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# Delaware Chancery Court issues rare decision finding Material Adverse Effect justifying termination of merger

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On October, 1, 2018, the Delaware Chancery Court issued its decision in *Akorn, Inc. v. Fresenius Kabi AG, et al.,* C.A. No. 2018-0300. The case is one of the rare instances where a court has concluded that a Material Adverse Effect (MAE)[1] existed that justified termination of a merger agreement. Indeed, it may be the first time that a court in Delaware has reached such a conclusion.

Cautioning that there is no bright-line test to determine when an MAE exists, the court applied ordinary contract interpretation principles to a heavily negotiated merger agreement and a complex set of facts developed during trial. In addition to finding that Fresenius Kabi AG ("Fresenius") was not obligated to close the transaction because of the MAE, the court held that Fresenius was justified in walking away because the target, Akorn, Inc. ("Akorn"), had breached its representations regarding regulatory compliance and those breaches would be expected to have an MAE, and that Akorn failed to use "commercially reasonable efforts" to carry on its business "in all material respects in the ordinary course of business" after signing the merger agreement. Each of these breaches and failures permitted Fresenius to terminate the merger agreement by its terms. While Akorn has vowed to appeal, the lengthy (247-page) opinion provides an extraordinarily detailed analysis and application of typical provisions in merger and acquisition agreements to an egregious set of facts.

## Facts

Fresenius, a German pharmaceutical company, signed an agreement in April 2017 to buy Akorn, a U.S. generic drug manufacturer. The agreement anticipated an unusually long (up to one year) period between signing and closing, due to antitrust concerns. Shortly after signing the merger agreement in April 2017, Akorn's financial performance deteriorated. Within months, Akorn's "business fell off the cliff," in the words of one witness, and continued to decline: full-year EBITDA

[1] For 16 years, Nixon Peabody has tracked the evolution of Material Adverse Effect and Material Adverse Change provisions in acquisition agreements. See the 2017 Nixon Peabody Annual MAC Survey, available here. The court cited the Nixon Peabody 2017 MAC Survey as authority in its opinion. See note 628 at p. 152 of the opinion.

declined 86%, adjusted EBITDA declined 51%, and quarterly revenues and income declined 25% and 105%, respectively. Akorn attributed the reversals to increased competition, loss of a major contract, supply problems and price erosion.

In late 2017 and early 2018, Fresenius received anonymous letters from whistleblowers complaining of data integrity and compliance issues at Akorn. The ensuing investigations, conducted primarily by Fresenius's outside counsel, who was experienced in Food and Drug Administration (FDA) matters, revealed serious and pervasive compliance problems.

On April 22, 2018, Fresenius gave notice that it was terminating the agreement. The next day, Akorn filed suit to seek a declaration that the termination was invalid and to compel Fresenius to complete the transaction. Fresenius counterclaimed for a declaration that its termination of the agreement was valid. The case proceeded to trial less than 90 days later, even as the regulatory issues continued to unfold and Akorn's problems deepened.

## Contract provisions at issue

The dispute focused on three conditions to Fresenius's obligation to proceed to closing:

- First, Akorn must not have suffered an MAE, as defined in the agreement (which the court referred to as the General MAE Condition).
    - The court found that the sudden and sustained drop in Akorn's business performance constituted an MAE.
- Second, Akorn's representations, including its representation that it was in full compliance with its regulatory obligations, were required to be true and correct as of the closing date, except where failure would not, individually or in the aggregate, reasonably be expected to have an MAE (which the court referred to as the Bring-Down Condition).
    - The court concluded that Akorn's representations regarding regulatory compliance were not true and correct, and the deviation would reasonably be expected to result in an MAE related to Akorn's regulatory issues, based on an analysis of both qualitative and quantitative factors.
- Third, Akorn must have complied with or performed in all material respects its obligations, including its obligation to use "its commercially reasonable efforts to carry on its business in all material respects in the ordinary course of business" between signing the merger agreement and the closing (which the court defined as the Covenant Compliance Condition).
    - The court concluded that Akorn materially breached the Covenant Compliance Condition, because it took conscious and deliberate actions that departed from the ordinary course of business of a generic pharmaceutical company, and those changes were material.

Fresenius contended that each of these conditions excused its refusal to close and justified its termination of the merger agreement. In its defense, Akorn pointed out that the contract expressly precluded Fresenius's right to terminate the agreement based on the Bring-Down Condition and the Covenant Compliance Condition if Fresenius was in material breach of any of its representations, warranties, covenants or agreements. Akorn also claimed that Fresenius was in material breach of its obligations to use its reasonable best efforts to satisfy the closing conditions and to take all actions necessary to secure antitrust clearance. Akorn also argued that Fresenius had been aware of regulatory risks, and had assumed those risks.

