SIGNIFICANT 2021 DECISIONS AFFECTING PRIVATE COMPANY M&A

Arnold&Porter

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This newsletter is our eigth annual review of significant state court decisions relevant for private company M&A transactions and related governance matters and disputes.

Express Scripts, Inc. v. Bracket Holdings Corp., 248 A.3d 824 (Del. Feb. 23, 2021)

Summary

Delaware Supreme Court held that Abry's prohibition on sellers from excluding seller liability for fraud under the acquisition agreement only applies to intentional fraud; under Delaware law, fraud based on recklessness can be excluded.

Background

Express Scripts involved an appeal from an $82.1 million jury award to an affiliate of a private equity fund (buyer) against sellers of businesses acquired by buyer for fraudulently inflating revenue and working capital of one of the acquired businesses. The fraud claim was based on financial statement representations and warranties under the securities purchase agreement (the SPA). The issue on appeal was whether the jury in the Delaware Superior Court action was properly instructed to consider both deliberate fraud and recklessness. In reversing the Superior Court's judgment and remanding for a new trial, the Supreme Court held that the relevant provisions of the SPA permitted recovery only for intentional fraud, and that limiting recovery for fraud under the SPA in this manner was permissible under Delaware law.

ABRY Partners

The court noted the tension articulated in *ABRY Partners V, L.P., v. F&W Acquisition LLC*,[1] between the "strong tradition in American law that holds that contracts may not insulate a party from damages or rescission resulting from the party's fraudulent conduct", and the "strong American tradition of freedom of contract."[2] The *Express Scripts* court noted that the *Abry* court resolved the tension by holding that a contracting party cannot limit its own liability for fraud that it consciously participated in, but can limit its own liability for fraud where it merely acted "in a reckless, grossly negligent, or negligent manner".

The SPA

The court held that the indemnification framework under the SPA was consistent with the approach endorsed in *Abry*. Section 9.6(D) of the SPA provided (text bolded by the court):

> "NOTWITHSTANDING ANY OTHER PROVISION HEREIN TO THE CONTRARY, EACH OF THE BUYER AND PARENT ACKNOWLEDGES AND AGREES, THAT FROM AND AFTER THE CLOSING, **EXCEPT IN THE CASE OF FRAUD**, PARENT SHALL NOT HAVE ANY DIRECT OR INDIRECT LIABILITY

[1] 891 A.2d 1032 (Del. Ch. Feb. 14, 2006).

[2] *Express Scripts*, 248 A.3d at 830 (citing *ABRY*, 891 A.2d at 1059).

> (DERIVATIVELY OR OTHERWISE) WITH RESPECT TO ANY BREACH OF ANY REPRESENTATION OR WARRANTY (OTHER THAN THE FUNDAMENTAL REPRESENTATIONS) MADE BY PARENT IN THIS AGREEMENT. IN FURTHERANCE OF THE FOREGOING, THE BUYER AND PARENT EACH ACKNOWLEDGES AND AGREES THAT **EXCEPT IN THE CASE OF ANY DELIBERANT [sic] FRAUDULENT (I) ACT, (II) STATEMENT, OR (III) OMISSION** (1) THE SOLE AND EXCLUSIVE REMEDY OF WITH RESPECT TO ANY BREACH BY PARENT OF ANY REPRESENTATION OR WARRANTY (OTHER THAN THE FUNDAMENTAL REPRESENTATIONS) CONTAINED IN THIS AGREEMENT SHALL BE SATISFIED SOLELY FROM THE R&W INSURANCE POLICY. .”

The court held that this unambiguously provided that except in the case of deliberate fraud, the buyer’s exclusive remedy for breach of the general representations and warranties was the representation and warranty insurance policy (the R&W Policy). The court held that this interpretation was supported by language in the buyer’s representations and warranties relating to the R&W Policy, which contained exceptions from a representation that the R&W Policy would not create liability for sellers, and from the obligation to include a waiver on subrogation rights, in connection with deliberate fraudulent acts, statements or omissions.

The court rejected the buyer’s arguments that various references in Article 9 and elsewhere in the SPA to fraud, without referencing deliberate fraud, evidenced a coherent drafting approach that permitted buyer to recover for common law fraud, including fraud based on recklessness. The court noted that Section 9.6(D) expressly superseded other provisions of the SPA, and that while the first sentence of Section 9.6(D) referenced fraud generally, the second sentence, which referenced deliberate fraud, followed on from, and refined, the first sentence. The court also rejected the buyer’s grammatical arguments that the word “deliberate” in Section 9.6(D) qualified the words “act”, “statement” and “omission”, and not the word fraudulent”, and that “deliberate” fraud can include recklessness.

Takeaway

The decision provides useful confirmation of the scope of *Abry*, which is the seminal decision on the permissibility of limiting liability for fraud in M&A transactions. *Express Scripts* confirms that the approach taken in many deals of limiting the fraud exclusion from the exclusive remedies under the acquisition agreement to just intentional fraud is permissible under Delaware law. *Express Scripts* also serves as a reminder to parties of the importance of having a clear definition of fraud in acquisition agreements and ensuring that it is consistently used.

Manichaean Cap., LLC v. Exela Techs., Inc., 251 A.3d 694 (Del. Ch. May 25, 2021)

Summary

In case of first impression, Delaware Chancery Court adopted theory of “reverse veil piercing” to permit plaintiffs to pierce the corporate veil to enforce an award against the judgement debtor’s subsidiaries.

Background

Plaintiffs were former stockholders of SourceHOV Holding, Inc. (the Company), a company that was acquired by defendant Exela Technologies, Inc. in a merger in which shares of common stock of the company were converted into the right to receive a membership interest of an affiliate of Exela. The merger and related follow-on merger resulted in the Company becoming an indirect subsidiary of Exela.[3] Plaintiffs exercised dissenters rights and commenced an appraisal action in the Delaware Court of Chancery. The court appraised the fair value of the common stock at $4,591

[3] The court’s decision refers to the Company becoming an indirect subsidiary of Exela, but an org chart in the decision indicates that the Company may have converted into an LLC in connection with the mergers. Whether the Company ended up becoming a corporation or an LLC following the mergers does not appear to be critical to the decision.

per share, resulting in plaintiffs' shares being worth $57,684,471. The decision was affirmed on appeal by the Company.

When the Company did not pay, plaintiffs obtained a charging order against the Company's membership interest in SourceHOV, LLC, pursuant to Section 703 of the Delaware Limited Liability Company Act (DLLCA). The charging order required that any upstream distributions made to the Company had to be paid over to plaintiffs. This was intended to prevent funds from the Company's operating subsidiaries being dividended upstream to Exela, and leaving the Company with no ability to pay the appraisal judgment award. However, a few weeks before the appraisal award, Exela entered into a $160 million accounts receivable facility (the A/R Facility), in connection with which most of the operating subsidiaries sold their accounts receivable to a new receivables entity, which pledged them as collateral for loans and letters of credit to be issued to the receivables entity. This effectively circumvented the charging order because it allowed value at the subsidiary level to be appropriated by Exela without passing through the Company.

The plaintiffs brought an action against Exela and its subsidiaries based on abuse of corporate form, seeking upwards veil piercing against Exela, and downwards veil piercing against the Company's subsidiaries. The plaintiffs also sought to recover against Exela on the basis of unjust enrichment. Defendants filed a motion to dismiss.

The Court's Decision

The Charging Order

The court noted the origin of the appraisal process as being a *quid pro quo* for abolishing the requirement of unanimous stockholder approval for mergers, and the corresponding importance of actually being able to receive the appraised fair value of shares. The court then considered the impact of the charging order under DLLCA §703. The court noted that Section 703 enables a judgment creditor of a member of a limited liability company to "charge the limited liability company interests of the judgment debtor to satisfy the judgment." Per Sections 703(d) & (e):

> "a charging order is the exclusive remedy by which a judgment creditor of a member . . . may satisfy a judgment out of the judgment debtor's limited liability company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor . . . [A judgment creditor does not] have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company."

The court noted that Section 703 limits the judgment creditor's enforcement mechanism, but does not define the entities that can be subject to the charging order.

Upwards Veil Piercing

The court recounted the Delaware law factors considered when evaluating whether to grant traditional upwards veil piercing: "(1) whether the company was adequately capitalized for the undertaking; (2) whether the company was solvent; (3) whether corporate formalities were observed; (4) whether the dominant shareholder siphoned company funds; and (5) whether, in general, the company simply functioned as a facade for the dominant shareholder."[4] No single factor is determinative. The court found many of these factors present.

Accepting plaintiffs' allegations as true for purposes of the motion to dismiss, the court held that it was reasonably conceivable that the Company was insolvent, given that the Company had "no direct operating assets . . . no bank account, money market account or brokerage account" and given that funds were now bypassing the Company under the A/R Facility. The court noted that Exela was aware of the potential for a large appraisal judgment but decided to avoid having funds flow through the Company.

The court noted plaintiffs' allegations regarding failure to observe corporate formalities, including that Exela: "(1) is headquartered at the same address as [the Company], (2) has failed to maintain proper business registrations for [the

[4] *Manichaean*, 251 A.3d at 706 (citing *Doberstein v. G-P Indus., Inc.*, C.A. No. 9995-VCP, 2015 WL 6606484, at *4 (Del. Ch. Oct. 30, 2015)).

Company], (3) has significantly overlapping personnel with [the Company], (4) has referred to Exela and its subsidiaries as one combined enterprise in SEC filings and (5) requires [the Company] to obtain Exela's consent before [the Company] may pay its own creditors. The court held that plaintiffs had sufficiently alleged fraud and injustice as a result of Exela's entry into the A/R Facility in order to divert funds away from the Company. Given the foregoing, the court declined to dismiss plaintiffs' claims relating to upwards veil piercing.

Downwards Veil Piercing

The court noted that reverse veil piercing, which consists of imposing "liability on a business organization for the liabilities of its owners", includes insider veil piercing and outsider veil piercing. The former is where the controller of the subsidiary seeks veil piercing, and the latter is where it is a creditor or other third party that seeks veil piercing. Since reverse veil piercing was first considered, and rejected, by Judge Learned Hand in a 1929 decision, some courts have permitted the approach and some have not. Those refusing to allow it have based their rejection on protection of innocent parties, such as shareholders and creditors.

The court considered decisions where reverse veil piercing had been allowed. In *C.F. Trust, Inc. v. First Flight L.P.*,[5] the Virginia Supreme Court recognized the potential for harm to third parties and held that reverse veil piercing would be allowed only if a plaintiff proved the traditional veil piercing elements plus a showing that reverse veil piercing "will not cause harm to 'innocent investors . . . [or] innocent secured and unsecured creditors,' and that there are no other legal or equitable remedies 'availab[le] . . . [for] the creditor [to] pursue.'"[6] Similarly, the court in *In re Phillips*[7] permitted reverse veil piercing where, in addition to the traditional elements, the court assesses "whether there is an inequitable result that can be remedied by piercing. And finally, before authorizing the piercing, the court must consider whether innocent shareholders or creditors would be prejudiced as a result of the piercing".[8] The *Manichaean* court noted that in a federal court decision that purported to apply Delaware law, the federal court held that where: "(1) an LLC has a single member, (2) that LLC is the member's alter ego, and (3) that member is using the LLC as a fraudulent shield against judgment creditors, reverse veil-piercing is a tool available to the court to avoid fraud and injustice when other legal and equitable means are unavailing."[9]

The court then set forth a framework pursuant to which Delaware courts would permit outsider reverse veil piercing in "exceptional circumstances" where there are "egregious facts, coupled with the lack of real and substantial prejudice to third parties." The framework first considers the traditional "alter ego" factors described above, and then considers "whether the owner is utilizing the corporate form to perpetuate fraud or an injustice", focusing on additional factors that include the following:

> (1) the degree to which allowing a reverse pierce would impair the legitimate expectations of any adversely affected shareholders who are not responsible for the conduct of the insider that gave rise to the reverse pierce claim, and the degree to which allowing a reverse pierce would establish a precedent troubling to shareholders generally; (2) the degree to which the corporate entity whose disregard is sought has exercised dominion and control over the insider who is subject to the claim by the party seeking a reverse pierce; (3) the degree to which the injury alleged by the person seeking a reverse pierce is related to the corporate entity's dominion and control of the insider, or to that person's reasonable reliance upon a lack of separate entity status between the insider and the corporate entity; (4) the degree to which the public convenience, as articulated by [the Delaware General Corporation Law and Delaware's common law], would be served by allowing a reverse pierce; (5) the extent and severity of the wrongful conduct, if any, engaged in by the corporate entity whose disregard is sought by the insider; (6) the possibility that the person seeking the

[5] 580 S.E.2d 806, 810-11 (Va. June 6, 2003)

[6] *Manichaean*, 251 A.3d at 712 (citing *C.F. Trust*, 580 S.E.2d at 811).

[7] 139 P.3d 639, 645 (Colo. June 26, 2006)

[8] *Manichaean*, 251 A.3d at 713 (citing *In re Phillips*, 139 P.3d at 646).

[9] *Id.*(referencing *Sky Cable, LLC v. DIRECTV, Inc.*, 886 F.3d 375, 387 (4th Cir. Mar. 28, 2018)).

> reverse pierce is himself guilty of wrongful conduct sufficient to bar him from obtaining equitable relief; (7) the extent to which the reverse pierce will harm innocent third-party creditors of the entity the plaintiff seeks to reach; and (8) the extent to which other claims or remedies are practically available to the creditor at law or in equity to recover the debt.[10]

Applying this framework to the situation at hand, the *Manichaean* court held that it was reasonably conceivable that the Company's subsidiaries were alter egos of the Company and had "actively participated in a scheme to defraud or work an injustice against [the Company's creditors, like the plaintiffs], by diverting funds that would normally flow to [the Company] away from that entity to Exela." The court easily found that the well-plead facts of the complaint were sufficient to satisfy the traditional "alter ego" factors of the framework based on factors such as undercapitalization and failure to observe corporate formalities.

Accepting the allegations in the complaint as true, the court also found that it was reasonably conceivable that certain Company subsidiaries used the A/R Facility to shield proceeds from the plaintiffs. With regard to the additional factors enumerated above, the first factor was satisfied given that the subsidiaries of the Company were wholly owned. With respect to the second and third factors, Exela and certain of the Company's subsidiaries "agreed to the A/R Facility without the involvement or consent, and to the detriment of, the dormant [Company]," indicating dominion and control that caused injury to the plaintiffs. The public interest would be served, pursuant to the fourth factor, by not allowing the defendants to retain the benefits of the merger while simultaneously avoiding their statutory obligations of paying plaintiffs the fair value for their shares by using a sham structure. Defendants scheme to avoid paying fair value supported the fifth factor. There was no evidence of wrong doing by plaintiffs, for purposes of the sixth factor. For the seventh factor, the court held that there was nothing in the complaint to suggest harm to innocent third party creditors, and any argument that the subsidiaries were primary obligors on debt at a level above the company was not something that could be considered at the motion to dismiss stage. For the eight factor, the court held that "it is not clear at this nascent stage of the proceedings that enforcement of the properly placed Charging Order can be achieved through means other than reverse veil-piercing."

Reverse Veil Piercing Not Precluded by Charging Order

The court reasoned that reverse veil piercing does not invoke a new remedy in violation of DLLCA section 703(d), which holds that Section 703 is the exclusive remedy for a judgment creditor of an LLC member or its assignee to satisfy a judgment out of the judgment debtor's LLC interest. Rather, reverse veil piercing merely expands the group of entities against which the charging order can be enforced. To hold otherwise would incentivize judgment debtors to use their subsidiaries to avoid judgments.

Claim for Unjust Enrichment Not Allowed

Plaintiffs alleged that Exela was unjustly enriched by obtaining the Company's assets without paying for them. The court held that the plaintiffs could not avail themselves of the equitable remedy of unjust enrichment both because the charging order provided an adequate remedy at law, and because Section 703(d) provides that the charging remedy is a judgment creditor's exclusive remedy under these circumstances.

