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RISK MANAGEMENT

Breaking Up Is Hard to Do: A Guide to Types of Litigation That Frequently Follow Broken Deals and Associated Risks (Part One of Two)

By Justin M. Ellis and Caleb Hayes-Deats, *MoloLamken LLP*

Even the most promising joint business ventures can fall apart. If they do, parties that once saw each other as partners can quickly find themselves as adversaries. To that end, the term "broken deals" is intentionally broad – designed to capture not just failed mergers but also other types of disputes that can arise from a transaction. Even completed transactions can lead to serious litigation risk from dissatisfied stakeholders. Fund managers need to watch carefully for those risks and guard against them in any transaction they undertake.

This first article in a two-part series surveys different types of claims that can arise after broken deals and provides practical lessons for fund managers from caselaw, including those arising from material adverse changes (MACs) or material adverse effects (MAEs); misrepresentation claims; or breaches of non-disclosure agreements (NDAs). The second article will examine risks associated with deals falling apart due to a breach of fiduciary duties; situations involving distressed companies; and where parties are charged with aiding and abetting conduct in connection with a broken deal.

For coverage of allocating fees resulting from broken deals, see "Primer on Deal-by-Deal Funds: Balancing Deal Uncertainty Against Attractive Carry Opportunities (Part Three of Three)" (Mar. 3, 2020); and "SEC Enforcement Action Involving 'Broken Deal' Expenses Emphasizes the Importance of Proper Allocation and Disclosure" (Jul. 9, 2015).

Material Adverse Changes or Events

Lawsuits can arise under the agreement that structured the transaction itself, after one party claims that a MAC or MAE – or the failure of some other contractual condition – absolves it of its obligation to close the deal. Although MAC or MAE clauses are common in deal documents and have always posed potential litigation risk, the Delaware Court of Chancery's decision in *Akorn, Inc. v. Fresenius Kabi AG* breathed new life into those risks by showing that enforcing a MAC/MAE clause is not as impossible as it once might have seemed.

Akorn Facts

The case arose out of a 2017 transaction in which Fresenius Kabi AG (Fresenius), a German pharmaceutical company, agreed to purchase Akorn, Inc. (Akorn), a U.S. generic drug manufacturer. A condition to closing was that there would be no "[MAE] on the business, results of operations or financial condition of" Akorn. Further, Fresenius could terminate the merger if Akorn's representations and warranties (R&Ws) were breached at closing and that breach could "reasonably be expected to have [an MAE]."

After the parties signed the merger agreement, Akorn's financial performance dramatically declined, and Fresenius received two whistleblower letters alleging that Akorn had violated FDA regulations. Fresenius thus asserted two MAEs as a reason to back out of the deal:

- one based on Akorn's financial performance; and
- the second based on Akorn's failure to cure its regulatory non-compliance.

For coverage of other contractual provisions that can excuse performance, see "Can a Fund Manager Use a Force Majeure Provision to Extend a Fund's Investment Period During the Coronavirus Pandemic?" (Jul. 21, 2020); and "When Do Force Majeure Clauses Excuse Performance?" (Apr. 21, 2020).

Court Ruling

When analyzing Fresenius's claims, the court reiterated the high bar for finding a standalone MAE in the merger context, holding there must be "an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." The court found that high standard was satisfied by both MAEs asserted by Fresenius.

First, Akorn's "legacy business . . . took a nosedive," which did not occur as a result of industrywide factors or restrictions created by the merger agreement. Although the court cautioned that events must impact a "company's long-term earnings power" over "years rather than months," the "nosedive" that Akorn endured – including a year-over-year decrease in EBITDA of over 50 percent – met that test. Separately, the court also found that Akorn's violation of FDA regulations breached its warranty of regulatory compliance, which independently constituted an MAE. Given that Akorn's business was manufacturing generic pharmaceuticals, compliance with regulations was "essential" to its business.

Key Takeaways

Akorn remains the only Delaware case finding that an MAE occurred, and its facts involve dramatic declines in performance that go to the heart of a company's business. The fact that Delaware courts have been willing to find an MAE even once, however, will embolden buyers looking to back out of deals that have become unfavorable.

Whether acting as buyers or sellers, funds should carefully examine contract terms that will affect bargaining rights – and potentially result in litigation – around asserted MAEs. For example, the information rights common in many merger agreements are powerful tools buyers can use to find problems that could constitute an MAE. Likewise, fund managers must scrutinize any terms (*e.g.*, R&Ws) that go to the parties' allocation of risk. *Akorn* reaffirmed Delaware's willingness to strictly enforce the parties' contractual risk allocation, even if that leads to "sandbagging."

