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LITIGATION ADVISORY

Is the Coronavirus Pandemic a Material Adverse Event? It Depends.

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As the human toll of the novel coronavirus continues to rise, individuals, businesses and governments face a Hobson's Choice between preserving lives and livelihoods. A pandemic-related economic downturn may eventually threaten the economic fundamentals of many business relationships formed before the appearance of COVID-19. Legal and equitable concepts like force majeure, frustration of purpose, and impossibility may provide default rules for determining ongoing rights and responsibilities in some circumstances. In others, the parties will have allocated the risks of unexpected economic events beforehand, through the use of "Material Adverse Change" (MAC) or "Material Adverse Event" (MAE) provisions in their contracts.

This advisory examines the applicability of MAC/MAE clauses—particularly in purchase agreements—to a business downturn resulting from the coronavirus pandemic and offers practical guidance for parties facing those issues.

MAC/MAE provisions allow parties to allocate the risk of unforeseen events beforehand

A MAC/MAE provision in a contract allocates the risk that an unforeseen adverse event might impair a party's business operations in a way that alters the fundamental economics of the agreement. MAC/MAE clauses appear most commonly in transactions — like purchase agreements — with a significant lag between the initial agreement and closing, or in transactions where the parties commit themselves to perform over an extended period of time. Using MAC/MAE provisions, parties can decide who is best suited to bear the risk of unexpected changes in the economy, to an industry or specific to a party. The parties can then negotiate to set an appropriate price for accepting those risks beforehand. If an adverse event occurs, the courts will look to the specific language of the MAC/MAE provision, and to the specific circumstances surrounding the event, to determine which party agreed to bear the cost.

Courts and commentators, for example, recognize the ubiquitous use of MAC/MAE provisions in merger agreements to allocate general market risks to buyers and company-specific risks to sellers. Thus, a general downturn in the economy or throughout an industry may not relieve a buyer of its obligation to close a transaction. See, e.g., *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 71 (Del. Ch. 2001) (finding an industry-wide downturn did not cause an MAE). But, an unexpected event — even an industry-wide event — that disproportionally affects one enterprise may trigger a MAC provision. See, e.g., *Akorn Inc. v. Fresenius Kabi AG*, No. 2018-300-JTL, 2018 WL 4719347, at *1, *62 (Del. Ch. Oct. 1, 2018) (finding an MAE arose from company-specific problems or industry-wide conditions that affected the seller disproportionally).

Similar analyses may apply to MAC/MAE provisions in financing agreements, though the authorities are less numerous and the rules less clear. See *In re Lyondell Chem. Co.*, 567 B.R. 55, (Bankr. S.D.N.Y. 2017) (impending Chapter 11 filing did not excuse refusal to honor revolving credit agreement under terms of MAC clause); *Pan Am Corp. v. Delta Air Lines, Inc.*, 175 B.R. 438, 492-93 (Bankr. S.D.N.Y. 1994) (enterprise-specific year-over-year decline in business was a MAC that excused performance of financing agreement).

The COVID-19 pandemic is a systemic shock that may affect some firms disproportionally

The appearance of the novel coronavirus causing COVID-19 is a classic example of a known-unknown. Like war or weather, the parties to an agreement could anticipate the possibility of a pandemic disease affecting their contract, but no one can predict precisely when, where or how it may occur. Depending on the specific language of the contract, the severity of the effect and the degree to which a particular firm suffers in proportion to others, the spread (and efforts to combat the spread) of COVID-19 could give rise to a Material Adverse Change.

MAC/MAE provisions may require proof of a long-term enterprise-specific impact

The factors leading to opposite outcomes in two decisions by the Chancery Court of Delaware involving similar MAC/MAE clauses in two different merger agreements, may foreshadow the treatment of MAC/MAE provisions by courts in the era of COVID-19. In the first decision, the Chancery Court examined the effect of MAC/MAE provisions in an agreement obligating a large poultry producer, Tyson Foods, Inc., to purchase the stock of a beef and pork producer, *IBP*, Inc. See generally *IBP*, 789 A.2d at 14. Though initially exuberant, Tyson's ardor for the merger waned as the performance of both companies suffered during an industry-wide downturn. *Id*. at 22-23. Citing the significant decline in IBP's performance in the two quarters reported immediately after signing the merger agreement, Tyson sought to invoke the MAC/MAE provisions to avoid closing the deal. See *id*. at 65.

