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Material Adverse Effects and Damages in Failed Merger Disputes

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2:30pm to 3:30pm

About The Presenters

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Gesta Abols is the Co-Leader of the firm's Cross Border Practice and on the executive of the firm's Capital Markets and Mergers & Acquisitions Committee.

Gesta is consistently recognized as a leader in the areas of Mergers & Acquisitions and Private Equity by various third-party ranking organizations.

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Michael specializes in damage quantification and business valuation for commercial and investment disputes.

He has more than thirteen years of professional experience in audit and assurance, business valuation, damage quantification, and investment banking.

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Aayush specializes in quantification of economic damages and valuation of business interests and complex hybrid securities.

He has authored expert opinion reports on valuation and financial issues and has provided expert oral testimony in international arbitral matters under the ICC rules and SIAC rules.

What is an MAE?

- Provides buyers with a mechanism to avoid closing on a transaction if there is a significant enough change in the business of the target (or assets).
- It is a heavily negotiated definition in the agreement and part of the economic bargain of the parties.
- It is intended to allocate the risks of certain adverse events occurring between the buyer and seller, after the parties agree to the transaction.
- The buyer retains the risks of certain adverse changes or events through 'Exclusions' that will be specified in the MAE definition.

Sources: American Bar Association - What do Exceptions in MAE Definitions Except? (20 May 2021);

Components of an MAE Clause

Core Concept of an MAE	*"Any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a [material adverse effect] … on the condition (financial or otherwise), business assets, liabilities or results of operations of [the Target] and [its] Subsidiaries taken as a whole…"*

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Carve-Out Clauses	Sets forth certain events or developments that are *excluded* from contributing to an MAE

+

Carve-Back Subclause	This subclause is used to clarify that an event that was previously carved-out, would contribute to an MAE where the event has a *disproportionate adverse* impact on the target *as compared to its industry peers*.

Sources: Fasken Private M&A in Canada: Transactions and Litigation, and Guhan Subramanim & Caley Petrucci, "Deals in the Time of the Pandemic"

Excluded Effects or Carve-Outs

- The SPA established between the parties will identify certain exclusions, i.e., effects that can or cannot be used to claim an MAE.
- The implication is if there is a major decline in the business due from an effect that is specifically carved out of the definition, it is not an MAE.
- Exclusions are decided by the parties as part of their economic bargain and is memorialized in their agreement.
- It determines which risks each party is accepting between the time they execute the purchase and sale agreement, to the closing of the deal.
- Risks subject to Exclusions, i.e., risks borne by the acquiror:
    1. **Systematic Risk** – events that affect the broader economy or industry at large
    2. **Indicator Risk** – risk of variability in certain measures or indicators of value or performance
    3. **Agreement Risk** – risk from effects relating to the execution of or compliance with the purchase and sale agreement.
- Typically, broader economic and industry risk is retained by the acquiror, whereas company-specific risks are retained by the seller, but the terminology varies and is the result of an economic bargain by the parties.

Source: Robert T. Miller - Pandemic Risk and the Interpretation of Exceptions in MAE Clauses.

Excluded Effects or Carve-Outs: Examples

EXAMPLES OF EXCLUDED EFFECTS

SYSTEMATIC RISK

1. Changes in:
   a) the economy or economic or business conditions,
   b) conditions in financial, credit, debt, capital, or securities markets,
   c) in the industries or lines of business in which the company operates,
   d) in law or legal or regulatory conditions,
   e) in political or social conditions.
   f) in weather or climatic conditions,
2. Acts of war, terrorism, or sabotage,
3. Hurricanes, tornadoes, earthquakes, tsunamis, floods, or **pandemics,**
4. Calamities or natural disasters,
5. Changes in GAAP policies.

INDICATOR RISK

1. Failures to meet **financial projections** prepared by the company, industry or securities analysts, or other parties (but not the underlying cause of any such failure),
2. **Downgrades** or similar **adverse actions by rating agencies** relating to the company or its debt or equity securities (but not the underlying causes of any such downgrades or actions),
3. Changes in the prices or trading volumes of the **company's shares or other securities** (but not the underlying causes of any such changes).

AGREEMENT RISK

1. Complying the **terms of the agreement** between the parties;
2. The public **announcement or disclosure** of the agreement between the parties,
3. Any action (or omission) taken (or omitted) by the company as required *or* permitted by the agreement, or
4. Any action (or omission) taken (or omitted) by the company with the prior written consent of the acquirer.

Source: Robert T. Miller - Pandemic Risk and the Interpretation of Exceptions in MAE Clauses.

