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Delaware Court Finds "Material Adverse Change" Permitted Merger Termination

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In a highly anticipated decision after a closely watched trial, the Delaware Court of Chancery has held for the first time that a target company experienced a "material adverse change" sufficient for the acquirer to terminate the transaction prior to closing. The court also found that the acquirer had an additional termination right based on the target's material failure to comply with an affirmative covenant to conduct its business in the ordinary course.

Akorn v. Fresenius arises from a merger agreement entered into for the $4.3 billion all cash acquisition of the U.S. generics pharmaceutical company Akorn, Inc. by the German pharmaceutical company Fresenius KGAA. The merger agreement was entered into in April 2017 and during the second quarter of 2017 Akorn's business performance, as characterized by the court, "fell off a cliff", and "continued to slide in July and again in August." In addition, in October 2017 Fresenius received two anonymous "whistle blower" letters alleging that certain Akorn product development and quality control activities failed to comply with regulatory requirements. Fresenius then conducted a rigorous investigation of the issues raised by these letters and Akorn's compliance program more generally using a team of external advisors with extensive relevant experience, which investigation uncovered numerous additional issues. This was in contrast to, in the court's view, Akorn's more reactive efforts which, at least initially, were focused on "shadowing" the Fresenius investigation and preserving the transaction rather than reaching independent views on problem identification and remediation.

Under the terms of the merger agreement, Fresenius had the right to terminate the transaction pursuant to several provisions, all of which are common in public company merger agreements:

- If Akorn's representations failed to be true at either signing or closing, the failure was not curable by the "outside date" (April 2018), and the failure would be reasonably expected to have a "Material Adverse Effect" on Akorn. Fresenius could not, however, exercise this termination rights if it was itself in material breach of its own obligations under the merger agreement. The court analyzed Akorn's regulatory issues in the context of this termination right (referring to the object of this analysis as the "Regulatory MAE").

- If Akorn failed to comply in all material respects with its covenants under the merger agreement, including the customary obligation to use its commercially reasonable efforts to operate its business in all material respects between signing and closing in the ordinary course, and such failure was not curable by the outside date. Fresenius also could not exercise this termination right if it was itself in material breach.

- If all conditions to the obligations of Fresenius to close were not satisfied by the "outside date", as long as Fresenius's own breaches of the merger agreement (if any) had not been a principal cause of the failure of the parties to close by the outside date. Under the terms of the merger agreement, Fresenius did not have to close if, since the signing of the merger agreement, Akorn had suffered a Material Adverse Effect (the court referred to this as the "General MAE"). Fresenius asserted that this closing condition was not satisfied as of the "outside date."

On April 22, 2018 Fresenius gave notice to Akorn that it was terminating the merger agreement pursuant to all three of these provisions, and on April 23 Akorn filed the subject litigation seeking a declaration that Fresenius's termination notice was invalid and specific performance.

The decision upholding Fresenius's termination of the transaction is voluminous (246 pages), followed a week-long trial where testimony from 55 witnesses and nearly 2,000 exhibits were admitted, and considered numerous arguments by both sides. But from a deal professional's point of view, the principal issues of interest are:

- What are the parameters of a "Material Adverse Effect" as was defined in the merger agreement and which is substantially similarly defined in most public company merger agreements.
- What would constitute a breach of a target company's obligations to use "commercially reasonable efforts" to operate its business between signing and closing "in all material respects" in the ordinary course.
- Whether an acquirer that is found to have breached some of its obligations under a merger agreement may nevertheless validly terminate the merger agreement if those breaches were not material.

"Material Adverse Effect". At the outset, the court recognized that to find a "Material Adverse Effect" is a "high burden" under Delaware law. The court cited at length a number of seminal cases on this topic, including *Hexion v. Huntsman* and *IBP, Inc. S'holders Lit.* In broad terms, those cases held that in order for there to be a material adverse effect sufficient to permit an acquirer to terminate a merger agreement prior to closing, a change in the target between signing and closing must (1) be material, (2) be "durationally significant" and (3) have arisen from "unknown events".

