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Material Adverse Effect in the Uncertain World of COVID-19

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COVID-19 has spread throughout the world at devastating speed, causing unprecedented lockdowns and quarantines in numerous countries, disrupting global supply chains and plunging capital markets dramatically lower. Companies across a variety of industries have already experienced and anticipate future substantial declines in their businesses and financial performance.

For M&A transactions that have already been signed but have yet to close, and for those currently being negotiated, COVID-19 and its fallout increase the risk that buyers may try to walk away from transactions, or renegotiate central deal terms by asserting the target or borrower suffered a material adverse effect or material adverse change (MAE). For financing transactions, similar to the aftermath of the 2008 financial crisis when MAE clauses dominated headlines after several high profile transactions collapsed, COVID-19 and its fallout increase the risk that lenders may try to pull back their commitments claiming an MAE has occurred, as typically one of the conditions to financing is that an MAE has not occurred since a referenced date.

Complaints recently filed in the Delaware Court of Chancery may portend similar litigation trends while the world struggles with COVID-19. In that pending dispute, Sycamore Partners refused to consummate its affiliate's acquisition of a majority stake in Victoria's Secret and related businesses owned by L Brands, Inc. In its complaint filed on April 22, 2020, Sycamore Partners alleged that actions undertaken by L Brands in response to the pandemic and closure of its retail stores breached multiple provisions of the parties' agreement, and that an MAE had occurred. One day later, on April 23, L Brands filed its complaint seeking to specifically enforce certain obligations of Sycamore, and highlighting the continued minority ownership interest in the target businesses held by L Brands and similar commercial steps undertaken by Sycamore Partners' portfolio companies in response to COVID-19. Subsequently, L Brands and Sycamore Partners announced that they would settle the litigation and have mutually agreed to terminate the transaction agreement.

This article seeks to guide transaction participants in approaching what is a fact-intensive inquiry governing MAE determinations by highlighting key questions for self-analysis of potential MAE events. It offers practical suggestions to help those in pending transactions and negotiations begin to mitigate risks in connection with potential MAE litigation as an expected consequence of COVID-19 and the resulting turbulent market conditions.

Key Features of an MAE Clause

Courts scrutinize the specific language of

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the MAE clause at issue, and so transaction participants should pay close attention to the precise wording of the clause, particularly any deviations from the commonly used language in both M&A and financing agreements. MAE is a contractual construct which is deceptively simple in wording but complex in its application to specific events.

As traditionally drafted, a market standard MAE is defined as an event or circumstance that has had, or is reasonably expected to have, a material adverse effect on the target's business, assets, liabilities or results of operations. However, changes generally affecting the target's markets and industries, and items outside of the target, such as synergies, are usually excluded. Although New York and Delaware case law provides helpful guidance, each case is highly fact specific. The lack of clarity in interpretation of MAEs may actually advantage a buyer, which can leverage its threat of termination against the risk adversity of a seller to renegotiate more favorable terms whether or not it may actually have a viable claim.

Buyer bears the burden of proof but the seller bears substantial litigation risk. As a general matter, it is worth noting that courts, including in both the two recent 2018 Delaware cases, *Akorn, Inc. v. Fresenius Kabi AG, Quercus Acquisition, Inc. (Akorn),* the first case in which a Delaware court affirmatively determined an MAE had occurred, and *Channel Medsystems, Inc. v. Boston Scientific Corporation and NXT Merger Corp. (Channel),* the first post-*Akorn* Delaware case addressing an MAE determination, held that buyers bear the burden of proof in establishing the occurrence of an MAE.

Further, as explained in *Akorn*, "[a] buyer faces a heavy burden when it attempts to invoke a material adverse change clause in order to avoid its obligation to close" and that a detailed facts and circumstances determination is required. Nevertheless, in the negotiation context, counter-balancing the buyer's high burden of proof is the buyer's significant leverage created in calling an MAE, forcing the seller to consider the risk of a failed transaction on its business and the cost of the all or nothing litigation that may follow.

Does COVID-19 Trigger an MAE?

