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Akorn v. Fresenius: Delaware Chancery Court Upholds MAE-Based Termination

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On October 1, 2018, in *Akorn, Inc. v. Fresenius Kabi AG*,[1] the Delaware Court of Chancery determined conclusively for the first time that a buyer had validly terminated a merger agreement due to the occurrence of a "material adverse effect" (MAE). Though the decision represents a seminal development in M&A litigation generally, Vice Chancellor Laster grounded his decision in a framework that comports largely with the ordinary practice of deal professionals.

In addition, the Court went to extraordinary lengths to explicate the history between the parties before concluding that the buyer had validly terminated the merger agreement, and so set the goalposts for a similar determination in the future to require a correspondingly egregious set of facts. As such, the ripple effects of *Fresenius* in future M&A negotiations may not be as acute as suggested in the media.[2]

Factual Overview

On April 24, 2017, Fresenius Kabi AG, a pharmaceutical company headquartered in Germany, agreed to acquire Akorn, Inc., a specialty generic pharmaceutical manufacturer based in Illinois. In the merger agreement, Akorn provided typical representations and warranties about its business, including its compliance with applicable regulatory requirements.

In addition, Fresenius's obligation to close was conditioned on, among others, Akorn's representations being true and correct both at signing and at closing, except where the failure to be true and correct would not reasonably be expected to have an MAE. In concluding that an MAE had occurred, the Court focused on several factual patterns:

Long-Term Business Downturn. Shortly after Akorn's stockholders approved the merger (three months after the execution of the merger agreement), Akorn announced year-over-year declines in quarterly revenues, operating income and earnings per share of 29%, 84% and 96%, respectively. Akorn attributed

[1] *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347, C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018).

[2] See, *e.g.*, Jef Feeley, Chris Dolmetsch & Joshua Fineman, *Akorn Plunges After Judge Backs Fresenius Exit from Deal*, Bloomberg (Oct 1, 2018) ("'The ruling is a watershed moment in Delaware law, and will be a seminal case for those seeking to get out of M&A agreements,' Holly Froum, an analyst with Bloomberg Intelligence, said in an emailed statement."); Tom Hals, *Delaware Judge Says Fresenius Can Walk Away from $4.8 Billion Akorn Deal*, Reuters (Oct. 1, 2018) ("'This is a landmark case,' said Larry Hamermesh, a professor at Delaware Law School in Wilmington, Delaware.").

Table of Contents

– *Akorn v. Fresenius:* Delaware Chancery Court Upholds MAE-Based Termination. 1
– Delaware Supreme Court Clarifies *MFW's Ab Initio* Requirement. 4
– Carve-Out Transactions: Negotiated Issues & Diligence Matters for Buyers 5
– Delaware Chancery Holds Contractual Appraisal Waivers Valid 11

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the declines to the unexpected entrance of new competitors, the loss of a key customer contract and the attrition of its market share in certain products.

Akorn revised its forecast downward for the following quarter, but fell short of that goal as well and thereafter announced year-over-year declines in quarterly revenues, operating income and earnings per share of 29%, 89% and 105%, respectively. Akorn ascribed the results to unanticipated supply interruptions, added competition and unanticipated price erosion; it also adjusted downward its long-term forecast to reflect dampened expectations for the commercialization of the products in its pipeline.

The following quarter, Akorn reported year-over-year declines in quarterly revenues, operating income and earnings per share of 34%, 292% and 300%, respectively. Ultimately, over the course of the year following the signing of the merger agreement, Akorn's EBITDA declined by 86%.

<u>Whistleblower Letters.</u> In late 2017 and early 2018, Fresenius received anonymous letters from whistleblowers alleging flaws in Akorn's product development and quality control processes. In response, relying upon a covenant in the merger agreement affording the buyer reasonable access to the seller's business between signing and closing, Fresenius conducted a meticulous investigation of the Akorn business using experienced third-party legal and technical advisors.

The investigation revealed grievous flaws in Akorn's quality control function, including falsification of laboratory data submitted to the FDA, that cast doubt on the accuracy of Akorn's compliance with laws representations. Akorn, on the other hand, determined not to conduct its own similarly wide-ranging investigation (in contravention of standard practice for an FDA-regulated company) for fear of uncovering facts that could jeopardize the deal.

During a subsequent meeting with the FDA, Akorn omitted numerous deficiencies identified in the company's quality control group and presented, in the Court's determination, a "one-sided, overly sunny depiction."

<u>Operational Changes.</u> Akorn did not operate its business in the ordinary course after signing (despite a covenant requiring that it do so) and fundamentally changed its quality control and information technology (IT) functions without the consent of Fresenius. Akorn management replaced regular internal audits with "verification" audits that only addressed prior audit findings rather than identifying new problems.

Management froze investments in IT projects, which reduced oversight over data integrity issues, and halted efforts to investigate and remediate quality control issues and data integrity violations out of concern that such investigations and remediation would upend the transaction.