Excluded Effects or Carve-Outs with a Disproportionality Qualification

- Excluded events can be qualified with disproportionality considerations.
- For example, although pandemics may be an excluded event, there can by a qualification that they are excluded, unless the effects of the pandemic on the target is disproportional relative to its peers, then it can be included to the extent it is disproportional.
- To measure if an effect is ‘disproportional’ you need to measure it against something, i.e., a peer group or comparable businesses.
- Without a specific definition, it would be up to the lawyers to interpret the language, or the experts to determine what peer group would be reasonable in this circumstance.
- As CPAs and CBVs, we are well versed in the processes of identifying comparable businesses from a valuation perspective so we can bring that expertise if the definition in the agreement is vague, and assess from a performance or value perspective, what is an appropriate peer group to serve as a comparison or benchmark.

Source: ABA – What do Exceptions in MAE Definitions Except?

Materiality: CPA Guidance v. Case Law Threshold

Financial Statement Materiality

- Financial statement audit materiality based on determining amount that *could reasonably be expected to influence the decisions* of its users.

MAE Materiality Threshold (Case Law)

- A much high materiality threshold is applied when assessing MAEs – but **there is no bright-line rule.**
- Akorn decision considered that:
  - A **40% decline in profits** was evidence of an MAE.
  - A greater than **20% decline in value** is evidence of an MAE

Year-Over-Year Change in Akorn's Performance			
	Revenue	Operating Income	EPS
Q2 2017	(29%)	(84%)	(96%)
Q3 2017	(29%)	(89%)	(105%)
Q4 2017	(34%)	(292%)	(300%)
FY 2017	(25%)	(105%)	(113%)
Q1 2018	(27%)	(134%)	(170%)

"No one should interpret this decision as suggesting that there is one set of percentages for revenue and profitability metrics and another for liabilities. No one should think that a General MAE is always evaluated using profitability metrics and an MAE tied to a representation is always evaluated relative to the entity's valuation."

(Akorn Inc. v. Fresenius Kabi AG et. al.)

Source: Arthur R. Bookout Analyzing Akorn Delawares First M&A Termination Under Material Adverse Effect. Edward B. Micheletti, 19 October 2018; Press New York Law Journal - Materials Adverse Changes March 6 2019

Summary of Akorn v. Fresenius (1)

- First decision which allowed for a termination of an M&A due to an MAE
- Akorn (Target) was a generic pharmaceutical company was going to be acquired by Fresenius for $4.3 billion
- In October 2017, Fresenius received an anonymous whistleblower letter, followed by more detailed letter in November 2017 providing disturbing allegations about Akorn's quality compliance programs
- Fresenius investigated and uncovered serious and pervasive data integrity problems that rendered Akorn's representations about its quality assurance programs inaccurate
- Eventually on April 22, 2018, Fresenius delivered notice to terminate the transaction due to
  (1) Akorn's regulatory representations were not true and correct, and was reasonably expected to result in an MAE;
  (2) Akorn failed to use commercially reasonable efforts to carry on its business in all material respects; and
  (3) Akorn suffered a general MAE following execution of the merger (Akorn's results following merger announcement were poor and did not recover at the end of 2017).

Year-Over-Year Change in Akorn's Performance			
	Revenue	Operating Income	EPS
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Summary of Akorn v. Fresenius (2)

- Fresenius showed that a General MAE occurred because the underlying causes of the financial decline were durationally significant (due to new entrants for Akorn's top products resulting in price erosion, and loss of key contracts) which was disproportionate to pers
- Court also opined on whether the MAE occurred with respect to the data regulatory issues
- Both sides had experts that used a DCF to assess the financial impact of implementing a remediation plan to fix the data integrity issues by delaying certain drugs that were under development
- Court acknowledged the challenges of this assessment and used the mid-point of the experts submissions, of $900 million, which represents an impact of 21% based on the equity value of $4.3 billion.

"*unfortunately, the parties have not provided much assistance in determining whether remediation costs equal to approximately 20% of the targets standalone value would…be material when viewed from the longer-term perspective of a reasonable acquirer*".

- Judge then looked at 4 reference points, and concluded a 21% decline in value would be material

Definition of a "bear market" (20%)	Renegotiated price after a party declares an MAE (15%)	Upper and Lower Bounds in stock transactions (10-20%)	Termination Fees (6.36%)

Durational Significance (1)

- Any decline in financial performance must be durationally significant, i.e. the decline must last for "**years rather than months**"…*in most cases*

- Requires an understanding of the nature of the decline

- Depending on the circumstances, event lasting months may be considered an MAE

- "One-off" or "non-recurring" events it could cause permanent or lasting effect on performance and value.

*"whether there has been an adverse change in the target's business that 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**."*

(Hexion Spec. Chemicals v. Huntsman Corp)

*"The important consideration . . . Is whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which on would expect to be measured in years rather than months . . . Put differently, **the effect should 'substantially threaten the overall earnings potential of the target in a durationally significant manner.'**"*

(Akorn Inc. v. Fresenius Kabi AG et. al.)

