

Mergers & Acquisitions

Considerations of the Effects of COVID-19 on M&A Transactions



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The spread of COVID-19 across the world is severely impacting daily life, bringing historic volatility to financial markets, and slowing business operations and international trade across industries. In the United States, the states of New York, New Jersey, Connecticut, Pennsylvania, Delaware, Ohio, Illinois, Kentucky, Louisiana, Oregon and California have issued “stay at home” orders. Other states have closed schools, banned gatherings of more than 10 people and implemented other social distancing policies, all in an effort to slow the spread of the virus. Currently, no one knows how long these orders and policies will remain in place.

In the M&A context, many companies are asking whether the effects arising from the COVID-19 outbreak have caused or will cause a material adverse effect (MAE). This client alert analyzes the effects of COVID-19 under MAE provisions for M&A transactions that have already signed and discusses issues parties may wish to consider when completing due diligence and contract drafting for M&A transactions that have yet to be signed.

Considerations of MAE and COVID-19 under signed Purchase Agreements.

In an M&A transaction, one way a buyer and seller allocate risk related to the closing of the transaction is through the definition of MAE. In its most basic form, MAE is defined to mean a change, development or event that has a material adverse effect on the business or condition of the target company. Typically, the definition is heavily negotiated and includes a litany of effects that will not be considered in or “carved-out” from the determination of whether a MAE has occurred. In the event the target company experiences a MAE prior to closing, a buyer will likely be relieved of its obligation to consummate the purchase of the target company. So the determination of whether the effects arising from COVID-19 do or do not constitute a MAE can have very significant consequences.

As with any contract interpretation question, the first step to determine whether the effects of COVID-19 constitute a MAE is to examine the definition of MAE itself. If one of the carve-outs to the definition explicitly states that the effects of pandemics, epidemics or viruses will not be taken into consideration when determining whether a MAE has occurred, then the analysis is cut and dried; the effects of COVID-19 will not be deemed to be a MAE. If no such carve-out exists, then the analysis will move to an examination of the other carve-outs to the definition.

Typically, carve-outs from the definition of MAE will include (i) effects arising from acts of God or natural disasters, (ii) effects arising from political or economic conditions and (iii) effects that impact the industries in which the target company operates. However, these carve-outs are often subject to a provision that will preclude their applicability to the extent the effects arising from acts of God, political or economic conditions, or that affect an industry have a disproportionate impact on the target company as compared to other participants in the same industry. In this case, the analysis of whether the effects of COVID-19 will be excluded from the determination of whether a MAE has occurred is nuanced and will be largely dependent on the facts and circumstances applicable to the target company and the industry in which it operates.

But what if the MAE definition in question does not contain any carve-outs that would cover COVID-19’s negative impacts? Would the effects from COVID-19 constitute a MAE? US courts have been reluctant

to excuse buyers from their obligation to consummate a transaction on the basis that a MAE has occurred. In Delaware and New York, courts have said that a MAE will be deemed to have occurred only if the negative effects in question substantially impact the overall earnings potential of the target company in a durationally-significant manner. In fact, no Delaware court released a buyer from its obligation to close a transaction by finding the occurrence of a MAE until 2018, in *Akorn Inc. v. Fresenius KABI AG*. In *Akorn*, the court stated that to give rise to a MAE, the adverse effect must be “material when viewed from the longer-term perspective of a reasonable acquirer,” which usually equates to examining a “company’s long term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months.”

The pandemic, governments’ reactions to the pandemic and their respective economic impacts are evolving on a daily basis. This dynamic situation is impacting industries and particular companies within certain industries in sometimes very different ways. Based on the information that is currently available, there is no certainty about how long COVID-19 and its negative economic impacts will last. As a result, there is no bright line as to whether the effects of COVID-19 on a particular company or industry do or do not constitute a MAE. What is clear is that the effects of COVID-19 on M&A transactions that signed prior to the outbreak warrant further monitoring and careful analysis.

Consideration of COVID-19’s Effects on Deal Negotiations and Due Diligence.

