

Does COVID-19 constitute a material adverse effect?

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In addition to a vast human toll, COVID-19 has wreaked havoc on businesses, markets and supply chains. With infections still spreading, businesses have suffered cash and liquidity constraints and anticipate such suffering to continue.

The pandemic also presents unique risks to parties in acquisition agreements, such as risks concerning the financial viability of the target company. Parties often address these risks by including material adverse effects, or MAE, clauses.

Generally speaking, an MAE is an event, circumstance, change or effect that presents a material threat to the business of the target company. MAE clauses account for this possibility and allocate risk among the parties.

Such clauses are frequently used as conditions to closing and qualifiers to the seller's representations. If the target company suffers an MAE as defined in the agreement, the clause allows the buyer to unilaterally terminate the deal without being considered in breach of contract. The seller can qualify representations made about the condition of the target company, making it more difficult for a buyer to assert a breach. Also, exclusions to the definition of an MAE are identified, such as industrywide market conditions.

One increasingly common issue is whether COVID-19 constitutes an MAE. The following questions may help determine the answer and assist parties in the negotiation stages:

- Are there MAE exclusions such as epidemics, pandemics and natural disasters?
- Has COVID-19 resulted in unique issues for the target company that are disproportionate to other companies in the same industry?
- Is the buyer obligated to use certain efforts to close the deal notwithstanding events that affect the financial condition of the target company?
- What other limitations apply to an MAE? For example, can events only occurring after executing the agreement qualify as an MAE?
- Have the parties contractually shifted the burden to the seller to prove that an MAE has not occurred?

While these questions may provide guidance on the issue, establishing whether an MAE has occurred is a highly fact-intensive issue that depends on the unique circumstances involved and the specific language used in the acquisition agreement. It should also be noted that buyers have faced a significant burden in court to show that any event meets the criteria of an MAE. As more parties litigate the issue, the courts will play an important role in establishing precedent that will shape how parties negotiate acquisition agreements.