DELAWARE CORPORATE LAW BULLETIN

Chancery Court—for the First Time—Releases Buyer from Obligation to Close due to Target MAE

*Robert S. Reder**

*Katie Clemmons***

**Professor of the Practice of Law at Vanderbilt University Law School. Professor Reder has been serving as a consulting attorney at Milbank LLP in New York City since his retirement as a partner in April 2011.*

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Detailed opinion nevertheless confirms high threshold imposed by Delaware courts for successfully claiming an MAE

INTRODUCTION

Under the standard adopted by the Delaware Court of Chancery ("*Chancery Court*") in *In re IBP Inc. Shareholders Litig.*, 789 A.2d 14 (Del. Ch. 2001) ("*IBP*"), a buyer seeking release from its obligations under an acquisition agreement due to a target company material adverse effect ("*MAE*") must satisfy a very stiff burden of proof. In fact, for nearly two decades following *IBP*, the Chancery Court did not release a single buyer from its obligation to close due to an MAE. That statement can no longer be made following the Chancery Court's decision in *Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018) ("*Akorn*").

In *Akorn*, Vice Chancellor J. Travis Laster, while applying *IBP*'s high threshold, nevertheless allowed Fresenius Kabi AG ("*Fresenius*") to terminate its acquisition *via* merger of Akorn, Inc. ("*Akorn*") based on Akorn's post-signing MAE. The Vice Chancellor's 246-page opinion—purportedly a Chancery Court record—detailed the post-signing events leading to his finding of an MAE. Nevertheless, *Akorn* affirms the heavy burden a buyer faces when seeking relief from its obligation to close on account of a post-signing target MAE. In addition, Vice Chancellor Laster's thoughtful opinion contains numerous gems—even beyond his analysis of MAE clauses—that any corporate practitioner ought to consider before negotiating and drafting her next acquisition agreement.

I. FACTUAL BACKGROUND

Fresenius, "a pharmaceutical company headquartered in Germany," and Akorn, a smaller, Illinois-based "specialty generic pharmaceuticals company," signed a merger agreement on April 24, 2017, providing for Fresenius to acquire Akorn for a "total purchase price . . . [of] $4.75 billion" ("*Merger Agreement*"). The events following signing strayed so far from the parties' expectations reflected in the

Merger Agreement, however, that Vice Chancellor Laster found Akorn had suffered a post-signing MAE and permitted Fresenius to terminate the Merger Agreement.

A. Key Provisions of Merger Agreement

As is customary, "[i]n the Merger Agreement, the parties allocated risks through detailed representations, warranties, covenants, and conditions . . . ." Of relevance to the subsequent dispute between the parties are the following provisions:

- "Akorn made extensive representations about its compliance with applicable regulatory requirements" ("*Regulatory Compliance Representations*") and "committed to 'use . . . commercially reasonable efforts to carry on its business in all material respects in the ordinary course of business' between signing and closing" ("*Ordinary Course Covenant*").
- The parties committed to use their respective "reasonable best efforts . . . to cause the conditions to Closing to be satisfied as promptly as reasonably practicable" and to complete the transaction ("*Reasonable Best Efforts Covenant*").
- Fresenius assumed a heavy burden by committing to "take all actions necessary to secure antitrust approval, without any efforts-based qualification" ("*Hell-or-High-Water Covenant*").

In addition, the Merger Agreement contained several conditions to Fresenius's obligation to close, including:

- Akorn must not have suffered a "Material Adverse Effect" ("*General MAE Condition*"). Failure of this condition did not give Fresenius a right to terminate the agreement, but once the designated outside date for the merger passed ("*Outside Date*"), either party could terminate "as long as the terminating party's own breach of the Merger Agreement had not been a principal cause of or resulted in the parties' failure to close before the Outside Date." The initial Outside Date was April 24, 2018, subject to a three-month extension if antitrust clearance was the only condition not satisfied by the original date.
- Akorn's signing-date representations must have been "true and correct as of the Closing Date, except 'where the failure to be true and correct would not, individually or in the aggregate, reasonably be expected to have a Material Adverse Effect' " ("*Bring-Down Condition*").
- Akorn must have "complied with or performed in all material respects its obligations required to be complied with or performed by it at or prior to" the consummation of the merger

(“*Covenant Compliance Condition*”), including its obligations under the Ordinary Course Covenant.