Durational Significance (2)

Duration can differ when considering the nature of the acquisition (strategic acquisition vs financial acquisition)

Ganesco v. Finish Line

- Ganesco's Q2 and Q3 2007 earnings were the worst in 10 years, causing Finish Line to declare an MAE
- Court concluded an MAE did not occur because of a carve. Absent the carve-out, **concluded an MAE did occur**
- Ganesco argued that a blip in earnings cannot constitute an MAE (*IBP v. Tyson*). Court disagreed for two reasons:
  - The transaction was highly-leveraged
  - MAE definition included a "Cure" provision

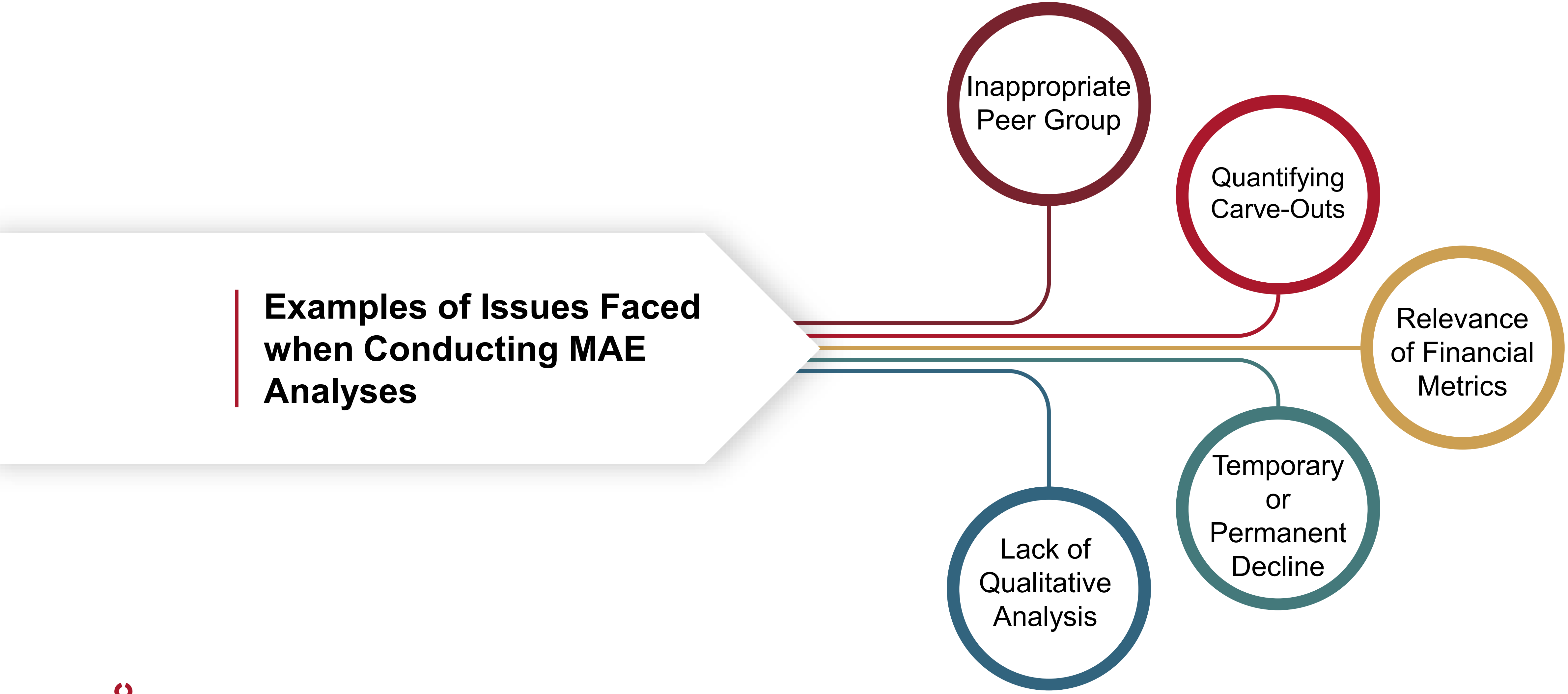
"For the purposes of determining whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting. In the absence of evidence to the contrary, a corporate acquirer maybe assumed to be purchasing the target as part of a long-term strategy."

