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The Material Adverse Effect Landscape after *Akorn v. Fresenius*

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The Court of Chancery's October 1, 2018 opinion in *Akorn, Inc. v. Fresenius Kabi AG*[1] marked the first time in Delaware history that the Court of Chancery confirmed the existence of a Material Adverse Effect ("MAE") and validated the buyer's termination of a merger agreement on that basis. That outcome is important because, in the ten years since the last significant MAE opinion, many deal lawyers had come to believe that courts would never actually find an MAE. At the very least, this ruling will give additional leverage to buyers to renegotiate the deal price between signing and closing based on an arguable MAE—unless and until the Delaware Supreme Court addresses these issues on appeal. The court has scheduled oral argument on the expedited appeal for December 5, 2018.

In the meantime, Vice Chancellor Laster's opinion is a nuanced application of legal principles old and new, and offers many crucial lessons for dealmakers moving forward. Its unanswered questions also pose challenges. And, at 246 pages, there is a lot to sift through. Given the importance of the facts to this opinion, we outline the background of the case and walk through the court's analysis before highlighting what we believe to be key MAE takeaways and useful practice points for clients and their in-house counsel, advisors, and deal counsel.

Background

On April 24, 2017, German pharmaceutical company Fresenius Kabi AG, agreed to purchase Akorn, Inc., a specialty generic pharmaceutical company headquartered in Illinois and incorporated in Louisiana. Less than a year later, Fresenius refused to close the deal based on the failure of three separate "conditions" outlined in the Merger Agreement and terminated the deal based on the failure of two of them.

General MAE Condition. The parties agreed as a condition to closing that, "[s]ince the date of this Agreement there shall not have occurred and be continuing any effect, change, event, or occurrence that, individually or in the aggregate, has had or would reasonably be expected to have a Material Adverse Effect." While a failure of this condition did not permit Fresenius to terminate immediately, it permitted Fresenius to delay closing and then terminate upon the expiration of the applicable deadline for closing (the "Outside Date").

The Bring-Down Condition. Akorn's representations in the Merger Agreement included that it complied with the extensive FDA regulations governing pharmaceutical companies. Akorn attested that these representations were true at signing and would continue to be true at closing. But, if these representations proved untrue and incapable of being cured by the Outside Date, Fresenius could refuse to close and terminate the Merger Agreement—but only if the representations' lack of truthfulness would "reasonably be expected to" result in a "Material Adverse Effect." For its part, Fresenius could only exercise its termination right if it was not in material breach of its own obligations under the agreement, including (i) the Reasonable Best Efforts Covenant, requiring both parties to use "reasonable best efforts" to take all "necessary, proper or advisable" actions to "consummate and make effective" the Merger; and (ii) the so-called Hell-or-High-Water Covenant requiring Fresenius to take "all actions necessary" to achieve antitrust approval.

The Covenant Compliance Condition. Akorn also covenanted that it would use commercially reasonable efforts to operate in the ordinary course of business in all material respects. But if Akorn breached that promise, and its breach could not be cured by the Outside Date, then Fresenius could refuse to close and terminate the agreement immediately—even before the Outside Date—as long as it did not materially breach its own obligations under the agreement.

Material Adverse Effect Defined. "Material Adverse Effect" for the purposes of both the Bring-Down Condition and General MAE Condition is defined in relevant part as "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; provided, however" that the cause of such an effect is not one of the causes listed in a number of carve-outs. Those carve-outs are largely systemic and industry-wide causes. Yet, there is also a common exception to the carve-outs: if the effects of certain of those carve-outs "has a disproportionate adverse affect [sic] on the Company and its Subsidiaries, taken as a whole, as compared to other participants in the industry in which the Company and its Subsidiaries operate (in which case the incremental disproportionate impact or impacts may be taken into account in determining whether there has been, or would reasonably be expected to be, a Material Adverse Effect)." Once these carve-outs and exception to the carve-outs are applied, what is theoretically left as contributing to an MAE are causes endemic to Akorn itself.

