SULLIVAN & CROMWELL LLP

December 20, 2019

Delaware Chancery Court Rejects MAE Termination of Merger Agreement

The Court Finds Buyer Breached Best Efforts Covenant and Orders Buyer to Close Transaction

SUMMARY

In a decision issued earlier this week in *Channel Medsystems, Inc.* v. *Boston Scientific Corp.*, No. 2018-0673 (Del. Ch. Dec. 18, 2019), the Delaware Court of Chancery held that the putative purchaser in a merger agreement failed to prove a Material Adverse Effect ("MAE") justifying its purported termination of the merger agreement. Following a four day trial, the Court of Chancery ruled in a 119-page decision that the buyer, Boston Scientific Corp. ("BSC"), failed to prove that theft and other misconduct by an employee of the target, Channel Medsystems ("Channel")—which included falsifying documents that were included in Channel's then pending application for Food and Drug Administration ("FDA") approval of Cerene, an in-development medical device and Channel's only product—met Delaware's stringent test for establishing an MAE that might justify termination of a merger agreement. After Channel remediated the employee's misconduct and resubmitted its FDA application, Cerene received FDA approval in March 2019—about the same time BSC contemplated approval would be achieved upon signing of the merger agreement, and six months before the deadline for FDA approval in the merger agreement. The Court forcefully rejected BSC's claim that the effects of the employee misconduct were qualitatively and quantitatively material, as is necessary to prove an MAE in Delaware, in part because they appeared to be litigation-driven justifications that nowhere appeared in any documents and instead conflicted with contemporary evidence. The Court of Chancery also found BSC in breach of its contractual obligation to use "commercially reasonable efforts" to consummate the merger by "failing to vet any concerns" about the events with Channel and to "keep the transaction on track thereafter," but instead BSC "simply pulled the ripcord." The *Channel* decision reinforces long-standing Delaware jurisprudence that MAE claims are highly fact-specific, and present a very high bar to success.

BACKGROUND

Channel is a privately held company. BSC owned 15% of its equity following two investments in 2013 and 2015, pursuant to which BSC had an observer on Channel's Board of Directors. Following rumors in 2017 of potential third party interest in Channel, BSC began considering an acquisition of Channel and, in June 2017, executed a non-binding letter of intent to acquire the equity BSC did not own for up to $275 million, subject to due diligence, which BSC thereafter pursued, including, as the Court of Chancery emphasized, diligence of some of the same quality control areas that BSC would later argue contributed to an MAE.[1] In November 2017, the parties executed the merger agreement which provided for, among other things, (i) the immediate purchase by BSC of additional equity, increasing its interest to 20%, (ii) a BSC-nominated director on the Channel board, and (iii) a put-call structure whereby BSC could close the purchase of Channel's remaining equity at any time, while Channel could put that equity to BSC following FDA approval of Cerene, provided approval was received by September 30, 2019.

In late 2017, Channel discovered falsified expense and other reports by an employee as part of a broad theft scheme, and immediately commenced an extensive investigation with outside legal, regulatory and accounting experts. Among other things, the investigation concluded that the misconduct did not affect the outcome of Channel's clinical study or the safety and efficacy of the clinical data, but (i) as many as six (out of 138) test reports submitted to the FDA and European regulators contained falsified data, (ii) certain measurement and calibration data used in manufacturing were falsified, and (iii) quality assurance and other records that would be needed to comply with FDA regulations were doctored. Most of these findings were included in a March 2018 report (the "Greenleaf Report"), which was provided to the FDA and to BSC, along with a host of follow-up internal audit reports and remediation plans and results. By April 18, 2018, the FDA "accepted Channel's remediation plan for its PMA application" and advised Channel that it "ha[d] addressed all of FDA's concerns and that the agency appreciate[d] the company's transparency and timeliness."[2]