The court, however, found that IBP had not suffered a material adverse effect within the meaning of the contract. *Id*. at 71. Rather, the court viewed the two-quarter decline as a "short-term hiccup" that was not material "from the longer-term perspective of a reasonable acquirer." *Id*. at 68. Tyson offered no evidence to suggest that the short-term decline in IBP's performance translated into a long-term diminution in value. See *id*. at 69-70. Instead, Tyson appeared to suffer what the court termed "buyer's regret" as a result of an industry¬wide downturn that adversely impacted Tyson's performance, as well as that of IBP. See *id*. at 22.

In the second decision, the Chancery Court examined the effect of MAC/MAE provisions in a merger agreement between two pharmaceutical companies. See generally, *Akorn*, 2018 WL 4719347 at *1. The dispute arose when the financial performance of the seller, Akorn, Inc., "fell off a cliff" after entering into a merger agreement with the buyer, Fresenius Kabi, AG. *Id*. Though Akorn assured Fresenius that the decline was temporary, Akorn's performance continued to slide throughout the year. *Id*. at *2.

In addition, an anonymous whistleblower raised credible concerns about regulatory compliance issues that Akorn was unable adequately to address. *Id*. These issues led Fresenius to invoke the MAC/MAE provisions to terminate the merger agreement after roughly a year of due diligence, investigation and negotiation with Akorn. *Id*. Finding in favor of Fresenius, the court distinguished the facts of the case from those presented in *IBP*. See *id*. at *3. Unlike the buyer in the earlier case, Fresenius presented evidence of unexpected year-over-year declines in performance at Akorn that decreased the long-term value of the target company. *Id*. at *54-55. Moreover, those declines were not the result of an industry-wide downturn. *Id*. at *58. Rather, they resulted from regulatory issues specific to Akorn or from industry-wide factors (e.g., the entrance of new competitors) that affected Akorn disproportionally as a result of its product mix. See *id*. The risks at issue in *Akorn* were thus business-specific risks that the MAC/MAE provisions allocated to the seller (Akorn), rather than systematic risks that the MAC/MAE provisions allocated to the buyer (Fresenius). See *id*. at *62.

Whether a disruption relating to COVID-19 qualifies as a MAC/MAE likely depends on several factors

The result in *IBP* suggests that courts may be reluctant to find a material adverse change relating to a COVID-induced downturn if the downturn (1) lasts months, rather than years; (2) does not adversely affect the long-term prospects or operation of the business; or (3) is felt equally across the economy or industry. By contrast, the result in *Akorn* suggests that a court may find a material adverse change relating to COVID-19 if the downturn (1) lasts years, rather than months; (2) adversely affects the long-term value or operation of

the business; and (3) is felt disproportionally by a specific firm, as compared to others. In addition to examining the specific language of the contract and the potential nuances of the governing state law, parties invoking or defending MAC provisions should thus consider:

- The duration of any COVID-related economic decline;
- The potential for long-term impairment to the value of the business or substantial disruption to operations; and
- The presence or absence of special harm to the particular business at issue.

For example, a "V-shaped" downturn (a sharp fall with a quick recovery) in the performance of a business may not qualify as an MAC/MAE — especially with a long-term investment contract — because the "V" presents a "short-term hiccup" for the firm. A "U-shaped" downturn (a sharp fall with an extended downturn followed by a substantial recovery) may not qualify as an MAC/MAE if the evidence shows that the business retains its long-term value. Instead, an "L-shaped" downturn (a fall with an extended period of underperformance and little recovery) is the most likely to constitute an MAC/MAE. Even an extended downturn, however, might not suffice if the decline is pervasive throughout the economy or an entire industry. Rather, an MAE/MAC tends to occur most often when the underlying conditions in the specific client base, supply chain or other structures of an enterprise leave it particularly susceptible to disruption. Of course, as in all cases of contract interpretation, the specific language of the contract will ultimately dictate the result.

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