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COVID-19 as a Material Adverse Effect (MAC) Under M&A and Financing Agreements

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A critical legal issue that has arisen in recent days is whether the COVID-19 pandemic may constitute a "Material Adverse Change" (or "Material Adverse Effect"–both referred to here as a "MAC") under existing agreements. We expect that every party to a merger agreement or financing agreement will be reviewing the agreement to determine whether any party has a right to terminate the agreement or not perform certain obligations based on developments relating to the COVID-19 pandemic. Typically, the non-existence of a target company MAC is a condition to closing under a merger agreement; and the non-existence of a MAC on a borrower or its ability to perform under a credit facility is a condition to funds being drawn down. Even when a MAC (or other) provision does not clearly provide a right to terminate or not perform, the potential that a MAC has occurred may create leverage for a renegotiation of terms.

Generally, MAC provisions have been interpreted narrowly and there has been a high bar to a finding that a MAC has occurred (as discussed below, there has been only one case in which a Delaware state court has found that a MAC occurred that permitted termination of a merger agreement). At the same time, the COVID-19 pandemic appears to be a truly singular event, with the potential to have an extreme impact on companies–and arguably is unlike the types of events that the courts have evaluated in the past with respect to MAC provisions. *General* advice as to whether the COVID-19 pandemic is a MAC is not possible as in each case the analysis will depend on the specific wording of the provision at issue and the effects on the particular company. Importantly, the evaluation may change over time to the extent the pandemic does not resolve in the relative near-term. It should be kept in mind that the COVID-19 pandemic may affect many other provisions of agreements as well–such as bring-downs of representations and warranties (some of which will not be subject to a MAC standard), covenants to operate in the ordinary course, end dates, and others.

Discussion

Standard MAC provision. A standard MAC provision in an acquisition agreement includes three parts. First, a MAC typically is defined as any event, development or condition occurring that has had, or would be reasonably expected to have, a material adverse effect on the business, financial condition or results of operations of the company and its subsidiaries (taken as a whole). Second, the provision typically excludes specified events, such as acts of God, weather events, floods, earthquakes, natural disasters, terrorism or military actions, general economic downturns, conditions existing generally within the company's industry, and other broad categories of market or credit conditions. Some provisions specifically exclude "pandemics," "epidemics," "disease," or "health emergencies"–and, recently (for example, in the Morgan Stanley-E*TRADE merger agreement), some have specifically excluded "the COVID-19 pandemic." Third, the provision typically states that, with respect to some or all of the specified exclusions, they will *not* be excluded to the extent that they have disproportionately adversely affected the company and its subsidiaries (taken as a whole) as compared to others in the same industry. In an acquisition financing agreement, typically, a condition to closing is that there has not been a target company MAC and there is a cross-reference to the MAC definition in the merger agreement.

A standard MAC provision in other types of credit agreements defines a MAC as a material adverse effect on (i) the business, financial condition, or results of operations of the borrowers and their subsidiaries (taken as a whole); (ii) the ability of the credit parties and their subsidiaries (taken as a whole) to perform their payment obligations under the loan documents; or (iii) the material rights and remedies (takes as a whole) of the agent and the lenders under the loan documents. The first clause sometimes also includes "prospects" of the borrowers. The provision does not typically specify carve-outs for industry-wide or other types of conditions (given that a lender's sole focus is on the borrower's ability to repay the loan).

Strict contractarian approach. There is no free-standing definition of a MAC–it is, simply, whatever the definition that the parties set forth in the agreement provides. Generally, courts have interpreted MACs narrowly based on the specific words of the agreement and have not "read in" concepts that the parties did not specifically provide for. The 2018 *Akorn* decision is the first *ever* in which a Delaware state court found that a company experienced a MAC that entitled an acquiror to terminate a merger agreement (*Akorn v. Fresenius* (Del. 2018)). We note that very few MAC disputes have been litigated to judgment; and that strong cases for asserting a MAC usually have resulted in a renegotiation of terms or settlement.

"Materiality" and "durational significance." In both Delaware and New York, generally there is a high bar to the finding of a MAC, with a focus on the particular language of the provision and the specific facts and circumstances. With respect to both merger agreements and financing agreements, the courts generally have required that the change was "material" *and* had "durational significance." There is no bright-line test. A material change is one that is severe, not a "blip." A durationally significant change is one that has an effect "over a commercially reasonable period, measured not in months but years." As stated in *Akorn*, the focus is on whether there has been "an adverse change in the target's business that is consequential to the company's long-term earnings power"—that is, a change (generally, based on company-specific, rather than industry-wide, factors) that would be material when viewed from the perspective of a reasonable *long-term* investor. In New York cases, the courts have considered "whether the alleged material adverse change was within the contemplation of the parties at the time they executed the agreement, whether it was within the control of the parties, and the magnitude of the impact on the relevant party's business" (*In re Lyondell* (Bankr. S.D.N.Y. 2017)).

