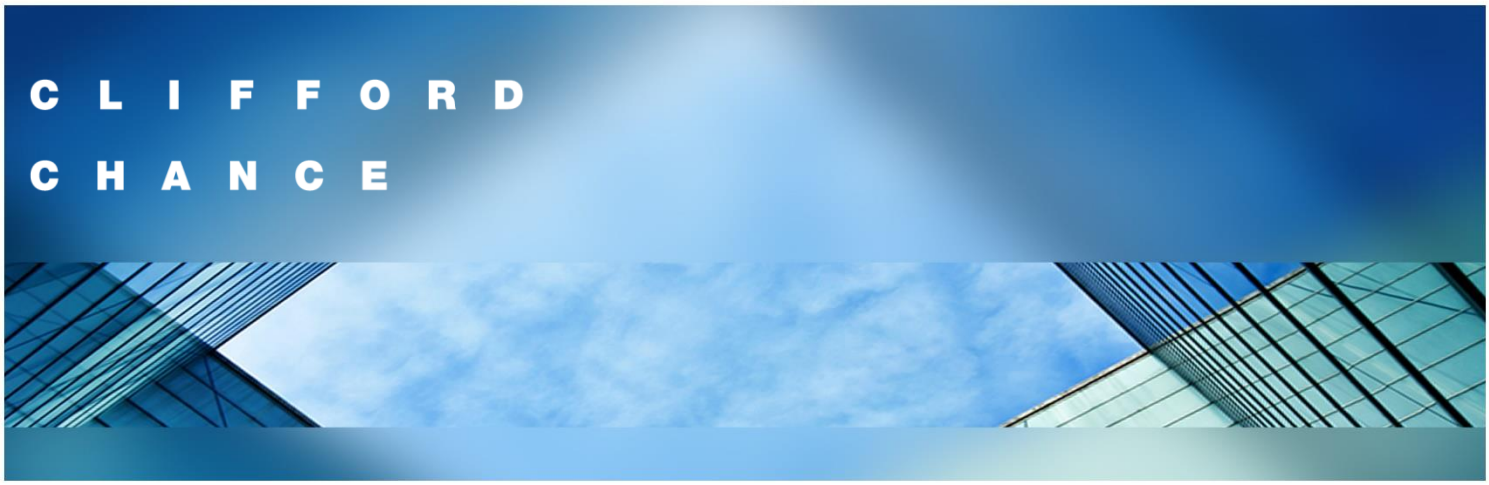


# DELAWARE CHANCERY COURT UPHOLDS INVOCATION OF MAC OUT

The Delaware Chancery Court ruled last week that the would-be acquirer of a publicly traded company had validly invoked a "MAC out" to terminate the merger agreement that otherwise required it to buy the target. The decision, in *Akorn v. Fresenius*, marks the first time the Chancery Court has upheld the exercise of a MAC out.

## Background

Last year Fresenius Kabi AG, a German pharmaceutical company, agreed to acquire Akorn, Inc., a US generic pharmaceuticals company listed on NASDAQ, for $4.3 billion. The merger agreement was typical for transactions of this type. Akorn provided customary representations about its business, including with respect to its compliance with applicable regulatory requirements. Akorn also agreed to operate in the ordinary course of business between signing and closing (the "interim operating covenant"). Fresenius' obligation to close was subject to a "bring-down" condition – Akorn's representations had to be true and correct at closing, except where the failure to be true and correct would not reasonably be expected to have a "Material Adverse Effect" ("MAE") on Akorn. Fresenius' obligation to close was also conditioned on no MAE having occurred with respect to Akorn between signing and closing (a "MAC out"). The definition of MAE was a customary one. A further condition to Fresenius' obligation to close was that Akorn had to have complied with its covenants (including the interim operating covenant) in all material respects.

