TRANSACTION COST ECONOMICS & MAES: THE DEALMAKER'S CRYSTAL BALL

Christina M. Sautter[*]

INTRODUCTION

Crises provoke behavior modifications.[1] This is particularly true with dealmakers in the mergers and acquisitions (M&A) world as, even in the best of times, every M&A transaction is an exercise in risk allocation.[2] As a crisis unfolds, two questions inevitably arise for dealmakers: in the short term, what grounds may parties use to exit pending transactions; and, in the long term, what impact will the crisis have on negotiating current and future deals and drafting related contractual provisions.[3] In many M&A transactions, especially those involving publicly traded companies, the answers to both questions almost always involve material adverse effect (MAE) or material

[*] Cynthia Felder Fayard Professor of Law, Byron R. Kantrow Professor of Law, and Vinson & Elkins Professor of Law, Louisiana State University Paul M. Hebert Law Center. I would like to thank Afra Afsharipour and Megan W. Shaner for their helpful comments. In addition, I owe a deep debt of gratitude to my research assistants, Addison Hollis (LSU Law '21) and Marina Speligene (LSU Law '22), for their invaluable assistance.

[1] Kathleen Grave, Demos Vardiabasis & Burhan Yavas, *The Global Financial Crisis and M&A*, 7 INT'L J. BUS. & MGMT., June 2012, at 56, 63 ("From crisis comes change and new behaviors.").

[2] R. Tyler Hand, *Managing Risks and Liabilities in Today's M&A Market*, *in* M&A DEAL STRATEGIES: LEADING LAWYERS ON CONDUCTING DUE DILIGENCE, NEGOTIATING REPRESENTATIONS AND WARRANTIES, AND SUCCEEDING IN A POST-RECESSION MARKET *1 2015 WL 1802924 (2015) (stating that "every transaction involves some degree of risk," which presents an "opportunity to add value by creating effective solutions to manage risks . . . [and] facilitate successful transactions").

[3] Priscilla C. Hughes & Seth B. Bryant, *Will the MAC Clause Become a Permanent Deal Stopper?*, 37 MERGERS & ACQUISITIONS, Apr. 2002, at 27, ProQuest Doc. No. 215916351 (discussing the impact of September 11, 2001, terrorist attacks on M&A activity and the use of material adverse change (MAC) clauses); Brain Salsberg, *The Case for M&A in a Downturn*, HARV. BUS. REV. (May 17, 2020), https://hbr.org/2020/05/the-case-for-ma-in-a-downturn [https://perma.cc/DT6Y-7WZ9] (drawing parallels between the actions of dealmakers in prior crises to the crisis of the COVID-19 pandemic and noting that although transactions halted at the beginning of the virus to deal with short-term issues, dealmakers will now look to the future for recovery and impact); Andrew A. Schwartz, *A "Standard Clause Analysis" of the Frustration Doctrine and the Material Adverse Change Clause*, 57 UCLA L. REV. 789, 820 (2010) (noting the economic realities and rise in prominence of the MAC clause as a result of events such as "the dot-com stock crash, the attacks of September 11, 2001, the spectacular frauds at Enron and Worldcom, the bursting of the housing bubble, and what may have been the worst recession since the Great Depression").

adverse change (MAC) provisions.[4] These provisions allow parties, typically the acquirer, to exit a transaction without penalty if the other party has suffered a MAE, as that term is defined in the agreement.[5]

Not surprisingly, MAEs have recently taken center stage in the dealmaking world. Since early 2020 the world has been living through an extraordinary crisis: the COVID-19 pandemic. The pandemic is unlike past crises such as September 11, 2001, the resulting escalation of the war on terror, and the Great Recession of 2007–2009. September 11 was tragic in terms of lives lost and it, along with the Great Recession, had severe financial impacts. The pandemic, however, has not only resulted in over 1 million deaths to date but caused economies worldwide to come to an unprecedented grinding halt.[6] As the world went into lockdown, many dealmakers scurried to evaluate the impact on pending deals, with a number opting to terminate or renegotiate agreements.[7] As the pandemic stretches on, dealmaking has resumed amidst the looming uncertainty of what economic impacts the continuing pandemic may have—not only on a global macro level but also for specific companies and industries. Dealmakers must now consider these uncertainties when negotiating transaction provisions, particularly MAEs.

This Essay examines MAEs through the lens of transaction cost economics (TCE), a theory first proposed in 1937 and utilized to determine how to best structure transactions[8] especially amidst uncertainty. Uncertainties are inherent in purchasing a highly specific asset, like a company, which are

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[4] MAEs and MACs refer to the same type of provision and this Essay uses the terms interchangeably.

[5] Schwartz, *supra* note 3, at 789. *See also infra* Part II.

[6] WHO Coronavirus Disease (COVID-19) Dashboard, WORLD HEALTH ORG., https://covid19.who.int/?gclid=CjwKCAjwz6_8BRBkEiwA3p02VToJoS_G8prFqkbn6SSRINtFZXDRTGHf10VcKWHtRoXsDnszAz6f_xoCxDsQAvD_BwE (Dec. 19, 2020, 9:45 AM) [https://perma.cc/JLE6-DB7P] (stating that as of 9:45 AM CET on December 19, 2020 there were 1,663,474 reported COVID-19 deaths). *See* Lora Jones et al., *Coronavirus: A Visual Guide to the Economic Impact*, BBC NEWS (June 29, 2020), https://www.bbc.com/news/business-51706225 (detailing the pandemic's spread and effect on the global market and how it has left businesses around the world looking for recovery). *See generally* JAMES K. JACKSON ET AL., CONG. RSCH. SERV., R46270, GLOBAL ECONOMIC EFFECTS OF COVID-19 (2020), https://fas.org/sgp/crs/row/R46270.pdf [https://perma.cc/LFU7-FL6R] (providing data and predictions on COVID-19's impacts on the global economy).