Akorn. As noted, in *Akorn*, the court found that a MAC occurred that permitted the acquiror to terminate the merger agreement. The target company's financial decline and its durational significance were more dramatic than in previous cases in which the Delaware courts have evaluated whether a MAC occurred. The target's financial performance "fell off a cliff" shortly after signing. Over the course of one year following the signing, EBITDA had declined 86%; analyst valuations for the company had decreased from about $32 per share to $5-12 per share; and the declines showed no sign of abating. The court (i) rejected the concept that MAC clauses *implicitly* allocate to the acquiror risks "known" to the acquiror at the time of signing; and (ii) found that the emergence of new competitors for the company's top three products was a "company-specific" change. The court also found that the failure of the target's regulatory compliance representation to be true and correct (to the extent of a MAC) at closing provided a second, independent ground for termination of the agreement. The court found that remediation by the target (a pharmaceutical company) of the long-standing, pervasive regulatory noncompliance would take several years, cost the equivalent of 21% of Akorn's market capitalization, and have lasting "qualitative" effects.

The quantitative effect in other cases. Outside Delaware, courts have generally found a MAC in cases involving decreases in profits in the 40% or more range (with durational significance). In one Delaware case, then-Chancellor Allen posited (without deciding the issue) that a decline in earnings of 50% over two consecutive quarters likely would be a MAC (*Raskin v. Birmingham Steel* (Del. Ch. 1990)). Then-Vice Chancellor (and now former-Chief Justice) Strine was "torn" in one Delaware case as to whether a 64% drop in quarterly earnings constituted a MAC (but ultimately held that it was not because it did not have "durational significance") (*IBP Shareholders Litig.* (Del. Ch. 2001), decided under New York law). However, these precedents do not preclude that *smaller* percentage changes *could* constitute a MAC or that *larger* percentage changes *might not* constitute a MAC. (Note that, for purposes of determining whether a MAC has occurred, the company's performance generally should be evaluated against its results during the same quarter or period of the prior year in order to minimize the effect of seasonal adjustments (*Hexion v. Huntsman* (Del. Ch. 2008).)

"Durational significance" in *Akorn*. In *Akorn*, the target's "dramatic downturn" started just after the merger agreement was signed and, at the time of trial, had "persisted for a full year and show[ed] no sign of abating." Also, the court noted: "There [was] every reason to think that the additional competition [to which both parties attributed the decline] [would] persist…." The discounted cash flow analysis conducted by the target's financial advisor in connection with the board's approval of the deal provided a midpoint valuation of $32.12 per share—but, based on the post-signing performance, analysts estimated the company's standalone value at $5 to $12 per share. At the date of termination of the agreement, analysts' forward-looking estimates for 2018, 2019 and 2020 EBITDA were lower than their estimates at signing by 63-67% (while analysts' estimates for peer companies had declined by only 11% to 15%). Also of note, in *Akorn*, the court observed (in a footnote) that the requirement of "durational significance" may not apply when evaluating whether a MAC occurred in the context of a buyer who is "a financial investor with an eye to a short-term gain."

Company-specific versus industry-wide factors. As noted, a standard MAC definition (in acquisition agreements, as well as acquisition financing agreements that cross-reference the MAC in the acquisition agreement) excludes the effects of industry-wide conditions except to the extent that specified industry-wide conditions disproportionately affect the company. Thus, usually, a change must be based on "company-specific" factors of effects to constitute a MAC. The court found in *Akorn* that the target's decline *was* due to company-specific conditions**.** The target (Akorn) argued that there was not a MAC because its decline was the result of industry-wide "headwinds," including an increase in new competitors due to the FDA's efforts to approve generic drugs. The court observed that "everyone—including [the acquiror], knew about these 'industry headwinds'" and also knew that, if the headwinds were greater than expected, Akorn "would likely underperform relative to its competitors." However, the court concluded, "[u]nder the risk allocation established by the Merger Agreement,…the causes of Akorn's adverse performance were actually business risks allocated to Akorn." The unexpected new market entrants who competed with Akorn's three top products "were problems specific to Akorn based on its product mix…. [T]he problems were endogenous risks specific to Akorn's business." Moreover, the court commented, even if (for argument's sake) these problems were industry-wide, they "disproportionately affected Akorn" and, therefore, under the merger agreement, were risks allocated to Akorn. The court pointed to Akorn's far greater underperformance than its peer companies relative to consensus analyst estimates as evidence of the disproportionate effect of these problems on Akorn.

