



ANALYZING THE PRACTICE OF MATERIAL ADVERSE CHANGE: A POST PANDEMIC MERGER AND ACQUISITIONS CONTRACT NON-PERFORMANCE CLAUSE FROM THE PERSPECTIVE OF UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACT

Dessandra Divanadia*, Sinta Dewi Rosadi**, Purnama Trisnamansyah***

ABSTRACT

The uncertain conformity between the characteristics of the condition attributable to the inability of mergers and acquisition contract performance due to COVID-19 and the characteristics of force majeure and hardship leads to the use of material adverse change (MAC) as an alternative clause for contract non-performance as a perennial consequence of COVID-19 pandemic in the post pandemic era. This study aims to analyze the implications of COVID-19 pandemic with the use of MAC according to the laws of the nations and the adherence of MAC as a clause with UNIDROIT's six general principles of international contract during and post pandemic as issued in UNIDROIT Principles of International Commercial Contract. The method of writing used was normative juridical approach with descriptive analytical research specifications. The writing process taken in drafting this study was through a process of literature review from primary, secondary, and tertiary sources. Data analysis method used in this study was through qualitative juridical normative method. The outcome of the analysis shows that the use of MAC as an alternative clause for contract non-performance differs between one national law to another; one of the outstanding characteristics is that the basis of the use of MAC depends on the agreed definition and the burden of proof of MAC set forth in the contract. The use of MAC as an alternative clause for contract non-performance in mergers and acquisitions is compliant with UNIDROIT's principles of international contract, with considerations of the limitations and exceptions of the international contract principles.

Keywords: material adverse change; mergers and acquisitions contract; pandemic.

I. INTRODUCTION

The first finding of a Coronavirus plague in Wuhan, China, in December 2019, followed by World Health Organization's (WHO) pandemic declaration in March 2020¹, has sent the world into a health and economic unrest. As the pandemic proved to be a danger to world health, national governments took turns implementing counter policies and regulations to control the spreading of the virus, which includes social restrictions, resulting in economic and socio-economic obstruction.

The onset of the pandemic and the implementation of its countermeasures, as a means of response to the pandemic declaration and to control the spreading of the virus, which had gone light speed, had left substantial adverse effects to businesses, most notably as an impact to the implementation of travel restrictions, export and import restrictions, and social restrictions. For instance, the travel restrictions halted most corporate operations in travel and aviation industry; export and import restrictions put the electronic industry in peril as it puts an uncertainty in raw materials procurement; industries such as mining, shipping, and construction underwent a domino effect due to the supply chain jeopardy; and

* Faculty of Law, Universitas Padjadjaran, Jl. Ir. Soekarno KM. 21, Jatinangor, Kab. Sumedang, Indonesia. Email: dessandra17001@mail.unpad.ac.id

**Faculty of Law, Universitas Padjadjaran, Jl. Ir. Soekarno KM. 21, Jatinangor, Kab. Sumedang, Indonesia.

***Faculty of Law, Universitas Padjadjaran, Jl. Ir. Soekarno KM. 21, Jatinangor, Kab. Sumedang, Indonesia.

¹ Coronavirus Disease (COVID-19) is an airborne disease caused by severe acute respiratory syndrome virus 2 (SARS-Cov-2), attacking the respiratory system aggressively with high contagion level, due to which WHO declared the transmission of the virus as a public health emergency and as a pandemic in early 2020.

the subsequent oil price markdown left a ripple effect suffered by oil and gas, commodity, and services industry; the regulations had also impacted stock prices and shareholding ability within the capital market,² resulting in economic unrest³.

The supply chain disturbance eventually affects companies' revenue. The prevalence of salary deduction, employee termination, and the ceasing of corporate activities, and on occasion bankruptcy, are common occurrences as a result of the impact of the pandemic and its countermeasures. An article released by Kompaspedia in 2020 showed that the impact of COVID-19 countermeasures had resulted in negative economic growth and eventual recessions in a lot of countries, not excluding the economic situation of developed countries⁴.

As one of the countries implementing COVID-19 pandemic countermeasures, Indonesia suffered from several economic challenges as drawbacks in 2020⁵. The increasing number of employee termination went as high as 1.2 million employee terminations in 2020; a significant deflation of the Purchasing Management Index as low as 27.5 in April 2020⁶; highest reduction of import in to a total percentage of 26.9% in October 2020; inflation rate of 0.95% in the span of January-October 2020, and 1.44% year-on-year inflation rate (in the period of October 2019-October 2020); the fluctuation of economic growth, which went downturn in Q4 2019, which then surge back in Q2 2020⁷.

