WINSTEAD

COVID-19's Effects on Material Adverse Events and other Deal Terms

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As the novel coronavirus ("COVID-19") continues to disrupt business practices across the globe, M&A transaction processes are increasingly being put on hold while the pandemic's true economic effects can be evaluated. Many M&A deal terms will likely face scrutiny in the upcoming months, but one in particular, the definition of "material adverse event" or "material adverse change" (collectively, "MAE"), will be of particular interest to both buyers and sellers.

MAEs Defined

MAE clauses are a tool used to allocate risks in a transaction by giving the buyer a "walk away" right whenever an event or change materially affects (or is adverse to) the target company or business. Consequently, as buyers continue to evaluate the ongoing scope of COVID-19's economic impact, they may increasingly attempt to claim MAE language as a means to temporarily suspend or completely terminate their transactions in the weeks and months to come.

Typically, MAEs "carve out" or exclude from their definition: Acts of God or other general, broad-sweeping economic changes or events, including acts of terrorism, war, natural disasters, coup d'état, presidential elections, etc., or other specific exclusion events that may affect the seller disproportionally when compared to others in the industry. Whether COVID-19 falls under these carved out exclusions will require analysis of each specific deal's MAE definition. Sellers may increasingly claim that COVID-19 does indeed fall under such MAE carve-outs, and that buyers cannot rely on this language to postpone or terminate transaction proceedings.

Prudent buyers and sellers should closely examine their current deal's MAE definitions to see whether the effects of COVID-19 (or other public health emergencies) are either included (pro-buyer) or carved out (pro-seller), and seek to clarify the same in any future transactions.

Buyer's Perspective

Buyers trying to enforce their MAE clauses will still likely be held to the high bar set by the Delaware Chancery Court in Akorn v. Fresenius[1]; where, for the first time, a buyer's claim of a MAE was upheld. The court in Akorn confirmed that for a buyer to effectively enforce a MAE provision, the seller must have endured a protracted period of adverse circumstances that is "durationally significant" and not a "short-term hiccup in earnings." Consequently, it is unclear whether COVID-19 will have the required temporal effects to truly be considered a MAE.

Additionally, buyers may seek to push for "disproportionate effect" provisions as a way to combat any MAE carve-outs. These provisions allow buyers to claim that, despite an event being carved out from a MAE definition, the event adversely affects the seller disproportionately as compared to others in the industry, and could be a second method buyers seek to postpone or cancel their transaction obligations.

Seller's Perspective

Alternatively, sellers in strong negotiating positions should push for COVID-19's carve-out from their deal's MAE definitions and limit buyers' attempts to expand their "disproportionate effects" safety net. Sellers might also start claiming that COVID-19 is a known factor, and that, accordingly, buyers should account for its effects in their diligence process and purchase price.

Sellers may also want to review their deal's specific representations and warranties, as they may have negotiated these prior to the COVID-19 pandemic, and certain representations and warranties (e.g. material contracts; workforce capability; liabilities; accounts receivable; holdings; etc.) may be affected. Moreover, sellers may also consider reviewing the operating covenants they made during a transaction. These covenants usually require a seller to continue operations in their ordinary course of business during the term of the transaction, meaning they usually cannot make material changes to their workforce, budgets, debt financing, material contracts, etc. – all of which may be necessary for sellers to weather the COVID-19 storm.

[1] Akorn, Inc. v. Fresenius Kabi AG, 2018 WL 4719347, at *53 (Del. Ch. Oct. 1, 2018), aff'd, 198 A.3d 724 (Del. 2018).