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Interpreting Material Adverse Effect Clauses in a COVID-19 World

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Introduction

COVID-19 has drastically changed the economic landscape for businesses that have pending obligations, such as lenders with outstanding lines of credit to borrowers, or businesses that are in contract to merge with or acquire others. Many of these obligations are governed by contracts containing "Material Adverse Effect" ("MAE") provisions.[1]

These contracts may include representations and warranties of the non-occurrence of MAEs—for example, that a material adverse change in the condition of an entity being acquired has not occurred and will not occur through the closing date of a business acquisition. Other contracts may contain MAE clauses that limit a party's contractual obligations—for example, a material adverse change in the borrower's financial condition may permit a lender to freeze or suspend a line of credit.

An understanding of how these clauses are interpreted by the courts will be critical in litigation precipitated by COVID-19.

On March 18, 2020, just two days before Governor Andrew Cuomo announced the signing of an Executive Order requiring all non-essential workers in New York to work from home as a result of COVID-19, Judge Ronnie Abrams of the U.S. District Court for the Southern District of New York issued a decision in *Newmont Mining Corp. v. Anglogold Ashanti Ltd.*[2] Despite that timing, the decision did not involve allegations of an MAE arising from COVID-19, but it does shed light on whether and how a court deems an MAE to have occurred under New York Law.

Relevant Facts of *Newmont*

Background

The dispute in *Newmont* arose from the sale of a mine in Colorado (the "Mine") by certain Anglogold-affiliated entities (collectively, "AGA") to Newmont pursuant to a stock purchase agreement (the "SPA").

Prior to the completion of the sale, issues had arisen in connection with a mill (the "Mill") which had been designed by a third-party contractor and which was being operated at the Mine. As part of the due diligence process, certain documents and information were provided to Newmont. The court's decision indicates that

Newmont had knowledge of some of the issues which had arisen in connection with the Mill but nevertheless proceeded with closing the transaction and ultimately purchased all stocks in the Mine pursuant to the SPA.

The MAE Clause in the *Newmont* SPA

In Section 4.14 of the SPA, AGA represented, in pertinent part, that "except as set forth in Schedule 4.14 [3] or as expressly required or permitted by the SPA, since December 31, 2014 . . . there has not been any Company Material Adverse Effect. . . ."

"Company Material Adverse Effect" was defined in relevant part, as "any change, effect, event, occurrence, circumstance or state of facts that . . . is or would reasonably be expected to be materially adverse to the business, results of operations, condition (financial or otherwise) of . . . the Mine."

Exceptions to the definition of a Company MAE included "any change, effect, event, occurrence, circumstance or state of facts" relating to "the failure to meet any projections or forecasts (it being understood that . . . the facts or causes underlying or contributing to such failure may be considered in determining whether a Company Material Adverse Effect has occurred unless otherwise excluded pursuant to any of the other clauses of this definition)."

Disclaimers in the SPA

Among other things, the SPA provided that (a) the sale was "as-is" except as expressly set forth therein; (b) Newmont acknowledged that it had been permitted full access to books and records that it had requested for review and that it had a full opportunity to meet with certain officers and employees to discuss the business; (c) AGA had not made any representation as to the accuracy or completeness of information provided unless expressly stated otherwise; and (d) Newmont would not be liable for any information or documents distributed during the due diligence period.

At closing, AGA provided Newmont with a certification stating that all representations and warranties in the SPA were true and correct as of the date of closing.

Newmont's Lawsuit and the Alleged MAEs

Approximately two years later, Newmont sued AGA for, among other claims, breach of contract. Newmont alleged that AGA breached Section 4.14 of the SPA (the failure to disclose that a Company MAE had occurred during the relevant time period (the "MAE Period").

