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M&A Trends: COVID-19 As A Material Adverse Change

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As COVID-19 has proliferated throughout the United States, the resulting health-related government actions - in the form of school and business closures, emergency declarations, shelter in place requirements and the like - along with the behavioral adjustments in the consumer population at large ("social distancing," etc.) continue to have a brutally unprecedented impact on our national economy. Clearly, COVID-19 has had heart-breaking impact and costs in the number of Americans who have suffered from or died from the virus. There are also, of course, direct financial costs attributable to the public health responses to the outbreak. And finally, there are the wider, more disparate, but clearly growing economic and social costs which COVID-19 continues to cause, which are not to be underestimated.

In these unprecedented times, businesses have been forced to confront practical, world decisions, with real economic and human impact. How do I keep my workforce safe? How do I run my business without travel or face-to-face meetings? How do I deal with current contracts that I know my business can't perform? Do I have any rights for rent abatement under my leases? Is my business exempt from government closures as an essential business?

At the same time, legal terms and concepts such as force majeure, the impossibility of performance, the frustration of purpose and material adverse change or effect ("MAC") provisions have become commonplace in these commercial discussions and decisions. The last of these, MAC provisions, are the subject of this piece.

An Overview of MACs

MAC provisions are clauses commonly seen within business acquisition (M&A) agreements (or debt financing or other contracts)[1] and which usually serve three purposes: (1) as the subject of an affirmative seller representation and warranty (i.e., that since a certain date there has been no MAC); (2) to be a qualifier and limitation to one or more other seller representations or warranties (e.g., that the target business has qualified to do business in all applicable states except where the failure to qualify would not have a MAC); and (3) to provide a termination right to the buyer, after signing but prior to closing, giving the buyer a right to walk away if a MAC occurs in the intervening period.

MAC clauses are the focus of negotiation during the transaction process, but at the same time the resulting, final language has become fairly consistent, along increasingly established lines. The clauses tend to have three components: (1) the definition of MAC itself, which is usually broad in scope; (2) "causal exclusions" to the definition; and (3) qualifiers to the causal exclusions.

1. ***Definitional Component***. A typical definitional component of a MAC clause would include any "event, circumstance, development, change or effect that, individually or in the aggregate with other events, circumstances, developments, changes or effects, has been or would reasonably be expected to be materially adverse to the business, assets, financial condition or results of operations of the Target Business, taken as a whole." Clearly, this is broad (and one might reasonably argue, vague) language. While the parties may argue as to whether the definition should include "prospects" along with the "business and assets" listing, and/or whether the forward-looking language above ("would reasonably be expected to") should be included or excluded, for the most part, ***the core definitional component of a MAC clause is generally consistent and well established in M&A practice***. Occasionally, the parties may include a specific dollar or other objective measurements to serve as a MAC trigger, though these tend to be highly fact-specific, and unusual (seen, according to the ABA Studies, in well under 10% of reported private company M&A transactions).

2 ***Causal Exclusions***. Over the years, MAC provisions have evolved to exclude from a MAC clause the adverse effects caused by certain, specified facts and circumstances. These causal exclusions typically include (as described in the ABA Studies) one or more of the following, in general order of frequency: economic conditions; war or terrorism; changes in law; changes in accounting standards; announcement of the transaction; industry condition; financial market declines; changes in political conditions; actions required by the M&A agreement; force majeure events or acts of God; failures to meet projections; or actions taken with the buyer's consent. Accordingly, in most M&A agreements, unless falling within one of the causal exclusion qualifiers, as described below, ***the negative impact to a business which results from general economic conditions or another causal exclusion, even if materially adverse to the business, will not be considered a MAC***.

3. ***"Disproportionate Effect" Qualifiers to the Causal Exclusions***. While MAC causal exclusions have become commonplace, exceptions to those exclusions have also developed alongside. Specifically, most M&A agreements now qualify one or more of the causal exclusions so that the specific causal circumstances ***may, in fact, be considered*** for MAC purposes, ***if the adverse effect impacts the target business disproportionately***. According to the ABA Studies, including a "disproportionate effect" carve-out to a MAC causal exclusion in private company M&A agreements has increased consistently over the past 12 years of the studies, from 62% of reported transactions in 2006 to 93% in the 2019 study. While the ABA studies do not identify which of the causal exclusions are more likely to have disproportionate effect qualifiers, in practice those qualifiers tend to apply more frequently to the causal exclusions outside of the parties' control - -such as general economic conditions, acts of terrorism or war, or natural disasters - - as opposed to those within - - such as the announcement of the transaction, conduct with the consent of the parties, and the like. Significantly, the disproportionality is usually measured in relation to the effect of the causal element on other businesses within the same or similar industries, or to "similarly situated" businesses. Thus, a representative disproportionate effect qualifier might apply to specified causal exclusions by considering any such effects **"to the**

extent the Business is materially and disproportionately adversely affected thereby as compared to other businesses in the industries in which the Business operates (and then only to the extent of such disproportionate impact)."

COVID-19 As a MAC

There is little doubt that COVID-19 is causing, directly and indirectly, material and adverse changes to and effects on businesses of all sizes and types across any number of industries in the United States. But do those factual realities constitute a MAC under the typical M&A agreement?

Under the plain reading of a typical contemporary MAC provision, one would likely find one or more of the most frequently appearing MAC causal exclusions to apply to COVID-19 and its impacts, whether as general economic conditions, acts of God, or natural disasters. It's possible that a particular set of COVID-19 circumstances may nonetheless fall within a "disproportionate effects" exception to the exclusion, though this too will likely be an uphill battle, since disproportionality is usually measured within comparable businesses within the same industry - -which is usually the result of the M&A agreement language. Where the disproportionality test is not expressly tied to the same industry - - which is sometimes, though rarely, the case in M&A agreements - - a buyer may have a stronger argument that a MAC has occurred if the target business is in a particularly impacted industry. For example, a buyer of a business in the hard hit restaurant sector may be able to show that COVID-19 had a disproportionate effect on the business (and other restaurants) relative to all other industries. This argument would likely not prevail to trigger a MAC clause if the M&A agreement uses the common "within industry" measurement of disproportionate effect, but may be at least colorable if the agreement does not have that measurement standard (which, as noted, is not common).

Case law is of limited help in this area. Generally, courts will impose a high burden on a party seeking to invoke a MAC clause, applying a fact-based inquiry to determine if the circumstances at issue had a meaningful, long-term impact on the financial well-being of the target company. As explained in an oft-cited Delaware case from 2018, the event must "substantially threaten" the earning potential of the business in a "durationally significant manner."[2] Courts will tend to view M&A transactions as reflecting long-term business investments where the buyer assumes the risk of general economic trends and developments when entering into the agreement - - unless, of course, the M&A agreement specifies with clarity that the parties have decided otherwise. As a practical matter, currently, the typical MAC clause is unlikely to provide a buyer with an easy "out" from its agreement due to post-signing, pre-closing stresses resulting from the COVID-19 virus.

[1] This article focuses on MAC provisions in M&A agreements.

[2] *Akorn, Inc., v. Fresenius Kabi AG, et al.,* C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018), at page 130 (*quoting In Re IPB Shareholders Litigation*, 789 A.2d 14, 68 (2001)("[The] provision is best read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. 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").