Following signing, NSF International, an independent, accredited standards development and certification group focused on health and safety issues, also identified numerous deficiencies in Akorn's manufacturing facilities.

Conclusions and Key Takeaways

The Court concluded, among others, that (i) the sudden and sustained drop in Akorn's business performance constituted a "general MAE" (that is, the company itself had suffered an MAE), (ii) Akorn's representations with respect to regulatory compliance were not true and correct and (iii) the deviation between the as-represented condition and its actual condition would reasonably be expected to result in an MAE. In addition, the Court found that the operational changes implemented by Akorn breached its covenant to operate in the ordinary course of business.

Several aspects of the Court's analysis have implications for deal professionals:

<u>Highly Egregious Facts.</u> Although the conclusion that an MAE occurred is judicially unprecedented in Delaware, it is not surprising given the facts. The Court determined that Akorn had undergone sustained and substantial declines in financial performance, credited testimony suggesting widespread regulatory noncompliance and malfeasance in the Akorn organization and suggested that decisions made by Akorn regarding health and safety were re-prioritized in light of the transaction (and in breach of a highly negotiated interim operating covenant).

In *In re: IBP, Inc. Shareholders Litigation*, then-Vice Chancellor Strine described himself as "confessedly torn" over a case that involved a 64% year-over-year drop-off in quarterly earnings amid allegations of improper accounting practices, but determined that no MAE had occurred because the decline in earnings was temporary.

In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, Vice Chancellor Lamb emphasized that it was "not a coincidence" that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement" and concluded the same, given that the anticipated decline in the target's EBITDA would only be 7%. No such hesitation can be found in the *Fresenius* opinion.[3]

MAE as Risk Allocation Tool. The Court framed MAE clauses as a form of risk allocation that places "industry risk" on the buyer and "company-specific" risk on the seller. Further explained in a more nuanced manner, the Court categorized "business risk," which arises from the "ordinary operations of the party's business" and which includes those risks over which "the party itself usually has significant control", as being retained by the seller.

By contrast, the Court observed that the buyer ordinarily assumes three others types of risk—namely, (i) systematic risks, which are "beyond the control of all parties," (ii) indicator risks, which are markers of a potential MAE, such as a drop in stock price or a credit rating downgrade, but are not underlying causes of any MAE themselves and (iii) agreement risks, which include endogenous risks relating to the cost of closing a deal, such as employee flight.

This framework comports with the foundation upon which MAE clauses are ordinarily negotiated and underscores the importance of sellers negotiating for industry-specific carve-outs from MAE clauses, such as addressing adverse decisions by applicable governmental agencies in heavily regulated industries.

High Bar to Establishing an MAE. The Court emphasized the heavy burden faced by a buyer in establishing an MAE. Relying upon opinions that emerged from the economic downturns in 2001 and 2008,[4] the Court reaffirmed that "short-term hiccups in earnings" do not suffice; rather, the adverse change must be "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."

The Court underscored several relevant facts in this case, including (i) the magnitude and length of the downturn, (ii) the suddenness with which the EBITDA decline manifested (following five consecutive years of growth) and (iii) the presence of factors suggesting "durational significance," including the entrance of new and unforeseen competitors and the permanent loss of key customers.[5]

Evaluation of Targets on a Standalone Basis. Akorn advanced the novel argument that an MAE could not have occurred because the buyer would have generated synergies through the combination and would have generated profits from the merger.

The Court rejected this argument categorically, finding that the MAE clause was focused solely on the results of operations and financial condition of the target and its subsidiaries, taken as a whole (rather than the surviving corporation or the combined company), and carved out any effects arising from the "negotiation, execution, announcement or performance" of the merger agreement or the merger itself, including "the generation of synergies."

Given the Court's aversion to considering synergies as relevant to determining an MAE, buyers should consider negotiating to include express references to synergies in defining the concept of an MAE in their merger agreements.

Disproportionate Effect. *Fresenius* offers a useful gloss on the importance to buyers of including "disproportionate effects" qualifications in MAE carve-outs regarding industry-wide events. Akorn argued that it faced "industry headwinds" that caused its decline in performance, such as heightened competition and pricing pressure as well as regulatory actions that increased costs.

However, the Court rejected this view because many of the causes of Akorn's poor performance were actually specific to Akorn, such as new entrants in the markets for Akorn's top three products and Akorn's

[3] The egregiousness of the facts in this case is further underscored by the fact that the Court determined that the buyer had breached its own covenant to use its reasonable best efforts to secure antitrust clearance, but that this breach was "temporary" and "not material."

[4] See, *e.g., Hexion Specialty Chems. Inc. v. Huntsman Corp.,* 965 A.2d 715 (Del. Ch. 2008); *In re: IBP, Inc. S'holders Litig.*, 789 A.2d 14 (Del. Ch. 2001).

