**Will COVID-19 Qualify as a 'Material Adverse Effect'?**

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**Ben Rand:** Hello and welcome to the Harris Beach Podcast. I'm your host Ben Rand and I'm joined today by Harris Beach Partner Kelly Foss of our Rochester office. Kelly is part of our litigation team here at Harris Beach, focusing on helping clients resolve complex business and commercial disputes. She has litigated cases in both state and federal courts in New York including appeals to the State Appellate Division and US Circuit Court of Appeals. Today Kelly will explore an area of law that's likely to get some renewed focus in the aftermath of the COVID-19 pandemic, the use and enforcement of material adverse effects clauses in transaction. These may come into play if, as anticipated, businesses find themselves in a position of having pending transaction terminate due to COVID-19's aftermath. Kelly, first I'll like to explore the lay of the land with you, how MAE clauses are applied and interpreted by the courts. Toward the end of our episode will explore the main question that people are confronting, the extent to which COVID-19 qualifies as material adverse effect. Kelly, once again thanks for being here.

**Kelly Foss:** Sure, thanks Ben for having me.

**Ben Rand:** Now Kelly, you once coauthored a whitepaper about material adverse clauses where you referred to it as allusive and mysterious. Before we get into why you think that, let's start with some basics. What is this clause all about?

**Kelly Foss:** So, a material adverse effect clause is a provision in a contract that allows one party to take a certain action in the event a material adverse change or sometimes a material adverse effect occurs. These are often abbreviated M.A.C or mac clause or M.A.E. clauses. So most of the time we see material adverse effect clauses in a termination provision of a contract. In that situation a perspective buyer could walk away from a deal that has already been signed, before closing, by claiming that a material adverse effect has occurred. It can also be included in other types of contract provisions such as warranties or covenant, and in that situation often a party is suing for breach of warranty or breach of covenant in hopes of recovering damages or indemnification although they can also seek other relief if it specifically provided for in the contract, such as a repurchased of the asset in question or an actual rescindment of the deal.

**Ben Rand:** Sounds like there's maybe some ambiguity in terms of defining it. Is that one of the reasons why you consider it elusive and mysterious?

**Kelly Foss:** It's typically the definition that poses a problem. This is entirely a creature of contract, so everything depends upon what the definition of material adverse effect is within the contract. And the reason that I consider it elusive and mysterious, as included in the title of the whitepaper, is that it's typically defined so vaguely and broadly that neither party really knows with certainty whether it applies to any given situation. The definition is often circular in nature. So an example of this type of clause that might help illustrate my point on this, and it's very similar in a lot of the contracts, is where a contract defines material adverse effect as quote "any event occurrence or development of a state of circumstances or facts, which has had or reasonably could be expected to have a material adverse effect on the condition financial or otherwise business assets liabilities or results of operations of the target or its subsidiaries taken as a whole". As you can probably imagine just from chewing on that, if something happens after a purchase contract is signed that negatively impacts what's being bought, whether it's a company or assets, looking at a definition like that in the contract often leaves both parties just scratching their heads and wondering whether it could possibly apply.

**Ben Rand:** I was kind of wondering, why are these clauses important? Obviously, there's a lot at stake here, but why should people pay attention to these?

**Kelly Foss:** Well really they're important because of the impact of invoking them. So, you know, it's not really like a typical contract clause where you might allege a small breach and seek some damages. The invoking of a material adverse effect clause could result in the complete tanking of a transaction, which was otherwise already set to close and may have been years in the making. Additionally, if it's not used to actually walk away from a transaction, it can be used to sue for significant damages or indemnification or to even reverse a deal that has closed. It may be used to try to rescind a deal that has closed for instance.

**Ben Rand:** So Kelly, all this talk makes me wonder that you know if a buyer in a transaction walks away what accommodations, what steps can the seller take?

**Kelly Foss:** Well it's interesting because it does depend on what the contracts said and it can be a little bit tricky for a seller in this situation. A seller that has already built into the contract or remedy for specific performance is going to be the best situated. In other words, the buyer walks away from the transaction. A seller with a specific performance remedy can sue to seek to compel the buyer to close. But if the seller does not have a remedy for specific performance, then it's going to be left trying to seek damages and the reason that puts the seller into a tricky situation is on the one hand the seller has to claim that the buyer breached by walking away and proving breach necessarily requires the seller to take the position that no material adverse effect has occurred. And so they have to argue that there has not been a large impact on the target but then if they're trying to

seek damages then they have to try to explain how high they think they're damages are, which often requires showing a negative impact. So they're sort of stuck between a rock and a hard place when they're trying to seek damages in in many circumstances, which is why I say that the specific performance remedy is so important.

