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The Akorn Case – New Development in Delaware for Termination by Material Adverse Effect

In *Akorn, Inc. v. Fresenius Kabi AG, C.A.*, No. 2018-0300-JTL Del. Ch. October 1, 2018, the Delaware Court of Chancery determined that the buyer (Fresenius) had validly terminated a merger agreement because (i) the seller's (Akorn) 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" (MAE); (ii) the seller materially breached its obligation to continue operating in the ordinary course of business between signing and closing; and (iii) the seller had suffered an MAE constituting a sudden and long-term drop in the seller's business performance.

This recently issued decision is significant because it is the first case in Delaware in which the court found that a public target company had suffered an MAE between the signing of a merger agreement and the closing, which, in part, entitled the buyer to properly terminate the agreement. Notably, an appeal could amend the court's findings in this case.

The *Akorn* opinion is also noteworthy because it provides detailed guidance on how MAE provisions and other customary language in a merger agreement may be construed under Delaware law.

The *Court of Chancery* suggested that Delaware law is strongly inclined to respect an agreement negotiated at arm's length by sophisticated parties and will require the parties to live with the language of the contracts they negotiate. Therefore, the wording of provisions in a merger agreement is likely to be construed by Delaware courts as written, rather than looking to general commercial standards. The parties should accurately articulate their intentions and business understandings as much as possible and expressly include any specific issues or concerns in the provisions of their agreement.

The court considered an MAE provision as a tool for risk allocation. From a drafting perspective, MAE provisions accomplish this function by placing the general risk of an MAE on the seller and using exceptions to reallocate specific categories of risk to the buyer; exclusions from the exceptions return risks back to the seller. The opinion also elaborated that the proper way for the contracting parties to allocate risks is through bargaining and specifically spelling out the special circumstances or conditions the parties consider exceptions to certain provisions (such as exceptions and exclusions to the definition of an MAE).

The court remarked that the definition of MAE could exclude "certain specific matters that the seller believes will, or are likely to, occur during the anticipated pendency of the agreement", or matters disclosed during due diligence, or even risks identified in public filings." The parties could also define

"an MAE as including only unforeseeable effects, changes, events, or occurrences."

The court observed that according to a survey of merger and acquisition "agreements executed between June 1, 2016 and May 31, 2017, 28 percent of deals valued at $1 billion or more involved an MAE carve-out for developments arising from facts disclosed to the buyer or in public filings."

The *Akorn* opinion points out the importance to the buyer of including "disproportionate effect" qualifications in MAE provisions regarding industry risks. In *Akorn*, the seller argued that its sudden adverse business performance (resulting in an MAE) was due to industry headwinds, which was a risk the buyer knew about. The court dismissed that argument and observed that the problems were risks specific to the seller's business. The court went on to state that, even assuming these were industry effects, such allocation of risk on the buyer was subject to a disproportionate-effect exclusion provided under the merger agreement. That exclusion returned the risk to the seller to the extent that an event falling into one of the categories disproportionately affects the seller as compared to other participants in the industry.

The court referenced a law journal article that stated the "typical MAC provision is not quantitative and remains remarkably vague" on the definition of materiality. Further, the court recognized the difficulty of setting specific quantitative thresholds during negotiations and for purposes of subsequent litigation. However, achieving agreement on a specific metric is not impossible. The court referenced a treatise which observed "that most courts which have considered decreases in profits in the 40 percent or higher range found a material adverse effect to have occurred" and that a chancellor in another case posited "that a decline in earnings of 50 percent over two consecutive quarters would likely be an MAE." From a drafting perspective, if a particular MAE the contracting parties contemplate could be quantified, the parties should consider setting a specific metric to the definition of such MAE.

The court's decision in *Akorn* reaffirms that an MAE does exist in Delaware and provides useful guidance as to the analysis of what constitutes an MAE. Such guidance will be instructive to transactional parties as they seek to quantify risk in the period between signing and closing. Accordingly, practitioners may consider revisiting the MAE definition with a view to identifying any particular subject areas of risk in which the definition can or should be tightened. On another level, the case also serves as a useful review of Delaware case law regarding contractual, damage and MAE claims.

A link to the full case is set forth here.

For more information, or if you have questions about how the issues raised in this legal update affect your policies, practices, or other compliance efforts, please contact one of lawyers listed below:

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