Takeaways

The decision provides welcome guidance as to Delaware's position on reverse veil piercing. The court made clear that the framework it set forth only applied to outsider reverse veil piercing, and that it was not endorsing insider reverse veil piercing. The court also noted that outsider reverse veil piercing is available on an "exceptional basis" where not only traditional veil piercing factors are considered, but also a large number of additional factors such as potential harm to third parties and availability of alternative remedies are also taken into account.

The judgment debtor's status as a member of an LLC was a factor in the court's decision. In Delaware (as in many other jurisdictions), a charging order provides the exclusive remedy available to a judgment creditor to satisfy a

[10] *Id.* at 715 (citing Gregory S. Crespi, The Reverse Pierce Doctrine: Applying Appropriate Standards, 16 J. Corp. L. 33, 68 (1990)).

judgment out of the LLC membership interest. In considering the eighth factor of the reverse veil piercing test, the court noted that there did not appear to be other remedies available to the plaintiffs to enforce the charging order. Had the Company's sole subsidiary been a corporation instead of an LLC, it is not clear that reverse veil piercing would have been available.

Snow Phipps Grp., LLC v. KCake Acquisition, Inc., C.A. No. 2020-0282-KSJM, 2021 WL 1714202 (Del. Ch. Apr. 30, 2021)

Summary

Delaware Chancery Court invoked prevention doctrine to require private equity buyer to close acquisition, where buyer's actions had caused debt financing to be unavailable.

Snow Phipps ruled in favor of a seller seeking specific performance against a buyer who, citing a pandemic downturn in the target business and buyer's purported issues obtaining debt financing, refused to close on an acquisition. The court rejected buyer's argument that a material adverse event (MAE) had occurred, finding the pandemic-related downturn in the target's business was temporary and immaterial and that the definition of MAE also included an applicable exception for events related to government directives. The court also found that the seller's cost mitigation efforts did not give rise to a breach of seller's obligation to operate in the ordinary course of business. Finally, the court held that the buyer breached its reasonable best efforts obligation to obtain debt financing and therefore, under the prevention doctrine, buyer could not invoke its purported inability to secure debt financing to avoid closing.

Background

Snow Phipps Group, LLC, a private equity firm (Seller), commenced a process to sell DecoPac Holdings, Inc. (DecoPac), a supplier of cake decorating ingredients and products to in-store bakeries in supermarkets, at the end of 2019. It entered into a stock purchase agreement (SPA) with an acquisition vehicle affiliated with Kohlberg & Company, LLC (Kohlberg),[11] another private equity firm, on March 6, 2020—"at the outset of the COVID-19 pandemic." The buyer's funding package included a debt commitment letter (DCL), equity commitment letter and limited guaranty. Among its terms, the DCL contained a maximum leverage ratio financial covenant (Financial Covenant), and had an expiration date of May 12, 2020. The buyer agreed to seek alternative financing if the funding under the DCL became unavailable.

Around the middle of March, Kohlberg's senior leadership started to develop buyer's remorse. Kohlberg internally developed two downside financial models, one more pessimistic than the other. Kohlberg then called DecoPac to discuss sales information, under the false pretext that the lenders were asking questions. On the call, DecoPac described the decline in sales and a delay in pre-orders, but also customer feedback that there would be a return to normalcy by the end of the summer. Two days after the call, DecoPac sent revised detailed projections to Kohlberg, which Kohlberg immediately dismissed in an internal email as "illogically optimistic."

While waiting for these revised DecoPac projections, Kohlberg prepared its own revised internal projections (the March 26 Model) that were almost as pessimistic as the most pessimistic of the two projections it previously prepared. The court noted that the March 26 Model was significantly less thoroughly developed than DecoPac's revised projections, and the underlying assumptions were "largely unexplained and unsupported at trial." Kohlberg sent the March 26 Model to its lead lenders (not having shared them with DecoPac), with a demand for changes to the DCL (the Financing Demands). These changes included an increase in the revolver size from $40 million to $55 million, an

[11] For simplicity, this summary refers to Kohlberg & Company, LLC and various affiliated entities generically as "Kohlberg" or the "buyer," unless the context requires otherwise.

addback for lost revenue from COVID-19, which it initially requested be uncapped but then revised to be capped at $35 million, and a holiday from testing the Financial Covenant. The lenders refused these changes, but confirmed they would still close under the existing terms of the DCL. Kohlberg then spent four days going through the motions of seeking alternative financing, without success.

In early April, Kohlberg communicated to Seller that it was unwilling to close, based on a belief that the closing conditions would not be satisfied—including because of the occurrence of an MAE—and that debt financing was unavailable. During the first half of April, Kohlberg received sales data that was materially better than indicated in the March 26 Model, but Kohlberg did not update its model. Seller and DecoPac filed a lawsuit on April 14, 2020,[12] seeking specific performance of the obligation to close. On April 20, 2020, Kohlberg delivered a notice to Seller and DecoPac purporting to terminate the SPA.

The Court's Analysis

In ruling on Seller's claims,[13] the court interpreted various provisions of the SPA.

No MAE

In considering Kohlberg's claim that DecoPac suffered an MAE under the SPA, the court looked to the recent decision in *Akorn, Inc. v. Fresenius Kabi AG*,[14] and noted that decreases in profits of 40% or more have typically been found to give rise to an material adverse effect, and that an earnings decline of 50% over two consecutive quarters would probably also give rise to one. The court held that DecoPac's performance during the two quarters prior to termination "were nowhere near that range", noting that DecoPac's Q4 2019 EBITDA increased 15% year-over-year, and its Q1 2020 EBITDA decreased only 16% year-over-year.

The court rejected Kohlberg's argument that at the time of termination, it was reasonable to expect that DecoPac's sales decline would reasonably be expected to have an MAE, where there were year-over-year sales declines of 42.4%, 63.9%, 60.3%, 62.2%, and 53.4% for each of the five weeks prior to termination. The court rejected the argument by Kohlberg's expert regarding a shift from custom cakes, which may incorporate DecoPac's products, to thaw-and-sell cakes, which do not, because DecoPac was starting to make sales in the thaw-and-sell industry. The court also found Kohlberg's expert's opinion that DecoPac's sales were expected to remain flat from April 2020 through the end of the year was unreasonable given the upward trend in sales prior to termination. The court looked to the parties' contemporaneous projections as evidence of what was objectively reasonable to expect. The court noted that DecoPac management projected that 2020 revenue and EBITDA would be 11% and 22% lower, respectively, than that budgeted. The court noted that the higher of Kohlberg's original two projections projected revenue and EBITDA shortfalls of 15% and 27%, respectively, and that 2021 revenue and adjusted EBITDA would be 2% and 5% higher, respectively, than in 2019.

The court noted that in the seminal *IBP* decision,[15] a 64% decrease in year-over-year first quarter earnings did not give rise to a reasonable expectation of a material adverse effect, where there had been two weeks of strong earnings prior to the termination date, and Wall Street expected IBPs earnings to rebound the following year. The court compared this to the situation in *Akorn*, where the finding of a material adverse effect was supported by a "sudden and sustained drop in Akorn's business performance," and "[a]nalyst estimates for the seller's 2018, 2019 and 2020 EBITDA were lower than those as the time of signing by 62.6%, 63.9% ad 66.9%, respectively. The *Snow Phipps* court held that DecoPac's "precipitous drop" followed by a rebound two weeks later was more like the situation in *IBP* than *Akorn*, and thus Kohlberg had failed to demonstrate the occurrence of an MAE.

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[12] For simplicity, the plaintiffs are generically referred to in this summary as "Seller," unless the context requires otherwise.

[13] The court also ruled on various counterclaims made by Kohlberg. For simplicity, given that the counterclaims raised similar issues as Seller's claims, they are not separately described in this summary.

[14] C.A. No. 2018-0300-JTL, 2018 WL 4719347, at *53 (Del. Ch. Oct. 1, 2018).

[15] *In re IBP, Inc. S'holders Litig.*,789 A.2d 14, 66-70 (Del. Ch. June 18, 2001).

Though Kohlberg failed to show the occurrence of an MAE, the court also considered whether the drop in sales fell within the MAE exception covering effects "arising from or related to . . . changes in any Laws, rules, regulations, . . . issued by any Governmental Entity." Based on a regression analysis by Seller's expert regrading the impact of government mandated school closures, shelter-in-place orders, and business and restaurant closure orders, which showed "the vast majority of the decline in DecoPac sales arose from, or at the very least related to, those government orders," the court held that the drop in sales fell within the MAE exception, and DecoPac's drop in sales was not disproportionate relative to its industry peers. Accordingly, even if an MAE had occurred, the exception relating to government directives would have applied.[16]

No Breach of Condition Tied to Ordinary Course Covenant

The SPA contained a customary covenant that Seller must have operated DecoPac in a manner consistent with past practice, and a condition that this covenant have been complied with in all material respects. Kohlberg argued that the covenant was breached both through DecoPac having drawn down $15 million of a $25 million revolver, and through implementation of cost cutting measures in response to the pandemic.

The court looked to the recent *AB Stable* decision for guidance in interpreting the phrase "in all material respects."[17] According to the *AB Stable* court, this required that the deviation "significantly alter the total mix of information available to the buyer when viewed in the context of the parties' contract." According to the *Snow Phipps* court, this test "asks whether the business deviation significantly alters the buyer's belief as to the business attributes of the company it is purchasing."

Rejecting Kohlberg's argument that the revolver draw-down satisfied this standard, the court noted that DecoPac had drawn down on the facility five times since late 2017, the draw was pursuant to a Seller policy for its portfolio companies and not due to liquidity issues, and DecoPac never used the funds and offered to repay them within two days of Kohlberg questioning the draw. The court held that the draw was both consistent with past practice, and could easily be cured. Moreover, the court noted that the SPA included a breach notice and cure mechanism, and Kohlberg's failure to have provided notice of a breach precluded it from using the revolver draw as a basis for terminating the SPA.

The court also rejected Kohlberg's cost cutting arguments, both because DecoPac's measures were consistent with its prior practice of cutting costs when sales decline, and because Kohlberg had not timely raised the arguments, having done so only when the *AB Stable* decision came out.

Kohlberg Breached Its Financing Obligations

The court considered Seller's argument that Kohlberg failed to use reasonable best efforts to obtain the debt financing provided for under the DCL, or alternative financing, in breach of the SPA. Under section 6.15(a) of the SPA, Kohlberg was obligated to:

> use its reasonable best efforts to arrange and obtain the Debt Financing on terms and conditions acceptable to the Buyer, including commercially reasonable efforts to (i) maintain in effect the Debt Financing and the [DCL], (ii) satisfy all conditions applicable to the Buyer obtaining the Debt Financing, including the payment of any commitment, engagement, or placement fee required to be paid as a condition to the Debt Financing, (iii) enter into definitive agreements with respect to the Debt Financing that are on terms and conditions no less favorable to Buyer than those contained in the [DCL], so that such agreements are in effect as promptly as

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[16] The court also rejected an argument by Kohlberg that it was excused from performing because a condition tied to the rate of business of Deco-Pac's top ten customers was not satisfied. Similar to the MAE analysis, the court found that the contemporaneous projections indicated that sales to these customers "would see a near-full rebound by 2021."

[17] *AB Stable VIII LLC v. Maps Hotels & Resorts One LLC*, C.A. No. 2020-0310-JTL, 2020 WL 7024929, at *11 (Del. Ch. Nov. 30, 2020).

practicable but in any event no later than the Closing Date, (iv) consummate the Debt Financing at or prior to the date that the Closing is required . . . and (v) comply with its obligations under the [DCL].

The court held the reasonable best efforts obligation required an examination of whether "the party subject to the clause (i) had reasonable grounds to take the action it did and (ii) sought to address problems with the counterparty." The court noted that the SPA also prevented Kohlberg from consenting to any amendment or modification of the DCL without Seller's prior written consent, subject to exceptions where, generally stated, the amendment would not result in insufficient debt financing, impose conditions adverse to DecoPac, materially delay funding, or jeopardize closing. According to the court, considering these obligations together, the SPA required "Kohlberg to use its reasonable best efforts to execute Debt Financing on the terms of the DCL or on better terms and prohibit Kohlberg from modifying the terms of the DCL if doing so would jeopardize Debt Financing or the Closing."

Kohlberg argued that the DCL entitled Kohlberg to make its Financing Demands, because the DCL merely established a floor for Kohlberg's protection, and Kohlberg was entitled to demand more favorable terms. The court noted numerous problems with this argument, including its inconsistency with a prior Kohlberg position that the credit agreement could only contain terms mutually agreed with the lenders, testimony of plaintiffs' expert that the applicable DCL clause just permitted addbacks for nonrecurring easily quantifiable events and not lost revenue, an express cap on EBITDA addbacks under the DCL of $15 million, and Kohlberg's failure to try to enforce its position against the lenders under the DCL.

The court considered Kohlberg's alternative theory that its demand for addbacks was merely an attempt to negotiate terms that were left open in the DCL and intended to be negotiated after the DCL's signing.[18] The court noted that the only applicable SPA provision under which Kohlberg's demand could be evaluated was catchall language for "other adjustments, exclusions and addbacks as shall be mutually agreed or as otherwise consistent with the First Lien Documentation Principles". The court noted the inconsistency in Section 6.15(a) of the SPA between the obligation of Kohlberg to use reasonable best efforts to obtain the debt financing, and wording that the debt financing had to be "on terms and conditions acceptable to the Buyer". The court noted that an interpretation that the "acceptable to Buyer" language operated as a veto for Kohlberg had previously been rejected by the court in a bench ruling. The court accepted Kohlberg's more recent interpretation that the "acceptable to Buyer" language gave Kohlberg "the right to insist on acceptable provisions as to open terms, limited by its efforts obligations, including the obligation to use 'commercially reasonable efforts to . . . enter into definitive agreements with respect to the Debt Financing.'" The court held that even assuming Kohlberg's addback demands were intended to address open terms, Kohlberg nonetheless breached its efforts obligations in negotiating them. Kohlberg relied on the March 26 Model to justify its demand for these terms, but the court held that evidence showed that the March 26 Model "was predestined to reflect a covenant breach as a platform for Kohlberg to make the Financing Demands rather than any genuine effort to forecast DecoPac's performance." The court held that Kohlberg failed to work with its counterparties to resolve the problems it faced, and accordingly breached its obligation to use reasonable best efforts to obtain the debt financing provided for under the DCL.

The court noted that this finding of a breach by Kohlberg mooted any inquiry in to whether Kohlberg breached its obligation to use reasonable best efforts to find alternative financing. The court nonetheless held in dictum that "best efforts likely required more than just four days of inquiries," particularly where the DCL didn't expire for another five weeks.

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[18] The court noted that Kohlberg did not, and could not, raise the argument that the other two Financing Demands (the demands for an increase in the revolver size and a holiday for testing compliance with the Financial Covenant) were justified as responses to terms left open in the DCL. Thus, the court held that these two Financing Demands breached Kohlberg's obligation under Section 6.15(a) of the SPA to use reasonable best efforts to obtain debt financing under the DCL.

