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Delaware Court Refuses to Dismiss a Material Adverse Effect Claim Brought by an Unhappy Buyer

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DELAWARE CORPORATE LAW BULLETIN

Delaware Court Refuses to Dismiss a “Material Adverse Effect” Claim Brought by an Unhappy Buyer

*Robert S. Reder**
*Danielle S. Lee***

Chancery Court examines level of competition in the target company’s market to address “disproportionate effect” exception

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INTRODUCTION

Parties to merger and acquisition transactions frequently include the concept “Material Adverse Effect” (“*MAE*”)¹ in their purchase and sale agreements. An MAE provision generally serves two principal functions in this context: *first*, as a qualifier that creates an exception to a representation and warranty made by one party (usually the seller) to the other party (usually the buyer) as to a state of facts relating to the representing party’s business;² and *second*, as a state of facts that must *not* exist if the buyer is going to be required to consummate the transaction.³ Negotiated exceptions to MAE provisions have become somewhat standardized, often relating to developments that impact *all* participants in the industry in which the target company does business.⁴ However, in legal drafting, we frequently see an *exception to an exception*: in this connection, even if an industry-wide development falls within an MAE exception, if the buyer can demonstrate that the development in question has had a “disproportionate effect” on the target company, then the industry-wide exception will not be applicable.⁵

There are several Delaware Court of Chancery (“*Chancery Court*”) decisions analyzing whether a development impacting a target company has triggered an MAE.⁶ However, there is scant judicial analysis of the “disproportionate effect” exception to the MAE industry-wide development exception. The Chancery Court’s recent, albeit brief, order in *Pheonyx LLC v. Luxtel Acquisition Company, LLC*,⁷ which denied a seller’s motion to dismiss a post-closing damages claim

1. These are sometimes referred to as “Material Adverse Change” or “MAC.”

2. For example, “The Company and its Subsidiaries are not subject to any Action or Proceeding, except in each case for those that would not, individually or in the aggregate, reasonably be expected to have a Company MAE.”

3. For example, “There shall not have occurred any change, event, effect or occurrence arising since the date of this Agreement that has had or would reasonably be expected to have, individually or in the aggregate, a Company Material Adverse Effect.”

4. For example, “Changes after the date hereof in general legal, regulatory, political, economic or business conditions or changes in generally accepted accounting principles that, in either case, generally affect the industry in which the Company and its Subsidiaries conduct business.”

5. These provisions are interrelated; even if a buyer can demonstrate that a development has had a “disproportionate effect” on the target company relative to other industry participants, it still must prove that the development itself has had or would reasonably be expected to have an MAE on the target company.

6. See, e.g., *In re* IBP, Inc. Shareholders Litig., 789 A.2d 14 (Del. Ch. 2001); *Frontier Oil v. Holly Corp.*, No. CIV.A. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005); *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008).

7. No. 2017-0004-JTL, 2017 WL 4083124 (Del. Ch. Sept. 14, 2017).

brought by an unhappy buyer, provides some insight into how the Chancery Court will analyze the “disproportionate effect” exception.

I. FACTUAL BACKGROUND

A. New Competitors in the Xenon Lamp Industry

Pheonyx, LCC (“*Pheonyx*”) manufactured and sold xenon lamps (“*Business*”).⁸ Apparently, “the market for specialized xenon lamps was highly concentrated, with Pheonyx historically enjoying minimal, if any, competition.”⁹ In fact, as late as May 2016, Ushio, Inc. (“*Ushio*”) was Pheonyx’s only competitor. However, unlike Pheonyx, “Ushio had an exclusive distribution agreement to sell all of its capacity to one manufacturer”¹⁰

On May 27, 2016, Pheonyx sold the Business to Luxtel Acquisition Company, LLC (“*Luxtel*”) pursuant to an Asset Purchase Agreement (“*APA*”). In Section 4.16 of the APA (“*MAE Representation*”), Pheonyx represented to Luxtel that, before the purchase, “there had not been any ‘event, occurrence or development that has had, or could reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect on [Pheonyx], the Purchased Assets, or the Business.’”¹¹ The APA defined “*Material Adverse Effect*” as:

any circumstance, change, occurrence, event or development that is, or could reasonably be expected to become, individually or in the aggregate, *materially adverse to* . . .

(B) the business, results of operations, condition (financial or otherwise) or assets of the Business, or

(C) the value of Purchased Assets;

but, in each case, none of the following, either alone or in combination, shall be deemed to constitute, or be taken into account in determining whether there has been, a Material Adverse Effect:

any change, occurrence, event or development: . . .

(ii) *generally affecting companies in the industry* in which [Pheonyx] conducts its business;

. . .

