Yes, Virginia, there is an MAE

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Yesterday, the Delaware Court of Chancery, in a record-breaking 246-page opinion, held that Fresenius Kabi AG (a German publicly listed healthcare company) did not have to consummate its proposed acquisition of Akorn, Inc. (a Nasdaq-listed generic pharmaceutical company) on the basis that Akorn had suffered a Material Adverse Effect, or MAE. The court also found that Akorn had breached certain representations in the parties' merger agreement, and that the breach would reasonably be expected to result in an MAE. The decision represents the first time in memory that a Delaware court has allowed a buyer to walk away from a public company merger on the basis of a contractual MAE provision.

On April 24, 2017, Fresenius agreed to acquire Akorn for $34 per share. The merger agreement terms were in all relevant respects entirely customary. While Akorn had been growing steadily, starting in the quarter immediately after signing the merger agreement its business "fell off a cliff." To add insult to injury, six months after signing, Fresenius received a letter from an anonymous whistleblower alleging that Akorn was violating its regulatory compliance obligations. Fresenius investigated and uncovered, among other things, "serious and pervasive data integrity problems." On April 22, 2018, Fresenius sought to terminate the merger agreement on the grounds that (i) Akorn's representations regarding regulatory compliance were incorrect to a degree that would reasonably be expected to result in an MAE, (ii) Akorn failed to use commercially reasonable efforts to operate its business in the ordinary course in all material respects, and (iii) Akorn had suffered an MAE. Akorn sued, seeking a declaration that Fresenius's attempted termination of the merger agreement was invalid and a decree of specific performance compelling Fresenius to close.

In a decision dated October 1, 2018, the Court of Chancery called the question of whether Akorn had experienced an MAE a "straightforward issue" of contract interpretation. During each of the four quarters following signing, on a year-over-year basis, Akorn's revenues declined between 29% and 34%, its operating income declined between 84% and 124%, and its earnings per share declined between 96% and 300%. Referring to the standard set forth in *IBP, Inc. v. Tyson Foods, Inc.* (Del. Ch. 2001), the court found this deterioration in performance to be both "material when viewed from the longer-term perspective of a reasonable acquirer" and "durationally significant." As to the former, the court focused on the size and the quarter-to-quarter consistency of the decline in financial performance; as to the latter, it noted that the decline continued for a full year and "shows no sign of abating."

Akorn raised a number of counterarguments, none of which was availing. The court rejected Akorn's contention that its decline in value should be measured against its synergistic value to the buyer rather than as a stand-alone entity. The court rejected Akorn's argument that so long as the buyer can profit from the acquisition an MAE cannot have occurred. The court rejected Akorn's assertion that its decline in performance was the result of industry-wide conditions (and thus excepted from the MAE definition) and held that even if—for the sake of argument—the decline was caused by "industry headwinds," the effect on Akorn was disproportionate. Accordingly the court found that Fresenius had "carried its heavy burden" and showed that Akorn had suffered an MAE.

As to the breach of representation claim, Akorn did not seriously dispute the allegation that its regulatory compliance representation was incorrect. The debate was whether "the deviation between Akorn's as-represented condition and its actual condition" was so great that it would reasonably be expected to result in an MAE. In addressing this issue, the court looked at both qualitative and quantitative factors. Qualitatively, it determined that Akorn's regulatory violations were widespread and pervasive and that they had gotten worse between signing and closing. Quantitatively, the court determined that the financial impact of these violations to the Company was approximately $900 million, representing about 20% of the equity value implied by the merger price. In finding that this change was "material when viewed from the longer-term perspective of a reasonable acquirer," the court observed that "when a deal is priced to perfection, a reasonable acquirer has less ability to accommodate an expense that equates to a substantial portion of the seller's value." The court also compared the 20% diminution in equity value to other indicia of materiality: the fact that a 20% decline in stock prices is considered a bear market; a study that showed that when deal prices are renegotiated after buyers assert an MAE, the average price reduction is 15%.; the fact that in stock deals with price collars, the upper and lower bounds are generally between 10% and 20%.; and a study that determined that median reverse termination fees are 6.36% of transaction value. The court found these facts to support its determination that 20% of deal value is material to a reasonable buyer.

Akorn contended that even if it had suffered an MAE, and even if the breach of the regulatory representation was false to the level of an MAE, Fresenius could not decline to close on this basis because, as a result of its due diligence and general industry knowledge, it was aware of the underlying risks when it signed the merger agreement. In other words, Akorn asserted that it was "sandbagged" (which the court called a "loaded and pejorative term"). Pejorative or not, the court reaffirmed that Delaware is a pro-sandbagging state, in keeping with its generally "contractarian regime," and rejected Akorn's objection.

The court also found that Akorn had failed to use commercially reasonable efforts to operate its business in the ordinary course of business in all material respects after signing—which, according to the court, required Akorn to maintain industry-standard compliance procedures. The court found, however, that once the merger agreement was signed, Akorn canceled regular compliance audits, failed to maintain a functioning data integrity system, instructed its IT department not to devote any resources to data integrity projects and submitted regulatory filings based on fabricated data, all of which violated the ordinary course of business covenant.

Akorn will inevitably join *Tyson* as the seminal Delaware cases on MAEs. Buyers will claim their facts are *Akorn*-like. Targets will assert that their circumstances are just like *Tyson*. But targets will no longer take comfort in—and buyers will no longer lament—the fact that Delaware courts have never found an MAE. If it were ever true that there is no such thing as an MAE (which is doubtful), there are now 246 pages to the contrary.

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