

**Professional Perspective**

# **Pre-Closing MAE/MAC to Post-Closing M&A Purchase Price Disputes**

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# Pre-Closing MAE/MAC to Post-Closing M&A Purchase Price Disputes

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## Introduction

In mergers and acquisitions, transaction parties and their counsel typically use the period between contract signing and closing to button-up items such as ensuring the bring-down of representations and warranties, obtaining the associated closing certificates and any additional agreed-upon documents, and arranging for orderly remittance of the purchase price.

Another important pre-closing task for a buyer is to conduct final due diligence to confirm that no material adverse effect (MAE) or material adverse change (MAC) has occurred in the target's business that has diminished the value of the target, or otherwise created uncertainty about the target's future business prospects, to such an extent that it might enable the buyer to terminate the deal.

After the closing of an M&A transaction, it is customary for the parties to attempt to reach agreement on the target's working capital balance as of the closing date and to adjust the purchase price to reflect any significant difference from the estimate used at closing, in the manner prescribed by the purchase and sale agreement. If the parties are unable to reach agreement, M&A agreements typically include a provision that requires the parties to refer the dispute to an independent third party.

## Current Economic Environment

The World Health Organization characterized the Covid-19 virus as a pandemic on March 11, 2020. It is difficult to fully measure, or even describe, the financial and economic disruptions attributable to the pandemic thus far, or to reliably estimate the long-term consequences. The current economic volatility has led to heightened focus on the potential applicability of MAE clauses for any signed transaction that has not yet closed. If Covid-19 has, for example, led to supply chain disruptions or loss of customers for the target, at what point can it reasonably be determined that an MAE has occurred?

Similarly, for closed M&A transactions, the business dislocations attributable to Covid-19 will likely make the post-closing determination of the target's closing working capital a more onerous and potentially disruptive exercise, as there are likely to be significant differences between a seller's and a buyer's estimations of the target's accounts receivable and inventory, among other accounts, in the pandemic environment.

This article outlines the key accounting, financial, and economic analyses that parties and counsel to M&A transactions should undertake in this period of unprecedented economic disruption in attempting to resolve MAE and working capital disagreements or to support their litigation or arbitration posture if disagreements can't be resolved through negotiation.

## MAE Disputes: Analytical Approach

The issue of Covid-19 serving as a trigger to terminate a transaction under an MAE clause has already engendered significant legal commentary. Most analyses are informed by Vice Chancellor Laster's landmark ruling in the 2018 *Akorn, Inc. v. Fresenius Akabi AG* decision in Delaware Chancery Court. *Akorn, Inc. v. Fresenius Kabi AG, et al.*, Del. Ch., C.A. No. 2018-0300, Laster, V.C. (Oct. 21, 2018) (Mem. Op.). *Akorn* is consequential because it represents the first time that the Chancery Court has permitted a buyer to terminate an M&A transaction due to an MAE.

For our purposes, the most noteworthy element of *Akorn* is that the Court upheld Fresenius's claim that an MAE had occurred due to two separate events: Akorn's breach of the bringdown representations and warranties concerning its compliance with certain FDA requirements (including with respect to data security) and its failure to remedy these significant deficiencies (the "bring-down representations" MAE); and the sudden and sustained drop in Akorn's business performance following execution of the merger agreement (the "stand-alone" MAE).

In addressing Fresenius's stand-alone MAE claim—i.e., that Akorn's sharp business decline constituted an MAE—Laster deployed a three-part construct:

- The magnitude of decline in the target's business. Laster ruled that this factor should be determined in part by “measuring a company's performance against its results during the same quarter of the prior year, which minimizes the effect of seasonal fluctuations.”
- The duration of the decline. On this issue, Laster cautioned that a “buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close,” and that “a short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror.”
- The degree of disproportionality of the extraneous event on the target as compared with its competitors or its industry at large. On this factor, Laster found that Fresenius met its burden by demonstrating “that Akorn's poor performance resulted from Company-specific problems, rather than industry-wide conditions.” Among other things, Laster relied on evidence that the drop in Akorn's EBITDA was comparatively much greater than those of its peers.

This analytical framework reaffirms that analyses of alleged MAEs, and associated arguments in negotiation or litigation, are highly dependent on the facts and circumstances of each transaction. The *Akorn* ruling is significant because, for the first time, it provides an organized approach, or playbook, for conducting the necessary analyses to determine whether an MAE has occurred.