[5] This view comports with the analysis highlighted by the Court from *In re: IBP, Inc. Shareholders Litigation*, in which the court determined that an MAE had not transpired in part because the target's "problems were due in large measure to a severe winter, which adversely affected livestock supplies and vitality" and that therefore affected all players in the industry. *In re: IBP*, 789 A.2d at 22. In this case, the decline of Akorn was not the product of systemic risks or cyclical declines, but rather a company-specific effect.

loss of a specific key contract. As such, these "industry effects" disproportionately affected and were allocated from a risk-shifting perspective to Akorn. To substantiate this conclusion, the Court relied upon evidence that Akorn's EBITDA decline vastly exceeded its peers.

The Bring-Down Standard. A buyer claiming that a representation given by the target at closing fails to satisfy the MAE standard must demonstrate such failure qualitatively and quantitatively. The Court focused on a number of qualitative harms wrought by the events giving rise to Akorn's failure to bring down its compliance with laws representation at closing, including reputational harm, loss of trust with principal regulators and public questioning of the safety and efficacy of Akorn's products.

With respect to quantitative measures of harm, Fresenius and Akorn presented widely ranging estimates of the cost of remedying the underlying quality control challenges at Akorn. Using the midpoint of those estimates, the Court estimated the financial impact to be approximately 21% of Akorn's market capitalization.

However, despite citing several proxies for financial performance suggesting that this magnitude constituted an MAE, the Court clearly weighted its analysis towards qualitative factors, noting that "no one should fixate on a particular percentage as establishing a bright-line test" and that "no one should think that a General MAE is always evaluated using profitability metrics and an MAE tied to a representation is always tied to the entity's valuation."

Indeed, the Court observed that these proxies "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."

* * * *

Fresenius offers a useful framework for considering how courts analyze MAE clauses. While this understanding largely comports with the approach taken by deal professionals, the case nevertheless offers a reminder that an MAE, while still quite unlikely, can occur. Deal professionals would be well-advised to be thoughtful about how the concept should be defined and used in an acquisition agreement.

Delaware Supreme Court Clarifies *MFW's Ab Initio* Requirement

By Peter Walsh, Jr. and Michael Reilly, Partners, and Kwesi Atta-Krah, Associate, of Potter Anderson & Corroon LLP

In a significant development for controlling stockholder transactions, the Delaware Supreme Court has held in *Flood v. Synutra International, Inc., et al.*, No. 101, 2018 (Del. Oct. 9, 2018), that the *MFW ab initio* requirement is satisfied so long as the controller conditions its offer on both of the requisite procedural protections prior to the commencement of any economic negotiations between the special committee and the controlling stockholder.

Ab Initio Means Before Economic Negotiations Commence

In *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014) ("*MFW*"), the Supreme Court established that the business judgment rule will apply to a going private transaction proposed by a controlling stockholder when the controller conditions the transaction *ab initio* on two key procedural protections—approval by an independent, adequately empowered special committee that complies with its duty of care and the uncoerced, informed vote of a majority of the minority stockholders.

Confronted with a situation where the controller did not include the requisite conditions in his initial written offer, the Court nevertheless found that the *MFW* requirements were satisfied because the controller's second offer contained the requisite conditions and preceded any economic negotiations with the special committee.

Further, the Court overruled its prior dicta in footnote 14 of the *MFW* opinion in which the Court suggested that a plaintiff, in asserting a due care claim, may avoid application of the business judgment rule by challenging the sufficiency of the price. The Court clarified that "a plaintiff can plead a duty of care violation only by showing that the Special Committee acted with gross negligence, not by questioning the sufficiency of the price."

The *Synutra International* case involved a proposal by Liang Zhang to acquire the approximately 36.5% of the stock of Synutra International that he did not already own. Zhang's initial offer to Synutra was not conditioned on either special committee approval or a vote of a majority of the minority stockholders.

Shortly after the formation of a special committee, however, Zhang sent a second letter to the newly-formed special committee that did contain these requisite conditions. As the Supreme Court explained in affirming the Court of Chancery's dismissal of the action based on compliance with *MFW*, this second letter satisfied the *ab initio* formulation, coming as it did in the "beginning" of the process and before economic negotiations commenced.

As the Court stated, "so long as the controller conditions its offer on the key protections at the germination stage of the Special Committee process, … and has not commenced substantive economic negotiations with the controller, the purpose of the pre-condition requirement of *MFW* is satisfied."

Dissent: *Ab Initio* Means At the Time of Initial Formal Proposal

In a lengthy dissent, Justice Karen Valihura took issue with the Majority's adoption of a "when the negotiations begin" test. In Justice Valihura's view, in order to obtain the benefits of the *MFW* standard, the dual protections must be contained in the controller's initial formal written proposal.

