

# NKF Client News

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## M&A Transactions in Times of Corona: Is COVID-19 a Material Adverse Change (MAC)?

The rapid spread of COVID-19 (declared a pandemic by the World Health Organization (WHO) on 11 March 2020) is hitting the economy and companies hard. The negative impact of COVID-19 is widespread, with almost all industries recording significant declines in sales and profits.

In connection with M&A transactions, the negative economic impact of COVID-19 raises the question of whether the outbreak represents a so-called material adverse change (MAC), and whether purchasers can derive certain rights from it.

### 1. The MAC clause and its variations

The MAC clause aims to protect the purchaser in circumstances where signing and closing of a share purchase agreement do not take place simultaneously, as, for example, the approval of the competition authority is still pending or certain carve-outs have to be implemented. If a material adverse change occurs during this period which directly or indirectly affects the target company (and/or its subsidiaries), the purchaser may rely on the MAC clause to derive some protection. The MAC clause provides that in the event of a material adverse change, the purchaser has the right to withdraw from closing the purchase (walk-away right). In reality, the MAC clause also gives the purchaser the opportunity to demand an adjustment of the contract in the event of a material adverse change.

The MAC mechanism can take a number of forms: either as a stand-alone MAC clause, which expressly provides for the absence of a MAC as a closing condition in favour of the purchaser; or the back-door MAC, which is a combination of a representation and warranty that no MAC has occurred and a general closing condition that all representations and warranties must be true at both signing and closing (bring-down condition).

Even though the definitions of a MAC in share purchase agreements vary according to the individual case, they can be categorized as follows:

- General and specific MAC clauses: general MAC clauses include a generic description of what would constitute a material adverse change that would allow the purchaser not to close the share purchase agreement. Specific MAC clauses describe in detail which material adverse changes would allow the purchaser to refuse to close.
- Quantified and non-quantified MAC clauses: quantified MAC clauses define the material adverse change by using certain thresholds. Non-quantified MAC clauses use generic terms as "material adverse effects" or "significant adverse effects". In the event of a dispute, adjudicator would need to rely on contract interpretation principles to determine how to apply the clause in practice.

- Subjective and objective MAC clauses: subjective MAC clauses grant the purchaser a certain discretionary power to judge whether a material adverse change has occurred. Objective MAC clauses quantify the material adverse change or delegate the determination of whether one has occurred to a third party.
- MAC clauses relating to the target company or its market, sector or industry: the MAC clause specifically refers to the target company or to the market, sector or industry in which the target company is active.

In practice, MAC clauses are often combined with certain carve-outs, whereby, depending on the interests and negotiating position of the seller and purchaser, certain categories of material adverse changes may be excluded. For example, a material adverse change may be deemed not to exist in case of general economic and/or industry-specific developments, a downturn in the financial markets or changes in the legal landscape. It is also regularly explicitly stated that the material adverse change must not have been foreseeable at the time the contract was concluded.

As far as can be seen, no Swiss court has yet ruled on the existence of a withdrawal right based on a MAC clause. In the U.S., however, the Delaware court in *Akorn v. Fresenius Kabi*<sup>1</sup> ruled in favor of Fresenius on the rescission of a signed but not yet completed merger agreement based on a MAC clause in circumstances where Akorn had reported an 80% decline in EBITDA for four consecutive quarters. However, the court also clarified that a MAC must not only have short-term implications, but also longer-term effects. It is unclear whether Swiss law would also require a long-term impact to determine the existence of a MAC.

## 2. Does COVID-19 constitute a material adverse change?

Whether COVID-19 or its effects represent a MAC depends primarily on the concrete wording of the MAC clause in question.

If the share purchase agreement provides, for example, for a general or non-quantified MAC clause (without carve-outs), the purchaser will attempt to qualify the changes and implications caused by COVID-19 (e.g. significant decrease in sales or profits) as "material adverse changes" affecting the target company and/or its subsidiaries. Depending on the wording, however, the above may also apply to quantified MAC clauses. It has to be taken into account that a withdrawal from an agreement based on a MAC may result in protracted court or arbitration proceedings, while at the same time the value of the target company may decrease.

If the MAC clause provides for a carve-out, i.e., if changes in the general economic conditions or the general economic conditions of the sector in which the target company operates are excluded from the definition of "material adverse change", this makes it difficult for the purchaser to argue.

## 3. Alternatives to material adverse change clauses

### 3.1. *Clausula rebus sic stantibus*

The principle of *clausula rebus sic stantibus* has developed primarily in the context of contracts that provide for ongoing or continuing obligations. However, it can in principle be applied to any contract where there is a delay between signing and closing, and thus can also apply to share purchase agreements.

*Clausula rebus sic stantibus* means that a contract can be terminated or adapted if, after its execution, the circumstances relevant to the performance of the contract by the parties change

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<sup>1</sup> *Akorn, Inc. v. Fresenius Kabi AG*, C.A. no. 2018-0200-JTL [Del. Ch. Oct. 2018].

so fundamentally that a serious imbalance arises, such that insisting on fulfilment of the contract would constitute an abuse of rights. The event that triggers the imbalance must be unforeseeable and unavoidable and the change in value must significantly exceed the fluctuations in value that arise during the normal course of business.

Only truly exceptional developments, such as a natural disaster, could qualify as unexpected changes in share purchase agreements. Whether also a pandemic like COVID-19 qualifies as such remains to be seen.

### 3.2. Force Majeure

In Swiss M&A practice, force majeure clauses in share purchase agreements are rare as they are not particularly appropriate.

## 4. Conclusion and Outlook

Whether a purchaser who is about to close a share purchase agreement that includes a MAC clause can invoke the clause essentially depends on the wording of the clause and on the circumstances of the individual case, and in particular on whether the pandemic was already on the horizon when the contract was signed. If the MAC clause does not offer a workable solution, the purchaser may need to examine other alternatives.

The COVID-19 crisis may mark a turning point from a today's seller-friendly M&A market to a more buyer-friendly market. The MAC clause could possibly see a comeback.

Whatever the future brings, the catalogue of carve-outs is likely to be expanded to include pandemics (as the carve-out "terrorism" found its way into MAC clauses following the events of 9/11).

If you have further questions and suggestions on this topic, please contact your regular NKF contact.

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