COVID-19's Impact on the M&A Market: Measures and Precautions

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By **Andrew L. Burnstine and Perry F. Sofferman** | July 10, 2020 at 01:59 PM

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Although it is uncertain what impact the COVID-19 pandemic will have on the M&A market over the medium- and long-term, the severity of the short-term effects that COVID-19 is having on the M&A market is readily apparent. Whether parties are

moving forward with their agreements, placing them on the backburner until the markets stabilize, or initiating deals during the COVID-19 pandemic, both parties should prudently review deal terms and contemplate what must be revised to properly account both for the existing crisis and for the possibility of similar epidemics or pandemics in the future.

In the context of M&A agreements entered into prior to the pandemic, there may be situations under which a court, considering all the factors, might find, in light of the global market implications surrounding the COVID-19 pandemic, that a "material adverse change" (MAC) or "material adverse effect" (MAE) occurred when it would not have done so under ordinary conditions. (Interchangeably MAC and MAE).

Straying Away From a Seller's Market

Immediately preceding the COVID-19 pandemic, the United States and global economies were in the midst of a 10-year bull run and one of the most seller-friendly markets in decades. During this run, agreement terms deemed to be leveled with the market increasingly became more seller-friendly, as sellers had several withdrawal opportunities at desirable valuations backed by an abundance of debt and equity capital. In fact, the MSCI World, S&P 500 and STOXX Europe 600 indices all closed at record highs at the end of February. In a matter of weeks, however, the situation changed dramatically. From their peaks through March 18, these benchmarks lost between 30% and 35%, which in turn has resulted in the scales of leverage tipped in favor of a buyer-friendly market.

Material Adverse Change/Effect Provisions

A crucial legal issue that has surfaced over the past few months is whether the COVID-19 pandemic constitutes a MAC under existing M&A agreements that have not closed. Sellers should expect buyers to argue that the COVID-19 pandemic

constitutes a MAC in the context of existing M&A agreements currently in the executory period. Typically, boilerplate MAC provisions in an M&A agreement includes three parts:

First, defining a MAC as any event, circumstance, development, or condition occurring that has already had, or would be reasonably expected to have, a MAC on the target. Second, an exclusionary provision for certain events, such as acts of God, floods, earthquakes, natural disasters, terrorism, economic collapses, and conditions specific to the target's trade and industry. Some provisions specifically exclude pandemics or health emergencies. Third, a provision that provides that some or all the exclusions are exempt from exclusionary status such as in a scenario during which the triggered exclusion disproportionately resulted in a MAC to the target with respect to others in the same trade and industry.

Case Studies

In both Delaware and New York, there is a high-bar to the finding of a MAC, with a focus on the language of the provision and the facts and circumstances surrounding the MAC. Generally, courts required that the change was material and had, or will likely have, "durational significance." However, there is no bright-line test to meet that longstanding standard.

The Delaware Court of Chancerys' decision in *Akorn v. Fresenius Kabi AG*, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), aff'd (Del. Dec. 7, 2018), is the first decision in which a Delaware state court found that a target company experienced a MAE that entitled a buyer to walk away from an M&A agreement. Conversely, in *Channel Medsystems v. Boston Scientific*, 2019 WL 6896462 (Del. Ch. Dec. 18, 2019), the Chancery Court found that there was not a MAE which allowed a buyer to walk away from an M&A agreement.

Following the precedent set forth in *Akron,* the court assesses whether the circumstances at issue indicate a MAE in the target's long-term future earnings potential. Even though the court never found a MAE before *Akorn*, the facts seem to have presented a straightforward route for a finding of a MAE. At the same time, the

facts in *Channel* seem to have presented a straightforward route for a finding of *no* MAE.

The State of Current M&A Agreements

In the foreseeable future, as the values of many recent acquisition companies have rapidly declined due to COVID-19's severe impact on the U.S. and global markets, the courts will likely see a rise in litigation relating to claims by buyers arguing that the previously agreed upon purchase price of the target should be lowered in closed transactions or alternatively, the deal should be terminated altogether. Much of that litigation will undoubtedly involve concepts such as MAE closing conditions and pre-closing covenants of the seller to operate the target in the ordinary course of business.

Sycamore Partners' lawsuit surrounding its $525 million purchase of a controlling stake in Victoria's Secret from L Brand Inc. is one of the highest-profiled examples yet in the post COVID-19 atmosphere of a buyer seeking to terminate a transaction even after the agreement had been signed.

Sycamore invoked MAE provisions in seeking to walk away from a deal to acquire a majority stake in Victoria's Secret. Sycamore claimed there was a MAE because COVID-19 prevented L Brands from satisfying its operating covenants and that L Brands violated the interim operating covenants by operating outside the ordinary course of business. Ultimately, the parties reached a mutual decision to terminate the agreement and settle the pending litigation.

While we won't see how the merits of Sycamore's arguments are resolved in court, the initial filings in the lawsuit offer helpful insights and considerations for business currently in M&A negotiations, as well as those in the pre- and post-closing stages of the deal.

Given how rapidly the events are developing and the uncertainty surrounding the COVID-19 pandemic, we suspect that the federal government will implement additional precautions and measures that will help shine a light as to how the courts will handle the apparently inevitable rise in litigation surrounding MAEs in M&A agreements.

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