Mindful of the guidance provided in *Akorn*, and regardless of whether you are assessing your ability to invoke an MAE clause or preparing to contest a claim that a MAE has occurred due to Covid-19, there are at least four quantitative analyses a party to a pending MAE dispute should undertake:

**Detailed Historical Financial Analysis of the Target:** Analyze the target company's historical results and financial projections to determine the nature, timing and extent of the decline in the target's business in relation to the potential Covid-19 related MAE. It will be important to examine in depth any pre-Covid-19 downturns in determining whether a post-Covid-19 business or financial decline can be persuasively linked to the pandemic.

**Industry and Competitor Analysis:** Perform detailed industry, competitor and geographic analyses to determine the extent of any disproportionate impact on the target's business due to business or economic disruptions attributable to the pandemic.

**Update Short- and Long-Term Forecasts:** Revisit short-term and long-term forecasts of the target company to carefully assess the expected duration of the target company's downturn, to differentiate between an anticipated short-term reduction and a longer-term adverse effect that more significantly impacts the underlying value of the target's business, or the value of the consolidated enterprise to the buyer.

**Refreshed Valuation Analysis:** Beyond updated forecasts, used as cash flow inputs in a discounted cash flow valuation analysis, assess the appropriateness of discount rates used in determining the magnitude of decline in the underlying value of the target company. Whether or not an MAE is found to have occurred, this analysis will better prepare the parties for potential purchase price renegotiations that may bring the transaction to a mutually satisfactory closing.

In sum, while there is no indication that the *Akorn* decision will lower the bar for buyers to make the difficult case that an MAE has occurred, we should expect an increase in MAE challenges to pending transactions in the Covid-19 environment and a more pronounced quantitative focus by courts in weighing the parties' arguments. As has historically been the case, disputes regarding MAEs will be very fact-and-circumstances specific, and parties will be better prepared to defend their respective positions by undertaking the analyses described above.

## Post-Closing Working Capital Adjustments

Another customary feature of an M&A transaction—the post-closing determination of the target's closing working capital and making associated purchase price adjustments—likely will become a more challenging exercise due to the Covid-19 pandemic. Working capital disputes can be contentious in the best of times, but in this period of global economic upheaval

across national and industry borders, there likely will be an even greater degree of discrepancy between a seller's pre-closing estimate and a buyer's post-closing true-up of working capital.

U.S. GAAP and IFRS provide relevant guidelines to consider when seeking to measure any impact of Covid-19 on a target company's closing balance sheet.

They include the following:

- Assessment of compliance with the appropriate basis of accounting preparation, including U.S. GAAP, IFRS, consistent practice, contractually specified and/or other applicable guidance
- Application of FASB's Subsequent Events guidance, ASC 855, which will be critical to loss contingencies estimated in the context of Covid-19 considerations
- Consistency of applied policies, practices and methods across the relevant measurement period

Closing working capital is calculated as of the closing date, and under a GAAP or IFRS basis of preparation, is derived from a balance sheet limited to accounting for those conditions that existed at the closing date but which are informed by additional information learned through the date of preparation of the true-up for those conditions. ASC 855 defines these post-balance sheet subsequent events as Type 1.

By contrast, Type 2 subsequent events either inform conditions or are conditions that did not exist at the balance sheet date and, accordingly, do not affect account balances. In today's environment, the date on which Covid-19 became a condition affecting the target company in relation to the transaction closing date will determine the extent of the pandemic's impact on closing working capital, if any.

In addition, ASC 250 (Accounting Changes and Error Corrections) addresses accounting for a change in an accounting estimate, which is routinely treated as a prospective event and is often an issue in working capital disputes involving improper attempts to use hindsight.

## Conclusion

In the context of M&A transactions, the effects of the pandemic on the parties and the industries and geographies in which they compete likely will add to the complexity of negotiations and disputes relating to the alleged occurrence of an MAE, and the process of truing up the target's closing working capital. In this environment, consideration of the unique facts and circumstances of each transaction will be more relevant than ever. M&A transaction participants and practitioners should be especially mindful of the importance of in-depth accounting, financial, and economic analyses to support their positions.