BSC had a less favorable reaction to Channel's efforts. Although BSC "employees uniformly testified that Channel was fully transparent with [BSC] in the aftermath of discovering [the employee's] fraud," Channel's updates to BSC about its progress with the FDA were largely left without a response. Instead, shortly after Channel informed BSC that the FDA had accepted its remediation plan, BSC in an April 22, 2018 e-mail for the first time expressed concerns about the "extremely troubling" Greenleaf Report, and expressed a lack of confidence that the FDA "would be acquiescing" of Channel's clinical data or be "optimistic" of a final approval application based on that data. Channel requested a meeting to discuss the concerns in the April 22 e-mail, but BSC did not respond to that request, or to five follow-up requests. Instead, on May 11, BSC sent a notice of termination of the merger agreement citing, among other things, breaches of representations and warranties, which BSC contended at trial were based entirely upon the Greenleaf Report without any "discuss[ion of] any steps [BSC] could take to remediate Channel's quality system."[3] Later, in June 2018, BSC asserted in a letter that the false reports submitted to the FDA "placed the

approval of Cerene in jeopardy, thereby substantially threatening Channel's overall earnings potential."[4] Yet, the FDA gave its approval to Cerene in March 2019—the same timeframe contemplated by the parties at the time the merger agreement was signed and six months prior to the merger agreement deadline (and, unfortunately for BSC, a few weeks before the start of trial).

THE COURT OF CHANCERY DECISION

Based upon detailed factual findings that were critical of BSC and dubious of its claimed adverse effects that in many ways were contradicted by Channel's success in achieving timely FDA approval, the Court of Chancery easily concluded that BSC had failed to prove an MAE. The focus of the opinion is on the claim that the employee fraud breached various representations and warranties in the merger agreement. As is typical, the Channel merger agreement permits termination based upon such breaches only if the inaccuracies constitute, or are reasonably likely to constitute, an MAE. The Court of Chancery first found that BSC had proven that Channel was not in compliance "in all material respects" with various representations and warranties in the merger agreement. After concluding that materiality for this purpose followed the same standard developed under the federal securities laws (*i.e.*, "viewed by the reasonable investor as having significantly altered the 'total mix' of information"), the Court ruled that various representations about product quality, compliance, internal controls and the accuracy of regulatory filings were materially inaccurate.[5]

Noting the "'heavy burden'" a buyer faces "'when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close,'" the Court proceeded to "consider[] 'quantitative and qualitative aspects'" of the effects alleged by BSC to be material and adverse.[6] As to the qualitative factors, the Court was skeptical of the effects asserted by BSC, given that it "shifted its strategy" from the no longer viable claim that the events jeopardized Cerene's FDA approval prospects to a claim that BSC would need to start over and "remediate and retest the product before placing Cerene on the market," despite the FDA's approval. The Court found this claimed need to start over not credible for a host of reasons, including that BSC had not evaluated the remediation work Channel had done or spoken to the experts that investigated Channel's quality systems, or even consulted the quality control experts within BSC on the topic, and not a "single scrap of paper" referenced these concerns. Moreover, the BSC employee appointed to Channel's board testified that, "[m]ore or less," he viewed this "all [as] a non-issue." "In sum, the weight of the evidence demonstrates convincingly that [BSC's] professed need—notwithstanding FDA approval of the Cerene device—to remediate and retest Cerene before placing it on the market is not objectively reasonable, and that [BSC's] concerns about potential products liability litigation, competitive harm, and future regulatory action are based on little more than unsubstantiated speculation."[7]

Turning to the quantitative factors, the Court observed that "[t]hat there is no bright-line test for determining an MAE based on quantitative considerations," but decreases in excess of 40% in key financial metrics have generally led courts to find an MAE, and the Court of Chancery last year found remediation costs

equaling 21% of the target's equity value to be material.[8] Chancellor Bouchard rejected entirely BSC's claimed quantitative effects, as they were based largely on the already rejected notion that Cerene would be withheld from the market for two to four years while BSC remediated and retested the device. Beyond this, the Court found that BSC improperly based its claim on BSC's valuation model, which included merger synergies, rather than Channel's stand-alone value, which was the measure provided for in the merger agreement MAE clause.