Newmont alleged three MAEs:

(1) that during the MAE Period, AGA received certain reports, which established that AGA built the wrong type of mill (the "First Alleged MAE");

(2) that during the MAE Period, "severe design defects arose that would prevent the Mill from ever reaching design throughput" (the "Second Alleged MAE"); and

(3) that during the MAE Period, "AGA determined in a memorandum written by an employee at the Mine, that the Mill, in its entirety, suffered from critical deficiencies that would prevent it from ever reaching design throughput and recovery" (the "Third Alleged MAE").[4]

The Law Governing MAE Clauses

In construing the MAE clause, the Court cited to existing case law holding that: (a) "MAE provisions are a common feature of many contracts, and are subject to the same rules of interpretation as any other contract provision," (b) "New York courts interpret MAE provisions in the context of the entire agreement, and in conjunction with other evidence of the parties' intent, including separately executed and/or contemporaneous other documents," and (c) "[c]ourts also consider whether the alleged material adverse change was within the contemplation of the parties at the time they executed the agreement, whether it was within the control of the parties, and the magnitude of the impact on the relevant party's business."

The Court also reiterated case law confirming that "because merger and acquisition agreements are heavily negotiated and cover a large number of specific risks explicitly, an MAE provision—even where it is broadly written—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. In other words, a short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror."

An MAE did not Occur in *Newmont*

With those legal principles in mind, the Court cited multiple reasons why a Company MAE had not occurred:[5]

1. The plain language of the Company MAE definition excluded "the failure to meet any projections or forecasts" from serving as the basis of a Company MAE.

In this regard, the Court viewed each of the Alleged MAEs as falling within the exception for missed projections or forecasts. The Court held that reliance on an underlying cause for the failed projection here would create an exception that swallows the rule as it would allow nearly any circumstance to constitute a Company MAE if it causes a failure to meet projections or forecast.

2. The Company MAE definition referred to the Mine as a whole, and not just the Mill, so in order to constitute a Company MAE, the adverse effect must be materially adverse to the entire Mine.

Here, the Court found that notwithstanding Newmont's contention that the Mill was the "centerpiece" of the transaction, it still had to demonstrate that its Alleged MAEs had a materially adverse effect on the Mine as a whole, which it did not do. The Court further held that Newmont was aware that the Mill was still being commissioned at the time the transaction closed and that if Newmont wanted the Company MAE definition to include the MAEs measured in terms of the Mill, it should have bargained for that definition. The Court noted that while there may be circumstances where an adverse event involving the Mill constitutes an MAE, since Newmont did not show that the Mill was incapable of producing *any* gold, such circumstances were not present.

3. Given the disclaimers contained in the SPA, the Alleged MAEs cannot constitute a Company MAE under New York law.

The Court noted that since MAE clauses are read in the context of the entire agreement, in light of Newmont's repeated waivers and disclaimers, "the scope of the material and adverse change clause must be limited by at least two considerations: first, the clause must be limited to events that were outside the contemplation of the parties at the time of the transaction, and second, the clause must be limited to events outside the buyer's control." Here, by entering into the transaction on an "as-is" basis, Newmont assumed the risk that foreseeable events might occur. In this regard, the Company MAE definition would conflict with the disclaimers in the SPA if that definition included events which were foreseeable. The Court stated that "[a] foreseeable occurrence does not become a material and adverse change simply because it would require the expenditure of money to remedy or ameliorate."

Potential Applications of *Newmont* to COVID-19

In many cases, lending and acquisition agreements will be silent as to the rights and obligations of the parties in the case of a pandemic, and not surprisingly, there is a dearth of case law interpreting MAC or MAE clauses in the context of pandemics,[6] but *Newmont* provides at least some insight.

Initially, many businesses might argue that the loss of cash flow resulting from the COVID-19 pandemic was (i) not within the contemplation of the parties at the time they entered into the agreement and (ii) beyond the parties' control. Moreover, the magnitude of the impact in many cases may be substantial. At first glance, this would seem to bring many of the adverse effects arising from COVID-19 within most boilerplate definitions of an MAE or MAC. However, *Newmont* necessitates greater scrutiny in this analysis.

