



March 23, 2020

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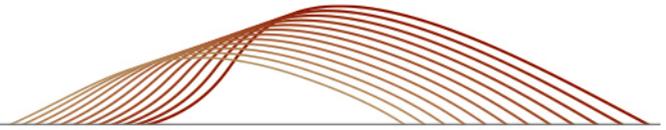


## *PH COVID-19 Client Alert Series: Managing Risk, From Material Adverse Effects to Contractual Considerations*

By [Richard Horvath](#), [Thad Malik](#) & [Kevin Logue](#)

As COVID-19 continues to impact participants in the global economy, common questions have arisen, including whether that impact would constitute a Material Adverse Effect (“MAE”) sufficient enough to terminate commercial obligations. That a MAE exists typically would be a fact intensive analysis, and no generic analysis can speak to every situation. Nonetheless, commercial parties would do well to familiarize themselves with certain key principles recognized by courts in interpreting MAE clauses. For the purposes of the following summary, “Buyer” shall be the contractual party or entity claiming a MAE exists, and “Seller” shall be the contractual party or entity claiming a MAE does not exist.

- In the absence of evidence to the contrary, a court will presume that Buyer is purchasing Seller as part of a long-term strategy.
- A MAE clause “is best read as a backstop protecting an acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.”<sup>1</sup>
- Moreover, a court will default to reviewing a MAE from a “seller-friendly perspective.”<sup>2</sup>
- Buyer typically bears the heavy burden of proving the existence of a MAE.
- Critical factors for whether an event triggers a MAE are:
  - The event substantially threatens the overall earnings potential of Seller; and
  - The impact of the event to Seller’s earnings is of a durationally-significant and disproportionate manner.
- While there is no precise bright line or threshold, courts generally accept that events causing a decline in profits of 40% or higher could demonstrate a MAE occurred. Nonetheless, a MAE may or may not exist at a lower or higher threshold.
  - When evaluating the magnitude of a decline, a court is likely to compare Seller’s performance against its results during the same time period of the prior year in order to minimize the effect of seasonal fluctuations.

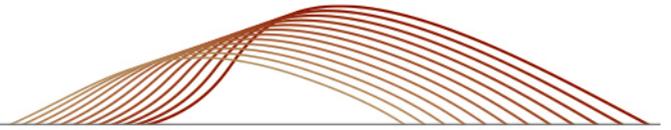


- It is possible for a MAE to have occurred without its effects having yet been felt, though there “must be some showing that there is a basis in law and in fact for the serious adverse consequences prophesied by the party claiming the MAE.”<sup>3</sup>
- For the negative impact from an event to be durationally-significant, “[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 earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months.”<sup>4</sup>
  - Courts have recognized that certain contractual relationships are of significantly less duration. In those situations, courts will evaluate the durational significance of a MAE consistent with the contractual relationship.
- Moreover, it is also common for a MAE clause to require that the triggering event has disproportionately affected Seller, as compared to other companies in Seller’s industry.

As both the above and case law make clear, a MAE—as with most contractual provisions—reflects an allocation of risks between Buyer and Seller. As such, Buyers and Sellers should consider how their contractual agreements allocate the risks associated with COVID-19. Such considerations could include:

- Avoid a one-size-fits-all approach to drafting. Instead of relying on general MAE constructs, commercial parties could draft specific provisions to address COVID-19 concerns.
- If relying on the MAE construct, employ metrics, timelines, and deadlines for events that could trigger a MAE. Most MAE clauses are written descriptively. Quantifying specific triggers could prove more effective for specifically allocating risks.
- Specifically allocate the burden of proving the existence of a MAE or an exception to it. Such allocation could be of general application to any or all MAEs, or could be targeted to specific events.
- Because each transaction is different, address the duration or proportionality of a potential MAE. As recent events have shown, COVID-19 may have significant short-term impacts with severe moderate or long-term consequences.
- Because other contractual provisions, such as ordinary course of business, key customer, or key supplier representations and warranties, could be impacted by developments related to COVID-19, do not limit attention only to a MAE clause.
- The market for representation and warranty insurance, and exclusions that carriers may impose, continues to evolve in response to COVID-19. Commercial parties will need to take these developments into account when allocating COVID-19 related risks within an agreement.

A fear of tomorrow is not an appropriate response to COVID-19. Rather than allow such fears to forestall all future planning, sophisticated commercial parties and their advisors have a number of tools available to them to manage the risks presented by current market developments.



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<sup>1</sup> *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 68 (Del. Ch. 2001).

<sup>2</sup> *Id.*

<sup>3</sup> *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347, at \*65 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

<sup>4</sup> *In re IBP*, 789 A.2d at 68.

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