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Court allows buyer to walk away from deal based on material adverse effect

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OCTOBER 29, 2018

In *Akorn Inc. v. Fresenius Kabi AG*, No. 2018-0300, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), the Delaware Court of Chancery recently ruled that a buyer could walk away from a merger agreement because the target suffered a material adverse effect, or MAE, also commonly referred to as a material adverse change, or MAC. The decision is believed to be the first time a Delaware court has allowed a buyer to cancel a deal based on an MAE or MAC.

According to research by the M&A Market Trends Subcommittee of the Mergers and Acquisitions Committee of the American Bar Association's Business Law Section, virtually all public target deals and 93 percent of private target deals today include provisions for the buyer to cancel the deal if it would result in an MAE.

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However, the overwhelming majority of acquisition agreements offer no definition of the key term "material." According to the M&A Market Trends Subcommittee, only 2 percent of recent private target M&A transactions included a specific dollar amount threshold for an event to qualify as "material." In practice, buyers and sellers find it difficult to agree on a percentage or dollar amount as constituting the grounds to terminate the contract. Instead, they essentially punt and leave the difficult issue to the court's discretion.

The uncertainty over whether a change is "material" may be beneficial to the extent it gives both the buyer and seller an incentive to renegotiate a lower price to avoid the risky and uncertain result of litigation. In practice, however, the M&A community has been operating largely in the dark when it comes to an objective standard regarding an MAE under Delaware law.

The *Akorn* decision provides welcome guidance about what constitutes an MAE or MAC.

THE MERGER AGREEMENT

Akorn involved a merger agreement signed in April 2017. Fresenius Kabi AG, a German pharmaceutical company, agreed to acquire Akorn Inc., an American generic pharmaceutical company, for $4.75 billion.

The merger agreement contained customary terms. Because Akorn is a pharmaceutical company, extensive representations were made about its compliance with applicable regulatory requirements.

The merger agreement conditioned the buyer's obligation to close on Akorn's representations being true and correct both at signing and at closing, except where the failure to be true and correct would not reasonably be expected to have a contractually defined "material adverse effect."

If this condition was not met by the outside "drop dead" date, then the buyer could terminate the agreement. This type of provision is known as the "bring-down condition."

In addition, the buyer's obligation to close was conditioned on the target not having suffered any change, event or occurrence that, individually or in the aggregate, has had or would reasonably be expected to have a material adverse effect. A failure to meet this condition did not give the buyer a right to terminate the agreement.

However, once the outside "drop dead" date passed, either the buyer or the seller could terminate provided that the terminating party's own breach of the agreement was not the principal cause of the failure to close. This type of provision is often referred to as the "general MAE condition."

The general MAE condition is not tied to a particular representation about a specific issue. The bring-down condition examines the inaccuracy of specific representations and uses as a measuring stick whether the deviation between the as-represented condition and actual condition constitutes an MAE.

The merger agreement contains a relatively standard, albeit convoluted, definition of material adverse effect. The agreement defines the term to include "any effect, change, event or occurrence that, individually or in the aggregate … has a material adverse effect on the business, results of operations or financial condition of the company and its subsidiaries, taken as a whole."

The definition carves out certain types of events that otherwise would give rise to an MAE, including changes generally affecting the industry in which the company and its subsidiaries operate, acts of war, weather-related events and changes in law.

The MAE definition then creates an exception to the carve-out if the event, change, effect or occurrence has had a disproportionately adverse effect on the company. This approach follows the customary risk allocation between buyer and seller in today's M&A market.

TARGET'S BUSINESS FALLS OFF A CLIFF

After the companies signed the agreement, Akorn's business performance deteriorated dramatically, or as Vice Chancellor J. Travis Laster colorfully said, it "fell off a cliff." In the quarter after the parties signed the merger agreement, on a year-over-year basis, revenue declined by 29 percent, operating income declined by 84 percent and earnings declined by 96 percent.

Akorn attributed the bad results to unexpected new market entrants who competed with its top products, resulting in unexpected price erosion. Akorn also unexpectedly lost a key contract to sell a drug, resulting in a loss of revenue in an area where Akorn had been forecasting growth.

During the following quarter, on a year-over-year basis, Akorn's revenue declined by 29 percent and its operating income declined by 89 percent.