[7] Nabila Ahmed, *Virus Upends $87 Billion of Deals in Sign of Corporate Fears*, BLOOMBERG (June 29, 2020, 8:00 AM), https://www.bloomberg.com/news/articles/2020-06-29/virus-upends-87-billion-of-deals-in-sign-of-corporate-fears (stating that at least $87 billion worth of deals had been terminated or put on hold since the pandemic); Cara Lombardo & Dana Cimilluca, *Tiffany Agrees to New Deal Terms with LVMH*, WALL ST. J. (Oct. 29, 2020, 5:01 AM ET), https://www.wsj.com/articles/tiffany-lvmh-near-agreement-on-new-deal-terms-11603899275?st=ssaie27q83sp2lt&reflink=desktopwebshare_permalink [https://perma.cc/MS2V-Y43G] (stating LVMH argued the pandemic damaged Tiffany's business to the extent that the agreement was invalid and renegotiated for an over $400 million discount); Fareed Sahloul, *Coronavirus Pandemic Drags Global M&A to Lowest Level Since 2012*, BLOOMBERG (June 30, 2020, 12:00 AM), https://www.bloomberg.com/news/articles/2020-06-30/coronavirus-pandemic-drags-global-m-a-to-lowest-level-since-2012 [https://perma.cc/F2TF-39WT] (stating that the coronavirus pandemic "brought global dealmaking to an abrupt halt").

[8] *See infra* notes 14–23 and accompanying text.

further compounded by external socioeconomic conditions.[9] This, in turn, gives rise to higher transaction costs, such as due diligence, increased negotiations, and ex post enforcement.[10] MAE provisions are one of the ways in which dealmakers attempt to control the transaction costs of ex post enforcement.[11] As life in a pandemic becomes the new reality, dealmakers are adjusting to ensure that pandemic-related effects do not trigger MAEs.[12] Consequently, this raises transaction costs and has an impact on whether a deal is signed and ultimately consummated, and on what terms.[13]

This Essay attempts to look into the dealmaker's crystal ball to foresee those changes. Part I of this Essay briefly describes TCE and the relevant assumptions underlying the theory. Part II explains how dealmakers have structured MAEs to control for closing uncertainty and briefly describes how courts have interpreted MAEs. Finally, Part III discusses how dealmakers have dealt with the pandemic in terms of MAEs and argues that while revised MAEs may complicate dealmaking, they will not hinder it. Part III argues that, in place of the traditional role of a MAE, dealmakers instead will take other steps to compensate for uncertainty, including expanded due diligence, adjusted valuations, provisions to renegotiate terms, or reverse termination fees.

I. TRANSACTION COST ECONOMICS

TCE theory explores how to structure businesses and complex transactions to make them more efficient.[14] TCE originated with economist Ronald H. Coase in 1937.[15] Coase introduced the idea that firms are formed to save on market costs, now known as transaction costs.[16] Another noted economist, Oliver Williamson, popularized TCE in a series of articles and books from the 1970s to the 1990s. In particular, Williamson applied TCE to vertical integrations and considered whether it was better to integrate or to buy in the

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[9] *See infra* note 26 and accompanying text.

[10] *See infra* notes 41–44 and accompanying text.

[11] *See infra* notes 46–47 and accompanying text.

[12] *See infra* Part III. Although this Essay is focused on MAEs, dealmakers have also been concerned with the pandemic's effects on non-MAE provisions, such as interim operating covenants, which are also discussed in Part III.

[13] *See infra* Part III.

[14] *See generally* Mikko Ketokivi & Joseph T. Mahoney, *Transaction Cost Economics as a Theory of the Firm, Management, and Governance*, OXFORD RSCH. ENCYCLOPEDIA OF BUS. & MGMT. (Oct. 26, 2017), https://oxfordre.com/business/view/10.1093/acrefore/9780190224851.001.0001/acrefore-9780190224851-e-6 [https://perma.cc/H6P4-F5J4] (stating that TCE "is a theory of how business transactions are structured in challenging decision environments" and tends to focus on "commitments that are difficult to reverse without significant economic loss").

[15] *See generally* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937) (introducing TCE theory); *see also* C.N. Pitelis, *Transaction Costs and the Historical Evolution of the Capitalist Firm*, 32 J. ECON. ISSUES 999, 999 (1998) (summarizing Coase's theory).

[16] Coase, *supra* note 15, at 392.

market.[17] But his prolific research has been extended and applied well beyond vertical integrations.[18] According to Williamson, TCE consists of three dimensions: asset specificity, uncertainty, and frequency of the transactions occurring.[19] Asset specificity refers to the transferability of assets to alternative uses; thus, higher asset specificity results in higher transaction costs.[20] Uncertainty refers to the threat of opportunism or the behavioral uncertainty of a buyer or seller.[21] Frequency refers to the number of times a transaction is expected to take place.[22] If a transaction is a one-time deal, it will not be efficient to devote significant resources to its coordination; however, if the transaction has a high frequency, the cost of allocating resources to its arrangements is efficient and justified.[23] Of particular import for M&A and MAEs are uncertainty and asset specificity.[24]

As stated above, asset specificity involves how a specific asset may be used.[25] If the asset is unique to particular parties, and therefore has limited transferability, then it has higher transaction costs.[26] Asset specificity has been most studied and applied in vertical integration settings.[27] But the concept is equally applicable in the context of larger M&A transactions. In these transactions, the target company is a highly specific asset. The potential transaction is generally unique in terms of achieving economies of scale or scope and synergies. For the acquirer, there may be a very limited number of companies with which it can achieve such value. From the target's

[17] *See* OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION 95–101, 107 (1975); *see also* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 3–12 (1985) [hereinafter WILLIAMSON, ECONOMIC INSTITUTIONS] (summarizing previous literature focusing on contract law and economic organization); OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 364–72 (1996) (self-reflecting on his own application of transaction cost economics to vertical integration during the 1970s).