The economic downturn arose from the fluctuation of the prices of material, oil, and stocks, financial circulation, and lending access due to the pandemic and its countermeasures ultimately resulted in a shift in corporates' ability to perform their contractual obligations; the restrictions and constraints of supply and demand, as well as the decrease of human resources availability within the company derived from the social restrictions exposed the company to a risk unforeseen prior to the pandemic declaration and its subsequent implementation of countermeasures.

Mergers and acquisitions are two business transactions, falls into the category of company restructuring, which continuously suffered from the impact of the pandemic and its countermeasures. The economic instability induced a decrease in productivity and the dynamic alteration of the transactions further caused the increase of mergers and acquisitions contract non-performance cases.

Failure of contract performance due to the implementation of COVID-19 countermeasure can be observed through the dispute between L Brands, a fashion retail company based in the United States, and Sycamore Partners, a private equity firm specialized in retail and consumer investment based in New York. Both companies announced in February 2020 of their agreement to enter into a contract, of which stipulates the separation of Victoria's Secret Lingerie, Victoria's Secret Beauty, and PINK—collectively referred to as Victoria's Secret—from L Brands and placing it into a private company in which Sycamore Partners will act as the major shareholder. The enactment of COVID-19 countermeasures in Northern America, particularly the shelter-in-place regulation, prior to the closing of the contract, forced L Brands to mitigate the risk of revenue decline and cash flow bottlenecks

² Wall Street Journal Market Data reported that the first half of 2020 showed significant decline in stock investment figures compared to the latter half of 2019 prior to the discovery of the initial case of COVID-19.

³ Peter Goldsmith dan David W. Rivkin, "COVID-19: Impact on Contracts and Dispute Resolution", Debevoise & Plimpton, April 2020.

⁴ Antonius Purwanto, "Ekonomi Dunia di Masa Pandemi COVID-19: Dari Dampak Hingga Proyeksi Pertumbuhan 2021-2022", last modified in August 2021, <https://kompaspedia.kompas.id/baca/paparan-topik/ekonomi-dunia-di-masa-pandemi-covid-19-dari-dampak-hingga-proyeksi-pertumbuhan-2021-2022>.

⁵ Alfany Arga Alil Fiqry, et. al., "Peluang dan Tantangan Merger Bank Syariah Milik Negara di Indonesia Pada Masa Pandemi COVID-19", *EL-DINAR: Jurnal Keuangan dan Perbankan Syariah* 9, 1(2021): 1-18

⁶ Purchasing Management Index is an economic health indicator in manufacture, substantial to a corporate's decision making, analysis, and purchasing management.

⁷ Alfany Arga Alil Fiqry, et. al., *Loc. Cit.*

through employee termination, salary deduction, elimination of employees' annual benefits, and substantially diminish the production of new products and simultaneously detract the amount of out of season and product surplus, resulting in the reduction of the value of the goods.

L Brands' mitigative measures, which resulted in value reduction, inflicted a contractual dispute. Sycamore Partners filed for a suit through Delaware Chancery Court under the grounds of a breach of contract's representations and warranties and pre-closing covenants by L Brands; failing to carry out its contractual obligations. L Brands then refuted the claim, stating that Sycamore Partners' lawsuit was only intended to renegotiate the contract⁸.

The COVID-19 pandemic's most prominent characteristic is instability and uncertainty, both congruent within one another. The dispute between L Brands and Sycamore Partners is only one of the many manifestations of the consequences of the instability and uncertainty of COVID-19 pandemic and its countermeasures. While the pandemic itself and the spreading of the virus has not been as rampant as it was in 2020-2021, there is no guarantee that the impact and its imminent effect will not happen post pandemic.

A contract non-performance is usually pardoned through the application of force majeure and hardship. Non-performance is concept stipulated in Article 7.1.1 UNIDROIT Principles of International Commercial Contract (from here onwards referred to as UPICC), which refers to the failure by a party to perform any of its obligations under the contract, including defective performance or late performance⁹. Force majeure is a contract non-performance clause used to define the concept of non-performance in Article 7.1.1., which allows a non-performance on the condition that that the nonperformance was due to an impediment beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences¹⁰; while hardship is a condition in which an event occurred and alters the equilibrium of the contract; either due to the increase of the cost of the contract performance or the depreciation of the value of the contract performance received by a party¹¹.

As both clauses are codified non-performance clauses, certain conditions must be met for a contract non-performance to be pardoned under the clause of force majeure or hardship. Should an impediment, however critical it may be, failed to meet certain characteristics of force majeure or hardship according the choice of law agreed in the contract, a non-performance can be classified as a breach of contract regardless of how complicated the situation might be for the injured party.