The ongoing effects of COVID-19 highlight the importance of due diligence and contract drafting for M&A transactions. Buyers and sellers will want to have a solid understanding of the implications of COVID-19 on the target company so they can knowingly allocate the risks of COVID-19 between them in the Purchase Agreement.

In this regard, the first step to better understand the effects of COVID-19 on a target company is to perform due diligence that is focused on revealing how COVID-19 may have changed the target company’s ordinary course business operations. Of paramount importance is understanding whether a target company has been providing and will continue to provide goods and services to its customers on a timely basis and in accordance with the terms of its customer contracts. Relatedly, buyers will want to know whether any of the target company’s key suppliers have been or will be delayed or precluded from continuing to provide any goods or services that the target company needs to perform its obligations under its customer contracts. This is especially important in relation to any sole source suppliers or suppliers that are located in areas that have been significantly impacted by COVID-19, such as Italy and China.

As part of the due diligence process related to customer and supplier contracts, a buyer will want to review the *force majeure* provisions and ask specific diligence questions about whether any supplier of the target company or whether the target company itself has delivered notice of a *force majeure* event as a result of COVID-19. For more information on *force majeure* clauses please see [“Evaluating Force Majeure Clauses in Connection with the COVID-19 Outbreak.”](#) Similarly, a buyer will want to understand if the target company has been designated as an “essential business” and whether the key suppliers of the target company have also been so designated. For more information on guidance from the US Department of Homeland Security on “essential critical infrastructure” and related matters please see [“California Quickly Adopts DHS Guidance on the Essential Critical Infrastructure Workforce, While New York and Pennsylvania Promulgate Their Own Lists of Essential Businesses.”](#)

Buyers should also consider the effects of COVID-19 on a target company’s employees. Buyers should understand whether the target has engaged or will engage in any layoffs and whether necessary notifications of such layoffs under federal, state or local laws have or will be required. For more information about COVID-19 related layoffs, please see [“Employer Guidance for Addressing Possible Layoffs and Closures.”](#) Similarly, Buyers should determine whether the newly enacted Families First Act will impact the amount of paid sick leave and the amount of protected leave under the expansion of the Family and Medical Leave Act that are available to the target company’s workforce. For more information about Families First Act and related matters, please see [“Financial Relief in Response to COVID-19, So Far. . .Episode I.”](#)

Once the parties have a better understanding of the potential effects of COVID-19 on the target company, they will need to consider how to address those effects in the Purchase Agreement, including whether one party should bear the risks related to COVID-19 or whether the parties should share in those risks in some way. As discussed above in this client alert, the parties will need to determine whether to include in the definition of MAE an express carve-out for any effects arising from the COVID-19 pandemic in determining whether a MAE has occurred (and thereby shift those risks to the buyer).

If the M&A transaction in question will involve some period of time between when the parties sign the Purchase Agreement and the closing of the transactions contemplated by the Purchase Agreement, the parties should also expressly address in the Purchase Agreement the risks of COVID-19 in the covenants applicable to the operation of the target company between signing and closing. Chief among those covenants is the requirement for the target company to operate “in the ordinary course consistent with past practice” during the period between the signing and closing of the transaction. In this regard, the parties may wish to consider whether a seller should be allowed to take actions without the consent of the buyer that it believes it needs to take to respond to the ever changing dynamics that arise from COVID-19, which actions would typically require the consent of a buyer. In addition, in transactions where financing will be required by the buyer, it will be important to pay particular attention to how COVID-19 is treated by the lenders in the financing commitments.

While the consequences of COVID-19 for M&A transactions continue to evolve and change, what is certain is that parties to an existing M&A Purchase Agreement and parties thinking about entering into an M&A transaction will need to carefully consider COVID-19 and its effects. No matter what your particular situation is, Jenner & Block is here to help clients navigate the chaotic waters created in the wake of the COVID-19 pandemic.

Conscious of the human, operational and financial strain that coronavirus is placing on businesses and organizations worldwide, Jenner & Block has assembled a multi-disciplinary Task Force to support clients as they navigate the legal and strategic challenges of the COVID-19 / Coronavirus situation.

For additional information and materials, please visit our COVID-19 / Coronavirus Resource Center.

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