Akorn Falls Far from the Tree:
Delaware Chancery Court Finds a "Material Adverse Effect" for the First Time in *Akorn, Inc. v. Fresenius Kabi AG, et al.*

October 25, 2018

On October 1, 2018, the Delaware Court of Chancery found in *Akorn, Inc. v. Fresenius Kabi AG, et al.* that Fresenius was entitled to terminate its merger agreement with Akorn. In so ruling, Vice Chancellor Travis Laster found that: Akorn suffered a "Material Adverse Effect" ("MAE") following the execution of the merger agreement; Akorn breached its representations related to regulatory compliance in a manner that would reasonably be expected to have an MAE; and Akorn did not comply in all material respects with its covenant to use commercially reasonable efforts to operate in the ordinary course of business following execution of the merger agreement. The decision is the first time a Delaware court has held that a seller has suffered an MAE, entitling the buyer to terminate an acquisition transaction. The decision offers insight into the interpretation of the term "Material Adverse Effect," as well as other provisions commonly used in M&A agreements.

Background

Fresenius and Akorn entered into a merger agreement in 2017, shortly after Akorn announced strong results for the first quarter of 2017. During the second quarter of 2017, however, "Akorn's business performance fell off a cliff." The Company's second quarter results were well below its projected guidance, as well as the prior-year performance. Akorn's performance did not recover by the end of 2017. Akorn attributed its failure to meet guidance and its sharp decline in performance to the loss of a key contract and unexpected competition. In October and November 2017, Fresenius received anonymous whistleblower letters that made "disturbing allegations about Akorn's product development process failing to comply with regulatory requirements." As a result of these communications, Fresenius and its advisors, relying on the reasonable access covenant contained in the merger agreement, conducted an investigation into these allegations. Akorn elected not to conduct an investigation, instead relying on its deal counsel to "shadow" Fresenius' investigation. The Fresenius investigation "uncovered serious and pervasive data integrity problems that rendered Akorn's representations about its regulatory compliance sufficiently inaccurate."

Due to the allegations made in the whistleblower letters and the serious issues uncovered by Fresenius' investigation, tensions escalated between the parties as Akorn "downplayed its

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problems and oversold its remedial efforts" in a misleading presentation to the FDA, its primary regulator. Akorn further exacerbated its regulatory issues by cancelling regular audits at certain of its facilities following execution of the merger agreement, failing to maintain or remediate its data integrity systems in a manner that allowed it to comply with FDA requirements, submitting regulatory filings to the FDA based on fabricated data and failing to engage experienced counsel to investigate the whistleblower allegations.

As a result, Fresenius delivered a notice to Akorn on April 22, 2018 indicating Fresenius' election to terminate the merger agreement based on certain termination rights that were triggered by the fact that (i) Akorn's regulatory representations were not true and correct, and such inaccuracy was reasonably expected to result in an MAE; (ii) Akorn failed to "use its commercially reasonable efforts . . . to carry on its business in all material respects in the ordinary course of business" following execution of the merger agreement; and (iii) Akorn suffered a general MAE following execution of the merger agreement. Akorn responded by filing an action in the Delaware Court of Chancery claiming that Fresenius' attempt to terminate the merger agreement was invalid and requesting specific performance to compel Fresenius to consummate the merger.

Following a five-day trial, the Court determined that Fresenius' termination was valid because Akorn's financial performance following executing the merger agreement constituted a general MAE. The Court also held that Akorn breached its regulatory compliance representations in a manner that would reasonably be expected to result in an MAE. Furthermore, the Court found that Akorn's failure to maintain adequate data integrity procedures and its improper response to the data integrity issues alleged in the whistleblower letters represented a material breach of Akorn's obligation to use commercially reasonable efforts to operate in the ordinary course of business. In so ruling, the Court stated that the breach was material because the "deviation from ordinary course practice was significant" and "changed the calculus of the acquisition for purposes of closing."

Takeaways

- A "Material Adverse Effect" Must be Substantial and Durationally-Significant. In determining that Akorn had suffered a general MAE, the Court applied the standards set forth in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.* and *In re IBP, Inc. Stockholders Litigation*, which provide that an MAE will be deemed to have occurred if the effect would "substantially threaten the overall earnings potential of the target in a durationally-significant manner . . . which one would expect to be measured in years rather than months." In holding that Akorn's performance declined materially, the Court observed, among other things, that Akorn's year-over-year quarterly decline in revenue, operating income and EPS were 34%, 292% and 300%, respectively. The Court further stated that Akorn's full-year 2017 EBITDA declined 86% and full-year 2017 Adjusted EBITDA declined 51% on a year-over-year basis. The Court highlighted that these dramatic

declines commenced only after the merger agreement was executed and represented a reversal of historical trends of year-over-year growth.

