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## INSIGHTS

### Using the “Material Adverse Change” Condition to Terminate

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According to a recent decision of the Delaware Court of Chancery, a buyer may rely on the material adverse change condition (also known as a “material adverse effect”, “MAC” or “MAE” condition) to terminate an acquisition agreement if the change in the target company *“substantially threatens the overall earnings potential of the target in a durationally-significant manner” ... “measured in years rather than months.”*

Almost every merger or acquisition agreement contains a closing condition in favour of the buyer that the target company not suffer a MAC prior to closing but courts have historically been reluctant to conclude that a MAC has occurred. However, recently and for the first time, the Delaware Court of Chancery ruled (in *Akorn, Inc. v. Fresenius Kabi AG, et al.*) that a buyer had properly relied on a MAC condition in terminating an acquisition agreement. The burden for a buyer in establishing that a MAC has occurred remains high but the court’s decision does establish that court will, in the right circumstances, conclude that a MAC has occurred. It also provides more clarity on the threshold that must be achieved for a court to conclude that a MAC has occurred. This is important as the Delaware Court is considered the leading commercial court in the United States and its decisions are influential in Canada.

In the case being considered by the Delaware Court, after signing the merger agreement the target company’s financial performance declined significantly due to unexpected market competition and the loss of a key contract. For the 2017 year, the target company’s revenue, operating income, and earnings per share fell by 25%, 105% and 113%, respectively, and those declines continued through Q1 2018. In contrast, the target company had shown continuing growth over the prior five years. In addition, the target company’s financial performance prior to the execution of the acquisition agreement did not show any signs of the significant decline ahead. The court determined that the deterioration in the target company’s financial performance constituted a MAC.

In its decision, the court clearly articulated that it was not establishing a bright-line test and that all factors in each case need to be considered and weighed. But, as indicated earlier, the court stated that a MAC must “substantially threaten the overall earnings potential of the target in a durationally-significant manner,” and that the relevant period is “measured in years rather than months.” If that threshold is met, the court will agree that a MAC has occurred. Buyers and sellers should consider this guidance when negotiating their acquisition agreements to ensure they understand how and when the MAC condition can be used.

#### Invitation for Discussion:

If you would like to discuss this article in greater detail, or any other business law matter, please do not hesitate to contact one of the lawyers in the Business Law group at Nerland Lindsey LLP.

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