For more on the use of R&W insurance to mitigate certain risks, see "Adapting RWI to Secondary Transactions: Mechanics of the Insurance Policies and Obstacles Posed by Secondaries (Part One of Two)" (Apr. 13, 2021); and "RWI in the Secondary Market: Financial Impact on Transactions and the Process of Obtaining Insurance (Part One of Two)" (Feb. 11, 2021).

At the same time, *Akorn* is not a green light for remorseful buyers to break off deals at the first hint of an MAE. In that case, the court relied heavily on the fact that, unlike other cases involving "buyer's remorse," Fresenius attempted in good faith to close for as long as it could and remained committed to fulfilling its obligations under the merger agreement if it could not terminate. Funds suspecting an MAE would do well to follow Fresenius's approach and act deliberately before breaking the deal.

Misrepresentation Claims

Claims about misrepresentation also often arise when business deals go sour. Even if a misrepresentation does not constitute an MAE, it may justify breaking off a deal. For example, in its recent decision in *AB Stable VIII LLC v. Maps Hotels & Resorts One LLC*, the Delaware Court of Chancery refused to find an MAE but nonetheless permitted a buyer to terminate a transaction in response to what the Court deemed "fraud about fraud."

AB *Stable* Facts and Ruling

Maps Hotels & Resorts One LLC (Maps) had agreed in 2019 to acquire the hotel holding company Strategic Hotels & Resorts LLC (Strategic) and its portfolio of hotels from a subsidiary of Anbang Insurance Group., Ltd. (Anbang) for $5.8 billion. Issues arose when Anbang and its lawyers failed for months to disclose to Maps that a "shadowy and elusive figure" had forged a contract to claim title to some of Strategic's hotels. Moreover, the coronavirus pandemic had hurt Strategic's performance together with the rest of the hospitality industry. Maps thus refused to close, citing both the pandemic and the fraudulent scheme as breaches of Anbang's representations.

For more about misrepresentation claims in another context, see "How Fund Managers Can Use Non-Reliance Clauses to Protect Themselves From Investor Claims of Misrepresentation" (Sep. 24, 2019).

The court rejected Maps' claim of an MAE but found that Maps was entitled to walk away because of a breach of the condition that Anbang deliver clean title insurance for the Strategic properties at closing. That breach resulted directly from Anbang's (and its lawyers') lack of candor. Anbang knew the third-party fraudster well and correctly dismissed him as a "hold-up artist." If Anbang and its lawyers had been candid about the fraudster, "then the transaction likely would have closed, and this litigation would never have happened."

Anbang's misleading and belated disclosures spooked the title insurers, however, causing them to refuse to insure Strategic's title and, therefore, the title insurance condition to fail. As a result, the court concluded that Maps could terminate the transaction and obtain a refund of its deposit, plus interest and attorneys' fees.

Key Takeaways

AB *Stable* provides a powerful lesson about the need for thorough disclosure and candor in transactions. Too often, sellers are so concerned that bad news will scare away potential buyers that they try to hide it or downplay its significance. That tactic will too often have unforeseen consequences that can doom the deal, especially if actions by third parties are required as a condition of closing. Further, the more a seller tries to explain something away, the more likely it will simply give a buyer a potential out, or at least grounds to initiate litigation. Early and thorough disclosure allows counterparties to work through problems rather than litigating them afterwards.

See "Five Sources of Manager Obligations to Disclose SEC Examinations and Results to Investors (Part One of Three)" (Apr. 9, 2019); and "Investor Pressure Drives New Performance Compensation Models and Increased Disclosure Obligations for Managers" (Jun. 29, 2017).

Breach of NDAs

Definitive transaction documents are not the only possible source of litigation. If deals fall apart, funds may face serious exposure from preliminary agreements such as non-disclosure agreements (NDAs).

Martin Marietta Facts and Ruling

For example, in *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, the Delaware Court of Chancery held that an NDA from an unconsummated merger barred one company from using information it had learned in a subsequent bid for a hostile acquisition of the other.

In 2010, Martin Marietta Materials, Inc. (Martin) and Vulcan Materials Company (Vulcan) entered into an NDA to consider whether to merge. The NDA prohibited each party from using information the parties shared other than to evaluate the contemplated transaction. The NDA also prohibited them from disclosing that they had exchanged that information or considered the transaction. The friendly merger talks did not result in a deal, but Martin was so impressed by the information it received that it subsequently decided to pursue a hostile acquisition of Vulcan.