[18] Robert Gibbons, *Transaction-Cost Economics: Past, Present, and Future?*, 112 SCANDINAVIAN J. ECON. 263, 275–76 (2010) (stating that, in addition to his vertical integration work, "Williamson also performed more applied analyses on topics relating [to] law and economics, such as antitrust (1968) and regulation (1976), and edited a book of contributions (including one of his own) on Chester Barnard and organization theory (1990).").

[19] WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 17, at 52–61.

[20] Oliver E. Williamson, *The Economics of Organization: The Transaction Cost Approach*, 87 AM. J. SOCIO. 548, 555 (1981).

[21] Oliver E. Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 253–54 (1979).

[22] *Id*. at 246–47.

[23] *Id*.

[24] Because most M&A deals are one-time deals, under the frequency dimension, they are inefficient in terms of the amount of resources devoted to them. This increases transaction costs.

[25] *See supra* note 20 and accompanying text.

[26] Williamson, *supra* note 21, at 239–40. Williamson identified at least four types of asset specificity, including physical asset specificity, human asset specificity, site specificity, and dedicated assets. WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 17, at 55.

[27] Williamson, *supra* note 21, at 240 (arguing that internal production is an attractive structure of idiosyncratic (i.e., highly specific) transactions); Williamson, *supra* note 20, at 555–56 (studying asset specificity as applied to vertical integration).

perspective, a similarly small number of acquirers likely exists. Accordingly, the entire transaction is highly specific.

M&A deals inevitably involve uncertainty. Dealmakers cannot be completely certain about decisions—and M&A contracts reflect this. Uncertainty is demonstrated both in provisions like MAEs and by way of what the parties *do not* contract for.[28] In fact, TCE recognizes that contracts are incomplete.[29] Incompleteness is a result of parties entering into contracts without all of the necessary and relevant information that would otherwise make them complete.[30] This information void may stem from parties withholding information, their inability to comprehend or synchronize the information they do have, or the inability to predict future events.[31] In behavioral economics, when parties act within their own self-interests (such as withholding information), this is known as opportunism.[32] The ability to comprehend or synchronize information is known as bounded rationality.[33]

Opportunism is the assumption that transacting parties will use tactics such as deception to withhold information to maximize their own interests.[34] A party may purposefully disclose biased or partial information designed to advantage themselves over the other party.[35] Often this asymmetrical dissemination of information results in an impairment of negotiations.[36] Opportunism also affects the execution and renewal of contracts.[37] Parties who act in their own self-interest incur major transaction costs in monitoring and enforcing the contract.[38]

Bounded rationality is the assumption that most transactions occur with rational actors that have limited information.[39] Two examples of bounded rationality include: (1) it is costly for a party to convey information to the other party, possibly because the receiving party is less sophisticated and cannot comprehend it; and (2) it may be difficult for one party to communicate the intricacies of the information because those very nuances

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[28] Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 856–59 (2010) (explaining that parties often purposely utilize vague terms to control for uncertainty).

[29] Oliver E. Williamson, *Transaction Cost Economics Meets Posnerian Law and Economics*, 149 J. INSTITUTIONAL & THEORETICAL ECON. 99, 102 (1993); *see also* Williamson, *supra* note 20, at 553–54 (stating that given the complexity inherent in all contracting, "incomplete contracting is the best that can be achieved").

[30] Williamson, *supra* note 20, at 553–54.

[31] *Id*. at 553 ("The two behavioral assumptions on which transaction cost analysis relies that both add realism and distinguish this approach from neoclassical economics are (1) the recognition that human agents are subject to bounded rationality and (2) the assumption that at least some agents are given to opportunism.").

[32] Oliver E. Williamson, *Markets and Hierarchies: Some Elementary Considerations*, 63 AM. ECON. REV. 316, 317 (1973).

[33] *Id*. at 317.

[34] *Id*.

[35] *Id*.

[36] *Id*.

[37] *Id*.

[38] *Id*.

[39] Williamson, *supra* note 29, at 109.

are not clear to the disclosing party itself.[40] Furthermore, parties are unable to predict the future, which is particularly relevant currently as the COVID-19 pandemic was generally unexpected. Moreover, this inability to predict the future has a potentially greater impact on M&A transactions which take longer to sign and close than typical consumer contracts.

The combination of higher asset specificity and uncertainty, stemming from bounded rationality and opportunism, increases transaction costs.[41] Transaction costs are defined as "search and information costs, bargaining and decision costs, [and] policing and enforcement costs."[42] As Professor Carl Dahlman stated, these unique categories of costs all share one core element in that "they represent resource losses due to lack of information."[43] Thus, no matter how much parties may desire to do a deal, they are contracting under a veil of uncertainty. For example, an acquirer does not fully know all the information pertaining to the target's value. Likewise, a target cannot be positive the acquirer is offering the maximum it is willing to pay. Meanwhile, neither party can be completely sure what may unfold between signing and closing—i.e., during the pre-closing period—which may affect the pending transaction. As Williamson eloquently wrote, "all of the relevant contracting action cannot be concentrated on the ex ante incentive alignment but some of it spills over into ex post governance."[44]

II. USING THE PAST TO THE PREDICT THE FUTURE

The "ex ante alignment" and "ex post governance" to which Williamson alluded is on full display in any merger agreement. A merger agreement's primary functions are to control for and allocate the various systemic and business risks at play and to plan for what may happen if actual results are different than expected.[45] The parties accomplish this through numerous provisions, the MAE being one of the most significant.[46] In drafting MAEs, dealmakers attempt to allocate risk and plan for uncertainties while also responding to crises and MAE jurisprudence. This Part briefly describes the uses and construction of MAEs and MAE jurisprudence to date, all of which aids in determining how dealmakers will respond in the future.