The Court also determined that the underlying causes of Akorn's declining performance were durationally-significant. In making this determination, the Court noted that Akorn's poor performance had already continued for a full year with no signs of improvement. Furthermore, the reasons given by Akorn's management for its declining performance were of a nature that would have durationally-significant effects; namely the entry of new competitors in the marketplace and the loss of a key contract without any reason to believe that the additional competition would subside or that it could enter into a new replacement contract. As supporting evidence, a number of financial analysts significantly lowered annual EBITDA estimates for Akorn by more than 60% for each year through 2020, which were materially in excess of the reduction in analyst estimates for Akorn's peers.

The Court rejected Akorn's argument that the decline in Akorn's value should be measured against its value to Fresenius as a synergistic buyer, as opposed to Akorn on a standalone basis. The Court reasoned that a plain reading of the merger agreement provides that the evaluation should be made as to "the Company and its Subsidiaries" and that the definition of "Material Adverse Effect" "carves out any effects resulting from . . . 'the consummation of the [Merger.]'" Furthermore, the Court rejected Akorn's argument that no MAE may be deemed to have occurred so long as Fresenius could profit from the acquisition because there is no language in the merger agreement to support such an interpretation. According to the Court, the evidence established that the parties sought to lower the bar set by the black-letter doctrine of frustration by agreeing to a lower "materiality" standard for entitling a party to withdraw from the contract.

- Sellers Should not Overreact; Proving an MAE Still Requires Evidence of Substantial Performance Deterioration or Other Significant Effects. The decision in *Akorn* is based on evidence showing a drastic decline in performance and financial condition, as well as significant regulatory issues that relate to the core of Akorn's business. M&A participants should not view this case as supporting a new trend of courts finding MAEs in unanticipated circumstances. Instead, this decision should be viewed as confirmation that the determination of whether an MAE has occurred is very fact-dependent, and that the Court will not find an MAE absent substantial and durationally-significant performance deterioration or other significant effects. The facts in *Hexion* and *IBP* evidenced far less deterioration and were found not to constitute an MAE. In *Hexion*, the Court held that an MAE did not occur where the target's 2007 EBITDA was only 3% below its 2006 EBITDA and target management forecasts indicated that its 2008 EBITDA would be only 7% below its 2007 EBITDA (and only 11% based on the buyer's more conservative estimates). In *IBP,* in what the Court labeled as a "close one," the Court held that the target's 64% drop in quarterly earnings did not constitute an MAE because it was the result

of widely known cycles in the industry, and the company began performing at a similar level to its historical results shortly after the negative quarter.

- The Analysis May be Different Under Certain Circumstances for a Financial Buyer. In this case, and in *Hexion* and *IBP*, the Court evaluated the existence of an MAE from the "longer-term perspective of a reasonable acquirer" and noted that such an approach is appropriate "absent evidence to the contrary." The opinion notes that commentators have suggested that the level of durational significance required to find an MAE may differ for a financial buyer that enters into a highly leveraged transaction with the objective of a shorter-term profit.

- An MAE May be Deemed to Occur Even if the Buyer had Known or Contemplated the Risks That Could Lead to the MAE. Akorn relied on statements made in *IBP* to argue that an MAE should be based upon "unknown events," and that there was no MAE here because Akorn's financial performance was attributable to risks that Fresenius learned about in due diligence and should have understood based on knowledge of the industry. The Court rejected this argument because it improperly expands "unknown events" into "known or potentially contemplated risks." The Court observed that if the parties wanted to exclude known risks or other matters disclosed to Fresenius in diligence from the definition of MAE they would have done so explicitly in the merger agreement. Furthermore, the Court stated that the *Hexion* and *IBP* decisions should not be interpreted in terms of whether risks were known or unknown, but instead, "held that buyers could not rely on the manifested consequences of widely known systematic risks" in claiming an MAE.