See "How ILPA's Model NDA Could Change Preliminary Due Diligence Practices" (Feb. 16, 2021).

The court found that the NDA barred Martin's use of confidential information for purposes of a hostile takeover, and the Delaware Supreme Court affirmed. The court found that a hostile takeover bid was not the type of transaction for which the parties had agreed confidential information would be used. Martin had not only used the information to evaluate the hostile bid, however, but had also unnecessarily described the parties' past dealing in filings with the SEC. After finding a breach of the NDA, the court also enjoined Martin from proceeding with its hostile takeover bid until the NDA's term had concluded.

Key Takaways

Martin Marietta shows that preliminary agreements such as NDAs must be negotiated and performed with the same care as the final transaction. Not only are scenarios like *Martin Marietta* possible, but a party that breaches that NDA could face hefty liability for the victim's lost profits even if the NDA explicitly bars consequential damages. It is therefore essential to understand just what information is being shared and what the consequences could be if that information is misused.

Moreover, funds should give care to limit access to confidential information to the fewest number of people possible. To that end, consider using a discrete, "walled-off" team to review confidential information in the first instance to limit exposing key individuals to information that may, like *Martin Marietta*, later limit what actions they or the company can take.

For more on confidentiality provisions, see "Non-Disclosure Provisions in Settlement Agreements in the Wake of #MeToo" (Dec. 10, 2019); and "How Are Your Peers Responding to the Most Intrusive Requests From Private Fund Investors? (Part Two of Two)" (Apr. 2, 2019).

Justin M. Ellis is a partner at MoloLamken LLP, where his practice focuses on complex civil litigation, white collar matters and appellate litigation. He has tried multiple cases in federal and state trial courts and has argued appeals before the U.S. Court of Appeals for the Seventh Circuit, the Virginia Supreme Court and the en banc Virginia Court of Appeals. He has litigated in every level of the judicial system from trial courts to the U.S. Supreme Court. Ellis has particular experience in bankruptcy, distressed debt and structured finance litigation, as well as with clients including corporations; hedge funds and asset managers; indenture trustees; family offices and high net worth individuals.

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RISK MANAGEMENT

Breaking Up Is Hard to Do: A Guide to Types of Litigation and Associated Risks That Frequently Follow Broken Deals (Part Two of Two)

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When people refer to broken deals, they often use a broad brush to describe how they occur and the ramifications resulting therefrom. Typically, the focus is on the costs associated therewith and how they are allocated among GPs and LPs. There is another set of concerns, however, related to potential liability that can flow from broken deals. The potential scope and severity of that liability often stems from what type of issue caused the deal to collapse or the context of when it occurred. Fund managers need to guard against those risks as they pursue transactions.

This second article considers different types of claims that can arise after deals fall apart and provides practical lessons for fund managers from caselaw, including those arising from a breach of fiduciary duties; situations involving distressed companies; and circumstances where parties are charged with aiding and abetting conduct that results in the collapse of a deal. The first article examined risks associated with deals falling apart due to the occurrence of material adverse changes or effects; misrepresentation claims; and breaches of non-disclosure agreements.

For more on transactional risks, see "Practical Tips for Overcoming the Operational Challenges of Corporate Carve-Out Transactions by PE Funds" (Aug. 4, 2020).

Breach of Fiduciary Duty

Even completed deals can spark litigation if not all stakeholders are satisfied. One common type of dispute is where shareholders claim that one group that approved a transaction violated its fiduciary duties of loyalty or care it owed to the dissatisfied stakeholders.

Eccles Facts

For example, *Eccles v. Shamrock Capital Advisors, LLC* arose out of the 2018 merger of two betting companies: FanDuel, Inc. (FanDuel); and Paddy Power Betfair (Paddy Power). Before the merger, FanDuel had both preferred and common shareholders. FanDuel's articles of incorporation had a waterfall clause providing that, in the event of a "winding up," the preferred shareholders would receive the first $555 million in value, and the common shareholders would receive any residual value.

The merger between FanDuel and Paddy Power offered FanDuel's shareholders a 40% share of the merged entity, which was nicknamed "PandaCo." Under that structure, if the 40%

share of PandaCo was worth less than $555 million, it would go entirely to FanDuel's preferred shareholders. As the PandaCo shares increased in value above the $555-million threshold, FanDuel's common shareholders would receive more shares in PandaCo and the preferred shareholders fewer.