Plaintiffs Entitled to Specific Performance

The SPA permitted specific performance against Kohlberg only if the full proceeds of the debt financing had been or would be funded. The court considered whether the "prevention doctrine" should apply to prevent Kohlberg from relying on the debt financing condition. The court described the prevention doctrine as being available to excuse the non-occurrence of a condition where a party's breach "contributes materially to the non-occurrence" of the condition. According to the court:

> [I]t is not necessary to show that the condition would have occurred but for the lack of cooperation. It is only required that the breach have contributed materially to the non-occurrence. A breach "contributed materially" to the non-occurrence of a condition if the conduct made satisfaction of the condition less likely. But if it can be shown that the condition would not have occurred regardless of the lack of cooperation, the failure of performance did not contribute materially to its non occurrence and the rule does not apply.[19]

The court held that Kohlberg's breach of the debt financing covenant contributed materially to the failure to obtain the debt financing. The court rejected Kohlberg's argument that the reason the debt financing was unavailable was that the DCL had expired by its terms, holding that the DCL only expired because Kohlberg "ran out the clock." The court dismissed the argument that Kohlberg was contractually permitted to refuse to negotiate definitive debt documents as a repurposing of arguments Kohlberg made relating to whether it breached its debt financing obligations. The court also rejected Kohlberg's argument that the prevention doctrine required a showing that it have acted in bad faith as "contrary to black-letter law." Accordingly, the court held that the prevention doctrine applied, and plaintiffs were entitled to the remedy of specific performance under the SPA.

Takeaways

The biggest takeaway from *Snow Phipps*, particularly for private equity buyers, is the risk of being required to close as a result of the "prevention doctrine." Under customary private equity deal documentation, specific performance is only available if the debt financing is available, and the remedy in other cases is limited to the reverse termination fee. *Snow Phipps* is a caution to buyers that they cannot cause the debt financing to be unavailable as a way to avoid their obligation to close.[20]

The court's analysis of a breach of the ordinary course operating covenant provides useful additional color to the *AB Stable* decision from 2020. That decision highlighted the tension between a target company's efforts to cut costs in order to avoid an MAE, and its obligation to continue operating in the ordinary course of business. Since then (but not in *Snow Phipps*), sellers have typically sought to apply similar pandemic-related exceptions to the MAE definition to the interim operations covenant. For additional (or alternative) protection, *Snow Phipps* indicates that sellers should try to map cost mitigation efforts to those employed during prior business downturns.

The MAE analysis in *Snow Phipps* is consistent with that in seminal cases such as *IBP* and *Akorn*, and turned on the short length of DecoPac's downturn during the pandemic. *Snow Phipps* is a reminder to buyers that these cases set a high hurdle for invoking an MAE in order to avoid closing.

[19] *Snow Phipps*, 2021 WL 1714202, at *52 (citing *In re Anthem-Cigna Merger Litig.*, C.A. No. 2017-0114-JTL, 2020 WL 5106556, at *91 (Del. Ch. Aug. 31, 2020); referencing *WaveDivision Holdings, LLC v. Millennium Dig. Media Sys., L.L.C.*, C.A. No. 2993-VCS, 2010 WL 3706624, at *14 (Del. Ch. Sept. 17, 2010)).

[20] Note that in this case, the lenders had indicated a willingness to fund on the terms agreed in the DCL. Kohlberg was able to obtain debt financing and, after the court's decision, closed the acquisition. The case did not involve the more complex situation where a private equity buyer is forced to close, but is genuinely unable to obtain debt financing to fund closing.

Yatra Online, Inc. v. Ebix, Inc., C.A. No. 2020-0444-JRS, 2021 WL 3855514 (Del. Ch. Aug. 30, 2021)

Summary

In granting motion to dismiss, Delaware Chancery Court held that plaintiff's claims for breach of contract were forfeited when Plaintiff terminated merger agreement.

Background

Yatra Online, Inc. (Yatra), a Nasdaq-listed company with operations primarily in India, entered into a merger agreement with Ebix, Inx. (Ebix), a Nasdaq-listed company headquartered in the State of Georgia, on July 16, 2019. The merger agreement provided for a reverse triangular merger in which Yatra's stockholders would receive convertible preferred stock of Ebix, based on a fixed exchange ratio. The convertible preferred stock included a put right, pursuant to which Yatra's stockholders could force Ebix to redeem unconverted shares for $5.31 per share during the 25th month after closing. Under the merger agreement, Parent agreed to prepare a Form S-4 registration statement covering the convertible preferred stock to be issued in the merger and file it with the SEC as promptly as practicable, and in no event later than August 30, 2019. Parent agreed to use "reasonable best efforts" to have the SEC declare the Form S-4 effective as promptly as practicable. It was a condition to closing that the Form S-4 have been declared effective.

The Form S-4 was significantly delayed, and the deal still hadn't closed when the pandemic hit, causing a big decline in Ebix's stock price. Yatra gained the impression that Ebix started looking for a way out of the deal when this happened. Ebix sought to amend the merger agreement, and the parties agreed to several extensions of the outside date. Without consulting Yatra, Ebix negotiated an amendment to Ebix's credit agreement[21] that prevented Ebix from granting the put rights without triggering a violation of the credit facility.

On June 5, 2020, the day after the most recently amended outside date, Yatra terminated the merger agreement and commenced litigation against Ebix and other parties for breach of contract and related claims. The complaint alleged breach of various provisions of the merger agreement, including various representations and warranties, the covenant relating to the Form S-4, and Ebix's agreement to use reasonable best efforts to ensure satisfaction o the closing conditions.

The Court's Analysis

Section 8.2 of the merger agreement contained the following language regarding the effects of termination:

> "In the event of any termination of this Agreement . . . the obligations of the parties shall terminate and there shall be no liability on the part of any party with respect thereto . . . ; provided, however, . . . nothing contained herein shall relieve any party from liability for damages arising out of any fraud occurring prior to such termination."

Ebix claimed that this language meant that termination extinguished liability for pre-termination breaches, other than those arising from fraud. Yatra claimed that the phrase "with respect thereto" qualified the termination, as opposed to the merger agreement. Thus, according to Yatra, Section 8.2 did not terminate liability of Ebix for its pre-termination breach. The court disagreed with this interpretation as inconsistent with the sentence structure, including that the exception for fraud would be redundant if all pre-termination breaches survived termination. The court also noted that Vice Chancellor Laster had considered a similar provision in *AB Stable VIII LLC v. Maps Hotels & Resorts One LLC*,[22] and interpreted it in a way consistent with Ebix.

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[21] The *Yatra* decision incorrectly references this as an amendment to Yatra's credit facility.

[22] C.A. No. 2020-0310-JTL, 2020 WL 7024929, at *104 (Del. Ch. Nov. 30, 2020).

The court rejected other arguments of Yatra based on alleged inconsistencies between merger agreement provisions, with the court explaining away the purported inconsistencies. Yatra also claimed that it was absurd to adopt an interpretation that would require a party seeking to sue for breach to refrain from terminating the contract. The court disagreed, noting that if Ebix had materially breached, Yatra did not need to terminate because Yatra's obligation to perform would already have ceased. The court also noted that a party could prefer termination over suing for breach if the terminating party itself had exposure for a breach claim under the merger agreement. In granting the motion to dismiss, the court held: "This is a perfectly logical way for parties contractually to manage risk, and it is not for this Court to redline the parties' bargained-for limitations of liability because one party now regrets the deal it struck."

Takeaways

The *Yatra* decision serves as a drafting pointer to deal parties that instead of viewing the "Effect of Termination" provision as mere boilerplate, they should consider whether their language achieves the appropriate balance. At one extreme, deal parties may have an interest in not permitting any claims to survive termination other than fraud, so that they know that if the deal is terminated prior to closing, they will have finality and not be pestered will litigation. At the other extreme, deal parties could allow all pre-termination breaches to survive. Deal parties often chose a middle ground, where only material and/or intentional breaches survive. The other takeaway from *Yatra* is that deal parties should make sure they factor the "Effect Of Termination" language into their strategic decision making regarding the appropriateness and timing of termination.

Online HealthNow, Inc. v. CIP OCL Invs., LLC, C.A. No. 2020-0654-JRS, 2021 WL 3557857 (Del. Ch. Aug. 12, 2021)

Summary

Delaware Chancery Court held that nonsurvival and non-recourse provisions under stock purchase agreement were not a bar to fraud claim arising under representations and warranties in the stock purchase agreement.

Background

Online HealthNow involved a motion to dismiss an action brought by Online HealthNow, Inc. (OHN) and Bertelsmann, Inc. (Buyer) for fraud and related claims against defendants CIP Capital Fund, L.P. (CIP Capital), a private equity fund, its holding company CIP OCL Investments, LLC (Seller) and various owners and agents of Seller, in connection with Buyer's purchase of CIP OCL Holdings, Inc. (OCL Holdings, or the Company) from Seller.

In 2018, CIP Capital ran a process to sell OCL Holdings, a holding company that was the indirect parent of OnCourse Learning Corporation (OCL), a provider of continuing education programs. In 2015, OCL management discovered that it was not using its eCommerce software platform and tax reporting software correctly in order to properly calculate and collect sales tax on sales of its products, and remit those amounts to tax authorities. OCL management decided to retain an outside accounting firm to investigate the issue in early June 2018.

During the sales process, different information was provided to different bidders. One bidder was informed about the sales tax issue, but Bertelsmann was not. The bidder that was informed about the issue estimated the tax liability exposure as being in the range of $8-9 million. After that bidder sought either a large escrow or a reduction in the purchase price to account for the tax liability exposure, it was dropped from the sales process.

Bertelsmann ended up winning the auction based on a deal price of $525 million, subject to adjustments, including a post-closing purchase price adjustment. The stock purchase agreement (SPA) for the deal was signed on August 20, 2018, and the deal closed on November 1, 2018.

After closing, while Bertelsmann was going back and forth with Seller over the Closing Statement delivered in connection with the purchase price adjustment procedure, Bertelsmann became fully aware of the sales tax issue. Bertelsmann and OHN commenced litigation in the Delaware Superior Court in July 2019, alleging fraudulent inducement against CIP Capital and Seller based on representations in the SPA, and various related claims against some or all of the defendants. Defendants had the litigation removed to the Court of Chancery.

The Court's Decision

The plaintiffs alleged fraudulent inducement based on knowingly false representations and warranties in the SPA relating to the timely filing, completeness and correctness of all tax returns, the accuracy and completeness in all material respects of the financial statements, and the absence of undisclosed liabilities. Defendants filed a motion to dismiss. The court summarily rejected defendants' argument that plaintiffs failed to plead fraud with particularity. The court held that because the fraud claim was based on contractual representations, the plaintiffs "need only allege facts sufficient to support a reasonable inference that the representations were knowingly false,"[23] and the plaintiffs easily met that standard. The court then turned to defendants' arguments that (i) plaintiffs' claims should be dismissed based on the survival clause in the SPA, which provided that the representations and warranties terminated at Closing, and (ii) plaintiffs' claims against some of the defendants should be dismissed based on a non-recourse provision in the SPA, which provided that claims arising under the SPA could only be asserted against the parties and their successors and permitted assigns.

Contractual Limitations On Fraud Claims Under ABRY Partners

The court first gave an overview of the holdings from the seminal fraud case, *ABRY Partners V, L.P. v. F & W Acquisition LLC*.[24] The court noted that the *ABRY* court balanced the policy in favor of freedom of contracts with the policy against fraud by holding that a clear non-reliance clause will bar a claim for breach of extra-contractual representations and warranties. The *ABRY* court also held that "a seller could allocate the risk of intentional lies by *other* parties to the buyer, so long as it did not know of the lies . . . . Where, however, an agreement purports to limit liability for a lie made within the contract itself, and parties *know* of the lie, such parties cannot skirt liability through contractual limits within the very contract they procured by fraud."[25]

The *ABRY* court did not expressly discuss whether survival or non-recourse[26] provisions could act as a bar to contractual fraud claims.

The SPA's Survival Clause

The *Online HealthNow* court noted that the *ABRY* decision contained language that indicated that survival clauses do not preclude fraud claims. The *Online HealthNow* court noted that *Sterling Network Exchange, LLC v. Digital Phoenix Van Buren, LLC*[27] addressed survival clauses in the fraud context. The survival period at issue there was six months for some representations and a year for others. According to the *Online HealthNow* court, the *Sterling* court seemed to acknowledge that the issue was within the scope of *ABRY*'s pronouncement regarding contractual restrictions on fraud claims, but distinguished *ABRY* on the basis that the contract in *ABRY* "failed to provide a reasonable period of opportunity to unearth possible misrepresentations."[28] *Sterling* could therefore be viewed as supporting a rule that contractual survival periods can limit fraud claims as long as they are reasonable. But the *Online HealthNow* court questioned whether that was an accurate interpretation of Delaware law.

Plaintiffs in *Online HealthNow* took the position that under *ABRY*, the survival clause could not bar recovery for fraud. Defendants argued that the survival clause did not limit a claim for recovery, just the period in which the claim can be brought. Relying on *Sterling*, the defendants argued that a limitations period need only provide a reasonable opportunity for the plaintiffs to discover the misrepresentations. Defendants argued that Bertelsmann's 73-day

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[23] *Id,* at *10 (quoting *Prairie Cap. III, L.P. v. Double E Hldg. Corp.*, 132 A.3d 35, 62 (Del. Ch. November 24, 2015)).

[24] 891 A.2d 1032 (Del. Ch. Feb. 14, 2006).

[25] *Online HealthNow,* 2021 WL 3557857, at *12 (citing *ABRY*, 891 A.2d at 1062-63).

[26] The *Online HealthCare* court noted that there was a non-recourse provision in the agreement considered by the *ABRY* court, but it was not considered by the *ABRY* court.

[27] C.A. No. 07C-08-050WLW, 2008 WL 2582920 (Del. Super. Ct. Mar. 28, 2008).

[28] *Id.* at *5.

diligence period was a reasonable period to discover fraud, where Bertelsmann had represented under the SPA that it had been given full access to information. The court rejected this argument where the pleadings alleged that tax information was intentionally withheld from the data room.

Defendants also pointed to Section 11.3 of the SPA, which provided that if a provision of the SPA was invalid, illegal or incapable of being enforced, the parties should negotiate in good faith to replace it and preserve the parties' intent. Defendants argued that this provision mandated dismissal of plaintiffs' fraud claim where plaintiffs failed to bring the claim for eight months, and the *Sterling* court indicated that six months was a reasonable discovery period. The court rejected this argument, both given doubts about that interpretation of *Sterling* as accurately capturing Delaware law, and given that the "reasonableness" of any delay was necessarily fact intensive. The court noted that the *Sterling* decision did not involve facts similar to the alleged tax misrepresentations, and its conclusion with respect to timing could not be "reflexively applied" based on the pleadings.

The SPA's Non-Recourse Provision

Defendants also argued that none of the defendants other than Seller could be liable for fraud based on the SPA's non-recourse provision, given the following language in *ABRY*: "it [is] difficult to fathom how it would be immoral for the Seller and Buyer to allocate the risk of intentional lies by the Company's managers to the Buyer."[29]

The court rejected defendants' position on the basis that it took language out of context and ignored *ABRY*'s main holding "that the public policy of this State will not permit the Seller to insulate itself from [liability or] the possibility that the sale would be rescinded if the Buyer can show . . . that the Seller knew that the Company's contractual representations and warranties were false."[30]

Takeaways

The decision reinforces Delaware courts' reluctance to enforce parties' contractual limitations on fraudulent inducement claims based on contractual representations and warranties in an acquisition agreement. First, it calls into question the decision in *Sterling*, which applied a "reasonableness" standard to survival clauses in the context of fraud based on contractual representations and warranties. Until further guidance is given by Delaware courts, the working assumption for deal parties should be that a survival provision cannot be used as a shield from contractual fraud.

Second, it provides useful gloss to the *ABRY* decision. It makes clear that under Delaware law a non-recourse provision cannot shield non-parties to an acquisition agreement from fraud based on contractual representations and warranties where the non-parties were allegedly complicit in the fraud.

***Deluxe Ent. Servs. Inc. v. DLX Acquisition Corp.*, C.A. No. 2020-0618-MTZ, 2021 WL 1169905 (Del. Ch. Mar. 29, 2021)**

Summary

Delaware Chancery Court held that share purchase agreement did not permit seller to claw back cash erroneously left in the company it sold at closing, even though cash was excluded from the purchase price calculation and adjustment provisions.

