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M&A MAC Clauses – Implications of Coronavirus

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Trends in Material Adverse Change Clauses – Implications of Coronavirus on M&A Transactions

On M&A transactions deal certainty may be a key negotiation issue. Whilst a seller may be reluctant to concede a material adverse change (MAC) or material adverse effect (MAE) clause, in the current climate the buyer may be concerned about pre-completion changes and push hard for it. We face unprecedented market conditions, given the scale and speed with which the coronavirus situation is developing. Businesses may experience customer, workforce and supply chain issues which emerge and develop quickly. Sellers may be concerned a buyer might use this to try to delay completion and force the price down, but a buyer will still have a high hurdle to meet to be able to invoke a generic MAC clause successfully.

What is the approach to MAC clauses on UK M&A deals?

The English courts will seek to apply the bargain that the parties have made. A buyer will get considerably more certainty from a MAC clause expressed to be triggered on specific events with specific consequences than from a generic MAC definition. For example, a drop in revenue will be easier to invoke as a MAC event where the MAC definition expressly includes a specific drop in revenue over a specific period as a MAC trigger than where the MAC definition is merely generic (such as matters affecting the business, financial condition, operation or liabilities of the target). This is particularly so as, most commonly, M&A MAC clauses only apply where a change occurs to the target between signing and completion. Without a specifically-worded formulation, this will be hard for a buyer to prove in relation to effects from an ongoing and global health crisis which already existed pre-signing.

What about broad "market MACs"?

It is clear that a generic MAC clause or "financial condition" trigger alone does not encompass other matters, such as the prospects of a company or external economic or market changes. For a MAC clause to catch such matters, they must be covered expressly in the clause. The difficulty for buyers contracting now is that they are likely to be treated as having "bought into" the current market volatility from the coronavirus crisis. A buyer would have a heavy burden of proof, even under an express "market MAC", to demonstrate:

- an impact on the target's earning-capacity viewed in the long-term and that will persist in a durationally-significant way[1] (usually years, rather than months or a comparison between consecutive quarters, and meaning a temporary[2] or short-term blip is not enough)[3];
- probably some sort of disproportionate effect on the target compared to other industry participants; and
- in an M&A context, a significant change in the broad types of financial and economic challenges the target faces which has arisen since signing.

Notwithstanding this, we are in uncharted territory. What distinguishes the coronavirus outbreak from the more politically-driven developments which have impacted on market-wide conditions in recent years, such as Brexit, is the pace with which it is spreading and its effects unfolding. Sudden lockdowns, quarantines and travel restrictions can impact on a company's supply chains and interrupt its business and operations. Companies may experience reduced demand, contractual performance may be impeded and risk of default under debt finance or of material litigation increased. However, a buyer would still have a high bar to reach to meet the above tests, particularly on durational significance.

How severe need the downturn be?

It depends on the nature and size of the deal and the business. In the *Levison v Farin*[4] UK case the court said a 20% drop in net asset value would be material for a warranty on no MAC in net asset value. It is also clear that a MAC would not be triggered by substantial downward revisions to a target's financial forecasts alone. A claimant would need a causal effect giving rise to a MAC, and the fact of revising the forecasts itself is not enough.

There is more guidance from US cases, to which the English courts may have regard. In *Akorn v Fresenius*[3] the Delaware Chancery Court decided that Akorn had suffered an MAE where its financial performance had "dropped off a cliff" (for example, revenue, operating income and earnings per share fell by 25%, 105% and 113%, and its ebitda and adjusted ebitda fell by 86% and 51% respectively, where the drop showed no sign of abating). In the *Hexion v Huntsman*[5] Delaware case the court found that ebitda, rather than earnings per share, was the right benchmark on a cash acquisition. Poor quarterly results showing a 3% drop in ebitda were viewed there as more of a hiccup than a sign of long-term change. The court said that only 25% of Huntsman's ebitda had suffered significantly after signing the merger agreement and this was just a function of the company's cyclical business.

How does the "financial condition" benchmark work?

If asked to assess the impact of a change on the target's "financial condition", an English court would generally do so on the basis of accounting metrics and the change would need to be significant. In the UK *Thomas Witter v TBP Industries*[6] case the court said that a warranty on no MAC *in the financial or trading position* of a business encompassed the balance sheet and current profitability and performance against budget. In the UK *Levison v Farin*[4] case the underlying warranty *(no post-balance sheet MAC in net asset value)* expressly used the balance sheet as a benchmark *("on the basis of a valuation adopted in the balance sheet allowing for normal trade fluctuations")*. In *Urvasco v Carey*[7], the High Court said the financial condition of a company during an accounting year can usually be established from interim financial information and/or management accounts, but this is not necessarily limited to the company's financial information. There may be compelling other evidence to show a

1 *Grupo Hotelero Urvasco S.A. v Carey Value Added S.L. and others* [2013] EWHC 1039 (Comm).

2 *Decura IM Investments LLP & others v UBS AG* [2015] EWHC 171 (Comm) and *Thomas Witter v TBP Industries* [1996] 2 All ER 573.

