SHEARMAN & STERLING

M&A WATCH

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HOW DO YOU GET A BIG "MAC" IN DELAWARE

In a recent high-profile decision, the Delaware Court of Chancery excused a buyer from its obligation to purchase a public company target on the basis that, among other things, the target company had suffered a material adverse effect (otherwise known as an "MAE" or "MAC"). Vice Chancellor Laster's decision in *Akorn, Inc. v. Fresenius Kabi AG, et al. C.A. No. 2018-0300-JTL* (Del. Ch. Oct. 1, 2018) is certain to resonate with practitioners and dealmakers alike, many of whom have often speculated about the circumstances required to properly invoke an MAE termination right. We expect savvy practitioners may revisit certain time-worn provisions of acquisition agreements in light of the Court's decision.

BACKGROUND

The merger agreement between Fresenius Kabi AG and Akorn, Inc. contained usual and customary closing conditions. Specifically, Fresenius was not required to consummate its acquisition of Akorn if, among other things: (i) Akorn suffered an MAE, (ii) Akorn breached its representations and warranties and the magnitude of such breach would reasonably be expected to result in an MAE, or (iii) Akorn failed to comply with its covenants in any material respect. Fresenius alleged that Akorn failed to satisfy each of these three closing conditions and terminated the merger agreement. The Court agreed with Fresenius that none of the three closing conditions had been satisfied in holding that:

- The precipitous, significant decline in Akorn's business performance constituted an MAE;
- Akorn's representations with respect to regulatory compliance were not true and correct, could not be cured within the time frames set forth in the agreement and the difference between Akorn's as-represented financial condition and its actual condition would reasonably be expected to result in an MAE; and

- Akorn materially breached its covenant to use "*commercially reasonable efforts*" to operate its business in the ordinary course in all material respects during the period between signing and closing.

The Court's finding that Akorn suffered an MAE was based on the "*sudden and sustained drop in Akorn's business performance*". The definition of Material Adverse Effect in the merger agreement referred to 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 Akorn (subject to customary exceptions). Following execution of the merger agreement, Akorn's EBITDA and EBIT fell by 55% and 62%, respectively, after growing each year from 2012 to 2016. The court found that Akorn's decline in financial performance since the parties signed the merger agreement was material, and that the underlying causes of this decline posed a "*durationally significant*" threat to Akorn's overall earnings potential. Notably, Vice Chancellor Laster found that the customary laundry list of exceptions in determining whether an MAE has occurred, including for changes affecting Akorn's industry as a whole, did not preclude a finding that an MAE had occurred.

The Court also found that Fresenius had validly terminated the merger agreement on the basis of a breach by Akorn of its representations and warranties related to regulatory and compliance. In the merger agreement, Akorn had represented that it was in compliance with all applicable laws and FDA regulatory requirements and that it had not made any untrue statements to the FDA. The Court found "*overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn*". It was estimated that remediation related to the regulatory issues would cost approximately $900 million. Based upon the transaction's implied equity value of $4.3 billion, the estimated remediation costs would represent a reduction in value of 21%. After engaging in a discussion about the difficulty in determining "*materiality*" for these purposes, the Court concluded that "*an expense amounting to 20% of Akorn's value would be material to a reasonable acquiror*". The Court concluded that Akorn's breach of its regulatory compliance representations and warranties would reasonably be expected to result in an MAE, thus the closing condition was not satisfied.

Third, the Court found that Akorn had breached the covenant requiring it to use commercially reasonable efforts to operate its business in the ordinary course in all material respects during the period between signing and closing. The Court interpreted the requirement to use "*commercially reasonable efforts*" to mean that Akorn must "*take all reasonable steps*" to ensure that its operations were maintained in the ordinary course of business. Akorn failed to meet this standard by cancelling its regular audits, failing to continue to search for deficiencies, calling off third-party assessments of certain sites, failing to maintain an adequate data integrity system and, notably, not conducting its own investigation into whistleblower allegations. The Court speculated that Fresenius would not have agreed to buy Akorn had it known that Akorn would take these actions and therefore concluded the breach was "*material*". Thus, Akorn failed to satisfy the closing condition requiring it to comply with its covenants in all material respects.

OUR VIEW

We think *Akorn* should serve as a cautionary fact pattern for sellers and buyers and as an instructive decision for all M&A professionals. The Court's decision confirms that a MAC does exist in Delaware and it provides helpful guidance as to the quantitative analysis of what constitutes a MAC. We suspect the Court's analysis will be instructive for many parties as they attempt to quantify risk in the period between signing and closing. As such, practitioners may consider revisiting the MAE definition with a view to identifying any particular subject areas of risk where the definition can or should be tightened. Moreover, as a practical matter, Vice Chancellor Laster's comprehensive recitation of Delaware case law regarding contractual, damages, and MAE claims will also serve as a handy (albeit heavy) guide to the Chancery Court's views and holdings on such matters.

Finally, we also think it noteworthy that a meaningful portion of the decision was devoted to a discussion of Akorn's behavior in the context of the regulatory issues that were uncovered. One can only wonder whether the Court would have found a MAC in respect of the deterioration of the business had Akorn comported itself differently during the executory period.

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