Background

Deluxe Entertainment involved a motion to dismiss an action brought by Deluxe Entertainment Services Inc. (Seller) against the purchaser (Buyer) of its subsidiary (the Company), where Seller sought to recover several million dollars of cash that remained in the Company at Closing. In granting the motion to dismiss, the Delaware Court of Chancery held that cash was not excluded from the assets that transferred with the Company's business at closing, and the court

[29] *ABRY*, 891 A.2d at 1062-63.

[30] *Id.* at 1064.

declined to reform the purchase agreement to address a problem that, according to the court, arose not from a drafting mistake, but from Seller's own failure to sweep cash prior to closing.

The court noted that the deal was structured as a share purchase, and so all of the Company's assets remained with the company at closing unless expressly excluded under the purchase agreement. The purchase agreement did carve out certain assets and liabilities, and included "wrong pocket" provisions to correct certain erroneous transfers after closing. But Seller acknowledged that cash was not among the excluded assets. Seller based its argument that the cash should be returned on the definition of "net working capital" in the purchase agreement and the parties' negotiations leading up to signing of the purchase agreement, which Seller claimed evidenced the parties' intent that cash was not to be transferred at closing.

The purchase price under the purchase agreement had a net working capital adjustment. The definition of "Net Working Capital" expressly excluded cash, through an illustrative example included on a schedule. Seller argued that the exclusion of cash from the net working capital calculation, and hence from the purchase price, evidenced an intent for the deal to be "cash-free, debt-free", and thus for cash to be excluded. Rejecting Seller's argument, the court held that the fact that the purchase price did not factor in cash did not mean that cash was to be treated as an excluded asset. Had the parties intended that, they could have expressly provided so. The court also rejected Seller's contention that the purchase agreement was ambiguous and that the parties' negotiation history should be considered as evidence of the parties' intent.

Implied Covenant of Good Faith and Fair Dealing

Seller next argued that the implied covenant of good faith and fair dealing required Buyer to return the cash. Rejecting Seller's argument, the court held that the implied covenant could only be invoked to fill a gap in the agreement, and no such gap existed here since the parties had contemplated the possibility that an asset could be inadvertently transferred at closing as evidenced by the inclusion of "wrong pocket" provisions.

Reformation

Seller argued that the failure to exclude cash from the assets transferred at closing was a scrivener's error, and the court should reform the agreement. The court noted that there are two principal bases for reformation: mutual mistake and unilateral mistake. The court noted that for either type of mistake, the mistake must be of a fact that forms the basis, or *sine qua non*, of the agreement, and that courts apply reformation narrowly. The court held that to survive a motion to dismiss, a reformation claim based on mutual mistake must allege:

> "(i) that the parties reached a definite agreement before executing the final contract; (ii) that the final contract failed to incorporate the terms of the agreement; (iii) that the parties' mutually mistaken belief reflected the true parties' true agreement; and (iv) the precise mistake the parties made."[31]

The court held that for unilateral mistake, a plaintiff must also allege that "the parties reached a definite agreement that differed materially from the agreement they ultimately put into writing." Both types of mistake must be pled with particularity.

Rejecting Seller's reformation argument, the court held that Seller had failed to plead the terms of such a definitive agreement and the parties' intent to incorporate those terms into the purchase agreement. The court held that "the mistake that has led to the perhaps unintended transfer of the [cash] is not the sort of mistake that supports reformation; it is not a mistake in the expression of the Purchase Agreement, but rather an operational mistake by Seller in preparing to perform." The court continued: "Seller's failure to sweep [the Company's] cash is an operations or accounting mistake, which is crucially distinguishable from a scrivener's error in the underlying agreement itself that can be remedied by reformation."

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[31] *Id.* at *9 (quoting *Great-W. Invs. LP v. Thomas H. Lee Partners, L.P.*, C.A. No. 5508-VCN, 2011 WL 284992, at *11 (Del. Ch. Jan. 14, 2011)).

Takeaways

The decision serves as a reminder of Delaware's pro-contractarian stance, and a caution to parties that they should not expect Delaware courts to rescue them from loose drafting. Here, the fact that cash was excluded from the net working capital definition was not the problem—it is typically excluded in deals because it is typically listed as a separate addition to the purchase price. The fact that cash was not listed as a separate addition to the purchase price suggests that the parties expected that Seller would sweep cash prior to closing, as the court noted Seller was permitted to do under the purchase agreement. Most practitioners would view the risk of the cash sweep not occurring as theoretical, with the expectation that it would be prominently listed on the closing checklist and closely monitored. *Deluxe Entertainment* shows that even theoretical risks can sometimes occur and give an unfair windfall to the other party. Sellers in this situation would be well advised to expressly address this risk in the purchase agreement, such as by listing cash as an excluded asset that, if not swept prior to closing, has to be returned after closing.

Pacira Biosciences, Inc. v. Fortis Advisors LLC, C.A. No. 2020-0694-PAF, 2021 WL 4949179 (Del. Ch. Oct. 25, 2021)

Summary

In granting motion to dismiss, court held that selling securityholders' efforts to influence achievement of milestones did not give rise to direct or indirect breach of merger agreement in the absence of express language prohibiting such actions, nor did demands for milestone payments constitute breach of implied covenant of good faith and fair dealing where merger agreement did not prohibit such demands and they were not harassing, oppressive, or sent in bad faith.

Background

Pacira stemmed from the acquisition by Pacira BioSciences, Inc. (Pacira) of MyoScience, Inc. (MyoScience), a medical device company that manufactured a pain management product called iovera® (iovera), in a reverse triangular merger that closed on April 9, 2019. Under the merger agreement, MyoScience's securityholders (Former Securityholders) received $120 million in cash at closing and were entitled to up to $100 million in contingent payments post-closing, if the surviving company (renamed Pacira CryoTech) achieved specified milestones. In connection with the merger, Former Securityholders signed either a letter of transmittal for securities or an option holder letter of transmittal (Option Holder Letter) agreeing to be bound by certain provisions of the merger agreement.

iovera and CPT Codes

Prior to the merger, iovera had received FDA clearance and, as is typical for medical devices, its success was dependent in part on Medicare and Medicaid reimbursement rates set by the Centers for Medicare and Medicaid (CMS). To be reimbursed by Medicare and Medicaid for performing a medical procedure, a medical provider is required to describe the applicable procedure using a Current Procedural Terminology code (CPT Code). CPT Codes are set, and guidance for the use of CPT Codes is issued, by the American Medical Association (AMA). National and local reimbursement rates for CPT Codes are set by CMS and are updated annually based on industry feedback. Device manufacturers typically want not only a high reimbursement rate, but also certainty as to which CPT Code applies, so that medical providers are not deterred from using their product as a result of billing audit and claw back risk.

Also prior to the merger, Timothy Still (Still), Gumballa Kris Kumar (Kumar) and Jessica Preciado (Preciado), then employees and securityholders of MyoScience and each a named defendant in *Pacira* (Individual Defendants), with the assistance of outside reimbursement counsel Gail Daubert (Daubert), sought to clarify the CPT Code applicable to procedures using iovera in the treatment of knee pain. In 2018 and 2019, they successfully lobbied AMA to rescind prior guidance assigning a vague catch-all code applicable to iovera and to publicize a new, more specific code. And when an opportunity for iovera to come under an even more favorable code (CPT Code 64xx1[32]) later arose, Still, Kumar, Preciado and Daubert worked together to influence CMS in its drafting of the reimbursement rate that would apply to that new code.

Milestone Payment Provisions of the Merger Agreement

The merger agreement required Pacira to make post-closing payments to the Former Securityholders on the achievement of various milestones. Relevant here, the "CMS Reimbursement Milestones" (CMS Milestones) set forth in Section 1.15(a) of the merger agreement required Pacira to pay the Former Securityholders (a) $20,000,000 if the CMS reimbursement amount effective in 2020 for treatment of a patient in an office setting using CPT Code 64xx1 was equal to or greater than $600 per procedure, (b) $20,000,000 if the CMS reimbursement amount effective in 2020 for treatment of a patient in an ambulatory surgery center using CPT Code 64xx1 was equal to or greater than $800 per procedure, and (c) $10,000,000 if the CMS reimbursement amount effective in 2020 for treatment of a patient in an out-patient hospital setting using CPT Code 64xx1 was equal to or greater than $1,400.

Section 1.15(d) of the merger agreement provided that Pacira was obligated to use commercially reasonable efforts to achieve the milestones. Section 1.15(e)(ii) provided that Pacira could otherwise operate the business as it chose, in its sole discretion (the Sole Discretion Provision). Section 1.15(e)(i) provided that the "sole and exclusive right" of the Former Securityholders under the milestone provisions was to receive the milestone payments (the Exclusive Right Provision).

Defendants' Post-Closing Conduct

When CMS released the draft reimbursement rates for CPT Code 64xx1 on July 29, 2019, the rates were insufficient to meet any of the CMS Milestones. The Individual Defendants then began what Pacira described as a "coordinated campaign" to make sure the final, published rates would meet the CMS Milestones, including retaining Daubert to influence CMS and AMA.

Pacira, working with its outside reimbursement counsel, was also taking steps to address the draft reimbursement rates. Unbeknownst to Pacira, Preciado and Kumar, who were still employed by or performing services for Pacira CryoTech, forwarded certain relevant information produced by Pacira and its counsel to Still, including, among other things, copies of draft letters to CMS regarding the draft reimbursement rates and competitive intelligence gathered by Pacira about actions others in the industry might take with respect to the draft reimbursement rates. In August 2019, Preciado also participated in a call with Pacira's general counsel and outside counsel regarding the draft reimbursement rates, which she recorded in secret and later shared with Kumar and Still. In addition, Still sought to influence Pacira's CEO, including by sending him a list of actions he would take with respect to the draft reimbursement rates.

In August 2019, Pacira's general counsel attempted to retain Daubert to help formulate Pacira's response to the draft reimbursement rates. Daubert declined, citing a conflict of interest given her representation of the Individual Defendants, which Pacira contended led to increased costs and inefficiencies.

On November 1, 2019, CMS published the final reimbursement rates, finalizing CPT Code 64xx1 as 64624. The reimbursement rates for CPT Code 64624 ($417.56 for procedures in an office setting, $471.33 for procedures in an ambulatory surgery center and $1,872.01 for procedures in an outpatient hospital setting) were beneath the CMS Milestone thresholds in the merger agreement for office and ambulatory surgery center settings, but above the CMS Milestone threshold for an out-patient hospital setting. Accordingly, on January 3, 2020, Pacira sent Fortis Advisors, LLC (Fortis), the securityholders' representative under the merger agreement, a letter indicating that the applicable CMS Milestone had been met, and on May 27, 2020 made the $10,000,000 CMS Milestone payment.

Thereafter, on May 29, 2020, Fortis sent a letter to Pacira demanding an additional $40 million in CMS Milestone payments, arguing that the CMS Milestone thresholds for in-office and ambulatory surgery center settings were met

[32] The "x" represented a draft designation, to be replaced with a number when the code was finalized.

under local reimbursement rates for various CPT Codes. Pacira rejected Fortis's demand on June 5, 2020. On June 8, 2020, Fortis responded to say its experts were compiling a package of data to demonstrate the many ways the CMS Milestones had been achieved. Pacira contended these demands were made in bad faith.

Pacira and Pacira CryoTech (plaintiffs) filed their complaint in August 2020, asserting claims for declaratory judgment (that the Former Securityholders were not entitled to any other CMS Milestone payments), breach of the Option Holder Letter by the Individual Defendants, breach of the implied covenant of good faith and fair dealing by the Individual Defendants and Fortis, breach by Kumar of his consulting agreement, breaches of fiduciary duties by Kumar and Preciado, and aiding and abetting such breaches by Still. The Individual Defendants then moved to dismiss the complaint in its entirety, and Fortis moved to dismiss the implied covenant claim.[33]

The Court's Decision

Alleged Breach of the Option Holder Letter

Plaintiffs alleged that the Individual Defendants breached the Option Holder Letter by failing to comply with the Exclusive Right Provision and Sole Discretion Provision, which were incorporated into the Option Holder Letter. Plaintiffs argued that, together, those provisions imposed "an obligation on the Individual Defendants to refrain from interfering in Pacira's internal affairs or operations," and that the Individual Defendants breached that obligation by attempting to "influence and instruct" plaintiffs' employees to do the minimum necessary to trigger the CMS Milestone payments, and by hiring Daubert, which precluded Daubert from working with plaintiffs. Rejecting plaintiffs' position, the court held that the Exclusive Right Provision set forth a right of the Former Securityholders but did not impose any obligation on them. Similarly, the court held that when considered together with other language in the relevant provisions of the merger agreement, such as an obligation for Pacira to operate Pacira CryoTech in good faith during the earnout period and to use commercially reasonable efforts to achieve the milestones, the Sole Discretion Provision was a disclaimer of any obligation of Pacira to take action beyond that set forth in the Merger Agreement and did not impose any obligation on the Individual Defendants to refrain from communicating with plaintiffs' employees or the reimbursement authorities. Accordingly, the court granted defendants' motion to dismiss plaintiffs' claim for breach of the Option Holder Letter.

Alleged Breach of the Implied Covenant of Good Faith and Fair Dealing

Plaintiffs alleged that Fortis (and the Former Securityholders through Fortis) breached an implied covenant that Fortis "would only make proper, good faith demands for payments under the Merger Agreement's milestone provisions." In support of their claim, plaintiffs argued that the merger agreement was silent with respect to Fortis's ability to submit demands for payment and that such gap should be filled by the court by implying a prohibition against making payment demands in bad faith. The court rejected this argument, holding that there was no such gap because the merger agreement did address the issue of demands from Fortis. Specifically, the court noted that Section 1.15(f) of the merger agreement set forth a mechanism for Fortis to deliver an objection notice with respect to any dispute regarding any report delivered or audit conducted under that provision, and included an obligation for the parties to work together in good faith to resolve the dispute and to submit any unresolved dispute to a mutually agreed accounting firm. The court reasoned that Section 1.15(f) set forth a narrow set of circumstances in which Fortis's ability to make demands was curtailed, thereby indicating that Fortis was otherwise free to make demands for payment. According to the court, this made sense because the ability to make payment demands is not typically provided for: "demands are simply made and, once they are made, the question is not whether one was entitled to make the demand, but whether there is a legal obligation to comply with it."[34]

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[33] The court dismissed plaintiffs' claims for breaches of fiduciary duties and aiding and abetting against the Individual Defendants for lack of personal jurisdiction.

[34] *Pacira*, 2021 WL 4949179, at *14 (quoting *Schick Inc. v. Amalgamated Clothing & Textile Workers Union*, 533 A.2d 1235, 1240 (Del. Ch. Sept. 16, 1987)).

The court distinguished a bench ruling cited by plaintiffs, *HCP CH1 Saddle River, LLC v. Sunrise Senior Living,* in which the counter-claim defendant (HCP) sought to renegotiate certain management agreements with the operator of assisted living facilities (Sunrise), and tried pressuring Sunrise by excessively invoking contractual rights, such as audit and information rights.[35] In dismissing HCP's motion to dismiss, then-Vice Chancellor Strine held that "Sunrise had sufficiently pleaded that 'HCP used its contractual discretion in bad faith by engaging in harassing conduct designed to put financial and other kinds of pressure on Sunrise to renegotiate.'"[36] The *Pacira* court held that the situations in *Saddle River* and *Pacira* were different because *Saddle River* involved excessive invocation of a contractual right to which Sunrise was required to respond, whereas there was no obligation for Pacira to respond to Fortis's payment demands.

The court also noted that even if Pacira had been obligated to respond to Fortis's payment demands, such demands did not constitute "harassment or 'oppressive or underhanded tactics.'"[37] While plaintiffs alleged that Fortis sent "multiple emails and letters to Pacira," they cited to just two emails and two demand letters. The court characterized the two emails as "non-threatening business communications" and further noted that even if the emails were considered in connection with the two demand letters, which Fortis sent *ten months later*, such communications fell short of a "'conscious, persistent campaign to put pressure on somebody to renegotiate by making their life hellacious.'"[38] The court also held that that plaintiffs' claim that the emails were sent in bad faith was baseless.