**Ben Rand:** Yeah sure sounds like a catch-22. Well you know one of the things I was wondering with what we've talked about so far, as we've talked about it in the context of mergers but are there other types of transactions that might include M.A.E. clauses?

**Kelly Foss:** There are but the vast majority of the disputes that I've seen in the case law in my practice have involved purchase or merger contracts. Examples of these have been contracts to purchase or merge with another company, stock purchases, and large asset purchases. So it doesn't have to be limited to these types of contracts but this is by far the most frequent type of contract where these types of clauses have been invoked.

**Ben Rand:** So in invoking an material adverse effect clause, does the impact have to be very severe? Obviously, as you've said earlier, that discussion of what's material is up for debate but what do people who invoke these clauses typically have to show?

**Kelly Foss:** So to walk away from a transaction on the basis of an alleged material adverse effect, the legal standard for that seems relatively consistent in the case law but it's also highly fact specific. So you may have a consistent legal standard but actually applying it to a set of facts remains difficult and highly dependent upon the situation you find yourself in. The general legal standard is that the buyer seeking to walk away must prove that the claimed effect was unforeseeable and the quote that's often thrown around with these classes is that it quote "substantially threatened the overall earnings potential of the target in a durationally significant manner". Boiling that all down, there's really four main issues: one the foreseeability of the event, two the significance of the event, three the impact on earnings potential, and four whether that impact is long term or short term. This is why it's so fact intensive. In just looking at the event alone, you can't tell whether it qualifies as a material adverse effect because you have to look at the specific impact on either the target company or asset in question. And the result of this is that many of these cases settle because in order to get a resolution to a litigation it's pretty much always necessary to take the case to trial because it's so hard to resolve these types of issues on a motion to dismiss or a motion for summary judgment. So often these cases go to trial with expert testimony and evidence submitted in support of those four main elements I mentioned. This is also kind of tricky because as we all know litigation can take a long time to conclude, particularly when going all the way to trial, so by the time the parties get to trial they have the benefit of hindsight bias and they can see what the impact actually was. Whereas a buyer that's in a position of, for instance trying to decide whether to walk away from a transaction, they have to do their best with their projections on these four

elements and they don't have the benefit of that hindsight that you'd have by the time you've got to trial.

**Ben Rand:** Oh, I see, that's interesting but from a finder of fact perspective then does the finder of fact have to put themselves in the mindset of the person who invoked the clause at the time they invoked the clause?

**Kelly Foss:** Yeah, I mean typically you'd have to look at whether at the time the evidence supported the buyer's position that this was going to have a long-term impact but it's really hard not to have your thinking on that swayed by the events as they actually unfolded. So I've just explained the legal standard for walking away from a transaction or invoking a termination clause that contains material adverse effect provisions, but the legal standard for invoking a material adverse effect class contained in a warranty or covenant in attempting to seek damages or indemnification, the case law actually seems to suggest that the legal standard might be different in that situation. A case law is far from clear on that and some of the cases don't include much analysis but just looking at some of the facts of those cases, the party seeking to invoke the material adverse effect clause was able to do so successfully based upon facts that did not seem to fit within the four elements that have typically been required for invoking a termination provision.

**Ben Rand:** We'll get into this a little bit more a little bit later, but do you suspect that as we see some cases brought under in the post COVID age that that area of law might get some further definition?

**Kelly Foss:** I hope that it does. If parties are pursuing claims for breach of warranty or breach of covenant making use of material adverse effect clauses, I certainly expect that we may see some more litigation in that area and hopefully we do get some clarity from any courts that might make a final judication on that. In the white paper that I mentioned earlier I included a greater in depth look at what the legal standard appears to be in those cases and the potential reasons for reaching a different result when looking at a warranty or covenant as opposed to a termination clause.

**Ben Rand:** So who bears the burden of proof in a case like this?

**Kelly Foss:** Regardless of how it comes up It's almost always the party that seeks to invoke the material adverse effect clause that bears the burden of proof, but it would depend on whether something else is specified in the contract but unless it explicitly imposes a burden of proof on a different party, it's going to be the party that seeks to invoke it must meet the burden of proof.