Post-Signing Events

On the same day that the parties signed the agreement, Akorn reaffirmed its full-year 2018 guidance. But the next quarter, Q2 2017, the company reported revenues down 29% from the same quarter in the prior fiscal year. Quarterly operating income dropped 84% year-over-year, and earnings per share fell 96% year-over-year. Akorn initially attempted to assuage Fresenius's concerns by insisting that these setbacks were temporary.

But, for Q3 2017, revenue, operating income, and EPS declined 29%, 89%, and 105% year-over-year, respectively. For Q4 2017, these figures were 34%, 292%, and 300%. And, for Q1 2018, the year-over-year drops were 27%, 134%, and 170%. Akorn's full-year 2017 EBITDA was down 86% from the prior year, and adjusted EBITDA dropped 51%. In contrast, "[o]ver the five-year span that began in 2012 and ended in 2016, Akorn grew consistently, year over year, when measured by revenue, EBITDA, EBIT, and EPS."

Akorn's CEO blamed the downturn in sales and erosion of prices on the introduction of competition for its top three products (ephedrine, clobetasol, and lidocaine) and a rival for another key product (Nembutal).

Then, in October 2017, and again in November 2017, Fresenius received whistleblower letters alleging that Akorn had been failing to comply with its regulatory requirements. Acting on the information rights that it had bargained for in the Merger Agreement, Fresenius investigated the claims and discovered that Akorn had arguably not been truthful with the FDA, among other problems with data integrity and product safety. All the while, at least as found by the court, Fresenius continued to complete the steps necessary for closing, including obtaining antitrust approval.

But after evaluating its options, investigating the allegations, warning Akorn of the perceived infractions—and offering to extend the "Outside Date," which Akorn declined—on April 22, 2018, Fresenius told Akorn that it was terminating the Merger Agreement based on failure of the three conditions outlined above.

Akorn objected and sought a declaration from the Delaware Court of Chancery that Fresenius's termination of the Merger Agreement and refusal to close were invalid. Akorn argued, among other things, that Fresenius entered into the deal knowing of certain risks or should have discovered them through its pre-signing diligence, as well as that Fresenius had failed to uphold its own obligations under the Reasonable Best Efforts and Hell-or-High-Water covenants. Akorn sought specific performance requiring Fresenius to close. In turn, Fresenius answered and counterclaimed seeking a declaration that it validly terminated the Merger Agreement, as well as damages for breach of contract, among other relief. The parties prepared for trial on an expedited basis, and trial occurred over five days in July 2018.

The Court of Chancery's Opinion and Analysis

In his post-trial opinion, Vice Chancellor J. Travis Laster held that Fresenius validly acted on all three grounds and rightfully terminated the Merger Agreement.

The Court Found the Buyer Could Refuse to Close Based on the Existence of a General MAE

The Court of Chancery first considered what it deemed the "most straightforward issue"—"whether Akorn suffered a General MAE" based on the court's evaluation of "whether the magnitude of the downward deviation in the affected company's performance is material."

For guidance, the court relied on two earlier Court of Chancery opinions addressing MAE clauses, *In re IBP, Inc. Shareholders Litigation*,[2] and *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*[3] In *IBP*, the court had stated that "[a] short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror." And *Hexion* provided that, "[w]hen 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, which minimizes the effect of seasonal fluctuations." The party attempting to invoke its rights dependent on the existence of an MAE bears the burden of proving one exists by a preponderance of the evidence.

Here, the Court of Chancery found that, through the "credibl[e] and persuasive[]" testimony of its expert, Fresenius made the requisite showing "that Akorn's financial performance has declined materially since the signing of the Merger Agreement and that the underlying causes of the decline were durationally significant."

The court highlighted the company's decline in every financial metric against the same quarter in the prior year—four straight quarters of year-over-year declines in revenue exceeding 25%, declines in operating income exceeding 80% (and as high as 292%), and drops in EPS exceeding 95% (and as high as 300%). And the court also considered it important that these declines—including over-50% yearly declines in EBITDA and adjusted EBITDA for 2017 from 2016—marked a sharp contrast from the prior five years of consistent year-over-year growth. The court cited a treatise on M&A, which observes that "most cases that have considered decreases in profits in the 40% or higher range have found a material adverse effect to have occurred . . ."[4]

The court also found the decrease in financial performance durationally significant. It cited comments from Akorn's own CEO blaming the company's performance on unexpected new competitors to the company's top products and the loss of a contract. It then observed that "[t]here is every reason to think that the additional competition will persist and no reason to believe that Akorn will recapture its lost contract."

