How COVID-19 Impact Analysis May Shape MAE Disputes

By David Tabak and Edward Flores (June 29, 2020, 5:31 PM EDT)

The COVID-19 pandemic has resulted in several lawsuits regarding pending corporate acquisitions in which buyers have alleged that the pandemic has caused a material adverse effect, or MAE, that should allow them to walk away from their deal. In other cases, sellers have asked for a ruling that there was no MAE and the deal should proceed.

For instance, Realogy Holdings Corp. filed a breach-of-contract claim, alleging that "[a]ccording to the buyer, COVID-19 has caused a Material Adverse Effect, excusing it from closing the Transaction," which Realogy disputes.[1]

Similarly, in seeking specific performance, Bed Bath & Beyond Inc. alleges, "Under the plain terms of the definition, even a calamitous event such as COVID-19 does not permit a party to avoid its obligations unless it causes a disproportionate impact on the Company, which is simply not the case."[2]

A March National Law Review article by Kathleen M. Porter and Anna Jinhua Wang points out that many deals have MAE clauses that allow a purchaser to withdraw from the deal.[3] MAEs often contain exceptions (i.e., the MAE does not apply to the effects of certain events, often events that affect the economy broadly), which, if they apply, would deprive the purchaser from the right to cancel the deal by invoking the MAE.

However, the article points out that the "exceptions to MAE clauses are normally subject to a disproportionate-effect exclusion, which returns the risk to the seller (i.e., giving the buyer the right to terminate) to the extent that an event falling into one of the exceptions disproportionately affects the target company as compared to other participants in the industry." Such clauses are referenced in recently filed complaints.[4]

Thus, an important question is whether the ongoing COVID-19 crisis is tending to create disproportionate effects within industries. We can use market data to estimate the anticipated effects of COVID-19 across different companies.

Stock prices represent the market's estimate of the future cash flows of a company and, therefore, change in response to changes in expectations of a company's future performance. Of course, stock prices will respond to more than just news about COVID-19, but, for simplicity, we will ignore that issue for now.

To begin, the COVID-19 crisis has created a growing disparity across members of the S&P 500 Index, as shown in the graph below.
As this chart shows, the differences in the daily returns, or price movements, across various firms have spread dramatically since the COVID-19 crisis first hit.

The lines on the graph, each representing the return of a company at a particular percentile of daily returns each day, seem reasonably constant through early March of this year. However, at that point, the lines not only move farther from 0% (i.e., larger net movements), but also spread apart from each other.

Another way to see the dispersion in daily returns across firms is by examining the range between selected percentiles. In the graph below, we examine the range between (1) the 25th and 75th percentiles, and (2) the 5th and 95th percentiles of daily returns for 2019 and 2020, plotted over a trading day calendar in order to see any year-over-year differences.

As can be seen in the graph, the 25th through 75th and 5th through 95th percentile ranges in 2020 are roughly constant through mid-February, at which point the 2020 percentile ranges increase dramatically, remaining at elevated levels through May 2020.

Moreover, from mid-February onward, the 2020 percentile ranges are substantially higher than the 2019 percentile ranges when comparing similar points in the year. This timing supports the conclusion that the increased dispersion we see is due primarily, if not wholly, to the COVID-19 crisis.
While these figures highlight that firms across many industries have been differentially affected, it does not speak to the degree of differential impacts within industries.

To examine this further, we look at the cumulative returns since Dec. 31, 2018, and Dec. 31, 2019, for all members of the S&P 500 within each of the 11 Global Industry Classification Standard, or GICS, sectors.[5]

While GICS is a well-known, standard industry classification scheme, it may or may not be the appropriate measure of industry participants for any individual test of disproportionate effects across an industry for MAE purposes.

In addition, stock-price movements are not the only possible measure of the impact of an event.[6] As an example of a specific industry, the graph below shows the results for the GICS real estate sector.
When comparing cumulative returns across firms in the real estate sector in 2019 and 2020, the range between the 25th and 75th percentiles and the 5th and 95th percentiles of cumulative returns has increased substantially during the COVID-19 crisis.

The 2019 and 2020 percentile range lines are reasonably similar through early March, when they start to diverge. From that point on, the 2020 lines have substantially increased relative to the 2019 lines at the same points in the trading calendar year.

This shows that the spread between firms experiencing above-average returns and firms experiencing below-average returns in the real estate sector has increased during the COVID-19 crisis.

In conclusion, it is clear that the COVID-19 crisis has been causing disproportionate effects both across industries and within industries. Whether the effects have been disproportionate for any one company will likely be an interesting area of analysis of MAEs, as well as in other business disputes. Fortunately, there are tools that may help address that question, though questions of defining the relevant industry and the proper tool(s) to employ will depend on the facts and circumstances of each individual dispute.

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[4] Complaint, ¶12, Forescout Techs., Inc. v. Ferrari Group Holdings, L.P., No-2020-0385-SG (Del. Ch. May 19, 2020). ("The definition of 'Company Material Adverse Effect' in the Merger Agreement expressly excludes any effects on the Company resulting from 'epidemics' and 'pandemics,' barring a materially disproportionate impact on the Company, and—even then—only to the extent the Company experiences an incremental disproportionate impact."); Bed Bath & Beyond, ¶32 ("[T]he Agreement does allow such events to be considered, but only 'to the extent that such Effect has a disproportionate effect on the Company compared to other participants in the industries or markets in which the Company operates.'"); Realogy, ¶13 ("Exclusions '(i)-(iv) and (vii) shall not apply to the extent the Business is disproportionately adversely affected by any change, event, occurrence, circumstance or effect in such clauses relative to other similarly situated participants in industries in which the Business operates.'").

[5] The Global Industry Classification Standard (GICS) is a four-tiered hierarchical industry classification system comprised of 11 sectors, 24 industry groups, 69 industries, and 158 sub-industries.

[6] Stock prices have the benefit of taking into account the market’s estimate of current and future effects and summarizing those effects into a single number. However, the observed stock prices will account for all new information over the period being examined, which may include material news unrelated to the event that is the subject of the potential MAE clause. Other measures of impact (e.g., changes in actual financial results and changes in analyst forecasts) may provide additional information relevant to understanding the depth and duration of the effect of a possible MAE.

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