DELAWARE CHANCERY COURT MAKES GROUNDBREAKING "MATERIAL ADVERSE EFFECT" FINDING ALLOWING BUYER TO TERMINATE MERGER AGREEMENT

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In a landmark decision, a Delaware court has, for what is widely believed to be the first time ever, found that a material adverse effect actually occurred in an acquisition transaction, giving the buyer a right to terminate the pending transaction. In *Akorn, Inc. v. Fresenius Kabi AG*,[1] the Delaware Court of Chancery (the “Court”) held, following a trial, that the buyer properly terminated the parties' merger agreement, due to such a material adverse effect between signing and closing, under the terms of the agreement and the pertinent Delaware case law. Unlike prior decisions rejecting buyer material adverse effect claims,[2] the Court found that a pre-closing decline in the business of the target – Akorn – was not merely a “cyclical trend” and was likely to have a post-closing, durationally-significant effect that was “material when viewed from the longer-term perspective of a reasonable acquiror.”[3] Although groundbreaking, the *Akorn* decision reflects that the Delaware courts will still approach the question of whether an MAE has occurred on a case-by-case basis and does not establish a particular “bright line” test.

This case arose out of the proposed strategic acquisition by Fresenius Kabi AG, a German healthcare company (“Fresenius”) of Akorn, an Illinois-based generic pharmaceutical manufacturer, pursuant to a merger agreement signed on April 24, 2017. Shortly after the signing of the merger agreement, Akorn's financial performance deteriorated significantly. In addition, during the period between the signing and the planned closing, Fresenius received whistleblower letters alleging “alarming” problems at Akorn. These led to investigations by Akorn and Fresenius that uncovered “serious and pervasive data integrity problems”[4] and regulatory violations at Akorn. In mid-April 2018, shortly before the April 24, 2018 outside date for closing, Fresenius sent Akorn a letter that identified the contractual bases for a potential termination of the merger agreement by Fresenius, including: (i) a closing condition that there was no “Material Adverse Effect” (“MAE”) of Akorn, (ii) a bring-down closing condition that required Akorn to be in compliance as of the closing date with relevant laws and regulations, except as to any noncompliance that would not constitute an MAE, and (iii) a covenant that required Akorn to continue to conduct its business in the ordinary course between signing and closing. On April 22, 2018, Fresenius notified Akorn that it was actually terminating the merger agreement due to these three issues, and Akorn subsequently brought this action, seeking a declaration that Fresenius' termination was invalid and specific performance of the merger agreement. The Court sided with Fresenius on all three issues.

Consistent with prior Delaware case law, the Court noted that an MAE must “substantially threaten the overall earnings potential of the target in a durationally-significant manner."[5] The Court also reaffirmed that the target's performance should be considered on its own as a standalone business and not in light of its value to Fresenius as a synergistic buyer, despite Akorn's argument to the contrary.

The Court determined that Akorn's quarterly results reflected very significant year-over-year declines, with revenue falling 25%–34%, operating income declining 84%–292%, and earnings per share of falling 96%–300%. The Court also noted that in 2017, annual EBITDA fell 86% and adjusted EBITDA fell 51%. The Court determined that the causes of these declines were durationally significant, citing forward-looking analyst estimates for 2018, 2019, and 2020, which had fallen roughly 65%. Although the merger agreement contained standard provisions excluding, among other things, "general industry conditions" from the scope of an MAE, the Court held that the performance issues were specific to Akorn and not the result of such general industry conditions and that, therefore, an MAE had occurred.

The Court also determined that Akorn breached its legal and regulatory compliance representation and that such breach would "reasonably be expected" to constitute an MAE. The Court explained that the "reasonably be expected to" standard is an objective one that requires showing more than "a mere risk of an MAE,"[6] and also requires consideration of both the "quantitative and qualitative aspects"[7] of the claimed breach. The Court held that the qualitative aspects supported the finding of a breach leading to an MAE: There was "overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn."[8] On the quantitative side, the Court determined that the most reasonable figure for remediating Akorn's FDA violations was approximately $900 million over a two year period, which would decrease Akorn's equity value by about 21% from the merger price. The Court determined that such a 21% decline was material under the circumstances of the case, but recognized that no particular percentage established "a bright-line test."[9]

The Court also determined that Akorn breached the covenant requiring it to use commercially reasonable efforts to continue to conduct its business in the ordinary course in all material respects between signing and closing. This determination was based on the Court's finding that after signing the merger agreement, Akorn cancelled regular audits, assessments, and inspections of its facilities even though these had been planned to take place prior to the signing of the merger agreement; instructed its personnel not to devote any resources to data integrity projects; failed to investigate claims of wrongdoing; and even submitted fabricated data to the FDA. The Court held that these breaches were material and not capable of being cured in sufficient time to prevent Fresenius from terminating.

Finally, the Court held that although Fresenius was briefly in breach of its covenant to take all actions necessary to secure antitrust approval, the breach was not material because Fresenius quickly remedied that situation and continued on its path to securing approval. The Court therefore determined that Fresenius was entitled to exercise its termination right under the merger agreement.

Notes

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

[2] See, e.g., *In re IBP Shareholders Litig.*, 789 A.2d. 14 (Del. Ch. 2001) and *Hexion Specialty Chemicals, Inc. v.*

Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008).

[3] *Akorn* at 204.

[4] *Id.* at 3.

[5] *Id.* at 130 (quoting *IBP*, 789 A.2d at 68).

[6] *Id.* at 162.

[7] *Id.* at 162-63 (quoting *Frontier Oil Corp. v. Holly Corp.*, 2005 WL 1039027, at *37).

[8] *Id.* at 163.

[9] *Id.* at 185 n.740.

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