

Insights: Publications

DE Chancery Court Finds Material Adverse Effect Allowed Fresenius to Terminate Merger Agreement with Akorn

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Summary:

A perfect storm of facts in *Akorn, Inc. v. Fresenius Kabi AG et al.* allowed the Delaware Chancery Court to conclude that Fresenius could properly terminate its obligations to acquire Akorn without liability, seemingly satisfying the Delaware requirement of “materiality and durational significance” of the material adverse effect previously enunciated in *In re IBP, Inc. Shareholders Litigation*. Even after *Akorn*, it is axiomatic that parties to a Merger Agreement or Stock Purchase Agreement — regardless of whether they meticulously negotiate a Material Adverse Effect (MAE) closing condition — should not casually rely on the availability of a negotiated right to terminate the acquisition by asserting the occurrence of a post-signing MAE. Conjuring Justice Potter Stewart’s oft-used shorthand, although the Delaware Chancery Court, in *In re IBP, Inc. Shareholders Litigation*, could not truly define an MAE that would relieve an acquiror of its obligations to close a transaction, it suggested that, in the future, should one occur, the Court would know it when it saw it. It has now done so. The Court’s 246-page fact-laden opinion suggests that *Akorn* provides limited new guidance as to when an MAE exists, reinforcing the “material and durationally significant” standard of *In re IBP*. The 246 pages and their 867 footnotes provide useful guidance as to the interpretation of numerous typical M&A clauses and leave practitioners with much to unpack and consider in negotiating acquisition agreements (see below Key Takeaways). Akorn, Inc. has publicly announced that it intends to appeal the Chancery Court’s decision, so this may not be the final act in this case.

Facts:

Fresenius Kabi AG agreed to acquire the U.S. specialty generic pharmaceutical company, Akorn, Inc., by signing a Merger Agreement on April 24, 2017. Akorn made extensive representations about its compliance with applicable regulatory requirements, among others, and committed to use commercially reasonable efforts to operate in the ordinary course of business between signing and closing. Both Fresenius and Akorn agreed to use their reasonable best efforts to complete the merger, and the parties anticipated closing the merger by April 24, 2018 after obtaining antitrust approval. Fresenius’s obligation to close was subject to satisfying the following contractual conditions:

1. Akorn had not suffered a Material Adverse Effect (General MAE).

2. Akorn's representations were 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 (Bring-Down-Condition).
3. Akorn had complied, in all material respects, with its obligations under the Merger Agreement (Covenant-Compliance Condition). The Merger Agreement specifically provided an express termination right if one of the conditions was not met, at least as long as Fresenius was not in breach of its obligations under the Merger Agreement.

Shortly after the Merger Agreement — at a price of \$34 per share — was signed, Akorn's business performance “fell off a cliff” and was drastically underperforming compared to the prior year's results. Also, in the fall of 2017, Fresenius received anonymous whistleblower letters, alleging that Akorn's product development process failed to comply with the regulatory requirements of the Food And Drug Administration (FDA). After informing Akorn, Fresenius undertook its own investigation into the allegations, invoking extensive contractual rights to access employees, facilities, and data. It even hired a consulting firm to investigate whether Akorn's testing practices and FDA reporting were fraudulent. Fresenius uncovered a series of pervasive data integrity problems, and in response, Akorn made a presentation to the FDA, which the court found to be misleading. In April 2018, Fresenius terminated the Merger Agreement based on these facts and occurrences. Akorn sued Fresenius to compel it to perform its obligations under the Merger Agreement, but the court found that Fresenius had validly exercised its contractual termination rights because none of the three closing conditions, mentioned above, had been met.

Summary of the Court's findings:

Specifically, the court found that (1) a General MAE occurred; (2) Akorn's representations would not be accurate at the time of the closing, which would lead to an additional MAE in the future; (3) Akorn did not comply with the covenant to operate the business in the ordinary course after signing; and (4) Fresenius was entitled to terminate because Fresenius did not breach its own obligations under the Merger Agreement:

1. **General MAE:** The court found that a General MAE occurred as Akorn's performance metrics measured on a quarter-over-quarter basis had precipitously declined for five successive quarters. Taken together, the declines in Revenue (with quarter-over-quarter declines of 25% to 34%), Operating Income (with quarter-over-quarter declines of 84% to 292%), and EPS (with quarter-over-quarter declines of 96% to 300%) presented a continuously grim, consistent picture of the post-signing performance of Akorn. In *In re IBP*, the court found that a single quarterly decline in earnings (albeit a 64% drop) did not constitute an MAE, particularly against the back drop of subsequent performance more in line with its recent year's results. The limited duration of the IBP earnings drop was subsequently reinforced by the court in *Hexion Specialty Chems. Inc. v. Huntsman Corp.*, which stated that a “years over months” standard was necessary for an acquiror to invoke a “no MAE” closing condition in terminating a merger agreement or stock purchase agreement.
2. **Bring-Down Condition:** The deviation at closing from Akorn's as-represented condition would be “reasonably expected” to result in an MAE. Akorn's representations as to its regulatory compliance were grossly inaccurate. Overwhelming evidence showed widespread regulatory and pervasive FDA compliance problems, including data integrity problems. Vice Chancellor Laster rejected the argument that

In re IBP espoused an implicit anti-sandbagging provision as Fresenius had learned of the business risks facing Akorn, instead finding that the negotiated risk allocation provisions set forth in the Merger Agreement were controlling. The inaccuracy would cause an estimated future decline of the target's equity value of approximately \$900 million or 21%, which the court considered material after considering the circumstances of the merger at hand.

3. **Covenant Compliance Condition:** Akorn failed to “use commercially reasonable efforts” to operate in the ordinary course of business “in all material respects” as it cancelled regular site audits post signing in favor of less vigorous verification audits that would not look for further deficiencies. As such, it did not maintain an adequate data integrity system to prove the accuracy of required FDA regulatory filings, submitted regulatory FDA filings based on fabricated data, and failed to conduct proper investigations after receiving whistleblower letters alerting it to these and other deficiencies. The court found that these facts established failures in material respects because there was a “substantial likelihood that the ... fact [of a breach] would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information” as contemplated by *Frontier Oil*.
4. **No Breach by Buyer:** Buyer Fresenius was not in breach of its covenant to use reasonable best efforts to satisfy the closing conditions. When Fresenius hired a consulting firm to investigate the allegations of the whistleblower letters, it seemed that Fresenius was trying to find reasons to terminate the agreement. However, the court found that Fresenius did what it was obligated to do under the Merger Agreement to protect its contractual rights — despite hiring the consulting firm and terminating the transaction — and had a valid basis for doing so.

Key Takeaways:

Moving forward, please consider the following takeaways when faced with a possible MAE.

1. The “material and durational significance” standard, announced in *In re IBP* and amplified by its progeny, remains the standard in determining whether an MAE has occurred in an acquisition context.
2. When faced with a possible MAE, the acquiror's response is critical and will be viewed with the benefit of hindsight. A considered approach to, and communication with, the target while investigating the situation, coupled with continued compliance with contractual obligations and commitment to the transaction, will serve the acquiror well should it wish to exercise an MAE-related termination right.
3. Under Delaware law, negotiated “best efforts,” “commercially reasonable efforts,” and “best reasonable efforts” standards embedded in acquisition agreements, are without real legal difference and fundamentally require the parties to take “all reasonable steps” to satisfy their contractual obligations.
4. Access covenants are not throw-away clauses, but allow for meaningful rights for an acquiror to continue to test the continuing validity of the target's representations and warranties and compliance with its interim and other covenants.

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