Analysis of the characteristics of force majeure and hardship according to the definition and characteristics stipulated in the UPICC shows that on the condition that a party failed to perform their contractual obligations caused by the COVID-19 pandemic and its countermeasures, it cannot necessarily be said that the party has experienced a force majeure or hardship; the said condition has to be analyzed through the accessibility of the countermeasures prior to the closing of the contract, proof of the impediment, the obligor's inability to foresee the impact of the pandemic and its countermeasures, the correlations between the pandemic, countermeasures, and the agreed terms of non-performance, whether the condition is fundamental and objective, whether the condition impacted the cost of performance, and whether there is a change in the value of the performance, all in relation to the pandemic and its countermeasures.

⁸ James Fontanella Khan and Sujeet Indap, "Sycamore and L Brands Call Off Victoria's Secret Deal", last modified in May 2020, <https://www.ft.com/content/3f458e9c-e864-4fe1-8740-37136bae7b62>.

⁹ Article 7.1.1. UNIDROIT Principles of International Commercial Contract.

¹⁰ Article 7.1.7 UNIDROIT Principles of International Commercial Contract.

¹¹ Article 6.2.2. UNIDROIT Principles of International Commercial Contract.

In the practice of mergers and acquisitions contract, on the condition that the obligor failed to prove that their non-performance is a force majeure nor hardship, one of the alternative clauses that can be used by the injured party in a merger and acquisition contract non-performance due to the pandemic and its countermeasure is material adverse change (MAC).

Material adverse change (MAC) or material adverse effect is a clause commonly used in mergers and acquisitions and credits agreements to allocate the risk related to the fulfillment of a contract that may occur during the contract period, from the signing of the contract to the closing of the contract. Material adverse change is an important clause in a business contract, as the clause allows one or both parties to terminate the contract with no obligations and penalties due to an unforeseen condition that affects the injured party¹².

While the world has now entered a post pandemic, nothing can be said regarding the perennial effects of the pandemic and the implementation of its countermeasures. The complication stems from the pandemic and the implementation of its countermeasures may still have a legal quandary that persists even post pandemic that could be a cause of a contract non-performance.

With the uncertain congruency between a contract non-performance caused by the aftereffect of the pandemic and its countermeasures and the characteristics of force majeure and hardship, the codified contract non-performance clause, MAC could serve as an alternative clause for such cases to avoid a breach of contract and the impending penalties. The absence of codified regulation that stipulates the use of MAC as an alternative clause drives the need for MAC to be analyzed of its conformity with the contract principles in accordance to governing law. This paper aims to analyze the implications of MAC within different jurisdictions and its conformity with the six general contract principles as stipulated in the UNIDROIT Principles of International Commercial Contract, a source of international contract law, and Kitab Undang-Undang Hukum Perdata, or Indonesian Civil Code, of which the articles of the code apply to contracts that falls under the jurisdiction of Indonesian law.

II. RESEARCH METHOD

The method of writing used was normative juridical approach with descriptive analytical research specifications with the purpose of analyzing the implementation of MAC as an alternative clause to a contract impediment caused by the COVID-19 pandemic and its countermeasure and its adherence to the contract principles according to the governing contract law in Indonesia and the UNIDROIT Principles of International Commercial Contract (UPICC), a legal instrument of international contract law.

The writing process taken in drafting this study was through a process of literature review from primary, secondary, and tertiary sources, which includes the related governing law, books, articles, and journals of which the contents of the literature support the result of the analysis of this paper. Data analysis method used in this study was through qualitative juridical normative method by through examining the comparisons of theories, concepts, and legal principles related to the content of this paper.

¹² Robert T. Miller, "Material Adverse Change and the COVID-19 Pandemic (18 May 2020)", University of Iowa Legal Studies Research Paper No. 2020-21

III. DISCUSSIONS

1. Comparative Analysis of the Implementation of Material Adverse Change in Different Jurisdictions

Material adverse change is an alternative clause that has yet to be codified but frequently used in mergers and acquisitions and credits contract, thus can be concluded that the use of MAC as an alternative clause is a part of the practice of a customary contract law. Customary law is a set of rules that are not determined by the legislative institutions, but rather the agreed upon legal awareness and legal needs of community members (*werkelijkheid*)¹³. The existence of customary law is the result of a combination between *usus* and *opinion juris sive necessitates* in society. *Usus* means that the practice of customary law must encapsulates the behavior that occurs in conditions related to the custom and represents a constant and stable pattern of practice in the customary rule; a conventional perspective requires a normative belief that society members should remain compliant to the practice, unless they decided to opt out of the custom. The normative belief expects that a normative dimension of mutual trust can be borne to the society members' compliance to the custom, as it is essential to support the trading activities¹⁴. Customary law is almost always formed gradually, though certain condition can bore a new customary law in spontaneity, with different inferential process depending on the existence of a codified related customary law¹⁵.