The court also compared the discounted cash flow valuation that Akorn's financial advisor, JPMorgan, had prepared for the board when evaluating the proposed merger—showing a midpoint valuation of $32.13 per share—with more recent analyst estimates placing Akorn's standalone value at between $5 and $12 per share. And the court noted that analysts had "dramatically reduced their forward-looking estimates for Akorn."

The court stated that Akorn did not even attempt to contest that it suffered an MAE on a standalone basis, and instead argued that (1) Akorn's value for the purposes of an MAE should be measured against its value with the synergies that Fresenius expected in the merger, and (2) the causes of the decline were captured in the carve-outs to the MAE and not disproportionate to the same impacts felt by its peers. The court rejected the first argument based on the language of the MAE clause that provided that the effect has to be measured against the company and its subsidiaries. The court also noted in rejecting this argument that "[t]he parties could have bargained for that standard, but they did not." The court also rejected the second argument because "the primary driver[s] of Akorn's dismal performance" were "unexpected new market entrants who competed with Akorn's three top products" and the unexpected loss of a "key contract." These were "problems specific to Akorn based on its product mix." The court also credited Fresenius's expert testimony showing that Akorn drastically underperformed the mean and median performance of industry peers, and Wall Street analyst projections that a standalone Akorn would continue to underperform its peers over the ensuing three years. As such, the court concluded that Fresenius met its burden of showing a General MAE.

The Court Found the Buyer Could Terminate the Contract Based on Failure of the Bring-Down Condition

Next, the court evaluated whether Fresenius validly terminated the Merger Agreement based on failure of the Bring-Down Condition. Since Fresenius asserted that Akorn had misrepresented its compliance with the applicable regulations, the Court of Chancery stated that the required analysis "boils down to whether Akorn would reasonably be expected to suffer a Regulatory MAE," as opposed to a General MAE.

When the test is whether an MAE would "reasonably be expected to" occur, then an MAE "can have occurred without the effect on the target's business being felt yet."[5] The court explained that evaluating whether there is a Regulatory MAE involves consideration of both "quantitative and qualitative aspects," as there must already be "a basis in law and in fact for the serious adverse consequences prophesied by the party claiming the MAE."

Regarding the "qualitative significance" of the regulatory problems, the court found "overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn" that "would reasonably be expected to result in a Material Adverse Effect." For example, the court noted that one compliance consultant who had inspected an Akorn plant in September 2016 testified at trial "that some of Akorn's data integrity failures were so fundamental that he would not even expect to see them 'at a company that made Styrofoam cups,' let alone a pharmaceutical company manufacturing sterile injectable drugs." And the Court of Chancery detailed how Akorn only "exacerbated its compliance problems" after the signing of the Merger Agreement. For instance, Akorn's Executive Vice President for Global Quality Affairs—the head of the company's quality function—submitted false data and made misleading presentations to the FDA.

Regarding the "quantitative significance" of the regulatory breakdowns, after comparing the parties' expert reports estimating the economic impact of Akorn's data integrity failures, the court arrived at its own determination of the likely blow to Akorn's standalone equity value—a $900 million hit, which would bring the company's value 21% below the $4.3 billion equity value implied by the Merger Agreement. And the court ultimately reasoned, based on its own "intuition and experience," that "for Akorn, this expense would be 'material when viewed from the longer-term perspective of a reasonable acquirer.'" The court set up 20% as a benchmark for satisfying the quantitative aspect of materiality in future cases by considering a number of examples, "[a]s a cross check," that "suggests that an acquirer would regard a drop in value of 20% as material." The court observed that a 20% drop often indicates a "bear market" and that a 20% single-day decline for the Dow Jones Industrial Average would represent the second-largest one-day drop in its history. The court also cited a study finding that, when buyers assert that their target experienced a firm-specific MAE, the price is, on average, renegotiated 15% downward.[6] The Vice Chancellor reasoned that "[t]he fact that acquirers force renegotiations and then reach agreement (on average) at the 15% level suggests that an acquirer would regard a drop in value of 20% as material." The court also found average collar pricing and reverse termination fees supported its view that 20% is a material decline.