Advocating for a more bright-line approach, Justice Valihura observed that the Court may have "muddied the waters" when it summarily affirmed a dismissal in *Swomley v. Schlecht*, C.A. No. 9355-VCL (Aug. 27, 2014) (TRANSCRIPT), *aff'd*, 128 A.3d 992, 2015 WL 7302260 (Del. 2015) (TABLE), where the dual *MFW* conditions were satisfied at the start of the negotiations. Justice Valihura indicated that her "initial formal written proposal" approach would aid the courts in ascertaining the proper standard of review.

Carve-Out Transactions: Negotiated Issues & Diligence Matters for Buyers

By Eva Davis, Kyle Gann, Rachel Ingwer and Becky Troutman, Partners of Winston & Strawn LLP

Value creation in the M&A industry is equal parts art and science. Success in the deal-making space requires an ability to identify assets that present an opportunity to create value, paying enough to win the deal (but not significantly more) and avoiding unnecessary risks. One of the core functions of a deal lawyer is to help a client identify and think practically about risks and provide creative solutions to mitigate them.

This is the second in a series of three articles that explores the ways to maximize value, and avoid hazards, in carve-out acquisitions.[1] In this article, we explore how buyer's counsel can add value to a transaction by focusing on key negotiated issues and diligence matters. Fundamental to the ability to provide value added services in a carve-out transaction is acquiring robust knowledge of the facts of the deal and the target business.

Scope of the Assets to Be Sold

Factual mastery is critical to understanding and negotiating the scope of the assets subject to the transaction. In describing the assets, parties typically use one of four variations that operate on a sliding scale of most inclusive to least inclusive: (1) buyer gets all of the assets used in the business, (2) buyer gets the assets

[1] The first article in this series, *"Maximizing Value & Minimizing Risks in Carve-Outs: Seller's Pre-Sale Preparation,"* appeared in the May-June 2018 issue of *Deal Lawyers*.

primarily used in the business, (3) buyer gets the assets necessary for the business, or (4) buyer gets the assets exclusively used in the business.

As a general rule, buyers tend to expect an asset conveyance mechanic that delivers at least all of the assets primarily used in the business. But one size does not fit all in complex transactions. For instance, a strategic seller who is engaged in a wider restructuring or who has a number of business divisions with inter-related assets (such as intellectual property) may be reluctant to agree to a "primarily used" standard. In contrast, buyer may not be willing to accept responsibility for certain assets primarily used in the business if those assets are viewed as a cost center, a drag on profitability or source of undue liability exposure.

As a result, parties will often slice and dice these general variations on an asset class by asset class basis, which are often further clarified and modified by lengthy schedules. For example, buyer will typically obtain all of the inventory used in the business, but it is not unusual for seller to convey the business without financial or accounting staff, IT systems or a fully staffed sales force.

These complex waterways are often only navigable with an experienced and factually informed helmsman. For instance, if seller only wants to convey intellectual property used exclusively in the business, what's being left behind? Is there an alternative conveyance mechanic, such as a license agreement? What's the practical impact of that alternative structure? What representations ensure that buyer is getting everything it needs? And what's the remedy for breach of those representations? This level of detailed knowledge allows parties to navigate the tensions that often arise in carve-out transactions.

Transition Services Agreement

Since it is unlikely that buyer will acquire all the assets used in the operation of a carved-out business, buyer will often enter into a transition services agreement (or "TSA") with seller. Under a TSA, seller provides services that are delivered by assets (and employees) that are not "going" with the target business.

Typical transition services include IT systems and support, finance and accounting functions, and other human resources. More complex transition services may contemplate short-term sharing of physical space or manufacturing capabilities between the acquired and retained business. The diligence challenge for buyer is determining the services needed, describing each service appropriately and determining how long the services are needed and at what price.

Buyers are often able to obtain comfort when the senior management team is coming with the business. In such circumstances, the management team will be aligned with buyer in identifying necessary transition services and applicable duration and costs for those services. Another potential source of comfort with respect to the reasonability of the legal terms (though not necessarily the scope of the schedules) may arise in circumstances where seller needs buyer to provide services back to it under a "mutual" or "reverse" TSA. In situations where both parties have an interest in ensuring continuity of post-closing services, it tends to push them toward the middle on legal terms.

Thus, the first step in negotiating a transition services agreement is making an assessment of (1) with which party the management team is aligned for purposes of negotiating the TSA, and (2) the relative strength of the interests of the parties in the services flowing under the TSA. Although, in our experience, it is not uncommon for parties to view the TSA as a simple ancillary agreement, this is often a mistake.

It is important to remember the critical function served by a TSA: to ensure operational continuity of the acquired business and/or retained business. Achieving this objective requires close coordination between the lawyer(s) negotiating the TSA and the operators negotiating the schedules to the TSA.

Key issues that need to be thoughtfully considered include:

- Scope of Services. What happens if, after closing, buyer discovers that the TSA did not account for a service that it needs to smoothly transition the business? Is seller obligated to provide those additional services? Or, is buyer's recourse limited to making an indemnity claim under the purchase agreement (*e.g.,* breach of the "sufficiency of assets" representation)?
- Enterprise Software. Enterprise software may be a fundamental component for the efficient operation of a business, but may not be transferred in a carve-out transaction. Accordingly, buyer will need

to diligence how the enterprise software is used in the business and whether it needs the right to access and use the software during the transition period or can rely on seller using the software for its benefit in performing transition services.

