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Alert

Deal Terms — Assessing Material Adverse Change Clauses and Other Deal Certainty Considerations Under and After COVID-19

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Given the extreme volatility of equity markets in the face of the COVID-19 pandemic, questions have arisen as to whether the coronavirus constitutes a "material adverse effect," "material adverse change" or similar concept (collectively, an "MAE") in a stock or asset purchase agreement or other definitive M&A agreement. (An MAE provision sets forth the parameters for which a buyer is permitted to terminate a transaction when an adverse event affects the target company or business.) Questions have also arisen as to whether the customary closing conditions, relating to accuracy of representations and compliance with interim covenants, will present significant deal certainty risk.

The short answer to all those questions is that it is too soon to tell.

Typically, MAE provisions — which can be heavily negotiated — are defined to include any development, event, condition or situation that has had, or would reasonably be expected to have, a material adverse effect on the business, assets, financial condition or results of operations of the target company or business. However, MAEs usually exclude acts of God (and various other categories of broad market or industry risk, including those relating to general economic, business, financial, credit or other market conditions) *unless the resulting effects disproportionately adversely affect the subject party as compared to others in the industry*.[1] The market, unsurprisingly, has moved to clarify that COVID-19 is among the excluded MAE occurrences.[2]

Historically, MAEs have been exceedingly difficult to prove, although credible MAE allegations have served as a basis for renegotiating an M&A contract. When determining whether an MAE has occurred, courts do not apply a bright line test; instead, the inquiry is highly fact specific. Under Delaware law, to give rise to an MAE, the adverse effect must substantially impact the overall earnings potential of the target in a durationally significant manner usually measured in years rather than months — a mere "hiccup" in performance is not enough.[3] Among other factors, courts assess the magnitude of the effect both qualitatively and quantitatively — as measured against the target company's historical results, recent earnings guidance and pricing expectations — viewed from the perspective of a reasonable

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[1] *See,* e.g., E*Trade Financial Corp., Agreement and Plan of Merger (Exhibit to Form 8-K) 9 (Feb. 20, 2020) (providing that certain MAE exclusions do not apply "to the extent that any such event, circumstance, development, change, occurrence or effect has a disproportionate adverse effect on the Company and its Subsidiaries, taken as a whole, relative to the adverse effect such event, circumstance, development, change, occurrence or effect has on other companies operating in the securities brokerage industry or the other industries in which the Company or any of its Subsidiaries materially engages.").

[2] *Id.* (specifically carving out "epidemic, pandemic or disease outbreak (including the COVID-19 virus)" from MAE events).

[3] *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347, at *53 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018). New York law is similar to Delaware law on this issue. *See In re IBP, Inc. Shareholders Litigation*, 789 A.2d 14, 68-69 (Del. Ch. 2001) (applying New York law).

acquiror.[4] Although no one benchmark is dispositive, in a recent decision, the Delaware Court of Chancery looked to "intuitive" benchmarks, such as a 20% decline in a target's value, as likely material to a reasonable buyer.[5]

It has been extremely difficult for an acquiror to establish the occurrence of an MAE. Before *Akorn v. Fresenius*,[6] decided in 2018, no Delaware decision had ever released a buyer from its obligation to close a transaction as a result of the occurrence of an MAE. The cases previously adjudicated under Delaware law all had required the acquiror to close, often despite a significant diminishment in target value and including cases brought following the financial crisis of 2008.

Nonetheless, *sellers* of businesses must take certain precautions when negotiating deal documentation to ensure that the COVID-19 pandemic does not introduce undue deal certainty risk. In addition to making sure that the MAE construct in the documentation clearly and unequivocally excludes the effects of a pandemic, sellers must consider the impact of COVID-19 on a business's ability to make customary representations regarding the absence of undisclosed liabilities, the availability and stability of the workforce, the reliability of suppliers and other operational considerations. Those representations are typically "brought down" at closing, but subject to an MAE standard of accuracy, so deal risk relating to inaccuracies in representations is governed by the documentation's agreed MAE definition. Significantly, for private company transactions, transactional insurance, such as rep and warranty insurance, may not be available for the effects of COVID-19 to the extent the pandemic leads to known rep breaches, which are typically excluded from coverage.

