

## M&A Hotline

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### CAN COVID-19 AMOUNT TO A MATERIAL ADVERSE CHANGE?

The unprecedented scale of the COVID-19 pandemic is starting to show its chilling effect on commercial transactions across the global economy; recent projections by multilateral organizations have painted a grim economic future. For businesses, the biggest hurdle at the moment is to maintain liquidity to keep their operations afloat despite allowing flexible modes of remote working options. The impact of the present uncertainties may also have a telling impact on deal-making: valuations are likely to take a hit, the stock markets have their steepest fall in the shortest time in living memory, and the demand scenario in the post-COVID-19 world will not be clear till the dust settles. M&A transactions that are in the pre-signing or the pre-closing stages will, undoubtedly, be subject to the COVID-19 endurance test. During these uncertain times, one key question that deal-makers should start thinking about is: *whether the COVID-19 pandemic can trigger a material adverse effect (MAE) / material adverse change (MAC)?*

The determination whether COVID – 19 would qualify as a trigger under a MAE/MAC provision (hereinafter, the 'MAE provision') requires a case-by-case determination, and will, *inter alia*, depend on the language of a contract along with the law governing such contract. Considering the current ambiguity and the differing risks in various deals and contracts, this piece seeks to address points to consider from a contracting perspective in M&A deals.

Typically, the MAE provision in the acquisition agreement contemplates events which if *they occur*, or *are likely occur*, would have a "materially adverse change or effect on the assets, business, property, liabilities, financial condition, results, operations of the target" or that "affects the ability of the transacting parties to consummate the transaction" or the "validity or enforceability of the transacting parties to its rights and remedies under the transaction documents". Thus, a MAC provision kicks in when an unknown event can alter the status of a target's business, its continued existence, or the enforceability of the documents (in a materially adverse manner) from the time the acquirer has *agreed* to acquire such business to the time the acquirer *actually* acquires the business. From a sellers' perspective, on the other hand, the definition is used as a qualifier to representations and warranties relating to the condition of the business of the target.

In drafting the definition of a MAE, the seller would most likely limit the ambit of the MAE provision and include carve outs for *'changes in general market, economic, financial, legal or political conditions or' ('General Changes')*. However, since the burden of proof of proving a MAE is with the acquirer, a further carve out to the aforementioned exclusions for General Changes is typically negotiated by the acquirer and includes any situation where a General Change has a *"disproportionate effect on the target company or its assets or the operations"*. Such consequences, if and when proven by the acquirer, can permit the acquirer to walk away right from a transaction.

### CAN THE COVID-19 PANDEMIC TRIGGER A MAC?

Whether the COVID – 19 pandemic could trigger a MAE or MAC or not is a fact based determination and would differ from contract to contract. Unless a MAE provision is specifically negotiated to be made exhaustive so as to include pandemics, epidemics, or specific thresholds of deviations in the financial condition of the operations of a target's business, an acquirer will need to evaluate how the present circumstances have affected have caused a material adverse change or effect and if it can be fit within MAC provision.

Precedents in this regard have been far and few between, and the burden of proving a MAE/MAC is especially difficult unless such an exhaustive set of trigger events (including the duration for which the impact of an event must last for it to be so considered) have been included at the time the contracting parties sign on the dotted line. As far as M&A transactions in India are concerned, to our knowledge, there is no instance of a MAE provision being successfully invoked before courts.

From an M&A transaction perspective however, the closest that Indian courts have come to ruling on instances where impossibility of performance was proven was in *Nirma Industries Ltd. and Anr v. Securities Exchange Board of India*<sup>1</sup> wherein the Supreme Court confirmed that SEBI can permit the withdrawal of an open offer (under the Takeover Regulations 1997) only where the impossibility of performance can be framed within the criteria specified in the relevant statutory provisions, strictly read. However, it is likely that the courts will interpret a negotiated contractual clause differently from its interpretation of statutory provision and a MAC/MAE provision cannot excuse statutory compliance.

Globally, only a few precedents exist: the Supreme Court of China issued a judicial interpretation holding that non-performance of a contract owing to the SARs outbreak (or on account of administrative measures to combat it) would qualify as a 'force majeure' event excusing performance<sup>2</sup> -- though this was not in the context of M&A transactions.

There have been a few instances of MAE provisions being triggered in US deals markets after the 9/11 attacks<sup>3</sup>. However, courts have rarely upheld the rights of acquirers to walk-away. Recently, the Delaware Court of Chancery in *Akom, Inc. v. Fresenius Kabi AG*<sup>4</sup> allowed the acquirer to walk-away on the ground that the business "fell off a cliff"

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with a sustained decline in the business performance after a 25% decline in revenue flows and the uncovering of pervasive regulatory non-compliances. Significantly, the trial-court held that it would go by the specific language in the MAE provision and would not supply any meaning to the specific wording of the provisions. This was affirmed by the Supreme Court of Delaware subsequently.