The TSA will also address responsibility for obtaining and paying any required third party consents to use such enterprise software. Buyer will also need to (1) determine whether it needs to negotiate and purchase its own licenses from the vendors or transition the software functionality to new vendors, and (2) consider what data migration will be necessary for any transition.

- Duration of Services. What is the term of the TSA and is it extendable? Does extension trigger additional costs? Is the duration reasonable in light of the other post-closing drains on management time (*e.g.,* purchase price adjustments, implementing buyer's business plan, realizing synergies)?
- Access & Standard of Care. Does the service recipient have unfettered access to the service provider's employees or is it channeled through key contacts? Is availability restricted to normal business hours? Is there a general standard of care applied to the service provider and, if so, what is it?
- Cost. The practical reality is that while buyers may desire TSA services to be provided at no (or low) cost, if seller is not adequately compensated for such services, it may delay providing them, provide them at only a very basic level, or may not provide them at all. As such, most buyers provide payments beyond deal purchase price to seller for TSA services.

  In such cases, buyer needs to assess how the fees are determined. There are many options: (1) the cost-basis reflected in the historical financials, (2) actual cost (or cost-plus) basis, or (3) some flat fee basis. In assessing appropriate methodologies, buyers will need to balance concerns over maintaining simplicity (which may dictate flat fees) with consistency with the deal model (which may require more complexity, but dictate historical cost basis).
- Reverse TSA and Synergy Recognition. If buyer is providing reverse services, what impediment does that pose to the realization of deal synergies (*e.g.,* pursuant to a reduction in head count or warehousing space)? Is buyer appropriately compensated under the TSA for any delayed recognition of synergies? If buyer is allowed to require seller to provide additional services that were not properly identified on the TSA schedules, is it appropriate for that concept to be reciprocal? Or would reciprocity pose risk to timely recognition of synergies?
- Remedies. If the service provider does not perform, what are the remedies for breach? Are damages under the TSA limited in a meaningful way? For instance, it is not uncommon for seller to seek damages caps (*e.g.,* at the fee for such service, the total fees contemplated by the TSA, or some multiple of fees). Additionally, seller will often also seek to exclude recovery for consequential damages.

  As a result of these limitations on recoverable damages, buyer may not have dollar for dollar recovery for damages suffered under the TSA. In those situations, can buyer seek specific performance of seller's obligations? Or, is there an escalation mechanic under the TSA that has to be complied with prior to seeking judicial relief?

Representations Related to Assets Sold and Financial Statements

1. Sufficiency of Assets Representations.

In a carve-out, buyer will need assurances that it can run the business after closing. It obtains this assurance via the "sufficiency" representation, which provides that the "purchased assets" (together with the transition services agreement and any intellectual property license agreement) comprise all of the assets "sufficient" for the conduct of the target business "as currently conducted" or "as conducted for the 12 months prior to the closing" or words to similar effect.

However, seller may seek to impose limitations on sufficiency representations. Examples of such limitations include using the phrases "necessary" or "required" (as opposed to "sufficient") or through other qualifications embedded in the representation, such as the assets will be sufficient "in all material respects" or will be sufficient to conduct the business "in substantially the same manner" conducted prior to closing.

Seller may also seek to limit the scope of the assets covered by the representation (*e.g.,* to tangible assets). If these kinds of limitations are imposed, buyer needs to consider whether it has protections through other representations (such as an IP specific sufficiency representation) or the limitations are otherwise acceptable (*e.g.,* because intangible assets are not meaningful to the business or because materiality qualifications are scraped for purposes of indemnity recovery).

But, the strength of the sufficiency representation is just the first step. What happens in the event of breach? Are there limitations on recovery? For instance, the sufficiency representation could be framed as a regular operating representation (*e.g.,* subject to short survival and inside the caps and baskets), a fundamental representation (*e.g.,* outside the caps and baskets and subject to extended survival) or a hybrid/quasi-fundamental representation.

2. Financial Statements Representation

Another critical representation is the financial statements representation. While the financials often form the basis of purchase price, a representation on the financial statements is typically subject to meaningful limitations.

First, the representation is usually framed as an operating representation, which means that, absent fraud, the timeframe for discovering breach will be limited and recoverable damages will be subject to indemnity caps and baskets. Secondly, the negotiation of these representations can be further complicated in carve-out transactions. For example, in a carve-out transaction, financial statements are often unaudited and seller may seek to impose qualifications that they may not accurately reflect the standalone costs of the target business.

It is not unusual for buyer and seller to heavily negotiate the financial statement representation, including whether the carve-out financial statements have been prepared in accordance with generally accepted accounting principles and present fairly in all material respects the financial position, results of operations and cash flows of the target business on a standalone basis.

