ALERT MEMORANDUM

Return of the MAC? – Protecting Buyers During a Pandemic

30 March 2020

The full impact of the COVID-19 pandemic on M&A in 2020 remains to be seen: some potential buyers have put dealmaking on hold while others eye reasonably-priced targets and want to proceed (cautiously) if they can be protected against the situation becoming even worse. Many have little choice, having already signed before the crisis began to unfold, but may be caught out by financing no longer being available.

Do MAC/MAE provisions offer a way out of deals that are no longer attractive? Could mismatches in MAE exceptions force buyers to close even as their lenders walk away? What protections can buyers build in to deals that have not yet been signed? After several years of seller-friendly terms, could the current crisis present an opportunity to make deal documents more buyer-friendly, including through use of MAC clauses?

In this memorandum, we highlight the main challenges when drafting or trying to invoke a MAC/MAE condition to protect a buyer against any adverse effects brought about by the COVID-19 pandemic, the risk to buyers of differences between M&A deal documents and credit agreements, differences in approach to MAC/MAE provisions in the U.S., UK, France, Italy, Germany and Russia, and some alternative options to protect buyers in deals being negotiated during the pandemic.[1]

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[1] The authors are grateful to the following for their assistance in the preparation of this memorandum: Tom Jemson, Elisabeth Macher, Timofey Neklyudov and George Taylor.

[EMEA_ACTIVE 300485150_1]

KEY TAKEAWAYS

Five key points to take away from this memorandum are:

1. **MAC/MAE conditions are difficult to invoke:** In all of the jurisdictions we have considered, invoking an existing MAC/MAE condition due to the COVID-19 pandemic will be challenging and carry significant litigation risk.

2. **Careful drafting required for COVID-19 coverage:** Buyers currently in negotiations should carefully craft MAC/MAE conditions so that they mitigate the risk of a seller arguing that the condition cannot be triggered due to the COVID-19 crisis commencing pre-signing and include triggers relating to short-term defined impacts on the target business within specified parameters.

3. **Financing may not be available where credit agreements contain broad MAC/MAE 'outs':** Buyers relying on non-deal-specific facilities to finance closing of a transaction should check whether the credit agreement contains broad MAC/MAE 'outs' that are more favourable to lenders than any MAC/MAE condition in the sale and purchase agreement.

4. **Other options available to combat COVID-19 risk:** MAC/MAE conditions are not the only option available to protect a buyer against COVID-19 risk. Potential alternatives (addressed in more detail below) include (i) specific COVID-19 warranties brought down as closing condition; (ii) robust interim operating covenants; and (iii) deferred consideration or split investment structures.

5. **Expect significant Seller push-back, but now is the time to ask**: Sellers will be very resistant to buyers attempting to shift COVID-19 risk to the seller and any clauses addressing the matter will be heavily negotiated.

DIFFICULTIES INVOKING MAC/MAE CONDITIONS

Conditions precedent that a material adverse change ("MAC") or material adverse effect ("MAE") has not impacted the target are designed to allow a buyer to walk away from the transaction (or renegotiate) prior to completion, on the occurrence of certain events that have a significantly detrimental long-term effect on the target company or business. MAC/MAE provisions are essentially a tool for allocating risk between the parties, transferring from the buyer to the seller the risk of fundamental adverse changes in the target business occurring in the period up to completion.

MAC/MAE provisions are often drafted in a "catch-all" manner, designed to capture unpredictable and unforeseen events or circumstances which would otherwise be difficult to cater for specifically in documentation. Indeed, who negotiating a deal in December 2019 could have predicted that a pandemic would arise a few weeks later with such massive impact on the world economy? Yet, in some jurisdictions this lack of specificity can make these clauses too vague to be enforceable in practice and in others (including the US), specific or not, the courts have established such a high standard for a MAC/MAE that the provisions are rarely invoked. In addition, MAC/MAE clauses often have extensive carve-outs for matters that affect the industry or economy as a whole, so the risk is likely to fall on the buyer unless the adverse effect is unique to the target company or, in the case of economy- or industry-wide adverse effects, the target is (significantly) disproportionately affected relative to others in the same industry.

Buyers should be aware that even the most carefully crafted MAC/MAE provision will not necessarily allow them to walk away from (or renegotiate) a deal. Invoking a MAC/MAE may simply lead to a prolonged dispute as to whether the right to walk away has in fact been triggered. In some cases, a seller may be willing to renegotiate a transaction to avoid the cost and risks of pursuing litigation. However, proving the occurrence of a "material adverse effect" is a very high bar, even when unforeseen circumstances arise.