In addition, plaintiffs alleged that the Individual Defendants breached the implied covenant of good faith and fair dealing by hiring Daubert and attempting to "commandeer and misdirect" plaintiffs' employees. Rejecting plaintiffs' allegations, the court held that plaintiffs had not identified a gap in the merger agreement or any express contractual terms indicating any obligation to refrain from communicating with plaintiffs' employees or from recruiting Daubert. The court explained that if the parties had intended to prohibit the Individual Defendants from engaging with plaintiffs' employees or from retaining Daubert, they could easily have included such prohibition in the merger agreement; courts will not imply a covenant to give a party contractual protection it could have secured for itself in negotiations. Accordingly, the court dismissed plaintiffs' implied covenant claim.

Takeaways

While it is common to have milestone payments in acquisitions of medical device companies, and also common to have disputes regarding achievement of milestones, the focus is typically on the actions of the acquiror not of the selling securityholders or former key employees. Plaintiffs' issue in *Pacira* seems to be that the former MyoScience key employees operated a sort of shadow operation after closing where they tried to influence the behavior of Pacira employees and hired away a legal advisor to influence regulators, in order to engineer a situation where the regulators came up with CPT Codes that would trigger the milestone payments under the acquisition agreement. While perhaps not the case here, one can imagine a situation where material harm could have been incurred by Pacira as a result of the key employees having steered the regulatory process in a direction that was suboptimal for Pacira. Pacira's merger agreement did not contain any express prohibition that Pacira could point to, and Pacira unsuccessfully tried to convince the court that language intended for other purposes was being breached. It is not common in medical device deals to include language in acquisition documentation that expressly restrains former target employees from engaging in those sorts of efforts. This decision serves as a caution to acquirors that they should consider including it.

Another problem for Pacira was that Fortis claimed that the regulatory milestone was satisfied based on CPT Codes other than the 64624 CPT Code that Pacira seems to have intended. Acquirors with similar milestones based on CPT Codes should heed the necessity of tighter drafting.

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35 *Saddle River,* C.A. No. 4691-VCS (Del. Ch. Dec. 9, 2009).

36 *Pacira*, 2021 WL 4949179, at *15 (quoting *Saddle River*, C.A. No. 4691-VCS Hrg. Tr. at 55:7-10).

37 *Id.* at *16 (quoting *Chamison v. HealthTrust-Hosp. Co*., 735 A.2d 912, 920 (Del. Ch. June 30, 1999)).

38 *Id.* (quoting *Saddle River*, C.A. No. 4691-VCS Hrg. Tr. at 10:6-8).

While this decision is particularly relevant to acquisitions of medical device companies, the lessons regarding foreclosing seller interference with milestones, and tightly drafting milestone payment triggers, is also relevant for deals in other industries that involve milestones or other deferred payments.

S'holder Representative Servs. LLC v. Shire US Holdings, Inc., C.A. No. 2017-0863-KSJM, 2020 WL 6018738 (Del. Ch. Oct. 12, 2020), aff'd, No. 170, 2021, 2021 WL 5370065 (Del. Nov. 17, 2021)

Summary

Delaware Chancery Court held acquiror was obligated to make a milestone payment even assuming a "Fundamental Circumstance" occurred, because delay in commencing clinical trials under merger agreement was not solely "as a result of" the Fundamental Circumstance; court also held acquiror liable for attorneys' fees that, due to contingent fee arrangement, resulted in a 2.5x multiplier.

Shareholder Representative Services LLC (SRS) v. Shire US Holdings, Inc. (Shire) involved a post-trial decision in a dispute concerning whether Shire breached its obligation to make a milestone payment under the merger agreement governing its acquisition of FerroKin BioSciences, Inc. (FerroKin, or the Company). The milestone payment was due upon the initiation of Phase III clinical trials, which, under the merger agreement, was deemed to have occurred on December 31, 2015, notwithstanding whether the trials had actually been initiated by that date. However, Shire's obligation to make the milestone payment would be terminated if the failure to initiate the Phase III clinical trials by December 31, 2015 was "as a result of a Fundamental Circumstance", as defined in the merger agreement. Here, Shire did not timely initiate the Phase III clinical trials and asserted that a Fundamental Circumstance occurred. the court held that Shire owed the milestone payment because even assuming a Fundamental Circumstances occurred, the record demonstrated that the failure to initiate was "as a result of" routine drug delays and business decisions. Put another way, the court concluded that regardless of the Fundamental Circumstance occurring, because of the delays and Shire's business decisions, Shire still would not have commenced Phase III clinical trials by the required date, meaning that the milestone would have been deemed to have been achieved under the terms of the merger agreement.

Background

FerroKin was developing a drug called deferitazole, for use in removing excess iron in the blood of patients who are dependent on blood transfusions. Shire viewed deferitazole as a good first product to help Shire build a hematology business unit and to compete with Exjade, the iron chelator product then dominating the market. After a competitive sale process, Shire and FerroKin signed a merger agreement in March 2012, pursuant to which Shire agreed to acquire FerroKin for an upfront cash payment of approximately $95 million, and contingent milestone payments of up to $225 million. The deal closed in April 2012.

Section 2.9(a) of the merger agreement set forth the milestone payments, $45 million of which became due upon initiation of a Phase III clinical trial (the Initiation of Phase III Clinical Trial Milestone).[39] Section 2.9(f) provided:

> "Notwithstanding anything else in this Agreement to the contrary, in the event that the Company has not achieved the Initiation of the Phase III Clinical Trial Milestone on or before December 31, 2015, other than as a

[39] The milestone trigger in Section 2.9(a) was "the earlier to occur of (i) the first dosing of the first patient in the first Phase III Clinical Trial or (ii) the filings of an NDA or an MAA with respect to a Covered Product." For purposes of this summary, the trigger in clause (ii) is not relevant and therefore not discussed.

result of a Fundamental Circumstance, then the Initiation of Phase III Clinical Trial Milestone shall be deemed to have been achieved on such date."

A "Fundamental Circumstance" was defined as a "material safety or efficacy concern related to the [drug product] that would reasonably be expected to make production and sale of [deferitazole], or receipt of applicable Regulatory Approvals, impracticable."

Prior to closing, the Company had initiated studies in animals and humans, including a rat carcinogenicity study (the RatCarc Study) and a Phase II clinical trial testing deferitazole's ability to remove cardiac iron (Study 201). After closing, Shire initiated two additional Phase II studies in pediatric and adult patients (Studies 202 and 203), planned a head-to-head comparison with Exjade in a fourth Phase II study (Study 204), and planned to begin Phase III clinical trials in late 2013. In early 2013, in response to data received from Study 201, Shire switched Study 203 from a daily dosing to a twice-daily dosing "to generate the required efficacy" to move to Phase III. This switch delayed the projections for commencement of Phase III clinical trials to early 2015.

In or around April 2013, the Phase II trials demonstrated that some patients had experienced adverse reactions involving the peripheral nervous system, most of which were categorized as mild or moderate. By May 2013, additional cases involving similar reactions were reported.

In or around May 2013, Shire formed a Pipeline Committee to analyze its research and development (R&D) pipeline to help address a perceived near-term revenue gap and prioritize later stage programs over earlier ones. The Pipeline Committee focused on deferitazole due to its anticipated high cost in 2014, but delayed making a decision on changing course until Phase II data was available, which it anticipated receiving in 2014. The Pipeline Committee also noted the potential decrease in the commercial value of deferitazole due to the expected generic competition for Exjade. In the fourth quarter of 2013, an internal Shire report indicated that the projected spend for deferitazole in 2014 was $58 million, making it the most expensive out of Shire's fifty-five R&D programs. The expected net present value of the deferitazole program was negative $21 million. In November 2013, the Pipeline Committee thus decided to delay initiating Study 204 until data from Study 203 was available.

In late 2013, Shire also formed a Peripheral Neuropath Adjudication Committee (the PN Committee), comprised of external neurological experts, to evaluate the relationship of the peripheral nervous system reactions reported earlier in the year to deferitazole. Based on a December 2013 report of the PN Committee, Shire halted dosing in its ongoing trials at 75 milligrams per kilogram, but continued with 50 and 60 milligram dosing. Both the dosing halt and delay in commencing Study 204 delayed the projections for commencement of Phase III clinical trials once again, this time from early 2015 to May 2016.

In February 2014, a preliminary review of tissues from the RatCarc Study revealed an increase in tumors. It was unclear at that time whether the tumor increase was due to deferitazole or to a naturally occurring condition predominantly found in male rats. Shire's Executive Safety Review Committee noted the lack of clarity in the data and "voted in favor of suspending dosing" in the clinical studies until the issue could be investigated further. In March 2014, after Shire had informed the US Food and Drug Administration (FDA) of the tumor issues, the FDA put a clinical hold on the deferitazole studies. Shire engaged a Pathology Working Group to examine the study results. The Pathology Working Group found that the issue was likely due to renal toxicity in rats, which would not be relevant to humans, and recommended that Shire undertake two additional rodent trials. Based on this recommendation and input from the deferitazole clinical development team, in July 2014, Shire's Executive Safety Review Committee endorsed completing the ongoing Study 202 and Study 203, then undertaking the rodent studies. The target date to commence the Phase III clinical trials was now delayed to "at least" mid-2017.

In July 2014, the Pipeline Committee formally terminated the deferitazole trials that were subject to the clinical hold, although it did not terminate the overall program or pass judgment on whether a Fundamental Circumstance occurred under the merger agreement. In February 2015, however, the Pipeline Committee decided to formally and fully terminate the deferitazole program, and Shire sent SRS a "Notice of Fundamental Circumstance" on February 25, citing concerns about safety, and the ability to demonstrate the required efficacy at least comparable to Exjade. SRS commenced the *Shire* litigation on December 4, 2017.

The Court's Analysis

Whether Milestone Payment was Due

SRS claimed that Shire breached its obligation under the merger agreement to make the $45 million milestone payment. Given that a Phase III clinical trial was not initiated, the payment obligation turned on whether the milestone was nonetheless deemed achieved because the failure to achieve was not "as a result of a Fundamental Circumstance." Finding that the Fundamental Circumstance Clause was a condition subsequent (and not a condition precedent) to Shire's obligation to make the milestone payment, the court held that Shire had the burden of proving both (i) the occurrence of a Fundamental Circumstance; and (ii) that the failure to initiate Phase III clinical trials before December 31, 2015 was "as a result of" the Fundamental Circumstance.

The court held that even assuming clause (i) was satisfied, Shire was unable to satisfy its burden of proof with respect to clause (ii) because the record showed that Shire's changes to the clinical trial timeline made "failure to initiate Phase III clinical studies by December 31, 2015 . . . inevitable, notwithstanding any Fundamental Circumstance that later occurred." The court held that the first such change was switching to twice-daily dosing in Study 203 in early 2013, which pushed out the target commencement date of Phase III trials to early 2015. The court did not suggest Shire did this for any improper reason, noting that the decision to change the dosing was the type of decision routinely made in Phase II clinical trials.

The court held that the second change to the clinical trial timeline was the decision to delay Study 204 until after completion of Study 203 after instances of peripheral neuropathy had begun to appear in April 2013. The court described two aspects of this decision as "striking." First, the decision to delay Study 204 was made *before* the Pipeline Committee had received the initial conclusions of the PN Committee. Second, the decision was made during a company-wide initiative to prioritize later-stage drug development. The court found that the "evidence demonstrate[d] that, in the months leading up to the November 15, 2013 meeting, the Pipeline Committee was actively engaged in an effort to reduce the deferitazole program's budget in light of its sheer expense and its 'tight squeeze with generic Exjade.'" Thus, the court found that the dosing change coupled with the Study 204 delay had pushed the Phase III trial commencement projections to even later—May 2016. The court noted that these delays arose even before considering the RatCarc Study preliminary results and the Executive Safety Review Committee's vote in February 2014 to suspend clinical trials, which Shire contended constituted Fundamental Circumstances excusing its obligation to pay a milestone payment under the merger agreement.

The court rejected Shire's argument that the delay to May 2016 was just an estimate of when the Phase III clinical trials would commence and not a definite delay. The court held that the record showed "it was a 'planned' and inevitable delay, not a projected or estimated one."

Shire also argued, based on the merger agreement's wording "other than as a result of a Fundamental Circumstance," that even if Shire's business decisions prevented initiation of Phase III clinical trials before December 31, 2015, a subsequent Fundamental Circumstance could also prevent initiation of the trials by that date and terminate Shire's obligation to make the milestone payment. Analyzing the meaning of the words "other than" and "as a result of," the court held that the analysis reduced to two questions. The first question was: "Did Shire fail to initiate Phase III clinical trials on or before December 31, 2015 because of a Fundamental Circumstance?" If the answer to that question was yes, that would end the analysis and Shire's payment obligation would be terminated. If the answer was no, then the second question was: "Did Shire fail to initiate Phase III clinical trials on or before December 31, 2015 because of anything except for a Fundamental Circumstance?" If the answer to that question was yes, that would end the analysis and Shire's payment obligation would *not* be terminated. The court summarized: "In other words, if the delay would have transpired notwithstanding the absence of the Fundamental Circumstance Shire claims to have occurred, Shire's payment obligation remains intact."

The court held that this interpretation of Section 2.9(f) of the merger agreement was supported by three other provisions. First, the payment provisions of the merger agreement were structured so that $225 million of the $320 million consideration was for post-closing milestone payments. Second, defendants had "the right, in their sole and absolute discretion, to direct and control the development, commercialization, manufacture, marketing, distribution and selling of [deferitazole] in all respects, including the determination . . . to make any strategic product portfolio decisions affecting [deferitazole]." Third, Shire expressly disclaimed "any express or implied obligation, duty or expectation to test, develop, pursue, market, make any regulatory filings or seek any Regulatory Approvals with respect to, or otherwise advance [deferitazole]." According to the court, given the amounts tied to milestones (and their timing), Shire's complete control over the clinical trials, and Shire's lack of obligation to continue the trials, it made sense for Section 2.9(f) to be interpreted to give Shire only a narrow circumstance under which it could escape its payment obligation. Thus, given that the Phase III trials would not have been initiated by December 31, 2015 even if a Fundamental Circumstance had not occurred, Shire was still obligated to make the milestone payment.

Attorneys' Fees

The court granted SRS' request for attorneys' fees in the amount of $22,272,933.31, and interest in the amount of $13,260,534 pursuant to the following fee provision in the merger agreement:

> "[I]n the event that any action, suit or other proceeding is instituted concerning or arising out of this Agreement, the prevailing party shall recover all of such party's costs and reasonable attorneys' fees incurred in connection with each and every such action, suit or other proceeding, including any and all appeals and petitions therefrom."

Of the $22,272,933.31 for attorneys' fees, Shire disputed $19,647,517 as unreasonable. This large amount was due to SRS having entered into a contingent fee arrangement with its attorneys, which entitled the attorneys to one-third of the proceeds recovered by SRS and resulted in the attorneys receiving a multiplier of approximately 2.5x.

In considering Shire's objection to the fees as unreasonable, the court held that "there is nothing inherently unreasonable in enforcing a contractual fee-shifting arrangement to cover a contingent fee award." The court held that a one-third contingent fee arrangement was "quite typical," and allowed SRS to retain experienced counsel when it lacked the resources to pay them. The court noted that Shire could have excluded contingent fee arrangements under the merger agreement, but did not. The court also rejected Shire's objection to prejudgment interest, holding that there was nothing "inherently unreasonable" about including it "particularly when the underlying agreement includes interest in the relevant proceeds."