Because of the highly contextual nature of determining whether an MAE occurred, buyers, sellers and lenders should carefully evaluate the specific factual basis for any assertion of an MAE in light of the express language of the MAE provision. In light of this fact-specific inquiry and the evidentiary burdens imposed on the buyer, the existence of the COVID-19 pandemic and the impact of the fallout from it may or may not be an MAE. Indeed, target companies across industries, and within an industry, have been affected differently by COVID-19. While no one size fits all, some of the key common thematic questions that should be analyzed are discussed below.

Are pandemics specifically excluded? Most directly, the determination of whether the coronavirus triggers an MAE will be affected by whether, like most MAE clauses, 'acts of god' are excluded or whether, as had become common even before COVID-19, epidemics, pandemics or international calamity are excluded. It will of course be more difficult to prove an MAE has occurred as a result of COVID-19 if epidemics, pandemics and/or international calamity are expressly excluded in the MAE definition. According to a recent American Bar Association webinar, for example, approximately 80% of publicly filed deals signed in February 2020 expressly excluded 'epidemics' and 'pandemics' in the MAE definition, compared to less than 10% in January 2020.

Known risks and general market risks. MAE definitions very often, by some estimates, over 90%, provide exclusions for 'changes generally affecting target markets and industries' unless they cause specific disproportionate effects on

the target company. Case law in various states from prior downturns generally strongly supports the concept that general economic or market conditions are risks assumed by the buyer, but they are less clear on whether the buyer's pre-signing knowledge of actual or potential events precludes an MAE finding.

The application of these findings to the rapidly changing COVID-19 landscape which is at once (i) the world's general issue as well as (ii) a corporation's specific crisis, and which has been known in some form since January 2020, but with evolving understanding of its expected scope and detailed impact, will be a matter of contention by parties in MAE litigation and negotiations. The reasonableness of a claimed MAE will likely be significantly affected by the facts known with respect to the particular companies and industries at issue on the date the transaction was signed.

In favor of allocation of known and general market risks to the buyer is the landmark MAE decision, in *In Re IBP Inc. v. Tyson Foods Inc. (IBP),* where a Delaware court, applying New York law, declined to find an MAE. The MAE clause was silent on whether industry effects were specifically excluded. The buyer claimed an MAE because the financial performance of the seller, a beef producer, suffered due to cyclical effects in the meat industry and the *IBP* court specifically rejected the concept that industry wide factors were either automatically excluded from constituting an MAE or sufficient to automatically qualify as an MAE, and, instead held that an MAE clause is best read as "a backstop protecting the buyer from the occurrence of unknown events …."

However, the court in *Akorn* rejected the argument based on *IBP* that MAE provisions implicitly exclude risks that the buyer knew or could have discovered through ordinary due diligence and addressed through representations and warranties, emphasizing that the parties could have drafted appropriate carve-outs in the applicable representation and warranty.

Is failure of projections of the target enough?

The target's failure to meet its financial projections is itself generally not enough to create an MAE. A customary MAE definition usually allocates to buyers any risk of failure to meet financial projections and this allocation is reinforced by other provisions commonly included in negotiated agreements. In 2008, in the midst of the financial crisis, the Delaware court in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp. ("Hexion")* found that Huntsman, a chemicals company, had not experienced an MAE. Shortly after the signing, Huntsman showed poor quarterly earnings for 2008 and Hexion claimed the merger, if consummated, would produce an insolvent company, and therefore, an MAE had occurred.

The court noted that "poor earnings results must be expected to persist significantly into the future" to constitute an MAE. The court further noted that the merger agreement "explicitly disclaims any representation or warranty by Huntsman" with respect to any projections, forecasts or other estimates. Huntsman's failure to meet projections did not constitute an MAE as the parties had "specifically allocated the risk to Hexion that Huntsman's performance would not live up to management's expectations at the time."

Similarly, as is now less common, if the MAE clause specifically includes events that 'would reasonably be expected to be an MAE' or includes an event which is an MAE on the target company prospects, courts are likely to interpret such MAE definitions in ways that provide more buyer flexibility in terms of arguments that COVID-19 could be considered an MAE. Such forward-looking language will still require not a mere risk of an MAE but an evidentiary showing for such claim, and will tend to focus on how disruptive to business operations a particular effect appears to be.