Fresenius could terminate the Merger Agreement if either the Bring-Down Condition or the Covenant Compliance Condition was not satisfied, “but only if (i) the breach that would give rise to the failure of the condition is incapable of being cured by the Outside Date and (ii) Fresenius [wa]s not ‘then in material breach’ ” of its obligations under the Merger Agreement, including the Reasonable Best Efforts Covenant and the Hell-or-High-Water Covenant.

Finally, “Material Adverse Effect” was defined, “in customary albeit complex and convoluted prose,” as “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] and its Subsidiaries, taken as a whole.” As is typical, the parties did not define the term “material.” The foregoing was subject to a series of exceptions for effects, changes, events, and occurrences that were not, generally speaking, related to Akorn specifically but more generally to market conditions not unique to Akorn and its business. Under the definition, Fresenius bore the risk of these general market conditions, *except* to the extent of “a disproportionate adverse affect [sic] on [Akorn],” the risk of which was shifted back to Akorn.

B. Akorn’s Post-Signing Business Performance and Regulatory Issues

Fresenius and Akorn signed the Merger Agreement shortly after Akorn announced its results for the first quarter of 2017. During the 2017 second quarter, however, “Akorn’s business performance fell off a cliff, delivering results that fell materially below Akorn’s prior-year performance on a year-over-year basis.” When Fresenius inquired about the dismal performance, Akorn management blamed unexpected competition and loss of a key contract.

Things then went from bad to worse. The downturn was not as temporary as Akorn had predicted, and it was forced to adjust “full-year [earnings] guidance downward.” By September 2017, Fresenius suspected Akorn may have suffered an MAE, but its legal counsel could not advise with certainty that an MAE had occurred given the heavy burden established by the Chancery Court in *IBP* and succeeding cases. Rather than taking any drastic steps, Fresenius exhibited patience by seeking “new synergies and developing a business plan that would offset Akorn’s problems.”

To compound its concerns, in October 2017, Fresenius “received a letter from an anonymous whistleblower who made disturbing allegations about Akorn's product development process failing to comply with regulatory requirements." One month later, "Fresenius received a longer version of the letter" with much more detail about the deficiencies in Akorn's quality compliance programs. Fresenius confronted Akorn with the letters and demanded reasonable access to "Akorn's officers, employees, and information," as permitted by the Merger Agreement, to enable Fresenius to investigate whether various closing conditions would be satisfied. Rather than conduct its own internal investigation, Akorn engaged outside counsel whose "job was not to conduct an investigation, but rather to monitor Fresenius's investigation and head off any problems." Fresenius's ensuing investigation uncovered "serious and pervasive data integrity problems" that undermined the accuracy of the Regulatory Compliance Representations.

C. Fresenius Terminates; Akorn Seeks Specific Performance

As tensions between the parties rose, Akorn downplayed its problems. To facilitate its obfuscation, Akorn "was 'not fully transparent' " during a meeting with the Federal Drug Administration ("*FDA*") to discuss the whistleblower issues and sought to "denigrate[ ] Fresenius's motives." After this meeting, Fresenius's legal counsel sent a letter to Akorn's legal counsel "accusing Akorn of having given the FDA 'false, incomplete and misleading information.' " Meanwhile, Akorn's business performance continued to deteriorate, resulting in "a loss of $0.20 per share" for 2017, "representing a year-over-year decline of 113%."

Finally, in April 2018, Fresenius sent Akorn a letter detailing "why conditions to closing could not be met and identifying contractual bases for terminating the Merger Agreement." Instead of immediately terminating, however, Fresenius offered to extend the Outside Date to provide additional time for Akorn to resolve its issues if it believed it could. When Akorn declined, Fresenius gave notice of termination. Akorn, in turn, filed suit in Chancery Court on April 23, 2018—one day before the Outside Date—seeking (1) a declaration that Fresenius's purported termination of the Merger Agreement was invalid and (2) specific performance to compel closing. Fresenius's answer argued it had validly terminated the Merger Agreement and, therefore, was not required to close. With the Chancery Court litigation pending, Akorn reported significant "year-over-year" declines for the first quarter of 2018 in revenues and net income, while the FDA continued to press Akorn on several serious regulatory issues.