Takeaways

This case serves as a warning to acquirors to avoid loose drafting around milestone payment obligations. The language that the parties used here is the type of language intended to prevent an acquiror from being able to delay making milestone payments by dragging out contemplated clinical trials (or avoid making payment for reasons other than a Fundamental Circumstance). Shire seems to have had mixed reasons for delaying the initiation of Phase III clinical trials under the merger agreement at issue here, some related to regulatory strategy and some related to a desire to reduce expenses, and also a business questioning whether the deferitazole program made commercial sense in the first place. But the problem that acquirors can face is illustrated even more by simplifying the facts of *Shire* further.

In *Shire*, the court interpreted the merger agreement language as a but-for test. This meant that even if Shire delayed the Phase III initiation beyond December 31, 2015 for valid reasons related to maximizing the chance of FDA approval, and none of the factors relating to expense reduction or questioning the commercial viability of the program had been present, Shire would still have been obligated to pay the $45 million milestone payment even if a Fundamental Circumstance occurred prior to December 31, 2015 because it would not have been solely "as a result of" the Fundamental Circumstance. That is a harsh result. It could be avoided, however, through revised wording such as the following: "other than *wholly or partially* as a result of a Fundamental Circumstance." Alternatively, the language could have been turned into a proviso along the following lines: "; provided, however, the [milestone] shall not be deemed to have been achieved on such date if there shall have occurred any Fundamental Circumstance prior to such date."

The other harsh result for Shire was having to pay contingent attorneys' fees. This is not something that is typically contemplated in life science M&A deals, and it creates an asymmetry: had Shire won the litigation, SRS would have had to pay Shire's legal fees but not its own legal fees. On the other hand, given that SRS won, Shire had to pay legal fees for both Shire and SRS, with SRS' being 2.5x the customary base rates for its attorneys. Acquirors should consider including language in merger agreements with legal fee reimbursement provisions that either prohibit reimbursement for contingent fee arrangements or simply cap reimbursement to 1x the attorneys' customary base rates.

RSUI Indem. Co. v. Murdock, 248 A.3d 887 (Del. Mar. 3, 2021) (en banc)

Summary

In a D&O insurance coverage dispute arising from a going private transaction, Delaware's Supreme Court held that Delaware law applied to a policy issued in California insuring a California-based Delaware corporation, and that Delaware public policy did not preclude coverage for losses arising from the insured's fraud.

Background

In 2013, David Murdock, who was then CEO of Dole Food Company, Inc. (Dole), one of its directors, and owner of 40% of its stock, took the company private by purchasing the remainder of its stock through a holding company he owned. Certain stockholders sued Murdock for breach of fiduciary duty, alleging that he had manipulated the stock's price lower in advance of the transaction. The Delaware Chancery Court found in favor of the stockholders, holding that Murdock had engaged in fraudulent transactions to lower Dole's stock price. Murdock ultimately settled with the stockholders for the amount of damages awarded by the Chancery Court, about $148 million. Dole also settled a separate securities class action stemming from related conduct for $74 million.

After notifying its D&O carriers, including RSUI Indemnity Company, regarding the progress of the dual settlement negotiations, Dole sought coverage for the resulting settlements from these carriers. The insurers declined to cover the settlements, citing various policy exclusions. After unsuccessful mediation with Dole, several of the excess policy carriers sued for a declaration that they were not obligated to fund these settlements.

The Superior Court ruled in favor of Dole. RSUI appealed, chiefly arguing that California's law (rather than Delaware's) applied to its policy, and that under either state's law fraudulent conduct is uninsurable.[40]

Choice of Law

RSUI argued that California law should govern the interpretation of its policy, which—like the vast majority of D&O policies—did not contain a choice-of-law provision. The insurers favored California law because, unlike Delaware law, a provision of California's Insurance Code precludes coverage for an insured's willful act.

The parties agreed that the "most significant relationship" test from the *Restatement (Second) of Conflicts of Law* applied in Delaware,[41] but disagreed about how the factors set forth in the *Restatement* should be weighed. While Section 193 of the *Restatement* provides that insurance contracts are generally to be construed according to the law of the "principal location of the insured risk," the court noted that some risks "are not confined to a single jurisdiction" and

[40] The remaining carriers had either paid their policy limits or settled with Dole during the course of the coverage litigation.
[41] *See Certain Underwriters at Lloyds, London v. Chemtura Corp.*, 160 A.3d 457 (Del. Apr. 28, 2017).

thus require the more fulsome analysis spelled out in Section 188 of the *Restatement* regarding choice-of-law in contract disputes more broadly.[42]

The parties agreed that Section 188's multi-factor analysis was applicable to Dole's D&O policies, but disagreed on the proper balancing of those factors. In support of its argument that California law should apply, RSUI noted that the policy negotiations occurred at Dole's California headquarters via a California broker, and that the primary policy included California-specific endorsements. Further, at the relevant time, Dole was based in California, and its directors and officers worked there. The insureds countered with Dole's Delaware incorporation, which they argued was especially relevant because of Delaware's statutory provisions authorizing corporations to purchase insurance to indemnify their directors and officers.

The court held that Delaware had the more significant relationship, and thus Delaware law applied. The court cited a prior holding that a broadly applicable insurance policy should be construed under a single state's law, rather than the law of individual states in which losses may arise, in order to assure uniformity and predictability.[43] It then found that where an insurance policy broadly protects against wrongdoing of directors and officers of a corporation, the state of incorporation will usually have the most significant relationship because its law sets the directors' and officers' duties to the corporation, as well as the corporation's ability to indemnify the directors and officers. In reaching this conclusion, the court noted several aspects of Delaware law, particularly provisions of Delaware's General Corporation Law (DGCL) that govern the duties of corporate directors and officers (and of corporations to their directors and officers), indicate Delaware has a strong interest in having its law apply where breaches of fiduciary duty owed to a Delaware corporation are alleged. In particular, the court discussed DGCL Section 145, which the court explained "permits Delaware corporations to provide broad indemnification and advancement rights to their directors and officers and to purchase D&O policies to protect them even where indemnification is unavailable."[44]

The court considered the possibility that "the California contacts in this particular instance are sufficient to tip the balance toward California," but found that Dole's *physical* location in California did not overcome its *legal* location in Delaware:

> But this emphasis on physical location underrates the significance of Dole's status as a Delaware corporation—an entity formed and existing by virtue of the Delaware Constitution and the Delaware General Corporation Law. As such, Dole is every bit a "citizen" of Delaware as it is of California. And its directors and officers, to the extent they are acting "in their capacity as such" and are therefore covered by the Policy, act on behalf of Dole as a corporate entity, whose legal residence is in Delaware.[45]

The court stopped short of stating that Delaware law governs every D&O policy issued to a corporation incorporated in Delaware, and it acknowledged that contacts with a non-Delaware state "might be dispositive were we addressing an insurance policy covering a different subject matter and insureds with a more tenuous connection to Delaware than a Delaware corporation and its directors and officers have."

Insurability of Fraud

Next, RSUI argued that fraud "should be uninsurable in Delaware" on public-policy grounds. Many states (including California) preclude coverage for losses that arise from intentional acts or that are considered to be disgorgement of ill-gotten gains. RSUI argued that the court should recognize such a limitation as a matter of Delaware public policy. The court declined to do so.

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[42] The Court summarized, "The contacts to be taken into account at this step are: the place of contracting; the place of negotiation of the contract; the place of performance; the location of the subject matter of the contract; and the domicile, residence, nationality, place of incorporation and place of business of the parties." *Murdock*, 248 A.3d 887 at 896-97.

[43] *Id.* at 899 (citing *Chemtura*, 160 A.3d 457).

[44] *Id.* at 900 (citing 8 Del. C. § 145).

[45] *Id.* at 901.

The court's rejection of RSUI's public-policy argument was grounded in what it construed as superior public policies—the general freedom of contract, and the specific "right of sophisticated parties to enter into insurance contracts as they deem fit." The court noted that the parties could have written an anti-fraud limitation into their contract that applied here, but did not do so.[46]

Thus, it reasoned that Delaware's pro-contracting public policy cut against RSUI's argument that the court should deem part of an insurance contract unenforceable. In other words, the public policy for which RSUI argued would need to be a strong enough to overcome a countervailing public policy: "the parties' freedom of contract."

In addition to this pro-contracting public policy, the court reiterated that, under DGCL Section 145, Delaware's legislature had specifically authorized corporations to purchase insurance to indemnify officers regarding conduct as to which the corporation itself could not indemnify them.[47] Considering these points together, the court summarized:

> The question here then is: does our State have a public policy against the insurability of losses occasioned by fraud so strong as to vitiate the parties' freedom of contract? We hold that it does not. To the contrary, when the Delaware General Assembly enacted Section 145 authorizing corporations to afford their directors and officers broad indemnification and advancement rights and to purchase D&O insurance "against *any* liability" asserted against their directors and officers "whether or not the corporation would have the power to indemnify such person against such liability under this section," it expressed the opposite of the policy RSUI asks us to adopt.[48]

The court then explained further that rather than determining public policies on its own, the court will usually "defer[] . .. to the legislature's prerogative in matters of public policy," because of the "legislature's primacy in establishing this State's policy." Finally, it noted that permitting coverage in fraud cases would also ensure that aggrieved stockholders would not be left without a remedy if an insured lacked the means to pay.

Takeaways

Both the choice-of-law holding and the public-policy holding in *Murdock* are significant. A presumption in favor of applying the law of the state of incorporation to disputes regarding directors' and officers' fiduciary duties—even when the policy is purchased, and the insured is headquartered, in another state—means that Delaware law may frequently apply to the interpretation of D&O policies of Delaware corporations. It is especially notable that this presumption was not overcome in *Murdock*, where California undisputedly had multiple contacts with the policy and the loss.

The court's ruling on the insurability of fraud is also significant. The court not only declined to find the existence of the specific public policy for which RSUI was arguing—there is an arguable moral hazard that can arise where an insurer, rather than the perpetrator of a fraud, is made to pay for the consequences of the fraud—but more broadly indicated it would be reticent to deem a risk uninsurable based on a public policy that is not clearly expressed legislatively.

For Delaware corporations and their directors and officers, *Murdock* highlights two aspects of their D&O insurance policies that insureds should understand. First, do their policies include a choice of law provision? Many do not, in which case Delaware law may well govern. Second, do their policies include an exclusion for fraud? The scope of any such exclusion could be important, because Delaware courts have shown a willingness to honor the terms of policies with respect to coverage for fraud, if any.

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[46] The court noted that the policy did exclude losses arising from fraudulent acts, but only if "established by a final and non-appealable adjudication", which was inapplicable here.

[47] 8 *Del. C.* § 145.

[48] *Murdock*, 248 A.3d at 903.

Arnold & Porter

In re Solera Ins. Coverage Appeals, 240 A.3d 1121 (Del. Oct. 23, 2020)

Summary

In an insurance coverage dispute where an insured sought coverage for costs incurred in connection with a Delaware appraisal action, the Delaware Supreme Court held that appraisal actions do not seek a remedy for any "violation" of law and therefore fall outside the definition of a covered "Securities Claim" under a directors and officers liability (D&O) policy.

Background

Solera Holdings, Inc. (Solera) was a software corporation that purchased D&O insurance coverage from primary and excess insurers. The primary policy (to which all excess insurers followed form) provided coverage for lawsuits brought against Solera itself (as opposed to Solera's directors and officers) only if the lawsuit constituted a "Securities Claim," defined in relevant part as a "Claim … made against [Solera] for any actual or alleged violation of any federal, state or local statute, regulation, or rule or common law regulating securities."[49] An affiliate of private equity firm Vista Equity Partners later acquired Solera pursuant to a reverse triangular merger.

Shortly after Solera's stockholders approved the merger, several dissenting stockholders exercised their statutory appraisal rights and filed an appraisal action against Solera under 8 Del. C. § 262 (Section 262) seeking a judicial determination of the fair value of their shares. Ultimately, the Delaware Court of Chancery ordered Solera to pay the appraisal petitioners the fair value of their shares, which the court found was *less* than the negotiated merger price. The appraisal proceeding was not, however, without cost to Solera: (1) the court's order required Solera to pay pre-judgment interest (approximately $38 million), and (2) Solera incurred over $13 million in defense costs.

After seeking coverage under its primary and excess D&O policies for its pre-judgment interest payments and defense costs, Solera filed an action against the primary and excess insurers in Delaware Superior Court for breach of contract and declaratory judgment. Several insurers moved for summary judgment, arguing that the appraisal action did not meet the primary policy's "Securities Claim" definition. In particular, the insurers argued that because appraisal actions are neutral valuation proceedings and do not involve any inquiry into claims of wrongdoing, the appraisal action against Solera was not a claim for any "violation" of any law regulating securities, and therefore was not a covered Securities Claim.

On July 31, 2019, the Superior Court denied the insurers' motion for summary judgment, holding that an appraisal action under Section 262 constituted a "Securities Claim" under the primary policy. The Superior Court held that a "violation" of law does not require an allegation of wrongdoing and further stated an appraisal action "necessarily alleges a violation of law or rule" because "[u]nder Delaware law, shareholders have the right to receive 'fair value' for their shares when they are cashed out of their positions through certain types of mergers or consolidations."[50]

Appraisal Actions are not Covered "Securities Claims"

On appeal, the Delaware Supreme Court reversed and held the Solera appraisal action did not fall within the primary policy's "Securities Claim" definition and thus, Solera's defense costs and pre-judgment interest payments were not covered. To arrive at this conclusion, the court analyzed the policy's express terms and Delaware's appraisal remedy.

First, the court determined that an appraisal action is not a "violation" under the policy's clear and unambiguous language. Applying Delaware's contract interpretation principles, the court concluded that the plain meaning of the term "violation" involves an "element of wrongdoing, even if done with an innocent state of mind."[51] The court further

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[49] *Id.* at 1125.

[50] *See Solera Holdings, Inc. v. XL Specialty Ins. Co.*, 213 A.3d 1249, 1254 (Del. Super. Ct. July 31, 2019).

[51] *In Re Solera*, 240 A.3d at 1131-32.

concluded that “appraisal actions are not proceedings that adjudicate wrongdoing (including breaches of fiduciary duty)” and therefore, “do not involve ‘violations’ of any law or rule.”[52]

Second, the court also considered the appraisal remedy’s historical background and the text of Section 262. The court cited its 2017 opinion in *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, which in cabining the Court of Chancery’s discretion in appraisal actions had surveyed the historical impetus for appraisal, describing it as “a limited legislative remedy” with only one issue considered—“the value of the dissenting stockholder’s stock.”[53] The court found further support for that conclusion in Section 262’s plain text, which “imposes limited duties on … corporation[s]” like Solera and is “not designed to address breaches of fiduciary duty or other wrongdoing.”[54]

Third, the court reviewed the purpose of appraisal proceedings and outlined several idiosyncrasies evincing that that purpose is neutral and does not inquire into wrongdoing. For example, both the plaintiff and defendant in an appraisal action retain the burden of proving their respective valuation positions by a preponderance of evidence. The Court of Chancery makes an independent assessment of fair value, but is limited by the record the parties create. And as was the case in the underlying appraisal action against Solera, dissenting stockholders potentially can receive *less* than the negotiated merger price. So unlike ordinary civil litigation over whether the defendant violated the law to the plaintiff’s detriment, both parties to an appraisal proceeding bear some degree of risk.

Lastly, the court cited an “unbroken” line of Delaware cases holding that appraisal actions do not involve inquiries into claims of wrongdoing. This earlier authority describes the value of the appraisal petitioners’ shares on the date of the merger as the “only litigable issue in an appraisal action under Section 262.”[55] Accordingly, while appraisal petitioners sometimes present evidence of wrongdoing in the negotiation process leading up to a merger, that evidence relates only to what weight to give deal price in the determination of fair value and does not involve an adjudication of whether any party engaged in wrongdoing or violated the law.

