GIBSON DUNN

Barbara Becker and Stephen Glover are partners, and Daniel Alterbaum is an associate, at Gibson, Dunn & Crutcher LLP. Ms Becker can be contacted on +1 (212) 351 4062 or by email: bbecker@gibsondunn.com. Mr Glover can be contacted on +1 (202) 955 8593 or by email: siglover@gibsondunn.com. Mr Alterbaum can be contacted on +1 (212) 351 4084 or by email: dalterbaum@gibsondunn.com.

Published by Financier Worldwide Ltd

SPECIAL REPORT June 2019

Evolution of the ‘material adverse effect’ clause

BY BARBARA BECKER, STEPHEN GLOVER AND DANIEL ALTERBAUM

On 7 December 2018, the Delaware Supreme Court summarily affirmed the Delaware Court of Chancery’s decision in *Akorn, Inc. v. Fresenius Kabi AG*. The decision represented a remarkable development in the canon of corporate law, as the case signified the first time that a buyer had validly terminated a purchase agreement due to the occurrence of a material adverse effect (MAE). MAE clauses are hotly negotiated provisions of purchase agreements that bear on closing certainty, and until the *Akorn* decision, sellers often took comfort in the axiom that no Delaware court had ever concluded that an MAE had occurred. While *Akorn* has received extensive press coverage for breaking with history, the decision largely comports with ordinary deal negotiation practices and involves a set of facts so egregious as to keep the goalposts for the next MAE-related termination well outside the norm.

MAE clauses in context

Most purchase agreements contain MAE clauses, which serve to allocate the risk to the buyer and the seller of an adverse change affecting the target between the signing and closing of a transaction. The concept of an MAE can appear in multiple contexts, including in qualifications to representations and warranties given by the parties, as well as in covenants that the parties must perform and as a condition to the buyer’s obligations to consummate the transaction. Purchase agreements also frequently require parties to ‘bring down’ at the closing the representations and warranties given at signing. In this context, representations and warranties may be brought down at a standard of accuracy measured with reference to the MAE clause.

MAE clauses generally follow the same formulation. Most begin by defining an MAE as any event, change, circumstance, occurrence, effect, result or state of facts that, individually or in the aggregate is, or would reasonably be expected to be, materially adverse to the business, assets, liabilities, condition (financial or otherwise) or results of operations of the target and its subsidiaries, taken as a whole, or that, individually or in the aggregate, materially impairs the ability of

»

the seller to consummate or prevents or materially delays, any of the transactions contemplated by the definitive purchase agreement. The foregoing language can be heavily negotiated. For instance, buyers will endeavour to include that an effect on the future 'prospects' of the target may constitute an MAE. The clause then goes on to provide exceptions for events that do not give rise to an MAE.

Some such exceptions are fairly common, such as general changes in economic conditions affecting the industry at issue or changes in applicable law, but others are more specific to the industry or the transaction itself. Such carve-outs, in turn, may be further qualified as applying only if the event described is not disproportionately adverse to the target itself as compared to similarly situated companies.

Most MAE clauses do not provide a numeric indicator of what is 'materially adverse', though Delaware courts have provided some interpretive guidance in the past. In the 2001 case of *IBP, Inc. v. Tyson Foods, Inc.*, the Delaware Court of Chancery explained that 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 acquirer". In 2008, in *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, the court further explained that the adverse change should be "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". Such change should "substantially threaten the overall earnings potential of the target in a durationally-significant manner". While Delaware courts have mused in other contexts on whether a particular set of facts might give rise to a determination that an MAE has occurred, no such conclusion had ever been reached until *Akorn*.

The *Akorn* decision: key facts

On 24 April 2017, Fresenius Kabi AG, a German pharmaceutical company, agreed to acquire Akorn, Inc., an Illinois-based specialty generic pharmaceutical manufacturer. In the purchase agreement, Akorn provided typical representations and warranties about its business, including its compliance with applicable regulatory requirements. In addition, Fresenius's obligation to close was conditioned on Akorn's representations being true and correct both at signing and at closing, except where the failure to be true and correct would not reasonably be expected to have an MAE.

In concluding that an MAE had occurred, the court focused on several factual patterns. First, the court took note of several measures of substantial weakening in Akorn's performance between signing and closing, including year-over-year declines in quarterly revenues, operating income and earnings per share as dramatic as 34 percent, 292 percent and 300 percent, respectively, as well as a decline in earnings before interest, tax, depreciation and amortisation (EBITDA) over the year following the signing of the purchase agreement by 86 percent. These drops, the court described, were the not the result of one-off events but rather the product of multiple factors, including heightened competition and margin erosion.

