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## Is the Coronavirus a Material Adverse Effect?

“Material adverse effect” and “material adverse change” terms (“MAEs”) serve a number of functions in M&A agreements. Most importantly, the MAE definition sets the parameters for which a buyer is permitted to terminate the transaction if there is a material adverse event affecting the target company or business. Many clients are now asking whether the recent coronavirus (COVID-19) outbreak and its effects constitute a material adverse event that could trigger an MAE termination right. The short answer is that, as of now, the effects of the COVID-19 outbreak would not likely constitute a material adverse event under the typical MAE provision due to the currently unclear duration of its impact and its broader global and cross-industry reach. However, stay tuned, as this may change depending on how long the outbreak lasts, whether it begins to affect particular companies and industries disproportionately and whether MAE provisions become more tailored to address this issue. Certainly, if negotiations are ongoing for a prospective transaction, careful consideration should be given to crafting these provisions in light of the outbreak.

### Basic MAE Principles

The typical MAE is defined as any development, event, condition, state of facts, etc., that have had, or would reasonably be expected to have, a material adverse effect on the business, assets, financial condition or results of operations of the subject party, but excludes various categories of broader market or industry risk. Common exclusions from the MAE definition include effects related to (i) general economic, business, financial, credit or other market conditions and (ii) any epidemic or other natural disaster or act of God,<sup>1</sup> but often only to the extent such effects do not disproportionately adversely affect the subject party versus others in the industry.

Notwithstanding that these provisions are often heavily negotiated, there is typically no express definition of the specific events or dollar amount of value loss that would constitute an MAE. As a result, it is left to the courts to determine whether there has been an MAE, and the courts do not apply a bright-line test. Under Delaware and New York law (in the seminal cases of *Frontier Oil Corp. v. Holly Corp.* and *In re IBP, Inc. Shareholders Litigation*, respectively), an MAE is deemed to have occurred if a facts-based inquiry shows that the effects “substantially threaten the overall earnings potential of the [party] in a durationally-significant manner.” As recently confirmed in *Fresenius v. Akorn*, the only Delaware case to have found an MAE in the M&A context (a case in which Paul, Weiss represented the buyer Fresenius), these effects must

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<sup>1</sup> For our client alert on force majeure clauses and COVID-19, please click [here](#).

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be material when viewed from the longer-term perspective—a “short-term hiccup in earnings” will not suffice.

### **Impact of the COVID-19 Outbreak on MAE Provisions in M&A Agreements**

As the COVID-19 outbreak continues to develop and affect markets and industries, buyers may well argue that its effects on a particular company constitute an MAE that justifies terminating a deal. As discussed above, however, an MAE must be durationally significant, and it is likely too soon to tell whether the COVID-19 outbreak or any of its effects will constitute a durationally significant event. At this time, it is difficult to predict the lasting impact of the COVID-19 outbreak for any particular company or industry, or across companies and industries, as the effects may vary. In short, there is no standard analysis as to whether the effects of the COVID-19 outbreak on a particular business would justify a party’s refusal to close on a deal under an MAE analysis. By its nature, this will be a fact-specific inquiry. Further, even if the COVID-19 outbreak is a materially adverse event for a particular company, the effects of the outbreak may qualify as an exclusion under the epidemic/force majeure and/or market exceptions to the MAE definition. The question then will be whether the COVID-19 outbreak has had a disproportionate impact on the particular business, which again, is a fact-specific determination.

All of this, of course, is dependent on the particular language of the relevant MAE provision. As the COVID-19 outbreak continues, it is likely that sellers will negotiate for more specific references to pandemics and epidemics in the exceptions to the definition of an MAE, just as terrorism exceptions became more commonplace following the events of September 11, 2001.

For private company transactions, it is worth noting that going forward, transactional insurance, such as rep and warranty insurance, is unlikely to be available for the effects of the COVID-19 outbreak because these policies usually exclude “known issues” from coverage.

### **Impact of the COVID-19 Outbreak on Debt Financing**

Typically, debt financing provisions use the same MAE definition as the related acquisition agreement, and, therefore, the same issues discussed above should apply. An additional concern, however, is that the lender (in addition to the buyer and seller) will be making a determination as to whether an MAE has occurred, including whether the COVID-19 outbreak qualifies as an exclusion to the definition. The analysis may be slightly different for lenders than it is for the parties to an M&A agreement. While courts have emphasized the importance of the long-term prospects of the subject party in M&A MAEs, they may take a different view or consider alternative facts in the financing context where a borrower’s short-term ability to make debt payments may be relevant. For example, in *The Mrs. Fields Brand, Inc. v. Interbake Foods LLC*, the court stated that, in the context of an MAE provision in a five-year license agreement, “the period of time that would be ‘commercially reasonable’ in determining whether a consequential decline in earnings has

had a material adverse effect on the license presumably would be shorter than the period of time relevant to the acquisition of [a] business.”

Practically speaking, this means that the parties to the M&A transaction could be prepared to close, but the lender could nevertheless refuse to fund if it concludes that an MAE has occurred. In such a case, the buyer may very well argue that an MAE has occurred and that it is not required to close the M&A transaction. However, under these circumstances, the buyer cannot rely solely on the fact that the lender’s analysis supports the occurrence of an MAE. The buyer will still be required to demonstrate (potentially in litigation) that an MAE has occurred, and, if unsuccessful, the buyer will likely be required to find alternative, more expensive financing or (more typically in private equity transactions) pay the seller a reverse break fee.

We will closely monitor the legal and business implications associated with the global fallout from the COVID-19 outbreak, and will continue to report developments.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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