Hexion Specialty Chemicals v. Huntsman

"…contractual language must be read in the larger context in which the parties were transacting. To a short-term speculator, the failure of a company to meet analyst' projected earnings for a quarter could be highly material. Such a failure is less important to an acquirer who seeks to purchase the company as part of a long-term strategy…"

IBP v Tyson

Common Pitfalls in MAE Analysis



Selecting Peer-Groups

- Contractual language needs to be reviewed when assessing *disproportionate adverse impact* since an expert needs to develop a peer group

- In *Snow Phipps* the buyer argued the target's industry was "*the supermarket industry*". Court disagreed and concluded the industry was "*supplier of products used by in-store bakeries and other cake retailers to decorate cakes and cupcakes for celebratory events and other occasions*"
  - Buyers arguments was contradicted by deal documents

- In Simon Property Group v. Taubman, Simon argued that Taubman operated within a broad retail sector which included grocery stores, open-air centers, and indoor shopping malls.
  - Taubman argued that it operated in a narrower industry of indoor shopping malls, and within this industry, it did not suffer disproportionately

*"…has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the **chemical industry***

(Hexion Spec. Chemicals v. Huntsman Corp)

*"… may be taken into account in determining whether there has been a [MAE] to the extent, and solely to the extent, such event, change, development, state of facts or effect has a disproportionate effect on the [the eNett Group], taken as a whole, as compared to participants **in the industries** in which [eNett], [Optal] or their respective Subsidiaries operate"*

(Travelport v. Wex)

*"…to the extent that such matter has a materially disproportionate effect on the Group Companies, taken, as a whole, relative to other comparable entities operating **in the industry** in which the Group Companies operate"*

(Snow Phipps Group v. KCAKE Acquisition, Inc.)

*"extent such matter has a materially disproportionate impact on the Acquired Companies as compared to other similarly situated companies **operating in the same industries or locations**, as applicable, as the Business"*

(Bardy Diagnostics v. Hill Rom Inc.)

Selecting Peer-Groups: Travelport v. Wex (England)

- Travelport (Seller) v. Wex (Buyer) included a very detailed assessment on selecting the peer group
- Buyer argued “industries” should be interpreted to reference “B2B payments industry” while Sellers argued that “industries” should be interpreted as a subset of those industries (i.e. the “travel payments industry” [“TPI”])
- High Court conducted a detailed four stage assessment:

Construction - Explicit Choice of Wording	The parties explicitly chose the word “Industries” and not a subset or other terms such as “Market” or “Sectors” which supported Wex’s arguments
Objective Purpose of the Transaction	Concluded that although Wex was acquiring companies operating in the travel business, the acquisition carried future value in other markets through synergies, which supported Wex’s arguments.
Whether the TPI actually existed	Sellers argued TPI existed by identifying references made by the parties in presentations, conference calls, interviews, etc. Court concluded that the term was well understood, but was not a standard term.
Commercial Purpose of the MAE Clause	Sellers argued that the commercial purpose of the MAE clause was to identify a set of companies that would be similarly impacted to the Targets (i.e. companies operating in the TPI)

Metrics used in an assessing MAE

Case	Plaintiff's Expert	Respondent's Experts	Assessment
Akorn v. Fresenius	N/A	Several metrics (Revenue, EBIT, EPS) <u>focus on EBITDA</u>	• Used a DCF prepared by Fresenius in the ordinary course of business to evaluate the Merger based on a delay and calculated a decline in value.
Fairstone v. Duo	Used analyst projections and focused on Net Operating Income and EPS without considering events after the termination date	Focused on several operational and financial metrics (net income, expenses, impairment charges, operational expenses, quality of portfolio, history of managing problems)	• Court ruled that it was relevant to consider information after the termination date based on IFRS 9 • Court noted several limitations with using EPS and called it a frail basis for comparison in an economic downturn and is sensitive to the size of a loan-loss reserves a company takes. • Court noted that Plaintiff's expert did not use actual results that were available when Plaintiff's expert prepared his report
Hexion v. Huntsman	N/A	N/A	• Discussed what metrics to use evaluate the results of a business after signing • Concluded that the use of EPS is problematic as it is a function of the capital structure of a company • In a cash acquisition, the acquirer would replace the capital structure of the target with a desired structure • Since EBITDA is independent of capital structure, it is a better measure of operational results
Bardy Diagnostics v. Hill Rom	Focused on revenue and volume of sales	Profitability and discounted cash flows	• <u>**Court noted that previous MAE decisions focused on EBITDA as the primary metric, and that it measures FCF which is regarded as the "gold standard" valuation metric**</u> • However, EBITDA is less relevant for start-up such as the target which is unprofitable and invested heavily in growth • Did not conclude which metrics is more relevant