As a customary contract law that is yet to be codified, the interpretation of MAC as an alternative clause differs between cases depending on the applicable general legal provisions in accordance to choice of law previously agreed upon in the contract. The use of MAC as clause is more common and familiar within jurisdictions conforming to a common law system; samples of MAC cases in the United States through the Delaware Chancery Court and the United States District Court, S.D. New York showed different use and determination of MAC, yet drawing similarities in putting the burden of proof on the obligor to provide evidences of a material adverse effect through their company's financial report; while the England High Court acknowledges the use of MAC depends on the previously agreed terms and definitions of MAC between the parties prior to the closing of contract. The practice of MAC and its legality, on the contrary, remains ambiguous in Civil Law countries such as Indonesia, India, and the Netherlands, as the absence of a codified MAC terms complicates the determining of MAC cases within their jurisdiction.

1.1. MAC in the United States

The standard MAC clause used often by parties entering into a contract in the United States generally consists of three parts. The first part of the clause determines the definition of MAC agreed upon by the parties as any event, development, or condition that has had, or would be reasonably expected to have, a material adverse effect on the business, financial condition, or results of operations of the company and its subsidiary. The second part of the clause determines the exclusion of specified events, such as acts of God, weather events, natural disasters, terrorism or military actions, general economic downturns, conditions existing within the industry, and other general categories of market or credit conditions. The third part of the clause typically states that, with respect to some or all of the specified exclusions agreed upon, these excluded events will not be excluded to the extent that there have been a disproportionate adverse effect affecting

¹³ Magister Ilmu Hukum Universitas Medan Area, "Kebiasaan Sebagai Sumber Hukum", last modified in November 2022, <https://mh.uma.ac.id/kebiasaan-sebagai-sumber-hukum/>.

¹⁴ Fabrizio Cafaggi, "Custom and Law in Transnational Commercial Contracts: A Co-evolutionary Perspective", *TLCR* 2, 5(2022).

¹⁵ *Ibid.*

the company and its subsidiaries (taken as a whole) in comparison to other companies within the same industry. In acquisition financing agreement, a condition to closing is that there has not been a target company MAC and there is a cross-reference to the MAC set forth in the merger agreement.

Although the use of MAC as an alternative contract clause in the United States is more common compared to its usage in other jurisdiction, the regulations of MAC provisions, especially regarding the definition and criteria, is still very narrowly interpreted. Within the jurisdiction of Delaware Chancery Court, only one contract dispute had been found to experience a material adverse effect, thus allowed the termination of the contract. The contract dispute in question was the altercation between Akorn, a pharmaceutical manufacture company, and Fresenius Kabi AG, of which both parties entered into a merger contract to merge Fresenius Kabi AG's subsidiary, Quercus Acquisition Inc., with Akorn in Q1 2017. Q2 2017 then showed a significant decline in Akorn's performance: 29% drop of revenue compared to the revenue of the previous fiscal year, 84% degression of the quarterly operation revenue, and 95% of stock earning declines year-on-year. The drop down was supposed to be temporary, however Q3 2017 showed lower decline in the company's revenue (29%), operational revenue (89%), and earning per share to as low as 105% year-on-year; and even lower in Q4 2017, in which the company's revenue, operational revenue, and earning per share significantly dropped to 34%, 292%, and 300%; the drop went continuously to Q1 2018; by then it had become known that the total decline of Akorn's EBITDA in 2017 fell as low as 86% and 51% adjusted EBITDA.

The performance decline, followed their nonconformity in product development, lead to Fresenius filing a lawsuit through Delaware Chancery Court to terminate the contract under the grounds of material adverse effect experienced by Akorn.

The Delaware Chancery court ruling acknowledged the existence of a material adverse effect happened within Akorn and Fresenius' contract performance. The verdict was issued in considerations with the previous court ruling for disputes between IBP Inc. v. Tyson Foods and Hexion v. Huntsman, of which both claims of material adverse effect were denied, with considerations of lack of proof of revenue decline and that the condition experienced by the parties should show a significant difference in the revenue year-to-year as opposed to the deviation of the revenue of two consecutive years. The declining of Akorn's financial conditions and its significance were deemed to be substantial compared to the previous MAC cases acting as the comparative case for the Akorn v. Fresenius trial.