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[40] *Id*. at 103–04.

[41] *See* Sumit K. Majumdar & Venkatram Ramaswamy, *On the Role of Social Asset Specificity in the Channel Integration Decision*, 150 J. INSTITUTIONAL & THEORETICAL ECON. 375, 378 (1994) (noting that bounded rationality and "complexity and uncertainty" give rise to transaction costs).

[42] Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 148 (1979).

[43] *Id*.

[44] Williamson, *supra* note 29, at 102.

[45] Jeffrey Manns & Robert Anderson IV, *The Merger Agreement Myth*, 98 CORNELL L. REV. 1143, 1153 (2013).

[46] Robert T. Miller, *Material Adverse Effect Clauses and the COVID-19 Pandemic* 3 (Univ. of Iowa, Coll. Of L., Legal Studies Research Paper No. 2020-21, 2020), https://ssrn.com/abstract=3603055 [https://perma.cc/J2EP-GN5R].

A. Construction of MAEs and the Role of MAEs in Agreements

MAEs perform a few roles in an agreement. First, they are used as materiality modifiers in representations and warranties.[47] For example, a target may represent that there is no known pending or threated litigation that, individually or in the aggregate, has triggered or would trigger a MAE for the target. In addition, there is typically a representation that there has not been a MAE.[48] Finally, MAEs are used as conditions precedent to the closing of a transaction.[49] As a closing condition, the acquirer is able to walk away from a transaction if there has been a MAE without being held liable for a breach of contract.[50] Accordingly, the definition of what constitutes a MAE becomes of primary importance and is also highly negotiated.[51]

MAE definitions consist of three portions. First is the standard MAE clause allowing the acquirer to exit a transaction. This is typically defined broadly to include events or changes that, individually or in the aggregate, have had or are reasonably likely to have a material adverse effect.[52] Of note is the circularity of the definition in that the term "material adverse effect" is generally used to define a MAE.[53] Moreover, as Professor Andrew Schwartz has noted, the term "material" as used in the MAE is not defined and is left to the courts' interpretation.[54] Finally, the effect is often broken down further into two parts and means to have an effect (1) on the ability to close the transaction or (2) on the business of the target taken as a whole.[55]

The second part of the MAE includes a comprehensive set of detailed carve-outs which only modify the effect of these events or changes on the business (they do not modify the ability to close).[56] These function as

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[47] FRANKLIN A. GEVURTZ & CHRISTINA M. SAUTTER, MERGERS AND ACQUISITIONS LAW 46 (2018).

[48] *Id*.

[49] *Id*.

[50] *Id*.

[51] Miller, supra note 46, at 27.

[52] For example, the Morgan Stanley-E*TRADE Agreement defines the general MAE as "any event, circumstance, development, change, occurrence or effect that, individually or in the aggregate, is or is reasonably likely to result in, a material adverse effect" Morgan Stanley, Current Report (Form 8-K, Exhibit 2.1, § 1.01) (Feb. 21, 2020).

[53] Miller, *supra* note 46, at 2.

[54] Schwartz, *supra* note 3, at 826-27.

[55] The Morgan Stanley-E*TRADE MAE definition is broken down in this manner. It requires that the effect be

> on (x) the condition (financial or otherwise), assets, liabilities, business or results of operations of the Company and its Subsidiaries, taken as a whole, or (y) the ability of the Company and its Subsidiaries to timely consummate the Closing (including the Merger) on the terms set forth herein or to perform their agreements or covenants hereunder.

Morgan Stanley, *supra* note 52 (defining "Company Material Adverse Effect").

[56] For example, the Morgan Stanley-E*TRADE MAE definition states:

> [*P*]*rovided* that, in the case of clause (x) only, no event, circumstance, development, change, occurrence or effect to the extent resulting from, arising out of, or relating to any of the following shall be deemed to constitute, or shall be taken into account in determining whether there has been, a Company Material Adverse Effect, or whether a Company Material Adverse Effect would reasonably be expected to occur.

exceptions to the standard MAE clause, preventing the acquirer from exiting. Over the years, the number of carve-outs has grown significantly.[57] The carve-outs include changes to law, acts of God, failure to meet estimates or projections, and similar items unique to the company.[58] As will be described in Part III, pandemics are generally now included as a specific carve-out.[59]

The third, and final, portion of the MAE definition is the exception to some of the carve-outs. This allows the events identified in particular carve-outs to serve as a basis for the acquirer to walk if the effect has been disproportionate to the target and its subsidiaries considered together as a whole as compared to other companies in the target's industry.[60] Pandemic and acts of God carve-outs, among others, typically qualify for this exception.[61] As such, if pandemics are carved out, negative effects on the business will not rise to the MAE level unless those negative effects are disproportionate in comparison to the industry in which the company operates. But, as will be discussed in Part II.C below, disproportionate effects are a difficult standard to satisfy.[62]

B. Impact of September 11 and the Great Recession on MAEs

Financial crises, like the economic downturn after the September 11, 2001 terrorist attacks and the Great Recession of 2007–2009, have influenced the

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Id.

[57] *Compare* Warren S. de Wied, *The Impact of September 11 on M&A Transactions*, M&A LAW., Oct. 2001, at 1, Westlaw, 5 No. 5 GLMALAW 1 (explaining that parties typically decline to adopt specific carve-outs, finding that four general carve-outs sufficiently address most risks), *with* Miller, *supra* note 46, at 21 (stating that most MAE provisions carve-out various classes of risk), *and* Miller, *supra* note 46, at 27 (noting that sophisticated commercial parties regularly use elaborate MAE clauses).