- The Court Will Consider "Quantitative and Qualitative Aspects" in Determining Whether an Issue "Would Reasonably be Expected to Result in an MAE". The Court found that whether a particular issue would "reasonably be expected to result in an MAE" is an objective determination taking into account "quantitative and qualitative aspects." Here, there was vast evidence of widespread regulatory violations and pervasive compliance issues at Akorn. Indeed, the Court determined that a long-term acquirer would view the regulatory situation as material, as "Akorn has gone from representing itself as an FDA-compliant company with accurate and reliable submissions from compliant testing practices to a company in persistent, serious violation of FDA requirements with a disastrous culture of noncompliance." Furthermore, the Court, taking into account testimony from expert witnesses, estimated that the regulatory compliance issues at Akorn would result in a loss of value of $900 million, representing a 21% decline from the equity value implied by the merger agreement.

- Knowledge of a Potential Risk Does Not Restrict a Buyer From Terminating a Merger Agreement for Breach of a Representation that is Based on the Manifestation of Such Risk. The Court held that Fresenius' general knowledge about the potential regulatory issues in question should not prevent Fresenius from relying on the breach of Akorn's regulatory representations in order to terminate the merger agreement. To the contrary, the existence of a representation generally reflects the parties' knowledge of a specific potential risk, and the representation is a manner in

which the parties have agreed to contractually allocate risk with respect to the applicable subject matter. Citing its prior decision in *Cobalt Operating, LLC v. James Crystal Enterprises, LLC*, the Court reaffirmed that, absent express agreement to the contrary, a buyer may rely on a seller's breached representations to terminate a merger agreement regardless of the fact that the buyer was concerned about the accuracy of a representation and had the ability to conduct a due diligence review of the issue. The Court did note, however, that there could be a different outcome if the buyer had actual knowledge that the representation was inaccurate (as opposed to knowledge of the risk of inaccuracy) or if the buyer sought post-closing damages as opposed to termination of the merger agreement.

- Buyers Seeking to Terminate a Merger Agreement Based on an MAE Should be Mindful of the Evidentiary Record. As in *Hexion* and *IBP*, Akorn attempted to paint a picture of "buyer's remorse" on the part of Fresenius, and argue that Fresenius acted in bad faith in seeking to manufacture a record to justify termination. While the Court did not fully reject the notion that Fresenius suffered from "buyer's remorse," it did note that the difference in this case versus others was that such remorse was justified and not spurred by problems with the buyer's business or broader economic factors. Moreover, the Court found that, unlike in the prior cases, Fresenius satisfied its obligation to use reasonable best efforts to close the transaction because it "(i) had reasonable grounds to take the action it did and (ii) sought to address problems with the counterparty." For instance, even after learning of Akorn's dismal performance and regulatory issues, Fresenius continued to comply with its obligations under the merger agreement (including its obligation to seek antitrust approvals), investigated the issues with the assistance of experienced advisors, communicated directly with Akorn regarding its concerns and offered to extend the outside date in order to provide Akorn additional time to cure its regulatory issues.

- The Decision Provides Insight into How the Court Interprets the Phrase "In All Material Respects" and "Commercially Reasonable Efforts". In this case, Fresenius alleged that Akorn breached its covenant to use its "commercially reasonable efforts" to operate its business "in all material respects" in the ordinary course of business between signing of the merger agreement and closing of the transaction due to its ineffective data integrity procedures and insufficient response to allegations of regulatory non-compliance during this period.

  - "In All Material Respects". Rejecting Akorn's assertion that the "in all material respects" standard should be defined by the common law doctrine of "material breach," and only be satisfied if the breach "goes to the root or essence of the agreement between the parties, or touches the fundamental purpose of the contract," the Court adopted a lower standard based upon the Court's ruling in *Frontier Oil Corp. v. Holly Corp.* Under this standard, materiality should be based upon whether the issues are "significant in the context of the parties' contract, even if the breaches are not severe enough to excuse a counterparty's performance under a common law analysis."

- "Commercially Reasonable Efforts". The Court reaffirmed the Delaware Supreme Court's ruling in *Williams Companies v. Energy Transfer Equity, L.P.*, which held that despite the "hierarchy of efforts clauses" generally ascribed by practitioners, there is no distinction between the terms "reasonable best efforts" and "commercially reasonable efforts," with each term requiring a party to "take all reasonable steps to solve problems and consummate the transaction."

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