Securities Litigation Alert

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Buyer's Recourse: Delaware Court Validates Merger Termination Under Rarely Enforced Escape Clause

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Key Points

- In a rare move, the Delaware Court of Chancery affirmed a buyer's contractual right to terminate a $4.75 billion merger based on a sudden and sustained decline in the seller's business.
- The decision provides guidance to both litigators and dealmakers for negotiation and interpretation of so-called "material adverse effect" clauses.
- Although regarded as a potentially historic ruling, the Delaware Court made clear that its decision was driven by facts, not legal innovation.

Sellers beware: material adverse effect clauses, which give buyers the right to terminate an acquisition after a sudden downturn in the seller's business, may have new life under Delaware law. On October 1, 2018, Delaware's Court of Chancery ruled that pharmaceutical company Fresenius Kabi AG properly terminated its $4.75 billion purchase of Akorn, Inc., in part based on the court's finding that Akorn's sudden and sustained drop in business constituted a "material adverse effect" under the terms of the parties' merger agreement. The landmark decision, styled *Akorn, Inc., v. Fresenius Kabi AG, et al.,* C.A. No. 2018-0300-JTL, represents a rare victory among buyers seeking to walk away from deals that lose their appeal. Such cases—particularly in Delaware—are often viewed as mere occasions of "buyer's remorse," with the odds heavily stacked against the party seeking termination.

Background

Akorn and Fresenius entered into a merger agreement in April of 2017 whereby Fresenius agreed to acquire Akorn for $4.75 billion. Soon after, Akorn's business performance "fell off a cliff," delivering dismal results for the second quarter of 2017. Akorn initially attributed the sudden decline to unexpected competition and the loss of a key contract. But despite assurances from Akorn's CEO that the downturn was only temporary, the company's performance continued to decline throughout 2017.

In April 2018, Fresenius gave notice that it was terminating the merger agreement because Akorn had failed to satisfy at least three conditions of the contract: (1) Akorn must not have suffered a material adverse effect (MAE); (2) Akorn's representations must be accurate as of the closing date concerning matters that could "reasonably be expected" to have a material adverse effect; and (3) Akorn must materially comply with its obligations prior to the effective date. The second and third alleged breaches were based on Akorn's purported failure to comply with certain federal regulations.

Opinion

Vice Chancellor Laster delivered the post-trial opinion. After extensive analysis laid out in a 246-page opinion, the court concluded that Fresenius had successfully carried its "heavy burden" on all grounds, entitling Fresenius to terminate the merger agreement and/or precluding Akorn from seeking specific performance. Most notably, the court found that Akorn suffered a general material adverse effect through its sudden and sustained drop in performance. The court determined the MAE resulted from company-specific problems or, at a minimum, problems that disproportionately affected Akorn compared to other industry peers.

The court's opinion provides important insight into the construction and treatment of MAE clauses. Canvassing cases and commentators on the subject, the court observed that such clauses are typically structured to allocate categories of risk rather than to define specific tests for materiality. Indeed, MAE clauses commonly define a "material adverse effect" as something that has "a material adverse effect."

Accordingly, the court structured its own analysis to determine (1) whether Akorn bore the general risk of a material adverse event; (2) whether an applicable category of risk had been reallocated to Fresenius through a contractual exception; and (3) if so, whether any contractual exclusions allocated applicable risks back to Akorn.

Examining the merger agreement at issue, the court first determined that the MAE provision did place the general risk of an MAE on Akorn. Next, the court noted carve-outs of the MAE provision through which, among other things, Fresenius accepted systematic risks related to Akorn's industry. However, these exceptions were subject to contractual exclusions shifting the risk back to Akorn in the event such risks disproportionately affected Akorn "as compared to other participants in the industry."

Applying these contractual provisions to the facts, the court determined the case at bar was "markedly different" than the overwhelming body of cases from the same court that "correctly criticized buyers who agreed to acquisitions, only to have second thoughts after cyclical trends or industrywide effects negatively impacted their own businesses."

The court's decision seems to have been the product of at least two key factors:

1) Akorn's financial performance, following the execution of the merger agreement, was shown by expert testimony to be historically bad, regardless of whether it was measured relative to Akorn's own past performance or that of its peers. Despite having positive earnings before interest, tax, depreciation and amortization (EBITDA) growth each year from 2012 to 2016, Akorn's EBITDA suffered a year-over-year decline of 86 percent in 2017. Moreover, unlike other MAE cases, there was little evidence that this decline was the result of industry-wide problems. Notwithstanding, the court concluded the problems disproportionately affected Akorn.

Relying on past precedent, Akorn had argued that—regardless of the magnitude of the decline—Fresenius could not invoke the MAE provision because it was aware of risks in the pharmaceutical industry that ultimately precipitated the decline in Akorn's business. These risks included new market entrants, cyclical trends and losses of major contracts. Akorn's argument focused primarily on then-Vice Chancellor Strine's decision in *In re IBP, Inc. Shareholders Litigation*, which characterized MAE provisions as "a backstop protecting the acquiror from the occurrence of unknown events."

The court disagreed that the *IBP* case's "unknown events" qualifier was intended to apply as a legal standard governing all MAE clauses. In any event, the court rejected Akorn's invitation to apply the language from *IBP* so broadly as to preclude application of MAE provisions whenever a seller's decline is caused by "potentially contemplated risks." Therefore, the court drew a distinction between events reasonably anticipated by the parties, and those that—even if otherwise conceivable—were significantly different than any reasonable expectation given the information available at the time.

2) Fresenius consulted with Akorn frequently leading up to the merger close date concerning Akorn's declining business and regulatory issues. Moreover, prior to terminating the merger agreement, Fresenius approached Akorn to discuss the conditions that it believed Akorn would not be able to satisfy. During these discussions, Fresenius offered to extend deadlines for compliance if Akorn believed that further investigation would be beneficial. The court appeared to view these actions as consistent with those of a sincere buyer, contrasting them with more typical behavior in MAE cases where buyers file suit "in an effort to escape their agreements without consulting with the sellers."

Conclusion

The *Akorn* decision marks a historic win in the Delaware Court of Chancery for buyers seeking to walk away from deals that lose their appeal. However, the case should not be viewed as a panacea for any prospective buyer with cold feet. While there is plenty in the court's decision to guide parties in future negotiations and litigation over MAE clauses, perhaps the clearest takeaway from *Akorn* is that the "devil is in the detail." When trying to avoid a merger based on an alleged material adverse effect, buyers should be prepared not only to parse the specific, negotiated contractual provisions at issue, but also to clearly demonstrate that the decline in the seller's business was sudden, sustained and separate from industry-wide or otherwise reasonably anticipated difficulties. Of course, it also helps when a buyer can show it acted in good faith rather than opportunistically, communicating its concerns with the seller and allowing the seller a chance to cure its problems prior to termination.

Akorn has indicated it intends to appeal the Chancery Court's decision. Any appeal will likely focus on whether general MAE provisions are governed solely by their terms (as held in *Akorn*) or by an overarching legal standard requiring that a buyer did not—and could not—anticipate the general circumstances leading to a decline in the seller's business. Whether the Delaware Supreme Court determines to set forth such a general principle could have a significant impact on the negotiation and utility of MAE provisions going forward. The case therefore warrants continued attention by litigators and dealmakers alike.