BrothersSmith LLP
Attorneys at Law

ALERT

COVID-19 and Material Adverse Effect Clauses in M&A Agreements

Merger and acquisition agreements generally address the risk of significant adverse pre-closing changes to a target's business through the use of "Material Adverse Effect" or "Material Adverse Change" (both referred to herein as "MAE") representations, qualifiers and closing conditions. Broadly speaking, MAE provisions are intended to protect a buyer from unknown events that could substantially threaten the long-term earnings potential of the target. If triggered, such provisions may allow a buyer to terminate the agreement prior to closing and walk away from the deal. The worldwide COVID-19 outbreak has raised significant legal questions as to whether a global health crisis constitutes an MAE under merger or acquisition agreements.

MAE Background

MAE clauses in the context of mergers and acquisitions generally allow a buyer to terminate a transaction prior to closing in the event of a development, change, event or condition 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. These provisions typically provide exclusions for general economic, market, industry, and political risks that do not disproportionately affect the target company relative to other businesses in the industry.

Although MAE clauses are typically heavily negotiated, there is often no express definition of what types of events or dollar amount of losses constitute an MAE. Such questions have largely been left to the courts to determine on a case-by-case basis. In doing so, courts have tended to narrowly interpret MAE clauses and find that they do not to give rise to a termination right. In fact, the Delaware Chancery Court recently confirmed the buyer's heavy burden of proof in attempting to invoke an MAE clause in holding that a buyer must show that the effect will "substantially threaten the overall earnings potential of the target in a durationally-significant manner."[1]

Impact of COVID-19 on MAE Provisions

For agreements that have already been signed without specific inclusion of "pandemic" or similar language, the determination of whether an MAE has occurred in relation to COVID-19 will ultimately require a fact-based inquiry as to whether the impact will threaten the target's overall earnings potential in a durationally-significant manner and whether COVID-19 will disproportionately affect the target business versus others in the industry. It is likely too soon to tell whether the pandemic (or any of its effects) will constitute a durationally-significant event.

For ongoing negotiations and prospective transactions, parties should carefully consider how to draft the MAE provision in light of the COVID-19 outbreak. In particular, sellers may want to include express exclusions for pandemics, epidemics and other global health conditions from the definition of an MAE in order to prevent buyers from terminating agreements on the basis of such events. Conversely, although buyers face a heavy burden in attempting to invoke an MAE clause to

avoid closing, a lack of clarity as to whether an MAE has occurred may actually provide an advantage to buyers, who can leverage that uncertainty and the threat of termination to renegotiate more favorable deal terms.

Possible Developments and Next Steps

Parties to a merger or acquisition transaction should consult with legal counsel to review the MAE clause to determine the potential impact of COVID-19 on the transaction and how the pandemic is likely be treated under the clause. However, the COVID-19 pandemic appears to be a singular event, with a greater impact on companies than other types of occurrences previously evaluated by courts. Although the ultimate treatment of MAE provisions with respect to COVID-19 is still largely unknown, in light of the global impact of the pandemic, parties should be prepared for the possibility that courts may find an MAE to have occurred in instances where it may not have under normal circumstances.

We will continue to monitor the legal and business implications associated with the COVID-19 outbreak and report significant developments. Please feel free to reach out to us if you have any questions or would like any further clarification on MAE clauses and the impact of COVID-19.

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[1] *Akorn, Inc. v. Fresenius KABI AG, etc.* (DE Chancery Court, October 1, 2018)

Authored by:

Bart W. Springel
T 925.944.9700
bspringel@brotherssmithlaw.com

2033 North Main Street, Suite 720
Walnut Creek, California 94596
T 925.944.9700
F 925.944.9701

www.brotherssmithlaw.com