

A review of MAC Clauses in a COVID-19 Climate in Japan

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Considerations when reviewing your MAC Clause in a COVID-19 Climate

As was the case after the global financial crisis in 2008 and Japan's triple disaster in 2011, companies are turning their minds to their potential exposure to, or their ability to rely on, material adverse change (MAC) clauses in light of recent events surrounding COVID-19.

In an M&A context, a MAC clause enables a buyer to walk away from a transaction before closing if an event or circumstance arises which has, or could reasonably be expected to have, a material adverse effect on the target company's operations and financial condition.

Although the application of a MAC clause will largely depend on how the particular clause has been drafted, below is a short overview of the some of the issues you may need to consider in assessing whether COVID-19 and its flow on effects could trigger a MAC clause on your transaction.

What you should be considering

- **Defining material adverse change:** Does your MAC clause reference quantitative factors? A typical MAC clause defines a material adverse change by reference to there being a 'material adverse effect' on the target company's operations and/or financial condition. What constitutes a 'material adverse effect' is often left undefined and as a question to be ultimately determined by a court. The experience from the US and the UK is that a very high standard needs to be met in order to establish that there has been material adverse effect on a target company.

To address the ambiguity, some MAC clauses include quantitative factors to help the parties determine whether there has been a 'material adverse effect' on the target company, for example a drop in earnings over a certain percentage over a given period. If you have a quantitative element in your MAC clause, you will need to carefully consider whether those thresholds have been met.

- **Duration and impact:** Do you expect the impact on the target's business to be long term? Have contingency plans been implemented to minimise the long term impacts? Events or circumstances which will have long lasting impacts on the target company, its operations

and/or financial standing will be stronger indicators that there has been material adverse effect on the target company. Whether the effects of COVID-19 can be categorised as short term or long term will need to be determined on a case by case basis and will depend on the relevant jurisdiction in question. The impact of COVID-19 and governmental responses vary greatly by country, with some countries imposing sweeping lockdowns with non-essential businesses being closed and restrictions on movement. In contrast, businesses in Japan remain open and are largely operating as usual despite Japan being one of the first countries with reported cases of COVID-19 outside of China. **Knowledge of events:** Was the MAC clause negotiated in circumstances where the threat of COVID-19 was already known? Japan reported its first case in January 2020¹ and depending on the specific drafting of the clause or governing law, a buyer may be prevented from exercising the MAC clause if seller can argue that the events and the impacts were reasonably foreseeable.

- **Specified carve outs:** Do any carve-outs to the MAC clause apply? MAC clauses typically exclude material adverse effects which arise due to changes impacting the industry as a whole, and general economic conditions. Such systemic or general-market risks will be borne by the buyer, with a seller arguing that COVID-19 related impacts are related to general market conditions within the scope of a carve-out. Other specific carve-outs may also have been negotiated and you will need to consider these closely. It is to be expected that sellers will look to negotiate specific carve outs relating to COVID-19 given the degree and potential impact of disruptions to business as a result of lockdowns and other governmental measures are becoming clearer.
- **The threat of invoking a MAC clause:** Do you have a plan in place to respond to threats to invoke a MAC clause? You should be mindful that, given the high standard needed for a buyer to comfortably rely on a MAC clause to walk away from a deal, buyers may threaten to invoke a MAC clause merely as a tactic to renegotiate commercial terms. How you respond will depend on the credibility of the buyer's claim that the MAC clause has been triggered and the strength of their arguments. Proactively considering and understanding the potential arguments in advance will put you in a better position to counter this tactic.
- **Relevant considerations for Japan:** There is little guidance on how Japanese courts will interpret a MAC clause, partially stemming from the fact that litigation on M&A transactions are not so common in Japan and also that MAC clauses are not commonly used in M&A agreements entered into between Japanese parties or which are governed by Japanese law. It is however worthwhile noting that under the Civil Code of Japan, parties must exercise their rights and perform their duties in good faith. This may act as a barrier to buyers seeking to use the current events as a 'hair trigger' for a MAC clause.

Closing Remarks

The application of a MAC clause is ultimately a factual question, dependent on the drafting and the context of a transaction and therefore requires a close consideration of your company's individual circumstances. The effects of COVID-19 continue to unfold and if you are revisiting your MAC clause and would like a second opinion on how it applies to your transaction, or if you are currently negotiating a MAC clause that deals specifically with COVID-19, we would be happy to discuss with you.

¹ <https://www.who.int/csr/don/16-january-2020-novel-coronavirus-japan-ex-china/en/>

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