Delaware Court of Chancery Finds That Buyer Validly Terminated Merger Agreement Due to Material Adverse Effect

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In its post-trial opinion in *Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018), the Delaware Court of Chancery concluded that a buyer had validly terminated a public company merger agreement because, among other reasons, the target had suffered a "material adverse effect" (MAE, sometimes also referred to as material adverse change or MAC). The opinion has received considerable attention because it is believed to be the first time the Court of Chancery has permitted a buyer to terminate a public company merger agreement based on an MAE. The decision is a must-read for M&A practitioners because of the court's analysis of several key provisions and concepts commonly found in M&A agreements, including materiality qualifiers and efforts-based qualifiers.

The court's exhaustive 246-page opinion carefully recites the factual background of the case. Pursuant to a merger agreement signed on April 24, 2017, Fresenius Kabi AG, a German pharmaceutical company, agreed to acquire Akorn, Inc., a U.S. specialty generic pharmaceutical company whose common stock is publicly traded on the Nasdaq.[1] The total purchase price was approximately $4.75 billion. The Fresenius-Akorn merger agreement provided that the closing of the merger would take place at a future date to be determined once certain conditions had been satisfied (namely, obtaining the approval of Akorn's stockholders and U.S. antitrust clearance). The agreement permitted either party to terminate the merger if it had not closed by a termination date of April 24, 2018 (the first anniversary of the signing date), provided the terminating party was not in breach of the merger agreement. Fresenius's obligation to close the merger was also subject to several key conditions: (i) Akorn's representations and warranties in the merger agreement having been true and correct both at the time the merger agreement was signed and at time of closing, except where the failure would not reasonably be expected to have an MAE (a term defined in the merger agreement); (ii) Akorn having complied in all material respects with its obligations under the merger agreement; and (iii) Akorn not having suffered a general MAE. If conditions (i) and/or (ii) were not satisfied and were not capable of being cured by the termination date, Fresenius could terminate the merger immediately. The failure of condition (iii) did not permit Fresenius to terminate immediately, but it gave Fresenius the right to refuse to proceed to closing; thus, if the MAE was not cured by the termination date, Fresenius could walk away at that time.

Shortly after the merger agreement was signed, significant problems surfaced at Akorn. First, Akorn's financial results "fell off a cliff," according to the court, coming in well below the company's prior results and its internal financial projections. Second, Fresenius received two anonymous whistleblower letters alleging violations of Food and Drug Administration (FDA)data integrity regulations by Akorn. To investigate the allegations, Fresenius retained outside experts, who concluded that there were “serious and pervasive data integrity problems” at Akorn (notably, Akorn chose not to conduct any meaningful investigation, instead relying on its deal counsel to essentially monitor and try to rein in Fresenius’s investigation). In April 2018, shortly before the termination date, Fresenius informed Akorn that it was terminating the merger agreement. Akorn then filed suit in the Court of Chancery, seeking to compel Fresenius to close the merger.

The court, in its characteristically rigorous manner, analyzed the termination provisions of the merger agreement (and certain related provisions incorporated by reference therein, such as the representations and warranties, interim operating covenants, and closing conditions) against the factual record to determine whether Fresenius had validly terminated the merger. Key aspects of the court’s holding are summarized below.

A Large “Durationally Significant” Decline in the Target’s Financial Performance Due to Company-Specific Factors Constituted an MAE:

