Delaware Court of Chancery Upholds Termination of Merger Agreement Based on Material Adverse Effect

The notoriously elusive "Material Adverse Effect" clause made a decisive appearance in October when the Delaware Court of Chancery issued its decision in *Akorn, Inc. v. Fresenius Kabi AG*, finding a buyer had validly terminated a merger agreement due to the occurrence of a material adverse effect at the target.[1]

I. Background

Pursuant to an agreement and plan of merger dated April 24, 2017 (the "Agreement"), Fresenius Kabi AG ("Fresenius") agreed to acquire Akorn, Inc. ("Akorn") in a transaction that was expected to close by April 24, 2018 (the "Outside Date"). Between the signing of the Agreement and the anticipated close of the transaction, Akorn endured significant financial losses and discovered a host of regulatory compliance issues, causing Fresenius to believe that it had sufficient grounds to terminate the Agreement based on Akorn having suffered a material adverse effect ("MAE").[2] Akorn argued that Fresenius did not validly terminate the agreement and sought specific performance to compel Fresenius to close the deal.

Fresenius focused its argument on Akorn's failure to meet certain closing conditions laid out in the Agreement; specifically (i) the non-occurrence of an MAE at Akorn, (ii) the bring-down of Akorn's representations at closing, and (iii) Akorn's material compliance with its obligations under the Agreement. Fresenius was able to successfully show that Akorn's non-compliance with its regulatory obligations could reasonably be expected to result in an MAE (the "Regulatory MAE"), and that Akorn's handling of these non-compliance issues amounted to an incurable breach of Akorn's obligation to continue operating in the ordinary course of business (the "Ordinary Course Covenant Breach").

Either of these failures was sufficient grounds to terminate the Agreement since the Court found that (i) Akorn's Regulatory MAE and Ordinary Course Covenant Breach could not be cured by the Outside Date and (ii) Fresenius was not itself in material breach of its obligations under the Agreement. Fresenius was also able to overcome the heavy burden of proving that Akorn's financial downturn fell within the scope of the Agreement's definition of MAE (the "General MAE") which, while not giving rise to a termination right, allowed Fresenius to refuse to close.

II. The General MAE

Fresenius was able to prove that Akorn suffered a General MAE by focusing on the magnitude of Akorn's financial downturn, its durational significance and the disproportionate decline Akorn experienced compared to

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

[2] The Agreement defined an MAE as "any effect, change, event or occurrence that, individually or in the aggregate…has a material adverse effect on the business, results of operations or financial condition of the Company and its Subsidiaries, taken as whole," and went on to list a number of carveouts, which included "any effect, change, event or occurrence (A) generally affecting (1) the industry in which the Company and its Subsidiaries operate or (2) the economy, credit or financial or capital markets, in the United States or elsewhere in the world." Notably (and key to Fresenius' argument), the Agreement included an exception to this carveout for "any effect, change, event or occurrence referred to in clause (A)…to the extent such effect, change, event or occurrence has a disproportionate adverse affect [sic] on the Company and its Subsidiaries, taken as whole, as compared to other participants in the industry in which the Company and its Subsidiaries operate (in which case the incremental disproportionate impact or impacts may be taken into account in determining whether there has been, or would reasonably be expected to be, a Material Adverse Effect)." *Id.* at 124-126.

its industry peers. Although Akorn had exhibited consistent growth in the years leading up to the signing of the Agreement, in the period following signing Akorn's performance "dropped off a cliff,"[3] showing year-over-year declines in EBITDA of 86% and in operating income of over 100%. Akorn attributed these declines to the loss of a certain key contract and to unexpected new market competitors. These underlying causes were specific to Akorn's business, not industry-wide dynamics (or, even if they were industry-wide dynamics, they disproportionately affected Akorn), and they were durationally significant – there were no indications that the new market entrants would be exiting the market or that Akorn would be able to recover or replace its lost contract. Furthermore, analysts' valuations and forward-looking estimates of Akorn's profitability during the period in question were significantly lower when compared to those of its peers. For example, Akorn's actual EBITDA relative to analysts' estimates in the fourth quarter of 2017 was –77.1% compared to the peer median of –13.8%,[4] and analysts lowered their estimates of Akorn's 2018 EBITDA by 62.6%, compared to a decrease of 11.0% for Akorn's industry peers.[5] The Court rejected Akorn's argument that the declines should be measured against the expected value to Fresenius as a synergistic buyer, deferring to the plain language of the contract, which was focused solely on the target's stand-alone value. The Court also refused to expand the Hexion and IBP decisions to shift the risk of "unknown events" to Fresenius under the guise of widely known systemic risks.[6] All of these factors ultimately convinced the Court that Akorn's drop in performance fit squarely within the MAE framework Akorn and Fresenius had established in the Agreement, and that Fresenius could not be forced to close.