Assumption of systemic risks. In *Akorn*, the MAC provision (as is typical in acquisition agreements) specifically excluded the effects of "pandemics, earthquakes, floods, hurricanes, tornados or other natural disasters, weather-related events, force majeure events or other comparable events." The court observed that these events were typical "systematic risks," and that ordinarily parties allocate these types of risks to the buyer because they are "beyond the control of all parties (even though one or both parties may be able to take steps to cushion the effects of such risks) and … will generally affect firms beyond the parties to the transaction." By contrast, the court stated, company-specific risks are often allocated to the seller because it "is better placed to prevent such risks…and has superior knowledge about the likelihood of the materializations of such risks that cannot be prevented." Under this reasoning, absent contract to the contrary, the party assuming the systemic risks (the buyer) generally would assume the risks associated with COVID-19 (except to the extent that the target was disproportionality impacted compared to other industry participants)–and, in the Delaware courts' view as reflected in *Akorn*, there are sound policy reasons for this result.

Considerations relating to other agreement provisions. In many agreements, in determining whether conditions are satisfied to close an agreement or borrow funds, it will also be relevant whether the company's representations and warranties can be credibly "brought down" (for example, those relating to undisclosed liabilities; adequacy of reserves; status of existing supplier and other contracts and commercial relationships; availability of the workforce; and the like) and whether the company is in material compliance with its covenants (for example, operating in the ordinary course of business pending closing and maintaining certain capital or leverage requirements). As with a MAC generally, the evaluation of these changes in relation to the COVID-19 pandemic may change depending on how long the pandemic endures, what other governmental responses there are, and the cumulative effect of the pandemic on the company (in most cases, as compared to others in its industry) over time.

Key factors relating to COVID-19.

- ***Specific exclusions unless a disproportionate impact.*** In the case of acquisition agreements, many MAC provisions specifically exclude changes resulting from "acts of God," pandemics," "epidemics," "disease," or "health emergencies"–*unless* there has been a disproportionate effect on the company. It is not immediately apparent how the global COVID-19 pandemic would in general tend to affect companies within a given industry differently. However, depending on the specific facts and circumstances, a particular company may for some reason(s) be more vulnerable to the effects of the pandemic than others in its industry–arguably, for example, because of higher leverage; worse distribution, production, access to supply, intellectual property or goodwill; geography; or other factors. It may be that weaker companies in an industry may be forced into the zone of insolvency and this may provide a basis for arguing that the pandemic has been disproportionate on the company. On the other hand, New York courts have not held that insolvency constitutes a MAC (see *Lyondell*) and, to the extent the company already was weaker within its industry, its further decline in any event could be viewed as a foreseeable risk assumed by the buyer.

- ***Quantitative effect.*** If the COVID-19 pandemic is arguably covered within the definition of a MAC, the question will be what actual financial effect can be traced to the pandemic and whether it reflects a change in the *long-term* value of the company. Importantly, this judgment may change over time depending on the effects on the company (compared to others in its industry) as the pandemic continues.
- ***Foreseeability.*** A relevant consideration may be whether the court considers the pandemic to have been foreseeable. On the one hand, it has been common knowledge that a future global pandemic would be inevitable; on the other hand, the extreme impact of COVID-19 arguably could not be viewed as something parties would have contemplated as a regular risk of doing business.
- ***Common law contractual remedies.*** Parties should consider the possibility that other common law contractual remedies may be available if there is not a MAC–for example, based on impossibility of performance, frustration of contract and the like. In general, there has been at least as high a bar to these types of remedies as to the finding of a MAC. Also, it is potentially conceivable that a court could find that the implied covenant of good faith prevents a party from objecting to non-performance for reasons relating to the pandemic–although this would represent a break with past precedent.
- ***Possible developments.*** Finally, parties should be prepared for the possibility that there may be circumstances under which a court, weighing all the factors, might find, in light of this singular global event and its extreme impact, that a MAC occurred when it would not have so found under more normal conditions. There also is a potential that legislation could be adopted that affects the enforceability (or at least the timing of performance) of certain categories of contracts based on the effects of the COVID-19 pandemic. (We note that there already has been a suspension of interest on student loans and, in Italy, a suspension of rent and mortgage payments.) Given how rapidly events are developing with respect to the COVID-19 pandemic, we expect that there will soon be additional developments that will inform the analysis of MACs in both the litigation and negotiation contexts–and current analyses likely will have to be updated based on these further developments.

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