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What a Business Should Know Before Triggering a MAC Clause Based on COVID-19

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The COVID-19 pandemic has caused a sudden disruption to businesses and halted almost all forms of global commerce. Contractual parties, lenders and borrowers, and parties to Merger and acquisition agreements are now closely reviewing their contracts, loan agreements and, in particular, any Material Adverse Change clause (also called Material Adverse Effect) ("MAC") in the contract to analyze what options they might have. In business use, MAC is a change in circumstances that causes a substantial decline in the value of a business. If successfully invoked, the MAC clause allows the party to avoid its obligation – such as closing on a merger or acquisition or funding a loan — as required by an otherwise enforceable agreement. Although perhaps similar in some respects to its cousin the force majeure clause, force majeure describes facts that constitute contractual impossibility due to an unforeseeable event. *See Perlman v. Pioneer Ltd. P'ship*, 918 F.2d 1244, 1248 n. 5 (5th Cir. 1990) (citing 6A Arthur L. Corbin, Corbin on Contracts § 1324 (1962)). So although the end goal of invoking a MAC clause may be the same as invoking the force majeure, the MAC clause may allow parties to avoid their obligations under a contract because of a material adverse change in the other party's financial condition despite that fact *performance* of the contract is still possible.

Merger and corporate participants have long included a MAC clause in merger, purchase and sale, and like agreements to permit, for example, the acquiring party to exit the agreement or reduce the consideration being paid when events converge to reduce the value of the acquired company. Similarly, a lender or investor will often include a MAC clause in financial transactions to relieve an obligation to loan money or make an investment should the borrower's business collapse. Regardless of circumstance, the specific language of the particular MAC clause and the factual events surrounding the change in financial performance are material factors for any business leader to consider before invoking a MAC clause. Seeking legal guidance sooner rather than later can help the business determine its best path forward and evaluate the legal risks and hurdles the business will face.

Judicial Review of MAC Clauses in the M&A Context

The majority of cases interpreting and reviewing enforcement of MAC clauses arise in the M&A context in Delaware and New York courts, and other courts tend to cite those Delaware and New York cases as authoritative. The most common fact pattern confronting courts is when an acquiring company attempts to invoke a MAC clause to avoid its obligation to purchase a target after the target has suffered a material financial decline. These buyers face a heavy burden because the fact of a material decline is weighed less than the duration and permanency of the decline.

When a buyer invokes the MAC clause courts will examine the length of time the target company has experienced the alleged material adverse change in its financial performance, or as courts describe it, whether the adverse financial change was "durationally-significant." A short-term decrease in value is unlikely to support a buyer's invocation of a MAC clause. In this regard, one Delaware Court of Chancery opined that MAC clauses should be seen as providing a 'backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather [an adverse change] should be material when viewed from the longer-term perspective of a reasonable acquirer.'

Hexion Specialty Chems, Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008).

As is clear from the Court's quoted analysis, decisions involving MAC clauses are highly fact specific and typically are not interpreted in isolation. Thus, courts will examine MAC clauses in in the context of the entire agreement to discern the parties' intent, including "whether the alleged material adverse change was within the contemplation of the parties at the time they executed the agreement, whether it was within the control of the parties, and the magnitude of the impact on the relevant party's business." *See Weisfelner v. Blavatnik (In re Lyondell Chem. Co.)*, 567 B.R. 55 (Bankr. S.D.N.Y. 2017) (collecting authorities). To be sure, a party's invocation of a MAC is highly fact specific and there are few cases finding a successful invocation of a MAC. And, although no "bright line" rule necessarily exists, courts generally have summarized the material inquiry into the following two questions:

- At the time the parties made the agreement, was the material adverse effect known or contemplated by the party now seeking to invoke the clause?

- Did the material adverse effect substantially threaten the overall earnings potential of the acquired assets for a durationally-significant period?

See Luxco, Inc. v. Jim Beam Brands, Co., No. 14-C-0349, 2016 U.S. Dist. LEXIS 73085 (N.D. Ill. 2016) (*citing In re Ibp S'holders Litig. v. Tyson Foods*, 789 A.2d 14 (Del. Ch. 2001)).

Was the material adverse effect known to the party seeking to invoke the clause?

