Simpson Thacher

Memorandum

The Delaware Chancery Court Finds a "Material Adverse Effect" for the First Time

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One of the key terms in an acquisition agreement is the "Material Adverse Effect" definition, which essentially defines when a buyer does not have to complete an agreed-upon acquisition as a result of adverse change to a target's business during the period between signing and closing. Despite all of the attention given to this term by M&A practitioners, until the recent decision in *Akorn, Inc. v. Fresenius Kabi AG,* C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018), the Delaware Court of Chancery had never found that a buyer was justified in terminating a public company merger agreement on the basis that a Material Adverse Effect had occurred.

The absence of a Delaware decision finding a Material Adverse Effect has led many practitioners to wonder how high Delaware had set the bar for finding a Material Adverse Effect. However, we believe that the lack of such a finding is in part because, rather than litigate, merging parties have often looked to renegotiate price or jointly terminate their agreement when there are dramatic changes in the target's business following a signing. When analyzing whether a Material Adverse Effect has occurred, Delaware requires that "unknown events" threaten earnings potential in a "durationally-significant manner." For example, in *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001), the Court held that a 64% quarterly decline in year-over-year sales did not constitute a Material Adverse Effect because the decline was only in a single quarter and the target's business was cyclical by nature.

In *Akorn*, Fresenius terminated its merger agreement to acquire Akorn arguing that (1) significant declines in Akorn's performance amounted to a Material Adverse Effect (and therefore, a failure of the "standalone MAE" condition) and (2) significant FDA compliance failures were of a magnitude that they breached Akorn's regulatory compliance representations in a manner that constituted a Material Adverse Effect (and

therefore, a failure of Akorn's ability to "bring-down" its representations and warranties at closing).[1] During the four quarters following execution of the merger agreement, Akorn's year-over-year EBITDA declined by 86% due to competitors entering the market, loss of a material contract and other issues. In the same period, Akorn experienced year-over-year quarterly revenue declines of more than 25%, operating income declines of more than 80% and net income declines of more than 90%. Moreover, a whistle-blower came forward raising allegations concerning Akorn's FDA compliance practices, and further investigation uncovered significant FDA compliance issues which the Court determined reduced Akorn's equity value by 21% and would take up to four years to remedy.

The Court held that Fresenius satisfied its "heavy burden" to demonstrate that a Material Adverse Effect had occurred stemming from the combination of the severe decline in Akorn's performance and its myriad FDA compliance issues. With respect to Akorn's business performance, for example, the court found that the year over year decline was material and durationally significant as "[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." Additionally, while cautioning that a 20% decline in a target's equity value is not necessarily sufficient to show a Material Adverse Effect, the Court found that the 21% decline coupled with the need for up to four years to remedy the compliance issues meaningfully contributed to satisfying the Material Adverse Effect standard.

Akorn had argued that its decline in performance and FDA compliance issues could not result in a Material Adverse Effect because Fresenius knew of the potential for competition and was aware of some FDA compliance issues from its due diligence. The Court rejected this argument, finding risks that an acquiror discovers in its diligence will not preclude an acquiror from showing that a Material Adverse Effect occurred based on problems that arose as a result of those risks. Rather, the Court will look to the terms of a contract and its allocation of risks between the parties to determine whether the parties specifically agreed to exclude items uncovered in due diligence or unforeseen events from the definition of Material Adverse Effect.

The *Akorn* case does not represent a sea of change in Delaware law with respect to what constitutes a Material Adverse Effect. The court re-affirmed its prior decisions that require an adverse change to threaten earnings potential in a "durationally-significant manner." Instead, it is a decision specific to the facts and circumstances of the transaction. Nonetheless, the decision is notable and will likely be heavily scrutinized

[1] We note that Fresenius also sought to terminate the merger agreement on the basis of Akorn's failure of the customary condition that it had complied with its covenants in all material respects, arguing that Akorn failed to use commercially reasonable efforts to operate in the ordinary course of business in all material respects following signing when it, among other things, failed to comply with applicable FDA compliance laws and procedures and submitted "fabricated" reports to the FDA. The court found that Fresenius was permitted to terminate the agreement, in addition to the occurrence of a Material Adverse Effect, because of the failure of Akorn to satisfy such "covenant compliance" condition in the merger agreement.

by practitioners in the future advising clients considering the potential termination or renegotiation of a merger agreement as the only concrete example to date of a Delaware court finding a Material Adverse Effect.

Akorn has stated it intends to appeal the ruling. The full case can be found at: https://courts.delaware.gov/Opinions/Download.aspx?id=279250

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