#### WHAT HAPPENS IF A MAE IS IMMINENT?

If a MAE looks imminent, walking-away from the deal is not the sole option available to an acquirer. In order to save a deal, parties may be able to re-open/amend the contracts and re-negotiate price adjustments, deferred closing, or even deferred consideration constructs. Parties will need to evaluate the tax and regulatory implications of these alternatives. If the situation is intractable, walking-away might be the sole and safe option.

#### HOW MIGHT COURTS/ARBITRATOR INTERPRET MAE PROVISIONS IN INDIA?

In our view, consequence of trigger of a MAE provision if not resolved commercially, would fall squarely in the domain of the law of discharge – governed under Section 32 and Section 56 of the Contract Act, 1872.

- Per a landmark ruling the Supreme Court<sup>5</sup> affirmed that the law of discharge is to be governed solely under the terms of the Contract Act, 1872. Parties may be absolved from the further performance of an obligation if the whole purpose or basis of a contract was frustrated by the intrusion or occurrence of an unexpected event or change of circumstances which was beyond what was contemplated by the parties at the time when they entered into the agreement.
- What must be demonstrated is that the change is so fundamental as to be regarded by law as striking at the root of the contract as a whole. Only then can the contract be said to have been frustrated and the parties discharged<sup>6</sup>.
- Significantly, the courts may also question whether the event claimed to be a 'material adverse effect/change' was indeed unknown to the acquirer at the time of concluding the contract. The courts are unlikely to allow the acquirer to walk-away if the situation/events could reasonably have been foreseen.

#### HOW DOES THIS LEGAL RULE AFFECT A MAE PROVISION?

Contracting parties will need to demonstrate that the MAE that has occurred is so fundamental that it strikes at the root of the contract to warrant a discharge on the grounds of frustration per Section 56. In adjudicating, the courts will be guided by what the parties specified in a MAE provision. The Supreme Court<sup>7</sup> clarified that courts do not have the general power to absolve a party from the performance of its part of the contract merely because its performance has become onerous on account of an unforeseen turn of events. It must be shown that they never agreed to be bound in a fundamentally different situation which had unexpectedly emerged. More significantly, courts will look at the specific wording of the MAE provision for the events which can allow for a discharge<sup>8</sup>, and if an event has not been so contemplated the court cannot supply words to expand the discharge clause<sup>9</sup>.

Considering that the acquirer will typically be an outsider, access to crucial information may be limited and it is here that the seller's obligations to make necessary disclosures around occurrence of MAE become paramount. If the sellers are bound to disclose (in the case of a warranty) and inform (in the case of an undertaking) that a material adverse effect has, or is likely, to occur, the parties may be able to take timely mitigation measures and even save the deal.

#### HOW WILL A WIDELY-WORDED MAE PROVISION BE LOOKED AT?

A widely-worded MAE provision might not be of help to an acquirer. As a general rule, courts are reluctant to violate the sanctity of contracts. If there is any ambiguity in drafting, court would read the implied terms of a contract basis the following test: (1) the implied term must be reasonable and equitable; (2) it must be necessary to give "business efficacy" to the contract, so that no term will be implied if the contract is effective without it; (3) it must be so obvious that 'it goes without saying'; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract<sup>10</sup>. In such circumstances, the acquirer will need to rely on the test laid by Section 56 of the Contract Act, 1872.

#### PRECAUTIONARY MEASURES FOR TRANSACTIONS BEING NEGOTIATED: BETTER SAFE THAN SORRY!

COVID-19 has definitely put renewed focus on excuse clauses such as a MAE provision. In the coming years, discussions on MAE provisions will continue to be significant, as political economy evolves to find a new equilibrium with the rise of protectionist governments, climate challenges and attendant natural calamities, and as parties use far more sophisticated diligence tools. Some pointers while negotiating your MAE provisions are set out below:

1. *Diligence.* The importance of conducting adequate due diligence can never be understated. The acquirer should familiarize itself with the business and identify weaknesses which might be impacted an unexpected event, so it could be considered as specific events in a MAE / MAC provision. Sellers, on the other hand, may include specific information in their diligence or disclosures to inform the acquirer of its declining business conditions and the deviation from the well understood ordinary course as agreed between the contracting parties at the time of entering into the transaction.