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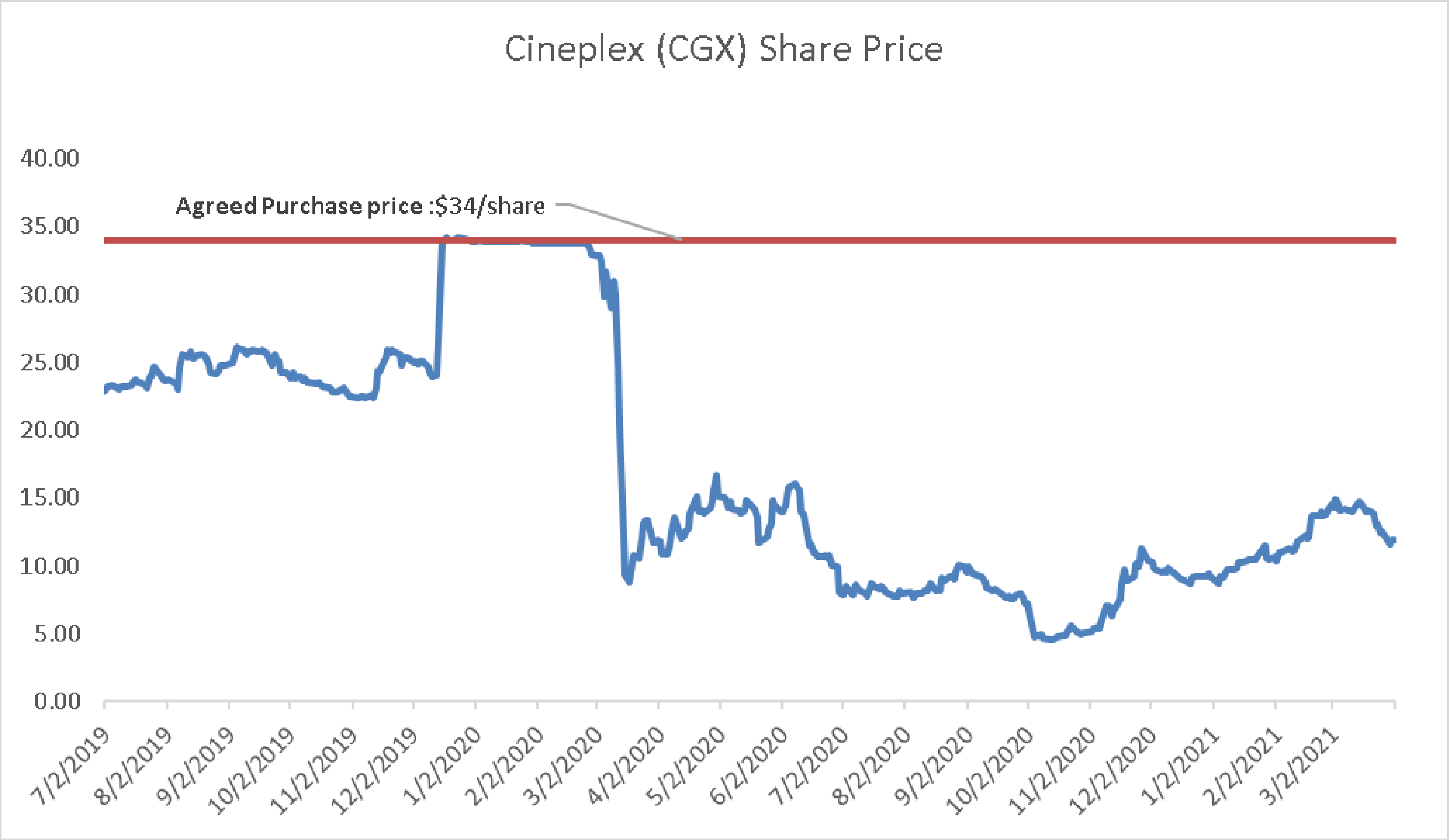
LOSS OF PREMIUM AS A MEASURE OF DAMAGES

Loss of Premium as a Measure of Damages

WHAT ARE LOST PREMIUM DAMAGES?

- Lost premium damages are the difference between the agreed-upon merger price, and the FMV of the target company (en-bloc equity value).
- **Crispo v. Musk -** This 2023 Chancery Court decision suggested that **<u>Lost Premium Damages were not recoverable</u>** in a breach of contract action, even if the merger agreement included a provision allowing for such damages.
- **Damages can only be claimed by contracting party (the company not the shareholders)**



Delaware amendments and implications

As of August 1, 2024, this legal uncertainty is resolved by the Delaware General Assembly's amendments to the DGCL:

- § 261(a)(1) now permits a target company to contract for and recover lost-premium damages from a breaching buyer, even if the stockholders are not designated as third-party beneficiaries.
- § 261(a)(2) Merger agreements may include provisions that explicitly allow for lost premium damages, either by defining damages to include such damages, by allowing the target to act as an agent for its shareholders to seek these damages, or by making shareholders express third-party beneficiaries of the agreement.
- The target company may retain these damages and is not required to distribute them to stockholders.