Courts (especially in the U.S.) will likely be very reluctant to allow buyers to walk away from deals signed up after the impact of the outbreak was already partially apparent. Although the more severe and unpredictable the impact, the likelihood of success may increase, in some jurisdictions only the most extreme circumstances may be sufficient.

In the US, Delaware courts have stated that to give rise to a MAC/MAE, the adverse effect must result in a significant and substantial deterioration in the target's business for a durationally-significant period of time. Indeed, there has only been one case in Delaware where the buyer has been allowed to walk away from a deal due to the occurrence of a MAC/MAE. In that case, the court found that the target company was in "persistent, serious violation" of applicable law and had a "disastrous culture of non-compliance". In addition to serious regulatory violations, the target company's EBITDA and EBIT declined by 55% and 62%, respectively year-over-year and its equity value declined by 21%.

Under English law, it is essentially not possible for a buyer to invoke a generic MAC/MAE clause if it was aware of the relevant state of affairs when signing, and difficult to do so even if it was not aware of such events but they were reasonably foreseeable. In a UK public deal, MAC/MAE conditions are common but to date never successfully invoked, although conditions related to specific events may allow an 'out' from the bid if material in the context of the offer.

In Italy, MAC/MAE clauses have hardly been enforced and are typically discussed in the context of confidential arbitrations, which results in the absence of clear guidance as to the requirements for triggering them. Specific negotiation and accurate drafting of a MAC/MAE clause are key, considering that the rules on contract interpretation focus on the wording of the clause and the true intention of the parties. Absent a specific MAC/MAE clause, other contractual or statutory remedies may be available to a buyer willing to walk away from the deal or renegotiating its terms. While the bar is normally high, the unprecedented nature of the COVID-19 pandemic and the extraordinary measures taken by the Italian government to address it suggest that a more buyer-friendly approach may be adopted, unless the effects of the pandemic were known or clearly foreseeable when the buyer negotiated and signed the deal.

Under German law, precise drafting of the MAC/MAE clause is pivotal. The parties need to clearly set out what kind of risk allocation they intend to agree on; for example, whether a defined aggravation of the general economic circumstances would suffice, or if the MAC/MAE clause should instead be triggered by a specified impact on the target company. In German public deals, MAC/MAE conditions are accepted in the offer document; however, the regulator (BaFin) requires that the MAC/MAE condition refers to key figures that can be determined objectively, based on accepted accounting principles or even legal terms.

Under French law, difficulties also exist when it comes to invoking MAC/MAE provisions. There is no useful guidance from French courts as to how they would apply a MAC/MAE provision, and parties should therefore be very careful to clearly define the trigger events, the reference period, and the consequences of such a provision to make it enforceable. This is true for both private and public deals. It should be noted that MAC/MAE provisions cannot be included as conditions precedent of a public tender offer. In practice, parties may agree to include such a provision in a business combination agreement (usually signed between the buyer and the target upon announcement), which the buyer can invoke to walk away before the public tender offer is filed with the French market regulator (the AMF); however, once the public tender offer is filed, only limited conditions precedent are permitted by the general regulation of the AMF, which do not include a MAC/MAE condition.[2]

In Russia, it is equally difficult to rely on MAC/MAE clauses to exit from a sale and purchase deal due to a pandemic. Although a lot will depend on how these clauses are drafted in the contract, their application is

[2] For information on the recent emergency law passed by the French Parliament in light of COVID-19 and the implications for certain contractual provisions, see our memorandum published on 26 March 2020: https://www.clearygottlieb.com/-/media/files/alert-memos-2020/covid19-the-french-government-issues-orders.pdf

largely untested in practice and is highly likely to result in litigation. Article 451 of the Russian Civil Code provides for a statutory MAC concept, but (i) there is extensive case law barring its application (even by consumers) in case of economic shocks, currency depreciation and other events affecting business in general, and (ii) normally, the parties would expressly opt out of this article in their agreement.

Given the very high bar for establishing that a MAC/MAE has occurred, and especially where there is any doubt about whether the particular circumstances fall within the definition, there will be significant litigation risk associated with invoking a MAC/MAE condition due to the COVID-19 pandemic, particularly given that the COVID-19 pandemic is now known to buyers.

In addition to MAC/MAE provisions, buyers should carefully consider other remedies, in particular any contractual and statutory termination rights that may be available to them under the relevant governing law.