Courts look to whether the claimed material adverse financial event or condition was generally known to the parties at the time of the agreement. In *Luxco*, the buyer/licensee bought an exclusive license to sell certain reformulated Jim Beam "value brands." The buyer later invoked the MAC clause, alleging the seller-licensor had breached a warranty because seller had failed to disclose to buyer the market's rejection of the reformulated vodka liqueurs. The defendant licensor moved for summary judgment on the breach of warranty claim and the court granted the motion. In examining the evidence, the court focused on the buyer's knowledge of the market's rejection of the reformulated vodka liqueurs. The summary judgment evidence showed the buyer had knowledge during the warranty and due diligence periods of both (1) customer and distributor complaints about the value brands and (2) the declining sales of the liqueurs. The plaintiff-licensee failed to raise a fact issue disputing its prior knowledge of the events it claimed caused a MAC. Thus, the court ruled against the plaintiff license-buyer's MAC action.

In the current COVID-19 pandemic setting, including the economic shutdown, timing is everything as well. A material inquiry will be made into what facts were known to the invoking party about the pandemic when the parties made the agreement. Agreements entered into in December 2019 or early January 2020, for instance, may likely be viewed through a different lens than agreements made in March and April 2020. What parties knew or should have or anticipated about the potential impact the coronavirus might have on the economy and a specific business or industry will be hotly contested, especially for agreements made in, say, February 2020 and after as the economic significance of the virus arguably began to more fully emerge. Additionally, the language of the MAC clause will be important as well, as at least one Court found an ambiguity as to whether the clause covered only *unforeseeable* changes to market conditions. *See Capitol Justice LLC v. Wachovia Bank, N.A.*, 706 F. Supp. 2d 23, 29-30 (D.D.C. 2009). This case is discussed later, but of immediate relevance is the durationally significant requirement.

Did the material adverse effect substantially threaten the overall earnings potential of the acquired assets for a durationally-significant period?

In one Delaware case supporting a party's invocation of a MAC clause, the Court found persuasive the fact that the financial performance of acquisition target (a generic drug manufacturer) "fell off a cliff" the first quarter after the acquisition and had "already persisted for a full year and show[ed] no sign of abating." *Akorn, Inc. v. Fresenius Kabi AG*, No. 2018-0300-JTL, 2018 Del. Ch. LEXIS 325 at * 4, 127 (Ch. 2018). In *Akorn*, the target pharmaceutical company had entered into a merger agreement with the acquirer. Before closing, the acquiring company invoked the MAC clause (among other provision of the agreement) as a basis to terminate the merger agreement. The target then sued. The court found the acquirer-defendant had successfully invoked MAC clause to terminate the merger agreement. Key to the court's analysis was evidence of the plaintiff target's ongoing and persistent adverse financial condition, including increased, unexpected market competition and loss of key contracts. *Id*. at 127-29. Additionally, the court relied on testimony that the target company's management had "dramatically reduced their forward-looking estimates by more than 60% from the time of signing" the agreement. *Id*. at *129. The court ultimately held the preponderance of this evidence "established the existence of a sustained decline in business performance that is durationally significant and which would be material to a reasonable buyer." *Id*. at * 132. Thus, the durationally significant financial downturn in the target company's value supported the defendant-acquirer's having invoked the MAC to walk away from the closing table.

Akorn reflects a factual circumstance showing a material decline that was durationally significant, whereas the facts of the *Hexion* case did not. In *Hexion*, a decline of almost 20% in EBITDA of the target company compared to the same period for the prior year, coupled with projections of EBITDA falling another 22% in the upcoming period, was insufficient to invoke the MAC clause in the acquisition agreement. *Hexion*, 965 A.2d at 740. In that case, the buyer invoked the MAC clause but lost testimony established that other factors — such as increases in oil prices and the weakening of the dollar relative to the euro — contributed to the reduction in the target's earnings, and that a reversal of the target's downward trend could lead to an increase in the target company's future EBITDA. *Id*. at 743. Although changes to the target's financial condition had clearly occurred, the court refused to find that, "in the context in which the parties were contracting," the changes resulted in a MAC. The main difference between the courts' decisions in *Hexion* and *Akorn* appear to rest on the durational significance requirement. In *Hexion*, the evidence showed the company's financial situation could still turn around, but in *Akorn* the prospects of a turnaround were much grimmer along with the passage of time. In short, a buyer faces "a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close." *Id*. at 738.

The duration and significance of an adverse financial change will be highly material to invocations of a MAC clause related to the current pandemic. As these cases instruct, courts will focus their inquiry on whether the pandemic caused a long-term, material adverse financial impact on a business. At present, whether the adverse financial effects of the pandemic will continue, and for how long after the economy "reboots," is unknown. For instance, the existing shutdowns may have already caused material, long-term, adverse consequences to some businesses' financial condition. But until a more durationally significant time period passes, invoking a MAC clause now could be more of a gamble or roll-of-the-litigation-dice. Indeed, some businesses may experience the currently touted "V" curve recovery—with minimal long-term financial consequences. Accordingly, acquiring companies should be prepared for the difficult burden of showing the target company's material adverse change was durationally significant before terminating an agreement solely on the basis of a MAC clause and the current COVID-19 pandemic.

