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Delaware Court of Chancery Finds No MAE

In *Bardy Diagnostics, Inc. v. Hill-Rom, Inc.*, the Delaware Court of Chancery, in an opinion by Vice Chancellor Slights, held that a dramatic 50+% reduction in the Medicare reimbursement rate for target's sole product (a cardiac medical device) did not constitute a "Material Adverse Effect" ("MAE") under the merger agreement. The court held, among other things, that the buyer failed to show that any material adverse effect on the target was "durationally significant" (as is required to establish an MAE in the M&A context in Delaware), and, further, such effects did not constitute an MAE under the agreement because of the specifics of the definition. The court ordered the buyer to close the transaction and, in a rare, if not first, imposition of such a remedy in this context, awarded prejudgment interest (which remedy was uncontested by the parties). While the failure to find an MAE is not surprising given the history of jurisprudence in this area and the court's specific factual findings in this case, the decision provides some helpful insight into the court's MAE interpretation.

Background

Bardy Diagnostics, Inc.'s sole product line is a patch used to detect heart arrhythmias and related services. After extensive due diligence, in January 2021, Hill-Rom, Inc. agreed to acquire Bardy for \$350 million plus contingent earnout consideration linked to the patch's revenue for 2021 and 2022. Although Hill-Rom believed that Bardy had significant growth potential, Hill-Rom did not expect to turn a profit for several years after closing a transaction.

One of Bardy's largest sources of revenue is through Medicare reimbursements for the patch, which had historically been set at about \$365 per patch. Two weeks following signing of the transaction with Hill-Rom, however, the private entity authorized by Medicare to set the reimbursement rate for the patch reduced the rate by approximately 86% for the two jurisdictions in which Bardy operated. Hill-Rom then refused to close on the transaction, arguing that Bardy had suffered an MAE. By April 2021, the reimbursement rate was increased to about \$133 per patch, though still less than half of the historic rate.

Following the rate reductions, Bardy continued to grow, with new patch enrollments and orders for the first quarter of 2021 increasing 85% year-over-year. Despite the growth, however, its revenue declined approximately 11% between the last quarter of 2020 and the first quarter of 2021, though its first quarter 2021 revenue was still up 56% year-over-year.

Takeaways

The court held that Hill-Rom failed to show that Bardy suffered an MAE under the agreement. The agreement defined an MAE as "any fact, event, circumstance, change, effect or condition that, individually or in the aggregate, has had or would reasonably be expected to have a material adverse effect on" Bardy's business, except for certain carve-outs, including for any change in "Health Care Law" to the extent it had a "materially disproportionate impact on [Bardy] as compared to other similarly situated companies operating in the same industries or locations. . . ." Based on the particular facts of the case and the specific language of the MAE definition, the court held that any material adverse effects were not durationally significant (which is an element needed to establish an MAE in the merger context under Delaware law) and that such effects caused by the reimbursement rate reduction did not constitute an MAE because (i) they fell within the carve-out to the MAE definition for changes to "Law" and (ii) did not have a disproportionate impact on Bardy as compared to the only other similarly situated company. The opinion provided some insights into MAE analysis as follows:

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- *Whether an effect is sufficiently “durationally significant” to constitute an MAE may turn on a company’s unique characteristics and the broader business dynamics in which it operates.* Delaware courts, including the court in *Bardy*, have declined to proscribe specific time periods when assessing whether an effect is “durationally significant,” and look instead at the context of the transaction at hand. Importantly, Hill-Rom’s own internal projections estimated that Bardy would not turn a profit in the first several years after its acquisition and, further, that Hill-Rom had acknowledged that five or more years was durationally significant. Given these facts and the likelihood that Medicare would raise the reimbursement rate in the next two years, the court concluded that the rate reductions were not durationally significant.
- *MAE analysis continues to be based on a close parsing of the exact language chosen by the parties and the court’s observations on how that language may differ from common market practice.* The court in *Bardy* closely examined the exact words chosen by the parties in the MAE definition, including the following:
 - The parties’ choice to define a material adverse effect by reference to Bardy’s “Business” (i.e., its operations) rather than the broader “financial condition.” Bardy relied on this distinction to argue that the effect of the rate reduction was financial, rather than operational, and therefore did not constitute an MAE. The court acknowledged that the exclusion of this phrase made the MAE definition more seller-friendly and narrow than what it observed to be the usual base MAE provision, but found that the “commercialization activities” included in the Business definition encompassed the effect of the rate reductions.
 - The exceptions to the carve-outs, which excluded any matters to the extent of its materially disproportionate impact on Bardy as compared to other “similarly situated companies operating in the same industries or locations. . . .” (emphasis added). Again, the court noted that this formulation was more target-friendly than other MAE provisions interpreted by Delaware courts insofar as it could only look to “similarly situated companies” as opposed to companies “operat[ing] in the [same] industry”. The court looked to operational scale (i.e., revenue), developmental maturity and product portfolio (i.e., relative product mix and sophistication) in identifying such companies, and found that only one company was “similarly situated” to Bardy. The rate reductions had similar effects to that company as to Bardy, and therefore Bardy did not suffer a disproportionate impact from the rate reduction.
- *A Delaware court may be willing to look at post-termination developments in its MAE analysis.* Prior Delaware MAE decisions have considered whether an MAE was reasonably likely as of the date of the buyer’s purported termination, which, in the case of *Bardy*, was February 2021 (after the first approximately 86% reimbursement rate reduction, but before the second adjustment in April 2021, which increased the reimbursement rate to \$133). The MAE analysis in *Bardy*, however, focused on post-termination events, as it addressed whether the April rate gave rise to an MAE.
- *Good faith efforts by the buyer to counteract the effects of the alleged MAE may figure into the court’s MAE analysis.* At the outset of the *Bardy* opinion, the court stressed Hill-Rom’s complete good faith and that it encouraged Bardy’s lobbying efforts to undo the reimbursement rate reductions and stood ready to close should the rates be restored to historic levels. Although the court noted that these actions did not excuse a breach of contract and did not ultimately trump the contractual analysis, the court’s acknowledgement of Hill-Rom’s efforts in this regard is perhaps noteworthy for future terminating buyers.

Finally, in addition to specific performance to compel closing, Bardy also sought prejudgment interest (running from the date closing should have occurred in February 2021) as well as additional compensatory damages. The court granted Bardy’s request for prejudgment interest, which Hill-Rom did not contest, but denied Bardy’s request for additional compensatory damages. Parties may wish to consider defining in more detail their intention regarding damages in the event of litigation or any compelled closing, such as their agreement surrounding the payment of prejudgment interest.

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Andrew G. Gordon
+1-212-373-3543
agordon@paulweiss.com

Jaren Janghorbani
+1-212-373-3211
jjanghorbani@paulweiss.com

Laura C. Turano
+1-212-373-3659
lturano@paulweiss.com

Krishna Veeraraghavan
+1-212-373-3661
kveeraraghavan@paulweiss.com

Counsel Daniel Mason and Frances F. Mi and legal consultant Cara G. Fay contributed to this memorandum.

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