ARTICLE

COVID-19 Could Drive Increase in Material Adverse Change & Fraudulent Transfer Litigation

The COVID-19 pandemic has inflicted a dire humanitarian impact on our communities that, at the time of this publication, is yet to be fully comprehended. The economic impact has been no less catastrophic, with record-setting drops in the stock market and increases in unemployment claims. Even as government stimulus funds seek to stabilize the economy, a highly uncertain near-term future will likely continue to impact credit markets for mergers and acquisitions, putting financing from lenders or potential investors at greater risk.

In the past, many of these lenders or potential investors have relied on the rarely used Material Adverse Change (MAC) clause in financing agreements or, in the case of investors, in purchase and sale agreements. MAC clauses typically allow parties to void contracts if and when a material change has significantly altered an entity's value or financial position. However, it is typically not possible to declare a MAC when the business change is industry wide. When a MAC claim fails, lenders or investors alternatively claim that the transaction is a fraudulent conveyance because it would leave the acquired business insolvent.

Industry Peer Comparisons & Receding Economic Tides

In the merger planned in 2007 between sportswear company Finish Line, Inc. and shoe retailer Genesco, UBS agreed to finance the $1.5 billion transaction. In the weeks following the agreement, Genesco's performance began to weaken and UBS and Finish Line decided not to close, claiming that Genesco had a MAC and would become insolvent if the deal closed. They also claimed that Genesco fraudulently withheld information. In December 2007, a Tennessee court ruled that Genesco did not fraudulently withhold financial information and a MAC did not occur. The court did conclude that Genesco experienced adverse changes; however, those adverse changes were not disproportionate to Genesco's industry peers. In summary, the court found that the contract specifically considered economic downturn to be a MAC factor; however, it concluded that this significant business change was due to deteriorating macroeconomic conditions – a circumstance specifically exempt from the contract MAC definition.

As the economy struggles to recover from the COVID-19 outbreak, we may see more banks and investors making MAC claims, although clause language will likely evolve to exclude COVID-19. More specific language reduces the likelihood of an adverse event and increases the chances of fair compensation in a MAC claim if a deal falls apart.

When analyzing a MAC claim, it's important for the CPA to select the appropriate peer group. Gathering data for peer group companies in many industries may be difficult since some peers may be private companies or public companies that report on a consolidated basis both segments in and out of the relevant industry. Often the segment reporting for these consolidated public companies does not include the revenue and expense details needed by the CPA. Due to these data issues, a CPA should be given ample time to investigate and gather the best industry information available.

The 'Bankruptcy Strategy' Alternative

As MAC clauses become more limiting, it will be tougher for companies to exclusively rely on them to escape transactions. The "bankruptcy strategy" will be used more often as the economy continues to struggle. This strategy typically is based on a claim that the transaction will cause the target company to become insolvent. Although Finish Line and UBS lost the lawsuit in Tennessee, they were confident that the merger would not go through based on the terms of insolvency under Bankruptcy Code Section 548(a) (2). The law states that a "transfer made or obligation incurred is avoidable, regardless of intent, if: the debtor receives less than "reasonably equivalent value" for the transfer made or obligation incurred, and the debtor: was insolvent at the time, or becomes insolvent due to the transfer made or obligation incurred; or was engaged in a business for which it had or retained unreasonably small capital; or intended to incur or believed it would incur debts beyond its ability to repay."

Finish Line and UBS claimed that the merger would create an insolvent entity. The companies ended up settling outside of court before trial and Finish Line and UBS paid a total of $125 million, a small fraction of the $1.5 billion that Genesco initially sought relating to this failed acquisition.

Three Tests For Insolvency

There are three tests that determine insolvency: the balance sheet test, the unreasonably small capital test and the ability to pay debts test. As the MAC clause becomes more restrictive, we can expect increasing use and evaluation of these three tests by the courts.

- The balance sheet test is the most commonly litigated of the three. It involves analyzing the components of the balance sheet and evaluating assets and liabilities not listed there. If the assets are valued at less than the liabilities, then the company could be considered insolvent.
- The unreasonably small capital test (cash flow test) evaluates solvency based on whether the company receives enough cash flow to operate, which is typically determined by analyzing the cash flows at the time of the merger or acquisition.
- The ability to pay debts test determines solvency using an assessment of a company's current and future debts and whether it can pay its debts as they come due. The ability to pay debts test is infrequently used because it is difficult to determine a company's ability.

CASE STUDY

Material Adverse Change & Fraud Damages

FTI's client, a company in the advertising industry, sought to rescind a $1.2 billion merger due to a significant shortfall in forecasted operating income. Prior to the signing of the sale and purchase agreement (SPA), the seller represented that its financial statements were materially correct and forecasted operating income in the current fiscal year. After the SPA was signed, the seller adjusted its forecasted operating income. The actual results of the entity for the year-end were approximately $30 million below expectations.

FTI analyzed whether the seller had sustained a material adverse change and whether FTI's client had obtained the benefit of its bargain. FTI analyzed four financial criteria to demonstrate a material adverse change. There was a dramatic downturn in earnings from the date of the signing of the SPA to the date of the close. During the relevant period, the client's operating performance was disproportionate as compared to the industry. The decline in earnings was determined to have affected future periods or was durationally significant. Lastly, these factors were unknown to our client, the buyer, at the merger close.

Based on FTI's analysis of the misrepresented operating income, FTI calculated an overpayment for the business between approximately $340 million and $400 million based on income and market approaches to value. The matter went to trial, and our client was able to recover a significant portion of the purchase price due to FTI's work.

Measuring to Historical Levels Instead of Projections

Returning to the bankruptcy strategy, another example of its use is *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, C.A. No. 3841-VCL (Del. Ch. Sept. 29, 2008). Apollo Management LP, owner of Hexion Specialty Chemicals, Inc., agreed to acquire Huntsman Corp. for $6.5 billion. Apollo ultimately decided not to complete this transaction and filed a lawsuit against Huntsman, saying that a MAC had occurred, and claiming that had the merger been consummated the combined Hexion-Huntsman entity would be insolvent. After hearing the evidence, the judge ordered that this transaction be completed since, in the court's view, a MAC did not occur. The court concluded that a MAC should be measured in terms of whether Huntsman suffered a material deterioration measured against its past performance, and whether the deterioration would likely cause substantial long-term effects on Huntsman's earning power. Hexion's presentation to the court focused more on adverse changes to the expected EBITDA (earnings before interest, tax, depreciation and amortization) projections rather than comparing the expected EBITDA adjusted for the adverse changes to historical levels.

With regard to the solvency question, the court noted that there was no insolvency "out" for Hexion under the merger agreement. The matter subsequently was settled for a $1 billion payment by Hexion to Huntsman. In addition, in another case related to this transaction, the two banks financing the transaction argued that this entity would be insolvent when the transaction was completed. The banks settled for $632 million in cash and $1.1 billion in loans to Huntsman.

When a bankruptcy strategy is considered and used, it is increasingly common for one of the litigants to call in a CPA to analyze the business' solvency. The CPA is usually asked to perform and present the analyses and tests discussed above to support insolvency claims. To perform such tests the CPA would typically need to analyze future cash flow projections, related asset values, liability balances, the entity's ability to pay debts and the adequacy of capital levels. In addition, CPAs could be called upon by one of the litigants to analyze and present support for a MAC claim. To support a MAC claim the CPA will typically consider the changes to the entity's business vs. changes to the entity's industry and related competitors. Many cases today involve both MAC and solvency claims. These cases usually require significant financial analysis to support such claims and CPAs who are well qualified to perform and present the related analysis.

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