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Delaware Chancery Court Finds Material Adverse Effect Permitting Buyer to Walk Away from Merger Agreement

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In a first-of-its-kind decision, the Delaware Chancery Court ruled that Fresenius Kabi AG was not required to close its $4.3 billion merger agreement with Akorn, Inc. because, after signing, Akorn suffered a Material Adverse Effect.

The Chancery Court distinguished prior cases involving Material Adverse Effect ("MAE") claims from buyers simply having buyer's remorse, citing Akorn's "dramatic, unexpected and company-specific downturn" after the merger agreement was signed, as well as whistleblower letters that revealed pervasive data integrity failures that violated regulatory requirements. In a fact-intensive, 246-page opinion, the Chancery Court provides important guidance on the significant burden that buyers must meet when attempting to terminate an acquisition on the basis of an MAE.

Background

In April 2017, Fresenius Kabi AG, the wholly owned subsidiary of a German pharmaceuticals company, entered into a merger agreement to acquire Akorn, Inc., an Illinois-based pharmaceuticals company that trades on NASDAQ. Under the merger agreement, Fresenius agreed to acquire Akorn for $34 per share, subject to certain standard closing conditions, including (i) Akorn's representations being true and correct at closing except as would not reasonably be expected to have an MAE, (ii) Akorn complying in all material respects with its obligations under the merger agreement, including using commercially reasonable efforts to operate in the ordinary course between signing and closing, and (iii) Akorn not suffering an MAE. If these conditions were not met by a certain outside date, Fresenius had the right to terminate the merger. Fresenius also had the right to terminate for a material breach by Akorn that could not be cured by the outside date.

Immediately after signing the merger agreement, Akorn's financial performance "dropped off a cliff." Akorn attributed the decline to unexpected market competition and the loss of a key contract. For the full year 2017, Akorn's revenue, operating income, and earnings per share fell by 25%, 105% and 113%, respectively, and its EBITDA and adjusted EBITDA fell by 86% and 51%, respectively. The decline in financial results continued through the first quarter of 2018. In contrast, Akorn had shown persistent growth over the prior five years. In addition, Akorn's financial performance in the first quarter of 2017—before the merger agreement was signed—did not exhibit the downturn that the ensuing three quarters of 2017 did.

In October 2017, Fresenius received anonymous whistleblower letters revealing pervasive flaws in Akorn's data integrity systems, which jeopardized Akorn's new drug applications and undermined Akorn's relationship with the

United States Food and Drug Administration (the "FDA"), its primary regulator. After receiving the letters, Fresenius began to have discussions with legal counsel about its termination rights under the merger agreement, but nevertheless continued to work toward obtaining antitrust approval for the merger and engaged an investigative team to look into Akorn's data integrity systems. The investigation found that after signing the merger agreement, Akorn had canceled regular audits of its data integrity systems in anticipation of the merger, failed to address critical deficiencies identified in earlier audits, and that in August 2017, Akorn's head of quality submitted false data to the FDA. In March 2018, Akorn made a presentation to the FDA about its remediation efforts that the Chancery Court found to be misleading. On April 22, 2018, Fresenius notified Akorn that it was terminating the merger agreement.

On April 23, 2018, Akorn filed a lawsuit against Fresenius in the Delaware Court of Chancery, requesting specific performance of the merger. Fresenius counterclaimed, asserting that it had terminated the merger agreement in accordance with its terms.

The Chancery Court's Decision

The Chancery Court found that Fresenius was not required to consummate the acquisition of Akorn, and had properly terminated the merger agreement, based on three independent grounds: (i) Akorn had breached its representation that it was in full compliance with regulatory obligations, and the magnitude of the inaccuracies would reasonably be expected to result in an MAE, (ii) Akorn had materially breached its obligation to use commercially reasonable efforts to continue operating in the ordinary course of business between signing and closing (and such breach was not curable), and (iii) Akorn had suffered an MAE.

Determining whether an MAE has occurred.

The Chancery Court determined that the deterioration in Akorn's financial performance constituted an MAE. Although it discussed certain thresholds at which a drop in profits or earnings could indicate that an MAE has occurred, the Chancery Court ultimately eschewed a bright-line test.

The duration of the downturn in Akorn's finances was significant to the Chancery Court's analysis. For an acquirer that is purchasing the target as part of a long-term strategy, the Chancery Court noted that an MAE must "substantially threaten the overall earnings potential of the target in a durationally-significant manner," and that the relevant period is "measured in years rather than months." In finding that Akorn had suffered an MAE, the Chancery Court observed that Akorn's dramatic downturn had already continued for a year and showed no signs of abating. Importantly, the Chancery Court noted that "[t]here is every reason to think that the additional competition will persist and no reason to believe that Akorn will recapture its lost contract."