Synergies of the target are no longer feasible, and the combined company may go bankrupt. In the current situation, a seller may be concerned that if it does not accept a price reduction, the combined company may go bankrupt, whereas the buyer may be concerned that the threat of bankruptcy by the combined company post-closing may not be an MAE. A court will generally not assess the materiality of a potential MAE from the perspective of a buyer's post-closing assumptions unless specifically required by the applicable MAE definition.

The court in *Channel,* for example, declined to take into account the buyer's calculation of loss, including anticipated merger synergies, noting that the target should be valued on a standalone basis. For example, if both the target and the buyer suffer a decline as a result of COVID-19 and the buyer would, as a result, be unable to satisfy the proposed business performance covenants under its financing post-closing, the buyer's decline would be irrelevant to an MAE analysis under guiding case law. Rather, a court's MAE analysis would focus on the target's independent and separate performance.

Are adverse events durationally significant, and how adverse are they? It has long been established that an MAE requires truly significant adverse events with a lasting impact on the target's business. In its final analysis, the court in IBP required an MAE to "substantially threaten the overall earnings potential of the target in a durationally significant manner." Prior to *Akorn*, an MAE had never been found to have occurred by Delaware courts, even in the wake of the stock market crash of 1987, the bursting of the tech bubble of 2001 and the financial crisis of 2008.

Courts have repeatedly determined that short-term adverse events, even dramatically negative quarterly results, earnings restatements and negative effects of 'acts of god,' such as unusually harsh winters, are not MAE events. Instead, they have focused on whether such events are 'durationally significant,' measured in years of decline in a target acquired by a strategic buyer, with possibly some flexibility for financial buyers.

Courts have evaluated whether in order to constitute an MAE, poor results are expected to persist significantly into the future and have a long-term or lasting impact in light of long-term acquisition strategies such as the multi-year horizon needed to integrate complex businesses. While the exact time horizon that is significant is factual, it is clear that the courts may consider the identity of the buyer and its investment horizon, for example, whether they are a strategic buyer with a longer time horizon, as was noted in *IBP*, and the period of time negotiated as the long stop or termination date upon which the transaction could be terminated.

In *Akorn*, by contrast, the court found a 'dramatic' year-long business decline based on business-specific problems that included, among other things, unexpected new market entrants competing with the target's top products and the unexpected loss of a key customer, with no signs of abating, a sufficient durational effect to constitute an MAE. Note that in *Akorn* the magnitude of the claimed MAE events was significant during this period. In *Akorn*, the remediation costs alone were approximately 21% of the equity value implied by the merger agreement, and court held that 20% "would reasonably be expected to result in an MAE." Channel noted that there is no bright-line quantitative test, but seemed to consider 20% as a floor.

Is it also a force majeure, or even something else? Unlike prior iterations of the MAE debate and case law related to solely economic contractions in 1987, 2001 and 2008, the question of whether COVID-19 constitutes an MAE will likely also be intertwined with similar questions of whether the events constitute force majeure, assuming the contract has such a provision, or whether such events implicated

the common law defenses of frustration or impossibility, if the contract does not include a specific force majeure clause.

Similar considerations from those described in this article are involved in such determinations, such as the language of the applicable contract, the nature and scope of the effect on a party's ability to perform its obligations under the contract, and, under some state laws, the steps the invoking party took to avoid the negative consequences of the virus. Most US states recognize common law doctrines similar to 'frustration' or 'impossibility.'

In fact, in a significant Delaware case arising out of the failure to close a transaction as a result of COVID-19, it was unclear from the complaint whether an MAE was invoked by the reticent acquirer. According to Bed, Bath and Beyond's complaint, its buyer, 1-800-Flowers, simply refused to close; while the MAE is described in the complaint, the complaint does not say that 1-800-Flowers expressly asserted an MAE or claimed force majeure, instead simply requesting a delay of the closing as a result of COVID-19 without a clear contractual basis.

Similarly, in another recent case, the We Company filed suit against Softbank in Delaware. Although there was no MAE termination right, other than an absence of MAE representation related to other closing conditions, in the financing and tender offer agreement, Softbank refused to close the transaction in response to circumstances alleged by We Company to be similar to an MAE.

