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How The Pandemic And UK Security Law Are Changing Deals

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Two and a half years after the outbreak of COVID-19, this article looks at how the pandemic has shaped the approach to material adverse change, or MAC, provisions in U.K. and U.S. deal making, and how the introduction of the U.K. National Security and Investment Act regime will affect investors across the globe seeking to acquire material influence in a U.K. company.

COVID-19 brought MAC provisions into focus on both sides of the Atlantic, following the decisions of the Delaware Court of Chancery, in AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC,[1] that was affirmed by the Delaware Supreme Court, and the English High Court in Travelport Limited v. Wex Inc.[2]

While decisions of U.S. courts are not binding on the English courts, as U.S.-style provisions find their way into English-style M&A purchase agreements, we increasingly see English courts considering U.S. practice and academic commentary.

The COVID-19 pandemic accelerated the need to tighten foreign direct investment controls on the basis of national security. The report of the U.K.'s Department for Business, Energy and Industrial Strategy on the first three months of the National Security and Investment Act regime[3] sheds some light on the impact the NSIA has on deal making.

Negotiating MAC Clauses in a Post-Pandemic World

In a typical U.K. M&A deal, closing is conditional only upon receipt of the necessary government approvals, which are antitrust and foreign investment approvals. The purchase agreement does not usually include a MAC condition.

In contrast, the typical U.S. M&A purchase agreement includes more extensive conditions to closing, including conditions relating to the continued accuracy of the representations and warranties, material performance of covenants and there being no occurrence of a MAC between signing and closing.

MAC clauses are designed to permit the purchaser to walk away from a deal, if

certain events that have a detrimental effect on the target's business occur prior to closing.

MAC clauses are structured in three parts:

1. Definition of what constitutes a material adverse change;

2. Exceptions to the definition; and

3. Exclusions to those exceptions.

MAC clauses apportion general market or industry risks to the purchaser and target-specific risks to the seller. Traditionally, there has been a very high bar to establishing a MAC, such that a purchaser would be permitted to exercise a MAC walk-away right.

In practice, there has been only one Delaware Court of Chancery decision ever — Akorn Inc. v. Fresenius Kabi AG in 2018 — where the court has found a MAC.[4] Therefore, purchasers should not rely on MAC clauses as an "easy exit" in the event that circumstances change between signing and completion of a deal.

The disputes in AB Stable v. MAPS Hotels and Travelport v. Wex both concerned the interpretation of U.S.-style MAC provisions that were included in their respective purchase agreement. In both cases, between signing and closing, the COVID-19 pandemic took a turn for the worse.

The decision in AB Stable considered the exceptions to the MAC definition: specifically, what is a calamity, or natural disaster.

There is a key takeaway for negotiations following this decision: Just because a pandemic is not expressly mentioned in a MAC clause, or the fact that it was present in earlier drafts of the agreement and removed, does not mean a pandemic is not a calamity.

The dispute in Travelport v. Wex concerned a U.S.-style MAC clause that the parties had included in the purchase agreement, with conditions resulting from pandemics as one of the carve-outs.

However, the pandemic carve-out was then covered by a disproportionality exclusion: If the pandemic and its effects had a disproportionate effect on the target, as compared to other participants in the industries in which they operated, there would be a material adverse change.

The fundamental question that the court had to determine was whether the performance of the target should be measured against the narrow travel payment industry or the broader payments industry.

When considering the general rationale for risk allocation within MAC clauses in Travelport, the English High Court referred to the judgment of Vice Chancellor Travis Laster in Akorn v. Fresenius, noting that "the seller should not have to bear general and possibly undiversifiable risk that it cannot control and the purchaser would likely be subject to no matter its investment."

The judgment favored Wex and the deal finally closed for $577 million — more than $1.1 billion less than the price agreed 11 months earlier!

In U.K. public M&A transactions, the Takeover Panel applies a high level of materiality and is unwilling to

allow offerors to rely on MAC clauses except in exceptional circumstances. The inclusion of MAC clauses in offer documents is common practice, however, an offeror's ability to invoke a condition is significantly restricted by Rule 13.5 of the Takeover Code.

In deciding whether a MAC condition can be invoked, the Takeover Panel will look at whether the relevant circumstances on which the offeror is seeking to rely are of material significance to it in the context of the offer. This will depend on the facts of each case.

What National Security Controls Mean for a Deal

The second way in which deals are changing is the introduction by the NSIA of mandatory preclosing filing requirements for share acquisitions in which, among other things, an interest of 25% or greater in shares or voting rights is acquired in a target entity with activities in one or more of 17 core sectors, including various technology sectors.

The core sectors provide an indication of the sectors which the U.K. government currently regards as most likely to give rise to a national security risk.

The regime applies to investors from any country, including U.K.-based investors, and there are no thresholds for market share or minimum target turnover.

The key question is whether there is an acquisition of material influence in a company. The regime can apply to minority investments and the BEIS has already used its power to review "material influence" below the 25% mandatory filing trigger. The requirements can also apply to internal reorganizations — BEIS has confirmed that this is intentional and not an application of the NSIA that it intends to change.

The U.K. government also reserves the right to review transactions in any sector involving the acquisition of "material influence" occurring on or after Nov. 12, 2020. These call-in powers may only be exercised based on a reasonable suspicion, held by the U.K. secretary of state for business, that a transaction may give rise to a risk to national security.

This means that transactions that closed prior to the NSIA coming into force could be subject to retrospective review.

Parties embarking on a transaction in one of the core sectors will need to consider whether a NSIA filing is needed early on in the due diligence process, alongside competition or antitrust clearances. As this is an evolving space, it does not currently benefit from the same level of precedence about when filings are required and the likely level of review by regulators, as there is, for example, with the Committee on Foreign Investment in the United States. However, securing the clearance will become a condition to closing for deals in the core sectors. For other sectors, preemptory notifications are likely to be made more regularly, as a result of the five-year call in period.

Of the 222 deal notifications received during the first three months of the NSIA regime, 17 transactions were called in by the government for further assessment. This is in line with prior expectation that around 10% of cases would be called in.

Where the government has called in a deal, the average decision time was 24 working days, and all cases have been decided within the deadline of 30 working days. At the end of the reporting period 14 cases were still being assessed.

Notifiable transactions that proceed without clearance will be legally void, and the sanctions for noncompliance with the U.K. regime are serious: fines of up to 5% of the annual global turnover of the acquirer or £10 million ($11.4 million) if this is less than £10 million and up to five years in prison for the director responsible.

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[1] AB Stable VIII LLC v. MAPS Hotels & Resorts One LLC, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020), aff'd 2021 WL 5832875 (Del. Supr. Dec. 8, 2021).

[2] Travelport Limited v. Wex Inc., [2020] EWHC 2670 (Comm).

[3] Follow link for the full report: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1083295/E02757792-nsi-annual-report-2022.pdf.

[4] Akorn Inc. v. Fresenius Kabi AG, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018).