[58] Matthew Jennejohn, Julian Nyarko, & Eric Talley, *COVID-19 as* Force Majeure *in Corporate Transactions*, *in* LAW IN THE TIME OF COVID-19, 141, 142 (Katharina Pistor ed., 2020), https://scholarship.law.columbia.edu/books/240/ [https://perma.cc/9WXJ-ZCBF] (listing carve-outs in the LVMH-Tiffany transaction); *see also* Morgan Stanley, *supra* note 52 (defining "Company Material Adverse Effect" and including an extensive list of carve-outs).

[59] *See infra* Part III.

[60] For example, the Morgan Stanley–E*TRADE definition includes the following exception to the carve-outs:

> [E]xcept in the case of [selected carve-out clauses, including the one relating to pandemics and COVID-19], to the extent that any such event, circumstance, development, change, occurrence or effect has a disproportionate adverse effect on the Company and its Subsidiaries, taken as a whole, relative to the adverse effect such event, circumstance, development, change, occurrence or effect has on other companies operating in the securities brokerage industry or the other industries in which the Company or any of its Subsidiaries materially engages.

Morgan Stanley, *supra* note 52, at Exhibit 2.1, § 1.01 (defining "Company Material Adverse Effect").

[61] *See, e.g.*, *id*. (referencing specific clauses). In the Morgan Stanley-E*TRADE deal, deals that qualified for the exception were changes "in general United States or global economic conditions"; changes in the securities brokerage industry or other industries in which the company operates; changes in law or U.S. generally accepted accounting principles (GAAP); or "any acts of God, natural disasters, terrorism, armed hostilities, sabotage, war or any escalation or worsening of acts of war, epidemic, pandemic or disease outbreak (including the COVID-19 virus)." *Id*.

[62] See *infra* Part II.C.

negotiation and drafting of MAE provisions.[63] These impacts were mainly due to the economic volatility that followed each of these events.[64]

At the start of the twenty-first century, MAEs typically did not include the vast laundry list of carve-outs present in today's MAE definitions. Prior to 2001, MAE provisions contained only a few general carve-outs for: (1) changes in general economic or financial market conditions; (2) changes in general industry conditions; (3) changes in market prices for parties' stock; and (4) changes in law.[65] Dealmakers typically did not include more specific carve-outs. However, in the wake of September 11 and the resulting financial uncertainty, attorneys and their clients increased their focus on the MAE and its role in M&A deals. The cluster of deal terminations that followed the September 11 attacks highlighted the significance of addressing extraordinary events in acquisition agreements.[66] As parties attempted to mitigate their risks pertaining to such events, negotiations resulted in more specified MAE clauses.[67] Deals announced after September 11 began referencing, explicitly or impliedly, acts of terrorism—some agreements incorporated similar attacks into the MAE definition, but a majority of agreements explicitly carved them out.[68] Similarly, as the 2007 financial crisis (which ultimately gave rise to the Great Recession) unfolded, many buyers attempted to walk away from deals claiming a MAE.[69] In addition, like after September 11, dealmakers responded to the increased financial uncertainty by including more carve-outs, thus shifting the risk to buyers.[70] As a result of adverse economic conditions in 2001 (and again in 2008), MAE provisions are now among the most negotiated terms of any transaction.[71]

C. Interpretation and Application of MAEs

In predicting the impact of post-pandemic MAEs (in particular, pandemic carve-outs), on deal terms and future deals, a key consideration is how courts

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[63] Schwartz, supra note 3, at 820.

[64] *Id*.

[65] de Wied, *supra* note 57.

[66] Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 847 (2002).

[67] *See generally* Jeffrey L. Rothschild & Thomas Sauermilch, *Impact of Financial Markets Crisis on MAC Clauses*, INSIDE M&A (McDermott Will & Emery), Nov.–Dec. 2008.

[68] *See id*. at 863; *MAC the Knife*, ECONOMIST, Dec. 8, 2001, at 57, 57–58, ProQuest Doc. No. 224056217.

[69] *See* Afra Afsharipour, *Transforming the Allocation of Deal Risk Through Reverse Termination Fees*, 63 VAND. L. REV. 1161, 1163 (2010).

[70] Eric L. Talley, *On Uncertainty, Ambiguity, and Contractual Conditions*, 34 DEL. J. CORP. L. 755, 760 (2009) (utilizing an empirical study to show that dealmakers responded to uncertainty in 2007 and 2008 with more "expansive" MAEs).

[71] Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 330 (2005) (noting that MAC clauses are now some of the most prominently negotiated provisions in M&A deals); Franci J. Blassberg, *Asset Purchase Agreement*, *in* CORPORATE MERGER & ACQUISITION (ALI-ABA Continuing Legal Education, Coursebook Series No. SP031) 139, 191 n.93 (2008) (stating that the events of September 11, 2001 and the adverse economic climate that followed made MAC provisions one of the most highly negotiated clauses).

interpret MAE provisions. As a general matter, the courts have interpreted MAE provisions narrowly with a strict burden on the party invoking the MAE.[72] In *In re IBP, Inc. Shareholders Litigation*,[73] the Delaware Chancery Court famously held that a "short-term hiccup in earnings" would not trigger a MAE and that negative effects must be "material when viewed from the longer-term perspective of a reasonable acquirer."[74] The court also reasoned that a MAE "is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner."[75] Several years later, in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*,[76] the Chancery Court reiterated the need for long-term effects to trigger a MAE.[77] It reasoned that although evidence of a significant decline in the target's earnings during the pre-closing period is relevant, for such a decline to trigger a MAE, declines in earnings must "persist significantly into the future."[78] The court also examined the company as a whole compared to the greater industry instead of relying on the poor performance of certain divisions, and the court pointed out that while the two divisions at issue may have been materially compromised, the company as a whole was not so impaired by their loss.[79]