Moreover, Woodward and Hexcel Corp. jointly called off their all stock merger of equals given the radical swings in value, both had recently fallen over 50% in value. These events indicate that COVID-19 may transcend some of the customary MAE arguments and involve new fact patterns and approaches than prior MAE case law arising during previous economic downturns.

MAE metrics and benchmarks. In the world of COVID-19, the length of the quarantine, business interruption, furlough or other adverse events will be relevant to determining an MAE. What we know is that the determination of an MAE and whether events are sufficiently severe to constitute an MAE will be intensely fact specific. When considering the measurements of materiality, courts will generally take into account both quantitative and qualitative aspects of the transaction in question.

Although financial metrics, e.g., impact on EBITDA, are the clearest indicators of adverse changes, courts are demonstrating a willingness to consider strategic benefits and risk profiles when assessing the materiality of adverse change. In *Akorn*, for example, the court referenced an 86% decline in EBITDA amongst other relevant circumstances referred to above, and upheld the MAE. By comparison, in *IBP*, the court found that a 64% drop in a beef producer's quarterly earnings as a result of a severe winter followed by a return to performance in line with prior years' results did not constitute a MAE.

Akorn is a 246-page decision that painstakingly reviews a detailed and lengthy post-trial factual record, but certain issues are likely to be particularly relevant. For example:

- How severe and durationally significant is the negative effect? And, how much is that effect related to the industry as a whole, generally allocated to the buyer, or the specific target company, generally allocated to the seller?

- Does the target company or the buyer have any evidence of wrong-doing or bad faith, such as:

  - Compliance problems? In *Akorn*, the courts found "overwhelming evidence of widespread regulatory violations and pervasive compliance problems."

  - Failure on the part of the buyer to diligently comply with its contractual obligations?

In *Channel*, where no MAE was found, the court believed that buyer Boston Scientific displayed a "lack of good faith" and that the buyer was "looking for a way out of its deal." The court's analysis focused on the fact that Boston Scientific did not generate a "single scrap of paper" assessing the impact of fraud by an executive on marketing of a new product, noting that the lack of any such documentation "casts doubt on the bona fides of the termination decision."

How to Limit Risk in Ongoing Contract Negotiations

When negotiating acquisition agreements, parties should specifically address how the current volatility affects the transaction. Buyers in particular should expressly provide if there are any risks arising from the outbreak that they are not willing to take in the form of express conditions.

Research the specific basis for making or responding to any MAE claim. Although it appears potentially obvious, because the determination of whether an MAE has occurred is highly contextual and will be evaluated against the specific language of and exclusions from the negotiated MAE definition, the facts of the particular company, the metrics related to such facts and the exact time period at issue will be critically important in assessing risk related to MAE claims. In addition, the parties should understand how COVID-19 affected other companies in the target's industry, and the extent to which the impact on the target may or may not have differed.

- *MAE definition changes.* In the short timeframe since the outbreak, parties are expressly addressing the 'elephant in the room' in multiple contractual provisions. Most directly, on the sell-side we are seeing more specific exclusions of pandemics, epidemics and COVID-19 in the definition of an MAE. We are also seeing similar express exceptions in force majeure clauses and express waivers of the doctrines of frustration and impossibility. Finally, there is significant resistance from sellers to include prospects and financial performance in the MAE definition, and buyer attention to the inclusion of carve-backs for disproportionate effects on the particular business.

- *MAE — market outs.* In particular, if a buyer is sensitive to closing in the face of adverse market conditions, they might consider including specific financial performance triggers relating to macro-economic or target-specific measures, e.g., Nasdaq or some other index falls more than a specified percentage, or specific EBITDA thresholds applicable to the target. Moreover, to lessen risk, buyers can try to expand the package of interim covenants in a purchase agreement, for example, include restrictions on borrowings, management of the workforce or plant shutdowns, which if materially breached would allow the buyer to terminate the purchase agreement, without liability.