Akorn also argued, as it did in objecting to Fresenius's assertion of a General MAE, that Fresenius's knowledge of the risks of a Regulatory MAE foreclosed its ability to terminate the Merger Agreement on those grounds. But, as before, the court rejected that contention as contrary to the language of the contract. The court observed that "[t]he legal regime that Akorn argues for would replace the enforcement of a bargained-for contractual provision with a tort-like concept of assumption of risk, where the outcome would turn not on the contractual language, but on an ex-post sifting of what the buyer learned or could have learned in due diligence." The court held that a "knew or should have known" exception is "not consistent with the plain language of the Merger Agreement," which did not mention anything about the buyer's knowledge. Instead, the Vice Chancellor suggested that if parties wish to exclude matters learned during due diligence, they can write a specific exclusion to the MAE stating so explicitly.

Last, the court found that "Akorn's breaches were not capable of being cured by the Outside Date." As a result, "Fresenius did not have to wait to give Akorn an opportunity to cure," but, instead, "could terminate immediately," as long as "Fresenius was not then in material breach of its own contractual obligations"—an issue that the court considered later.

The Court Found the Buyer Could Terminate the Contract Based on Failure of the Covenant Compliance Condition

The court also considered Fresenius's argument that Akorn had violated the Covenant Compliance Condition because it breached the Ordinary Course Covenant, which required Akorn to use "commercially reasonable efforts to carry on its business in all material respects in the ordinary course of business,"[7] which the court defined as the ordinary course of "a generic pharmaceutical company," and not Akorn's own ordinary course.

When evaluating whether Akorn complied with its obligations "in all material respects," the court borrowed from the familiar definition of materiality from disclosure law, which requires a showing of a "substantial likelihood that the . . . fact [of breach] would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information."[8] The court believed that the so-called *TSC Industries* test for materiality "fairly captures" the intent behind the "in all material respects" modifier: "limit[ing] the operation of the Covenant Compliance Condition and the Ordinary Course Covenant to issues that 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."

The court then identified four ways in which Akorn's operation departed from "a generic pharmaceutical company operating in the ordinary course of business." Akorn "cancel[ed] regular audits at four sites in favor of verification audits that would not look for additional deficiencies." Akorn's "management instructed its IT department not to devote any resources to data integrity projects." Akorn submitted fabricated data to the FDA because pulling its submission "would have been a red flag for Fresenius." And, upon receiving whistleblower letters, instead of launching a "'responsive and credible' investigation using counsel with experience in regulatory matters," Akorn's efforts appeared dedicated to damage control instead of uncovering the truth. In reaching that conclusion the court faulted the company for enlisting its deal counsel to conduct the investigation into the whistleblower allegations.

And then, using the *TSC Industries* test for materiality, the court found Akorn's post-signing departures from ordinary operating procedure to be material because "[n]o reasonable acquirer would have agreed that during this lengthy period, Akorn could stop engaging in ordinary-course activities relating to quality compliance and data integrity, much less that Akorn could trigger a major incident with the FDA by making a submission that relied on fabricated data." And the court found that these violations could not be cured by the Outside Date. As such, Fresenius could validly terminate the Merger Agreement before the Outside Date—as long as Fresenius did not materially breach its own obligations.

The Court Found that Fresenius Did Not Materially Breach Its Contractual Obligations

Akorn argued that Fresenius could not refuse to close or terminate the Merger Agreement because it breached its own obligations under the Reasonable Best Efforts and Hell-Or-High-Water covenants. Though the court found that Fresenius "technically breached" the Hell-or-High-Water Covenant by briefly pursuing a path toward antitrust approval that would take longer to complete, it ultimately decided that that breach was not material because Fresenius pivoted to another strategy that promised to deliver FTC clearance on schedule. Thus, the court found that Fresenius preserved its ability to exercise its options upon the failure of either the Bring-Down Condition or the Covenant Compliance Condition.