More recently, in *Akorn, Inc. v. Fresenius Kabi AG*,[80] the Chancery Court repeated the standards set forth in *In re IBP* and *Hexion* but found that the target, Akorn, Inc. ("Akorn"), had suffered a MAE.[81] The court noted that the facts of *Akorn* were significantly different from other MAE cases in which buyers were trying to escape a transaction due to a cyclical downturn.[82] More specifically, Fresenius Kabi AG ("Fresenius") demonstrated that Akorn's regulatory compliance issues were so significant and in breach of the representation that they would likely amount to a MAE.[83] Further, Fresenius demonstrated that Akorn's decline in performance resulted from a "company-specific problem" as opposed to an industry-wide issue.[84] The court also noted that if it assumed that industry-wide conditions caused

[72] *See In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 68 (Del. Ch. 2001) (setting the standard for a strict burden and a narrow interpretation of MAC clauses); *see also* Hexion Specialty Chems. Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008) (finding the same).

[73] 789 A.2d 14 (Del. Ch. 2001).

[74] *Id*. at 68.

[75] *Id*.

[76] 965 A.2d 715 (Del. Ch. 2008).

[77] *Id*. at 738.

[78] *Id*.

[79] *Id*. at 745.

[80] C.A. No. 2018-0300, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

[81] Akorn, Inc., 2018 WL 4719347, at *52–53, 57 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

[82] *Id*. at *3, *54.

[83] *Id*. at *82.

[84] *Id*. at *3.

Akorn's poor performance, then Akorn was disproportionately affected.[85] Moreover, the events that caused Akorn's issues were unanticipated by both parties.[86] Accordingly, *Akorn* became the first case in which the Delaware courts found that a company suffered a MAE.[87] As dealmakers look forward after *Akorn*, they know that it is at least possible to satisfy the heavy burden of proving a MAE. But *Akorn* also has quite unique facts which are not likely to be replicated in deals in which parties are attempting to exit for pandemic-related downturns.[88]

III. THE DEALMAKER'S CRYSTAL BALL: PREDICTING THE IMPACT OF MAEs ON DEAL TERMS AND FUTURE DEALS

Generally, dealmakers quickly respond to socioeconomic forces and the COVID-19 pandemic has been no different.[89] This is evident when examining MAE provisions in deals executed since February 2020. A survey of acquisitions of U.S. public target companies of $500 million or more in deal value executed between February 1, 2020, and September 18, 2020, revealed thirty-two transactions.[90] Of those, thirty transactions (or almost 94 percent) included carve-outs for pandemics, epidemics, outbreak of disease or illness, COVID-19, shutdowns, quarantine, or some combination thereof.[91] Only two transactions did not contain any COVID-19, pandemic,

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[85] *Id*. at *58.

[86] *Id*. at *62.

[87] Eric Fidel, *Akorn: Establishing a Material Adverse Effect*, AM. BAR ASS'N. (Jan. 16, 2019), https://www.americanbar.org/groups/business_law/publications/blt/2019/01/akorn/ [https://perma.cc/EX6V-CJT2].

[88] As of the date of this writing, U.S. courts have not addressed cases involving the pandemic and MAEs. However, in mid-October 2020, the English High Court rendered a decision, Travelport Ltd. v. WEX Inc., [2020] EWHC 2670 (Comm) (Eng.), in a dispute arising from the pandemic. The agreement at issue contained a MAE, with a pandemic carve-out, and an exception for disproportionate effects on the target as compared to the industries in which it operates. *Id*. at [46]. Tasked with identifying the relevant industry for purposes of the definition, the court looked to *Akorn* and noted the emphasis *Akorn* placed on establishing allocated risks in MAE clauses. *Id*. at [8], [179]–[189]. The judge went on to consider the parties' objective purpose of the deal, finding that the sellers' characterization of the deal as merely a "purchase of a travel payments business" was inaccurate. *Id*. at [203].

[89] *Dealmaker Optimism Remains High as Alternatives to Traditional M&A Take Center Stage, Deloitte*, ABL ADVISOR (Oct. 6, 2020, 9:05 AM), https://www.abladvisor.com/news/19440/dealmaker-optimism-remains-high-as-alternatives-to-traditional-ma-take-center-st [https://perma.cc/VNC3-3JQP] ("M&A executives have moved quickly to adapt and uncover value in new and innovative ways as systemic change driven by the pandemic has resulted in alternative approaches to transactions." (quoting a Deloitte & Touche LLP partner)); Darragh Byrne et al., *Dealmakers Plan to Lean into a Downturn*, WHITE & CASE (Mar. 10, 2020), https://www.whitecase.com/publications/insight/ma-top-mind/dealmakers-plan-lean-downturn [https://perma.cc/89T3-X3K3] (explaining that as valuations change, dealmakers' willingness to engage in M&A activity "can turn on a dime").

[90] This data was acquired using FactSet and is on file with the author. Transactions that appeared as "Rumor" or "Rumor Cancelled" were not included. In addition, the analysis excluded transactions that were not 100 percent acquisitions.

[91] Data on file with author.

shutdown, or quarantine language.[92] Both of those transactions were executed in late February or early March, just weeks before the World Health Organization declared COVID-19 a pandemic on March 11, 2020.[93]

This brief survey is consistent with and continues the trend found in Professors Matthew Jennejohn, Julian Nyarko, and Eric Talley's recent research. They found that in deals spanning from October 2019 to March 2020, over 65 percent of MAE provisions contained explicit "pandemic" (or the semantic equivalent) or general carve-outs, compared with 40 percent between 2003 and 2018.[94] This research also revealed that, within the last two years, the percentage of pandemic-specific carve-outs doubled and the percentage of MAE provisions containing these carve-outs—whether specific or general—increased by at least 20 percent.[95] These statistics reveal that as pandemics, or the possibility thereof, become the "new normal," dealmakers are responding to the related uncertainty by attempting to make their contracts more complete.