- *Case law responsive definitions.* As courts are unlikely to account for post-closing synergies in determining whether an MAE has occurred, and the definition of durational significance is uncertain, buyers may consider negotiating to include express references to synergies or limitations on durational significance in the MAE definitions.

- *Reverse termination fees, quantified MAEs.* Reverse termination fees, payable by a buyer if the deal falls through, may become more common as ways to provide negotiated outs in the face of uncertainty. They are an existing market concept and as such have the advantage of clear and well thought out precedent. For example, following the previous financial crisis, some agreements started to include specific dollar thresholds that qualified as an MAE. This trend abated following improved market conditions, but the approach can be considered to provide clarity, particularly for transactions being negotiated during current turbulence.

- *Adjust outside dates.* Given the uncertain-

ties around how quickly any regulatory approvals may be obtained and that financing may now take more time, the parties may consider extending outside dates or including a provision in the purchase agreement for extensions based upon regulatory authority slowdowns or shutdowns. Longer outside dates may, however, impact the proof required to show a sufficiently durationally significant MAE.

- *Locked box deals troublesome for buyers.* Given uncertainties around target performance, we may see deals that initially contemplated locked box mechanics revert to the traditional working capital adjustment provision to limit risks in declining working capital for buyers. We also are seeing a new layer of negotiations to establish working capital targets since historic levels, a typical benchmark, may be less relevant.

By thoughtfully considering these and other factors, within the construct of contractual interpretation, parties can actively mitigate risk and more likely achieve their respective transactional goals.

Does Special Committee Approval Protect a Transaction Involving a Conflicted Board Majority?

By Steve Haas, Partner of Hunton Andrews Kurth LLP

In a recent case, the Delaware Court of Chancery held that a transaction in which a majority of the directors had a conflict of interest (a "conflicted board majority transaction") could still be subject to the business judgment rule if it was approved by a special committee of disinterested and independent directors. The special committee, however, must be in place from the outset of the transaction.

Court of Chancery's Opinion

In *Salladay v. Lev,* the Court of Chancery addressed a conflicted board majority transaction that was approved by a special committee.[1] Three of the six directors on the company's board were allegedly interested in a merger based on a variety of allegations, including that (i) they or their affiliates were rolling over "substantial portions" of their equity in the merger; (ii) one of them (the chairman and chief executive officer) received severance compensation and entered into an 18-month consulting agreement with the acquiror; and (iii) in connection with the merger, two of them exchanged existing notes held by the company for new convertible notes on more favorable terms.

In ruling on the defendants' motion to dismiss, Vice Chancellor Glasscock wrote that the standard of review for approving the merger, as a conflicted board majority transaction, was entire fairness unless the merger was approved by a special committee[2] or by a majority of fully informed stockholders under the Corwin doctrine.[3] He also held that the defendants had the burden of invoking either doctrine.

In examining the effect of the special committee in this case, Vice Chancellor Glasscock borrowed from controlling stockholder jurisprudence under

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1 C.A. No. 2019-0048-SG (Del. Ch. Feb. 27, 2020).

2 See also *In re Trados Inc. Sholder Litig.,* 73 A.3d 17, 55 (Del. Ch. 2013) ("The decision not to form a special committee had significant implications for this litigation. The Merger was not a transaction where a controller stood on both sides…. If a duly empowered and properly advised committee had approved the Merger, it could well have resulted in business judgment deference."); see also *Frederick Hsu Living Tr. v. ODN Holding Corp.,* 2017 WL 1437308 (Del. Ch. Apr. 14, 2017) ("If the board delegates its full power to address an issue to a committee, then the judicial analysis focuses on the committee. A decision made by a disinterested, independent, and informed majority of the committee receives business judgment deference."); *In re PNB Hldg. Co. S'holders Litig.,* 2006 Del. Ch. LEXIS 158, at *3-4 (Ch. Aug. 18, 2006) ("In this conflicted situation, the [] directors are bound to show that the Merger was fair… or to point to the presence of a cleansing device, such as approval by a special committee of independent directors or an informed majority-of-the-minority vote, in order to justify review under the business judgment rule.").

3 See *Corwin v. KKR Holdings LLC,* 125 A.3d 304 (Del. 2015).