Knowledge and allocation of risk.

Akorn contended that Fresenius could not claim an MAE arising from risks that Fresenius was generally on notice of because of its industry knowledge or that it had uncovered in due diligence. However, the Chancery Court held that the events resulting in an MAE were unexpected, and even if Fresenius had foreseen them, the merger agreement allocated the risk of such developments to Akorn. The Chancery Court noted that Delaware law allows contracting parties to use representations and warranties to allocate risk for both known and unknown issues, and cited various sources describing Delaware as a "pro-sandbagging" state. (The Chancery Court did not discuss the Delaware Supreme Court's recent statements in *Eagle Force Holdings LLC v. Campbell* that raise doubt about whether a party can recover on a breach of warranty claim where the parties know that, at signing, certain of them were not true). Interestingly, the Chancery Court noted that the MAE definition in the merger agreement did not carve out unforeseeable events, specific matters that will or are likely to occur, matters disclosed in due diligence, or risks identified in public filings, implying that each of these provisions may have strengthened Akorn's argument.

Disproportionate effect.

Akorn argued that the decline in its performance was attributable to "industry headwinds," and that no MAE had occurred because the definition of MAE in the merger agreement included a carve-out for effects, changes,

events or occurrences generally affecting the industry in which Akorn operated (except where Akorn was disproportionately affected when compared to other participants in the industry). In holding that the carve-out did not apply, the Chancery Court determined that Akorn's financial difficulties were due to reasons specific to Akorn, and even if, for the sake of argument, the decline in Akorn's performance was caused by industry-wide effects, Akorn was nonetheless disproportionately affected.

Breach of Akorn's representations reasonably expected to result in an MAE.

The Chancery Court determined that Akorn's regulatory problems, and its breach of the associated representations in the merger agreement, would reasonably be expected to result in an MAE. The Chancery Court reached this decision after finding that Akorn's regulatory issues were both qualitatively and quantitatively material when viewed from the longer-term perspective of a reasonable acquirer.

In doing so, the Chancery Court determined the quantitative impact of these issues to be $900 million—a 21% decline in Akorn's $4.3 billion implied equity value. However, the Chancery Court took pains to note that "[n]o one should fixate on a particular percentage as establishing a bright-line test."

In the qualitative part of the Chancery Court's analysis, the Chancery Court based its finding on the "overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn" and the fact that "these problems existed at signing and got worse, rather than better, during the period between signing and when Fresenius served its termination notice."

Material breach of Akorn's ordinary course covenant.

The Chancery Court held that by failing to investigate and remediate quality and data integrity issues as they were identified, Akorn materially breached its covenant to operate in the ordinary course of business. The Chancery Court's analysis employed a materiality standard built on disclosure law, requiring a substantial likelihood that the breach would have been viewed by a reasonable buyer as having significantly altered the "total mix" of information. The Chancery Court also cited a statement from one source that "'[i]n an M&A context, and from the buyer's perspective, this meaning of *material* refers to information that would have caused the buyer not to enter into the agreement or would cause the buyer not to want to close the transaction.'"

The Chancery Court held that Akorn's breaches of its covenant to operate in the ordinary course departed from what Fresenius could reasonably expect and changed the calculus of the acquisition for purposes of closing. The parties disputed whether it would take three or four years to remedy Akorn's data integrity issues, and the Chancery Court found that Akorn's breach of its ordinary course covenants cost a year of what could have been meaningful remediation efforts. Further, the Chancery Court held that no reasonable acquirer would have agreed that during the period between signing and closing, Akorn "could stop engaging in ordinary-course activities relating to quality compliance and data integrity, much less that Akorn could trigger a major incident with the FDA by making a submission that relied on fabricated data."

Conclusion

The Akorn decision is regarded as the first Delaware decision holding that an MAE had occurred. While the opinion demonstrates the uphill climb a buyer would face in attempting to use an MAE clause to terminate an acquisition, it does provide helpful guidance on the exercise of a right that may have been viewed as purely formalistic by buy and sell-side parties. Although the Chancery Court reviewed and discussed specific financial metrics in determining that an MAE had occurred, it emphasized that it was not establishing bright-line quantitative tests. Qualitative factors relating to Akorn's regulatory shortcomings and behavior appeared to be critical to certain aspects of the decision. Going forward, buyers, targets, and their counsel will want to carefully consider the ramifications of the Chancery Court's decision in drafting and analyzing MAE clauses in acquisition agreements.

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