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M&A Agreements and Material Adverse Effect in the Wake of COVID-19

Like almost all other aspects of our lives, the COVID-19 crisis is also affecting the ways in which parties approach the bargaining table in the context of mergers and acquisitions (M&A). Buyers and sellers are now thinking about the effects this global pandemic has had on target companies the subject of M&A transactions and the respective negotiating leverage of the parties thereto. Specifically, principals on both sides of the table are asking themselves whether COVID-19 rises to the level of a Material Adverse Effect (MAE) on a company's financials and operations for the purpose of closing—or terminating—an agreement to merge or acquire.

There is no "one size fits all" MAE provision, but, in general, it is intended to allow an acquirer to opt-out of a transaction if, before the actual closing, unexpected events have taken place such that the financial health and stability of the target company has materially and adversely changed. In essence, an MAE clause allows a buyer to pull out when it is no longer getting the benefit for which it bargained. Customarily, systemic risks—such as market fluctuations, natural disasters, industry-wide downturns, responses to geopolitical and national economic shifts, or in some cases even pandemics—are assumed by buyers, while particularized exceptions are reallocated to sellers as a means of ensuring due diligence and continued best practices during the period leading up to the final closing of a merger or acquisition. Such exceptions are tested against a foreseeability MAE standard in terms of whether the target company has been disproportionately affected by an incident (such as COVID-19) as compared to others in the market.

From a practical standpoint, it is critical that parties to M&A contracts be clear and precise with respect to exclusions and special conditions in an MAE context. If a pandemic, or other such global catastrophe, and its potential effect on a business are not specifically provided for, an analysis will necessitate a fact-based investigation; and will turn on whether the residual effects of such a widespread occurrence would materially and disproportionately disadvantage a company's earning potential for a substantial duration relative to other industry participants. Some articulable company-specific considerations may take into account a business's debt leverage, a unique supply chain model, a vulnerable location, or other conditions unique to that particular target company. As such, the gathering and proactive tracking of operational data, documented production delays, and other operational records evidencing impact on income are paramount. Such documentation can be utilized to trace the effects of COVID-19 on deteriorating financials, and potentially link the coronavirus to the materially altered valuation of the target company.

Aside from MAE provisions, there are other practical points to consider while negotiating M&A agreements. First, even if it is unclear whether an MAE has occurred, and thus has changed the "essence" of a deal, its potentiality may create a scenario wherein increased leverage on one side could result in the loosening of contractual protections on the other. Also, other sections in a contract to merge or acquire may come into play even if the high bar of an MAE is not implicated. Thus, it is important to consider the impact of a global event, such as COVID-19, when negotiating and drafting representations and warranties, covenants, extension carve-outs, project deadlines, and the like. Moreover, common law concepts such as frustration of contract, impossibility, or the duty of good faith and fair dealing may also serve as potential grounds to terminate a deal. Lastly, it bears noting that the U.S. Department of Justice, through its Antitrust Division, announced on March 17, 2020 that M&A parties should tack on an additional thirty (30) days to any timing agreements for deals currently pending or proposed during the pendency of COVID-19. This temporary announcement will facilitate the Department's backlog in its review of M&A transactions.

Please contact the Updike, Kelly & Spellacy, P.C. attorneys listed below for any questions regarding this client alert or questions related to corporate matters, including but not limited to, mergers and acquisitions.

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