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Call Me MAE-Be?

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While not everyone may be familiar with (or lived through) Black Monday, the Savings & Loan Crisis, the Dot-Com Bubble or the Great Recession, it is impossible that anyone reading this note could be unaware of the COVID-19 pandemic and its impact on their social and economic lives.

While I have lived through more of the above events than I care to admit, for business lawyers, times like this cause three words to invariably rise from simple words on the page to real topics of conversation, analysis and angst. Those three words are "Material Adverse Effect." A full analysis of the concept, what it is (and perhaps, more importantly, what it is not), and how and when it can be successfully applied is well beyond the scope of this note. Nevertheless, an overview of the use of the MAE concept in acquisition and loan transactions, a discussion of recent developments and a brief roadmap for analysis hopefully is an achievable objective.

While Material Adverse Effect is the more common term used in syndicated loan agreements, when discussing the concept, we tend to use the term "MAC" or "MAC Clause" (Material Adverse Change). They are the same – an (almost painful) lesson learned as a "baby lawyer" at my first closing. As the funding deadline loomed, an issue came up and seemingly everyone in the conference room nervously started saying "well, what does the 'MAC' say?" Since my participation at the closing could best be described as appreciated, just not required, I scoured our loan agreement to try and be marginally helpful. I looked and looked – our document definitely did not have a "MAC" – yep, no "MAC," just a "MAE." Thankfully, I chose not to share my newfound (lack of) knowledge with the room of non-baby lawyers.

Is a MAE the same as a *Force Majeure*? The simple answer is no. *Force Majeure* clauses generally allow for parties to a contract to be excused from performance or entitled to suspend or extend the time of performance as a result of some "outside" event (generally, "Acts of God"), with the key being, the obligations resume once the event has been remedied or overcome – sort of a "pause button" for performance. Frustration of Contract is often part of a discussion of *Force Majeure*.

MAE clauses generally contemplate a change in circumstances that impacts the economic value of a transaction or the situation of a seller or borrower, with the key being, the buyer or lender may terminate a transaction because of the event – it's not a "pause button" but a "stop" or "eject" (for those of the cassette era) button.

So how and when is the MAE concept applied? In general, there are two groupings. The first is the MAE used in the context of a merger or acquisition transaction. In this space, the MAE has a similar effect/goal as the *Force Majeure* – to excuse the consummation of the transaction. For finance lawyers, it is important to note that the MAE in this context can have a loan agreement impact, since in the acquisition financing context a lender's "committed financing" to a buyer will often be subject to the MAE formulation and application defined in the acquisition agreement. Stated differently, the ability of a lender to back out of a committed financing will be linked to and limited by the buyer's ability to back out of the transaction as a result of the MAE it has negotiated.

The other grouping, and the primary focus of this note, is the business MAE used in loan agreements. In this context, the lender may use the MAE as both a "stop" button and as a "pause" button. I view the stop button as a pre-close tool, similar to an acquisition, in that the lender does not want to close the transaction, and the pause button as a post-close tool, where there is an existing loan agreement and a situation appears to have occurred where the lender wants to pause a funding request.

As for the "stop button" at closing, since most every loan agreement requires the borrower to make "clean representations" as a condition to closing, the existence of a MAE would almost always be a block to closing. One practice point here is the relatively common request from borrowers that certain scheduled material events be included as exceptions to the general "no MAE" – often in the context of known litigation. The significance of this ask is often lost on the various parties. First, "material" and a "MAE" are not the same thing, and the SEC standard for materiality is not the same as a MAE. Further, whether a true MAE has occurred (an extremely high bar, as discussed below) or a borrower simply wants a "material event" to be acknowledged by the lender, the effect on the lender is the same. Any exception (even something that started out as only "material" that ultimately escalates into a MAE-type problem) will forever be grandfathered in as an exception to the MAE. The ultimate effect is that a lender is not only agreeing to close into a potential MAE but also is agreeing to honor subsequent draw requests, since that pre-closing "material event" (even if snowballed into a real MAE) will forever be a non-MAE. The implication of this distinction hit home years ago on a loan transaction to a public company. We were a day or two from closing when the front page of *The Wall Street Journal* reported that our borrower was the subject of a *qui tam* action for false billing, with the government seeking fines and penalties of up to $6 billion. While the syndicate was aware of the *qui tam* case and the borrower did not view the action as a MAE during our diligence process, the borrower was adamant that they needed to schedule the *qui tam* as an exception to the litigation MAE. They understandably claimed, "How could it not? It certainly was material; it was on the front page of *The Wall Street Journal* and the government was asking for $6 billion." Once the initial surprise wore off, the lenders asked the borrower if they "could reasonably expect a MAE" to occur as a result of the action. If that were the case, clearly, the lenders would not close a loan agreement into a known MAE – whether the lenders or the readers of *The Wall Street Journal* were aware of the action or not. While the borrower explained that a $6 billion fine would likely be a MAE, they did not reasonably expect the action

to cost them $6 billion, but instead estimated their potential exposure to be $25-$100 million (an amount that would not be a MAE to that borrower). The result was no MAE was scheduled, and 6 years later (2 years after our facility went away) the borrower settled with the government for approximately $25 million.

As for the "pause button," this is the most likely situation for a finance lawyer to face – seemingly always in the context of a frantic call from the lender saying their borrower wants to borrow but has recently reported a negative event or the lender suspects that an event of default has or will likely occur in the near future. The MAE here is when a lender is looking for a "hook" to pause a funding request. Before it can be used, of course, a lender and counsel not only need to understand what it means (not a simple task), but also weigh potential lender liability ramifications of improperly using the MAE if it is the only potential hook to pause a funding.