**Ben Rand:** So maybe we'll get into a little bit of what we know about what the law has said so far but what types of precedence are you aware of in terms of material adverse effect cases? Is there a general agreement in the courts as to what counts as a material adverse effect?

**Kelly Foss:** Well the only general agreement is that the first thing you need to do is look at the language in the contract assuming that the material adverse effect clause is as vague and broad as the one that I described earlier in that is by far the most typical that we've seen in litigation. There is pretty good agreement on how the courts are interpreting that and making the buyer prove those four elements that I listed earlier. As far as specific precedents go - and I've got a couple of good examples of cases and in particular cases that seem to come up over and over again or be relied upon by court that confront these questions. So, a good example of a situation where a buyer successfully invoked a material adverse effect clause to terminate a purchase contract is the Cooper Tire case. This is a case that's out of Delaware, but the Delaware courts have served as a primary authority in this area and many other jurisdictions rely upon determinations out of Delaware and typically follow along suite and that's certainly been the case in New York for example. In the Cooper Tire case the facts of that case where that a labor union and a joint venture partner of the seller physically took over the seller's tire manufacturing facility in China, including stopping all tire production and physically barring sellers access to the facility as well as financial records. And the impact of this, I mean besides obviously impacting the earnings capacity of the seller for not having any tire production, actually prevented the seller from satisfying closing conditions as well. So that's a good example of a set of facts that allowed the buyer to walk away from the transaction and where the court actually upheld that.

**Ben Rand:** That certainly does sound averse to be sure.

**Kelly Foss:** Right. I mean it's a good example because it does show, you know, how severe the situation has to be to justify that. There's not a lot of precedent in this area as I mentioned because many cases settle. One example is of that is the Abbott Labs case in Delaware. I was watching that case for a while and I was curious to see how it turned out but that ended up settling a few years ago by dropping the 5.8 billion dollar purchase price by 500 million and with the parties agreeing to revise the definition of material adverse effect on their contracts going forward. So you know we do see a lot of settlements which is why we don't have you know scores and scores of examples of final adjudications. But I also have a couple examples of unsuccessful attempts to terminate transaction. One of which is the Bear Stearns case out of New York. It's an older case from the 80s and it's a trial court case but the decision was affirmed by the Appellate Court. so it is pretty good authority particularly in New York. That case involved a contract for a tender of 20% of Bear Stearns stock for a set price. Prior to the closing, but after the deal was signed, the stock market crashed and Bear Stearns net profit for the financial quarter dropped by 99.2%. So the buyer tried to walk away from the deal and Bear Stearns actually sued for breach, stating that the buyer was required to actually close the transaction and buy the 20% of the stock at the previously negotiated price notwithstanding the 99.2% drop. The court refused to dismiss the action - wouldn't dismiss it on a motion to dismiss or summary Judgment, requiring the case to go to trial and noted that a one quarter downturn, even 99.2%, does not automatically prove that a material adverse change occurred.

And the court also noted that the buyer knew that it was acquiring an interest in a volatile risky business that would be subject to fluctuating market conditions. So at the time they signed the deal, the court said the buyer knew that there was this risk and therefore the court was not willing to decide the case on emotion.

**Ben Rand:** Is that an example of the application of the foreseeability standard?

**Kelly Foss:** Exactly. So the foreseeability of a stock market crash and it also illustrates that durationally significant manner that I mentioned about. It's got to have a long-term effect and a one quarter downturn won't automatically prove that it occurred. And of course, as I mentioned earlier, you may only have one financial quarter of information to make a decision if you're a buyer looking to terminate a deal before closing. You don't have the luxury of waiting for multiple financial quarters to determine whether this is a short term or long-term impact. You've got to make a decision based on the best available evidence that you have and if you do want to walk away, you should really put together and compile proof that this does not look just like a short term drop for one financial quarter due to an overall stock market drop, but rather does appear to be a long term impact on the target. I have one more example of a situation where the buyer was unsuccessful in walking away. This is another case that's been cited quite a bit in the precedent that we've seen. It's the Tyson foods case, which is another case out of Delaware, but that case involved the Delaware Court actually applying New York law on this topic. So Tyson foods tried to terminate a merger agreement before closing due to an alleged sharp drop in the targets financial performance over a six month period. And the other reason was that the buyer discovered accounting impropriety at one of the target subsidiaries during the due diligence process. The case went to trial and following a trial with expert evidence submitted, the court concluded that the buyer failed to demonstrate that the alleged material adverse effect with something other than "a short term hiccup in earnings". So essentially the buyer had failed to provide convincing expert evidence that the effect was in, and the these are the courts words, "material when viewed from the longer term perspective of a reasonable acquirer".

