Material adverse effect clauses in credit agreements

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Lenders should note the Delaware Court of Chancery's recent opinion in *Akorn, Inc. v. Fresenius Kabi AG* which the Delaware Supreme Court recently upheld.

In December 2018, the Delaware Court of Chancery allowed an acquiring party to a purchase agreement to terminate the agreement because of the occurrence of a material adverse effect (MAE) or material adverse change (MAC) in the target company's business. The court's novel analysis of MAEs within the context of mergers and acquisitions provides valuable insight into how courts may treat lenders' rights under credit agreements with respect to MAEs.

Akorn, Inc. v. Fresenius Kabi AG

In *Akorn*, the parties entered into a merger agreement under which the buyer agreed to acquire the seller. The merger agreement provided for a two-step closing. After the parties signed the agreement but before the transaction closed, the integrity of the seller's business dramatically deteriorated due to a combination of factors. As a result, the buyer terminated the merger agreement, citing the seller's breach of several representations and covenants, including the general representation that there were no material adverse changes in the seller's business. While the court's exhaustive analysis of MAEs was confined to the context of a merger, such analysis can be applied to secured lending transactions in which borrowers make several representations that there are no MAEs and a general MAE falls under the definition of an event of default.

The court's analysis of whether the seller suffered a general MAE hinged on the following issues:

1. Whether the magnitude of the effect was material.
2. Whether the reason for the effect fell within an exception set forth in the agreement.
3. Whether the lender/buyer knowingly accepted the risks that led to the general MAE.

The court provided that, absent clear language to the contrary, the party seeking to excuse performance under the contract bears the burden of proving that an MAE exists. Noting that MAE clauses typically do not define the meaning of "material," the court stated that what constitutes an MAE is a question of fact that arises only when the clause is invoked and must be answered by the presiding court on a case by case basis.

Whether the Magnitude of the Effect was Material

The issue of whether the magnitude of the effect was material is viewed from a longer-term perspective, and the effect should substantially threaten the overall earnings potential of the target company in a "durationally-significant manner", which is measured in years rather than months. The court observed that "when evaluating the magnitude of a decline, a company's performance generally should be evaluated against its results during the same quarter of the prior year, which minimizes the effect of seasonal fluctuations." For such a decline to constitute an MAE, poor earnings results must persist significantly into the future.

The court also mentioned that a short-term hiccup in earnings should not suffice to constitute an MAE. Most courts have considered a decrease in profits in the range of 40 percent or higher to be an MAE. A decline in earnings of 50 percent over two consecutive quarters would likely be an MAE. However, "[t]hese precedents do not foreclose the possibility that a buyer could show that percentage changes of a lesser magnitude constituted an MAE. Nor does it exclude the possibility that a buyer might fail to prove that percentage changes of a greater magnitude constituted an MAE."

Whether the Reason for the Effect Falls Within an Exception

The court explored the issue of whether an exception in the merger agreement applied to the MAE. Merger agreements or credit agreements generally allocate risks among the parties in defining MAEs and their exceptions. For example, in *Akorn* the court noted that endogenous, business-specific risks were allocated to the seller and exogenous, systematic risks were allocated to the buyer. Exceptions to the MAE clauses were used to reallocate specific categories of risk back to the buyer, and exclusions from such exceptions were used to return risk to the seller.

In opining that the MAE in *Akorn* did not fall within an exception allocating risk to the buyer, the court recognized that the seller suffered a decline in its business that was disproportionate to its industry peers. The court relied on one expert witness's testimony which revealed that the seller significantly underperformed all comparable companies during all time periods and on all metrics.

Whether the Risks That Led to the General MAE Were Knowingly Accepted

The court set forth four categories of risk that are allocated among the parties by MAE provisions in a contract:

1. Systematic risks – risks beyond the control of all parties and that generally affect firms beyond the parties to the transaction.
2. Indicator risks – risks that indicate an MAE may have occurred, such as a drop in stock price or failure to meet financial projections.
3. Agreement risks – risks arising from the public announcement of the agreement or the taking of actions contemplated under the agreement.
4. Business risks – risks arising from the ordinary operations of the business besides systematic risks.

Lenders and borrowers are sophisticated parties bargaining at arm's length. The parties are generally free to contract however they want and will be bound by the terms of the credit agreement they voluntarily negotiated. One way lenders and borrowers allocate risk is through MAE representations and including an MAE under the definition of an event of default.

Lenders should pay attention to how the four types of risk set forth above are allocated between the parties under the definition of material adverse effect or material adverse change. Like what happened in *Akorn*, borrowers may argue that the lender accepted the risks of the MAE when negotiating the contract between the parties.

In determining whether the buyer knowingly accepted the risks that led to the general MAE, the court in *Akorn* stated that it relied on precedent that spoke in terms of unknown events instead of uncontemplated risks.

What lenders can learn from the Akorn opinion

Lenders can derive a few insights from the *Akorn* opinion, including, but not limited to:

- When negotiating the credit agreement with a borrower, pay special attention to how different types of risk are allocated between the lender and the borrower via the definition of an MAE or MAC. Negotiate the definition of an MAE and its exceptions and exclusions to the exceptions carefully.
- If you are considering invoking an MAE clause to declare an event of default under a credit agreement, pay attention to year-over-year performance in a borrower’s business. Materiality is generally measured by whether the decline in a borrower’s performance is durationally-significant, which is measured in terms of years instead of months to eliminate the effect of cyclical changes in a business. But there is no general rule of thumb for what constitutes an MAE.
- General MAEs are typically defined by the occurrence of unknown events. But lenders also accept a certain amount of risk by extending loans to borrowers.