See our two-part series on the growth of preferred equity: "Features of the Hybrid Debt/Equity Solution and Its Use for Fund Level Liquidity" (Dec. 1, 2020); and "Future Trends in the Asset Class and Options for Sponsor- and LP-Level Liquidity" (Dec. 8, 2020).

The parties to the merger ultimately valued the PandaCo shares at $559 million, effectively wiping out the common shareholders. Rather than allowing the transaction to go to an open shareholder vote, two preferred shareholders exercised a "drag along" right under FanDuel's articles of incorporation to force it to accept the transaction.

Following the merger, the common shareholders brought a lawsuit alleging a breach of fiduciary duties by the preferred shareholders and FanDuel's former officers and directors. Specifically, the complaint argues that FanDuel's officers, directors and preferred shareholders conspired to value the merger compensation at a price that maximized the preferred shareholders' return (and minimized common shareholders' return). Motions to dismiss remain pending as of the date of this article.

Key Takeaways

In the alternative entity context, claims for breach of fiduciary duty can largely be avoided by including language in governing agreements that eliminates those duties. In the corporate context, where those duties cannot be eliminated, or in alternative entities where the duties continue to exist, the "sale process" used by the seller is critically important to analyzing the viability of a fiduciary duty claim.

Generally speaking, it is exceptionally difficult to establish a breach of fiduciary duty where independent and disinterested managers run a thoughtful sales process. Resist the temptation to allow corner-cutting, such as where a company fails to retain outside financial or legal advisors or where it fails to hold appropriate board meetings.

See "Navigating the Interpretation Regarding an Investment Adviser's Standard of Conduct: What It Means to Be a Fiduciary (Part One of Three)" (Dec. 3, 2019).

Further, as *Eccles* demonstrates, fund managers must be mindful of how interactions with certain shareholders could be perceived by others. Relatedly, funds with substantial shareholdings should be careful about coordinating with other shareholders, as that may inadvertently result in a regular shareholder becoming part of a controlling stockholder group that owes other stockholders fiduciary duties.

Deals Involving Distressed Companies

The risk of fiduciary duty suits is especially high when an entity involved in a transaction is or may be insolvent. In those situations, company directors – and others involved in the transaction – must take special care to avoid facing liability.

Nine West Facts and Ruling

For example, *In re Nine West LBO Securities Litigation* arose out of the 2014 leveraged buyout of the apparel company Jones Group, Inc. (Jones Group) by the PE firm Sycamore Partners Management, LP (Sycamore). The transaction documents contained a "fiduciary out" allowing Jones Group's directors to back out of the deal if they determined that approving the deal would violate their fiduciary duties. Before closing, Sycamore changed the deal's terms so that the post-deal entity, Nine West Holdings, Inc. (Nine West), would be saddled with more debt and receive less equity than before. At that point, the directors approved the deal and chose neither to exercise their fiduciary out nor investigate whether the changed deal terms might render Nine West insolvent.

See "The Sky Is Not Falling: Contextualizing SDNY's Nine West Ruling Against the PE LBO Model" (Apr. 6, 2021).

Years later, Nine West filed for Chapter 11, and the bankruptcy trustee brought a claim for breach of fiduciary duty against the directors for approving the buyout. The district court denied the directors' motions to dismiss in December 2020. Among other rulings, the court held the directors could not enjoy the protections of the business judgment rule because, as alleged, they had failed to properly investigate whether Nine West would be insolvent after the transaction and did not make a business judgment whether to exercise the fiduciary out. The court also allowed claims to proceed against Nine West's officers that the transaction they approved was a constructive fraudulent conveyance.

Key Takeaways

Nine West is just one example of how possible insolvency can add extra risk to any transaction. In some jurisdictions, such as New York, directors of a corporation in the "zone of insolvency" may also owe duties not only to the corporation's shareholders but to its creditors as well.

In addition, any transaction involving a company later found to be insolvent may be unwound as a fraudulent conveyance. Further, both counterparties and the individuals involved in the transaction could also find themselves on the hook under an aiding-and-abetting or civil-conspiracy theory. When a transaction involves a distressed company, therefore, it is critical to understand the company's solvency, and to document how the transaction is being undertaken in good faith and for value.

For more on distressed companies, see "Is It Time to Become a Distressed Lender? How PE Sponsors Can Pivot to a Bankruptcy-Lending Strategy While Managing Attendant Risks" (Jun. 23, 2020); and "Key Terms, Process Considerations and Potential Issues When Providing Rescue Capital to Distressed PE Portfolio Companies (Part Two of Two)" (Jun. 16, 2020).

