COVID-19 UK INSIGHTS

CREATING CERTAINTY IN UNCERTAIN TIMES – THE RETURN OF THE MAC

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This note summarises certain legal considerations with respect to enforcing Material Adverse Change ("MAC") conditions in private and public M&A transactions and our tips for parties seeking to negotiate MAC protections whilst uncertainties arising from the COVID-19 pandemic continue to prevail.

Speed Read

- Businesses around the world have been substantially impacted by the COVID-19 pandemic and are likely to be managing the effects and remaining uncertainties for some time. In this context, we expect to see a shift in risk allocation in the European private M&A market to deal protection mechanisms more synonymous with a buyer's market and specific provision for COVID-19, such as tailored warranties and covenants.
- Among other measures, we are likely to see renewed emphasis on whether a buyer should be entitled to withdraw from a transaction if a material adverse change ("**MAC**") arises in the period between signing and closing. Already we have seen COVID-19 cited as a basis for a MAC-related exit right from a number of high-profile M&A deals, including L-Brand's aborted sale of Victoria's Secret, Silver Lake's divestment of Global Blue and Carlyle and GIC's investment in Amex's Global Business Travel unit.
- It is to be hoped that the impact of COVID-19, whilst substantial, will be temporary and further outbreaks will not mean that businesses prove to be fundamentally affected in the longer term. However, buyers may not be prepared to accept that they should be on the hook to complete if another severe outbreak occurs and/or the business they agreed to purchase suffers lasting damage in the period to closing.
- Buyers should be aware there is a high bar to being able to successfully invoke traditional, generic formulations of a MAC condition and such formats are unlikely to suffice to address further consequences or outbreaks of the pandemic.
- When negotiating a MAC condition in the context of the prevailing COVID-19 uncertainties, buyers should consider including specific, measurable triggers that are capable of appropriately testing the real business concerns. More specific language should bring certainty for both buyers and sellers and help to minimise the prospect of dispute and delay. Some suggested drafting tips can be found here.
- Although generic MAC conditions are included as standard in UK public M&A offer documents, the ability to invoke a MAC condition so to cause an offer to lapse is significantly restricted by the UK takeover rules. We do not expect to see a departure from the standardised MAC formulation used in UK public M&A deals nor a change in how the UK regulator, the Panel on Takeovers and Mergers (the "Panel") views these conditions. Indeed, we have already seen the Panel block the first (and possibly the last) attempt by a bidder for a UK public company to invoke a condition to lapse its offer due to the effects of Covid-19[1] and potential offerors considering a UK public bid should assume there is limited prospect of withdrawing, even if further adverse events arise from COVID-19 or a second wave of the pandemic breaks out.

[1] See Panel Statement 2020/5 dated 21 May 2020 in respect of Brigadier Acquisition Company Limited's offer for Moss Bros plc.

Material Adverse Change Protection in Private M&A

As the impact of the COVID-19 pandemic and the restrictions on everyday life continue to be felt across all jurisdictions and sectors, unsurprisingly, the global M&A market has slowed considerably. However, as we have seen in previous economic downturns, acquisition opportunities will develop and, when they do, buyers are likely to take a more aggressive stance with respect to deal protection measures. Indeed, a general move towards a buyer's market seems likely to continue in the medium term as economic and other uncertainties are likely to remain, at least until a reliable vaccine or effective treatments for COVID-19 can be broadly delivered. One deal protection measure buyers will be considering closely is the ability to use a MAC condition to allow them to withdraw from a signed deal, if a material change occurs in the period between signing and completion.

In recent years, in the European private M&A market, sellers have tended to hold the upper hand and the majority of deals have been executed on the basis of limited conditionality. MAC conditions have been rare and have only tended to be seen on deals which involve US buyers (or in those which have a US financing component) or in circumstances where the buyer has significantly greater bargaining power. Typically, closing conditions have only extended to cover mandatory regulatory or other necessary approvals, leaving buyers to carry the risk of the target business suffering a material change before closing.

However, given the unprecedented impact of COVID-19 on global business and the significant risk of further serious outbreaks occurring as we move through the year, we would expect to see an increase in the number of deals subject to MAC-related conditions. This may be structured as a simple condition or a walk-away right attached to a repetition of warranties or both. We may also see the increased use of MAC conditions in acquisition agreements as a result of lenders becomingly increasingly unwilling to finance transactions without the benefit of a MAC. Indeed, it remains to be seen the extent to which "certain funds" style debt financing will be available in the short-to-medium term.

MAC clauses are typically drafted in a generic format requiring that any adverse effect must impact the target's business and operations or financial position (or similar concept) as a whole when viewed on a long-term basis. Factors affecting the wider economy, industry and/or markets generally (save to the extent disproportionately affecting the target) as well as impacts stemming from national emergencies, disasters and pandemics are routinely excluded as these are events outside the control of the parties and have generally been accepted as buy-side risks.