Moreover, customary interim operating covenants, which require businesses to operate in the ordinary course of business between the signing and closing of a transaction, must be reconsidered in light of the pandemic. Those interim covenants often expressly prohibit a seller's business from taking actions outside the ordinary course with respect to a company's workforce, budget, capital expenditures, compliance and accounting practices, borrowing practices and otherwise. Compliance with interim covenants is a customary condition to a buyer's obligation to close an M&A transaction, and is typically not subject to an MAE standard. Accordingly, sellers with pending M&A transactions should be aware of the potential deal certainty risks introduced by their COVID-19 responses, and consider seeking the consent of the buyer before taking response actions that run afoul of applicable interim operating covenants. Those in the process of negotiating an M&A transaction should carefully consider the interim covenants that they agree to in the context of the measures that are likely to be taken by the target business in response to the pandemic.

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[4] Delaware case law has extended the reach of MAE jurisprudence to the licensing context even though the license agreement at issue did not use the 'magic' words or defined term "Material Adverse Effect/Change." In *Mrs. Fields Brand, Inc. v. Interbake Foods LLC*, 2017 WL 2729860, at *23 (Del. Ch. June 26, 2017), the Delaware Chancery Court noted that the nature of the agreement at issue is relevant to the duration required for an MAE:

> In an acquisition, where the buyer acquires the assets of a business outright and the cash flows they generate in perpetuity, "one would think" that a commercially reasonable period "would be measured in years rather than months." The License Agreement is different. Mrs. Fields retained ownership of the brand and Interbake's interest in the business only extends until the license expires, which occurs after a five-year term, subject to an option to renew the license for another five years. Thus, given the limited duration of the License Agreement, the period of time that would be "commercially reasonable" in determining whether a consequential decline in earnings has had a material adverse effect on the license presumably would be shorter than the period of time relevant to the acquisition of business.

[5] *Akorn, Inc.*, 2018 WL 4719347, at *74.

[6] *Id.*

Additional risks are presented by the potential declaration of an MAE by the lender. Typically, debt financing agreements use the same MAE definition as the related acquisition agreement for purposes of the closing date representations, and therefore the same analysis discussed above applies. However, given the different interests between acquiring a company and financing the acquisition, it is possible that an MAE might arise for the lender but not the buyer in connection with the same transaction. In particular, additional factors, such as the borrower's ability to make debt payments, may be relevant, and the duration of the impact might be shorter for a lender MAE (see footnote 4 above).

Accordingly, it is possible that the parties to an M&A transaction could seek to close, but the lender could refuse to fund if it concludes that an MAE has occurred under the terms of the financing agreement. In that event, and assuming that the M&A agreement does not contain a financing contingency, if the buyer is not able to able to declare an MAE on its own, it likely will be required to find alternative, more expensive financing or, when provided for in the transaction agreement, pay the seller a reverse break fee. In that scenario, it could be expected that the buyer will seek specific performance of the lender's funding obligation under the debt financing agreement and the lender would be required to prove the occurrence of an MAE under the standard applicable to it.

It is too soon to tell whether COVID-19 constitutes a durationally significant event for purposes of establishing that an MAE has occurred, and it is difficult to predict the lasting impact of COVID-19 for any particular company or industry, or across companies and industries, as the effects may vary significantly. Moreover, even if a particular company suffers a material adverse effect, exclusions for epidemics, general economic conditions or acts of God may apply, in which case the ultimate question becomes whether COVID-19 had a disproportionate impact on the target company or business. But there are considerations beyond MAE in considering the deal certainty risk introduced by COVID-19, especially relating to a seller's ability to comply with customary interim covenants. As such, pending and future transactions must be examined holistically to assess the deal certainty considerations presented by COVID-19.

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