase "commercially reasonable efforts" established a "soft" obligation that the parties "try" to close by that date, as opposed to a "firm obligation" to do so.

Further, Vice Chancellor McCormick noted that the overall "contractual scheme" adopted by the parties did not support imposition of a strict Closing deadline. Normally, "parties to a transaction agreement identify a 'drop-dead' or 'outside' date, after which the agreement either automatically terminates or either party can freely

terminate if certain conditions are not met." The APA, however, contained no such " 'drop-dead' or 'outside' date." When parties to an agreement fail to specify an outside date, "Delaware courts will keep the contract open for a 'reasonable period of time' to allow for performance." By arguing that Buyer was foreclosed from terminating after January 31, "regardless of when Closing was to occur," Target in effect was requiring Buyer to continue to perform, at least for a "reasonable period of time," with no ability to terminate. From the Vice Chancellor's point of view, this "makes no sense and is not a result for which a buyer would bargain."

Because the parties failed to establish a Closing Date, Buyer's notice of termination was timely. However, the Vice Chancellor recognized that Buyer's success on this aspect of its argument had a "self-defeating aspect to it." Specifically, because the relevant deadline for giving notice of termination did not pass, neither did the deadline for satisfying closing conditions. Accordingly, Buyer was not entitled to terminate the APA due to the nonoccurrence of any condition as of January 31.

B. An Impossible Closing Condition

Even though Buyer was not entitled to premise its termination notice on the failure of any condition to be satisfied "as of the Closing Date," as noted above, Section 7.1 also permitted termination "if satisfaction of such a condition by the Closing Date is or becomes impossible." For this purpose, Buyer focused on both the condition relating to the Landlord Consents and the Bring-Down Condition.

Vice Chancellor McCormick quickly dismissed Buyer's argument relating to the Landlord Consents. Based on the record before her, the Vice Chancellor concluded that "the landlords were ready, willing, and able to consent" and, therefore, it was "possible (indeed . . . likely) that the consents would have been executed had the parties moved to Closing" by January 31. In effect, Buyer's reliance on Target's failure to obtain the Landlord Consents was merely a "pretext" for seeking a further renegotiation of the terms of the APA.

By contrast, the record also demonstrated to the Vice Chancellor that it had become "impossible" for Target to satisfy the Bring-Down Condition. While conceding that the two post-signing physician resignations meant that the Physicians Representation would be inaccurate if brought down to the Closing Date, Target argued, *first*, that the Physicians Representation remained true "in all material respects" and, *second*, that the Physicians Representation was not

required to be brought down to the Closing Date for purposes of the Bring-Down Condition.

1. Physician Resignations Were Material

The Bring-Down Condition required that Target's "representations and warranties . . . shall be true and correct *in all material respects* as of the Closing Date" (emphasis added). 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), Vice Chancellor J. Travis Laster articulated that the "in all material respects" standard "strives to limit the operation of the [closing condition] to issues that are significant in the context of the parties' contract." For a discussion of Vice Chancellor Laster's opinion, 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).

Applying Vice Chancellor Laster's standard, Vice Chancellor McCormick found that the physician resignations were material given the context of the transaction: *first*, the physicians accounted for 11% of Target's total revenue for the year preceding the transaction; *second*, the resignations "materially affected [Target's] projected revenue as well"; and *third*, the negotiation history demonstrated that Buyer was "primarily concerned with attracting the physicians and keeping them on board with the transaction."

2. Physicians Representation Subject to "Bring-[D]own"

Excepted from the Bring-Down Condition's requirement that Target's representations and warranties be true "as of the Closing Date . . . as though made at and as of such date" were "those representations and warranties that address matters only as of a specified date, which shall be true and correct in all material respects as of that specified date." Target sought to take advantage of this typical exception by pointing out that the Preamble states that all of Target's representations and warranties—including the Physicians Representation—were "true and correct *as of the date of this Agreement*." In effect, Target argued that the exception to the Bring-Down Condition ate the rule and, therefore, none of Target's representations and warranties were required to be brought down.

Vice Chancellor McCormick rejected Target's approach, citing two grounds. *First*, Target's interpretation would render the Bring-Down Condition a "nullity" by making all Target representations and

warranties subject to the exception; that is, no representation and warranty would be required to be brought down. Simply stated, "Delaware law rejects interpretations of contracts that render provisions null and void." *Second*, the Vice Chancellor found that Target's reading "undermines the well-understood function" of the Bring-Down Condition "to 'protect[ ] each party from the other's business changing or additional, unforeseen risks arising prior to closing.' " If all Target representations and warranties needed to be true only as of the APA signing date, the Bring-Down Condition would fail to achieve that important function.

Thus, had the parties fixed a Closing Date and proceeded to closing, the Bring-Down Condition could not have been satisfied due to the physicians' departure. Accordingly, Buyer was within its rights to terminate the APA.

CONCLUSION

Vice Chancellor McCormick's opinion reaffirmed that Delaware courts give effect to every word of disputed contracts and, in the face of ambiguity, will often adopt an interpretation that might seem contrary to a phrase's literal meaning. For instance, although the APA's Closing Date definition seemed to indicate an outside date of January 31, 2017, the Vice Chancellor looked at the overall context in determining that the parties were required by the provision to use commercially reasonable efforts to "mutually agree" to a Closing Date within a range ending on that date, but failed to do so. Notably, the APA lacked a customary "outside" or "drop-dead" date. Therefore, because the Closing Date had not occurred, Buyer timely delivered its notice of termination.

Moreover, the Vice Chancellor effectively ignored the unusual language in the Preamble providing that Target's representations and warranties were all being made specifically as of the signing date. Rather than allow Target's position to render the Bring-Down Condition a "nullity," the Vice Chancellor required that the disputed Physicians Representation be subject to the Bring-Down Condition. Due to post-signing physician resignations, it was impossible for the Physicians Representation to be true "in all material respects" as of the Closing Date (that is, had there been one). Buyer, therefore, was entitled to terminate the APA, regardless of its underlying reasons for wanting to abort the transaction.