

**M&A Newsletter****APR 13,  
2020****COVID-19 and Material Adverse Change Clauses under Japanese Law****Yuki Oi, Takashi Nemoto, James Emerson, Kazuyoshi Furusumi, Peter Armstrong**

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This article provides a brief overview of the general use and interpretation of material adverse change clauses in purchase and sale agreements (each, a “MAC Clause”) under Japanese law and practice, with commentary on the application of COVID-19 to same.

As discussed in more detail below, parties with concerns about the potential impact of COVID-19 on a MAC Clause are well advised to: (i) carefully review the language and scope of the applicable MAC Clause, (ii) consider the likely effects of COVID-19 on the business and operations of the target company that is subject to the MAC Clause, and (iii) consult with their legal advisors, before commencing COVID-19-related negotiations or discussions with the counterparty to the contemplated purchase and sale transaction.

### 1. Introduction

It is standard for most purchase and sale agreements in Japan to include a MAC Clause, pursuant to which the prospective buyer is given the right to walk away from the contemplated transaction should a certain event, or series of events, occur that result in, or may reasonably result in, the target company or its assets suffering a material adverse change (a “MAC Event”).

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A MAC Clause allocates between the seller and the buyer the risks that are associated with unpredictable and/or unforeseeable events that could negatively effect the value of the target company or its assets prior to the closing of the contemplated transaction. Consistent with other jurisdictions, MAC Clauses in Japan generally provide one of the following: (i) that the completion of the contemplated transaction is conditional upon the nonoccurrence of any MAC Event between signing and closing, (ii) a seller's warranty, the accuracy of which is a condition precedent to closing, that since a defined reference date no MAC Event has occurred, or (iii) that the occurrence of a MAC Event between signing and closing is a termination event.

A standard definition of a MAC Event according to Japanese practice is, for example: "with respect to the target company, any event, change, development, or occurrence, that is, or is reasonably expected to become, materially adverse to its business, condition, assets, results of operations, or prospects<sup>1</sup>". Furthermore, it is common for there to be certain carve-outs from the definition of what would constitute a MAC Event, including: (a) general changes in business, economic or market conditions, (b) changes that impact the target's industry generally, (c) changes in law or accounting principles, (d) acts of war or terrorism, (e) acts of God, (f) the execution of the transaction documents, themselves, or the public disclosure of the contemplated transaction. Parties will also usually negotiate exceptions or limitations to those carve-outs, such as: "provided, however, that the exceptions set forth in the foregoing proviso shall not apply to the extent that the target company is disproportionately affected thereby".

## 2. COVID-19 and MAC Clauses

Given the existence of the ongoing COVID-19 pandemic, the question of whether its impact may trigger a MAC Clause, which in turn would entitle a buyer to walk-away or to terminate the contemplated transaction, is a key issue for many current market participants.

### 1) Court Precedent in Japan

Historically, Japanese courts have interpreted MAC Clauses narrowly and limited their application. For example, in its judgment on March 8, 2010 (Law Cases Report (Hanrei Jiho) No.2089 page 143), the Tokyo District Court of Japan denied the buyer's right to terminate a share purchase agreement by means of exercising the MAC Clause. In that case, the subject share purchase agreement included a seller's warranty that since a particular date "no material fact which has an adverse effect on the financial condition of the target company has occurred" and the parties had provided that the buyer may terminate the agreement should such warranty not be true and correct. In reliance on such MAC Clause, the buyer attempted to terminate the agreement, arguing that certain material facts, adversely affecting the target company, had occurred in breach of this warranty. The buyer claimed that: (i) the amount of the operating profit for the applicable fiscal year was much less than that stated in the business plan, which was used as the basis for the purchase price valuation, and (ii) the appraisal value of the subject real estate of the target company had materially decreased. Nevertheless, the Tokyo District Court ruled that neither (i) nor (ii) were sufficient to trigger the applicable MAC Clause because, with respect to (i), (a) the actual amount of operating profit of the target company for the fiscal year ended on September 2008 had not substantially decreased

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<sup>1</sup> Among others, whether to include "or is reasonably expected to become" and "prospects" is often heavily negotiated as such language could give the buyer a broader right to exercise the MAC clause.

in comparison to the operating profit from the previous fiscal year, and (b) the amount of operating profit for the target company provided in the business plan was merely an estimate, and with respect to (ii), the decrease in the appraisal value of the subject real estate was due to general market conditions and not events or facts that uniquely impacted the target company and, therefore, such loss in value was outside of the scope of the MAC Clause.