There have been relatively few English law cases in which the courts have considered MAC provisions. These cases have predominantly been in relation to lending agreements, for which MACs are a customary event of default; although there have been a number of cases where a "no MAC" warranty included in a share purchase agreement has been considered. In view of these cases, when interpreting a generic MAC condition, we would expect the English courts:

- will endeavour to uphold the bargain struck and so will be likely to construe the MAC condition narrowly;
- will take a long-term view in defining materiality, so events which have an impact on the target's business or operations will need to have an adverse impact over a significant period of time or otherwise be "significantly durational",[2] which is likely to mean years, rather than months or consecutive quarters;
- in the absence of specific provision to the contrary, are unlikely to consider a general market or economic effect as constituting a MAC for the target group, save to the extent there is a disproportional impact on the group; and
- are unlikely to enforce a MAC condition in respect of pre-existing events as the buyer will be taken to be on notice and to have accepted the resulting risks.[2]

Accordingly, buyers should be aware that there is a high bar to being able to successfully invoke a MAC condition, at least to the extent a MAC is expressed in the traditional, generic format.

[2] Grupo Hotelero Urvasco S.A. v Carey Value Added S.L. and others [2013] EWHC 1039 (Comm), referencing a Delaware case IBP Inc. v. Tyson Foods Inc. 789 A2d 14 (Del Ch 2001).

Material Adverse Change Protection in the context of COVID-19

As stated above, we would expect to see a rise in the number of M&A deals which are subject to MAC conditions and there may be particular pressure to include "market MAC" conditions, designed to be triggered by a worsening of the market or the economy generally. However, we would expect sellers to counter that buyers are aware of the market volatility and economic disruption that may ensue from COVID-19. In any event, even if a market MAC were to be included in an acquisition agreement, a buyer would still have a high burden of proof to discharge, particularly in convincing a court that the market issues would be reasonably likely to have a significant adverse effect on the target's business over the long term and that the target's business and economic issues at closing could not have been reasonably foreseen at the time of signing. For similar reasons, a reference to a material impact resulting from COVID-19 (or a further outbreak of COVID-19) is unlikely to be sufficiently precise to allow a buyer to invoke the condition.

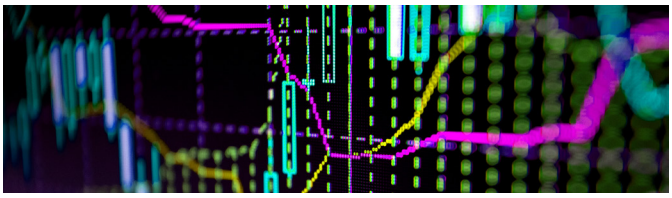
In considering how to structure MAC protection to achieve predictable outcomes in the current climate, buyers should look beyond traditional MAC formulations, market MACs and generic COVID-19 references and consider how MAC conditions can be expressed, without ambiguity, to be triggered on specific events with specific consequences. Measurable business-focused MAC conditions will deliver substantially more certainty and significantly lessen the litigation risk for both parties. Parties may also want to consider other remedies for unforeseen COVID-19 impacts, including earn out and other forward-looking pricing mechanisms. If closing accounts are used in place of a locked box, as seems more likely in the current environment, buyers may consider extending the typical net debt or working capital true-ups to encompass earnings and/or EBITDA.

In seeking to draft and negotiate a MAC condition, buyers should consider how the following matters are addressed:

- ***What specific events should warrant a right to terminate at closing***
  To demonstrate the necessary causal effect, a MAC condition should refer to an event that can be easily measured or tested. It will always be easier to measure a specified drop in revenue or earnings over a defined period or a measurable impact on a target's balance sheet, for instance, than a generic reference to a business or market change. Buyers may also wish to consider referring to specific business concerns in addition to financial measures, such as withdrawal of government support, a serious security breach or a government-mandated business closure.
- ***What is the relevant underlying accounting metric?***
  The courts will generally look to test events by reference to appropriate accounting measures. So, for instance, "financial position" would normally be understood by reference to financial statements (though other factors may be shown to be relevant)[2] and a provision referencing the target's "financial or trading position" has been considered to encompass balance sheet and current profitability and performance against budget.[3] Accordingly, buyers should consider the appropriate metric from an accounting perspective and whether, in place of a reference to financial position or similar concept, the contract should instead refer to specific line items (e.g., EBITDA or NAV).
- ***How should the long-term impact be judged?***
  Specifying a short-term test avoids the need for the court to determine if there is a sufficiently long-term impact. However, the parties will still want to consider what change in balance sheet and current trading data in the period to closing should be considered sufficient to indicate a MAC in the longer-term. A temporary earnings blip that does not materially impact the earnings power of the business should not suffice to derail the deal.

  Both parties will want to ensure the event can be measured definitively and sellers will be concerned to avoid references to "prospects" or other more uncertain concepts. Whilst any forward looking aspect will need to be judged against forecasts, it is also worth noting that a change in forecasts alone (as a matter of opinion, not fact) will not itself be a relevant event of change.[4] However, a long-term impact may be difficult to show without some element of judgement. For example, a 20% drop in EBITDA across the period to closing may need to be combined with a forward-looking judgement, such as "there is no reasonable prospect of" the shortfall being made up within the financial year or the full year forecast being met or a similar test. Whilst buyers will want to retain a discretion to make any such assessment, sellers should ensure there is an objective standard for prospective elements or, at the very least, that the buyer's assessment needs to be made on reasonable and good faith grounds.

