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M&A Update

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Delaware Court of Chancery makes notable MAE finding, allows Fresenius to terminate proposed US$4.3 billion acquisition of Akorn

In ***Akorn, Inc. v. Fresenius Kabi AG,*** C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018), the Delaware Court of Chancery determined that Fresenius Kabi AG (Fresenius) validly terminated its proposed acquisition of Akorn, Inc. (Akorn) based on Akorn's business having suffered a material adverse effect (MAE). In so holding, the Court determined that both a "general" MAE occurred, due to a "dramatic, unexpected, and company-specific downturn" in Akorn's performance, and that misrepresentations concerning Akorn's regulatory compliance rose to a level that would reasonably be expected to result in an MAE. This opinion is believed to be the first time a Delaware court has permitted a buyer to walk away from a signed acquisition agreement due to the occurrence of an MAE.

Background

On April 24, 2017, Fresenius, a Germany-based pharmaceutical company, entered into a merger agreement with Akorn, an Illinois based specialty generic pharmaceuticals company, pursuant to which Fresenius would acquire all of the outstanding shares of Akorn for US$4.3 billion, or US$34 per share.

Shortly after the agreement was signed, Akorn began experiencing severe business performance issues. During the second quarter of 2017, "Akorn's business performance fell off a cliff" due to an unexpected increase in competition and the loss of a key contract, resulting in an 86% drop in annual EBITDA for 2017 – after enjoying consistent growth in prior years. Moreover, on a year-over-year basis following signing, Akorn's quarterly revenues declined over 29%, operating income declined over 84%, and its earnings per share declined over 96%. Also, in the fall of 2017, Fresenius received letters from an anonymous whistleblower alleging serious compliance issues with Akorn's product development and quality compliance programs. Fresenius then conducted an investigation of Akorn's compliance programs that confirmed serious FDA compliance issues and pervasive data integrity problems.

On April 22, 2018, Fresenius terminated the merger agreement, asserting, among other things, that an MAE had occurred and that misrepresentations regarding Akorn's regulatory compliance would reasonably be expected to result in an MAE. Akorn filed suit in the Delaware Court of Chancery seeking a decree of specific performance under the merger agreement to compel Fresenius to close, and Fresenius filed counterclaims seeking confirmation that it validly terminated the merger agreement and was not required to close.

The Court's analysis

In the 246-page post-trial opinion, the Court thoroughly considered Fresenius' actions and Akorn's contention that Fresenius simply was suffering from "Buyer's remorse." After painstakingly reviewing the facts of the case and the underlying language of the merger agreement, however, the Court rejected Akorn's arguments, and found that Fresenius validly terminated the agreement on three principal grounds.

First, the Court held that the steep deterioration in Akorn's business qualified as an MAE, thereby allowing Fresenius to terminate the acquisition under the terms of the merger agreement. In referring to factors set forth in *IBP, Inc. v. Tyson Foods, Inc.,* 789 A.2d 14 (Del. Ch. 2001), the court found the decline in Akorn's business to be both "durationally significant" and "material when viewed from the longer-term perspective of a reasonable acquirer, which is measured in years." In addition, the court concluded that an MAE exception in the agreement – related to Akorn's contention that the decline resulted

from "industry-wide effects" – was not applicable in light of Akorn's decline resulting disproportionately from "Company-specific factors, not industry-wide effects." The court also rejected Akorn's contention that Fresenius could not claim an MAE based on risks known to Fresenius at signing (through diligence or given its industry knowledge), finding instead that because the MAE definition used "exceptions and exclusions to allocate risks between the parties," and the parties did not negotiate to limit the MAE solely to effects, changes, events, or occurrences that were unforeseeable, those risks were allocated to Akorn.

Second, the court found that "Akorn's representations regarding its compliance with regulatory requirements were not true and correct, and the magnitude of the inaccuracies would reasonably be expected to result in a Material Adverse Effect." In making this determination, the court emphasized "overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn" that were estimated to cost approximately 20% of Akorn's standalone value to address over several years.

Third, the Court held that "Akorn materially breached its obligation to continue operating in the ordinary course of business between signing and closing" by failing, in several respects, to identify and respond appropriately to regulatory compliance issues as those issues arose.

To attempt to overcome these findings, Akorn also pointed to a provision in the merger agreement that would preclude Fresenius from exercising its termination rights if it was in material breach of its own obligations. Even though the Court concluded that Fresenius may have breached certain of its obligations related to the pursuit of antitrust approval, the Court rejected Akorn's contentions that Fresenius' actions rose to a material breach of the merger agreement. Accordingly, the Court concluded not only that Fresenius had no obligation to close the transaction but also that Fresenius had properly terminated the merger agreement.

Conclusion

While the *Akorn* decision has made headlines based on the court's finding of an MAE that, as a result, supported termination of a merger agreement, there is limited reason to believe that this decision marks an increased willingness by the Delaware courts to entertain buyer MAE claims. Indeed, the decision highlights – and cannot be divorced from – the Court's intensive analysis of the particular facts and the contractual terms at issue, and illustrates the continued focus by Delaware courts on the specific language and terms of a contract. That said, while the decision reaffirms the "high burden" to prove an MAE, the court's finding also shows that the burden to prove an MAE is not insurmountable, and thus serves as an important reminder to consider carefully MAE definitions, usage and implications in negotiating acquisition agreements. Assuming the anticipated appeal of this decision to the Delaware Supreme Court proceeds, it is likely that we have not heard the last of this story.

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