DOES COVID-19 PROVIDE A MATERIAL ADVERSE EFFECT EXCUSE FROM COMPLETING A MERGER? THE PENDING COMTECH – GILAT MERGER UNDER THE MICROSCOPE

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I. Executive Summary

The Comtech Telecommunications Corp.(Delaware, USA) – Gilat Satellite Networks (Israel) merger, announced in late January, has become the latest large deal testbed for whether the Covid-19 Pandemic can furnish a "Material Adverse Effect" (sometimes "Material Adverse Event") ("MAE") excuse for a party to avoid closing on a pending transaction. On July 7, 2020, Comtech, the larger, "acquiring" party in the merger, filed a complaint in the Delaware Chancery Court through its merger subsidiary to determine whether Gilat's financial results had fallen so far in the first half of the year as a result of the Pandemic from the deal's over $500 million enterprise valuation as to justify Comtech's excusal from completing the merger based on the Agreement and Plan of Merger's (the "Merger Agreement") MAE clause (the Merger Agreement, by its terms, is governed by Delaware law). We will use the Comtech – Gilat MAE provisions to assess how Covid-based MAE or MAC claims of excused performance are likely to work out.

II. Background

MAE or MAC clauses (we'll use MAE as a shortcut from now on) are usually a defined term in the definitional section of M&A or other high-value corporate or commercial agreements. The MAE definition is then "brought down" into the body of the agreement, usually as at least a condition to the purchaser's ("Acquirer") obligation to close, stating that the Acquirer's obligation to close is conditioned on no MAE, as defined, having occurred in the period between signing the agreement, the Merger Agreement in the case of the Comtech – Gilat deal, and the closing. The MAE is also generally brought down into the agreement in the form of a representation or warranty and/or a covenant, sometimes as a condition to closing, and sometimes as a standalone provision, and then incorporated into the termination provisions of the agreement, giving rise to a right (not an obligation) of the ("Acquirer"), and sometimes the seller ("Seller") to terminate the agreement and not close the transaction if a MAE, as defined, has occurred. So, for example, the MAE is defined; that no MAE, as defined, has occurred pre-closing is made a representation and warranty of the agreement; and the termination provisions then allow Acquirer to terminate the agreement and not close the transaction if any representation or warranty, including that no MAE has occurred, has been breached prior to closing.

This is what Comtech is trying to do. In some cases, the occurrence of a MAE also gives Acquirer a right of renegotiation short of termination, either at Acquirer's election, or for certain specified kinds of MAEs, with others giving rise to the right of termination only. In other words, the threat of invoking an MAE clause may not only give Acquirer a right to terminate, but leverage to renegotiate its deal with a motivated Seller.

MAE clauses and their equivalents are not confined to M&A agreements, either. High value commercial agreements of all kinds can have performance-excusing conditions. For example, large pharmaceutical, chemical and other industrial manufacturing, supply and distribution agreements can contain either MAE clauses denominated as such, or equivalents such as volume commitment shortfall excuse provisions, force majeure clauses and others. See, our Biotech, Pharma and Life Sciences Master Distribution Agreement Sample Term Sheet Whitepaper, available at https://kurtinlaw.com. High value commercial contracts in the telecommunications, energy, information technologies and heavy industry sectors, among others, also frequently use MAE clauses or equivalents.

MAE definitions may not be standardized (and Acquirers will surely seek to include in them economic slowdowns caused by pandemics going forward), but they have a similar look from deal to deal. The "carve-outs" – exceptions – to the MAE are often far more heavily negotiated. The effect of a carve-out's applicability is to deny to Acquirer the benefit of what would otherwise be an MAE-based right to terminate the agreement and not close the transaction, and force the Acquirer to complete and close the transaction after all. There are even often negotiated exceptions to MAE carve-outs, exceptions to exceptions, the applicability of which would put the Acquirer back in the position of having a right to terminate and not to close. Let's examine the Comtech – Gilat Merger Agreement's MAE definition and the Merger Agreement provisions in which it is used as a paradigm and see if we can reach a conclusion as to which party is likely to succeed. The full text of the Merger Agreement can be found at http://www.comtechtel.com/static-files/a5b9e88a-40cc-492c-8b8e-7fb2bd8c2064.