FORCED TO CLOSE, WITHOUT FINANCING? MAC/MAE CONDITIONS IN CREDIT AGREEMENTS

While conditions (including MAC/MAE provisions) in deal-specific acquisition finance documents are generally drafted to track the conditionality in the underlying M&A deal documentation as closely as possible, MAC/MAE definitions in other credit agreements that the buyer may have readily available often do not have the litany of exceptions for matters that affect the economy or industry as a whole that are found in M&A agreements. This raises the possibility that a buyer planning to rely on its credit agreement (rather than deal-specific acquisition financing) to close a deal may find that it has no 'out' under the M&A documentation but that its lenders are not required to fund under the credit agreement.

NEW DEALS: HOW TO DRAFT MAC/MAE PROVISIONS THAT ACTUALLY OFFER PROTECTION

The principal and obvious obstacle to including a MAC/MAE condition that shifts the risk associated with COVID-19 to the seller is that the seller will be very reluctant to accept it.

In fact, while there is not yet much evidence of buyers successfully including COVID-19 MAC/MAE conditions, many recent publicly-filed merger agreements have included seller-friendly provisions that expressly exclude the impact of pandemics/epidemics generally or COVID-19 specifically (some subject to disproportionate effect qualifiers). Indeed, even prior to the COVID-19 pandemic, the typical MAE carve-outs in M&A agreements (such as changes affecting the economy or industry generally, acts of God or nature or even changes in law (in the case of quarantine orders)) would likely allocate COVID-19 related risk to buyers, unless the target was disproportionately affected relative to others in the industry.

Aside from this, there are three main challenges with drafting a MAC/MAE condition now, to capture any adverse effects on a target company brought about by the COVID-19 pandemic:

I. Timing: MAC/MAE trigger measured against signing or last accounts?

M&A agreements typically include a representation that there has been no MAC/MAE since the date of the target's last audited financial statements and through the date of the agreement. M&A agreements also typically include a closing condition to the effect that there has been no MAC/MAE since the date of the agreement. The representation and the closing condition work together to afford the buyer protection, and potentially the right to walk away, in the event that a MAC/MAE occurs after the date of the target's last audited financials and prior to closing.

Some M&A agreements only allow a buyer to invoke a MAC/MAE that occurs between signing and closing (e.g. because, as is usual in some jurisdictions, the agreement does not make closing conditional on there being no warranty breach and does not have the relevant warranty repeated at completion with a right to rescind for breach). In this case, unless the current economic impact of COVID-19 on the target business substantially worsens (which is still possible, given the fast-moving development of market changes related to the COVID-19 pandemic), a buyer signing today would find it very challenging (if at all possible) to argue based on usual drafting of a MAC/MAE condition that the condition is triggered by a pandemic that existed prior to signing. Therefore, if

circumstances allow, it would be preferable to draft the condition such that the financial impact is measured from the financial position in the year-end accounts that immediately preceded signing, rather than from signing itself.

II. Awareness: Risk of buyer's knowledge jeopardising protection

Even in the absence of an express carve-out from the MAC/MAE condition for COVID-19, a seller will likely argue that the buyer's general knowledge of COVID-19 (and its likely economic impact prior to signing) prevents it from seeking to trigger the MAC/MAE condition.

In order to mitigate this risk, it would be advisable for a buyer to (i) include a specific limb of the MAC/MAE definition that explicitly includes disproportionate adverse effects to the company arising from COVID-19, rather than rely on generic MAC/MAE language, and (ii) clarify that the specific COVID-19 limb is not qualified by disclosure or knowledge. Such drafting would also be looked upon more favourably by the courts, as they are more likely to enforce a clause expressed to be triggered by specific events, as opposed to a generic MAC/MAE.

III. Metrics: Durationally-significant effect on financial condition of target company

The generic "financial condition" benchmark that is usually found in a MAC/MAE condition tends to hinge on the long-term (rather than short-to-mid-term) effects on the target, which poses a challenge given the unknown long-term impact of the COVID-19 pandemic.

One way to address this issue would be to tie the MAC/MAE trigger to, or include as separate closing conditions, objective and specific financial or operational metrics related to the impact of COVID-19 over a defined period of time (e.g., specific monetary or % thresholds for: (i) fall in profits; (ii) loss of orders or customers, (iii) production interruption; (iv) supply outages; and/or (v) termination of material contracts, measured between 1 January and 30 September or year-end). This was an approach that, while not ubiquitous, gained some traction during the global financial crisis of 2007-2008, but has largely disappeared since, except in very limited circumstances. Using objective and specific financial or operational metrics allow the parties to define with specificity the terms on which the buyer would be allowed to walk away from the deal, without importing into the provision the MAC/MAE case law, which establishes a very nebulous—and very high—bar for declaring a MAC/MAE.

