

COVID-19: PRESSURE POINTS: MATERIAL ADVERSE CHANGE CONDITIONS TAKE CENTRE STAGE (AUSTRALIA)

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Legal Briefings - By **Tony Damian**

Difficult situations can pose difficult questions. The current COVID-19 pandemic has brought into sharp focus material adverse change clauses in deals. The context, the condition, and the carve-outs to it, all need to be examined in determining whether a MAC has been triggered.

IN BRIEF

- Material adverse change conditions (**MAC's**) in deals have received scrutiny in light of the COVID-19 pandemic.
- There is no one size fits all answer to the question of whether the pandemic has triggered a MAC. Each deal needs to be assessed on its own facts.
- In undertaking that assessment, the context of the MAC, the condition itself and the carve-outs to it will be key elements of the analysis.

MAC'S: THE USUAL CONSTRUCT

The modern MAC has evolved from humble origins. A MAC was typically defined as an event that had a material adverse effect on the business or financial position of the target. In other words, a MAC was a MAC. General qualitative formulations like that can be found in the early Australian cases, such as in the litigation that emerged from the 1982 Woolworths' takeover bid for Grace Bros. They can also be found in more recent North American cases, most notably the seminal 2001 case of *IBP Inc v Tyson Foods Inc*.

The cases demonstrate difficulties in enforcing general, qualitative MAC's. Tyson Foods was not allowed to walk away from its planned merger with IBP despite IBP suffering a 64% drop in quarterly earnings. A durationally significant fall was needed, and not a "short-term blip". Many others have also failed. The recent success in a Delaware Court of Fresenius Kabi AG in walking away from its proposed deal with Akorn Inc, required a perfect storm of a sustained and significant earnings drop alongside widespread and pervasive regulatory breaches.

The difficulties in enforcing general MAC's led to deeper thinking around these important provisions. In the Australian context, MAC's began to have quantitative triggers around specific drops in earnings or net assets, sometimes in conjunction with a qualitative trigger, and sometimes in lieu of a qualitative trigger.

From the target's perspective, more sophisticated carve-outs to the MAC being triggered began to emerge as well, with the result that the modern Australian MAC is now a more detailed and heavily negotiated provision than earlier iterations of the concept.

ANALYSING A MAC: CONTEXT, CONDITION AND CARVE-OUTS

CONTEXT

The context of a claim for a breach of a MAC is critical. And in that sense, there are often different contexts at play. These include:

- *Deal type*: in an English and Australian context, public M&A deals have tended to acknowledge a policy consideration that there should not be too low a hurdle for a bidder to walk away from an announced deal. Thus in the *NGM Resources* decision, the Australian Takeovers Panel found that the mobilisation of around 100 French anti-terrorist specialists and aircraft, with the permission of the Niger government to use its airspace, was "more a police action" that did not trigger the mobilisation of armed forces provision.
- *Buyer aims for the deal*: the cases have tended to examine in some detail the background to the deal and the commercial drivers for the bidder or buyer and how those drivers interact with the MAC and what has happened.
- *Buyer's regret*: whether the reliance on the MAC is a genuine one, or a right exercised because the buyer has otherwise become displeased with the deal, has been a question that Courts have confronted in a good number of the cases. Debate can be had about the relevance of that issue, but the reality is that it will be asked. In the IBP case, the Court found that there was "buyer's regret" (and did not allow the MAC to be exercised), whereas in Akorn, the Court rejected that idea (and did allow the MAC to be exercised).

There will be many different contexts in relation to the deals for which the COVID-19 situation has relevance. Questions of public policy, buyer aims in a radically altered landscape, and regret, whether buyer, financier or shareholder, will all be in the mix.

CONDITION

The condition that must be triggered is at the core of any MAC. Here, interesting questions for COVID-19 will centre around whether the MAC is qualitative or quantitative.

For qualitative MAC's, the durational significance of the current situation will be a key question. The answer to that question will depend upon the business and specifically how the industry it operates in has been affected. Will COVID-19 be a "short-term blip" or something of durational significance? When will we realistically know that to a standard sufficient to meet a MAC?

Quantitative MAC's will provide a theoretically clearer baseline to test against. Even then, challenges may remain for buyers where the effect on earnings is across recurring years, given that predicting the medium term effects may be difficult.

CARVE-OUTS

MAC's tend to have a lengthy list of carve-outs.

Relevantly to COVID-19, general changes in business conditions or markets are carved out from MAC's, as are changes in law. MAC's will usually have a force majeure style carve out as well, though (pre-COVID-19) MAC's have tended to be more fearful of weather events than pestilence.

MAC's can also carve out matters known to the buyer. This can raise interesting questions as well, depending on precisely when the deal was signed and what was known of COVID-19 at that time.

In response to more sophisticated carve-outs, buyers have often sought to introduce an exception to the carve-out - being that the carve out (such as altered business conditions) cannot have had a disproportionately adverse effect on the target. This is usually referable to a disproportionality as against other companies in the relevant industry, though formulations can vary.

There is little doubt that business conditions have been affected by COVID-19. Some of the changes in laws we have already seen have also been significant. But determining whether the carve outs will keep a deal on foot will depend on drawing all of that together alongside the company's performance while also keeping a look out for any exceptions to the carve out that could make the analysis more difficult.

A FINAL OBSERVATION

A final and important observation is that in matters where a MAC is in dispute, evidence is important. The attempts of bidders to exercise a MAC have often failed due to the bidder not putting on the right evidence. Thus in the US case of *Frontier Oil Corp v Holly Corp*, the Court found that the relevant litigation *could* have been “catastrophic”, but that the bidder did not lead credible evidence that this would have been the case.

Simply put, the work needs to be done to build the bridge between the MAC and the facts. As relates to COVID-19, and whether it relates to prosecuting a MAC or a target resisting a buyer attempting to utilise one, more is needed

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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