Ultimately, buyer will need to assess whether, in light of meaningful limitations on recovery for breach of financial statements, it can get comfortable through diligence with the nature and quality of the financial statements representation delivered in the deal.

Other Key Diligence Questions (and Related Contract Drafting/Modifications)

Buyer also needs to answer the following key questions in the diligence process in a carve-out transaction and address these issues in the acquisition agreement.

1. Spotlight on Intellectual Property

Intellectual property assets ("IP"), if licensed from a third-party, may have special costs associated with the transfer, and such costs need to be allocated between the parties. In addition, it is common for IP to be used in both the carved-out business and the retained business ("shared IP"). Common examples include:

- Software used in the products, services or operations of both businesses;
- Trademarks used to brand the products and services of both businesses; and
- IP licensed from third parties for use in both businesses.

The parties need to determine who will own the shared IP and who will receive a license. They also need to evaluate the appropriate structure of any license. Is it a one-way license or a cross-license?

In order to address these issues, the parties need to understand the nature and materiality of the IP, the current ownership structure and how the IP is used and planned for use in each of the subject businesses. Furthermore, buyer will want to understand whether (1) the IP was developed for the target business or by its employees, and (2) there are patent rights that cover the products and services of the business.

If there are key patents or other IP that buyer wants to enforce against third parties, it will need to own the IP or obtain an exclusive license (and seller's obligation to cooperate in any enforcement action). If seller retains ownership, buyer will also expect seller to maintain the IP.

The parties also need to settle on the scope of any license. This may be structured narrowly (patents, trademarks and other intellectual property assets specifically identified in the IP license), broadly (as categories of IP), or even more broadly (as all IP in the perimeter that is used in the other party's business). However structured, the recipient of the license will want to ensure that (1) it obtains all rights necessary to exploit the licensed IP, and (2) natural extensions and evolutions of the IP and its business are covered.

Other critical issues to negotiate in a license include:

– Sublicense or transfer rights (including in connection with a divestiture);
– Exclusivity and territory; and
– Termination rights and the effect of termination.

If the carved-out business uses "house" branding of seller (such as seller's name and logo used across all of its businesses), a transitional license may be needed for the relevant trademarks.

Buyer needs to understand how the licensed trademarks are used in the business (including whether they are embossed on products using customized tooling or otherwise embedded in products such as software), the inventory of products bearing the trademarks, what actions are required to cease use of the trademarks, and how much time it needs to complete those actions.

Buyer should consider whether (1) there are contracts with customers or other third parties that obligate it to sell products under the licensed trademarks or otherwise restrict its ability to rebrand, and (2) it needs different transition periods for different types of use of the licensed trademarks.

2. Intercompany Arrangements & Credit Support

Are there any intercompany arrangements necessary to the business case for the transaction? For example, if the retained business and target business were vertically integrated, does a commercial agreement need to be negotiated between buyer and seller and put in place at closing?

Are there existing credit support arrangements that may affect material contracts? For instance, are there parent company guarantees that need replacement? Can buyer provide a sufficiently credit-worthy replacement guarantor or is it a platform acquisition by a private equity fund?

Similarly, do key contracts include provisions relating to group financials of the retained business that need to be renegotiated? Are there letters of credit that require replacement (which will either take up capacity under buyer's debt facility or will need to be cash collateralized)?

3. Fully Assigned Contracts; Shared Contracts; Bargaining Power

Are there key contracts that cannot be partially assigned? For example, do each of the retained business and the target business sell products to a customer under one agreement?

Do the retained business and the target business license IP necessary for the operation of the retained business and the target business under one agreement? Is it even feasible to "split" the contract? Or will one party keep the contract while the other party negotiates a new contract?

What is the consequence of separating these commercial relationships? Does the target business risk a loss of bargaining power, increase in its cost basis or revenue loss?

4. Real Estate

Is the real estate used in the target business owned or leased? Will it transfer with the business? Or, will it stay with the retained business and be leased to the target business? On what terms? Will any landlord consents be required?

If there is any future "shared space" (reception, open floor plan, restrooms, lunch rooms, parking), are there additional contract provisions needed to protect confidential information, to comply with regulatory requirements or to delineate how shared space will be used and maintained? Will there be "hard" (maintenance) or "soft" (security, HVAC and electricity) costs that need to be shared on an ongoing basis?

5. Employees and Employee Benefit Matters

While employees are not assets and can freely choose where to work, buyer and seller often agree which employees will be offered jobs with buyer, which will not, whether buyer has access to such employees prior to closing, whether seller has the ability to solicit or hire such transferred employees post-closing and who has severance obligations for employees who transfer with the target business (and those who do not transfer with the target business and whether this is treated differently if it results from employee choice).

