CORPORATE LITIGATION:

'AKORN V. FRESENIOUS': A RARE DECISION FINDING 'MATERIAL ADVERSE EFFECT'

JOSEPH M. MCLAUGHLIN AND SHANNON K. MCGOVERN*
SIMPSON THACHER & BARTLETT LLP

October 10, 2018

A Material Adverse Effect clause (MAE) is a standard part of acquisition agreements; it permits the buyer to terminate the agreement upon the occurrence of contractually defined adverse changes in the target's business between the signing of the agreement and closing. Few decisions have interpreted this risk allocation provision because most disputes about the significance of post-signing adverse changes to the target are resolved without litigation through price renegotiation or agreed termination of the merger. But the general understanding from the case law has been that buyers asserting a Material Adverse Effect face a steep burden to terminate the merger.

Last week, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery issued a 246-page post-trial opinion finding that a buyer validly terminated a merger agreement where "overwhelming evidence of widespread regulatory violations and pervasive compliance problems" constituted breaches of multiple seller representations, and the extensive compliance failures and dramatic post-signing declines in financial performance were reasonably expected to have a "Material Adverse Effect." *Akorn v. Fresenius Kabi AG*, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018). *Akorn* has drawn considerable interest as the first decision applying Delaware law that found an MAE warranting a buyer's exercise of merger termination rights. While *Akorn* may embolden future parties to test the breadth of their own MAE provisions, the decision appears driven by extraordinary facts and now awaits review in the Delaware Supreme Court.

Background

In public company merger agreements, MAE provisions appear in several contexts: embedded in a representation or warranty by the seller, as a condition precedent to the buyer's obligation to close, and/or as a condition to the exercise of the buyer's termination rights. Merger agreements typically define an "MAE" as an event materially adverse to the business of the seller, with negotiated exceptions that may provide greater clarity on what that means in practice. The principal purpose of MAE clauses is to protect the buyer from unanticipated changes in the seller's business between signing of the merger agreement and closing of the transaction. So understood, MAE provisions protect acquirors from the risk of "the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner." *In re IBP Shareholders Litigation*, 789 A.2d 14, 68 (Del. Ch. 2001). In litigation, determining whether an MAE has occurred turns on "whether there has been an adverse change in the target's business

*__*Joseph M. McLaughlin*__ *is a Partner and* __*Shannon K. McGovern*__ *is an Associate at Simpson Thacher & Bartlett LLP.*

that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." *Hexion Specialty Chemicals v. Huntsman*, 965 A.2d 715, 738 (Del. Ch. 2008).

In practice, this standard has proved difficult to meet. In *IBP*, the Chancery Court held that a significant, 64 percent drop in sales in a single quarter and a $60 million impairment charge arising from improper accounting were insufficient to invoke an MAE clause, although it conceded the question was "a close one." 789 A.2d at 22. Likewise, in *Hexion Specialty Chemicals*, the seller's six-month declines in EBITDA, repeated failures to meet EBITDA forecasts, and increase in net debt contrary to projections were insufficient to meet the buyer's burden to demonstrate that an MAE had occurred, as year-over-year comparisons suggested seasonal fluctuations were responsible.

'Akorn v. Fresenius'

In April 2017, German pharmaceutical company Fresenius Kabi AG signed a merger agreement, committing to purchase Akorn, a specialty generic pharmaceuticals manufacturer, through a reverse triangular merger with one of its wholly owned subsidiaries. A year later, in April 2018, Fresenius terminated the agreement.

Akorn's business performance had, in Vice Chancellor Laster's words, "dropped off a cliff" shortly after the agreement was signed, but that was just one of many problems the company experienced in the year after signing. Beginning in October 2017, Fresenius learned of serious deficiencies in Akorn's data integrity processes. These problems, initially identified in an anonymous whistleblower letter, were confirmed by Fresenius's own investigation. In Fresenius's view—shared by Vice Chancellor Laster—Akorn exacerbated its regulatory problems by making misleading statements to the Food and Drug Administration, its primary regulator.

In terminating the agreement, Fresenius invoked provisions conditioning closing on Akorn's representations about its regulatory compliance being true and correct in all material respects as of signing and closing. Termination was authorized unless the difference between the as-represented and actual condition was not reasonably expected to result in an MAE, and Akorn was in compliance in all material respects with its obligations under the agreement, including its obligation to operate in the ordinary course of business. Fresenius further argued that Akorn's poor financial performance beginning post-closing was a general MAE, which did not provide an independent basis to terminate but would give Fresenius the right to refuse to close the transaction by April 24, 2018, the parties' contractually agreed "Outside Date" for closing.