One answer could come rather soon. In early April 2020, a dine-in movie theater seller sued its would-be purchaser for specific performance after the purchaser walked away from the closing, citing the COVID-19 pandemic. *See Omar Khan, S.C.G.C., Inc., et al. v. Cinemex USA Real Estate Holdings, Inc.,* No. 4:20-cv-01178 (S.D. Tex.). In its complaint the seller-plaintiff anticipated the defendant-purchaser would raise a MAC defense and attempted to head it off, alleging that the COVID-19 pandemic was contemplated at the time the parties signed the agreement dated as of March 10, 2020. The aggrieved seller alleges that because the parties negotiated the equity purchase agreement during the first quarter of 2020, the threat of COVID-19 was known and thus the purchaser cannot rely on the MAC clause as a basis to avoid closing. Specifically, the seller-plaintiff alleged the MAC clause excluded:

conditions generally affecting the United States economy, the regulatory environment or credit, securities, currency, financial, banking or capital markets (including any disruption thereof and any decline in the price of any security or any market index or any changes in interest rates or exchange rates) in the United States or elsewhere in the world, . . . any epidemics, pandemics, outbreaks, earthquakes, hurricanes, tornadoes or any other natural disasters (whether or not caused by any Person or any force majeure event) or any other national or international calamity or crisis[,] . . .[or] any change that is generally applicable to the industries or markets in which any member of the Company Group operates or in which products or services of any [Company] are produced, distributed or sold[.]

(Emphasis added). It will be interesting to follow the results of this case and compare it with the results of the other cases cited above.

Lenders – Refusal to Fund

There are limited cases addressing a lender's use of a MAC clause to refuse to fund a loan. As in the M&A context, the reported cases indicate that courts analyze MAC clauses in context with the overall facts surrounding the invocation of the clause. For instance, in one case, a lender refused to fund a loan commitment despite having entered into a letter agreement with the potential borrower. As the party invoking the clause, the court required the lender to carry the burden of proof on the alleged material adverse change, although the parties arguably had drafted the MAC clause in a manner that attempted to shift the burden to the borrower. *See Wachovia Bank, N.A.,* 706 F. Supp. 2d at 28. The court reached this result by declaring the MAC clause ambiguous and applying rules of construction. The court then reasoned that because MAC clauses are *sui generis*—meaning they are unique and provide a different form of legal protection — the burden had to rest with the lender who invoked it to avoid its funding commitment.

In *Wachovia*, the lender invoked the MAC clause as a basis to avoid funding a CMBS loan for the purchase of an office. The lender wanted to avoid funding because of its inability to sell the borrower's loan during the declining CMBS market in late 2007 and early 2008. *Id*. at 27-28. The MAC clause allowed termination of the agreement "in the event of any material adverse change in the financial, banking or capital market conditions that could impair the sale of the Loan by the Lender as contemplated in the Term Sheet." *Id*. at 29. The court determined this wording was subject to more than one reasonable interpretation and thus ambiguous. On the one hand, the clause could be interpreted to mean that a MAC is "any meaningful or significant change in the market conditions, whether foreseeable or not." *Id*. at 29.

And on the other hand it was equally plausible and reasonable to read the clause as only applying to "unforeseeable change in market conditions". *Id*. at 30. This ambiguity as well as fact questions about what the lender knew about the CMBS market at the time the parties entered into the agreement, which included evidence of outside trade publications and investor reports, lead the court to deny summary judgment to the lender. In particular the court held disputed issues of fact existed as to whether the changes in the capital markets in the summer and fall of 2007 could have impaired the sale of the loan. *Id*. at 29-31. The case ultimately went to trial and was declared a mistrial after the jury failed to reach a unanimous verdict. The case eventually settled.

Wachovia is instructive for lenders considering invocation of a MAC clause. At the very least a lender should evaluate potential risks:

- expect a fact-intensive inquiry that might not be resolved through summary judgment;
- be prepared to bear the burden of establishing a MAC occurred;
- anticipate disputes interpreting the parties' intent as expressed in the MAC clause and contract as a whole; and
- consider the possibility of reading the clause as being ambiguous.

For these reasons, a lender might look for additional avenues of support if it seeks to avoid a funding commitment.