- *Materiality*. In analyzing Akorn's financial performance (the "General MAE" issue), the court determined that the decline in Akorn's performance was "material". In reaching this determination the court looked at a variety of measures of financial results, on a year-over-year basis, for (i) each of the first three quarters of 2017, (ii) the full year 2017 and (iii) the first quarter of 2018. The declines noted by the court ranged from 300% for some measures down to 25% for other measures, but most declines were in the high double or low triple digit range. The court also found these results to be a significant departure from Akorn's historical trend and, for the sake of argument (as the court did not believe that Akorn's financial performance issues could be attributed to economy-wide or sector-wide effects), did a detailed analysis of the largely disproportionate harm Akorn suffered relative to its competitors. The court separately looked at the materiality of Akorn's regulatory issues in its analysis of the "Regulatory MAE" issue. In that analysis, the court evaluated the out-of-pocket remediation costs and the larger economic costs of delayed new product introductions and found an aggregate adverse effect amounting to a 21% diminution in the equity value of Akorn, which it also considered "material".[1]

- *Durational significance*. The court found that the downturn in Akorn's financial performance was "durationally significant" because it had "persisted for a full year and shows no signs of abating." In this regard, the court noted that Akorn's management team had attributed much of Akorn's performance decline to unexpected new market competitors, and this, the court believed, would be a continuing problem for Akorn. With respect to the Regulatory MAE, the court found that Akorn had "pervasive regulatory issues that would require years to fix [three in the view of Akorn and four in the view of Fresenius]."

- *Unknown events*. Akorn had alleged that the issues Fresenius was asserting were (1) learned about in due diligence and (2) generally on notice to Fresenius due to "industry knowledge" yet Fresenius chose not to investigate during its due diligence. The court rejected Akorn's assertions based on a plain reading of the representations, the definition of MAE and the absence of relevant disclosure schedule exceptions, rejecting the notion that all diligence materials and all information a buyer knows (or should have known) are implicit MAE carve-outs.

Operating in the Ordinary Course Covenant. Akorn was required under the merger agreement to use its "commercially reasonable efforts" to operate its business between signing and closing "in all material respects" in the ordinary course. The court found that Akorn had not used its "commercially reasonable efforts" because, among other things, it (i) failed to do regular internal audits and take steps to correct deficiencies, (ii) failed to maintain an adequate data integrity system, (iii) submitted "fabricated" FDA reports and (iv) used deal counsel to investigate the whistle blower letters rather than an independent firm not involved in the transaction. The court 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." The court rejected Akorn's contention that "material breach" should be based on common law doctrine requiring the breach to go to the "root or essence of the agreement" or touch the "fundamental purpose of the contract" and defeat "the object of the parties in entering into the contract".

***Fresenius Breach*.** The court recognized that there was "some evidence" that the termination by Fresenius was a case of "buyer's remorse". And the court further recognized that for approximately one week Fresenius utilized a strategy for achieving antitrust approvals that "would have breached its contractual obligations to take all steps necessary to satisfy that condition to closing" (although Fresenius did return to a compliant strategy after that one-week period). Thus, 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.

The Akorn decision will certainly garner headlines as the first Delaware case to find a material adverse effect in the takeover context. Yet the case may be appealed and there can be no certainty as to the ultimate outcome. In addition, the case is highly fact specific, and many of the alleged facts are, to say the least, unflattering to Akorn. Although the opinion clearly does find an MAE based solely on the basis of financial performance, the specific facts introduce some uncertainty as to the degree to which a precipitous decline in a target's business between signing and closing would trigger an MAE termination right in the absence of other material non-compliance by the target. However, the court found two distinct MAEs to have occurred (general and regulatory) but could have instead done its analysis of the aggregate effect of all the adversity Akorn faced, suggesting the alternative possibility that an MAE could be found with lesser financial impact than the financial performance and equity valuation declines discussed in the opinion.

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[1] Vice Chancellor Laster included a footnote in which he implored readers not to "fixate on a particular percentage as establishing a bright-line test", or "infer that "there is one set of percentages for revenue and profitability metrics and another for liabilities", or "think that a General MAE is always evaluated using profitability metrics and an MAE tied to a representation is always evaluated relative to the entity's valuation."