Akorn sued in the Court of Chancery seeking specific performance of the merger agreement. Fresenius, in turn, sought a declaration that it validly exercised its termination rights. After expedited discovery, the court conducted a five-day trial, ultimately agreeing with Fresenius that termination was proper in light of Akorn's misrepresentations about its regulatory compliance and failure to operate its business post-signing in the ordinary course. The court also concluded that Akorn's "sudden and sustained" drop in its business performance constituted a "general MAE" that relieved Fresenius of its obligation to close. In so holding, the court rejected Akorn's arguments that Fresenius improperly terminated the agreement because Akorn's deteriorating condition prompted buyer's remorse and Fresenius breached the agreement by failing to use reasonable best efforts to consummate the merger—notwithstanding Vice Chancellor Laster's conclusion that Fresenius had decided in November 2017 it did not want to proceed with the merger as negotiated and would seek to terminate the agreement if it could identify a valid contractual basis. Finally, the court held that Fresenius had "technically" but not materially breached its obligation to take all actions necessary to secure antitrust approval for the transaction by embarking on, and ultimately abandoning, a course of action that would have delayed approval by the FTC by several months.

General MAE

To establish a "general MAE," Fresenius invoked a portion of the contractual definition requiring an "effect, change, event or occurrence that, individually or in the aggregate … (ii) has a material adverse effect on the business, results of operations or financial condition of the Company and its Subsidiaries, taken as a whole." Relying principally on standards articulated in *IBP* and *Hexion*, as well as expert testimony by Dan Fischel, the court concluded that Akorn's financial condition materially declined post-closing in a "durationally significant" manner: Akorn's post-closing declines in revenue, operating income, and earnings per share were significant when compared on a year-over-year basis to past performance, represented a reversal of sustained, five-year increases for the same metrics, and had persisted for a year, including as of trial. Akorn attributed the declines principally to additional, unanticipated competition for some of its top products in 2017, which contributed to price erosion. The decision states, without extended comment, that this cause for the decline was likewise "durationally significant."

Vice Chancellor Laster rejected Akorn's arguments that its business declines were the product of changing industry conditions—a risk the agreement allocated to Fresenius—finding Akorn's financial woes to be disproportionate to those of its industry peers. Akorn also failed to convince the court that Fresenius had assumed the risk that industry conditions would affect Akorn's bottom line. Again relying on *IBP* and *Hexion*, the court held that interpretation of a broad MAE clause asks not whether "known or potentially contemplated risks" have materialized, but whether unexpected, "unknown events" have materially decreased the target's earning potential.

Conclusion

The *Akorn* decision is a significant application of existing MAE precedents, but is unlikely to lower the historically high bar to proving a MAE based on business declines post-signing. According to trial testimony, Fresenius believed as early as September 2017—more than seven months prior to termination—that Akorn's financial results constituted a Material Adverse Effect, but "its legal counsel was not certain at that point that Fresenius could satisfy the high burden imposed by Delaware law" to prove it. Vice Chancellor Laster himself acknowledged this distinction between a "businessperson's understanding of what should qualify as a material adverse effect" and Delaware law. It was only after building a record of pervasive data integrity problems at Akorn that Fresenius exercised its rights.

The court's finding that a general MAE occurred applied longstanding precedents and relied solely on financial data and expert testimony—not any of the pervasive data quality problems that informed separate findings that Akorn's failures to comply with its regulatory representations and commitment to operate in the ordinary course of business rose to the level of MAEs. However, it is difficult to isolate the result in *Akorn* from findings that Akorn attempted to conceal its true condition from Fresenius and the FDA.

Among other damaging findings, Vince Chancellor Laster concluded that, upon closing, Akorn scaled back its quality and IT functions and discontinued use of a third-party inspector that had previously identified problems at its sites, with the effect that new quality control problems that might frustrate efforts to sell the Company were unlikely to be identified; Akorn's then-head of quality knowingly submitted a response to FDA correspondence containing fabricated data "in an effort to avoid inviting any scrutiny of Akorn's data integrity deficiencies, until after the Merger closed, when it would be Fresenius's problem"; and an Akorn employee intentionally deleted relevant data during the course of a post-trial FDA investigation. And notwithstanding significant indications (including pre-merger) of a deeply flawed compliance culture, in Vice Chancellor Laster's view, Akorn only began taking serious steps to remedy data integrity problems in March 2018, after Fresenius's own investigation pursuant to contractual rights of inspection "forced its hand."

The scale of Akorn's data integrity problems—among the top three worst examples in the pharmaceutical industry, according to an inspector's report cited approvingly by the Vice Chancellor—is not directly relevant to the court's general MAE finding. But it certainly informed the court's overarching conclusion that Fresenius's termination was not merely a case of buyer's remorse, but the result of a long, deliberate process to exercise its investigatory rights under the merger agreement and evaluate its options after Akorn suddenly experienced significant financial decline.