[3] Thomas Witter v TBP Industries [1996] 2 All ER 573.
[4] Ipsos SA v Dentsu Aegis Network [2015] EWHC 1726 (Comm).



A requirement for a reasonable and good faith assessment lacks the certainty of a purely objective standard but should still require the buyer to justify its conclusion.

- ***What constitutes materiality in the circumstances?*** The courts have confirmed when considering generic MAC formulations that material will generally mean 'significant' or 'substantial' and, in the absence of any indication to the contrary, it will apply an objective test.[5] As noted above, judicial assessment of materiality in the context of MACs has predominately been limited to banking cases and SPA warranty claims and there is little guidance on the actual quantum of 'materiality'. In one such English case the court did take the view that a 20% drop in NAV over a four-month period ought to be considered sufficiently material for the purposes of a warranty as to the absence of a MAC.[6] However, persuasive judgements from the Delaware courts have applied a more stringent interpretation of materiality. Only once (in late 2018) have the Delaware courts allowed a MAC to be enforced in a merger context, in a case involving an 86% drop in annual EBITDA.[7] In another case it concluded a 64% quarterly decline in earnings from operations insufficient to constitute a MAC (although, in that case, the downturn was partly cyclical and there were signs of recovery in the following quarter).[8] In the current circumstances, to increase the prospect of enforcement, buyers may prefer to specify the degree of change that should be considered material and over what time period rather than defer this question to the courts.

Material Adverse Change Protection in UK Public M&A

Unlike the private M&A market, MAC conditions are standard in UK public takeover transactions which are subject to the rules of the City Code on Mergers & Acquisitions (the "City Code") regulated by the Panel. However, the ability of a bidder to invoke a MAC condition so as to cause an offer to lapse is significantly restricted by the rules of the City Code which applies an overriding concept of materiality and the Panel will only permit a condition to be invoked if the circumstances that give rise to the right to invoke the condition are of "material significance" to the bidder in the context of the offer. This is an extremely high bar and the Panel has consistently shown itself to be unwilling to allow bidders to rely on MAC clauses in order to lapse offers.

The Panel's position on MAC conditions is most prominently exemplified by its 2001 ruling in connection with WPP's offer for Tempus Group plc whereby WPP attempted to invoke the MAC condition in its offer document by arguing that the events of September 11, 2001 in the United States had caused a material adverse change to the prospects of Tempus. The Panel ruled that WPP was nonetheless required to go through with its offer because, to be permitted under the City Code, a material adverse change, however the condition is drafted, must be an adverse change "of very considerable significance striking at the heart of the purpose of the transaction". The Panel ruled that a temporary effect on profitability would not meet this standard.[9]

Since the Tempus ruling in 2001, there have been a handful of examples of the Panel permitting bidders to include bespoke conditions covering specific events. However, these remain rare and very fact specific cases. To date no bidder has successfully lapsed an offer by the invocation of a MAC or similar condition.

The few public offers announced since the UK lock-down measures were introduced on 23 March 2020 have included limited disclosure on the possible business impacts of COVID-19 but there has been no departure from the standardised MAC formulation adopted in most offer documents. We do not expect this to change nor do we expect to see a change in how the Panel views and interprets MAC conditions.

The Panel's interpretation of materiality in the context of a MAC condition was most recently tested in May 2020 in respect of Brigadier Acquisition Company Limited's ("Brigadier") offer for Moss Bros plc which is the first (and may possibly be the last) example of a bidder for a UK public company trying to invoke a condition to lapse its offer due to COVID-19 reasons. Although the Panel has not yet released the detailed reasoning behind its ruling, it confirmed that Brigadier

[5] Decura IM Investments LLP & others v UBS AG [2015] EWHC 171 (Comm).
[6] Levison v Farin [1978] 2 ALL ER 1149.
[7] Akorn v Fresenius Del. Ch. Oct. 1, 2018.
[8] IBP v Tyson, 2001 Del. Ch. Lexis 81.
[9] The conclusions of this ruling are reflected in the Panel's Practice Statement No 5 of 28 April 2004 (Panel Statement 2001/15).

had not established that the circumstances that gave rise to its right to invoke a MAC were of material significance to it in the context of its offer and, therefore, Brigadier was not permitted to lapse its offer and walk-away from the deal.

Given the Panel's prior views on MAC conditions, this is not an unsurprising decision and despite initially requesting an appeal, Brigadier has subsequently determined to accept the Panel's ruling. Indeed, given what we know already about the impact of COVID-19, it is extremely unlikely that the Panel would permit a bidder to invoke any condition relating to COVID-19 or find favour with any bidder argument that it should be able to walk away from an announced deal because of the impact of a further outbreak of the pandemic.

Any further COVID-19 effects on a target's operations would need to be unforeseeable at the time of the offer and strike "at the heart of the purpose of the transaction" – likely meaning a permanent and significant diminution in value of the target's assets, or worse, threatening the very existence of the target – to enable a bidder to invoke such a condition.

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