3 In *Akorn v Fresenius* Del. Ch. Oct. 1, 2018 the Delaware Chancery Court emphasized you needed to look at years rather than months, but allowed a MAC to be invoked where a dramatic downturn had lasted a year and showed no signs of abating.

4 [1977] 2 All ER 1149.

5 Del. Ch. Sept. 29, 2008.

6 [1996] 2 All ER 573.

7 *Grupo Hotelero Urvasco S.A. v Carey Value* Added S.L. and others [2013] EWHC 1039 (Comm).

sufficient adverse change to trigger a MAC clause, such as where the relevant company had ceased paying bank debts and instigated a wider group restructuring. In the Delaware *Hexion v Huntsman*[5] case, before addressing prospective elements, the court said that the terms "*financial condition, business, or results of operations*" were terms of art, to be understood with reference to their meaning in the context of the financial statements public companies must file with the SEC.

What is the effect of the buyer's knowledge?

The analysis depends on the governing law and varies in different jurisdictions. Under English law it is clear that, where a generic MAC clause is relied on, a party invoking the MAC must not be aware of the relevant state of affairs when it enters into the agreement.[7] Where events are reasonably foreseeable before signing the SPA, a buyer is likely to be treated as having accepted the risk. Buyers entering into English law agreements containing generic MAC clauses now are likely to be treated as being on notice of the global health situation. Analysis of pre-existing contracts would need to focus on those entered into before the health concerns became widely known and which still have live MAC provisions, particularly if they include prospective MAC wording. Having said that, these are highly unusual times, and the scale and speed with which the coronavirus issue is developing is unprecedented for its potential impact on modern M&A agreements. Depending on a company's particular business circumstances, it could face consequences particular to its operations from the spread of coronavirus which emerge and develop very quickly, such as supply chain problems, staff shortages or production delays. However, it is clear that specific (rather than generic) MAC clauses are easier to enforce. Parties would get more certainty by specifically addressing such issues when entering into new agreements.

Drafting tips for parties to Private M&A deals?

Specific MAC formulations

- Depending on the target's key geographies, supply chains and trading links, a buyer may want to make loss of orders or of meeting orders underpinning the target's business, production interruption or business interruption, or a more general fall in profits, specific MAC triggers or to expressly bring them within a more generic MAC definition.
- A MAC trigger linked to a specific drop in meeting orders or loss of contracts or to a specific materiality threshold (such as a specified fall in profits) will bring more certainty than a formulation tied to the consequences of coronavirus more generally (where the buyer would need to show a causal effect giving rise to a MAC).
- By contrast, a seller should try to expressly exclude such events and, more broadly, general economic and market conditions, including epidemics, pandemics or outbreak of disease such as coronavirus and their effects, as a basis for termination.

Other drafting issues

- A buyer could also try to shift the burden of proof away from it by requiring a confirmatory "bring-down" certificate from the seller as to no MAC having occurred (although rare on UK deals).
- A buyer should also resist a specific performance clause in the agreement.
- On the other hand, the seller should try to resist a prospective element to the MAC (so that it is limited to the actual, current impact of an event, not likely or potential future impacts).
- The seller should also try to limit the scope of the MAC definition so that only a single event can trigger the MAC (which would mean no aggregation of a number of consequential effects of the coronavirus situation).

Practical tips on UK public takeovers?

In a UK Public M&A context it is standard to include a MAC condition to the offer, although this can only be invoked if something exceptional and of a specific nature occurs and no bidder has succeeded in demonstrating this.[8] Alternatively, a bidder may be able to invoke a condition covering specific events which it can demonstrate to the Takeover Panel are material to it in the context of the offer. Again, the focus is on specifically-worded formulations. One example was Pension Corporation's offer for Telent in 2007, which was subject to a condition that no changes were made to Telent's pension scheme, including its trustees. The Takeover Panel ruled that the bidder could rely on this condition to lapse its offer when the Pensions Regulator intervened and appointed three new trustees (although ultimately the condition was not invoked). On Riccardo Silva and Marco Auletta's offer for Electric World plc in 2017 a specific offer condition, particular to the target's circumstances, was expressly drawn to shareholders' attention in the firm offer announcement (designed to protect against increases in expenditure, where the offer price had been based on specific levels of cash reserves). Visa International Service Association's offer for Earthport PLC (announced in 2018) and Connect Airways Limited's offer for Flybe in 2019 both contained specifically-worded Brexit-driven regulatory conditions (on the risks of loss of passport rights under the Payment Services Directive or ceasing to maintain the requisite air operating licence, respectively).

Alternative bidder approaches may be to invoke the acceptance condition, if that remains unsatisfied after a closing date, or non-satisfaction of a condition on shareholder approval or EC or UK anti-trust or other regulatory conditions.

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[8] See the UK Takeover Panel's Statement No 5 of 28 April 2004 on invocation of conditions, following its previous refusal to allow WPP to invoke the MAC condition to its offer for Tempus (Panel Statement 2001/15).