Takeaways

Solera confirms what M&A practitioners have generally assumed to be the case: D&O policies are typically not a source of recovery for losses in appraisal claims[56] because, as a matter of Delaware law, appraisal actions are not for a “violation” of law and therefore are not covered under language that is common (though not universal) in the Securities Claim definition in many D&O policies. To the extent insured corporations seek coverage for appraisal actions under other states’ laws, *Solera* is likely to guide the analysis. More broadly, *Solera* underscores that D&O policies ultimately are contracts subject to general contract-law principles, and the scope of coverage therefore turns on the particular language used and the nature of the proceeding for which coverage is sought.

* Arnold & Porter represented one of the insurers in this matter.

[52] *Id.* at 1133.

[53] *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd.*, 177 A.3d 1, 19 (Del. Dec. 14, 2017).

[54] *In Re Solera*, 240 A.3d at 1135.

[55] *See, e.g., Dell*, 177 A. 3d at 19; C*ede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1187 (Del. June 10, 1988); *In re Trados Inc. S’holder Litig.*, 73 A.3d 17, 35 (Del. Ch. Aug. 16, 2013).

[56] Solera did not seek recovery under the D&O policies for the fair value of the appraisal shares, perhaps in part given that the court determined that fair value was less than the merger price per share. But the court’s rationale is broad enough that it would also have precluded recovery for the fair value of the shares under the policy language at issue.

Arnold & Porter

Coster v. UIP Companies, Inc., 255 A.3d 952 (Del. June 28, 2021)

Summary

Delaware Supreme Court reversed lower court decision that upheld, under entire fairness standard of review, issuance of stock to director to avoid voting deadlock between equal stockholders on basis that lower court should also have considered whether issuance violated intermediate standard under Blasius, or was inequitable under Schnell.

Background

Marion Coster was one of two equal stockholders of UIP Companies, Inc. (the Company). She inherited the stock when her husband passed away, and she sought to be bought out. When her buyout efforts failed, given stockholder deadlock, she commenced an action under Section 226(a)(1) of the Delaware General Corporation Law to have a custodian appointed. The board of directors of the Company consisted of the other stockholder and two other individuals loyal to him. In order to moot the custodian action, which would allegedly be harmful to the Company because it would trigger change of control clauses under some of its contracts, the board approved the sale of one-third of the Company's equity to one of the two other directors. Coster then initiated a second action, including the directors as defendants, to challenge the stock sale, and the two actions were consolidated.

The lower court evaluated the stock sale under the entire fairness standard of review, and found that it was entirely fair. While the lower court found that the defendant directors clearly intended to eliminate Coster's vote blocking ability, it nonetheless declined to review the stock sale under the *Blasius* intermediate standard of review, holding that such an analysis was not necessary given that the sale satisfied the more exacting entire fairness standard. Coster appealed the lower court's failure to consider the context in which the stock sale occurred in order to evaluate whether the board acted inequitably in diluting her voting rights or otherwise had a compelling justification for the stock issuance. On appeal, the Delaware Supreme Court reversed and remanded for the lower court to consider the "motivations and purpose" of the stock sale. The Delaware Supreme Court held that if the board approved the stock sale for inequitable purposes, the sale should be cancelled under *Schnell*,[57] and if the board approved the stock sale in good faith, the board needed to show a "compelling justification" for the sale under *Blasius.*[58]

The Supreme Court's Decision

Evaluating both whether the correct legal standard was applied under *de novo* review and the lower court's factual findings for clear error, the Supreme Court expressed its support for the lower court's factual findings and conclusion that the stock sale was "at a price and through a process that was entirely fair." The court held, however, that an additional judicial review was required "where, as here, an interested board issues stock to interfere with corporate democracy and that stock issuance entrenches the existing board."

The court first considered the *Schnell* line of cases relating to inequitable conduct. In *Schnell*, where the board changed the date and location of the annual meeting to prevent a dissident from mounting a board campaign, the *Schnell* court held that the board's "manipulation of the election machinery to entrench themselves violated the board's duty to act equitably toward stockholders."[59] The *Coster* court, citing a subsequent Delaware Supreme Court precedent, summarized:

> "This Court has long recognized that 'inequitable action does not become permissible simply because it is legally possible.' Under Delaware law, 'director action[s] [are] 'twice-tested,' first for legal authorization, and

[57] *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. Nov. 29, 1971).
[58] *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661-62 (Del. Ch. July 25, 1988).
[59] *Coster*, 255 A.3d at 960.

> second [for] equity.' "Stockholders can entrust directors with broad legal authority precisely because they know that that authority must be exercised consistently with equitable principles of fiduciary duty."[60]

The *Coster* court noted that, when applying the *Schnell* line of cases, "careful judicial scrutiny will be given [to] a situation in which the right to vote for the election of successor directors has been effectively frustrated and denied . . . ."[61]

The *Coster* court then considered the *Blasius* line of cases relating to the interference with voting rights. The court noted that under *Blasius*, even where the board acts in good faith, and thus *Schnell* doesn't apply, "if the board nonetheless acts for the primary purpose of impeding stockholders' franchise rights, the board must prove a "compelling justification" for its actions."[62] The applicable standard for applying *Blasius* is not whether the board succeeded in preventing board nominees from being elected, but whether the board's action was "taken for the primary purpose of interfering with or impeding the effectiveness of the stockholder vote in a contested election for directors."[63]

Applying this law to the situation in *Coster*, the could held: "Coster alleged that an interested board approved the Stock Sale intending to interfere with her voting rights as a 50% stockholder and to entrench themselves in office . . . If that is the case, under *Schnell*, the court need not go any further to find a breach of fiduciary duty. And under *Blasius*, even if the court finds that the board acted in good faith when it approved the Stock Sale, if it approved the sale for the primary purpose of interfering with Coster's statutory or voting rights, the Stock Sale will survive judicial scrutiny only if the board can demonstrate a compelling justification for the sale." The court held that an entire fairness review did not supplant this analysis. The court noted that undisputed facts indicated that the stock sale failed the *Schnell* test, but nonetheless remanded to the lower court to review all of its factual findings in light of the new focus on a *Schnell*/*Blasius* review.

Takeaway

Coster reaffirms the importance of *Schnell* and *Blasius*. *Blasius* has historically been viewed as an anomaly that is rarely applied, and that is used more to rubber stamp a result than as a genuine test under which action is evaluated.[64] There has also been a tentative judicial effort to merge the *Blasius* standard with the *Unocal* test.[65] *Coster* pulls back from that approach and reaffirms *Blasius* as a separate test that must be applied.[66] *Coster* also serves as a reminder of the interplay between *Schnell* and *Blasius*. Considered together, the two decisions can be seen as a three-layered test applicable to board action in connection with director elections: first, whether the action is legally authorized; second, even if it is legally authorized, whether the action is equitable; and third, even if it is equitable and/or legally authorized, whether the action was taken for the primary purpose of interfering with statutory or voting rights.

[60] *Id.* (citing *Bäcker v. Palisades Growth Cap. II, L.P.*, 246 A.3d 81, 96-97 (Del. Jan. 15, 2021) (alteration in original) (emphasis in original) (first quoting *Schnell*, 285 A.2d at 439; then quoting *In re Invs. Bancorp., Inc. S'holder Litig.*, 177 A.3d 1208, 1222 (Del. Dec. 13, 2017); and then quoting *Sample v. Morgan*, 914 A.2d 647, 664 (Del. Ch. Jan. 23, 2007))).

[61] *Coster*, 255 A.3d at 961 (quoting *Giuricich v. Emtrol Corp.*, 449 A.2d 232, 239-40 (Del. July 30, 1982)).

[62] *Id.* at 962.

[63] *Id.* at 960 (citing *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1132 (Del. Jan. 7, 2003)).

[64] *See*, *e.g.*, *Mercier v. Inter-Tel (Delaware), Inc.*, 929 A.2d 786 (Del. Ch. Aug. 14, 2007).

[65] See *id.*; *see also Liquid Audio*, 813 A.2d 1118.

[66] There is a sub-issue as to whether *Blasius* applies to board action that impacts all stockholder voting rights, or only where it impacts director elections or election contests implicating corporate control. *See*, *e.g.*, *Mercier*, 929 A.2d at 808-12. That issue was not resolved in *Coster*.

Bardy Diagnostics, Inc. v. Hill-Rom, Inc., C.A. No. 2021-0175-JRS, 2021 WL 2886188 (Del. Ch. July 9, 2021)

Summary

Delaware Chancery Court held significant decrease in Medicare reimbursement rate did not give rise to an MAE because it was not durationally significant.

Bardy Diagnostics involved a post-trial decision in an action brought by Bardy Diagnostics, Inc. (Bardy) against Hill-Rom, Inc. (Hillrom), for specific performance to complete Hillrom's acquisition of Bardy. Hillrom counterclaimed, seeking a declaratory judgment that a significant decrease in the Centers for Medicare & Medicaid Services (CMS) reimbursement rate for Bardy's sole commercialized product constituted a Material Adverse Effect (MAE), and also led to frustration of the purpose of the acquisition agreement, excusing Hillrom from closing. In ruling for Bardy and granting specific performance, the court held, among other things, that the rate decrease lacked the requisite durational significance.

Background

Bardy had developed and was commercializing a long-term ambulatory electrocardiogram (AECG) medical device. The device took the form of a patch that was secured to a patient's chest for a 14-day period and used for recording electrocardiographic data. Medicare reimbursement rates for Bardy's extended AECG devices prior to 2021 had been temporarily set around $365 per patch for a number of years. These temporary rates were set by local contractors of CMS, the federal agency responsible for overseeing Medicare's reimbursement policy. CMS had signaled that it would set a permanent rate in January 2021, which was consistent with the typical CMS approach of transitioning to permanent rates after undertaking a thorough analysis, when a medical procedure becomes more widely adopted.

On August 4, 2020, CMS published its proposed reimbursement rates for 2021, which included separate rates of $451.24 for 2-to-7 day tests using extended AECG monitors, and $463.92 for 7-to-14 day tests, for the geographic region applicable to Bardy. On October 5, 2020, a third party submitted a comment to the CMS proposed rates that advocated a rate of $66.25 for the 2-to-7 day code, and $82.66 for the 7-to-14 day code.[67] Hillrom decided to wait for CMS to publish its final rates before committing to an acquisition of Bardy. On December 1, 2020, when CMS published its final reimbursement rates for 2021, it adopted permanent pricing codes for extended AECG patches, but deferred a decision on the actual pricing in order to collect more data. It delegated pricing for 2021 to the local contractors that had been setting the temporary rates (the contractor applicable to Bardy's region was called Novitas). Hillrom decided against delaying its acquisition of Bardy any longer, but proposed a different purchase price structure that paid less consideration at closing and introduced an earnout tied to 2021 and 2022 revenue in order to push some of the Medicare reimbursement pricing risk back to the selling stockholders. The parties completed negotiation of final terms and signed a definitive merger agreement on January 15, 2021.

On January 29, 2021, Novitas announced pricing for the new permanent pricing codes of $42.68 for Texas and $49.70 for New Jersey. The deal parties were shocked by the massive decrease in rates compared to the historic rate of approximately $365. They came to believe it must be a mistake. Bardy, with support from Hillrom, and Bardy's three main competitors engaged in an intensive campaign to get Novitas to change the pricing. Two of the competitors were also subject to pending acquisitions at the time, and those acquisitions proceeded to close.

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[67] The court's opinion lists $8.66 for the 7-to-14 day code, but this appears to be a typo and the comment letter indicates that the proposed rate was $82.66. *See* Muller Consulting & Data Analytics, LLC, Comment Letter on Centers for Medicare & Medicaid Services CY 2021 Notice of Proposed Rule Making (October 5, 2020), https://www.regulations.gov/document/CMS-2020-0088-27016.

On February 21, 2021, Hillrom notified Bardy that it believed Novitas' January rate gave rise to an MAE. One week later, Bardy initiated litigation to force Hillrom to close. On April 10, 2021, Novitas announced revised reimbursement rates that were about 2.5 times the January rates, although still well below the $365 historic rate. Bardy negotiated rates with commercial payors that were in almost all cases in line with their 2020 rates.

The Court's Analysis

The court noted that, as is typical in M&A deals, the MAE was drafted to allocate general market or industry risk to buyer through carve-outs to the MAE definition, and reallocate company specific risks back to the sellers through "disproportionate impact" exceptions to these carve-outs. The buyer has the initial burden of demonstrating a material adverse effect, which flips to the sellers to show applicability of a carve-out, and then back to the buyer to demonstrate the "disproportionate impact" exception.

Rate Decrease Was an "Event" That Fell Within Scope of MAE

Bardy made two preliminary arguments: First, the Novitas rate was not an "event" for purposes of the MAE definition because, under the *IBP* decision,[68] only unknown events could give rise to an MAE, and the risk of a rate change was known at the time of signing the merger agreement. Rejecting Bardy's position, the court noted that a similar argument had been rejected in the *Akorn*[69] decision, and the parties could have drafted the MAE definition to only include unknown events, but didn't.

Second, Bardy noted that the MAE definition was phrased in terms of requiring a material adverse effect on the "Business," and did not also include the customary reference to the company's financial condition. Bardy argued that the MAE therefore only addressed changes to operating matters, and not changes to the company's financial condition, and that changes to reimbursement rates, which impacted revenue, related to the company's financial condition but not operating matters. The court rejected this argument as overly narrow. The court noted that "Business" was defined in terms of Bardy and its subsidiary being "collectively engaged . . . in . . . commercialization activities," among other things. This includes the concept of revenue. The court also noted that the MAE definition contained a customary exclusion for the failure to meet revenue estimates, and this exclusion would not make sense if non-operating events, such as changes in revenue, could not give rise to an MAE.

Durational Significance

The court then considered whether the Novitas rate decrease was something that "has had, or would reasonably be expected to have a material adverse effect" on the Business. The court held that Hillrom had to show both (i) that the effect of the April Novitas rate on Hillrom's earnings potential, when Hillrom invoked the MAE, would reasonably be expected to constitute an MAE, and (ii) that it would "reasonably be expected to endure for a durationally significant period." The court assumed, without determining, that clause (i) was satisfied. But it held that Hillrom had not satisfied clause (ii) because "the preponderance of the evidence does not support the contention that neither Novitas nor CMS will increase the [Novitas rate] within a commercially reasonable period." The court held that "commercially reasonable" should be measured in years and not months. The court considered two years to be a reasonable period because, among other things, Hillrom's own models did not expect Bardy to become profitable until 2023. The court found the testimony of Hillrom's expert on the issue to be unpersuasive. It found that she did not have firsthand experience with CMS rulemaking; she had wrongly predicted Novitas would not adjust the rate upwards in April; and her opinion that CMS would see no need for a rate revision conflicted with Hillrom's stated justification for refusing to close the deal (i.e., that the April Novitas Rate resulted in an existential crisis for Bardy).

The court credited testimony of Bardy's expert. The court noted that she had extensive experience engaging with CMS and the local consultants on reimbursement codes, she correctly predicted that Novitas would increase its January rates, and she gave three reasons that the April rates would be increased again within two years. First, CMS'

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[68] *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 68 (Del. Ch. June 18, 2001).

[69] *Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL, 2018 WL 4719347, at *60 (Del. Ch. Oct. 1, 2018).

delegation to Novitas and its public statement that its deferral was "for 2021" indicated that the pricing was only intended to remain in place for 2021. Second, given CMS' core operating principles, she viewed it as unlikely that CMS would ignore the large number of Medicare claims for the service. Third, the April rate had "received considerable attention, not only from affected industry players but also from clinicians who are concerned about their ability to continue to provide this service to patients in need."

The court held that Hillrom had also failed to prove that the April rate would not be meaningfully revised upwards. It noted that prior to Novitas setting the rate in January, Hillrom had viewed a downward adjustment to the rate as unlikely. The court noted that Hillrom had completely changed its perspective in litigation, and was discounting the very thorough process that CMS goes through to set rates, including its initially proposed rates of over $400, in favor of Novitas' more cryptic and less thorough process. The court held that Hillrom's failure to prove that it was not reasonably likely there would be a meaningful increase in the reimbursement rate meant that Hillrom had failed to prove there was an MAE.