Akorn also fell behind in its new product launches. It had anticipated 34 launches in 2017, but by mid-November it had launched only 14 with another six planned by year end. The 14 launches netted only $3 million in sales, even though it had originally projected $60 million from new product launches in 2017.

Akorn's full-year EBITDA showed an 86 percent decline, and its full-year adjusted EBITDA declined by 51 percent, representing a departure from its historical trend. Over a five-year span, Akorn grew consistently, year over year, when measured by revenue.

REGULATORY PROBLEMS DISCOVERED AFTER SIGNING

After signing the merger agreement, Fresenius received a letter from an anonymous whistleblower who made disturbing claims about Akorn's alleged failure to comply with regulatory requirements regarding product development as well as claims of alleged deficiencies in Akorn's quality compliance programs. The letter called into question whether Akorn's representations regarding regulatory compliance were accurate.

Under the merger agreement, Fresenius bargained for a right to 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.

Pursuant to this right, Fresenius investigated the whistleblower's claims. Its investigation uncovered serious and pervasive data integrity problems that rendered Akorn's representations regarding its regulatory compliance inaccurate. Akorn appeared to have submitted unreliable and potentially even false data to the Food and Drug Administration.

The FDA may require the withdrawal of a drug application if there is an untrue statement of material fact. In case of repeated, intentional submission of inaccurate data, the agency may invoke its application integrity policy, or AIP, which halts all ongoing FDA review of pending applications until the company takes specific corrective measures.

Exiting from the AIP is a time consuming and expensive process that involves an independent investigation, corrective action plan and recall or retesting of products, along with withdrawal and resubmission of applications.

BUYER CLAIMS MAE, SEEKS TO WALK AWAY

Fresenius concluded that the merger was a bad deal. It provided written notice to Akorn that it was terminating the merger agreement, asserting that Akorn's representations regarding regulatory compliance were so inaccurate that the deviation could reasonably be expected to result in a material adverse effect.

Fresenius also cited the section in the merger agreement that conditioned its obligations to close on Akorn's not having suffered a material adverse effect.

Akorn responded by filing an action in the Delaware Chancery Court seeking a declaration that Fresenius' attempt to terminate the merger agreement was invalid. It also sought a decree of specific performance compelling Fresenius to close the deal.

In prior cases, the Delaware Chancery Court consistently ruled against buyers who sought to back out of acquisitions on the grounds of the material adverse change provision in the contract.

WAS THE DOWNTURN 'MATERIAL'?

Vice Chancellor Laster's opinion analyzed whether, as a matter of Delaware contract law, the decline in Akorn's business performance constituted a general MAE. The basic question was whether the magnitude of the downturn in Akorn's performance was "material."

The buyer, as the party seeking to establish the MAE to excuse its obligation to close the acquisition, bore the burden of proving that the MAE occurred.

The vice chancellor ruled that a short-term hiccup in earnings will not suffice to establish a material adverse effect. The adverse effect must be material when viewed from the longer-term perspective of a reasonable acquirer.

To constitute a general MAE, the poor earnings must be expected to persist significantly into the future.

The question should be whether there has been an adverse change in the target's business that is consequential to the company's long-term earning power over a commercially reasonable period. The effects should substantially threaten the overall earning potential of the target in a durationally significant manner, meaning years rather than months.

Vice Chancellor Laster also held that when evaluating the magnitude of a decline, a company's performance generally should be evaluated against its results during the same quarter of the prior year, to minimize the effect of seasonal fluctuations.

The vice chancellor observed that *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), held that declines in EBITDA in the 3 to 11 percent range were insufficient to create a general MAE.

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The vice chancellor further noted that according to "Negotiated Acquisitions of Companies, Subsidiaries and Divisions," an influential treatise by Lou R. Kling and Eileen T. Nugent, most courts that have considered decreases in profits of at least 40 percent have found that the decrease produced a material adverse effect.

In *Raskin v. Birmingham Steel Corp.,* No. 11365, 1990 WL 193326 (Del. Ch. Dec. 4, 1990), it was suggested that a decline of 50 percent over two consecutive quarters would likely be an MAE.

Vice Chancellor Laster noted that these precedents do not foreclose the possibility that a buyer could show that percentage changes of a lesser magnitude constituted an MAE. Nor do they exclude the possibility the buyer might fail to prove that percentage changes of a greater magnitude constitute an MAE.

