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COVID-19 virus: Considerations in US M&A transactions

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The migration of COVID-19 (the "outbreak") from Asia to over 100 countries (as of March 10, 2020) is impacting financial markets, international trade, business operations and social interactions around the world.

While it may be too early to predict how long the epidemic will last, its effects on the global economy are already being felt and will continue to evolve.

> Courts have historically been unlikely to find that an MAE occurred unless the negative impact of the issue was likely to be "durationally significant."

In this Legal Update, we highlight how the outbreak is impacting US M&A transactions and some key considerations in thinking about US M&A issues in light of the outbreak.

MAE IN EXECUTED ACQUISITION AGREEMENTS (POST-SIGNING/PRE-CLOSING)

In a typical M&A transaction in the United States, the acquisition agreement includes a condition to the consummation of the acquisition allowing the buyer to refuse to complete the deal if the target company has suffered a Material Adverse Effect ("MAE" or "MAC") after the signing of the acquisition agreement.

The MAE standard is specifically negotiated between the parties and is used to measure the negative effects of certain events on the business in the pre-closing period and to allocate the risk of those negative effects among the parties.

Where an acquisition agreement has already been signed, the question of whether the outbreak constitutes an MAE — and therefore, whether a buyer has the right to walk away from the closing — will depend on the specific language used in the acquisition agreement, the governing law applied to that language and the actual impact of the outbreak on the target business.

The first step is to determine if the outbreak is specifically excluded from the applicable MAE definition. Even prior to the outbreak, a seller-favorable definition of an MAE may have specifically excluded any occurrence, escalation or material worsening of any "outbreak," "epidemic," "pandemic" or other similar events.

If this language was included in the applicable definition, then the outbreak would pretty clearly not constitute an MAE with respect to that transaction.

But even if the outbreak is not specifically excluded, there are likely to be other exclusions in the MAE definition — ranging from general economic conditions to a force majeure — which could at least arguably apply to the outbreak. As in many situations, the specific language is key.

However, even if the outbreak arguably fits into an exception to the applicable MAE definition, many MAE definitions contain an exception to the exception to account for situations in which the event in question has a disproportionate effect on the target compared to others in its industry.

Again, the specific language of the definition, as well as the specific circumstances of the target in question, are very important to the analysis.

Unless the outbreak clearly fits into an exception in the applicable MAE definition, the next step is to consider whether a US court would declare that an MAE has occurred.

As a general matter, US courts have been reluctant to excuse buyers from their obligations to consummate a transaction on the basis that an MAE has occurred.

Courts have historically been unlikely to find that an MAE occurred unless the negative impact of the issue was likely to be "durationally significant."

As of this writing, it seems unlikely that a court (at least in Delaware) would conclude that the outbreak has met the high bar of an MAE, though the situation is very fluid and further developments could very well impact that analysis.

MAE IN ACQUISITION AGREEMENTS UNDER NEGOTIATION

Where an acquisition agreement is currently under negotiation, the parties should consider specifically addressing how the outbreak should be treated in the context of the transaction.

Given that this is very much a known risk at this point, parties likely will want the certainty of knowing how, if at all, this risk could impact the transaction (particularly once the deal is announced) rather than leaving the result unclear. Certainly, sellers will want to make it clear that any negative effects from the outbreak cannot impact the transaction.[1]

On the other hand, if buyers are not willing to take risks arising from the outbreak on the deal, they should clearly address that as well.

Given the US courts' likely reluctance to find that an MAE has occurred (at least at this point), buyers seeking certainty on this issue will not want to rely on the general terms of the MAE standard but, rather, should negotiate a specific closing condition regarding the spread of the outbreak.

> Certain buyers are now conducting due diligence on the supply chain and overall economic impacts of the outbreak on target businesses.

Of course, sellers may well be unwilling to take deal execution risk relating to the outbreak and may push back on buyers seeking specific closing conditions or pause their sale processes to allow the outbreak and its consequences to play out.

PRE-CLOSING COVENANTS AND CONDITIONS PRECEDENT TO CLOSING

As governments around the world struggle with staffing, and attention focuses on addressing the outbreak and away from other functions, certain governmental actions necessary to M&A deals, including antitrust review and formation of entities, may become delayed.

Dealmakers should consider allowing for extra time to prepare and file antitrust forms, formation documents and other documents requiring governmental approval.

Overall, parties should consider whether to extend closing deadlines where delay may be caused by the outbreak and whether to add such provisions as exceptions and automatic extensions where deadline dates are under negotiation.

In addition, parties should consider whether pre-closing operational covenants — i.e., requirements to operate the target business in the ordinary course business and to refrain from taking certain actions without buyer's approval — may conflict with a company's need to respond to the outbreak.

For example, parties should consider how voluntary (yet prudent) actions to limit social interactions or potential exposure to COVID-19 across their supply chains should be construed and whether a buyer's consent would be needed to take these types of actions.

DUE DILIGENCE

Travel bans, quarantines and halted factory operations have affected day-to-day business operations — including on-site inspections and in-person management meetings.

We have seen buyers communicating to sellers that signing may need to be delayed pending the ability to complete site visits and to get a better understanding of the impact of the outbreak on the target's business.

Certain buyers are now conducting due diligence on the supply chain and overall economic impacts of the outbreak on target businesses. For example, some companies have developed due diligence questionnaires to try to assess the impact of the outbreak on the target.

In due diligence, buyers should closely consider the way that the target's commercial contracts would treat performance failure due to the outbreak.

Commercial contracts often include a "force majeure" clause that typically excuses performance by a party if the failure to perform is caused by a "superior force," which usually includes "acts of God" and other natural occurrences.

Like an MAE clause in an acquisition agreement, force majeure clauses in the target's commercial contracts will be key in assessing how the outbreak may affect the target business.

Courts typically do not have the same hesitancy to find that a force majeure prevented contract performance as they have shown in deciding that an MAE has occurred.

While the term "act of God" is usually associated with earthquakes, hurricanes and other natural disasters, the term may also be taken to refer more generally to any naturally occurring event that is outside the control of a party despite reasonable preventative measures.

Certain effects of the outbreak such as the institution of quarantine and stops to production in factories in China arguably already constitute a force majeure.

Notes

[1] One way to do this is to specifically exclude "COVID-19," "outbreaks" and/or "epidemics" from the MAE definition; we are aware of at least one publicly filed merger agreement that has done this.

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