After rejecting BSC's claimed right to terminate the merger agreement, the Court of Chancery next found that BSC breached the agreement by failing in its duty to use commercially reasonable efforts to consummate the deal. The Court ruled that BSC "did not have reasonable grounds to terminate the Agreement when it did," and BSC's failure to take steps to confer and cooperate with Channel or to investigate the conclusions of Channel's outside experts "shows a lack of good faith."[9] The Court found this conclusion "corroborated by contemporaneous evidence" that (i) BSC's product and marketing teams advocated for terminating the deal because of dissatisfaction with the Cerene product that "will be a very heavy lift to commercialize," and (ii) BSC was in the process of evaluating a sale of the division that would house Cerene, which was rendered "too complicated" by the uncertain pending acquisition. While acknowledging motives to avoid a deal do not detract from a valid contractual right to terminate, the Court of Chancery ruled that BSC's motives corroborated other evidence that its MAE claim was pretextual.

IMPLICATIONS

Despite the first ever decision from the Court of Chancery last year finding an MAE that justified termination of a merger agreement in *Akorn*, which was affirmed by the Delaware Supreme Court earlier this year, the *Channel* decision is consistent with long-standing law imposing a heavy and rarely met burden on a party to a merger agreement that seeks to avoid its obligation to close based upon an MAE clause.

- The Court confirmed that a termination clause that allows termination for breaches of representations and warranties only if they amount to an MAE means that the effects incident to the conduct or events that breached the representation or warranty must be proven to qualify as an MAE on the termination date under the traditional, fact-specific MAE test.
- The Court found that a contractual provision that allows termination upon the occurrence of an event that "is reasonable likely" to constitute an MAE allows for termination only if it was reasonably expected (i) on the date of termination (ii) that an MAE would occur (iii) "as of the date when the parties anticipated the merger would close." This passage presumably does not suggest that the adverse effects must materialize prior to closing, as the Court elsewhere acknowledged settled existing law that "'an MAE can have occurred without the effect on the target's business being felt yet.'" Instead, this conclusion appears to confirm that effects that are proven likely to occur in the future and quantified should be discounted back to the expected closing date and compared to the target company as of that date.
- The Court reiterated that this is a situation specific, highly fact intensive qualitative and quantitative inquiry focused on "'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 reasonable period, which one would expect to be measured in years rather than months.'"

- A significant aspect of the buyer's failure to prove an MAE in *Channel* was the absence of contemporaneous records documenting the reasons for the termination, and the lack of any contemporaneous analytical work supporting the conclusion that an MAE had or was reasonably likely to occur. A party evaluating a potential MAE termination should carefully document its decision making, only after the business and financial analyses supporting the high bar for termination has been undertaken.
- As in *Channel*, despite variances in the wording of MAE clauses, it will remain the rare case that a merger party succeeds in avoiding closing based upon a claimed termination premised on an MAE.

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ENDNOTES

1 *Channel Medsystems, Inc.* v. *Boston Scientific Corp.*, 2019 WL 6896462, at *4-*5 (Del. Ch. Dec. 18, 2019).

2 *Id.* at *6-*10.

3 *Id.* at *12-*13.

4 *Id.* at *28.

5 *Id.* at *17-*21.

6 *Id.* at *25 (quoting *Akorn, Inc*. v. *Fresenius Kabi AG*, 2018 WL 4719347, at *53 & *65 (Del. Ch. Oct. 1, 2018), ***aff'd***, 198 A.3d 724 (Del. 2018)).

7 *Id.* at *30-*33.

8 *Id.* at *34 (citing *Akorn*, 2018 WL 4719347, at *74).

9 *Id.* at *37-*39.

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