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What constitutes a MAC in an M&A deal?

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On October 1, 2018, the Delaware Court of Chancery released its decision in *Akorn, Inc. v. Fresenius Kabi AG*, finding for the first time that a buyer had properly terminated a public company merger agreement based on the occurrence of a "material adverse effect" (sometimes also referred to as a "material adverse change," "MAC" or "MAE"). The decision provides important guidance regarding the circumstances where buyers may assert the occurrence of a material adverse effect in terminating an M&A agreement and may inform Canadian law and practice.

The decision

Fresenius agreed to purchase Akorn by way of a merger agreement entered into on April 24, 2017. Shortly thereafter, Fresenius learned of significant compliance and data integrity issues and Akorn's financial performance deteriorated significantly. Fresenius subsequently terminated the merger agreement based on the non-satisfaction of:

- the bring down condition for Akorn's representations and warranties (i.e., that inaccuracies in Akorn's regulatory compliance representation would, individually or in the aggregate, reasonably be expected to have a material adverse effect), as well as
- the covenant compliance condition (i.e., that Akorn had not complied with its obligation to carry on business in all material respects in the ordinary course of business).

Moreover, Fresenius asserted that the general MAE condition had not been satisfied (i.e., that Akorn had suffered a material adverse effect), with the result that Fresenius could refuse to close. Akorn disputed Fresenius' right to terminate as well as the occurrence of a material adverse effect, and sued to compel Fresenius to close.

The Court found that Fresenius had properly terminated the merger agreement and that Fresenius could not be compelled to close. In its decision, the Court reaffirmed existing Delaware case law, including that:

- buyers face a heavy burden when attempting to invoke a material adverse effect clause in order not to close;
- short-term hiccups in earnings should not suffice; rather the material adverse effect should be durationally significant (years rather than months); and
- MAE provisions are best read as a backstop protecting the purchaser from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner.

Turning to the facts at hand, the Court found that a general MAE had occurred. The Court's

conclusion was evidenced by, among other things, year-over-year EBITDA and adjusted EBITDA declines of 86% and 51%, respectively. In short, the Court found that "Akorn's performance dropped off a cliff" and that the decline was durationally significant.

The Court then considered the failure of the bring-down condition in respect of Akorn's representations and warranties, estimating that Akorn's value had decreased by approximately $900 million, or 21%. In cross-checking its "intuitive belief" that a decrease in value of 21% was material, the Court compared it to: (i) the definition of a bear market being a drop of 20% or more; (ii) historic data indicating that subsequent negotiations after an MAE usually result in a purchase price reduction of 15%; (iii) upper and lower bounds of collars in deals involving stock consideration are approximately 10%; and (iv) the median reverse termination fee in an acquisition agreement is 6.36%.

Having engaged in a quantitative analysis, the Court made clear that "no one should fixate on a particular percentage as establishing a bright-line test" and also engaged in a rigorous qualitative analysis, noting that Akorn's own expert identified its data integrity problems as "among the 'top three worst' of the 120+ pharmaceutical companies that he has assessed, a notorious status given that his practice only involves companies that 'have problems.'" The Court concluded that the regulatory situation at Akorn is qualitatively "material when viewed from the longer-term perspective of a reasonable acquiror."

Finally, the Court found that Akorn had materially breached its covenant to carry on its business in the ordinary course by failing to conduct regular audits and remediate identified deficiencies, by failing to maintain data integrity systems, and by submitting FDA filings based on fabricated data.

Relevance to Canadian M&A

Few Canadian decisions have interpreted the meaning of "material adverse effect," much less the ability of a purchaser to terminate in such circumstances. In cases that have been decided, courts have considered whether the changes, if known, would have reasonably affected the mind of a prudent experienced purchaser in deciding whether to make the purchase. Similar to Delaware, courts in Canada have emphasized that materiality depends on the facts of each case, the nature of the contract, who the parties are, and the state of their knowledge about the subject matter of the contract.

The *Fresenius* decision provides a useful reminder that while rare, MACs can and do occur and it is possible to successfully terminate a purchase agreement on these grounds. A purchaser must convincingly demonstrate more than buyer's remorse and the facts must support the conclusion that a durationally significant and material adverse change to the business of the target has occurred. While investigating any such issues, a purchaser ought to continue to comply with its own covenants under the purchase agreement. It is also important to note that where a buyer is concerned about a specific risk, it is generally advisable to address the risk directly in the purchase agreement (e.g., through a specific condition or purchase price adjustment), rather than relying on a MAC clause to get out of the contract if the risk materializes.

Akorn has announced its intention to appeal the Court's decision.