III. The Regulatory MAE

To support its finding of a Regulatory MAE at Akorn, the Court cited "overwhelming evidence of widespread regulatory violations and pervasive compliance problems," which got worse after signing and resulted in both qualitative and quantitative adverse effects at Akorn.[7] Qualitatively, the Court reasoned that, given that Akorn was a pharmaceutical company regulated by the FDA, compliance with the FDA's regulatory requirements was an essential part of its business. Most of these regulatory requirements centered around the protection of the integrity of the data collected at Akorn's facilities and ultimately communicated to the FDA, which were precisely the regulatory requirements the Court found to be at issue at Akorn. Furthermore, these issues were durationally significant, given that they would have taken about three to four years to remedy, thereby increasing the magnitude of their effect on the company. Quantitatively, the Court estimated the financial impact of these regulatory compliance issues on Akorn to be approximately $900 million (the midpoint of the parties' competing submissions), which represented 21% of Akorn's value as implied by the Agreement. The Court judged this to be a material amount given that it was about four to five times greater than the combined exposure from risks that Fresenius was aware of and willing to take on and also given the magnitude of change 21% would represent.[8] The

[3] *Id*. at 137.

[4] *Id.* at 146.

[5] *Id.* at 147.

[6] *Id.* at 153-155 (citing ***Hexion Specialty Chems., Inc. v. Huntsman Corp.***, 965 A.2d 715, 743 (Del. Ch. 2008) (finding no material adverse effect where the financial performance of the target, a chemical company, suffered due to "macroeconomic challenges" presented by rapidly increasing oil and natural gas prices and unfavorable foreign exchange rates) and ***In re IBP, Inc. S'holders Litig.***, 789 A.2d 14, 66, 70 (Del. Ch. 2001) (finding a downturn in the financial performance of the target due to the cyclical nature of its business and a severe winter that affected others in its industry did not constitute a material adverse effect)).

[7] *Id.* at 163.

[8] *Id.* at 186-190. The Court looked to outside sources for guidance on whether a 21% drop in value would be material. The Court discussed the 20% decline stocks must generally suffer to signal the arrival of a bear market (which would suggest that 20% is considered a material amount from a cultural perspective) and the 15% drop in a company's valuation that generally triggers renegotiations between buyers and sellers (which, assuming that parties renegotiate upon the occurrence of some material adverse event, would suggest that a 21% drop would also be material). The Court also noted that the

Court rejected as a re-trade of risk allocation Akorn's argument that because Fresenius knew of the potential for regulatory risk and had an opportunity to identify the issues in due diligence it could not now rely on the Regulatory MAE.[9]

IV. The Ordinary Course Covenant Breach

Under the Agreement, Akorn was obligated to use its "commercially reasonable efforts"[10] to carry on its business in "all material respects" in the ordinary course during the period between signing and closing. The Court interpreted "commercially reasonable efforts" to mean that Akorn had to take all reasonable steps to maintain its operations in the ordinary course of business. In order to discern what was reasonable, the court compared Akorn to a generic pharmaceutical company operating in the ordinary course of its business. The Court found that Akorn had breached its obligation by cancelling regularly scheduled audits designed to help remediate deficiencies, failing to devote resources to address its data integrity problems and submitting reports that relied on fabricated data to the FDA, all of which were actions that seriously jeopardized the ordinary course of its business operations rather than encouraging their continuation in any normal way.

The Court also found that Akorn did not comply with the covenant's requirement to operate in the ordinary course "in all material respects," rejecting Akorn's argument that this language "in all material respects" required an analysis of whether there was a "material breach." Rather, the Court adopted the more conventional meaning of "in all material respects" by focusing on whether the failure to comply with the covenant was "significant in the context."[11] Applying a standard similar to the one used when evaluating materiality under federal securities laws, the Court considered whether Akorn's data integrity problems and regulatory non-compliance had a substantial likelihood of being viewed by the "reasonable investor" as having "significantly altered" the "total mix" of information available at the time of signing.[12] Assuming Fresenius had a reasonable expectation that the business it had agreed to acquire would continue to engage in regulatory compliance activities post-signing, then information about the severity of Akorn's regulatory mishaps would have certainly altered the mix of information Fresenius used when forming that expectation. The Court concluded that the covenant was breached because Akorn's actions represented a significant departure from what a generic pharmaceutical company would do and also from the business Fresenius reasonably expected to receive at closing.

---

upper and lower bounds for collars generally fall within 10% to 20% of the consideration at signing, suggesting that parties view a 10% change in value as material, and explored using reverse termination fees as a proxy for materiality, since they can quantify the point at which a buyer is willing to absorb a loss in exchange for walking away from a transaction. Citing a study that found median reverse termination fees equaled about 6.36% of transaction value, the Court reasoned that an expense equal to about 20% of Akorn's value would likely be considered material to a reasonable acquirer.

[9] *Id.* at 201.

[10] In dicta, the Court contemplated a hierarchy of efforts clauses, with "best efforts" at the top, followed by "reasonable best efforts," "reasonable efforts," "commercially reasonable efforts" and finally "good faith efforts." Even though "commercially reasonable efforts" was fourth on its list, the Court observed that case law has not cared to make much of a meaningful distinction among that standard and the three before it. Even "best efforts" is implicitly qualified by a reasonableness standard which, in the context of mergers and acquisitions, is in turn qualified by a standard of commercial reasonableness. *Id.* at 213-216.

