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Delaware Chancery Court Upholds Termination of Merger on MAE Grounds in *Akorn* v. *Fresenius*

It can no longer be said that the Delaware Chancery Court has never found a Material Adverse Effect ("MAE") that justified termination of a public company merger agreement because that is exactly what Vice Chancellor Laster did in *Akorn, Inc.* v. *Fresenius Kabi AG et al.*, No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018).[1] However, lest anyone believe it has become easy to terminate a merger on MAE grounds in Delaware, it took the Vice Chancellor 246 pages to justify his decision. *Akorn* presented a perfect storm of dramatic post-signing performance decline at the target, Akorn, plus shocking regulatory misbehavior that combined to create an MAE record that will be difficult to replicate.

The intensively fact-based opinion found that the deterioration in Akorn's financial results met the Delaware MAE standard of being material and durationally significant.[2] This deterioration over four quarters included year-over-year quarterly revenue declines of more than 25%, operating income declines of more than 80%, and net income declines of more than 90% in each of the four quarters after the merger agreement was executed. Moreover, EBITDA declined by 86% and adjusted EBITDA by 51% in 2017 compared to 2016, and the decline was in stark contrast to a prior five-year consistent growth in EBITDA.[3] Akorn's poor performance also contrasted markedly with that of its industry peers, and showed no signs of a near-term rebound.[4]

While the Court noted that "[a] buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close,"[5] given the magnitude of Akorn's downward spiral, fundamental changes to Akorn's specific businesses, the absence of any visible path to improved results, and the depth of regulatory and compliance problems inside Akorn (which are discussed below), the finding of a Material Adverse Effect[6] on these facts is unsurprising.

Among the Akorn arguments rejected by the Court was an "anti-sandbagging" contention that, despite Akorn's dismal performance, Fresenius could not assert that an MAE had occurred because, in due diligence, it learned of the business risks that became the underlying causes of the downturn. The Court reasoned that, even assuming that Fresenius had learned about the relevant risks, Fresenius was not prevented from asserting an MAE because the contract's allocation of risk reflected the scope of information provided in due diligence, including future business risks.[7]

In addition to concluding that Akorn had suffered an MAE as defined in the merger agreement, the Court also held that Fresenius was justified in terminating the merger agreement because of a breach of the regulatory compliance representation[8] in the merger agreement due to "overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn," principally related to data integrity issues.[9] The Court, as was necessary for the breach to justify a termination under the agreement, found that the regulatory failings caused an MAE as they were both qualitatively material because they jeopardized existing and future FDA approvals of Akorn products and quantitatively material because the value diminution likely to result from remediating them was approximately $900 million, or 21% of the equity purchase price Fresenius agreed to pay for Akorn as of the termination date.[10]

The Court also found that Akorn's manner of addressing its regulatory and compliance problems failed to comply with its contractual covenant to operate its business in the ordinary course after signing the merger agreement.[11] An interesting aspect of this portion of the Opinion that might surprise practitioners is its treatment of the obligation to operate in the ordinary course of business as seemingly measured against a hypothetical reasonably managed company in the same business rather than against Akorn's own historic ordinary-course operations (which involved substantial non-compliance in the regulatory area).[12] This holding was not necessary to the decision because there were some significant deviations from Akorn's historic operations and likely is specific to the unusual facts of this case and the particular wording of the ordinary course clause in this merger agreement, yet it is not the way provisions of this sort ordinarily would be interpreted.

Finally, the Court rejected Akorn's argument that Fresenius was not permitted to terminate the merger agreement because it had breached its covenant to use "reasonable best efforts" to complete the merger.[13] The Court ruled that Fresenius did not obligate itself "to merge at all costs and on any terms," but only to use its reasonable best efforts to complete "the transactions that they had agreed to in the Merger Agreement on the terms set forth in that contract."[14] That obligation, the Court held, "did not require either side of the deal to sacrifice its own contractual rights for the benefit of its counterparty."[15]

As might be expected in a 246 page opinion, the *Akorn* decision provides an encyclopedic review of the legal principles implicated by an attempt to terminate a merger agreement, with expositions on a wide range of legal subjects related to materiality, burdens of proof, breach of contract claims and defenses, and interpretation of information access covenants, efforts covenants, and other customary merger agreement provisions. It is an excellent guide to the issues a practitioner should keep in mind when drafting the termination and other provisions of a merger agreement or advising a client about the manner in which to pursue a termination or renegotiation of a merger agreement.

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ENDNOTES

[1] C.A. No. 2018-0300-JTL, 2018 WL 4719347, at *3 (Del. Ch. Oct. 1, 2018).

[2] *See id.* at *52–57.

[3] *See id.* at *55.

[4] *See id.*

[5] *Id.* at *53 (quoting *Hexion Specialty Chems.* v. *Huntsman Corp.*, 965 A.2d 715, 738 (Del. Ch. 2008)).

[6] The relevant provision is set out at pages *50–51 of the Opinion.

[7] *See id.* at *60–62.

[8] The relevant provisions are set out at pages *63–64 of the Opinion.

[9] *Id.* at *66.

[10] *See id.* at *66–76.

[11] *See id.* at *83–91. The relevant provision is set out at pages *83–84 of the Opinion.

[12] *See id.* at *88–89.

[13] *See id.* at *91–95.

[14] *Id.* at *91.

[15] *Id.*

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