In terms of contract completeness and controlling for unknowns relating to the current pandemic, some parties have gone further than simply carving out COVID-19 in the MAE definition. For example, in Sunrun Inc.'s ("Sunrun") acquisition of Vivint Solar, Inc. ("Vivint"), the parties not only carved out COVID-19 but also specifically agreed that it (along with related changes to laws and policies) had not disproportionately affected Vivint as of the July 6, 2020 agreement date.[96] The parties did not stop there—the definition also stated that any changes to laws or guidelines promulgated by a governmental entity in response to COVID-19 would not constitute a MAE

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[92] Equitrans Midstream Corp., Current Report (Form 8-K, Exhibit 2.1, § 1.1) (Feb. 26, 2020); WillScot Corp., Current Report (Form 8-K, Exhibit 2.1, § 1.1) (Mar. 5, 2020).

[93] *See* Equitrans Midstream Corp., *supra* note 92, at Exhibit 2.1, § 1.1 (listing a transaction date of February 26, 2020); WillScot Corp., *supra* note 92, at Exhibit 2.1, § 1.1 (listing a transaction date of March 1, 2020); Jamie Ducharme, *World Health Organization Declares COVID-19 a 'Pandemic.' Here's What That Means*, TIME (Mar. 11, 2020, 12:39 PM), https://time.com/5791661/who-coronavirus-pandemic-declaration/ [https://perma.cc/CS9Y-95DP] ("The World Health Organization (WHO) on March 11 declared COVID-19 a pandemic, pointing to the over 118,000 cases of the coronavirus illness in over 110 countries and territories around the world and the sustained risk of further global spread.").

[94] Matthew Jennejohn, Julian Nyarko & Eric Talley, *A "Majeure" Update on COVID-19 and MAEs*, CLS BLUE SKY BLOG (Mar. 26, 2020), https://clsbluesky.law.columbia.edu/2020/03/26/a-majeure-update-on-covid-19-and-maes/ [https://perma.cc/7RV5-6XKZ]. The data in this study was limited to deals with transaction values exceeding $100 million, which produced eighty deals. *Id.* "General carve-outs," as used here, refer to "act of God" language and equivalents. *Id.*

[95] *See id.*

[96] Vivint Solar, Inc., Current Report (Form 8-K, Exhibit 2.1, § 9.5) (July 6, 2020). The language specifically read as follows:

> [I]t being agreed, for purposes of this Agreement, that COVID-19 (including Laws and policies effected in connection therewith and actions taken in response or in relation to COVID-19, such Laws and such policies) has not, as of the date of this Agreement, disproportionately affected the Company and its subsidiaries, taken as a whole, compared to other direct-to-home solar companies operating in the states in which the Company and its subsidiaries operate.

Id.

even if the effect of the change is materially disproportionate.[97] Likewise, the definition of a MAE relating to the acquirer, Sunrun, tracked the same language.[98]

Moving forward, at least some dealmakers will likely follow in Sunrun's and Vivint's footsteps and take pandemic-related MAEs off the table altogether. This allows for more confidence in deal closing and eliminates pre-closing opportunism.

Even if a deal does not include a Sunrun-Vivint-type of provision and dealmakers opt only for a pandemic carve-out, the ability to prove a pandemic-related MAE will be quite slim. This, in turn leads to a number of ripple effects and issues. The first issue is what role, if any, will MAEs play in the future? One possibility is that buyers may use MAEs (possibly along with other agreement terms like closing conditions) to pressure a target to renegotiate a transaction. Another possibility is that the inclusion of a MAE with pandemic-related carve-outs may help to signal to the target that the buyer is a serious one as it is willing to shoulder pandemic-related risks.

The ever-shrinking universe of MAE triggers and the courts' narrow interpretation of them make other pre-signing items, such as due diligence, increasingly significant. Whether or not pandemic-related MAEs are completely carved out, like in the Sunrun-Vivint deal, dealmakers are likely to engage in even more thorough due diligence to ensure that they understand the transaction risks. They will be expected to keep a particular eye on possible impacts of the pandemic both in the short and long term. These impacts could range from labor and employment matters to privacy matters to antitrust matters and beyond.[99] However, the question remains whether dealmakers will be able to accurately forecast the effects of the information they have.

The ripple effect of pandemic-related carve-outs continues beyond due diligence and into deal term negotiations. Namely, dealmakers will pay close attention to non-MAE provisions to compensate for the role that MAEs previously played in mitigating risks. More specifically, dealmakers will focus on provisions, like the ordinary course of business covenant, allowing a party to walk away from the transaction if there is a breach. This is a typical covenant that requires that the target continue to run the business in the

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[97] *Id*. The language specifically stated as follows:

> Notwithstanding anything to the contrary in this Agreement, any event, fact, development, circumstance, change, effect, or occurrence that arises out of a Law, directive, guideline or recommendation promulgated by any Governmental Entity related to COVID-19 shall not be deemed, either alone or in combination, to constitute or contribute to a Company Material Adverse Effect, regardless of whether such effect is materially disproportionate.

Id.

[98] *Id*. (defining "Parent Material Adverse Effect").

