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# Just Because a Really Bad Thing Happens Does Not Mean a Material Adverse Effect has Occurred: Assessing the Latest Delaware MAE Decision

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Last year's blockbuster opinion in *Akorn, Inc. v. Fresenius Kabi AG*—the first Delaware case to find the existence of a Material Adverse Effect ("MAE")—provided corporate litigators a roadmap for establishing an MAE to avoid closing a merger transaction. In the first post-*Akorn* MAE opinion, *Channel Medsystems, Inc. v. Boston Scientific Corporation*, released on December 18, 2019, the Delaware Court of Chancery refused to allow Boston Scientific to terminate its merger with Channel based on its assertion of an MAE and required Boston Scientific to close—confirming after a full evidentiary trial that a buyer still has a "heavy burden" when attempting to invoke an MAE clause to avoid closing. Chancellor Andre G. Bouchard's opinion confirms that proving an MAE requires more than the existence of a "bad" event relating to the seller: there must be strong evidence that its *effects* on the seller will be significant and long-lasting. The *Channel* decision also confirms that, absent settlement, MAE cases are likely to require a full evidentiary hearing or trial, following extensive discovery. *Channel* also provides new insights for M&A practitioners.

## *Background*

When Boston Scientific and Channel announced their merger agreement (the "Agreement") on November 1, 2017, Channel was a privately held medical technology company with just one product, the "Cerene" device intended to treat heavy menstrual bleeding, which had not yet obtained FDA approval. The court found that executives at Boston Scientific were having second thoughts about the merger soon after signing.

In late December 2017, Channel's CEO and VP of Finance discovered that the company's VP of Quality, Dinesh Shankar, had stolen approximately $2.6 million from the company by falsifying expense reports and routing payments to shell companies he controlled. Though other Channel executives did not know it at the time, the company's FDA submissions for Cerene approval contained several documents that Shankar had falsified. The company terminated Shankar's employment and alerted Boston Scientific, the FDA, and the Justice Department "[p]romptly."

According to the court, Channel conducted a "thorough[] investigat[ion]" and undertook an effective remediation plan. All the while, it communicated with both Boston Scientific and the FDA "in a fully transparent manner." Its efforts paid off. On April 18, 2018, the FDA approved Channel's remediation plan—a "strong[] signal[]" that the "fraud would not be the cause of any failure of the FDA to approve the Cerene device and which made the FDA's approval a distinct possibility," according to the court. Nonetheless, Boston Scientific terminated the Agreement on May 11, 2018 on grounds that an MAE had occurred. (The FDA approved the Cerene device nearly a year later, which was "consistent with the timeframe for receiving FDA approval the parties expected when they entered into the Agreement.")

On September 12, 2018, Channel filed suit against Boston Scientific in the Delaware Court of Chancery. It asserted that Boston Scientific breached the Agreement by terminating it "without a valid basis," and sought specific performance.

Though the court found that certain of the representations in the Agreement were inaccurate as of the date of the Agreement due to the fraud, Chancellor Bouchard held that their inaccuracy did not create—nor would reasonably be expected to create—an MAE. "Boston Scientific was not entitled to terminate the Agreement," and Channel deserved "an order of specific performance requiring Boston Scientific to close the merger."

### *Key Takeaways*

*Channel* cautions that Delaware has not loosened the historical heavy burden for establishing an MAE. (Please see our previous alert on the *Akorn* decision for more information.) Both the *Akorn* and *Channel* courts used the same general test to establish an MAE—that an adverse effect must be "material when viewed from the longer-term perspective of a reasonable acquirer," because it is "consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months"—which is flexible enough to produce different results depending on the facts. It remains clear that a buyer needs to demonstrate that the *effects* in question will have a long-term, substantial impact on the business being acquired based on contemporaneous evidence, not "after-the-fact rationalizations."

In *Akorn*, the court found "overwhelming evidence of widespread regulatory violations and pervasive compliance problems." It determined that remediating the data integrity problems would strip $900 million from the company's valuation—21% of the standalone equity value implied by the deal price. In contrast, the *Channel* court found the problems limited to a rogue employee and considered the fallout relatively circumscribed given that the FDA had already approved Channel's remediation plan, and it seemed likely that its key product would obtain FDA approval on schedule. Thus, while both cases addressed the submission of false information to the FDA, the specific facts necessitated different MAE conclusions.

Of particular interest, based on its reading of the contract, the *Channel* court held that a buyer could only terminate if it expected an MAE to occur by the closing date and not if it expected an MAE *after closing*. The court's analysis on this question is arguably dicta because the court observed its conclusion was "of little consequence in this case" given Boston Scientific's failure to prove that an MAE would reasonably be expected "at any future point in time." Nonetheless, practitioners should now consider drafting MAE provisions clarifying the date by when an MAE needs to be expected to occur to trigger an MAE.

The *Channel* court also explained that "[t]here is no bright-line test for determining an MAE based on quantitative considerations." Nonetheless, it referred to the 40% benchmark (as cited in *Akorn*) and *Akorn*'s determination that a 21% decline in standalone valuation was sufficient to establish an MAE. The Chancellor's highlighting of these benchmarks suggests that parties attempting to assert an MAE consider whether they can demonstrate a decline of *at least* 20% before asserting an MAE. Practitioners seeking a different level of long-term value destruction will now have to consider whether to negotiate different express materiality levels.

In sum, *Channel* confirms that MAE cases will almost always need to be decided based on their specific facts after a full trial on the merits and that buyers wishing to terminate based on an MAE will need to meet a "heavy burden" imposed by a long line of Delaware cases. *Channel* suggests that *Akorn*'s MAE finding is the exception rather than the start of a more lenient rule.

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