8. See *LuxteL – The Brilliant Choice in Imaging Lighting*, LUXTEL, http://luxtel.com/index.php?route=information/information&information_id=15 [<https://perma.cc/MC8U-CN82>] (last visited Jan. 14, 2018) (“These products are more rugged, offer better color rendition and eliminate environmental concerns associated with other lighting techniques. Quality is not compromised for cost in our design; we have engineered our costs out of the company from the beginning. This narrow focus, and our size, enable us to remain true to our aim of best value and speed of service in the imaging lighting industry.”).

9. *Pheonyx*, 2017 WL 4083124, at *2.

10. *Id.*

11. *Id.* at *1.

provided, however, that any circumstance, change, occurrence, event or development referred to in clauses (i) through (iii) above *shall be taken into account* in determining whether a Material Adverse Effect has occurred or could reasonably be expected to occur to the extent that such circumstance, change, occurrence, event or development has a *disproportionate effect* on the Business or the value of the Purchased Assets compared to other participants in the industries in which the Business operates.¹²

To complicate matters, Pheonyx previously had entered into a Non-Disclosure Agreement (“NDA”) with Excelitas Technologies Corporation (“Excelitas”) regarding Excelitas’ plan to introduce a competing product into the xenon lamp market. Luxtel apparently was aware of the NDA’s existence because Pheonyx represented in a previous letter of intent with Luxtel (“LOI”) that Pheonyx “had not and would not breach the NDA.”¹³ Assuming that Pheonyx would abide by this representation, Luxtel agreed in the LOI “to provide Pheonyx with limited indemnification against any lawsuit by Excelitas”¹⁴ However, Pheonyx did not reveal the nature of Excelitas’s plan to market a new xenon lamp to Luxtel for fear that disclosure of these plans “would have caused Pheonyx to breach” the NDA. This, in turn, would cause Pheonyx to forfeit the limited indemnity from Luxtel.¹⁵

Sometime following Luxtel’s purchase of the Business, Excelitas followed through on its plan revealed to Pheonyx (but not to Luxtel) to enter the xenon lamp market in direct competition to Luxtel. Allegedly, “Excelitas sold its competing lamp at prices well below where Luxtel could afford to manufacture its lamp.”¹⁶ As a result, Luxtel claimed, “competition from Excelitas has had a ‘catastrophic’ effect on Luxtel’s revenue and caused the value of the Business and Purchased Assets to plummet.”¹⁷

B. Litigation Ensues

In connection with a lawsuit brought by Pheonyx against Luxtel in the Chancery Court, Luxtel counterclaimed for damages, alleging that, at the time the APA was signed, Pheonyx knew that Excelitas was about to enter the xenon lamp market but withheld that information from Luxtel. Pheonyx’s failure to disclose the impending competition from Excelitas, Luxtel charged, constituted a breach of the MAE Representation.

12. *Id.* at *1–2 (emphasis added). This is the typically “circular” definition used in purchase and sale agreements. See *In re IBP, Inc. Shareholders Litig.*, 789 A.2d 14, 65 (Del. Ch. 2001).

13. *Pheonyx*, 2017 WL 4083124, at *3.

14. *Id.*

15. *Id.*

16. *Id.* at *2.

17. *Id.*

Pheonyx asked the Chancery Court to dismiss Luxtel's counterclaim on the pleadings,¹⁸ advancing three defenses to Luxtel's claims:

- *First*, referencing the APA's definition of Material Adverse Effect, Pheonyx argued that "as a matter of law, the release of a competing product . . . is a 'circumstance, change, occurrence, event or development . . . (ii) *generally affecting companies in the industry* in which [Pheonyx] conducts its business' . . . which did not have a '*disproportionate effect* on the Business or the value of the Purchased Assets compared to other participants in the industries in which the Business operates.'"¹⁹ ("*MAE Defense*").
- *Second*, Pheonyx contended it was excused from disclosing Excelitas' plans to Luxtel due to the promise it made to Excelitas in the NDA not to disclose those plans ("*NDA Defense*").
- *Third*, Pheonyx claimed that because it represented to Luxtel in the LOI that it would not breach the NDA, the LOI in effect prevented Pheonyx from violating the NDA by disclosing Excelitas' plans to Luxtel ("*LOI Defense*").

II. THE CHANCERY COURT'S ANALYSIS

Vice Chancellor J. Travis Laster summarily dealt with Pheonyx's defenses, denying its motion to dismiss Luxtel's claim that Pheonyx violated APA Section 4.16.