II. VICE CHANCELLOR LASTER'S ANALYSIS

Following a full trial on the merits, Vice Chancellor Laster issued his opinion in favor of Fresenius's position. The opinion began with a lengthy, in-depth recitation of the factual background, followed by his analysis of the General MAE Condition, the Bring-Down Condition, and the Covenant Compliance Condition. As the party invoking termination, Fresenius was assigned the burden of proving these conditions were unsatisfied at the time it gave the termination notice and could not be satisfied by the Outside Date. Finally, the Vice Chancellor analyzed whether Fresenius materially breached its obligations under the Merger Agreement, which would have prevented Fresenius from exercising its right to terminate.

A. General MAE Condition

1. MAE Clauses

Vice Chancellor Laster declared Akorn had in fact suffered an MAE. He began by pointing out that the Merger Agreement did "not define what is 'material.' " Accordingly, "[w]hat constitutes an MAE, then, is a question that arises only when the clause is invoked and must be answered by the presiding court." Generally speaking, MAE clauses allocate risks related to a post-signing downturn in the target company's financial condition and results of operations, and include various general market-based exceptions to reallocate some of this risk back to the buyer, but usually only to the extent the target is not disproportionately adversely impacted by these market-based exceptions in relation to its competitors. Although MAE clauses differ, the Vice Chancellor succinctly explained that typical MAE clauses allocate "general market or industry risk to the buyer, and company-specific risks to the [target]." The Merger Agreement followed this pattern.

2. Burden of Proof

Next, the Vice Chancellor highlighted the heavy burden imposed on a buyer to establish that a target suffered an MAE. Since a corporate acquirer can be "assumed to be purchasing the target as part of a long-term strategy," the effect (as per *IBP*) "should 'substantially threaten the overall earnings potential of the target in a durationally-significant manner.' " Moreover, "[a] short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror." For example, Vice Chancellor Laster pointed out that in *IBP*, then–Vice Chancellor (and now ex–Chief Justice) Leo E. Strine, Jr., held that, under the circumstances, "a 64% drop in quarterly earnings did not constitute a material adverse effect."

By contrast, Fresenius "made the showing necessary" to establish the downturn in Akorn's performance indeed was materially adverse. For instance, for 2017 Akorn reported a year-over-year decline of 51% in the key financial metric EBITDA. According to JP Morgan analyst valuations, Akorn's discounted cash flow valuation at signing had a midpoint of $32.13 per share, but its standalone value after signing was between $5.00 and $12.00 per share. Moreover, the decline was "durationally significant"—"[i]t has already persisted for a full year and shows no sign of abating." And the entry into Akorn's market by new companies to compete with Akorn's top three products reasonably could have been expected to cement the durationally-significant nature of the decline.

3. Akorn Counterarguments

Akorn offered several challenges to this finding, none of which swayed Vice Chancellor Laster. For example, Akorn argued its "value should be measured not against its performance as a standalone entity, but rather against its value to Fresenius as a synergistic buyer." This argument was "not supported by the Merger Agreement or the law." Akorn also contended that if Fresenius "can make a profit from the acquisition, an MAE cannot have occurred." The Vice Chancellor could find no support in the language of the MAE clause to support this argument.

Seeking to take advantage of the general market exceptions to MAE, Akorn attributed its "dismal performance to 'industry headwinds,' " but this argument failed inasmuch as the issues facing Akorn that stemmed from business risks specifically allocated by the Merger Agreement to Akorn. The Vice Chancellor explained that these problems—e.g., new market entrants, loss of a key contract—were specific to Akorn based on its product mix. And even if they were general industry risks allocated at first to Fresenius, the MAE clause would shift the risk back to Akorn if they disproportionately adversely affected Akorn in relation to its competitors. Given significant evidence presented by expert witnesses that Akorn's business suffered a decline that was "disproportionate to its industry peers," the Vice Chancellor concluded that the Merger Agreement allocated these risks to Akorn.

Finally, Akorn argued "most vigorously" that Fresenius should have known of these risks pre-signing through its "due diligence" or based on "industry knowledge." This argument was premised on language in *IBP* to the effect that MAE provisions are intended to protect buyers against "unknown events." Vice Chancellor Laster explained that this concept was not built into the language of the MAE provision; regardless, Akorn's problems were "unexpected" at the time of signing. On this basis, the Vice Chancellor ruled that the General MAE Condition had not been satisfied, giving Fresenius the right not to close.