III. The Comtech – Gilat MAE Provisions

a. Definitions: s. 1.1(mmm) of the Merger Agreement provides:

> "Material Adverse Effect" means, with respect to any Person, any fact, event, occurrence, change, development or effect (any such item, an "Effect") that, individually or in the aggregate when taken together with all other Effects that exist or have occurred prior to the date of determination of the occurrence of a Material Adverse Effect is or would reasonably be expected to be material and adverse

to the business, assets, Liabilities, financial condition or results of operations of such Person and its Subsidiaries, taken as a whole; ***provided, however, that "Material Adverse Effect" shall not include any Effect to the extent arising out of or resulting from (i) any failure of such Person to meet any projections, budgets, plans or forecasts of its revenues, earnings or other financial performance or results of operations or any published analyst or other third-party estimates or expectations of such Person's revenue, earnings or other financial performance or results of operations for any period, or any change in the market price or trading volume of the shares, or change in such Person's credit rating (it being understood that this clause (i) shall not prevent a Party from asserting that any Effect that may have contributed to such failure or decrease that are not otherwise excluded from the definition of "Material Adverse Effect" may be taken into account in determining whether there has been a Material Adverse Effect), (ii) general changes or developments in any of the industries or markets or geographic regions in which such Person or its Subsidiaries conduct business, (iii) any changes in the United States, Israel or global economy or the capital, financial, regulatory, business, political, geopolitical, credit, capital or securities markets, including changes in interest or exchange rates, (iv) any changes in Law or accounting regulations or principles or interpretations thereof, (v) the commencement, escalation or worsening of a war, military actions or armed hostilities (whether or not declared) or the occurrence of acts of terrorism or sabotage, (vi) the taking of any action expressly required by, or the failure to take any action expressly prohibited by, this Agreement, or at the express written request of, or with the express written consent of, the other Party, (vii) earthquakes, hurricanes or other natural disasters or any other acts of God, or (viii) the execution of this Agreement, the public announcement, pendency or consummation of the Merger or the other transactions contemplated by this Agreement (including the identity of the other Party or any effect on such Party or any of its Subsidiaries' relationships with their respective customers, suppliers, employees or other third parties);*** *provided, however, that the exceptions in clauses (ii), (iii), (iv), (v), or (vii) shall not apply to the extent the Effects set forth in such clauses disproportionately affect such Person and its Subsidiaries, taken as a whole, relative to other companies in the industries in which such Person and its Subsidiaries operate, in which case only the extent of such disproportionate impact (if any) shall be taken into account when determining a "Material Adverse Effect" (emphases added for purposes of this exercise).*

Comments: Here you see exactly what we previewed in the "Background" section. The first five-and-one-half lines of the definition (regular font) say what the MAE is. Then comes the familiar "provided that" phrase introducing the carve-outs – the exceptions (italic, boldface font). What follows are no fewer than eight carve-outs, numbered (i) – (viii), in essence saying that all the things listed in them are exceptions, events that will NOT constitute "Material Adverse Effects," or MAEs, and thereby excuse performance – closing the merger - if they do occur. They range from failure to meet revenues or earnings forecasts to general changes in

industries, markets or geographic regions, to occurrence or escalation of war, to natural disasters and acts of God. Note that the carve-outs are in many cases the opposite of what we would expect to see in a performance-excusing force majeure clause; for example, performance in case of war might commonly be excused under a commercial agreement's force majeure clause; by contrast, in this MAE clause, it is carved-out – excepted – from the things that excuse performance. The idea of the MAE is to protect Acquirer not against natural or manmade catastrophes, but specific events that might have negatively impacted the Seller's or target company's value, included those that might have been hidden until the deal was signed up. Following the eight carve-outs, there are exceptions to the carve-outs (italic, non-boldface font). They state that even though a certain event – a war, for example - might be excepted from being an MAE, it will under some circumstances – at least to some proportional extent, not count as an exception, and be restored to performance-excusing MAE status. The exceptions to the carve-outs apply in cases in which the company is affected disproportionally from other companies similarly situated, and then only to the extent that the company was disproportionately affected compared to other, similarly situated companies.

How might this apply in real life? Well, under this MAE clause, speaking purely hypothetically, an explosion demolishing the company's main factory or plant might well qualify as an MAE – a Material Adverse Effect excusing performance – if it were caused by a gas leak resulting from company negligence. But NOT if the explosion was caused by a bomb dropped by an enemy in wartime. However, if the bomb destroyed the factory but spared the company's neighboring competitors' factories, the company would have a good case for claiming that it was disproportionately affected by the bomb blast, and that its performance should be excused to the extent of the disproportion.

