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Is the COVID-19 Pandemic a Material Adverse Change?

In an attempt to flatten the COVID-19 contagion curve, businesses across the world are sending workers home and closing their doors to the public. Many continue to operate with remote workers or limited staff, while others may be forced to shut down completely.

While the COVID-19 pandemic is certainly changing businesses, industries and the economy, is it a material adverse change?

The short answer is probably not, given the uncertainty of the durational impact of the pandemic. However, the answer may change as we see how long the pandemic lasts and whether it disproportionately impacts certain industries.

Material Adverse Change and Material Adverse Effect Provisions

In M&A deals, material adverse change or material adverse effect (we will refer to both as a “**MAC**” provision) is a heavily negotiated defined term in the purchase agreement, but generally means an event, circumstance, fact, condition or change that is materially adverse to the target or its business or assets. It is primarily used to set the threshold circumstances under which the buyer is permitted to terminate the transaction, i.e., a buyer may terminate the agreement if there is a MAC provision during the period between signing and closing.

The general purpose of a MAC provision is to allocate pre-closing adverse change risk to sellers and allow buyers to terminate in limited circumstances where the target’s specific conditions have deteriorated so significantly that the agreement cannot proceed as contemplated. In line with this principle, MAC provisions generally exclude broader market and industry risks and often explicitly exclude force majeure events, including natural disasters (and occasionally even pandemics and epidemics), from their scope. The rationale being that a buyer already bears such risks in the conduct

of its business and should be able to adequately evaluate the risks in light of the acquisition. However, buyers often successfully negotiate the inclusion of such risks to the extent they have a disproportionate effect on the target compared to others in the industry.

Legal Standard

There is limited caselaw dealing with the invocation of MAC provisions and nothing directly addressing a pandemic. In general, courts will view a MAC provision in the context of the entire agreement and the invoking buyer bears a “heavy burden” in establishing that its failure to meet its closing obligations was justified. See *Hexion Specialty Chemicals v. Huntsman Corp.*, 965 A.2d 715, 738 (Del. Ch. 2008). In fact, prior to the Delaware Chancery Court’s decision in *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), no Delaware court had approved of a buyer’s reliance on a MAC provision to avoid closing a transaction.

In *Akorn*, the court noted that the adverse change must be “material” to the agreement. *Akorn*, 2018 WL 4719347, at *53. In addition, a change is material only if it “substantially threatens” the fundamental agreement in a “durationally significant” manner (i.e. years not months). *Id.*

Analysis

Considering the “heavy burden” that buyers face in invoking a MAC provision, there is little to suggest that a court would consider COVID-19, in and of itself, an adequate reason for terminating a deal at this time. First, a buyer would need to demonstrate that the pandemic has disproportionately and materially impacted the target. Second, a buyer would need to show that the change is more than temporary or transitory. This second point is particularly challenging because establishing the durational impact is an inherently speculative exercise.

However, the COVID-19 pandemic is rapidly evolving, and its duration is increasingly uncertain, with some experts projecting its effects will extend from months to years. As the economic impact

of COVID-19 continues to ripple through industries and companies, it is conceivable that specific deals could be or have been materially impacted. For instance, in the case of a buyer acquiring a cruise line, the outbreak could have extended economic consequences beyond short-term cancellations and rescheduling, perhaps due to significant changes in consumer tastes in favor of other types of travel.

Going forward, sellers and buyers will certainly draft purchase agreements with the pandemic in mind. It is hard to conceive of a seller agreeing to a MAC provision that does not explicitly exclude pandemics, and specifically COVID-19, from its scope. This is akin to the rise of exclusions for terrorism in the wake of September 11th. In turn, buyers will need to evaluate the uncertainty caused by the pandemic and adjust the purchase price accordingly or walk away.

We are closely monitoring the impact of the pandemic on M&A deals across industries and are watching for further developments. Our team has also issued additional guidance on “material adverse effect” provisions, specifically as it pertains to borrower/lender contracts and transactions. (See, [“COVID19: Credit Facility Material Adverse Effect Considerations.”](#) In the meantime, if you think COVID-19 might be affecting your past, present, or future transactions, [please contact us](#).

To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a [Coronavirus Response Team](#). Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.

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