# A Delaware First: Chancery Court Upholds Termination of Merger Based on MAE

On October 1, 2018, in *Akorn, Inc. v. Fresenius Kabi AG*,[1] the Delaware Court of Chancery held for the first time that a buyer had validly terminated a merger agreement due to the occurrence of a "material adverse effect" (MAE). In his landmark 246-page opinion, Vice Chancellor Laster also found that the buyer had additional termination rights based on the target's (1) breach of certain representations in the parties' merger agreement, which breach would reasonably be expected to result in an MAE, and (2) material failure to comply with an affirmative covenant to conduct its business in the ordinary course.

## Background

In April 2017, Fresenius agreed to acquire Akorn for $34 per share. The merger agreement included standard representations and warranties by Akorn, including that it was in compliance with applicable regulatory requirements. The merger agreement also required Akorn to use commercially reasonable efforts to operate in the ordinary course of business in all material respects between signing and closing. Fresenius could terminate the agreement if Akorn's representations and warranties were not true at signing and closing and the deviation would reasonably be expected to result in an MAE. Fresenius could also terminate if Akorn had failed to comply in all material respects with its obligations under the merger agreement. Finally, Fresenius would not be required to close if Akorn suffered a "general" MAE (i.e., an MAE not tied to a specific representation, but related to its overall business/financial condition).

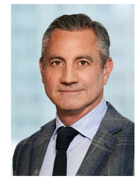
According to the court, after the merger agreement was signed, Akorn's financial performance "fell off a cliff":

- Just three months after the execution of the merger agreement, Akorn announced year-over-year declines in quarterly revenues, operating income, and earnings per share of 29 percent, 84 percent, and 96 percent, respectively.
- Akorn revised its forecast downward for the following quarter, but fell short of that goal as well and announced year-over-year declines in quarterly revenues, operating income, and earnings per share of 29 percent, 89 percent, and 105 percent, respectively.
- The following quarter, Akorn reported year-over-year declines in quarterly revenues, operating income, and earnings per share of 34 percent, 292 percent, and 300 percent, respectively.

Ultimately, Akorn's EBITDA for 2017 experienced a year-over-year decline of 86 percent. Akorn attributed the poor performance to various factors, including unexpected new market entrants for its three top products, new competition in another important product, and loss of a key contract.

Separately, in late 2017 and early 2018, Fresenius received several anonymous letters from whistleblowers alleging serious problems with Akorn's product development and quality control processes. Using its information access rights under the merger agreement, Fresenius conducted a comprehensive investigation with the assistance of outside regulatory counsel and consultants. Fresenius' investigation revealed "pervasive data integrity and compliance problems" and a culture of noncompliance with FDA regulations at Akorn, including the submission of falsified data to the FDA by Akorn's senior quality-control official. According to the court, Akorn failed adequately to investigate and remediate these issues both before and after signing the merger agreement. The court was also seriously troubled by evidence showing that, after signing, Akorn materially scaled back its quality control and related IT functions without Fresenius's consent.

Based on its investigation findings and Akorn's dismal financial performance, Fresenius gave



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notice that it was terminating the merger agreement on April 22, 2018. Fresenius cited its right to terminate based on:

- Its right not to close because Akorn had suffered a general MAE, which would give Fresenius a right to terminate two days later when the outside date would pass.
- Akorn's breach of its representations relating to its regulatory compliance.
- Akorn's breach of its covenant to operate in the ordinary course of business.

Akorn filed suit the next day seeking specific performance of the merger agreement. Fresenius counterclaimed and sought, among other things, a declaration that it was permitted to terminate the transaction based on Akorn's breaches.

## General MAE

While acknowledging the "high burden" imposed on a buyer to invoke an MAE clause for termination purposes (as set forth in cases such as *Hexion v. Huntsman*[2] and *IBP, Inc. S'holders Lit.*[3]), the court found that Fresenius had satisfied the burden by establishing that the material decline in Akorn's financial performance (1) was material, (2) was "durationally significant" and (3) arose from "unknown events."

- **Materiality.** The court found that the decline in Akorn's financial performance was material because it had drastically declined using every relevant financial metric in every year-over-year comparison beginning with the second quarter of 2017. The court also rejected Akorn's argument that the decline should be measured against the value of the post-merger combined entity (including synergies), thereby reducing the magnitude of decline.
- **Durational Significance.** The court found that the downturn in Akorn's financial performance was durationally significant because it had already persisted for a full year and shown no signs of abating. Given that Akorn's management team had attributed much of Akorn's downturn to new and unexpected competition, the court found there was good reason to think the downturn would be a continuing problem for Akorn.
- **Unknown Events.** The court rejected Akorn's claim that the issues Fresenius was asserting were (1) learned about in due diligence and (2) generally on notice to Fresenius due to "industry knowledge." Rather, the court found that Akorn's problems were "unexpected" and "unforeseen" and that it would be contrary to the language and purpose of an MAE clause to read into the merger agreement a "tort-like concept of assumption of risk" that would preclude Fresenius from establishing an MAE based on risks it contemplated or matters that were either disclosed to it during due diligence or publicly known.