We're making a point of going over the definition with some care for a particular reason. In even the biggest M&A and commercial transactions, the definitions are often treated dismissively by the principals, their lawyers, and their financial advisors as "boilerplate," beneath their acquired dignity to pore over. But the definitions are the foundation on which the skyscraper is built. Without care taken in the definitions, their use in other, often more carefully scrutinized parts of an agreement like the Comtech – Gilat Merger Agreement will not help – may even hurt, as it cascades through the agreement, as we will see.

b. Representations and Warranties by Gilat: s. 3.9 of the Merger Agreement provides:

Absence of Certain Changes. Except as set forth on Section 3.9 of the Company Disclosure Letter or as otherwise required by, or necessary to effectuate the transactions contemplated by this Agreement, since January 1, 2019: (a) the business of the Company and its Subsidiaries taken as a whole has been conducted, in all material respects, in the ordinary course of business; (b) there has not been or occurred any Material Adverse Effect on the Company; and (c) neither the Company nor any of its Subsidiaries has taken any action that, had such action been taken during the period from the date hereof through the Effective Time, would require the prior written consent of Parent pursuant to clauses (d), (e), (m), (n), (o), or, to the extent relating to any of the foregoing, clause (aa), of Section 5.2. Since April 1, 2019, there have been no general base salary or hourly rate of pay increases among the employees of the Company or any of its Subsidiaries.

Comments: this is the first example in the Merger Agreement of "bringing down" the MAE definition into the operating provisions. That there has not been an MAE, as defined, to Gilat since January 1, 2019 has now become a representation and warranty to Comtech by Gilat. We will see how the provision cascades through the Merger Agreement.

c. Conditions to Obligations of Comtech to Close: s. 7.2 of the Merger Agreement provides:

Additional Conditions to the Obligations of Parent and Merger Sub to Effect the Merger. The obligations of Parent and Merger Sub to consummate the Merger shall be further subject to the satisfaction or waiver (where permissible under Applicable Law) prior to the Closing of each of the following conditions, any of which may be waived (in writing) exclusively by Parent and Merger Sub (Comtech)…

(a)(iii)…The representations and warranties of the Company (Gilat) contained in…Section 3.9(b) (No Material Adverse Effect) shall be true and correct in all respects as of the date of this Agreement and as of the Effective Time as though made as of the Effective Time….

(c) Material Adverse Effect. Since the date of this Agreement, a Material Adverse Effect on the Company shall not have occurred.

Comments: Here, the MAE, brought down into the Merger Agreement as a representation and warranty by Gilat and then as a standalone definitional provision is made a condition of closing by Comtech and its merger subsidiary. If an MAE has occurred the section 3.9(b) representation and warranty has been breached, and Comtech and its merger subsidiary are

excused from closing. Moreover, the non-occurrence of an MAE is made a condition to Comtech's obligation to close even were it not a representation and warranty.

d. Termination: s. 8.1 of the Merger Agreement provides:

Termination. This Agreement may be terminated and the Merger may be abandoned at any time prior to the Effective Time, whether before or after receipt of the Requisite Shareholder Approval (except as provided below), only as follows…

(f)(i) in the event of a breach of (A) any covenant or agreement on the part of the Company set forth in this Agreement or (B) any of the representations and warranties of the Company set forth in this Agreement, in either case which breach would result in a condition set forth in Section 7.2(a) or Section 7.2(b) not to be satisfied and which breach is (x) incapable of being cured by the Company prior to the Termination Date or (y) if curable, has not been cured by the Company by the earlier of (1) the Termination Date; and (2) the date that is 30 days following Parent's delivery of written notice to the Company of such breach; provided, however, that Parent shall not be entitled to terminate this Agreement pursuant to this Section 8.1(f)(i) if Parent or Merger Sub is then in breach of any of its obligations under this Agreement so as to result in the failure of the conditions set forth in Section 7.3(a) or Section 7.3(b); or

Comments: The Merger Agreement's termination provisions give Comtech the right to terminate, and not close, if Gilat's representation and warranty of no MAE in s. 3.9, and condition to Comtech's obligation to close that no MAE has occurred are breached.