An example of the latter scenario is *In re IBP Inc. Shareholders Litigation*, 789 A.2d 14 (Del. Ch. 2001), which held that a 64 percent drop in quarterly earnings did not constitute an MAE because the decline was due to widely known cycles in the meat industry, exacerbated by a harsh winter that also affected the buyer. After the bad quarter and the onset of spring, the target's performance returned to more historical levels.

The vice chancellor found that Fresenius made the necessary showing to establish a general MAE. At trial, an expert witness testified credibly and persuasively that Akorn's financial performance had materially declined since the signing of the merger agreement and that the underlying causes of the decline were durationally significant.

Akorn's full-year EBITDA showed an 86 percent decline, and full-year adjusted EBITDA showed a 51 percent decline. In addition, the decline represented a departure from Akorn's historical trend.

New competitors had entered the market, and the new competition resulted in unexpected price erosion. In addition, Akorn lost a key contract that was unlikely to be replaced.

Vice Chancellor Laster also found that the carve-outs in the definition of MAE did not apply in this case. Akorn's dismal performance resulted from company-specific factors, not industry-wide effects. The court found that even if the causes were industry-wide effects, Akorn was disproportionally affected by the industry-wide effects.

COURT EXAMINES WHETHER BREACH OF REPRESENTATION CONSTITUTED AN MAE

Next, the vice chancellor's opinion considered whether the bring-down condition was satisfied and whether the inaccuracy of Akorn's regulatory compliance representation constituted an MAE.

The bring-down condition in the merger agreement required Akorn's representations to be true "as of the date hereof," meaning at signing and on the closing date. Fresenius asserted that Akorn breached the regulatory compliance representations in the merger agreement. In that section, Akorn made extensive representations regarding its compliance with regulatory requirements.

When the bring-down condition is analyzed, the buyer needs to prove both that the representations were inaccurate and that the deviation between Akorn's as-represented condition and actual condition would reasonably be expected to result in a material adverse effect.

The vice chancellor found overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn.

The vice chancellor determined that the regulatory situation at Akorn was qualitatively material when viewed from the longer-term perspective of a reasonable acquirer.

Akorn had gone from representing itself as an FDA-compliant company to a company with persistent, serious violations of FDA requirements and a disastrous culture of noncompliance. The qualitative aspect of the MAE analysis warranted a finding that the regulatory issues would reasonably be expected to result in a material adverse effect.

The quantitative aspect of the MAE analysis also favored a finding that Akorn's regulatory issues would be expected to result in an MAE.

The buyer's expert testified that using a discounted cash flow model, a delay in new product introduction of 18 months years would have a negative impact on Akorn's value of $600 million and a two-year delay would have a negative impact on Akorn's valuation of more than $800 million.

The valuation impact of an 18-month or two-year delay therefore represented, respectively, 16 percent and 22 percent of Akorn's stand-alone equity value. The court found that the financial impact of Akorn's data integrity issues was approximately $900 million, which was equal to 21 percent of Akorn's equity value.

The vice chancellor concluded that remediation cost equal to approximately 20 percent of the target stand-alone value would constitute an amount that would be material when viewed from the longer-term perspective of a reasonable acquirer.

LESSONS LEARNED

Akorn provides the following guidance regarding what constitutes an MAE or MAC under Delaware law:

- To constitute a general MAE, the decline in business performance must be durationally significant from a long-term perspective. A short-term hiccup will not qualify. A minimum of two bad quarters, measured on a year-over-year basis, is probably required.
- To constitute a general MAE, the decline in business performance must be greater than 10 percent. A decline of 40 percent or more will probably be a general MAE. Although Akorn does not provide specific guidance in the intermediate range of declines, a decline resulting in the loss of 20 percent of the target's value may be the threshold. However, Akorn cautioned the reader not to fixate on a particular percentage as establishing a bright-line test.
- To constitute an MAE for purposes of a bring-down condition, the breach of the representation must be both qualitatively and quantitatively significant when viewed from the longer-term perspective of a reasonable acquirer.
- To constitute an MAE for purposes of a bring-down condition, the difference between the as-represented condition of the company and the actual condition at closing probably must represent a decline in value equal to approximately 15 to 20 percent of the target's equity value.

All these factors should be considered when a buyer is exploring an MAE or MAC under Delaware law.

This article first appeared in the October 29, 2018, edition of Westlaw Journal Corporate Officers & Directors Liability.

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