Key Takeaways

A Delaware Court Once Again Confirms the Standard For Finding an MAE. Ten years after the last major MAE decision, the Delaware Court of Chancery confirmed that the standard for finding an MAE is still the test articulated in *IBP* and *Hexion*: the downward departure from the company's prior performance must be "material when viewed from the longer-term perspective of a reasonable acquirer," because it is "consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." But the court's application of the test in *Akorn* suggests that finding an MAE is likely easier than some had previously thought.

Facts Matter. Akorn also confirms the intensely factual nature of an MAE analysis. The Akorn decision, rendered after a trial on the merits, was 246 pages long with a recitation of the key facts spanning more than 100 pages. The case is a stark reminder that an MAE dispute is unlikely to be resolved in motion practice and the determination of whether an MAE exists will depend on the particular facts of each situation. Thus, any MAE dispute, if not settled or otherwise resolved, is likely to be expensive and time-consuming—albeit perhaps not as expensive as going through with a merger destined to cause more problems for the buyer.

Future Courts Will Likely Need to Weigh in on Materiality Standards For an MAE. In the absence of a contractual definition of "material," the court invoked three different tests for materiality in different parts of the opinion—two when examining MAEs, and a third in considering whether the seller breached the Covenant Compliance Condition. While it is not surprising that a determination of what one considers material will differ based on context, the court's different benchmarks and varying materiality frameworks are likely to spur future courts to weigh in these standards.

- ***The 40% Numerical Benchmark for Evaluating a General MAE:*** In determining whether a decrease in financial performance during the period between signing and closing would be "material" for the purposes of a General MAE, it is significant that the Court of Chancery referenced a 40% decline in earnings as indicative of an MAE because it endorses a numerical benchmark for materiality. While the Court of Chancery suggested that future cases may still find that drops less severe than 40% could constitute an MAE in the appropriate circumstances, and drops more severe might not be "material" in others—such as in *IBP*, where the court found a 64% drop did not qualify as an MAE because the durational element was lacking—40% is now likely to be the starting benchmark for future analyses of changes in the financial condition of a company between signing and closing. Where this 40% benchmark is met, especially over consecutive quarters year-over-year, buyers will likely be emboldened to try to negotiate a better deal or pursue an MAE termination.

- ***The 20% Benchmark for Determining Whether a Breach of a Representation Would Reasonably Be Expected to Result in an MAE:*** When evaluating whether departure from the represented conditions would reasonably be expected to result in an MAE, the court took a different approach: it weighed the parties' projections of the expected "economic impact of the data integrity problems" (i.e., the departure from the as-represented condition without such impact), and then calculated its own estimate of the likely cost of a remediation plan. The court projected a valuation hit of $900 million, or a 21% drop from the equity value implied by the deal price. And then the court suggested that a valuation drop of more than 20% should be material—a perceptibly lower bar than the 40% benchmark for determining whether a drop in financial performance is material.

  The court acknowledged that, in *Hexion*, the court had commented that "materiality for purposes of an MAE should be viewed as a term of art that drew its meaning from Regulation S-K and Item 7, 'Management's Discussion and Analysis of Financial Condition and Results of Operations.'" But the court commented that, here, no one offered "expert testimony or studies about the thresholds companies generally use when reporting material events, such as material acquisitions," and, as such, the court relied largely on its own intuition and external cross-checks confirming that a 20% hit to overall valuation is material. Though it is possible that a projected decline in overall value less than 20% (measured against the deal price) would also be material, litigants objecting to the alleged materiality of a projected valuation decrease of *greater than* 20%—especially when accompanied by compelling expert testimony—will have to explain why they believe that Vice Chancellor Laster's quasi-bright-line of 20% is off. Future cases will likely test whether an over-20% valuation hit automatically counts as quantitatively significant, as the *Akorn* court seemed to suggest. Regardless of the benchmark, the outcome of cases may well turn on how persuasively experts project the estimated decrease in valuation based on the event or circumstances at issue because such testimony is likely to drive the court's estimation of value. The court's use of the 20% benchmark when analyzing the Bring-Down Condition suggests it might be limited to this context, but it remains to be seen whether the benchmark might also be applied to the General MAE analysis in other cases.