2. *Drafting and negotiating the transaction agreements.*

a. *Scope of MAC.*

- An acquirer should make the MAE / MAC provision as exhaustive as possible to ensure it covers all possible anticipated events / series of events or percentage deviations to the financial conditions of the target's business that would support the trigger of a MAE / MAC provision and hence the walk away right of an acquirer in such event. In addition to this, in case of any exclusions to the MAC proposed by the sellers, an acquirer could include further language addressing any "*disproportionate effect on the target company or its assets or the operations*".
- Sellers, in particular, will need to think through the exceptions to a MAE, as these are significant. Besides this, typically, certain critical operational representations and warranties of a seller are also qualified to a MAE / MAC as well as a seller has the obligation to inform the acquirer of any MAE that may occur during the standstill period wherein the business is not being carried on its ordinary course.

b. *Representations and Warranties.*

- An acquirer could consider for specific representations and warranties to ensure the Sellers / target addresses the concerns of COVID-19 and its risks on the target's business. Further, COVID – 19 and its impact on a target's

business may result in representations being provided by the sellers and target to become untrue. Accordingly, an acquirer must evaluate the way forward assessing the risks or negotiate purchase price adjustments.

■ Sellers on the other hand should focus on including specific knowledge and materiality qualifiers to protect their interests considering the unknown event. Changes in law and knowledge of the acquirer are also key for Sellers in this regard.

c. *Closing timelines.* If COVID- 19 is interpreted under an agreement to trigger a MAC and is demonstrated by the acquirer to the extent of the real disruption to the operations of the business that has occurred in contrast with the expected business performance, contracting parties may commercially agree to either delay or defer the closing or in the alternate, structure the transaction to ensure parties meet their desired objectives. Interestingly, government authorities have stepped in to provide relief to businesses by extending timeline for filings to be made, placing a short moratorium on payment of interest on working capital facilities, etc.

d. *Termination Right and break fee.* Despite all commercial discussion, if an acquirer is convinced and is able to prove the material adverse effect on the ability of the acquirer to consummate the transaction, acquirer has the right to walk away from the deal. The Sellers should have negotiated for a reverse break fee contemplating such scenarios in the interest of their time spent.

3. *Insurance.* The level of insurance penetration in India is low, and businesses and individuals tend to be under-insured. Sellers and businesses should explore insurance policies targeted at mitigating losses arising out of loss of productivity or similar business interruption policies.

4. *Developing effective risk management policies and business continuance plans.* The present crises is an opportunity for sellers to introspect on the need to develop effective risk management policies and business continuance plans – these are qualitative tools to ensure liquidity in uncertain times.

## CONCLUSION

COVID-19 and its impact is yet to be digested and tested amidst players of various industries to understand what its long-term implications may be. While the damage may come across as temporary for the time being, where an acquirer is contemplating MAC, such provision is best read as a backstop protecting the acquiror from [1] the occurrence of unknown events that [2] substantially threaten the overall earnings potential of the target in [3] a durationally-significant manner. A short-term hiccup in earnings would not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror<sup>11</sup>. Given that we are entering unfamiliar waters, one will need to wait to see the significance of COVID – 19 from a duration and impact perspective on various industry players, disruptions of businesses and accordingly on acquisitions and contracts being entered into for the time being.

– Supratim Guha, Poonam Pal Sharma, Parag Srivastava & Simone Reis  
You can direct your queries or comments to the authors

<sup>1</sup> Nirma Industries Ltd. and Anr v. Securities Exchange Board of India, AIR 2013 SC 2360; Referred to in Securities and Exchange Board of India v. Akshya Infrastructure Pvt. Ltd. AIR 2014 SC 1963; Pramod Jain v. Securities Exchange Board of India (2016) 10 SCC 243; In the matter of Open Offer of M/s. Jyoti Limited in respect of Shri Lavjibhai Daliya and Anjani Residency Private Limited WTM/SR/CFD/39/08/2016.

<sup>2</sup> <https://www.pillsburylaw.com/en/news-and-insights/coronavirus-in-the-chinese-law-context-force-majeure-and-material-adverse-change.html>

<sup>3</sup> National Leisure Group had agreed to terminate its merger agreement with the USA Networks, Inc. on account of the fallout of the 9/11 attacks.

<sup>4</sup> Akom Inc. v. Fresenius Kabi AG C.A. No. 2018-0300-JTL.

<sup>5</sup> Satyabrata Ghose v. Mugneeram Bangur AIR (41) 1954 SC 44

<sup>6</sup> *Ibid.*

<sup>7</sup> Energy Watchdog v. Central Electricity Regulatory Commission, 2017 (4) SCALE 580

<sup>8</sup> *Ibid.*

<sup>9</sup> Oil and Natural Gas Ltd. v SAW Pipes Ltd. (2003) 5 SCC 705

<sup>10</sup> BP Refinery (Westport) Pty Ltd v Shire of Hastings, (1977) 180 CLR 266; Nabha Power Ltd. v Punjab State Power Corporation Ltd. (PSPCL) (2018) 11 SCC 508

<sup>11</sup> Mrs. Fields Brand, Inc. v. Interbake Foods, LLC, Court of Chancery of State of Delaware, 2017.

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