IV. Delaware Court Treatment

The Delaware Chancery Court's attitude towards MAE claims is a contractually rigorous, not balancing-of-equities, one. In 2018, in a case called *Akorn, Inc. v. Fresenius Kabi, AG*, the Court found, apparently for the first time, that an MAE clause supported a party's right to terminate. There, as in Comtech - Gilat, the performance of Akorn, the Seller company, precipitously declined in the months after signing a merger agreement. At the trial, there were allegations of various breaches of representations and warranties and regulatory violations by Akorn. The Chancery Court made a point of distinguishing the case from ones in which an Acquirer just sought to use an MAE clause to get out of a deal that had become less attractive after signing and before closing. The Court's decision was sharply

based on the merger agreement's contractual terms, rather than attempts to seek equity, balance fairness and similar considerations. The Delaware Supreme Court affirmed the Chancery Court's decision.

A subsequent Delaware Chancery Court case late last year, *Channel Medsystems, Inc. v. Boston Scientific Corp.* (2019), reaffirmed that the *Akorn* case did not signal a general loosening of MAE analysis rigor, and in particular that MAE clauses would not be available to Acquirers experiencing buyer's remorse, without more. The *Channel Medsystems* case was noteworthy because one of Seller's officers actually committed fraud with respect to regulatory approval of Seller's only product – in other words, underpinning Seller's whole enterprise value, a regulatory approval that was a condition to Acquirer's obligation to close. The Court held that the fraud breached Seller's representations and warranties, but because Seller discovered and remediated the fraud, and the needed regulatory approval was obtained anyway, Acquirer had not proved an MAE justifying rescission of the deal. The Court ordered Acquirer to specifically perform – close – the transaction, notwithstanding the bad – really bad – facts on Seller's part.

Previously, in cases called *In Re IBP, Inc. Shareholders Litigation v. Tyson Foods* (2001) and *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.* (2008), the Delaware Chancery Court refused to allow the application of MAE clauses. In *IBP*, the Court held that a few months of poor performance was not an adverse change material enough to excuse performance. In *Hexion*, the Court held, for a clause similar to Comtech – Gilat's, that the MAE clause included occurrences materially adverse to Seller's financial condition, business or results; a carve-out excluded from the MAC definition changes affecting the chemical industry generally; and a carve-out exception applied if the economic condition changes affected Seller disproportionately. Again, the Chancery Court held that a few quarters of bad performance was not enough to trigger the MAC clause, and further held that Seller's disproportionately bad performance compared to the chemical industry as a whole fell into the carve-out, and the carve-out only became applicable if the MAC clause was triggered in the first place.

V. The Yield

The purpose of this exercise is to examine not the Comtech – Gilat deal for its own sake, but to use it to assess how MAE provisions and other performance-excusing provisions in pending corporate and commercial transactions may be impacted by the Covid-19 crisis. Based on this review, for all that Comtech apparently wants out of its deal, its right to do so is not that clear. Simply put, the MAE definition in the Merger Agreement seems to include events like the Pandemic in its list of carve-outs for which performance will not be excused as an MAE, and the exceptions to carve-outs do not seem to

apply: Gilat is not, insofar as we know, disproportionately affected by the Covid-19 crisis, compared to other, similarly situated companies. Comtech may be able to prove otherwise in the Delaware Chancery Court, but we are not aware of current evidence of that (Comtech has also raised non-Covid related claims in the Delaware Chancery Court, but we are not considering them here.).

So the yield for Covid-19 MAE-based claims that performance should be excused is probably going to depend, at least where Delaware law governs, not on how bad and disruptive the Covid-19 Pandemic was, which will be almost a given, but whether sophisticated, counseled parties, clearly contemplating pandemic-like events, if not this Pandemic, chose to expressly include them as events or effects that should excuse performance – or not. In other words, in the world of sophisticated, counseled corporate or commercial transactions, even pandemics are a foreseeable event for which the parties can allocate risk and responsibility, if they choose to do so. If they do not, they should not expect the courts to reform their deals for them just because they want out of them.

A second yield, and even more fundamental, is that details and so-called, often sneered-at, "boilerplate" like definitions in a major corporate or commercial agreement count. They really are the foundation of the building, and once set, their effects cascade through the agreement with major impact.

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