- ***The Quantitative/Qualitative Materiality Test:*** When evaluating whether the departure from the as-represented condition would reasonably be expected to result in an MAE, the court separately examined the "quantitative significance" and "qualitative significance" of the representations' alleged distortions, instead of simply examining the magnitude of the impact on the company's earnings and the duration of the effect, as it did for a General MAE. Future cases will also need to confirm that the quantitative/qualitative test only—and always—applies when determining whether departure from an as-represented condition would "reasonably be expected to" produce an MAE and clarify how the test works in practice. For example, the court did not determine whether qualitative significance alone may be enough to satisfy the materiality test. A case may turn on the buyer's testimony concerning the qualitative significance of the departure from the represented state of affairs. For example, an executive from the buyer may persuasively testify that a representation concerning the validity of certain licenses or patents was crucial to the buyer, and the loss of a license or patent was qualitatively significant to the buyer because the entire deal was animated by a quest to obtain that intellectual property—even if the loss of that property accounts for a decline of less than 20% of the company's implied equity value. In such circumstances, perhaps the buyer would not need to show a 20%-or-higher valuation hit.

The Court Provides a Roadmap for Establishing that a Downturn in Financial Performance is Durationally Significant. No prior Delaware court had found that a downturn in financial performance was durationally significant such that it constituted an MAE. Unlike in *Hexion*—where the court rejected the forward-looking projections of Wall Street analysts as a tool for deciphering the expected length of the downturn because it was clear that analysts were "no longer interested in the fundamentals of the business, just the transaction"—here, the court cited analyst views on the company's long-term prospects at the time that Fresenius asserted its termination rights as "[a]dditional support" for the "durational significance" of Akorn's decline in value. The court did not explain how the proposed merger, or the expectation that the transaction might not be completed, figured into the analyst forecasts. Nor did it contemplate that the downgrades could have been driven by analysts' overreaction to Fresenius's disclosure that it was investigating an anonymous tip "alleging deficiencies and misconduct regarding the product development process for new drugs at Akorn." Naturally, Akorn's stock had "plummeted" on that news. But notwithstanding these questions, the court's application of analyst forecasts will likely provide a roadmap for proving durational significance in future MAE cases. Given the likelihood that analysts will almost certainly have a more pessimistic view of any company that has suffered a significant downturn in financial performance during one or more quarters, this approach is likely to be more buyer-friendly.

Financial Buyers Might Have A Lower Hurdle to Establish an MAE. In *IBP*, the court appeared to view materiality from the perspective of the buyer when it stated that, "[t]o a short-term speculator, the failure of a company to meet analysts' projected earnings for a quarter could be highly material," but noted that "[s]uch a failure is less important to an acquiror who seeks to purchase the company as part of a long-term strategy." After all, "[i]t is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause." Like *IBP* and *Hexion*, *Akorn* involved a strategic buyer so, as in those earlier cases, an arguably longer duration and greater magnitude of drop was necessary to show more than a "short-term blip." Nonetheless, the court noted in a footnote that "[c]ommentators have suggested that 'the requirement of durational significance may not apply when the buyer is a financial investor with an eye to a short-term gain.'"[9] This footnote raises uncertainty for sellers who transact with financial buyers such as private equity firms because a financial buyer might have an easier time establishing that a short term-drop in earnings is durationally significant and thus "material" when asserting an MAE.

Buyers' Knowledge of Certain Risks in Due Diligence Is Now Unlikely to Matter. The Court of Chancery rejected Akorn's attempts to argue that Fresenius could not assert a General MAE or Regulatory MAE because it knew of the risks of such events and already factored them into its purchase price. Akorn based its argument on then-Vice Chancellor Leo Strine's statement in *IBP* that an MAE provision, even a "broadly written" one, "is best read as a backstop protecting the acquiror from the occurrence of unknown events . . ." In *Frontier Oil Corp. v. Holly Corp.*,[10] Vice Chancellor Noble interpreted this "standard drawn from *IBP* as one designed to protect a merger partner from the existence of unknown (or undisclosed) *factors* that would justify an exit from the transaction."[11] Thus, post-*IBP* and *Frontier*, it was unclear whether a buyer could enforce an MAE based on some event or circumstance that was "known" to the buyer through due diligence or otherwise, as the Delaware Supreme Court had not decided the issue. At the very least, the attempt by a buyer to enforce an MAE clause based on a "known" but unrealized risk created uncertainty and therefore significant risk in asserting such an MAE. The *IBP* court's interpretation may have been a vestige of earlier days when contracts included "material adverse change" ("MAC") clauses instead of