## Breach of Regulatory Representation

As to the breach of the regulatory representation claim, Fresenius bore the burden of establishing that "the deviation between Akorn's as-represented condition and its actual condition" was so great that it would be reasonably expected to result in an MAE. In addressing this issue, the court noted its requirement under *Frontier Oil Corp. v. Holly Corp.*[4] to consider both qualitative and quantitative factors. Qualitatively, it determined that Akorn's regulatory noncompliance was so pervasive and widespread and that they had gotten worse between signing and closing. Quantitatively, the court determined that estimated remediation costs of approximately $900 million, or 21 percent of Akorn's equity value, was material "when viewed from the longer-term perspective of a reasonable acquirer."[5] The court cautioned readers, however, not to "fixate on a particular percentage as establishing a bright-line test."

As it did when arguing against the existence of a general MAE, Akorn contended that Fresenius could not claim that its regulatory issues would be reasonably likely to result in an MAE because, as a result of its due diligence and general industry knowledge, it was aware of the underlying risks when it signed the merger agreement. In other words, Akorn asserted that it was "sandbagged." The court rejected this argument on similar grounds as before, reaffirming that Delaware is a pro-sandbagging state, in keeping with its "contractarian regime."

## Breach of Ordinary Course Covenant

As to the ordinary course covenant, the court viewed this as imposing an obligation on Akorn to use its “commercially reasonable efforts” to maintain its operations between signing and closing. The court found, however, that following the execution of the merger agreement, Akorn failed to maintain a functioning data integrity system, instructed its IT department not to devote any resources to data integrity projects, canceled regular compliance audits, and submitted falsified data to the FDA, all of which violated the ordinary course covenant. The court rejected Akorn’s argument that the “in all material respects” qualifier required Fresenius to prove that Akorn’s conduct met the stringent standard of “material breach” under Delaware law. Instead, the court looked to disclosure case law and found these matters material because there was a “substantial likelihood that the … fact [of breach] would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information.”

## Fresenius Breach.

Finally, the court rejected Akorn’s argument that Fresenius was not permitted to terminate the merger agreement because it had breached both the “reasonable best efforts” covenant and the “hell-or-high-water” covenant in the merger agreement. The court recognized that there was “some evidence” that the termination by Fresenius was a case of “buyer’s remorse.” However, the court contrasted Fresenius with the buyers in *IBP* and *Hexion* (who did not raise their concerns before filing suit, did not work with their counterparties, and appeared to have manufactured issues solely for purposes of litigation), noting that Fresenius had good cause to evaluate its rights and obligations under the merger agreement. The court found that even as Fresenius was evaluating its contractual rights, it continued to analyze how the deal could still work.

As to the hell-or high-water covenant, the court recognized that — for approximately one week — Fresenius utilized a strategy for achieving antitrust approvals that would have delayed closing by two or three months. While the court found that although Fresenius had “technically breached” its contractual obligations during that one-week period, such breach was not material enough to deprive Fresenius of its termination rights.

## Takeaways

While the findings in *Akorn* arise in the context of an egregious set of facts, the decision provides an excellent framework for understanding how the Delaware Court of Chancery analyzes MAE clauses. The decision also provides a useful roadmap for how buyers should act when confronting unforeseen post-signing issues, to the extent they intend to exercise their termination rights. It remains to be seen, however, whether the decision will survive appeal.

**To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact Christopher J. Bellini at (612) 260-9029 or cbellini@cozen.com.**

[1] *Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018).

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

[3] *In re IBP, Inc. S’holders Litig.*, 789 A.2d 14 (Del. Ch. 2001).

[4] *Frontier Oil Corp. v. Holly Corp.*, 2005 WL 1039027, at *37 (Del. Ch. Apr. 29, 2005).

[5] To support its determination that 21 percent of deal value is material to a reasonable buyer, the court looked at other indicia of materiality: the fact that a 20 percent decline in stock prices is considered a bear market; a study that showed that when deal prices are renegotiated after buyers assert an MAE, the average price reduction is 15 percent.; the fact that in stock deals with price collars, the upper and lower bounds are generally between 10 percent and 20 percent; and a study that determined that median reverse termination fees are 6.36 percent of transaction value.