## 2) Triggering a MAC Clause

Determining whether the effects of COVID-19 may trigger a particular MAC Clause requires a case-by-case analysis based on the relevant facts and provisions of the relevant agreements between the parties. However, generally speaking, if the MAC Clause in the agreement is relatively simple and does not include any carve-outs, for example, “any event, change, development, or occurrence, that is, or is reasonably expected to become, materially adverse to its business, condition, assets, results of operations, or prospects”, then the buyer may be able to successfully argue that the effects of COVID-19 are sufficient to satisfy the MAC Clause<sup>2</sup>.

On the other hand, if the MAC Clause includes carve-outs, such as “changes in general business, economic or market conditions or changes generally affecting the industry”, or if a Japanese court holds that such carve-outs are implied, then it is likely that the seller will be able to successfully argue that the effects of COVID-19 are carved out from the scope of such MAC Clause. If the MAC Clause includes exceptions to such carve-outs (e.g., in the case that the target is “disproportionately affected by the event”), the buyer may be able to exercise the MAC Clause if there is demonstrable evidence that the target has been disproportionately affected by COVID-19 as compared to its competitors.

Finally, a buyer may want to also explore using a MAC Clause as a tool to negotiate a reduction in the previously agreed purchase price, rather than to terminate the transaction entirely. This may be appropriate where the impact on the target company has been substantial but there is doubt as to whether the impact on the target company has been disproportionate, or when the scope of the MAC Clause in question is not fully clear relative to the impact of COVID-19. Legal advisors should be able to assist with this analysis.

## 3. Impact on Future M&A Transactions

Seller’s may look to negotiate the inclusion of specific carve outs from a MAC Clause pertaining to pandemics and epidemics, in general, or COVID-19, specifically. As discussed above, though, even without such specific carve-outs, the seller may be able to successfully argue that the effects of COVID-19 should be excluded due to the inclusion of more standardized carve-outs such as “changes in general business, economic or market conditions” or “changes generally affecting the industry” or else by referring Japanese court precedent.

Buyers, on the other hand, should seek to more aggressively negotiate the scope of the MAC Clause in an attempt to

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<sup>2</sup> It should be noted that based on Japanese court precedent even without the inclusion of specific carve-outs in a given MAC Clause, an event that impacts the public at large, such as a recession in the real estate market, will likely be insufficient for the purposes of exercising a MAC Clause. Therefore, in light of such precedents, sellers may be able to successfully argue that even where a MAC Clause does not include any such carve-outs, the effects of COVID-19 ought to be insufficient for the exercise of the MAC Clause.

expand its application as much as possible so that consideration is given to adverse effects that may occur on the “prospects” of the target company, events “reasonably expected to become” material, and events that disproportionately affect the target company. Moreover, in light of the limited number of interpretations of MAC Clauses supported by Japanese court precedent, it might be prudent for buyers to include, in addition to the MAC Clause, itself, a separate termination right and/or price adjustment clause that would be triggered by the occurrence of certain events such as: (a) sales/profits of the target company falling below certain objective thresholds, (b) transaction volumes with specific customer(s) falling below beyond certain objective thresholds, or (c) the cessation of operations at any of the target company’s sites for some defined period of time. In addition, if a buyer requires a walk-away right associated with the impacts of COVID-19, a reverse break-up fee arrangement by which the buyer may terminate the transaction upon the payment of a fee to the seller could be an option that would be acceptable to both sides.

#### 4. Conclusion

MAC Clauses are tricky provisions that require careful drafting and deep consideration and forethought. While they should always be given serious attention, given the current COVID-19 climate, it is more important than ever that the parties to each contemplated transaction do their utmost to understand their respective rights and also the various risks involved in agreeing to the language and carve-outs of a MAC Clause.



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Named Japan's inaugural Young Lawyer of the Year at the ALB Japan Law Awards 2019, he was also selected as one of Asia's top 40 lawyers under 40 by Asian Legal Business in 2017.

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James Emerson is a foreign law partner with extensive experience running cross-border transactions involving companies from around the world, including Japan, the United States, Europe, Australia, Russia, other countries in Asia and South America.

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Peter assists Japanese and global entities on a wide range of complex cross-border commercial transactional areas, including mergers and acquisitions, foreign investment and finance, dispute resolution and crisis management.

His practice has a particular focus on cross-border energy and infrastructure projects, including providing advice with respect to the financing and structuring of projects as well as the negotiation and drafting of Operation and Maintenance contracts and engineering and construction contracts.

Peter also has expertise in managing complex regulatory and corporate crisis matters with multi-jurisdictional or parallel civil and criminal components and is regularly asked to assist clients with respect to the investigation and resolution of high profile and particularly sensitive matters.

He also frequently represents clients in connection with cross-border business investments, including mergers and acquisitions, the establishment of joint venture entities as well as licensing and distribution agreements.

Peter is a registered foreign lawyer (gaikokuho jimusho) and is fluent in Japanese.

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