Second, the court took note of the receipt by Fresenius of anonymous letters from whistleblowers after signing that alleged flaws in Akorn's product development and quality control processes. On the basis of these letters, Fresenius launched an investigation of Akorn's business that revealed grievous flaws in Akorn's quality control function, including falsification of laboratory data submitted to the FDA that cast doubt on whether Akorn had complied with applicable law and regulations.

Third, after the signing of the purchase agreement, Akorn scaled back funding of its quality control, data integrity oversight and internal investigations functions out of fear that it would uncover an issue that would upend the transaction.

Takeaways

The court determined that the sudden and sustained drop in Akorn's business performance constituted a "general MAE" – that is, the company itself had suffered an MAE – Akorn's representations with respect to regulatory compliance were not true and correct, and the deviation between the as-represented condition and its actual condition would reasonably be expected to result in an MAE. While the conclusion was judicially unprecedented in Delaware, the court's decision comported with the framework established in earlier cases.

From a financial perspective, the court found that Akorn had experienced an MAE on account of the magnitude and length of its downturn and the suddenness with which its EBITDA decline manifested after the signing of the purchase agreement. In addition, the court identified the presence of factors suggesting "durational significance" to these declines, including widespread regulatory noncompliance and malfeasance at Akorn and a realignment of organisational priorities away from health and safety that could affect Akorn's long-term relationships with its regulators and customers.

Despite the egregiousness of the facts, the case offers several valuable lessons for deal professionals. First, as the court explained, MAE clauses serve to allocate

»

"industry risk" to the buyer and "company-specific" risk to the seller. Most purchase agreements place "business risk", which arises from the "ordinary operations of the party's business" and which includes those risks over which "the party itself usually has significant control", on the seller. By contrast, the buyer ordinarily assumes three others types of risk: (i) systematic risks, which are "beyond the control of all parties"; (ii) indicator risks, which are markers of a potential MAE, such as a drop in stock price or a credit rating downgrade, but are not underlying causes of any MAE themselves; and (iii) agreement risks, which include endogenous risks relating to the cost of closing a deal, such as employee flight. Given this risk allocation structure, it is critical for sellers to negotiate for industry-specific carve-outs from MAE clauses, such as addressing adverse decisions by governmental agencies in heavily regulated industries.

Second, *Akorn* offers a useful gloss on the importance to buyers of including "disproportionate effects" qualifications in MAE carve-outs regarding industry-wide events. Akorn argued that it faced "industry headwinds" that caused its decline in performance, such as heightened competition and pricing pressure as well as regulatory actions that increased costs. However, the court rejected this view because many of the causes of Akorn's poor performance were actually endogenous to Akorn, such as Akorn's loss of a key contract. As such, these "industry effects" disproportionately affected, and were allocated from a risk-shifting perspective to, Akorn.

Third, *Akorn* affirms that a buyer claiming that a representation given with respect to the target at closing fails to satisfy the MAE standard must demonstrate such failure qualitatively and quantitatively. The court focused on a number of qualitative harms wrought by the events giving rise to Akorn's failure to bring down its compliance with laws representation at closing, including harm to Akorn's reputation and its relationships with regulators and customers. Regarding quantitative measures of harm, Fresenius and Akorn presented widely ranging estimates of the cost of remedying the underlying quality control challenges at Akorn. Using the midpoint of those estimates, the court estimated the financial impact to be approximately 21 percent of Akorn's market capitalisation. However, despite citing several proxies for financial performance suggesting that this percentage decline constituted an MAE, the court weighted its analysis towards qualitative factors, noting that "no one should fixate on a particular percentage as establishing a bright-line test". Indeed, the court observed that its use of proxies did "not foreclose the possibility that a buyer could show that percentage changes of a lesser magnitude constituted an MAE. Nor does it exclude the possibility that a buyer might fail to prove that percentage changes of a greater magnitude constituted an MAE".

Akorn offers a useful framework for understanding how courts analyse MAE clauses. Though the *Akorn* court's analysis aligns with the approach taken by deal professionals, the case nevertheless offers a reminder that an MAE, while still quite unlikely, can occur – and should be anticipated and considered thoughtfully in purchase agreements. ■