Buyers will want to ensure that seller is not keeping “the best” employees (or that buyer is not being stuck with employees unnecessary for the business, especially if they are poor performers). Moreover, since large reductions in force may implicate the WARN Act, buyer needs to diligence staff reductions (either because seller is terminating employees in the transaction who are not being rehired by buyer or because buyer may have plans to implement a reduction in force).

Another key point is whether closing is conditioned on the retention of certain employees. In current market conditions, which tend to be seller-favorable, deal certainty has become king and there are usually limited closing conditions. However, the parties will often spend time arguing over how retention costs for key employees should be allocated.

Seller will argue that it is buyer’s problem to provide sufficient incentives for employees to stick with the business, while buyer will argue that these costs are part of the cost of conveying the business. This discussion may become even more nuanced as the parties argue over who bears the cost of retention arrangements put in place prior to the closing but triggered post-closing.

To the extent seller is required to bear post-closing obligations, different mechanics may be utilized (*e.g.,* purchase price deduction at closing, escrow of likely obligations or contractual obligation of seller to make the payment in the future).

Another key consideration is post-closing benefits. In a typical carve-out transaction, employee benefit plans stay with seller. This is because enterprises tend to operate benefit plans that cover the full enterprise (there are rarely separate plans at each business division).

Sellers often seek to impose obligations on buyer to maintain “the same”, “comparable”, “at least as favorable,” salary, bonus opportunity and benefits “in the aggregate” or “in all material respects” for some period of time post-closing.

The reasons for doing so include (1) preserving its ability to maintain intact the business during the executory period (both to ensure covenant compliance and to protect the business if the deal falls apart after signing), (2) reputational concerns (*i.e.*, of being a good employer), or (3) obligations to pay severance to employees if certain ongoing compensation and benefits are not provided by buyer after closing.

On the other hand, buyer may be concerned that costs associated with employee benefits may not be accurately reflected in carve-out financial statements. Furthermore, buyer may view seller’s cost-basis in its employees as too high (and reducing these costs may be an anticipated synergy).

Some concerns may also be driven by the nature of buyer. A strategic buyer, for instance, will typically have its own existing employment arrangements and may not be willing to agree to maintain the same compensation structure and benefits as seller (but may be willing to agree that target employees will receive benefits comparable to its own existing employees of similar rank).

Unless it’s an add-on acquisition, a financial buyer will not have existing benefit plans to offer to the transferred employees and instead will have to create new plans. In such circumstances, buyer often lacks the buying power of seller and may not be able to implement comparable plans at comparable costs.

6. Cross-Border M&A

In carve-outs, it is important for buyer to understand the ownership structure of the assets and to determine the location of the assets. This is particularly important in cross-border M&A, where there may be multiple sellers with assets in multiple jurisdictions and where each jurisdiction has its own rules governing conveyance mechanics, employee approvals, allocation of purchase price and VAT, bulk sales, or other transfer taxes imposed on the sale of assets.

As part of a carve-out transaction, seller may implement a pre-closing restructuring to move assets around and to clean up intercompany balances. Any such reorganization needs to be carefully considered, as it can impact consent analysis, transfer pricing issues and other tax matters.

For instance, transfers involving movements of IP create particularly complex U.S. federal income tax issues. Typically, buyer will require that the cost (including the tax cost) of any pre-closing restructuring be borne by seller.

The purchase price (and relevant liabilities) will need to be allocated among all of the acquired assets in an asset carve out. The parties may agree to a methodology for such allocation up front; however, it will usually be impossible to agree to a specific dollar allocation prior to closing.

If there are multiple sellers in different jurisdictions, seller may have strong opinions regarding how purchase price should be allocated to minimize gain in high tax jurisdictions. While buyer will try to be accommodating, it is likely to have its own preference for purchase price allocation, which will take into account factors like whether a jurisdiction provides any benefit for a basis-step up.

In addition, as a result of the new GILTI (global intangible low-tax income) tax, U.S. buyers who acquire assets in foreign subsidiaries treated as corporations will be particularly concerned with purchase price allocation. This is because these rules generally serve to impose tax on certain U.S. shareholders of foreign corporations to the extent the income of the foreign corporation exceeds a permissible return on the fixed assets of such foreign corporation. Accordingly, U.S. buyers generally want to maximize allocation to fixed assets acquired by controlled foreign corporations to minimize the amount of GILTI.

Another factor in allocating purchase price among assets is the applicable transfer taxes (including VAT). For example, if Country X imposes a VAT on the sale of business assets in Country X but Country Y does not, the parties may be incentivized to allocate more value to Country Y assets and less value to Country X assets.

Where transfer tax is unavoidable, the parties will carefully negotiate who is responsible for payment and filing transfer tax returns. The parties commonly agree to split transfer taxes in order to incentivize cooperative efforts to lower the liability. However, if a transfer tax results from structuring a transaction to accommodate one party, that party may be expected to be responsible for the resulting liability. To the extent the parties are able to obtain a refund on a transfer tax, this refund will generally be divided in the same manner as the underlying responsibility for the tax.