Even If There Had Been a Material Adverse Effect, An Exception Would Apply

While not necessary, given the court's holding that Hillrom had failed to prove the occurrence of an MAE, it nonetheless considered whether the exception to the MAE definition for "any change in Law (including . . . any Health Care Law)" applied. The court noted that "Law" was defined to include any regulation or rule issued by any government body, including "any authorized contractor engaged by any governmental, legislative, executive or judicial agency . . . or regulatory body." The court held that this exception "squarely encompasses changes in the Medicare reimbursement rates set by Novitas."

The court considered whether the "disproportionate impact" carve-out applied. The court held that this required Hillrom to prove: "(1) the universe of 'similarly situated' companies operating in the same industries or locations' as Bardy, and (2) that Bardy, as compared to those businesses "similarly situated," suffered a "materially disproportionate impact." The court held that only one of Bardy's three main competitors, iRhythm, was similarly situated, because it was the only single-product company. For purpose of determining any disproportionate impact, and the type of impact to consider, the court held that impact "must be measured by reference to an event's relative, overall effect on other companies." Without delving into precise financial metrics, the court held that Hillrom had "failed to prove that Bardy suffered a disproportionate impact relative to iRhythm by any measure." The court noted that Hillrom's own expert's model showed that revenue impact was similar at both companies. The court noted that while there was not good data on profitability, the record indicated that Bardy was more profitable than iRhythm, and there was anecdotal evidence that iRhythm was impacted more severely by the rate changes. The court rejected Hillrom's argument that a discounted cash flow (DCF) valuation of Bardy yielded a value of less than $0, which was worse that iRhythm's stock price drop of 68%. The court noted that there were numerous indicia of value for Bardy, including its "intellectual property, its growth trajectory and its profitable unit economics," and that comparing Bardy's DCF valuation to iRhythm's stock price was inapposite. Accordingly, the court held that Hillrom had failed to prove that the disproportionate impact carve-out applied.

Doctrine of Frustration of Purpose Did Not Apply

The court considered Hillrom's frustration of purpose claim. The court held that this common law doctrine permits buyers to avoid closing if the target experiences a catastrophe prior to closing. "It is not enough that the transaction has become less profitable for the affected party or even that he will sustain a loss. The frustration must be so severe that it is not fairly to be regarded as within the risks that he assumed under the contract."[70] Rejecting Hillrom's claim, the court held that Hillrom "sought to acquire a growth company with clinically superior technology to expand its cardiology offering; Bardy remains exactly that. While the April Novitas Rate will lower Bardy's revenue in the short-term, the record does not support that this state will remain status quo for long. In any event, the parties allocated the

[70] *Bardy*, 2021 WL 2886188, at *40 (quoting Restatement (Second) of Contracts § 265 cmt. A (1981)).

risk of a reimbursement rate reduction onto Bardy through the Agreement's earnout, which helps to offset any short-term losses Hillrom will suffer as a result of the April Novitas Rate."

The court held that Bardy was entitled to specific performance, and to pre-judgment interest. The court rejected Bardy's claim that it was also entitled to $12 million in compensatory damages under the indemnity provisions of the merger agreement. The court held that the indemnities were for the benefit of "Equityholders," which was not defined in a way that would include the company.

Takeaways

The court noted at the outset of the decision that this was not a typical "busted deal" case where the buyer had "buyer's remorse" and, "through deliberate indolence or sabotage," sought to avoid closing. Here, both parties were blindsided by a significant and unanticipated decrease in Medicare reimbursement rates. But Hillrom faced an uphill task in trying to get out of the deal. First, Hillrom was unable to establish that the reimbursement rate decrease was durationally significant. Second, this was the type of industry risk that is typically allocated to buyers, and consistent with that norm, the merger agreement in *Bardy* did allocate that risk to Hillrom. Moreover, the court noted in passing that two other deals in the industry were completed, notwithstanding the rate decrease. A takeaway for buyers like Hillrom that sign a deal where there may be a big regulatory development during the pre-closing period is to have an express closing condition that gives them a walk-away right. Relying on an MAE, or a frustration of purpose argument, to avoid closing is a strategy that is very difficult to prevail on.

Another takeaway from the decision, while not outcome determinative in this case, is the potential importance of the reference group against which the "disproportionate impact" test is measured. In *Bardy*, the applicable wording was "other similarly situated companies operating in the same industries or locations." The court interpreted "similarly situated" to require a focus on factors such as "operational scale (i.e., revenue), developmental maturity and, most importantly, product portfolio (i.e., relative product mix and sophistication)." This resulted in iRhythm being the sole company in the reference group, largely because it was the only other single-product company. The court noted that in other Delaware MAE cases, the applicable language had been "comparable entities operating in the [same] industry," which presumably could have resulted in a much larger reference group. Deal parties should pay attention to this part of the MAE definition. Target companies will often want a reference group that is as similar to the target company as possible, and acquirors will often want a larger reference group that is more diversified and less likely to have been materially impacted by the effect at issue.

There was an interesting point at the end of the decision where the court denied Bardy's claim for $12 million in compensatory damages incurred by Bardy as a result of Hillrom's breach of its obligation to close. A review of the merger agreement indicates that there was a customary purchase price adjustment mechanism, so the $12 million in losses to Bardy would have resulted in a corresponding decrease to the purchase price paid to the stockholders. Accordingly, the stockholders were damaged, but they could not use the court case to claim compensation. Target companies should consider negotiating for a provision in the merger agreement that permits them to bring an action for these types of pre-closing damages.

Symbiont.io, Inc. v. Ipreo Holdings, LLC, C.A. No. 2019-0407-JTL, 2021 WL 3575709 (Del. Ch. Aug. 13, 2021)

Summary

Non-competition provision in a joint venture agreement purporting to restrict the parties to the joint venture and their respective "affiliates" applied to subsequent acquiror of one of the JV parties, because affiliate status is tested at the time of determining contractual compliance, and not just as of the effective date of the underlying agreement.

Background

Towards the end of 2016, Symbiont.io, Inc. (Symbiont) and Ipreo LTS, LLC (Ipreo) formed a joint venture (JV) that targeted the secondary market for syndicated loans. At the time, the market was dominated by IHS Markit Ltd. (Markit), which controlled more than 99% of the market through its product called ClearPar. The JV sought to take market share from ClearPar by developing superior technology solutions, and by early 2018 had completed a successful proof-of-concept demonstration and was working on securing financing from a syndicate of major banks. In May 2018, Markit announced its pending acquisition of Ipreo. Citing concerns that Markit's ownership of Ipreo would stifle the development of a ClearPar-competitive product by the JV, the JV's potential investors began to withdraw. The JV's management team attempted to persuade Ipreo and Markit to carve out Ipreo's interest in the JV from the acquisition, warning that upon consummation of the acquisition, Ipreo would be in breach of the non-competition provision in the JV agreement, which stated as follows:

> "[N]one of Ipreo LTS, Ipreo Holdings, Symbiont nor their respective Affiliates shall, without the prior written consent of the other,
>
> (i) during the period that it or its Affiliates holds a ten (10) percent or greater direct or indirect ownership interest in the Company, and
>
> (ii) (A) for one (1) year thereafter, or (B) in the event that during such period the Company ceases to engage in the Joint Venture Business, then for one (1) year thereafter;
>
> directly or indirectly, on its own behalf or on behalf of another Person:
>
> . . . own, manage, operate, jointly control, finance or participate in the ownership, management, operation, control or financing of, or be connected as a partner, principal, manager, agent, representative, consultant, advisor, promoter or otherwise assist (financially or otherwise) with or participate in, or use or permit its name or the name of any of its Affiliates to be used in connection with, any business or enterprise that is engaged in the Joint Venture Business anywhere in the world (the "Territory") except through the Company and the Joint Venture . . . ."

Markit refused to carve out the JV interest, and completed its acquisition of Ipreo on August 2, 2018. Shortly thereafter, Markit decided not to continue the JV, and insisted it was only interested in buying Symbiont out. At the end of January 2019, Markit offered to purchase Symbiont's interest in the JV for $5 million, and conditioned the deal on various additional terms, including a requirement that the JV's CEO, Joseph Salerno, work for Ipreo. Symbiont countered with a proposal that Markit pay $15 million for Symbiont's interest, dissolve the JV, and permit Salerno to continue working with Symbiont, among other conditions. The parties were ultimately unable to reach an agreement, and Symbiont filed suit against Markit and Ipreo in May 2019. On October 29, 2019, Salerno accepted an offer to work for Markit, and resigned from the JV board on November 25, 2019. From that point on, with a deadlocked board and no CEO, the JV had no ability to continue operating.

The Court's Decision

The predominant focus of the court's decision was Symbiont's claim that Ipreo breached the non-competition provision of the JV agreement. The issue turned on whether Markit, having acquired Ipreo almost two years after the JV agreement was signed, qualified as an "Affiliate." Symbiont argued that a person's status as an "Affiliate" should be evaluated at the time when contractual compliance is measured. Ipreo, on the other hand, claimed that the evaluation should be made on the date the JV agreement became effective.

The court first rejected Ipreo's argument that the non-competition provision could not bind a non-party like Markit, or require Markit to operate its competing business through the JV. The court held that this was irrelevant. It was established law that a "party can accept contractual consequences for events beyond its control, including the actions of entities that are not parties to the contract." Thus, Ipreo could contractually agree to consequences arising from Markit's actions.

The court then considered the "Affiliate" definition, which read as follows:

> "'Affiliate' means, with respect to any Person, any other Person who, directly or indirectly, controls, is controlled by, or is under common control with, such Person . . . . Notwithstanding the foregoing, with respect to Ipreo, Ipreo LTS, Ipreo Holdings or any Ipreo Member, 'Affiliate' shall not include the Ipreo Sponsors and any direct or indirect owner thereof, or any Person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the Ipreo Sponsors (other than Persons directly or indirectly controlled by Ipreo Holdings)."

Because the term "Ipreo Sponsors" was narrowly defined as Blackstone Group L.P. and Goldman Sachs Group, Inc., the court ultimately determined that the exemption in the second part of the above definition was inapplicable.

Time for Considering Affiliate Status

The court considered the plain language of the "Affiliate" definition, noting that it lacked any temporal restriction. The court also addressed the incorporation of "control" in the definition, noting that "control" was defined in a way that indicated it applied at the time of testing. For example, one aspect of the control definition was "the ownership, directly or indirectly, of not less than fifty percent (50%) of the then outstanding (i) stock, if the entity is a corporation, or (ii) partnership interests, membership interests, other entity interests or profit interests . . . " The court noted that the words "then outstanding" suggested that equity ownership could fluctuate, which indicated that the Affiliate test should be evaluated at the time of evaluating whether there was a breach.

The court noted that language in the non-competition provision also indicated that the Affiliate test was not fixed in time. Its restrictions on dealing with customers referenced "any then current customer" and "any Person that has been a customer . . . at any time within one (1) year prior to that date." Elsewhere in the non-competition provision there was a reference to "products or services . . . as of the date hereof." Thus, the parties knew how to impose temporal limitations on provisions, but had not done so in the "Affiliate" definition.

The court looked to *Universal Studios Inc. v. Viacom Inc*. as persuasive and directly on point. In *Viacom*, Universal and Paramount formed a joint venture pursuant to an agreement that contained a noncompete. Their parent organizations agreed to be bound by the agreement and to cause their Affiliates to be bound. "Affiliates" was defined in a customary way. Thirteen years after the joint venture agreement was entered into, Viacom acquired Paramount. Viacom indirectly owned a business that competed with the joint venture business. The court held that the Affiliate test was satisfied, and that Viacom breached the non-compete upon acquiring Paramount. The court in *Symbiont* found that the non-competition provision was likewise breached once Markit became an Affiliate of Ipreo. The *Symbiont* court also noted the *Viacom* court's reliance in part on the underlying business purpose of the non-competition provision, which was to "shield the joint venture from divided loyalties" of its owners. According to the *Symbiont* court: "[C]ompetition from a parent entity created those hazards, whether or not the competing parent entity had been the parent when the joint venture agreement was executed." The *Symbiont* court held that the same reasoning also applied to the non-competition provision in *Symbiont*, and thus the Affiliate definition should not be interpreted in a way that froze it to the date of the JV agreement.

Commercial Context

The court noted that the non-competition provision contained a 10% ownership reference, and so contemplated that the parties' relationship to the JV could change over time. It would not make sense to then fix the Affiliate determination to the time of signing the JV agreement. The court noted that Ipreo's interpretation would create the absurd result where "either Symbiont or Ipreo could form a new entity immediately after executing the JV Agreement, then conduct Joint Venture Business through that entity." The court also rejected Ipreo's claim that the Ipreo Sponsors would never have agreed to the interpretation advocated by Symbiont because of the impact it could have on a sale of Ipreo. The court held that this was not supported by the record. The court also noted that the JV was immaterial in value to Ipreo and thus was unlikely to impact a sale of Ipreo and, moreover, a sale could be structured to leave the JV behind.

Breach and Damages

The court held that Markit became an Affiliate of Ipreo when Markit's acquisition of Ipreo closed, and thus the acquisition gave rise to a breach by Ipreo of the noncompetition provision. The court noted that the JV agreement provided that in the event of a breach of the non-competition provision, the non-breaching party and the JV "shall be entitled to . . . an equitable account of all earnings, profits and other benefits arising from [the] violation. . . ." Considering the breach period during which the equitable accounting would apply, the court rejected Symbiont's position that it ran from the time of Markit's acquisition indefinitely into the future, because the JV had to been dissolved. The court held that the endpoint should be November 2019, when Salerno resigned as CEO and got off the board, because the company could no longer operate from that point onwards. Accordingly, under the non-competition tail provision, the damages would run until November 2020.

The court held that based on evidence at trial, the relevant Markit business earned $142 million in after tax profits during the period from the acquisition of Ipreo through to September 30, 2020. The court held that Ipreo was liable for that amount, plus after tax profits for October and November 2020. The court held that these damages should be paid to the JV and liquidating distributions should be made to the members and, pursuant to a request by Ipreo, the court ordered that the JV be dissolved.

Takeaways

In many industries, it is not unusual for acquirors to find in due diligence that the target company has one or more commercial agreements that contain restrictive covenants that purport to bind affiliates. *Symbiont* makes clear that exposure to the acquiror is not just theoretical. The damages award in *Symbiont*, based on the language in the JV agreement, was tied to the after-tax profits of Markit's competing business, which represented 98% of the applicable market. Accordingly, the damages were significantly in excess of those that the JV could have generated during the same breach period (and also significantly in excess of the price the parties were negotiating for Markit to buy Symbiont's JV interest). Acquirors should carefully analyze restrictions on "Affiliates" and how such term is defined in a target's commercial agreements during their due diligence process to evaluate whether such restrictions could apply post-closing, in light of the overall contract provisions and commercial context. Acquirors should also evaluate the extent of possible damages under the contract language. If restrictions on affiliates could apply to the acquiror, acquirors should consider the need for structural protections, such as leaving the contract behind (as advocated by the court in *Symbiont*), or requiring that the contract be amended as a condition to closing.

Arnold & Porter

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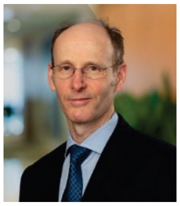

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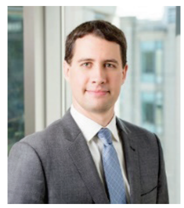

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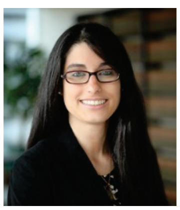

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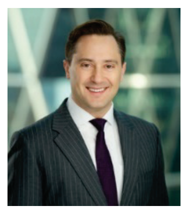

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