- The court explained that when evaluating the magnitude of a decline in financial performance to assess whether an MAE has occurred, a company’s performance generally should be evaluated against its results during the same quarter of the prior year, which minimizes the effect of seasonal fluctuations.
- Here, Akorn did not report EBITDA on a quarterly basis, so the court looked at annual performance. The court found that Akorn’s full-year EBITDA declined by 86% from the prior year (a 51% decline in full-year adjusted EBITDA), which was attributable to significant new competition for Akorn’s top three drugs and the loss of a key contract. The court found that the decline was “durationally significant” – Akorn’s EBITDA had *grown* in each of the prior five years, and the conditions causing the deterioration showed “no sign of abating.” Thus, the court concluded that the decline was material.
- The court also noted that the merger agreement’s definition of MAE did not permit Fresenius to terminate the merger if the adverse effect was caused by an industrywide or general economic downturn unless Akorn was disproportionally affected. Here, the court concluded that the drivers of Akorn’s financial underperformance (new competition for its top three drugs and the loss of a key contract) were “[c]ompany-specific factors, not industry-wide effects,” and that in any event, they disproportionately affected Akorn rather than its peers.
- The court rejected Akorn’s defense that Fresenius was aware of the increased competition and loss of contract issues during due diligence and therefore assumed the risk. Even if this were true, the court found, the plain terms of the merger agreement still permitted Fresenius to terminate the agreement. The court also held that for purposes of this analysis, Akorn should be viewed on a stand-alone basis, without factoring in any potential synergies from the merger (the court rejected an argument from Akorn that as long as the merger would be profitable to Fresenius, it could not claim an MAE).

Breaches of Akorn’s Representations and Warranties Regarding Its Regulatory Compliance, Which Would Have Cost Approximately 20% of Akorn’s Stand-alone Equity Value to Remediate, Constituted an MAE.

- As noted above, Fresenius’s obligation to close was subject to Akorn’s representations and warranties having been true and correct both at the time the merger agreement was signed and at time of closing, except where the failure would not reasonably be expected to have an MAE.
- The court explained that the “reasonably be expected to” standard is an objective one, under which future events and conditions can qualify as MAEs where “there is a basis in law and in fact for the serious adverse consequences prophesied by the party claiming the MAE” (*i.e.*, the “mere risk of an MAE cannot be enough”).
- The court concluded that Akorn’s representations and warranties regarding regulatory compliance were not true and correct and could reasonably be expected to have an MAE. To determine whether an MAE existed, the court looked at the “qualitative and quantitative” aspects of the breach. From a qualitative perspective, the court looked at the pervasiveness of the issues and their seriousness (in this case, involving noncompliance with FDA regulations that are essential to a pharmaceutical company in Akorn’s line of business and which jeopardized Akorn’s ability to get new drugs approved). From a qualitative perspective, the court found that the cost of remediation would be

"equal to approximately 20% of [Akorn's] standalone [equity] value." The court found this cost to be "material," looking at a variety of factors including the standard for disclosure under the federal securities laws, the fact that Fresenius paid a significant premium for Akorn (and thus had less flexibility to absorb the expense), the common perception that a "bear market" occurs when the market declines by at least 20%, studies discussing the range of price collars used in public company transactions involving stock consideration, and studies discussing the range of breakup fees in M&A agreements as a percentage of transaction value.

- The court cautioned readers not to assume that it was establishing a bright-line test or focusing on any particular financial metric; the court explained that the analysis required the court to evaluate the "quantitative and qualitative aspects" of the breach.
- The court also found that because the violations were not capable of being cured by the termination date, Fresenius could terminate the merger immediately rather than being required to give Akorn notice and the opportunity to cure.

By Failing to Take Appropriate Steps to Remedy Its Data Integrity Issues, Akorn Violated Its Covenant to Use Commercially Reasonable Efforts to Operate in the Ordinary Course of Business in All Material Respects.

1. Fresenius's obligation to close the merger was conditioned upon Akorn having complied in all material respects with its obligations under the merger agreement. One such obligation was an operating covenant requiring Akorn to use "commercially reasonable efforts" to carry on its business "in all material respects" in the ordinary course of business. The court found that by failing to take appropriate steps to remedy its noncompliance with FDA data integrity regulations (and instead attempting to disguise the problems, even going so far as to present misleading information to the FDA, the court found), Akorn breached this covenant.
2. The court explained that the "in all material respects" standard is less onerous than the common law standard of "material breach" of contract. Analogizing it to the materiality standard in the context of disclosure under securities law, the court concluded that "in all material respects" means something akin to whether the breach would be viewed by the reasonable buyer as altering the "total mix" of information available to it. The court also noted that the phrase "in all material respects" was used both in the closing condition *and* in the operating covenant, emphasizing that the breach "cannot be immaterial" and must represent a "departure from a generic pharmaceutical company's operations in the ordinary course of business and [a] deviation from the buyer's reasonable expectations regarding what it would receive at closing."
3. The court noted that under the Delaware Supreme Court's decision in *Williams Cos. v. Energy Transfer Equity, L.P.*, the terms "commercially reasonable efforts" and "reasonable best efforts" mean the same thing – "to take all reasonable steps to solve problems and consummate the transaction."[2]
4. The court observed that while transactional lawyers tend to believe there is a "hierarchy of efforts clause" comprised of (from highest to lowest) "best efforts," "reasonable best efforts," "reasonable efforts," "commercially reasonable efforts," and "good faith efforts," there is little support for this proposition in Delaware case law. The court pointed to prior decisions that used certain of those terms interchangeably and one decision that noted that even the "best efforts" standard must implicitly be qualified by a reasonableness limitation, as a matter of common sense ("it cannot mean everything possible under the sun.")