Conclusion

In order to maximize value in a carve-out transaction, buyer will need to engage in detailed diligence and deal negotiations. These negotiations will be designed to ensure it buys the assets it needs and has sufficient contracts in place (on acceptable terms) in order to position the target business for future success.

A deal lawyer can be a key player in identifying key issues and drafting and negotiating definitive deal documents that avoid landmines in carve-out transactions. Further, a deal lawyer can use complexity as an opportunity to position a client to acquire a business that others may not be able to sufficiently diligence, understand and document on the timeframes desired by seller.

Delaware Chancery Holds Contractual Appraisal Waivers Valid

By Joanna Cline and Matthew Greenberg, Partners, and Taylor Bartholomew and Christopher Chuff, Associates, of Pepper Hamilton LLP

In a recent opinion, the Delaware Court of Chancery, for the first time, held that contractual provisions in stockholder agreements barring common stockholders from exercising their statutory appraisal rights are enforceable as a matter of law, so long as the stockholders voluntarily signed the stockholder agreement in return for consideration, such as investment in the company.

The decision, *Manti Holdings LLC v. Authentix Acquisition Co.,* C.A. No. 2017-0887-SG (Del. Ch. Oct. 1, 2018), holds that appraisal waivers do not violate section 151(a) of the Delaware General Corporation Law (DGCL) and, in so doing, brings additional certainty to private equity and venture capital investors whose investments include drag-along rights with appraisal waivers.

Background & Analysis

In 2008, Authentix Acquisition Co. and its stockholders entered into a stockholder agreement to facilitate the investment of a group of investors, collectively referred to in the opinion as the Carlyle Group.

The stockholder agreement provided for drag-along rights, which required the stockholders to consent to a sale of Authentix (whether by merger or stock sale) if such a sale was approved by the holders of at least 50 percent of Authentix stock. The stockholder agreement also required the stockholders, including the plaintiffs, to refrain from exercising any appraisal rights in connection with such a sale.

After the stockholder agreement was signed, a majority of Authentix stockholders resolved by written consent to sell Authentix to a third party. Despite the fact that they had signed the stockholder agreement, certain stockholders sought to perfect their supposed appraisal rights and brought suit against Authentix seeking statutory appraisal pursuant to section 262 of the DGCL. In seeking appraisal, the plaintiff stockholders argued that their appraisal rights were not waived.

First, the plaintiff stockholders made a number of textual arguments regarding the language of the drag-along provisions. For instance, because the drag-along provisions stated that the stockholders were to "refrain from exercising" their appraisal rights, as opposed to "waiving" those rights, the plaintiffs maintained that their appraisal rights did not extinguish. According to the plaintiffs, the provisions merely obligated them to delay the exercise of those rights until after closing.

The court disagreed, finding that reading to be an unreasonable interpretation of the provision. Although the use of the word "waive" might have been clearer, the court ultimately held that the use of the term "refrain" unambiguously extinguished the stockholders' appraisal rights.

Second, the plaintiff stockholders argued that the drag-along rights, if construed to include an appraisal waiver, were unenforceable because they violated section 151(a) of the DGCL. As a general rule, holders of common stock in a Delaware corporation are entitled to appraisal rights in accordance with section 262. Further, section 151(a) requires that limitations on classes of stock must be set out in, or derived from, the corporation's certificate of incorporation.

Thus, the plaintiffs argued that to be enforceable, a waiver of appraisal rights must appear in the certificate of incorporation pursuant to section 151(a), and that appraisal rights cannot be waived by contract, such as a stockholder agreement.

The court disagreed, finding that enforcement of the appraisal waiver in the stockholder agreement is "not the equivalent of imposing limitations on a class of stock." It reasoned that the stockholder agreement "did not transform the [plaintiffs'] shares of stock into a new restricted class."

Rather, "individual stockholders took on contractual responsibilities in return for consideration," which included refraining from seeking appraisal. These contractual obligations, the court held, are enforceable and do not violate section 151(a).

Key Takeaways

Before the court issued its opinion on October 1st, the question of whether drag-along rights with an appraisal waiver could be enforced to prevent common stockholders from seeking appraisal was an open question under Delaware law.

Indeed, although the Court of Chancery previously held that prospective waivers of preferred stockholders' appraisal rights (which are largely contractual) are enforceable, no prior Delaware decision addressed the question of whether common stockholders can prospectively waive, by contract, the right to seek statutory appraisal. The court's decision answers that question in the affirmative and, in so doing, brings further certainty to private equity and venture capital investors whose investments include drag-along rights with appraisal waivers.

Another takeaway from the decision is that, even though there is now clear authority upholding drag-along rights with appraisal waivers, plaintiff stockholders will still seek to challenge the effectiveness of those waivers on interpretation and ambiguity grounds. Drag-along provisions with appraisal waivers should therefore be carefully drafted in order to achieve the desired effect of such provisions.

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