**Ben Rand:** Ah, there you go. The durational again. You know as we're heading into this next period of our response to COVID-19 and so much of COVID-19 is so unprecedented, I guess it would be simple to say that there must be – automatically, that the pandemic becomes a material adverse effect but that may not be the case right? What do you see coming down the pipe? You think there will be a run of canceled transactions or is it too soon to tell?

**Kelly Foss:** I do think that there will be a run on capital transactions. We've already seen that. We've seen a number of articles of huge billion-dollar deals that are being canceled or at least suspended for the time being. I think that there will be an attempt to invoke material adverse effect clauses certainly in termination provisions in some of these purchase contracts which have been signed but had not closed when the impacts of the pandemic had truly begun to show themselves. So I think really we're not going to see any hard and fast rule on whether COVID-

19 qualifies as a material adverse effect because whether it's going to just justify termination of a transaction is going to depend upon how COVID-19 impacts the target in question, and those impacts can be very different depending on the type of business - the type of asset and question. So I do think it's going to be important for anybody in this situation to first scrutinize the contract. Not all contracts are the same. What I've described throughout this podcast, has often involved very vague, broad clauses and those have pretty much been interpreted the same way by the courts, but your contract me say something different. So first and foremost look at what the contract actually says. And another big question is going to be whether the pandemic was foreseeable by the parties when they signed the contract. So for instance if you signed your contract in October of last year when there was little if any data on coronavirus, then maybe it wasn't foreseeable. Versus if you signed it in February, there may be some arguments that there had been reports out of China at that point and some of the data was available and it was receivable at the time of signing. So foreseeability can differ depending on when the deal was signed and whether the contract, for instance, contains any other language pertaining to pandemics. If the parties, for instance, have a force majeure clause that excludes pandemics, then there may be an argument that the parties did contemplate pandemics and decided to exclude them, meaning that it was foreseeable. There may be all sorts of arguments about that. Another important issue that will arise in the context of Coronavirus is the significance of the impact of pandemic as I mentioned. So questions to ask here would be - was the target subject to mandatory shutdown orders? Is this considered or deemed an essential business to remain open? What state was the business in and what executive orders actually applied to it? Could the staff effectively keep working remotely? Some businesses can transition to remote working relatively easily with less of an impact, others can't so that may impact the significance of the alleged impact. Another factor here would be whether the target is able to obtain relief. Whether it's through the Cares Act and the PPP loans or some other relief being made available to businesses hit hard by the coronavirus and to what extent was the relief obtained able to offset the negative impacts. All of those questions will play into whether those factors are met. In particular, the significance of the impact and whether that's going to be an impact long-term or short-term. So whether the impact, looking at for instance the target, is the target likely with the relief available, able to survive through the pandemic? If there's a projection that the target will come out of this on the other end and is not going to completely go out of business, then maybe it was a short-term impact. So all of those are questions that are going to have to be asked and at the end of the day the specifics matter - the devil is always going to be in the details with something like that.

**Ben Rand:** I see. Yeah sure sounds also that it takes the fairly complex analysis, not just from a legal standpoint, but from an operational business standpoint as well right? And I take it that if you're in an organization you probably do need to sit down with council and the other experts and figure this all out together.

**Kelly Foss:** Absolutely this is this is not a situation where the buyer can say "coronavirus - obviously a huge impact. It must justify walking away." This is - you can't make a decision without digging into the details - looking at the projection, looking at the data, looking at documentation and the available relief. You need to look at all those factors to determine whether you believe at the end of the day that you can prove all four of those factors that will play into the decision.

**Ben Rand:** Thank you, Kelly. You know, I think we've really dissected this subject fairly well.

**Kelly Foss:** Great. Thanks Ben. I was happy to come on and go through this with you today. I'm curious to see what happens with this area of law. I do think we're going to see quite a bit in the coming months and year.

**Ben Rand:** Thank you everybody for listening. For more information please visit our website at www.HarrisBeach.com.

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