## The court's analysis

### *The MAE condition*

The court described the MAE clause in this agreement as "customary albeit complex and convoluted prose" (Op. at 124). As is typical, the contractual definition of an MAE did not contain any quantified standard and had the effect of allocating risks between buyer and seller through various exceptions to the general provision that the target not have suffered an effect, change, event or occurrence that has a material adverse effect on its business, results of operations or financial condition. While the contractual definition provided that certain economic or market conditions generally would not constitute or be taken into account in determining the occurrence of an MAE, to the extent that those conditions had a disproportionate effect on the target compared to other participants in the industry in which the target operated, the incremental disproportionate impact of those conditions could be considered.

Court of Chancery Vice Chancellor J. Travis Laster cited and quoted extensively from the two leading Delaware decisions that declined to find an MAE: *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*[2] and *In re: IBP Shareholders' Litigation.*[3] The court began its analysis with cautionary language from each of those opinions that the party claiming an MAE bears a "heavy burden" and that "a short-term hiccup" should not suffice, but rather the impact must be consequential to the company's long-term earnings power and durationally significant when measured over a "commercially reasonable period, which one would expect to be measured in years rather than months" (citing *Hexion*). Ultimately, the court concluded that there had been a "sudden and sustained" drop in Akorn's business performance that constituted an MAE, citing as the evidence:

- The impact on Akorn appeared to be company-specific and due to conditions that affected Akorn uniquely, such as the loss of a key contract and competition from new entrants in the markets for three of Akorn's top products.
- The downturn at Akorn was disproportionate to the results of other pharmaceutical companies and the industry as a whole.
- The adverse trend was "durationally significant."
- The conditions resulting in the downturn, such as increased competition and price erosion, were unlikely to be short term as there was no evidence that the competitors would cease to participate in the market.
- The results were atypical for Akorn and a departure from its historical trend.

Repeatedly, the court cautioned that there is no bright-line test or single set of percentages to evaluate whether an MAE has occurred, whether for a condition of closing or tied to a representation. Future decisions will undoubtedly note the Vice Chancellor's admonition that his conclusions "do not foreclose the possibility that a buyer could show that percentage changes of a

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[2]*Hexion Specialty Chem., Inc. v. Huntsman Corp.*,965 A.2d 715 (Del. Ch. 2008).

[3]In re: IBP Shareholders' Litig.,789 A.2d 14 (Del. Ch. 2001).

lesser magnitude constitute an MAE. Nor does it exclude the possibility that a buyer might fail to prove that percentage changes of a greater magnitude constituted an MAE" (Op. at 132).

### *The bring-down condition*

The court had to revisit its MAE analysis in determining whether the Bring-Down Condition was satisfied, since the merger agreement provided that an untrue representation would not excuse closing unless the inaccuracy was reasonably expected to result in an MAE and would not permit termination if it could be cured before the drop-dead date. Thus, an MAE in this context had to be related to the representation at issue, which required an analysis separate from whether a general MAE existed.

Here, the court looked at the impact of the inaccuracy in the regulatory compliance representation both qualitatively and quantitatively. Qualitatively, there was overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn, which were exacerbated by Akorn's actions after signing the merger agreement. The court had no difficulty in concluding that these regulatory issues would be qualitatively material to a reasonable buyer in a highly regulated industry. Quantitatively, the court discounted Akorn's low estimates of the costs of remediation, but was also unwilling to accept the buyer's significantly greater estimate for the cost of review and remediation. In the absence of certainty, the court resorted to "intuitive sense" to conclude that the expense of remediation would be material to the acquirer and noting that even Akorn's witnesses conceded the process would consume several years.

As a crosscheck for its intuition that remediation costs of 20% of the target's stand-alone equity value would be material to a buyer, the court looked at what it concluded were comparable adverse economic events. The court noted that the percentage was more than the drop in stock price defining a bear market (20%), akin to the second-largest one-day drop in the stock market (exceeded only by the 22% drop on Black Monday), greater than the differential where parties renegotiate a transaction after assertion of an MAE (15%), greater than the upper and lower bounds of contractual collars on stock prices when used as currency (10–20%), and significantly greater than the cost of reverse termination fees (3–6%).

The court also rejected Akorn's argument that Fresenius's knowledge of the risk of potential compliance issues foreclosed its claim based on a breach of the regulatory compliance representation. Distinguishing *Hexion* and *IBP,* where the court held that buyers could not terminate a merger agreement based on the manifested consequences of widely known systemic risks, the specific regulatory failures that constitute Akorn's regulatory woes included specific actions by Akorn between signing and closing. While Fresenius may have known broadly about the risk of regulatory non-compliance, and had negotiated for a representation as protection, general knowledge of an issue or questions about the extent of due diligence would not foreclose reliance on representations.