As explained above, the more specificity and clarity in the drafting, the better the chances that a buyer could successfully invoke a MAC/MAE condition or a separate tailored closing condition. Buyers should be aware, however, that such specificity and clarity may be viewed as a very buyer-favourable clause relative to the jurisprudence on MAC/MAE clauses and sellers may vigorously resist the inclusion of such provisions.

POSSIBLE ALTERNATIVE PROTECTIONS

The impact of COVID-19 is wide-ranging and unprecedented. Desperate times may justify novel solutions.

MAC/MAE based on market conditions

In some cases a buyer may be more concerned with its ability to fund a transaction in the current economic climate, rather than the impact on the long-term performance of the target business. (This may be relevant, for example, where a private equity buyer is concerned about financial markets seizing and their limited partners being unable to contribute capital when called.)

We have seen some counterparties and clients consider a MAC/MAE condition that is triggered by a materially adverse change in market conditions due to COVID-19, as opposed to being triggered solely by materially adverse changes in the target company's performance.

A seller in a position of strength is less likely to accept this than a company-specific financial or operational metrics. Even though linked to the market rather than only the company, the points noted above remain relevant, in particular ensuring that the triggers for the MAC/MAE condition are sufficiently clear. In addition, given the lack of cases interpreting such a market-based MAC/MAE provision, it is unclear how the courts would view such a provision.

While it may still seem a request too far, the unprecedented nature of this crisis and the possibility that it may still worsen raise the question of whether buyers may also start to ask for a financing 'out'.

Standalone COVID-19-Specific "Improvement" Condition

Another option that we have seen parties discuss is a standalone, specific closing condition that sets out clear criteria for improvement in business metrics, that could only in practice be satisfied if there is a material improvement in adverse effects of the COVID-19 situation by closing. A seller, however, is unlikely to agree to a closing condition that could only be satisfied if its business improves, particularly in the current economic climate.

MAC/MAE Warranty

In non-US jurisdictions, buyers could try to include the US-style representation described above (that there has been no MAC/MAE since the date of the year-end accounts) and make closing conditional on there being no warranty breach / have that warranty repeated at completion with a right to rescind for breach. Such approach has been taken in particular in some recent non-US public M&A deals.

When taking this approach, buyers should be mindful that well-advised sellers will make as many specific disclosures as possible about the potential impact of COVID-19 on their business. Accordingly, if buyers are seeking to protect themselves against COVID-19 risk through such a warranty, buyers should be clear that such disclosures do not qualify the MAC/MAE warranty (or standalone MAC/MAE condition).

Earn-Out

A wholly different option to those already listed would be to use an earn-out pricing structure whereby future payments from the buyer would be contingent on the material improvement of those areas of the target's business suffering as a result of COVID-19. Such a solution would be most relevant for target companies in sectors most adversely affected by COVID-19 (e.g., restaurants and hospitality, aviation and transport, and entertainment)

By agreeing to an earn-out, a seller will likely be accepting a lower price at closing but in some circumstances this may be a more palatable alternative for sellers (particularly those forced into a fire sale), as it would increase completion certainty and certainty around at least a portion of the value the seller believes it should receive, with the potential for additional upside. However, as with any earn-out, it would require complex negotiation and careful drafting.

Interim Operating Covenants

Sellers typically agree to conduct of business covenants that require them to operate the target business between signing and closing only in the ordinary course consistent with past practice. The standard of the obligation may be qualified (e.g., by commercially reasonable efforts or by requirements of law) but the general obligation is typically supplemented with a list of specific actions that the seller is not permitted to take without buyer's consent. Failure to comply with these conduct of business covenants in a material respect would constitute a breach of the agreement which, if uncured, could allow the buyer to walk away from the deal. Even if the impact of COVID-19 does not result in a MAC/MAE on the target company, the target company's response to COVID-19 must not violate the conduct of business covenants. Even if there is no MAC/MAE condition (or there is one that in practice cannot be invoked), if the interim covenants have been crafted broadly and if the closing has been made conditional on there being no covenant breach (which is, however, not usual in certain jurisdictions), a buyer may have an independent right to refuse to close the transaction on the basis that the target company materially violated its conduct of business covenants.

Structural Solutions

Depending on the circumstances and deal dynamics, there may be ways to structure the deal to hedge the risks in a manner acceptable to both sides. For example, particularly in a venture capital setting, it may be possible to split the investment with part invested now and the remainder in a specified number of months, provided that the current circumstances (effectively constituting a MAE on the company's business) have been resolved by the time of the second tranche investment.

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