Lenders – Declaring Defaults

Although the occurrence of a MAC is often listed as an event of default under loan documents, for practical reasons lenders rarely rely solely on the MAC provision to call a default. Instead, lenders wisely prefer to rely on clear-cut monetary defaults before exercising remedies. This practice avoids unnecessary scrutiny from courts, and it supports the goal of obtaining a judgment as efficiently as possible. Conversely, a MAC provision analysis often considers more complex facts and circumstances without the benefit of clear-cut rules. This type of analysis does not lend itself to summary judgment. Lenders relying on MAC clauses as the sole basis of default could end up going to trial—and losing cases that would appear to be more a standard suit on a note or guaranty dispute. In one such case, the Fifth Circuit held that no default occurred under a MAC clause as alleged by the lender. *Stonehedge/Fasa-Texas JDC v. Miller*, No. 96-10037, 1997 U.S. App. LEXIS 43367, at *10 (5th Cir. 1997).

In *Stonehedge*, the lender attempted to enforce a guaranty of a promissory note by claiming a nonmonetary default on the guaranteed note. The note required the maker to give notice to the lender of "any material adverse change in the financial condition or business of Maker or any Guarantor," and notice of "any default under any material agreement, contract or other instrument to which Maker or any Guarantor is a party." The lender contended that because maker had defaulted on other promissory notes guaranteed by the guarantor, these other defaults caused a MAC in the guarantor's financial condition, thus the guaranteed note was in default.

The court found the lender's argument "unavailing." First, the court strictly construed the note finding that under the note terms neither "a change in financial condition nor default under another loan was itself a default of the note" the guarantor had backed, rejecting the lender's argument that existence of a MAC was a default. Instead, "the note required *notice* of such events [and] there was no evidence that the borrower failed to provide notice." The key to the court's analysis was its distinguishing between requirement (in the note) to provide *notice* of a MAC event versus a default that occurs as a result of the *existence* of a MAC (not required by the note). In other words, the fact that the borrower had defaulted on other loans (evidence of a MAC event) did not prove that an event of default occurred under the note at issue. Second, nonmonetary defaults could arise only after the lender had given written notice to the maker and a 30-day opportunity to cure. Because the lender failed to give the required notice and opportunity to cure, no non-monetary default had occurred and the lender could not collect on that note against the guarantor. *Id*.

Another case underscores the difficulty in obtaining summary adjudication without a full trial on the merits when invoking a MAC default. *See Tex. Capital Bank, N.A. v. Dall. Roadster, LTD,* No. 4:13cv625, 2015 U.S. Dist. LEXIS 27339, at *19-20 (E.D. Tex. 2015) (alleging MAC default based on company's business operations). The federal magistrate in *Dallas Roadster* recommended the lawsuit proceed to trial because it determined the lender had knowledge of the MAC and other events surrounding the MAC for several months before declaring a default, and that some of the lender's actions, i.e., additional extensions of credit, were inconsistent with its contention the borrower had suffered a MAC and hence was in default. In sum, the magistrate recognized that the allegations were not ripe for a summary judgment and that there was enough "conflicting evidence" for the case to proceed to trial. The parties thereafter engaged in extensive fact and expert discovery and motion practice and the issue of whether a material adverse change occurred was never resolved. *See Tex. Capital Bank N.A. v. Dall. Roadster, Ltd. (In re Dall. Roadster, Ltd.)*, 846 F.3d 112, 134 n.26 (5th Cir. 2017) ("Notably, the district court never made a finding regarding whether there was an event of default . . . based on a material adverse change in [the borrower or guarantor's] business or financial condition.").

Conclusion

MAC clauses are common provisions in M&A agreements and loan documents and have the potential—at some point—to be triggered as a result of the COVID-19 pandemic. Although some MAC clauses may be successfully invoked, the unknowns currently surrounding the global economic shut-down due to the virus, the heavy burden placed on parties invoking the clause, and the highly fact-specific inquiries conducted by the courts require a thorough legal analysis to be conducted before invocation of a MAC clause in the current COVID-19 climate. In the M&A context, courts heavily scrutinize MAC clauses—especially with respect to the duration of the alleged material adverse change in financial condition. In the loan-default context, lenders are wise to seriously consider the circumstances before invoking a MAC clause as the sole basis for default, as it is a non-monetary default and also invites additional scrutiny from courts. Until more time has passed and more is known about the financial impact of the COVID-19 pandemic including any recovery, parties to agreements should seek a thorough legal analysis before invoking a COVID-19 related MAC clause.

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