MAE clauses. MAC clauses typically required that some change in circumstances was required before an MAC could be invoked. If a party knew of a certain risk or fact and factored that into its purchase considerations, it was not considered a "change" that could trigger an MAC.

And just last year, in *Mrs. Fields Brand, Inc. v. Interbake Foods LLC*,[12] when evaluating whether a party validly terminated a licensing agreement based on an MAE, Chancellor Bouchard also applied the "unknown events" standard from *IBP* and stated that "[a]llowing Interbake to terminate the License Agreement based on something it knew about at the outset would be tantamount to building into the agreement an at-will termination mechanism that would vitiate Mrs. Fields' rights under the contract . . ." In contrast, in addressing this same "unknown events" language from *IBP*, Vice Chancellor Laster stated in *Akorn* that, "[i]f parties wish to carve out anything disclosed in due diligence from the scope of a representation, then they can do so. If parties wish to carve out specific items or issues from the scope of a representation, then they can use the common technique of qualifying the representations so that it excludes items listed on a corresponding schedule." Thus, practitioners should now add to their list of items to be negotiated whether prior knowledge will act as an exclusion to an MAE, at least until this issue is clarified on appeal or by a later decision.

Courts May Consider Ex-Post Events in Determining Whether an MAE Occurred or Was Reasonably Likely To Result. Though one might expect the analysis of whether Fresenius justifiably terminated the Merger Agreement to turn on the events as they existed on the date that Fresenius asserted its refusal to close and terminated the Merger Agreement, Vice Chancellor Laster proved willing to consider certain ex-post evidence as support for certain findings. For example, he considered financial results for the first quarter of 2018—announced after Fresenius had already decided to terminate the Merger Agreement—in evaluating whether the year-over-year quarterly decline in earnings was material, including the 134% reported year-over-year drop in operating income. He also weighed letters that the FDA sent after termination in evaluating the qualitative significance of Akorn's data integrity crisis. This ruling provides uncertainty for parties in an MAE dispute as events occurring after termination may strengthen or weaken the MAE argument.

Breach of Ordinary Course Covenant as an Alternative to Establishing an MAE. Though the Vice Chancellor's finding of an MAE grabbed headlines, the finding that Akorn also breached its covenant to continue to perform its business in the ordinary course may embolden future buyers to terminate merger agreements based on such clauses, where they exist. The court's ruling may be particularly attractive to buyers looking to get out of the deal insofar as it applied the "Total Mix of Information" test from *TSC Industries* to gauge whether a party breached the Ordinary Course Covenant or Covenant Compliance Condition "in all material respects," which the court found turned on largely qualitative considerations. The Vice Chancellor framed the inquiry as whether a "reasonable acquirer would have agreed" that the seller could depart from the alleged ordinary course activities, such as data integrity and quality control measures in this instance. Further, the court made compliance harder because it judged Akorn against a "generic pharmaceutical company operating in the ordinary course of business" instead of Akorn's own ordinary course. Thus, future buyers seeking to re-negotiate or terminate will now be looking toward the Ordinary Course Covenant where possible as a course for accomplishing those goals. In addition, practitioners might also seek to specify whether the standard for "ordinary course" is a hypothetical generic company in the industry or the seller itself.

Exercise Information Rights. After receiving two whistleblower complaints, Fresenius exercised its rights under the Merger Agreement's informational access covenant, which allowed it to obtain Akorn's confidential internal documents and conduct an on-site investigation of the claims that included interviews with key sources. This tool enabled Fresenius to act to protect the value of its investment by allowing it to work to identify the sources of any problems and push for remedial measures. The investigation rights ultimately served another purpose as well—helping produce a compelling case for an MAE. The case suggests that effective use of information rights could prove vital to prevailing in an MAE dispute, and they will likely become subject to more careful drafting where MAE clauses exist.

