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MAE/MAC Provisions in Private M&A - What Do They Mean Now?

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With every day bringing more news and information concerning business disruptions related to the COVID-19 pandemic, companies are giving thought to how this global health emergency may impact the way they do business, their day-to-day operations and their rights under existing contractual relationships. More specifically, many Canadian businesses are now asking whether the ongoing crisis and its impact may be considered a material adverse effect (commonly also referred to as a "material adverse change," "MAC" or "MAE") that would give rise to termination rights in their agreements, including private merger and acquisition (M&A) agreements.

An analysis of typical MAE provisions in the context of private M&A agreements will highlight certain issues to consider as the ongoing situation develops.

Basic MAE Principles

MAE clauses are commonly used in private M&A agreements to establish the conditions under which a buyer is permitted to terminate a transaction upon the occurrence of a material adverse event affecting the target company or business (and occasionally its prospects). Considered to have a high threshold before they can be operative, MAE clauses are generally used to broadly describe unforeseeable events such as acts of terrorism or unexpected governmental or political changes that can give rise to termination rights.

In the acquisition context, a condition to closing in favour of the purchaser may allow it to refuse to complete the transaction in the event the target company suffers a MAE after signing the purchase agreement, but prior to closing. Therefore, MAE clauses offer a certain degree of security to the purchasing party in an acquisition, as it allows the purchaser to terminate an agreement if an event or change occurs that materially and adversely impacts the target company.

In private M&A agreements, the definition of MAE typically includes "any change, event, occurrence, effect, state of fact or circumstance that can reasonably be expected to have a material and adverse effect on the business, operations, assets, liabilities or condition (financial or otherwise) of the respective party," but often contains exceptions that exclude certain risks that may broadly impact the market or industry of the party in question.

The exceptions from the MAE definition are usually the subject of considerable negotiation and commonly

include "effects related to (i) general economic, business, regulatory, political, financial, capital or credit market conditions, and (ii) any changes in applicable laws." In most instances, however, the exceptions only apply to the extent such effects do not materially and disproportionately affect the target company or its business as compared to other participants in the same industry.

Materiality in MAE Provisions

The Canadian courts have applied both subjective and objective standards when assessing materiality with respect to MAE provisions. Unfortunately, there is no specific threshold for materiality that is applied by the courts in the interpretation of MAE clauses. However, the courts have considered a factor to be material if it would induce a reasonable party not to enter into the contract. This includes economic factors such as a decrease in revenue or EBITDA, but the courts have not specified a particular quantitative threshold for such factors.

The courts have stated that materiality should be assessed by analyzing the context of the "particular circumstances" and what can reasonably be expected to influence the decision of the particular purchaser to complete the transaction. In situations involving sophisticated parties, such parties may wish to proceed with a transaction despite knowing of problems in a target's financial condition, even if it would have constituted a MAE.

In other cases, the courts have added an objective element to the analysis by considering what a "prudent purchaser" would consider material in the circumstances. Even in cases involving broadly-drafted MAE clauses that allow for the purchaser's discretion, the courts have commented that this discretion must be exercised with "reasonableness" and accounting for "*bona fide* considerations."

The Canadian courts have determined in prior cases that a change in governmental policy resulting in the reduction of funding available to a private medical laboratory was considered to be a MAE, whereas a significant drop in the price of oil did not constitute a MAE.

Disproportionate Affect

The concept of "disproportionate affect" that is commonly found in the language of exclusions to MAE provisions requires further examination in the context of recent events. The exclusions set out in MAE clauses, including general economic conditions and changes in applicable laws, only apply to the extent that such effects "do not materially and *disproportionately affect* the target company as compared to other participants in the same industry."

This raises several important questions parties may wish to consider. An analysis of whether the exceptions

of a MAE provision apply to a given situation will depend on how "disproportionately affect" is determined. Many factors can be read into such an analysis (e.g., economic, socioeconomic, demographic, geographic, psychological, etc.) and it is unclear how much weight should be given to any one such factor. As the ongoing situation develops and as parties consider applicable MAE clauses, an analysis of whether a target company is disproportionately affected may be particularly relevant.

MAE clauses are commonly drafted in general terms, without specific events or financial thresholds as triggers. Given that it is not always clear what is and what is not a MAE, determining a claim for relief will often require a detailed factual inquiry of the particular circumstances.

Impact of the COVID-19 Outbreak on MAE Clauses

As various businesses and industries are disrupted directly or indirectly by the COVID-19 outbreak, buyers may argue that its effects on a target company constitute a MAE that justifies terminating or renegotiating a transaction.

The specific language of a particular clause will need to be considered to determine if the impact of the ongoing crisis will meet the threshold of a MAE in any particular circumstance. Not only is the threshold generally regarded as being high, but the specific impacts of COVID-19 on businesses or industries are somewhat unknown at this time. As such, MAE clauses may prove more useful for parties to use as a basis for opening discussions or renegotiating certain deal terms in light of the adverse impacts that the current circumstances may have on the target company that is subject to a pending transaction.