[99] *See* Jaclyn Jaeger, *M&A Due Diligence Landscape Forever Altered by Coronavirus Pandemic*, COMPLIANCE WEEK (Apr. 29, 2020, 2:45 PM), https://www.complianceweek.com/risk-management/manda-due-diligence-landscape-forever-altered-by-coronavirus-pandemic/28817.article [https://perma.cc/WA5V-Q7VS] (identifying additional due diligence issues to consider as a result of the pandemic).

"ordinary course" and ensures that the status quo of the company continues.[100] The covenant generally requires the buyer's consent to take actions that are outside of the ordinary course.[101] The covenant should address what a target may and may not do during the "ordinary course" of business as defined in the specific context of a pandemic. However, the ripple effect does not stop with traditional deal terms like the ordinary course of business covenant.

As dealmakers look into the crystal ball, there is opportunity for them to rethink deal terms that may act in the place of MAEs. Unfortunately, dealmakers are never going to be contracting in a perfect world without bounded rationality and opportunism. But they can innovate in how they respond to issues of ex post governance. For example, parties may consider a covenant specifically setting forth the parameters regarding renegotiation of an agreement if the negative effects on the target reach certain significant predetermined levels. This would in effect act similarly to a price adjustment, but only in the gravest of situations. Another option could require the acquirer to pay a substantial reverse termination fee if the acquirer claims a MAE and refuses to close.

Reverse termination fees (paid by an acquirer to a target upon termination) are not new deal terms. Dealmakers began to use them more frequently during the private equity boom immediately preceding the Great Recession as a way of controlling for financing risk.[102] As the 2007 financial crisis took hold, buyers attempted to exit transactions and simply pay the reverse termination fee, arguing that they had contracted for that option in lieu of closing.[103] Of course, a substantial reverse termination fee is no substitute for full deal value. So, at the time, taking the reverse termination fee "option" did not sit well with targets.[104] In today's dealmaking world, reverse termination fees are common and are typically triggered for terminations stemming from a lack of financing or the inability to obtain antitrust consents. As such, targets should not be caught off-guard if acquirers use the fees as acquirers did during the financial crisis. In fact, targets can now plan for it and negotiate even more substantial reverse termination fees.

The ripple effects continue beyond deal terms and termination fees to deal value. In particular, some argue that deal values may go down as acquirers account for the continuing effects of the pandemic due to increased uncertainty with respect to further virus waves and vaccine development.[105] As described earlier, uncertainty in the context of asset specificity makes negotiating a deal and reaching an agreement more difficult but certainly not impossible.[106] In performing increased due diligence and negotiations, the

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[100] GEVURTZ & SAUTTER, *supra* note 47, at 43.
[101] *Id.*
[102] Afsharipour, *supra* note 69, at 1188.
[103] *Id.* at 1190–91.
[104] *Id.*
[105] Salsberg, *supra* note 3 (stating that as companies plan for the future amidst the COVID-19 crisis, they should consider that "deal premiums are likely to come down").
[106] See *supra* notes 42–45 and accompanying text.

parties, particularly the acquirer, incur additional transaction costs which will likely be reflected in the purchase price. Furthermore, the lack of certainty regarding what the future holds and market volatility may also impact deal value. Moreover, now that we have had one modern-day global pandemic resulting in a global shutdown, dealmakers may be wary that another unrelated pandemic is possible.

These legitimate concerns, combined with the likelihood that an acquirer will not be able to exit a deal based on a MAE, have not stopped dealmaking. A number of high-value M&A transactions have been executed since March 2020.[107] In fact, Sunday, September 13, 2020 and Monday, September 14, 2020 was the "fastest start to a week for global dealmaking" since November 2019.[108] But could those September deals have been valued even higher in non-pandemic times? This is certainly a possibility, although not the subject of this Essay. However, what has become clear in recent months is that the pandemic is not going to stop dealmaking. In fact, it may even ultimately spur consolidations in certain industries. As deals continue, likely with pandemic-related MAE carve-outs, and dealmakers look into their crystal balls, an opportunity for creativity in dealmaking exists.

CONCLUSION

As dealmakers refine MAEs to adjust for uncertainties relating to the COVID-19 pandemic, they incur increased transaction costs. These increased costs may simply be the cost of dealmaking in the "new normal" world. Refined MAEs are not going to stop deals from being done. The only question becomes: how much risk are dealmakers willing to take on in the short term in return for a potentially considerable gain in the long term? If anything is clear as dealmakers look into their crystal ball, it is that hope creates opportunity but so does chaos.

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[107] *See, e.g.*, Varian Med. Sys., Inc., Current Report (Form 8-K, Exhibit 99.1) (Aug. 2, 2020) (reporting the transaction value as $16.4 billion); Chevron Corp., Current Report (Form 8-K, Exhibit 99.1) (July 20, 2020) (reporting the transaction value as $13 billion); Immunomedics, Inc., Current Report (Form 8-K, Exhibit 99.1) (Sept. 13, 2020) (reporting the transaction value as approximately $21 billion); Maxim Integrated Prod., Inc., Current Report (Form 8-K, Exhibit 99.1) (July 13, 2020) (reporting a combined enterprise value of over $68 billion); *see also* Heather Haddon, *Dunkin' to Be Sold to Inspire Brands for $8.8 Billion*, WALL ST. J. (Oct. 30, 2020, 9:58 PM), https://www.wsj.com/articles/inspire-brands-to-acquire-dunkin-brands-group-for-11-3-billion-including-debt-11604102999?mod=djemalertNEWS [https://perma.cc/BC6S-CCZ8] (reporting the transaction as valued at $11.3 billion).

[108] Fareed Sahloul, *Dealmakers See $69 Billion of M&A in Year's Busiest Weekend (2)*, BLOOMBERG L. (Sept. 14, 2020, 4:25 PM), https://www.bloomberglaw.com/document/XDV61R5G000000 [https://perma.cc/CE78-VBE8].