B. Bring-Down Condition

Fresenius argued that the Bring-Down Condition was not satisfied because Akorn would reasonably be expected to suffer an MAE due to inaccuracies in the Regulatory Compliance Representations. To succeed on this argument, Fresenius was required to demonstrate, "by a preponderance of the evidence," that "(i) the Regulatory Compliance Representations were inaccurate and (ii) the deviation between Akorn's as-represented condition and its actual condition was so great that it would reasonably be expected to result in a Material Adverse Effect." The "'reasonably be expected to' standard is an objective one" meaning that "[f]uture occurrences qualify as material adverse effects."

Referring to both "quantitative and qualitative" measures, Vice Chancellor Laster found that the Regulatory Compliance Representations were inaccurate when the Merger Agreement was signed in light of Akorn's "pervasive data integrity and compliance problems that prevent[ed] Akorn from being able to meet" acceptable operational standards. According to one expert's testimony, "Akorn's data integrity issues were among the 'top three worst' of the 120+ pharmaceutical companies that he ha[d] assessed."

Moreover, Akorn's compliance problems were exacerbated post-signing. The record showed Akorn misled the FDA by withholding expert reports and its own correspondence with an investigating law firm. Also, several expert witnesses testified that they had never seen compliance issues of the severity and scope prevalent at Akorn. Even some of Akorn's own witnesses agreed that the effort to remediate all of Akorn's compliance issues would "take about three years."

Again, Akorn claimed Fresenius knew about the regulatory compliance risk at signing and thus could not use it as a basis for refusing to close. The Vice Chancellor rejected this argument on two separate grounds. First, the Vice Chancellor thought "it . . . should not matter whether or not the buyer had concerns about potential regulatory compliance issues . . . or conducted some degree of due diligence." The risk of these issues was allocated through the

Regulatory Compliance Representations, and if parties want to carve certain items out of representations, "then they can do so." But here, they did not. Second, even if known risks were excepted from the Regulatory Compliance Representations as Akorn argued, the Vice Chancellor concluded that Akorn's data integrity issues "had not yet occurred at the time of signing." Documents given to Fresenius during its due diligence showed manufacturing and other compliance issues, but none specifically identified data integrity issues.

Based on these findings, the Vice Chancellor concluded that the impact of the inaccuracies in the Regulatory Compliance Representations, both as of signing and at the time of Fresenius's termination notice, represented an Akorn MAE not curable before the Outside Date. Thus, the Bring-Down Condition was not satisfied, giving Fresenius the right to refuse to close and the right to terminate.

C. Covenant Compliance Condition

1. In All Material Respects

The Covenant Compliance Condition required Akorn to perform its obligations "in all material respects" before it could compel Fresenius to close. Vice Chancellor Laster rejected Akorn's argument based in common law that an "in all material respects" qualifier looks to whether a breach "goes to the root or essence of the agreement between the parties, or touches the fundamental purpose of the contract and defeats the object of the parties in entering into the contract." Instead, Vice Chancellor Laster followed Delaware precedent by adopting a "disclosure-based standard" which "is different and less onerous than the common law doctrine of material breach." At heart, this standard seeks to prevent parties from derailing an acquisition for "small, *de minimis*, and nitpicky issues."

2. Commercially Reasonable Efforts

In arguing that the Covenant Compliance Condition was not satisfied, Fresenius focused on Akorn's purported breach of the Ordinary Course Covenant. The Vice Chancellor initially pointed out that, in the Ordinary Course Covenant, "Akorn did not promise to maintain compliance" with the covenant, but rather "only committed to use 'commercially reasonable efforts' to try" to do so. According to the Vice Chancellor, this and similar clauses—"best efforts," "reasonable best efforts," "reasonable efforts," and "good faith efforts"—are intended to "mitigate the rule of strict liability for contractual non-performance that otherwise governs." Although noting that "practitioners have a general sense of a hierarchy of efforts clauses," the Vice Chancellor cited case law surveys "find[ing] little support for the distinctions that transactional lawyers draw." In one such decision, the Chancery Court considered a "best efforts" standard to be "implicitly qualified by a reasonableness test—it cannot mean everything possible under the sun." In another, the Delaware Supreme Court equated "commercially reasonable efforts" with "reasonable best efforts," declaring that both "impose obligations to take all reasonable steps to solve problems and consummate the transaction." Based on the latter precedent, the Vice Chancellor interpreted the Ordinary Course Covenant as requiring Akorn to "'take all reasonable steps' to maintain its operations in the ordinary course of business."

