

# **The Coronavirus (COVID-19) and Material Adverse Effect Clause**

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The recent worldwide outbreak of the coronavirus (also known as COVID-19) is causing many buyer parties in mergers and acquisitions to evaluate what effect, if any, the pandemic may have, or has already had on the business and operations of the targets that they are seeking to acquire. One component of these evaluations will certainly be whether a public health crisis such as COVID-19 is sufficient to trigger a material adverse effect (MAE) clause and permit a buyer to terminate a transaction in anticipation of deterioration of the target's business and financial performance due to the pandemic.

## **What is an MAE clause?**

Generally, an MAE clause in the mergers and acquisitions context permits a buyer to terminate a proposed transaction or agreement if, as a result of an event or series of events, there has occurred a significant or material deterioration in the financial health of the target or in the stability of the target's business between the signing of the agreement and the closing. In essence, an MAE clause functions as a tool for risk allocation by placing the general risk of MAE on the seller and using exceptions to reallocate specific categories of risk to the buyer. In other words, exclusions from these exceptions return risks back to the seller.

Although unique to each transaction and agreement, exceptions to MAE claims (i.e., where the buyer will not be deemed to have a legitimate reason to terminate a transaction based on alleged MAE) generally include: (i) general economic or political conditions in any country where a target operates; (ii) changes or conditions generally affecting a target's industry; (iii) changes in the market price or trading volume of a target's securities or the target's credit ratings; (iv) geopolitical conditions, such as acts of war, sabotage, terrorism or calamity; and (v) natural disasters, such as hurricane, tornado, flood, or earthquake. These are generally considered "systemic risks" that would affect all parties in a transaction and not just the target. It should be noted that risks related to contagious disease, such as "pandemics," "epidemics," and "public health crises," have not been included as commonly as MAE exceptions in purchase or merger agreements entered into prior to the COVID-19

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outbreak. However, that is now likely to change.

The exceptions to MAE clauses are normally subject to a disproportionate-effect exclusion, which returns the risk to the seller (i.e., giving the buyer the right to terminate) to the extent that an event falling into one of the exceptions disproportionately affects the target company as compared to other participants in the industry.

Courts have been reluctant to find that MAEs have occurred and thus allow buyers to terminate the agreements. However, in a recent case, *Akorn, Inc. v. Fresenius Kabi AG*, C.A., No. 2018-0300-JTL (Del. Ch. October 1, 2018), the Delaware Court of Chancery determined that an MAE existed and that the buyer had validly terminated a merger agreement. In so finding, the court observed that an MAE must “substantially threaten” the earnings potential of the entire business of the target “in a durationally significant manner.” The court also elaborated that the contracting parties should specifically articulate in their agreement the special circumstances or conditions that the parties believe constitute exceptions and exclusions to MAE provisions.

## **Is COVID-19 an MAE?**

For transactions for which agreements have been signed without specific inclusion of “pandemic” or similar words as exceptions to the MAE clauses, whether an MAE is deemed to have occurred ultimately depends on a facts-based inquiry showing whether the effects of COVID-19 substantially threaten the target’s overall earnings potential in a durationally-significant manner. Buyers would want to argue that COVID-19 will likely last for a prolonged period of time and will affect the target and its industry in particular disproportionately. However, due to its recent outbreak starting at the end of 2019, its duration and impact are not yet apparent and are hard to predict. Therefore, it may be premature to assess whether COVID-19 is likely an MAE for specific transactions based on its duration and industry impact. In that case, the buyers’ argument may not succeed. Furthermore, even if “pandemic” or similar words are not expressly excluded, to limit buyers’ ability to terminate the transactions, sellers would want to rely on other exceptions to the MAE clauses, such as conditions generally affecting a country and national calamity.

For ongoing negotiations for prospective transactions, the contracting parties should give careful consideration to crafting the MAE provisions in light of the COVID-19 outbreak. Sellers may want to add an express exclusion for COVID-19 and other pandemics, in which case the impact of COVID-19 will not allow buyers to terminate the agreements on the basis of an MAE. For example, some recent deals negotiated after the outbreak specifically include language such as “epidemic, pandemic or disease outbreak (including the COVID-19 virus)” [1] as exceptions to the MAE clause.

However, even when an MAE clause explicitly or generally includes language to exclude COVID-19 from the definition of an MAE (to the seller’s benefit), it may also include a disproportionate-effect exclusion (to the buyer’s benefit) to provide that such exception does not apply when the effect of COVID-19 outbreak has a disproportionate adverse effect on the target relative to the adverse effect it has on other companies operating in the same industry as the target.

## **What should a concerned party do now?**

If a party to a mergers and acquisitions transaction is concerned about whether the COVID-19 outbreak could constitute an MAE and thus impact the transaction, it is advisable to consult with legal counsel to review the language of the MAE clause in the agreement to determine if exceptions to MAEs include the COVID-19 outbreak explicitly or generally. Then, a facts-based inquiry should be

performed to evaluate how the COVID-19 outbreak has impacted the business of the target thus far and how it might do so in the long-term. Moreover, records and data demonstrating the financial impact, which may be needed later, should be accurately documented and properly maintained.

Other industry updates about the effect of COVID-19 on mergers and acquisitions

On March 17, 2020, the Antitrust Division of the Department of Justice (DOJ) announced that for mergers currently pending or that may be proposed, the contracting parties should add an additional 30 days to their timing agreements to allow DOJ to complete its review of the transactions after the parties have complied with document requests. This temporary change will remain in place during the pendency of COVID-19.

[1] Agreement and Plan of Merger, dated as of February 21, 2020, by and between Morgan Stanley and E\*TRADE Financial Corporation.

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