JONES DAY

COMMENTARY

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Delaware Chancery Court Finally Finds a Material Adverse Effect

IN SHORT

The Situation: In a significant decision, a Delaware court found that a target company has suffered a material adverse effect ("MAE"), allowing a would-be buyer to abandon an announced merger.

The Case: In *Akorn, Inc. v. Fresenius Kabi AG, et al.*, Vice Chancellor Laster of the Delaware Chancery Court found that Fresenius properly terminated the merger agreement because, among other things: (i) Akorn had sustained a material and durationally significant change in its financial performance that resulted in a MAE; and (ii) Akorn had breached its regulatory compliance representations and such breach would reasonably be expected to result in a MAE.

Looking Ahead: While *Akorn* represents the first time a Delaware court has found a MAE to have occurred, the decision itself is not inconsistent with prior case law. Instead, *Akorn* provides a clear example that a MAE can result from a "dramatic, unexpected and company-specific downturn," which continues to be a high threshold.

Showing that a target has suffered a MAE is an arduous task that places the burden of proof on the buyer. Prior to this case, no Delaware court had found that an MAE has occurred. In a seminal case, *In re IBP Inc. Shareholders Litigation* (2001), the court held that there was no MAE as a result of IBP's declining performance. The court explained that the buyer failed to show that the decline in IBP's performance was consequential to the business's earning power over a commercially reasonable period of time, measured in a period of years, rather than months. Additionally, the court noted that MAE clauses are "a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner."

On April 24, 2017, Fresenius agreed to acquire Akorn for $34 per share. After a "dramatic, unexpected and company-specific downturn" in Akorn's performance, whistleblower allegations and the discovery of substantial failures in data integrity, and compliance with critical regulatory requirements, Fresenius terminated the agreement. Among other things, Fresenius argued that it was not required to close the transaction because Akorn had suffered a MAE as a result of Akorn's financial condition and operations ("General MAE") and because Akorn had breached its regulatory compliance representations in a manner that would reasonably be expected to result in a MAE ("Regulatory MAE").

To establish the General MAE, Fresenius argued that: (i) the magnitude of the change in performance was material; and (ii) the change in performance was durationally significant. In establishing the magnitude of the change, the court relied heavily on financial indicators and historical trends. First, the court evaluated various financial metrics, including revenue, operating income, and EPS on a quarterly and annual basis to control for the impact of seasonality in Akorn's business.

In each case, Akorn performed significantly worse than it had the previous year and against expectations. For example, Akorn's 2017 operating income showed a 105 percent decline over 2016 operating income. The court distinguished this from *IBP* because IBP's business was inherently cyclical and had been affected by a particularly harsh winter, which subsided after the first quarter. Additionally, the court noted that Akorn's performance in 2017 was a departure from Akorn's historical trend of consistent growth from 2012 through 2016.

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The court found that the change in value was durationally significant, noting Akorn's continued poor financial performance had lasted well over a year at the time the trial took place in July 2018. The court also cited Akorn's management's reasons for poor performance as indications that such changes were durationally significant and not merely short-term hiccups. Specifically, the court referred to unforeseen competition with Akorn's top products and the loss of a key contract as evidence of the lasting impact on the business. In addition, while the court found some downturn in Akorn's peers' performance, Akorn's poor performance was significantly disproportionate to its peers.

Fresenius also demonstrated that Akorn had suffered a Regulatory MAE. Shortly after the merger was announced, Fresenius received multiple whistleblower complaints regarding deficiencies in Akorn's regulatory and compliance functions. After an investigation conducted by an outside law firm, it became apparent that Akorn's representations regarding regulatory compliance were not accurate.

Having found a breach of Akorn's regulatory representations, the court set out to determine if such breach would reasonably be expected to result in a MAE. In performing its evaluation, the court noted that the determination rested on both qualitative and quantitative analyses. As a generic pharmaceutical company, Akorn must comply with the FDA's regulatory requirements, and the failure to do so could have a significant impact on its ability to bring new drugs to market or keep existing drugs in the market. Akorn's widespread regulatory noncompliance and, in some instances, potential fraud provided significant support for the court's finding that the qualitative dimension of the MAE analysis was met.

The court also analyzed quantitative factors in performing its MAE analysis, including Akorn's estimated direct outlay in order to bring the company into compliance, plus an estimated 20 percent valuation reduction related to the delay in taking pipeline products to market. The court's analysis focused on the potential impact of the breach on the overall valuation of Akorn, analyzing whether such impact would be "material when viewed from the longer-term perspective of a reasonable acquiror." Ultimately, the court found that an estimated 20 percent valuation decline combined with the qualitative factors amounted to a Regulatory MAE.

Some practitioners have, for years, believed that an actual MAE is akin to a unicorn in light of the fact that a MAE had never been found in a Delaware court. But *Akorn* shows that a MAE means something and can exist notwithstanding the likelihood of the scenario in which it can be invoked.

THREE KEY TAKEAWAYS

1. A buyer can successfully show a MAE if it can demonstrate that the target suffered a company-specific, material change in performance that is durationally significant.
2. A buyer can establish that even amidst "industry headwinds," a target has been disproportionately affected if the target "underperform[ed] every single one of the comparable firms on all time periods, on all metrics."
3. Courts in other jurisdictions may use *Akorn* as a guide to make determinations of whether a MAE has occurred.

Benjamin L. Stulberg
Cleveland

James P. Dougherty
Cleveland / New York

Randi C. Lesnick
New York

Robert S. Faxon
Cleveland

Gabrielle Feuer, an associate in the Cleveland Office, assisted in the preparation of this Commentary.

All Contacts >>>

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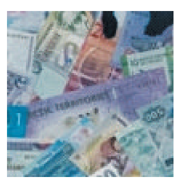

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