3. Ordinary Course Covenant

Based on the evidence presented, the Vice Chancellor concluded Akorn breached the Ordinary Course Covenant "in multiple ways." These included Akorn's failure, as "a generic pharmaceutical company," "to conduct regular audits," "to take steps to remediate deficiencies," "to maintain a data integrity system," to investigate the whistleblower allegations, and to submit FDA filings based on other than fabricated data. Akorn's breaches also were "material," "cost[ing] Akorn a year of what could have been meaningful remediation efforts."

All in all, Akorn's breaches of the Ordinary Course Covenant were "sufficiently significant to implicate the Covenant Compliance Condition." Surely "Fresenius would not have agreed to buy Akorn if Fresenius understood" the degree to which Akorn would operate outside the ordinary course. Finally, because Akorn would have required at least three years to remediate its compliance issues, its breach could not have been cured by the Outside Date, resulting in the Covenant Compliance Condition not being satisfied and giving Fresenius the right to terminate.

D. Did Fresenius Breach?

Regardless of these three failures of condition, if Vice Chancellor Laster determined Fresenius *materially* breached any of its obligations under the Merger Agreement, Fresenius would have been barred from exercising its termination right. Akorn claimed Fresenius breached both the Reasonable Best Efforts Covenant and the Hell-or-High-Water Covenant. The Vice Chancellor concluded otherwise.

1. Reasonable Best Efforts Covenant

Reiterating the standard he applied to Fresenius's claim that Akorn breached the Ordinary Course Covenant, the Vice Chancellor explained that "the 'reasonable best efforts' standard in this provision imposed an obligation on Fresenius 'to take all reasonable steps to solve problems and consummate the transaction.' " Moreover, "the Reasonable Best Efforts Covenant did not require either side of the deal to sacrifice its own contractual rights for the benefit of its counterparty."

Against this backdrop, the Vice Chancellor determined that Fresenius acted reasonably under the circumstances following Akorn's "dismal post-signing performance" and Fresenius's receipt of the whistleblower letters. The Merger Agreement gave Fresenius the right to investigate whether the closing conditions could be satisfied—in effect, "to continue the 'due diligence' process" post-signing—but, even after Fresenius became aware of the full extent of Akorn's problems, Fresenius offered to extend the Outside Date to allow Akorn time to investigate, remediate, and cure its issues. For its part, Akorn characterized "Fresenius's investigation cynically [labeling it] as an effort by Fresenius to manufacture grounds for termination" due to a case (reminiscent of the buyer in *IBP*) of "buyer's remorse." Distinguishing *IBP*, Vice Chancellor Laster viewed Fresenius's "remorse" as "justified . . . after Akorn suffered a[n] . . . MAE and after a legitimate investigation uncovered pervasive regulatory compliance failures." In short, "Fresenius succeeded in doing what it was obligated to do . . . [and] Akorn has not shown by a preponderance of the evidence that [Fresenius] breached the Reasonable Best Efforts Covenant."

2. Hell-or-High-Water Covenant

On the other hand, Vice Chancellor Laster determined Fresenius had breached its unqualified Hell-or-High-Water Covenant. It was undisputed that Fresenius "diligently pursued antitrust approval" during the first six months after signing. But when antitrust authorities thereafter asked Fresenius to agree to a divestiture strategy, Fresenius decided instead to "pursue 'parallel strategies,' " the second of which "would delay antitrust clearance by two months." By pursuing this option, "Fresenius technically breached the Hell-or-High-Water Covenant." Fresenius "changed course in approximately a week," however, making it likely that the clearance process would conclude on a timely basis. This change in course thus "cured" the breach by making its impact immaterial: "[u]nder these circumstances, Akorn did not establish that Fresenius materially breached the Hell-or-High-Water Covenant such that it should be barred from exercising an otherwise valid termination right."

CONCLUSION

Under Delaware case law going back to *IBP*, a buyer seeking a release from its obligation to close due to a target company MAE faces a significant burden. Even though Vice Chancellor Laster released Fresenius from its obligation to complete the purchase of Akorn, his opinion in no way eases the burden. The facts laid out by the Vice Chancellor in his detailed *Akorn* opinion highlight the depths to which Akorn's fortunes had fallen since signing the Merger Agreement, as well as Akorn's failure even to try to address Fresenius's concerns despite being given every opportunity to do so. On December 7, 2018, the Delaware Supreme Court issued a short order affirming the Vice Chancellor's opinion, stating he properly applied the standards established by *IBP*.