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LOSS OF SYNERGIES

Different Types of Damages Measures

LOST VALUE FROM DIFFERENT PERSPECTIVES

LOST VALUE OF SECURITIES RETAINED

Loss calculated as the consideration that the Buyer would have paid to the security holders of the Seller less the value of the securities retained.

LOST VALUE BASED ON FUTURE CASH FLOWS

Loss calculated based on diminution in value of the Seller's future cash flow.

DISGORGEMENT OF PROFITS

Disgorgement of benefits obtained by the Buyer as a result of failed merger.

LOSS OF SYNERGIES

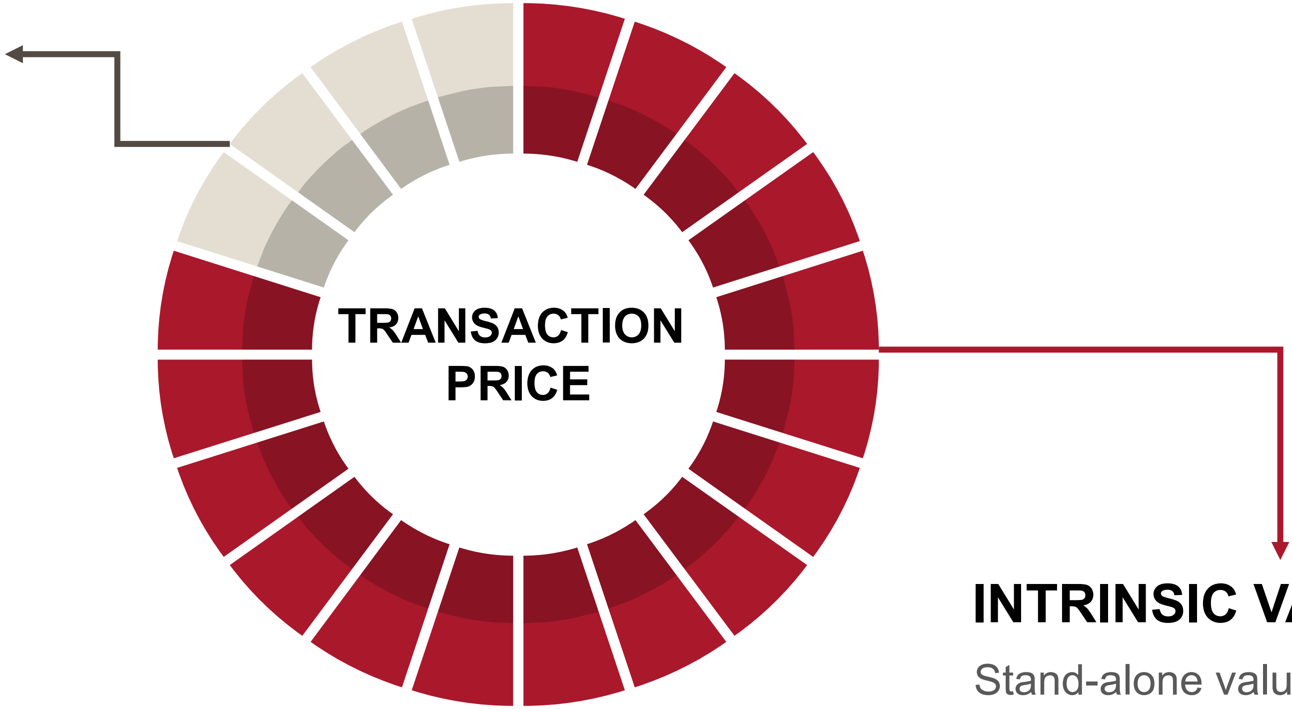
Loss of synergies suffered by the Seller that would result from the combination with the Buyer.

Loss of Synergies as a Measure of Damages

WHAT ARE SYNERGIES?

SYNERGIES

The **incremental value** over intrinsic value that a **buyer anticipates** it will realize following the acquisition**.**