Shortly after the deal was announced, Akorn's business "fell off a cliff." Akorn's revenue declined 25%, operating income declined 105%, earnings per share declined 113%, EBITDA declined 86% and adjusted EBITDA declined 51%. The decline in performance was attributable to various factors, including competition from new market entrants. Fresenius discovered other problems as well, which had not been disclosed and triggered breaches of regulatory compliance representations made by Akorn to Fresenius in the merger agreement: Akorn's product development process and quality compliance programs were flawed and failed to comply with FDA regulations. An investigation uncovered several instances of fabricated, altered and deleted data that tainted Akorn's FDA filings. During the period between signing and closing, Akorn also altered its quality

> ***"'What constitutes an MAE, then, is a question that arises only when the clause is invoked and must be answered by the presiding court.' Rather than devoting resources to defining more specific tests for materiality, the current practice is for parties to negotiate exceptions and exclusions from exceptions that allocate categories of MAE risk. 'The typical MAE clause allocates general market or industry risk to the buyer, and company-specific risks to the seller.'"***
>
> **Vice Chancellor Laster**
> **October 1, 2018**

control and IT functions, replaced regular internal audits with "verification" audits that only focused on prior findings rather than on identifying existing or new problems, and reduced quality control and data integrity oversight, which triggered breaches of the interim operating covenant.

## The Court's Findings

The Court found that the very large decline in Akorn's financial performance was unexpected and sustained and that, accordingly, Fresenius had discharged the difficult burden of establishing that an MAE had occurred between signing and closing, so Fresenius could invoke the MAC out condition. The Court further found that Akorn's breaches of its representations regarding regulatory compliance were so serious that the failure of those representations to be true and correct would reasonably be expected to result in an MAE, so Fresenius could invoke the bring-down condition. Finally, the Court found that Akorn had materially breached its interim operating covenant, so Fresenius could invoke the covenant compliance condition. These failed conditions allowed Fresenius to refuse to close and, ultimately, to terminate the merger agreement.

## Key Takeaways

- ***MAE Analysis.*** The Court invoked well-established legal principles to reach a result that to some nonetheless may be surprising. Under those established principles, and as recited by the Court, a MAC out is triggered only by developments that are unexpected, major and durationally significant. On the latter point, the Court said, *"'The important consideration … is whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months'… Put differently, the [material adverse] effect should 'substantially threaten the overall earnings potential of the target in a durationally-significant manner.'"* The Court's analysis appeared to place a greater emphasis on magnitude and duration than on predictability – indeed, the Court described testimony from a Fresenius executive that suggested that the *nature* of the adverse developments at Akorn (particularly the consequences of competition from new entrants) was not unexpected. And in the generic pharmaceuticals industry, where volatility can sometimes be greater than many other sectors, the magnitude of Akorn's performance downturn arguably did not necessarily mean it was unexpected or long-lasting.
- ***Bring-Down Analysis.*** In finding that Akorn's breach of its regulatory compliance representation reasonably would be expected to result in an MAE, the Court performed a qualitative and quantitative analysis. In its qualitative analysis, the Court found that Akorn's compliance with the FDA's regulatory requirements was essential to Akorn's business, and that there were widespread regulatory violations and pervasive compliance problems at Akorn, which existed at signing and then got worse. In its quantitative analysis, the Court determined that the cost to remediate Akorn's compliance failures was approximately 21% of Akorn's stand-alone market valuation, and that remediating those failures was not a short-term exercise. The Court cautioned practitioners against fixating "on a particular percentage as establishing a bright-line test" for this purpose, however, and noted that its use of remediation

***"A more nuanced analysis of the types of issues addressed by MAE provisions reveals four categories of risk: [systemic] risks, indicator risks, agreement risks, and business risks… Generally speaking, the seller retains the business risk. The buyer assumes the other risks."***

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costs as opposed to other metrics (such as profitability) was based on the parties' submissions in the litigation.

- ***Context.*** The Court was careful to emphasize that the issue before it was one of contractual interpretation. But it is hard to escape the sense that the Court may have believed that Akorn (or at least its management team) was a bad actor, and that this view may have influenced its analysis. Akorn has publicly announced that it will appeal the Court's decision to the Delaware Supreme Court. If the appeal proceeds it will be interesting to see whether the Supreme Court agrees that Akorn's shareholders should bear the cost of its management's shortcomings, or if the Court instead finds that the merger agreement allocated to Fresenius the risk of the adverse developments it cited to terminate the agreement.

## Practice Pointer

Acquirers concerned about the risks that materialized in the Fresenius/Akorn transaction need not subject themselves to the uncertainty inherent in the fact-specific and ultimately subjective analysis undertaken by the Court in *Akorn*. Acquirers can (and sometimes do) include objective triggers in their MAE definitions or in other conditions. If you think a 50% plus decline in EBITDA should allow you to walk away from the deal, say so in the contract.

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