Goodmans LLP Update

Delaware Court Allows Buyer to Walk due to Material Adverse Change

In a recent high-profile decision, *Akorn, Inc. v. Fresenius Kabi AG, et al.* C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018), the Delaware Court of Chancery ruled that German healthcare company Fresenius properly terminated the merger agreement relating to the acquisition of Akorn, a U.S.-listed generic drug manufacturer, as a result of, among other things, Akorn having suffered a material adverse change (also known as a "material adverse effect", "MAC" or "MAE"). The *Akorn* decision is receiving significant attention in both the U.S. and Canada because it is the first time Delaware Courts – considered the leading commercial courts in the United States and also influential in Canada – allowed a buyer to refuse to close an M&A transaction on the basis of a MAC, and also because Vice Chancellor Travis Laster's detailed analysis helps better explain the risk allocation buyers and sellers assume when they utilize a typical MAC framework.

Background

It is common practice in Canada and the United States for acquisition agreements to contain provisions that permit the buyer to "walk away" from a transaction without liability if the target suffers a MAC between signing and closing, or if breaches of the target's representations in the acquisition agreement (which generally must be "brought down" at closing) amount to a MAC (when compared to the "as represented" condition of the target). For a variety of reasons discussed in the *Akorn* decision, contracting parties tend to not define the concept of "material adverse change" in acquisition agreements, focusing instead on prescribing changes or events that should not be considered a MAC (i.e., risks that are allocated to the buyer). As a result, the question of when a MAC occurs has largely been left to the courts to determine. Before *Akorn*, the limited case law considering alleged MACs (virtually all of which comes from U.S. courts) left some legal practitioners and other market participants in both Canada and the U.S. questioning whether (and, if so, when) a MAC could ever occur or if a MAC is simply a tool that invites parties back to the table to renegotiate the deal if the business sours after an agreement is signed.

The *Akorn* Decision

In considering whether a MAC had arisen, Vice Chancellor Laster found the substantial deterioration in Akorn's financial performance that started almost immediately after the merger agreement was signed – primarily resulting from an unexpected increase in competition for Akorn's products – amounted to a MAC, primarily because:

- the magnitude of the deterioration met the high threshold of materiality required for a MAC (e.g., by the fourth full quarter following execution of the merger agreement, year-over-year- declines in revenue, operating income and earnings per share were 27%, 134% and 170%, respectively),

- the deterioration resulted from "company specific problems" and/or industry headwinds *that disproportionately affected Akorn* relative to other industry participants (which, based on Laster's interpretation of the MAC clause, were risks allocated to Akorn), and

- Akorn's problems were not merely short-term fluctuations (i.e., they were "measured in years").

The latter two factors in particular distinguish the *Akorn* case from previous Delaware cases that have held that even double-digit declines in quarterly performance did not constitute a MAC.

Notably, separate and apart from Akorn's deteriorating financial performance, the Vice Chancellor also found that significant undisclosed "systemic" quality control problems at Akorn constituted a MAC when compared to Akorn's representations about its regulatory compliance, which also allowed Fresenius to terminate the merger agreement. To put the magnitude of these issues into perspective, Laster found that it would cost approximately $1 billion to rectify Akorn's quality control issues, whereas the total purchase price for the transaction was $4.5 billion. Once again, these were found to be company-specific problems expected to take years to rectify.

Conclusion

The *Akorn* case does not lower the threshold for a MAC or fundamentally change the test for determining when a MAC has occurred. Courts will remain skeptical of buyers seeking to terminate a deal, not wanting to empower buyer's remorse. Buyers looking to invoke a MAC bear a heavy burden to show the downturn is material and expected to be long lasting. It does, however, show that the terms of a contract will be honoured and the burden on the buyer is not so high that it is impossible to establish a MAC. Stay tuned, as the case is being appealed to the Delaware Supreme Court, which could overturn the trial decision or alter the analytical framework for determining when a MAC has occurred.

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