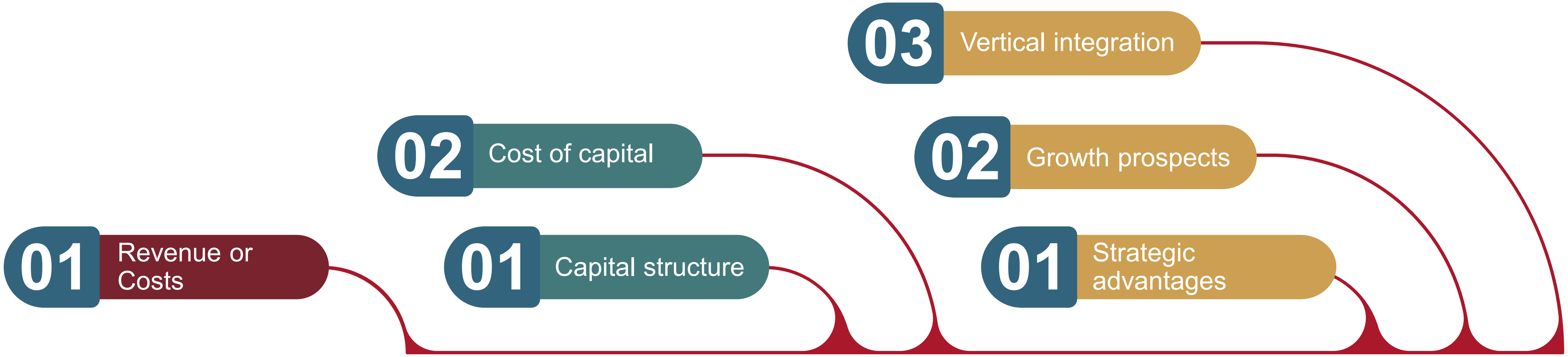


INTRINSIC VALUE

Stand-alone value of the business assuming it will continue **to operate as is, absent any divestiture or combination.**

Loss of Synergies as a Measure of Damages

TYPES OF SYNERGIES



TANGIBLE OPERATING SYNERGIES

Synergies that can be **isolated and quantified** in terms of **incremental prospective cash flows** (or incremental EBITDA) to be achieved through incremental revenue opportunities (net of associated operating costs) and/or cost reductions.

FINANCIAL SYNERGIES

Relates to a **lower cost of financing** available to the buyer or the buyer's ability to employ a **more efficient capital structure** (i.e., a higher portion of senior debt which costs comparatively less) than the seller.

INTANGIBLE OPERATING SYNERGIES

Relates to the **reduced level of risk** in achieving the prospective operating results (e.g., vertical integration with a key supplier) and/or enhanced long-term **growth prospects** or strategic advantages that have not been separately quantified. As these **synergies are often difficult to isolate**, in practice, they are **not quantified** separately from tangible operating synergies.

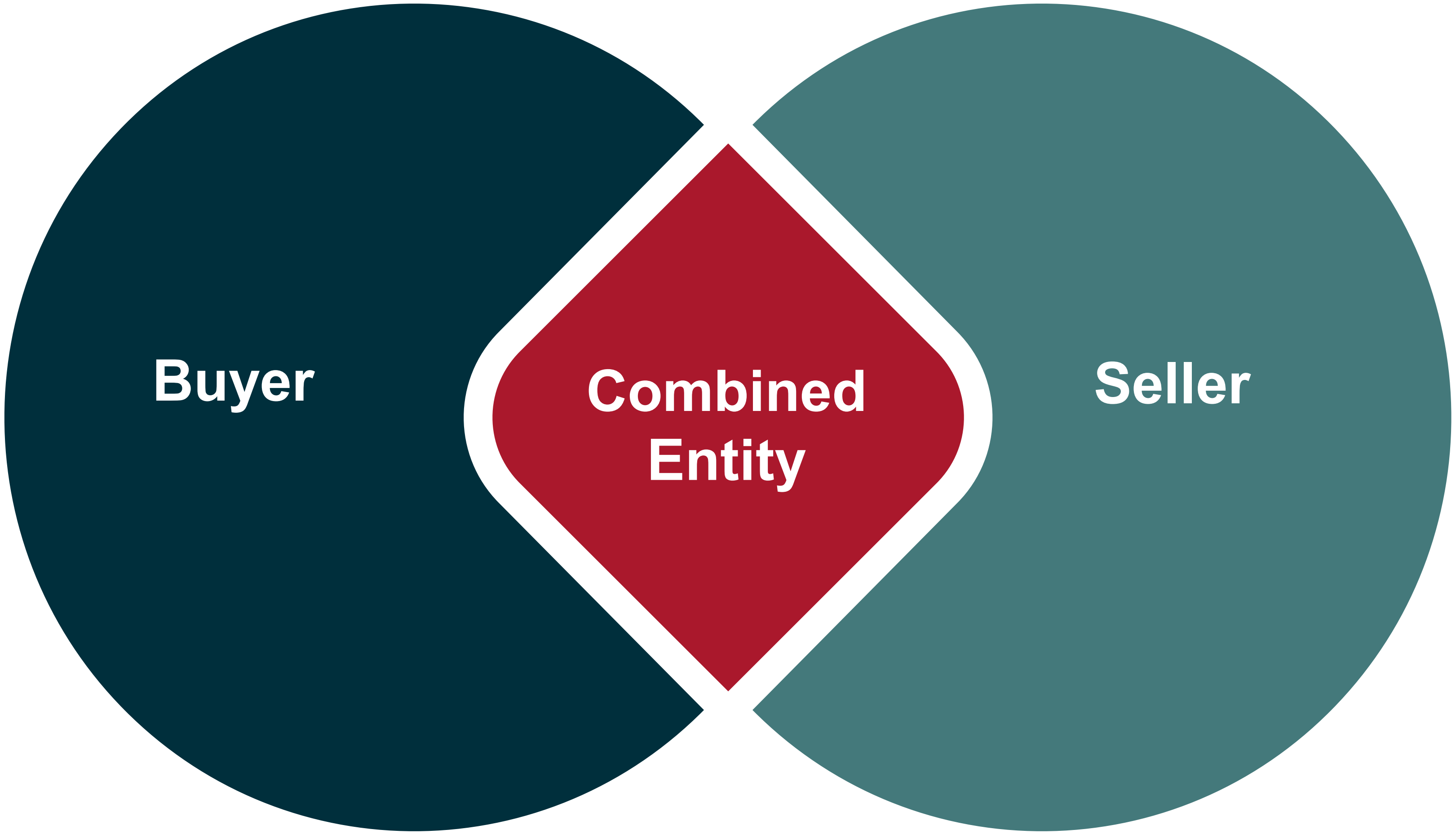
Loss of Synergies as a Measure of Damages