What a MAE means could be a book or a really short note – each of which arguably has the same amount of value to the practitioner, since murky, subjective and vague are only a few of the adjectives that can be applied to the analysis of what is a MAE. As stated, while still murky, this is where lending lawyers can look at the much more extensive acquisition MAE law for some guidance – most of which is from the Delaware courts.

Since the first word of the MAE acronym is "Material," it should not be surprising that the biggest question is, what is "material" – *i.e.,* what is the magnitude of the situation, how bad is it? I have purposely not discussed the actual MAE definition, since, while not universal, most definitions bear significant similarities, with the usual points of negotiation. Unfortunately, virtually all MAE definitions similarly fail to provide any clear, objective formulation for what is or is not "material adverse effect" – none of them say, for example, a more than 25% decline in net revenue over a period of more than three fiscal quarters is a MAE or losing more than two of a borrower's top five contracts equals a MAE.

Delaware courts, in the context of an acquisition agreement, have established the following interpretation of materiality:

A material adverse effect is "an unexpected event or series of events that threatens a business's overall earnings 'in a durationally-significant manner.'" *3M Co. v. Neology, Inc.*, NO.: N18C-07-089 AML CCLD, 2019 Del. Super. LEXIS 312, at *30–31 (Del. Sup. Ct. June 28, 2019). That said, "[whether a material adverse effect exists ultimately is a factual issue[.]" *Id*.

Despite Black Monday, the Savings & Loan Crisis, the Dot-Com Bubble and the Great Recession, no Delaware court has found the existence of a MAE – that is, until this past October.

For the first time ever, the Delaware Chancery Court in *Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 Del. Ch. LEXIS 325, *123-24 (Del. Ch. Ct. Oct. 1, 2018),* found that Fresenius properly terminated the merger agreement because, among other things: Akorn had sustained a material and durationally significant change in its financial performance that resulted in a MAE.

Are the flood gates now open? Do buyers and lenders now have clear guidance? The answer is likely "no" and "no," but some guidance is better than no guidance. While no objective criteria

came out of the case, there is value in noting the factors the court focused on while analyzing both materiality and durational significance. In establishing the magnitude of the change, the court relied heavily on financial indicators and historical trends. The court evaluated various financial metrics, including revenue, operating income, and EPS on a quarterly and annual basis to control for the impact of seasonality in Akorn's business. The court found that in each case, Akorn performed significantly worse than it had not only in relation to the previous year but also against expectations – *e.g.,* Akorn's 2017 operating income showed a 105 percent decline over 2016 operating income, which was a departure from Akorn's historical trend of consistent growth from 2012 through 2016.

With respect to durational significance, the court noted that Akorn's continued poor financial performance had lasted well over a year at the time the trial took place in July 2018. The court also cited Akorn management's reasons for poor performance as indications that such changes were durationally significant and not merely short-term hiccups. Specifically, the court referred to unforeseen competition with Akorn's top products and the loss of a key contract as evidence of the lasting impact on the business. In addition, while the court found some downturn in Akorn's peers' performance, Akorn's poor performance was significantly disproportionate to its peers.

As for the "flood gate" now being open, in the first case since *Akorn v. Fresenius*, the Delaware Court of Chancery ordered Boston Scientific Corporation to complete its acquisition of Channel Medsystems and emphatically reaffirmed the high bar facing a party seeking to terminate an agreement as a result of a MAE. Using the same quantitative and qualitative factors as prior decisions, the court found that "a mere risk of a MAE cannot be enough" and "[t]he important consideration… is whether there has been an adverse change in the target's business that is consequential to the company's long-term earning power over a reasonable period, which one would expect to be measured in years, rather than months" (quoting *Akorn*).

Bringing the question back to today, there is clearly still no bright-line test to establish whether the effect of COVID-19 will be a MAE. Based on the above, however, it does seem safe to say there are a few takeaways. First, as to materiality, one needs to look at quantitative and qualitative factors, including whether the seller/borrower has been disproportionately affected versus its peers. With respect to COVID-19, it seems as though the courts could say that as the water level is lowering for everyone, there is no unique materiality.

Second, and perhaps most perplexing, is the question of durational significance as to COVID-19. While Black Monday, the Savings & Loan Crisis, the Dot-Com Bubble and the Great Recession all had their ultimate "cliff moment," from a cause-and-effect perspective, one would be hard-pressed to say that the cause of those problems and their ultimate effect on the general economy and specific businesses could compare in any way to the speed and severity with which COVID-19 has impacted businesses. The point being, with respect to durational significance, which way does the analysis of the court in *Akorn* (and its lineage) cut?

In Akorn, the court stated that it was not simply a short-term hiccup. Does that mean a court will say that while the COVOD-19 impact has been severe, at this point in time, not even one full fiscal quarter has passed. As a result, it is still a "hiccup" and its effects on any particular business have not been durationally significant. Further, while the length of the pandemic is uncertain, unlike the other events discussed, there is a single cause of the issue with COVID-

19 and arguably a single solution such that the issue could go away almost as quickly as it appeared and, thus, it is not likely to “persist significantly into the future.” *Hexion Specialty Chems., Inc. v. Huntsman Corp.,* 965 A.2d 715, 738 (Del.Ch. Ct. 2008).

While a MAE analysis is always going to be fact-specific and while there is no bright-line test, it would be incorrect to say that a MAE is purely subjective. The existing case law does outline what the two hurdles are to establish a MAE: a problem that (i) has a significant negative magnitude and (ii) is durationally significant. Whether COVID-19 is that event will still hinge on its effect on a business (possibly against its peers) and how long it persists. My question is whether a future court looking at COVID-19 would continue to apply the two tests independently, or seek to balance the two tests in a single formula by softening the durational significance prong and giving more weight to the materiality prong in light of the generationally severe impact that COVID-19 has had on businesses.