Allocation of Risk in the Era of COVID-19: Material Adverse Change in M&A Agreements

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It is without question that changes to present-day life caused by the spread of COVID-19 are both material and adverse, in the traditional sense of these words. This is true for countries, communities, businesses and individuals, at a macro level, a micro level and all levels in between. However, when these terms?*material*, *adverse*, *change*?are grouped together in the context of merger and acquisition (M&A) transaction documents, their precise meanings, and the practical impact of their application, become less clear.

MAC in M&A:

M&A practitioners are familiar with the concept of Material Adverse Change (MAC) in merger and other acquisition agreements. One of the most important functions of acquisition agreements generally is to allocate risk between buyer and seller: Buyers typically assume systemic risks related to an acquired business and account for these risks in purchase price negotiations, while sellers often assume more target-specific risks that a seller is in a better position to know about and, in some cases, prevent.

Several contractual mechanisms are available to lawyers and their clients in order to allocate pre- and post-closing risks, including representations and warranties, covenants, purchase price adjustment provisions, closing conditions, termination rights and indemnification provisions. In sign-and-delayed-close transactions, buyers often employ MAC to allocate pre-closing adverse change risk to sellers. A MAC provision gives a buyer the right to terminate or refuse to perform if the target business suffers a MAC between signing and closing. MAC is used in other M&A contexts as well, e.g., to qualify seller?s representations or in bring-down closing conditions and covenants to operate in the ordinary course of business.

A typical MAC formulation is made up of three parts: (1) a change or development that has had, or reasonably would be expected to have, a materially adverse effect on the business, operating results, financial or other condition, or prospects of the target company and its subsidiaries (if any), taken as a whole, or on the ability of any party to close the contemplated transaction; (2) exclusions of systemic

risks such as changes to general business or financial market conditions or changes in the law, or, in some MAC definitions, epidemics, pandemics and/or states of emergency; and (3) exceptions to the enumerated exclusions where there is a disproportionate impact on the target company.

Historically, MAC provisions have been interpreted narrowly, with a significant burden of proof on the buyer to prove that a MAC has occurred. Indeed, there is only one instance (***Akorn v. Fresenius*, Del. Ch. 2018, aff?d Del. Dec. 7, 2018**) in which a Delaware court has found a MAC to permit termination of a signed merger agreement.

COVID-19 and MAC:

For businesses and their legal counsel who have existing M&A agreements (i.e., signed but not yet closed), a front-of-mind question in light of COVID-19 is whether any party has a right to terminate or refuse to perform based on the virus?s outbreak and its far-flung effects. History, here, is not the best teacher. With limited exceptions (see, e.g., *Akorn*), MAC provisions usually are not fully adjudicated; instead, disagreements between parties typically result in the renegotiation of deal terms. Furthermore, what case law does exist fails to provide clear guidance on pandemics such as COVID-19.

As such, it is important to note that we cannot advise as to whether the COVID-19 pandemic is or is not a MAC. This determination will vary case by case, depending on the specific wording of the MAC provision and the effects the pandemic has on the target company. This evaluation, like the ever-evolving effects of the virus, will continue to change over time as the materiality of business impacts comes into sharper focus.

In other words (and spoken like a true lawyer), to the question of whether the COVID-19 pandemic is a MAC, the answer is: It depends. There is no clear-cut rule; however, there are some general concepts to consider in interpreting existing MAC provisions, in each case keeping in mind courts? traditionally narrow interpretation of MACs based on the parties? negotiated language and the particular facts and circumstances:

- How has the target company been specifically impacted, as compared to its industry as a whole?
- Is this impact quantitatively significant? E.g., how does the target company?s performance compare against the same quarter of previous years?
- Is this impact ?durationally significant? (*Akorn*)?
- What is ?significant? for this particular target, considered in the context of its industry, from a commercially reasonable standpoint?

Risk allocation considerations, discussed above, might also play a role in a court?s interpretation. From this perspective, COVID-19 and associated risks might be considered systemic and, thus, more appropriately allocated to a buyer unless the seller is disproportionately affected. It is important to keep in mind, however, that even if a target is disproportionately affected, if the company was weak pre-COVID, its further decline may be deemed a predictable or systemic risk (i.e., buyer?s risk).

Practical Considerations:

So, what to do?

As a starting point, parties with signed agreements should review them carefully to assess the likelihood that the COVID-19 pandemic will be considered a MAC under the specific language, facts and circumstances. Where MAC is used as a qualifier, are representations, warranties and disclosure still accurate? Where the absence of MAC is used as a closing condition, notice requirements should be carefully reviewed to avoid missed deadlines. If there have been adverse impacts, can they be quantified, and can dollars lost be traced to the COVID-19 pandemic? Buyers might also consider whether they have additional leverage in this environment to add specific closing conditions to address COVID-19 and the related uncertainty, and parties might consider extending termination dates. Furthermore, in addition to MAC considerations, parties should evaluate whether the applicable jurisdiction permits excusal from contractual obligations under common law doctrines of impossibility or frustration of purpose.

For parties negotiating M&A agreements during and after the COVID-19 pandemic, it is safe to say that many of these documents will (and should) specifically allocate the risk related to COVID-19 or other similar pandemics going forward. Sellers, for example, may want to shift to buyers the risk related to generalized systemic risks like COVID-19 and other pandemics. Buyers will want to consider including quantitative measurements (revenue, balance sheet or other industry or target-specific metrics) for determining the existence of a MAC or in lieu of having to rely on a MAC. In any event, careful and intentional negotiation will be key.

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