Fresenius Did Not Breach Its Covenant to Use Reasonable Best Efforts to Consummate the Merger.

- Akorn seized on the fact (learned through discovery) that Fresenius had begun exploring whether it could terminate the merger almost immediately after first learning of Akorn's financial decline (even before the regulatory issues came to light). Akorn sought to characterize Fresenius's conduct as a simple case of buyer's remorse, akin to a series of 2007-08 era cases where the court refused to permit buyers to walk away from mergers that soured due to the financial crisis. The court explained that when evaluating whether a merger partner has used reasonable best efforts, the Court of Chancery looks to whether it (i) had reasonable grounds to take the actions it did and (ii) sought to address the problems with its counterparty first.
- The court found that the problems at Akorn gave Fresenius reasonable grounds to take the actions it did (retain counsel to analyze whether it had grounds to terminate the merger and conduct its own

investigation of Akorn's regulatory issues). The court found that "Fresenius wanted to live by the Merger Agreement and do what it was obligated to do, while at the same time protecting its own contractual rights and terminating the transaction if it had a valid basis for doing so." Ultimately, the court seems to have found that Fresenius acted in a reasonable and even-handed manner throughout the ordeal, which seems to have earned its management team a good deal of credibility with the court at trial. Counsel to parties considering invoking remedies such as termination under an M&A agreement should refer to the court's discussion on this point when developing a playbook for these inevitably contentious situations.

A few other noteworthy points regarding the *Akorn* decision:

- In several parts of the opinion, the court rejected defenses asserted by Akorn that were based on equitable or common law principles, focusing instead on the plain language of the contract and what the parties specifically bargained for. The opinion affirms Delaware's long-standing adherence to the principle of freedom of contract, particularly among sophisticated parties represented by experienced counsel. Indeed, it is important to keep in mind when analyzing this opinion that it is based on the specific contractual provisions of the Fresenius-Akorn merger agreement (*e.g.*, that agreement's definition of "material adverse effect") and that parties may have significant leeway to vary the result by drafting agreements differently.
- The merger agreement provided Fresenius with a right of reasonable access to Akorn's officers, employees, and information so that Fresenius could evaluate Akorn's contractual compliance and determine whether the conditions to closing were met. This turned out to be a very valuable right, as Fresenius was required to conduct its own investigation into Akorn's compliance with applicable FDA regulations. Counsel should carefully consider this and draft appropriate information and access covenants in the event similar circumstances arise.
- The court found that the nondisclosure agreement between Fresenius and Akorn did not prevent Fresenius from sharing Akorn's confidential due diligence materials with the law firm that Fresenius retained to handle the regulatory investigation. The nondisclosure agreement permitted Fresenius to use such information only for "evaluating, negotiating, and executing" a transaction." The court concluded that the investigation fell within that scope.
- Because Fresenius sought to excuse its performance under the merger agreement, Fresenius bore the burden of proof at trial.

Akorn subsequently appealed the Court of Chancery's decision to the Delaware Supreme Court, which affirmed the lower court's decision in an order dated December 7, 2018.

[1] An additional point of interest – no party to the merger agreement was organized in Delaware; however, the parties agreed in the merger agreement that Delaware law would govern the transaction.

[2] For a discussion of the *Williams* case, please see the Delaware Law Update published on June 5, 2017.