The Party Seeking To Exercise An MAE Right Should Be Careful to Uphold Its End of the Contract. Akorn argued that Fresenius was not able to exercise its MAE rights because it was not in compliance with its obligations under the Merger Agreement. Akorn argued that Fresenius acted contrary to reasonable best efforts and sought "to manufacture grounds for termination." The Vice Chancellor took these arguments seriously and, if he viewed them as meritorious, apparently would have negated Fresenius's rights to terminate based on the MAE. Although the court found that "Fresenius technically breached its contractual obligation," by "embark[ing] on a strategy for achieving antitrust approval that would have breached its contractual obligation to take all steps necessary to satisfy that condition to closing," Fresenius "promptly reversed course," and thus its actions were "not a material breach sufficient to deprive Fresenius of its ability to exercise the termination rights on which it relied." That proved critical in helping Fresenius persuade the court that it deserved to exercise its rights.

In reaching that conclusion, the court contrasted Fresenius's behavior with the buyers in *IBP* and *Hexion* who both decided to forego consulting with the seller about their complaints and appeared animated by buyer's remorse rather than a good-faith belief in an MAE.[13] For its part, Fresenius even offered to extend the Outside Date if Akorn thought the extra time would allow it to cure its deficiencies—an act viewed by the court as supporting its good faith.

Get a Good Expert. Akorn highlights the importance of not only having the facts on your side, but enlisting experts who can credibly persuade the court that, among other things, any MAE is durationally significant. In finding the change in Akorn's financial results to be durationally significant, the court noted that Fresenius's expert testified "credibly and persuasively" that Akorn's drop in financial performance was "durationally significant." In reaching this conclusion, the Vice Chancellor distinguished IBP where the court found a 52% decline in yearly earnings over the prior five-year average, in addition to the 64% drop in quarterly earnings against the same period in the prior year, was not durationally significant based on the fact that the buyer's MAE arguments were "unaccompanied by expert evidence that identifies the diminution in [the seller's] value or earnings potential."

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[1] 2018 WL 4719347 (Del. Ch. Oct. 1, 2018). On October 17, 2018, the court issued a judgment that allows the court's MAE-related holdings to be appealed before having to await a damages claim. On October 23, 2018, the Delaware Supreme Court granted Akorn's motion to expedite the appeal. Oral argument is currently scheduled for December 5, 2018.

[2] 789 A.2d 14 (Del. Ch. 2001).

[3] 965 A.2d 715 (Del. Ch. 2008).

[4] Lou R. Kling & Eileen T. Nugent, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* § 11.04[9] (2018 ed.)), cited in *Akorn*, 2018 WL 4719347, at *53.

[5] *Akorn*, 2018 WL 4719347, at *65 (quoting Kling & Nugent, *supra* note 4, at § 11.04[9], at n.102 (2018 ed.).

[6] *Id.* at *75 (citing Antonio J. Macias, *Risk Allocation and Flexibility in Acquisitions: The Economic Impact of Material-Adverse-Change (MACs) Clauses* 27 (Apr. 17, 2009), http:/ssrn.com/ abstract=1108792).

[7] *Id.* at *84 (quoting Merger Agreement).

[8] *Id.* at *86 (quoting *Frontier Oil*, 2005 WL 1039027, at *38 (Del. Ch. Apr. 29, 2005) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976))).

[9] *Akorn*, 2018 WL 4719347, at *53 n.551 (quoting Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 Yale L.J. 848, 877 (2010)).

[10] 2005 WL 1039027 (Del. Ch. Apr. 29, 2005).

[11] *Id.* at *34 (emphasis added).

[12] 2017 WL 2729860 (Del. Ch. June 26, 2017), *clarified*, 2017 WL 3863893 (Del. Ch. July 27, 2017).

[13] *See, e.g.*, *id.* at *91 ("In *Hexion* and *IBP*, this court criticized parties who did not raise their concerns before filing suit, did not work with their counterparties, and appeared to have manufactured issues solely for purposes of litigation.").

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