LEGAL UPDATES

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Material Adverse Change Clauses and the COVID-19 Deal Environment

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Overview

With the growing uncertainty surrounding the economic impacts of the COVID-19 pandemic, buyers may seek to revisit pending M&A transactions. Material Adverse Change or Material Adverse Effect ("MAC") clauses in transaction documents may give the buyer the ability to walk to the extent the buyer can demonstrate that a MAC has occurred. This article gives a brief overview of the relevant caselaw and outlines the factors one may consider in determining whether the current COVID-19 outbreak constitutes a MAC under an M&A agreement.

Legal Standard for a Material Adverse Change

MAC clauses in M&A agreements generally provide that a buyer may walk away from a deal if the target company's business and operations suffer a material adverse change between signing and closing. In transactions governed by Delaware law, the legal standard for determining if a MAC has occurred turns on "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." *Hexion Specialty Chemicals v. Huntsman*, 965 A.2d 715, 738 (Del. Ch. 2008). Until 2018, no Delaware state court had ever found a MAC to have occurred.

In October of 2018, the case law advanced significantly with the Delaware Chancery Court upholding a buyer's right to terminate a merger agreement due to a MAC for the first time in *Akorn, Inc. v. Fresenius Kabi AG*, 198 A.3d 724 (Del. 2018) – the decision was subsequently affirmed by the Delaware Supreme Court. Between signing and closing, Akorn (the target) experienced a continuous dramatic downturn in performance, which was coupled with

persistent federal noncompliance issues. Fresenius (the buyer) refused to close arguing that a MAC had occurred, and Akorn sought specific performance. The court allowed the buyer to walk, ruling that Akorn had suffered a MAC. The court also held that Akorn's breach of its FDA compliance representations would reasonably be expected to result in a MAC, and that Akorn breached its covenant to conduct the business in the ordinary course from signing until closing. *Akorn* provides a framework on how a court could interpret future situations to find a MAC.

1. Market Benchmarks – Although the court did not provide any bright line rule, *Akorn* suggests a court may look to certain market benchmarks such as a 20 percent decline in the target company's value or a 40 percent decline in its business performance, as evidence of a MAC.

2. Motive – In *Akorn*, the Court did not perceive "buyer's remorse" from the invoking party and concluded that the evidence was consistent with a buyer that fully planned to close and had complied with its contractual obligations. Therefore, it may be prudent for an invoking party to review their actions for complete consistency with the underlying agreement and ensure a court could not perceive any manipulation of the situation.

3. Qualitative and Quantitative Materiality – In finding that the inaccuracy of the FDA compliance would reasonably be expected to result in a MAC, the court adopted a two-prong test and looked to both a qualitative failure (the suddenness of the financial decline and/or significance of the factors that caused the decline) and quantitative failure (magnitude and length of the downturn) of such representations to be true and correct.

Even with the above considerations, the Court emphasized the heavy burden faced by a party invoking a MAC clause. *Akorn* reaffirmed that "short-hiccups in earnings" are not sufficient as a MAC – the change must be much more consequential to the company's long-term earnings power. Although was a landmark decision, it should not be interpreted as an open door for buyers to walk away from transactions in times of economic downturn.

Invoking a MAC in Connection with COVID-19

Given the high standard for demonstrating a MAC and the fact that the long-term effects of COVID-19 are still unknown, arguing that the disruptions caused by the pandemic constitute a MAC may be challenging for buyers. Further, as a matter of public policy, courts may look to enforce M&A agreements to prevent further damage to the markets and the economy.

In considering if the impact of COVID-19 constitutes a MAC, the invoking party would need to demonstrate that the pandemic has had a substantial adverse impact on the target's financial condition or operations, and such an impact will continue for a significant period of time. The question is whether this crisis caused a change so adverse and so material as to render the target's

business unviable or the transaction economically unworkable. Based on *Akorn*, one important question is whether COVID-19 and the harm it is currently causing to businesses will persist for a significant amount of time or will be temporary in nature.

Another consideration for invoking a MAC clause is specific to the transaction agreement itself and how the parties have allocated systematic risks. Epidemics and public health events have recently been more likely to be carved-out from what constitute a MAC in M&A transactions. However, buyers commonly push for a "disproportionate effect" exclusion – in such cases, events that affect the economy or an industry as a whole do not constitute a MAC *unless* such events disproportionally affect the target company as compared to other companies in the same industry. A factual analysis is then required to demonstrate the target was disproportionally affected.

The length of the interim period (time between the signing and closing of a transaction) will also play a major role when determining whether or not a MAC has occurred and can be used as an out for a buyer. The longer that period is, the more time there will be to evaluate whether COVID-19 has had an adverse impact over a significant period of time.

In such uncertain times, companies should be looking carefully at their specific transactions to mitigate risks. A review of a transaction agreement's MAC clause may be a helpful place to start in evaluating best courses of action in this unique environment.

Contact us

Husch Blackwell continues to monitor the evolving situation and its implications for our clients. Should you have any questions, please do not hesitate to contact Colleen Pagnotta, Remy Fesquet or your Husch Blackwell attorney.

Husch Blackwell has launched a COVID-19 response team providing insight to businesses as they address challenges related to the coronavirus outbreak. The page contains programming and content to assist clients and other interested parties across multiple areas of operations, including labor and employment, retailing, and supply chain management, among others.