[11] *Id.* at 212.

[12] *Id.* at 211-213. This standard is less onerous than the traditional common law one of material breach, which requires that a breach be so egregious that it excuses the other party's performance under the contract. The court acknowledged the "oddity" of relying on a disclosure-based standard to evaluate contractual compliance, but maintained that it fairly captured what the parties intended to accomplish by adding "in all material respects" – to keep the focus on issues that are significant in the context of the parties' contract.

V. Akorn's Breaches Could Not be Cured by the Outside Date

In addition to successfully showing that Akorn had breached both its bring-down regulatory compliance representation and its ordinary course covenant as described above, Fresenius also had to show that neither of these breaches was capable of being cured by the Outside Date. By Akorn's own admission, curing its regulatory non-compliance issues would have taken three years, but the Outside Date afforded only a one-year grace period.[13] Even though the Agreement required that Fresenius give Akorn an opportunity to cure and prevented Fresenius from terminating the Agreement while Akorn was engaged in good faith efforts to do so, this waiting period did not apply if the breaches were incurable by the Outside Date.[14] As such, Fresenius did not have to wait until the Outside Date to terminate the Agreement or even give Akorn an opportunity to cure, but could instead terminate immediately.

VI. Fresenius was Not in Material Breach

Before its termination could be considered valid however, Fresenius had to show that it was not itself in material breach of the Agreement. Akorn first argued that Fresenius had breached its covenant to use its reasonable best efforts to close the transaction (the "RBE Covenant") by focusing its efforts on termination rather than consummation of the merger. According to the Court, the RBE Covenant required Fresenius to "take all reasonable steps to solve problems and consummate the transaction."[15] Importantly, it did not require Fresenius to sacrifice its own contractual rights for the benefit of Akorn. Instead, it gave Fresenius room to evaluate whether an MAE had occurred at Akorn and explore its contractual rights under the Agreement (which included the right to terminate), provided it had reasonable grounds to do so and continued consulting with Akorn about a path to closing. The Court found that Fresenius did not breach its RBE Covenant – given the MAEs Akorn had experienced, Fresenius had reasonable grounds to investigate them further using its access covenant while evaluating its own obligation to close under the Agreement. [16] Moreover, Fresenius continued communicating with Akorn about ways to move forward with the transaction by continuing its efforts to obtain regulatory approval for the transaction and offering to extend the Outside Date so Akorn could continue its remediation efforts (an offer which Akorn refused).

Akorn also argued that Fresenius had breached its commitment to take "all actions necessary" to secure antitrust approval (the "Antitrust Covenant") by briefly considering a course of action that would have delayed antitrust approval by approximately two months. Even though the Court found this consideration to be a technical

[13] *Id.* at 203.

[14] *Id.*

[15] *Id.* at 224.

[16] As part of its investigation into Akorn's regulatory compliance, Fresenius engaged Sidley Austin LLP, which began its inquiry by examining the regulatory compliance materials Akorn had uploaded to an electronic data room. Even though Fresenius had entered into a confidentiality agreement with Akorn that would have normally prevented it from sharing the data room materials with Sidley, the agreement did allow Fresenius to share the materials with its "representatives" for the purpose of "executing" the transaction. The Court agreed with Fresenius' argument that the Sidley attorneys reviewing the materials were "representatives" of Fresenius and that they had been engaged in order to "execute" the transaction. In the Court's view, "executing" a transaction also meant "carrying out" the parties' contractual obligations, which included evaluating the parties' rights under the Agreement. Since the Agreement gave Fresenius the right to terminate under certain conditions, Sidley could properly access the materials in the data room in order to evaluate whether those conditions had been met. *Id.* at 72-73, 231.

breach of the Antitrust Covenant since Fresenius was obligated not to take any action that would delay approval, Fresenius abandoned it in time to avoid any delays and kept it from becoming a "material" breach.[17]

VII. Conclusion

Although the Court in *Akorn* considered a number of complex legal arguments in reaching its conclusions, central to the Court's decision was its finding that Akorn had, in fact, suffered an MAE. The MAE inquiry remains a fact-intensive one closely tied to the unique set of circumstances surrounding each case, as evidenced by the Court's extensive and detailed opinion, which can be accessed in full here.

* * *

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Helene R. Banks at 212.701.3439 or hbanks@cahill.com; Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Geoffrey E. Liebmann at 212.701.3313 or gliebmann@cahill.com; Kimberly Petillo-Décossard at 212.701.3265 or kpetillo-decossard@cahill.com; or Flavia Vehbiu at 212.701.3177 or fvehbiu@cahill.com.

[17] The Court also noted the tension between the Antitrust Covenant, which required Fresenius to take "all actions necessary," and the provision which gave Fresenius complete control over the strategy to obtain antitrust approval. Under the latter provision, Fresenius was allowed to consider different strategies, and it was only when it chose a strategy that would have delayed approval that the Court found it to be in breach (a breach that Fresenius cured one week later when it reverted to its original plan). *Id.* at 234-235, 242.

This memorandum is for general information purposes only and is not intended to advertise our services, solicit clients or represent our legal advice.