ACCOUNTING FOR IMPLEMENTATION COSTS AND RISKS

1 Implementation Costs	Initial and ongoing costs of implementing and realizing these incremental cash flows such as incremental operating expenses, capital expenditures or increased working capital requirements must be deducted.
2 Risk-adjusted cash flows	Probability weights are assigned to incremental cash flows to reflect likelihood of achieving synergies.
3 Discount rate	Higher than cost of capital used to value intrinsic stand-alone business to reflect additional risk of achieving synergies.

Loss of Synergies as a Measure of Damages

WHO EXPERIENCES THE SYNERGIES?



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Cineplex v. Cineworld

Cineplex v. Cineworld

1. Overview:

- Cineworld breached its obligation to close the deal.
- Cineplex **could not recover lost-premium damages** (benefits that would have gone to shareholders).
- Court emphasized that **only contract parties** (like Cineplex) can claim damages—not shareholders.

2. Lost-Synergy Damages:

- **Cineplex was awarded C$1.2366 billion** based on synergies it would have realized post-merger.
- These damages were allowed because they **reflected Cineplex's own business expectations**, not shareholder interests.

3. Con Ed Provisions:

- **Clauses that allow recovery of lost premiums** if a buyer wrongly terminates.
- Not included in Cineplex's agreement.
- Rare in Canadian deals (~2%) and often resisted by buyers.

Key Takeaways

MAE clauses must be carefully drafted; exclusions like pandemics can defeat MAE claims

Damages are limited to the losses of the contracting party — not shareholders

Cineplex v. Cineworld

4. Comparative Insight – Crispo v. Musk (Delaware)

- Under Delaware law, **lost-premium damages were unenforceable** unless:
  - Shareholders are granted explicit third-party beneficiary rights as part of the merger agreement.

5. Practical Contractual Lessons

- To claim lost-premium damages:
  - Contracts must **grant shareholders enforceable rights** or
  - Appoint the target as **agent/trustee** for shareholders via legal mechanisms.

7. Reverse-Termination Fees

- A **fallback if Con Ed clauses are not used**.
- Helps **price the buyer's “walk-away” option**, compensating for potential loss.

8. Legal Framework for Damages

- Court allows **only damages suffered by the contracting party** (Cineplex).
- Rejected: Shareholder-focused damages.
- Accepted: Lost synergies (C$1.2366B) and transaction costs (C$5.5M).

Key Takeaways

Contractual clarity is crucial for allocating risks and enforcing rights in M&A deals.

Lost synergies can be significant and recoverable, if properly substantiated.

A Simplified Illustration

Big Grocer and Organic Grocer operate multiple grocery stores across Canada.

→ Big Grocer acquired Organic Grocer as the demand for organic products increased.

→ Stores of both brands will continue to operate, but support teams will be combined.

→ Big Grocer's procurement team and Organic Grocer's marketing team would be laid off.

Annual Cost Summary

Cost	Big Grocer	Organic Grocer	Total
Marketing	$25 million	$15 million	$40 million
Procurement	$35 million	$25 million	$60 million
Total	**$60 million**	**$40 million**	**$100 million**

Questions

- Any potential synergies arising from the merger?
- What type of synergy?
- What is the value of the potential synergies?
- Who is experiencing the potential synergies?
- In the event of a failed merger, what can Organic Grocer potentially claim as damages?

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Thank you

Any questions?

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