Liability for Aiding and Abetting

Finally, funds involved in a broken deal can face claims that they aided and abetted the principals to breach their fiduciary duties or to commit other misconduct. Notably, under an aiding-and-abetting theory, third parties can face liability even if the principals do not.

Morrison Facts and Ruling

For example, *Morrison v. Berry* arose out of the sale of the Fresh Market grocery chain to Apollo Global Management LLC (Apollo). A shareholder brought claims alleging that the chain's founders breached their fiduciary duties by running a rigged sales process and deceiving shareholders into approving the sale to Apollo with misleading proxy disclosures.

The Delaware Court of Chancery ultimately dismissed breach-of-duty claims against the founders and other directors because they were protected by an exculpatory clause in the company's certificate of incorporation. The complaint's allegations failed to show the directors had the sort of conflict of interest, bad faith or lack of independence that would overcome the exculpatory clause.

In a later opinion, however, the court then allowed claims to proceed against the company's financial advisor, J.P. Morgan, for aiding and abetting that same breach of fiduciary duty. Under Delaware law, the court explained, "where a conflicted advisor has prevented the board from conducting a reasonable sales process . . . the advisor can be liable for aiding and abetting that breach without reference to the culpability of the individual directors."

The complaint met that standard for J.P. Morgan because it alleged that J.P. Morgan failed to inform the directors that it had its own conflict of interest given its extensive work for and backchannel communications with Apollo. According to the complaint, J.P. Morgan knowingly deceived the board with its actions. By contrast, aiding-and-abetting claims against Apollo and Cravath, Swaine & Moore LLP – the board's outside counsel – were dismissed because the complaint did not plausibly allege that those entities knew the board was violating its fiduciary duties.

For more on outside counsel, see "How Fund Managers Can Control Legal Costs and Negotiate Outside Counsel Fees (Part One of Three)" (Mar. 10, 2020); and "Private Fund Service Providers Must Exercise Caution When Communicating With Investors or Face Liability" (May 26, 2016).

Key Takeaways

As *Morrison* shows, a key distinction governing whether a third party to a deal can be held liable for a principal's alleged misconduct is what the third party knew about and whether they intentionally furthered that misconduct.

Other types of secondary liability against third parties that commonly arise out of broken deals similarly turn on what the third parties know and intend. For example, claims for intentional interference with contract require that the defendant know about the contract and intentionally acted out of malice or bad faith to cause that contract to be breached. Likewise, to be held liable as a co-conspirator, a third party must have a "meeting of the minds" to further some unlawful goal or use some unlawful means.

The critical role that knowledge and intent plays has two key implications. On one hand, fund managers can be confident that they cannot be held liable for others' misconduct of which they are not aware. But, on the other hand, deal parties that know of or suspect misconduct should carefully consider steps to stop that misconduct or warn others about it so they cannot themselves be accused of intentionally furthering it. In particular, managers should be particularly careful when they suspect they are dealing with a board that may be ill-informed, laboring under a conflict of interest or otherwise not living up to its fiduciary duties.

See our three-part series on sponsor-appointed directors on portfolio company boards: "Conflicted Transactions, MNPI and Other Risk Areas" (Aug. 4, 2020); "Best Practices to Mitigate Risk in Multiple Scenarios" (Aug. 11, 2020); and "Common Risk Scenarios Triggering Conflicts and Fiduciary Breaches" (Aug. 25, 2020)

Conclusion

The examples above highlight the diversity of legal issues that can arise when a deal does not go as planned – and sometimes even when it does. Fund managers would do well to keep the issues in mind when structuring new transactions, as even the most promising opportunities can go awry due to unforeseen or unforeseeable circumstances. In-house counsel in particular should perform careful due diligence to assess the risks and also tailor deal documents accordingly when possible. Preparing from the outset will help funds navigate any litigation that might result from a broken deal and transition to future opportunities.

Justin M. Ellis is a partner at MoloLamken LLP, where his practice focuses on complex civil litigation, white collar matters and appellate litigation. He has tried multiple cases in federal and state trial courts and has argued appeals before the U.S. Court of Appeals for the Seventh Circuit, the Virginia Supreme Court and the en banc Virginia Court of Appeals. He has litigated in every level of the judicial system from trial courts to the U.S. Supreme Court. Ellis has particular experience in bankruptcy, distressed debt and structured finance litigation, as well as with clients including corporations; hedge funds and asset managers; indenture trustees; family offices and high net worth individuals.

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