A. *MAE Defense*

1. Did the Business Suffer an MAE?

At the outset, the Vice Chancellor noted that "[a]lthough the 'material adverse effect' standard is high, [the] court will find that a plaintiff has adequately pled a material adverse effect if the pled facts support a reasonable inference that the misrepresentations 'could

18. Pursuant to Rule 12(c) of the Delaware courts, "A motion for judgment on the pleadings may be granted only when no material issue of fact exists and the movant is entitled to judgment as a matter of law." *Id.* at *1 (quoting *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1205 (Del. 1993)). Additionally, "a trial court is required to view the facts pleaded and the inferences to be drawn from such facts in a light most favorable to the non-moving party." *Id.*

19. *Id.* at *2 (emphasis added).

produce consequences that are materially adverse to the Company.’”²⁰ Here, Luxtel’s allegations as to (i) the “highly concentrated” nature of the xenon lamp market, (ii) Pheonyx’s failure to disclose Excelitas’ plan to enter the market, and (iii) the “catastrophic” impact of Excelitas’ low-cost product on the Business “are sufficient at the pleadings stage to state a claim for breach of Section 4.16.”²¹ That is, of course, unless Pheonyx could take advantage of “an applicable exception” from MAE listed in Section 4.16.²²

2. Was the Business’s Loss Disproportionate?

As noted above, Pheonyx’s MAE Defense rested on the theory that competition from Excelitas was “generally affecting companies in the industry” and did not have a “disproportionate effect” on the Business. As is always the case with an MAE dispute, the underlying facts can make or break a litigant’s claims. Vice Chancellor Laster credited Luxtel’s argument that Pheonyx in fact had only one competitor, Ushio, who enjoyed an exclusive distribution agreement to sell all of its capacity to one customer. Ushio, therefore, “was not affected by Excelitas’s entry into the market ... because Luxtel was not similarly situated.”²³ On this basis, the Vice Chancellor concluded that “Luxtel has pled facts making it reasonably conceivable that the release by Excelitas of a competing lamp . . . had a disproportionate effect on the Business . . . compared to other participants in the industries in which the Business operates.”²⁴ Accordingly, he ruled that “[t]hese allegations are sufficient at the pleadings stage to raise questions of fact as to the application of the exception on which Pheonyx wishes to rely.”²⁵

B. NDA Defense

Vice Chancellor Laster rejected Pheonyx’s NDA Defense, noting that the NDA was a “separate agreement” that “falls outside the four corners of the APA.”²⁶ The fact that a party “can enter into conflicting agreements that give rise to competing responsibilities” does not mean that such party “would get to pick between competing contractual

20. *Id.* (quoting *EMSI Acquisition, Inc. v. Contrarian Funds, LLC*, C.A. No. 12648-VCS, 2017 WL 1732369, at *15 (Del. Ch. May 3, 2017)).

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.* at *3.

obligations” or that, in Pheonyx’s case, its “prior contractual obligation to Excelitas would nullify its later obligation to Luxtel.”²⁷ The Vice Chancellor found “[i]t is reasonably conceivable that Pheonyx placed itself in that position.”²⁸

C. LOI Defense

Similarly, Vice Chancellor Laster gave short shrift to Pheonyx’s LOI Defense, labeling it a “*non sequitur*.” Recognizing that a “contractual representation is a bargained-for allocation of risk,” the Vice Chancellor explained that “Pheonyx did not make a commitment [to Luxtel] not to breach the NDA” but rather “made a representation, and it could face contractual consequences to Luxtel if its representation proves incorrect.”²⁹

CONCLUSION

Although *Pheonyx v. Luxtel* is not demonstrative of the circumstances that may constitute an MAE, Vice Chancellor Laster’s order provides insight on the Chancery Court’s approach to analyzing these provisions. It is interesting to note that the Vice Chancellor focused specifically on the nature of the competition within the xenon lamp industry to “give priority to the parties’ intentions as reflected in the four corners of the agreement, construing the agreement as a whole and giving effect to all its provisions.”³⁰ The courts of Delaware, a noted pro-contractarian state, seek to enforce and give meaning to contracts in line with what they view as the parties’ expectations.

It is also worth noting that Pheonyx knowingly (at least according to Luxtel’s pleadings) withheld information from Luxtel at the time Luxtel agreed to purchase the Business. Here, the Vice Chancellor might have seen the intentions of Luxtel as entering a market substantially similar to the market in which the Business historically operated. If Luxtel’s allegations are to be believed—as the Vice Chancellor was required to do at the pleading stage—Pheonyx *knew* that Luxtel would not in fact enjoy the “highly concentrated” market post closing once Excelitas introduced its new, low-priced product. One can reasonably assume that the Business’s dominant market position was one selling point touted by Pheonyx to promote the sale.

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.* (quoting *In re Viking Pump, Inc.*, 148 A.3d 633, 648 (Del. 2016)).