### *The covenant compliance condition*

The merger agreement required Akorn to comply with its contractual obligations in "all material respects." Akorn's obligations were also subject to a second qualifier: it had agreed to use its "commercially reasonable efforts" to carry on its business in the ordinary course. The court mused over whether there are any distinctions among "best efforts," "reasonable best efforts" and "commercially reasonable efforts," ultimately concluding that at least the latter two standards are indistinguishable. This language required Akorn to "take all reasonable steps" to maintain its operations in the ordinary course of business.

Adopting an objective analysis and comparing Akorn's conduct to that of a generic pharmaceutical company, the court readily concluded that Akorn had not done so: it made regulatory submissions that appeared to rely on data that it knew were fabricated; it lacked a data integrity system that would allow the company to prove to the FDA that the data underlying its regulatory filings were accurate and complete; it affirmatively decided to suspend its periodic audits in favor of a less stringent verification process; and it failed to take steps to remediate known data integrity deficiencies. These were conscious choices by Akorn and departed from its own past practices.

In contrast, certain data destruction events, although not in the ordinary course, were unexpected events outside Akorn's control, and did not result from a failure to apply commercially reasonable efforts.

As to the materiality standard, the court concluded that "in all material respects" in this context called for a standard that is different and less onerous than the common law doctrine of material breach. Here, the court adopted a test based on disclosure law to conclude that "material" means that the breach must be both a departure from a generic pharmaceutical company's operations in the ordinary course of business and a deviation from the buyer's reasonable expectations of what it would receive at closing (Op. at 212).

***Fresenius's conduct***

By the express terms of the contract, Fresenius was not entitled to invoke its termination rights (including based on the Bring-Down Condition and Covenant Compliance Condition) if it was in material breach of *any* of its own obligations. Both parties had agreed to use their respective "reasonable best efforts" to cause the conditions to closing to be satisfied as promptly as reasonably practicable. The court defined this obligation as one to "take all reasonable steps to solve problems and consummate the transaction" (Op. at 24). In addition, Fresenius had agreed to take all actions necessary to secure antitrust clearance, an obligation which "shall be unconditional and shall not be qualified in any manner."

The court found that Fresenius had breached its unconditional obligation to obtain antitrust approval by pursuing a strategy that would have led to delay; however, that breach was short-lived (one week) because Fresenius had reversed its course. Therefore, the breach was not material, and did not preclude its ability to terminate the merger agreement.

The court took great pains to distinguish Fresenius's conduct from the conduct of the acquirers in *Hexion* and *IBP*, as well as other cases. As Vice Chancellor Laster noted, "the difference between this case and its forebearers is that the [buyer's] remorse is justified" (Op. at 229). Among the actions the court cited to reject any claim of a fabricated motive (while acknowledging that some evidence supported that view) is that, unlike in other disputes, Fresenius had not rushed to court to terminate the merger without notice to the target. It had engaged in its own extensive investigation of the regulatory compliance issues and had even offered to extend the outside closing date. Whether it had evaluated its ability to terminate the merger at several points in time was beside the point, as the issue was whether it had reasonable grounds to take the actions it ultimately did, and had continued to work toward a closing until it provided notice of termination.

## Conclusion

It will remain a "heavy burden" to demonstrate an MAE. Here, Fresenius was not relying solely on short-term financial reverses to demonstrate an MAE, nor on an MAE only to terminate the deal, but rather pursued three separate bases to walk away from the merger.

Cases will always be dependent on the facts. While the decision stressed that there are no bright lines for deciding when an MAE exists, or when an acquirer can terminate an agreement, there are several valuable takeaways for M&A practitioners:

- The court focused on the words of the contract — specifically, the negotiated definitional carve-outs and exceptions. This underscores the importance of considering deal-specific terms that reflect the risks presented by a particular target or a particularly heavily regulated industry.
- When assessing the existence of an MAE, the supporting facts must be tailored to the scope of the applicable contractual definition, and generally will be required to be company-specific, disproportionate to the relevant industry, of some expected significant duration, and result from unexpected events or circumstances.
- To avoid a breach of an "ordinary course" covenant, any changes in prior or existing business practices between signing and closing must be considered carefully and not out of step with peer businesses.
- Buyers must ensure that their own conduct is reasonable and complies with their contractual obligations.
- Acquirers should negotiate for broad rights of access and information for themselves, as well as their advisors and consultants, during the period between signing and closing, and attempt to obtain the right to use any information in a dispute between the parties, in both the transaction agreement and any confidentiality agreement that may survive. When Fresenius received the whistleblower complaints, it invoked its contractual right of access, which allowed it to conduct its own wide-ranging investigation that ultimately provided the basis of its claims.
- In the end, in this case, the court's analysis repeatedly came back to the contract the parties had negotiated and the facts, which were egregious. While the case may be unprecedented, the decision should not be read as a signal that courts will be more willing to find that an MAE has occurred in the absence of detailed factual support.

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