Renewed Spotlight on Material Adverse Effect Clauses following Covid-19 and the Musk-Twitter Dispute

Material adverse effect ("**MAE**", also referred to as 'material adverse change' or 'material adverse event') clauses are a key part of mergers and acquisitions ("**M&A**") contracts.

The implications of MAE clauses in agreements executed before the advent of the Covid-19 pandemic disruptions have been debated at length across the world. Recently, the attempted termination of the agreement for acquisition of Twitter by Elon Musk on MAE grounds has once again brought MAE clauses under the spotlight. Musk claimed that the MAE clause in Twitter's acquisition agreement was triggered due to the target's materially inaccurate representations in relation to fake Twitter accounts. The ongoing trial in the Delaware Chancery Court is likely to have implications for M&A transactions and parties.

In this note, we consider certain key issues relating to MAE clauses, including in the context of the Indian legal landscape, while discussing relevant practical aspects both from a seller and buyer's perspective in an M&A context.

MATERIAL ADVERSE EFFECT CLAUSES

M&A transactions with a significant time gap between execution and closing of an agreement may entail financial and other risks for both the buyer and the seller. An MAE clause is one possible mechanism to allocate risks during this time period. It will typically provide the buyer with an option to terminate the transaction before closing (or not to proceed to closing of the transaction) due to the occurrence of certain events which have materially affected the target company or its business. Apart from events

affecting the target, MAE clauses may also be triggered if the parties are no longer in a position to complete the transaction due to certain events between signing and closing.

The precise language of MAE clauses is a contentious area of negotiation. Acquirers will look for broadly defined MAE clauses, while sellers will generally look to have precise definitions based on objective criteria, although it has been argued that parties sometimes find it efficient not to define what is “material” because the resulting uncertainty generates productive opportunities for renegotiation.

In addition, sellers will seek to include exceptions or carve outs for excluding general industry-wide or macroeconomic events. In contrast, buyers will renegotiate these carve outs to include general industry-wide events which have a *disproportionately* high impact on the target compared to others in the same industry.

PRECEDENTS IN INDIA, THE UNITED KINGDOM AND THE UNITED STATES

Interpretation of MAE clauses is heavily dependent on the language used in such clauses. There are few judicial precedents interpreting MAE clauses in India and the United Kingdom. There is however a well-established body of case law from the Delaware Chancery Court in the United States interpreting MAE clauses.

In the listed companies’ context in India, Regulation 23 of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 provides grounds for withdrawing a public offer. An acquirer is entitled to withdraw a public offer, among other grounds, in the event any condition precedent stated in the acquisition agreement is not met for reasons outside the acquirer’s control, provided that such condition precedent is disclosed in the detailed public statement and the letter of offer. The Indian securities regulator and courts have interpreted this provision narrowly to limit situations in which a public offer can be withdrawn.

BURDEN OF PROOF

Absent clear language to the contrary, courts in both the United Kingdom and the United States have consistently placed the burden of proof on the party relying on an MAE clause to excuse its performance under a contract.

An interesting question was posed before the Delaware Chancery Court in *Hexion Specialty Chemicals vs. Huntsman*[1] as to whether or not a different approach should

[1] 965 A.2d 715 (Del. Ch.2008)

be adopted when the MAE clause is a condition precedent to closing (instead of a representation and warranty that no MAE had occurred). The court however did not entertain this argument and followed the principle set out in earlier case law that the burden of proof should be on the party relying on an MAE clause to excuse its performance.

MATERIALITY; DURATION; BENCHMARK FOR MEASUREMENT

In the matter of *In Re IBP Shareholders Litigation*,[2] the Delaware Chancery Court has held that to be material, an event must "*substantially threaten the overall earnings potential of the target.*" In that matter, the court did not specify whether earnings before deduction of interest, taxes, depreciation and amortization (EBITDA), earnings before interest and taxes (EBIT), earnings per share (EPS) or some other income parameter is the best measure of earnings potential. In addition, the court did not quantify the percentage or absolute decrease required to "substantially threaten" earnings potential.

In *Hexion,* the Delaware Chancery Court held that in a cash acquisition, EBITDA is a better measure of changes in results of operations and concluded that the target's decline in EBITDA did not support an MAE. It rejected an argument based on decline in EBITDA based on consecutive quarters, noting that that the target's results were historically down in the third and fourth quarters given the cyclical nature of the target's business. The court further held that "*a short-term hiccup*" in earnings should not suffice; rather the MAE should be material when viewed from the perspective of a reasonable acquiror. The court noted that: "*the important consideration therefore is whether 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*."

In *Akorn, Inc. vs. Fresenius Kabi AG*,[3] a landmark judgement of the Delaware Chancery Court where the assertion of an MAE was upheld by the court, the court held that determining whether a downward deviation in a company's performance is material or not requires an assessment of both qualitative as well as quantitative factors. From a qualitative perspective, the court found that the evidence supported a finding of MAE on the basis of "*pervasive noncompliance and widespread regulatory violations.*" From a quantitative perspective, the court acknowledged a working

[2] 789 A.2d 14 (Del. Ch. 2001)

[3] 2018 WL 4719347 (Del. Ch. 2018)

assumption among practitioners recorded in a leading treatise on M&A[4] that a decrease in profits in the 40% or higher category is a prevailing guideline for finding an MAE. However, importantly, this does not foreclose a possibility that a lesser decline can still constitute an MAE. Similarly, a decline that is steeper than 40% may not be considered an MAE if it is due to a seasonal fluctuation as held in earlier cases.

In the Indian context, reference can also be made to the Companies Act, 2013 ("**Companies Act, 2013**") and the SEBI (Listing Obligation and Disclosure Requirements) Regulations, 2015 ("**SEBI LODR**") to consider standard for '*materiality*' although in different contexts. 'Material subsidiary' as defined in the SEBI LODR considers materiality in a numerical sense envisaging subsidiaries whose income or net worth exceeds ten percent of the consolidated income or net worth of the listed company. On the other hand, in the context of sale of an undertaking under the Companies Act, 2013 which would require shareholders' approval, an 'undertaking' is defined numerically to mean an 'undertaking' in which the investment of the company exceeds 20% of its net worth or an undertaking which generates 20% of the total income of the company.

CONCLUSION

During periods of economic uncertainty, volatility and disruption, buyers will desire greater flexibility to terminate M&A deals upon occurrence of adverse events after signing of a transaction. The ongoing trial in the Musk-Twitter dispute may well be a case of buyer's remorse but nevertheless reiterates the importance of carefully considering MAE clauses and avoiding boilerplate versions.

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[4] Lou R. Kling and Eileen T. Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions (Law Journal Press)