While the exceptions and carve-outs such as those in the MAE clause in *Newmont* are more common in M & A transactions, in the lending context MAE (or more frequently, MAC) definitions do not generally include such exceptions and can be relatively basic: e.g., "a material adverse change in the Premises or financial condition of the Borrower." Nevertheless, under *Newmont*, careful attention should be paid to the impact that MAE definition exceptions, if any, may have, on existing or foreseeable facts or occurrences. If any exception is deemed to apply, such that there is no MAE, or if an MAE is not ultimately deemed to have otherwise occurred, then the party who relied on the alleged MAE and failed to perform its contractual obligations, may be subject to claims of breach or anticipatory breach of contract.[7]

Further, based on *Newmont*, even when reading an MAE clause in the context of the entire agreement and other related evidence, New York courts will likely apply the MAE definition *precisely* as written, (remember, "*Mine*" vs. "*Mill*"), especially where the party seeking to invoke the MAE clause had or should have had knowledge of any other facts constituting the alleged MAE. For example, shutdowns resulting from COVID-19 may cause a significant reduction in the cash flow of encumbered *property*, but in the few instances where a corporate borrower has extraneous sources of income, these shutdowns may not necessarily cause a significant reduction in the condition of the *borrower*.[8] Thus, in that scenario, depending on the circumstances, an MAE definition of a "material adverse change in the condition of the borrower" may not ultimately be deemed an MAE.

Critically, and perhaps more so for M & A transactions, the duration of any alleged MAEs arising from COVID-19 lockdowns may be a significant factor in determining whether an actual MAE has occurred. It appears that the longer there remains an impact on earnings, the greater the likelihood will be that a Court may find that an MAE has occurred.

Conclusion

Currently, periodic issuances of Executive Orders are resulting in a fluid landscape in this field, and they may play a crucial role in driving lenders and other businesses to make decisions that may be financially costly, but that are nevertheless in the public interest, for example, not declaring material adverse changes in certain circumstances. Ultimately, where a MAC or MAE is invoked and whether it was done successfully will depend on, among other things, the nature of the alleged MAE, the precise language in the governing agreements and the totality of the circumstances relating to the transaction.

Please note that this is an overview of *Newmont* and the potential issues that it may implicate when dealing with allegations of material adverse effects or changes resulting from COVID-19. This summary is not intended to constitute legal advice or a definitive review of all potential issues that may arise.

Footnotes

[1] These provisions are also frequently referred to as "Material Adverse Change" ("MAC") clauses.

[2] No. 17-CV-8065, 2020 WL 1285543 (S.D.N.Y. March 18, 2020).

[3] Schedule 4.14 stated "None" under "Changes or Events."

[4] "Throughput" and "recovery" are common metrics used in the gold mining industry.

[5] The Court ultimately also found that no Company MAE occurred based on the evidence in the record.

[6] *River Terrace Associates, LLC v. Bank of New York*, a post-9/11 New York State Supreme Court case, briefly touched upon MAC clauses in the 9/11 context. However, there, the Court held that "with the backdrop of 9/11, [it was] unwilling to rule as a matter of law that [the lender's] taking what was perhaps an unreasonable amount of time to determine a Material Adverse Change and pressuring [the borrower] to accept a reduced loan amount, was not a total breach. 809 N.Y.S.2d 483, 10 Misc.3d 1052(A), 2005 N.Y. Slip Op. 51915(U), 2005 WL 3134228, at *10 (N.Y. Co., Apr. 13, 2005). Thus, in that case, the Court did not ultimately reach the question of whether a MAC occurred.

[7] While they do not generally constitute exceptions to the definition of MAE, circumstances such as acts of God, *force majeure*, governmental actions, frustration of purpose and impossibility of performance, may alternatively be invoked as excuses for a party's failure to perform its contractual obligations.

[8] However, given the requirements of many if not most lenders to lend predominantly to single asset borrowers or entities, a material adverse change is indeed more likely to have occurred in the condition of such entities that may not have other sources of income.

Practices

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