Similar to the Delaware Chancery Court ruling, the United States District Court, S.D. New York (S.D.N.Y) granted a material adverse effect to Delta Airlines on the contractual dispute between Pan Am Corp. and Delta Airlines. S.D.N.Y found that a material adverse effect had transpired when Pan Am experienced a significant decline in revenue in a significantly short time. The court ruling freed Delta from their contractual obligations to Pan Am, and required Pan Am to return the investment they had previously received from Delta as part of the contract.

Both rulings from the Delaware Chancery Court and S.D.N.Y corroborates that in determining the occurrence of MAC within the jurisdiction of the United States, the courts put the burden of proof to the parties to show that there is a significant decline in revenue year-on-year. The decline of revenue and/or a company's financial performance should be supported by evidences that shows significant decline within a significantly short period of time. Indication of recurring condition can be used as proof of MAC (as ruled by the Delaware Chancery Court), as well as conditions of MAC as previously provisioned in the contract (as ruled by S.D.N.Y).

1.2. MAC in the United Kingdom

In a dispute between Travelport and WEX, adjudicated by England High Court, the use of MAC as an alternative clause can be reinforced through the definition of MAC set forth in the contract previously agreed upon by the parties.

The falling out between Travelport and WEX, previously entered into a sales and purchase agreement of the shares of eNett International (Jersey) and Optal Limited. The shares of eNett and Optal were previously owned by Travelport, in this agreement acting as the Seller. The altercation happened due to the difference in interpretation regarding the validity of COVID-19 as a material adverse effect in accordance to the clause agreed to in the contract.

The consequence of MAC had been provisioned in Article 8.2(d) of the SPA, which stipulates:

“Since the date of this Agreement there shall not have been any Material Adverse Effect and no event, change, development, state of facts or effect shall have occurred that would reasonably be expected to have a Material Adverse Effect”.

With the declaration of a pandemic in 2020, WEX then addressed a letter to Travelport, claiming that there was a material adverse change happening, and that the provision of Article 8.2(d) of the SPA was not met, hence WEX, in this case the Buyer, should be released of any of their contractual obligations to Travelport.

Travelport denied the claim, stating that there was no material adverse effect happening, and that eNett and Optal’s financial situation had to be measured and compared to their competitors within the travel payment industry for it to be deemed experiencing a material adverse effect; WEX, on the other hand, understood that the measurement of eNett and Optal’s financial situation shall be evaluated by comparing them with the financial situation of competitors within a broader, general payment industry, rather than specifically compared with competitors from the travel payment industry.

England High Court, in their ruling, inferred that a merger and acquisition contract is a contract strictly negotiated between knowledgeable parties expertizing in the transaction. The nonexistence of a clause or a factor to the clause is recognized as the result of careful considerations between the parties; including all the risks that comes with the formulation of the clause.

England High Court identified that there is a carve-out clause in the SPA, an exception of certain obligation or liability¹⁶, which essentially governs that a material adverse effect can happen on the condition that there is a detrimental condition unforeseen by the Seller (including COVID-19). Exception to the clause can also be found on the SPA: that regardless of the detrimental condition caused by COVID-19, a material adverse effect can still be considered if eNett and/or Optal (both as separate entities or collectively), experience a loss and decline in revenue compared to their competitors within the industry.

England High Court concluded that the term “industry”, the subject of disagreement between the Seller and Buyer, in the context of the SPA, referred to the *business-to-business* (B2B) payment industry in general and not the travel payment industry, specifically, as claimed by the Seller. Furthermore, the parties did not previously agree to a specific comparison, which

¹⁶ Christopher R. Drahozal & Erin A. O'Hara O'Connor, “Carve-Outs and Contractual Procedure (Vanderbilt Law & Econ. Research Paper No. 13-16”, Vanderbilt Pub. Law Research Paper No. 13)-29).

should have been done. England High Court also stated that an MAC clause should not be interpreted narrower than other clauses.

Based on the elucidation of the case in England High Court, it can be said that the England High Court recognized the use of MAC, and in its considerations set out that in order for a MAC claim to be acknowledged, the parties involved shall make sure of the existence of the clause, the definition set forth within the contract, as well as the exclusion and characteristics of the clause, hence the burden of proof of MAC cases adjudicated by the England High Court falls on the MAC definition set forth in the contract hereupon.

1.3. MAC in India

MAC interpretation and practice in India, as shown in the case of *Nirma Industries Ltd. & Anr. v. Securities Exchange Board of India*, is a clause of an ambiguous nature. The court has yet to determine a definition of what can be considered an “adverse change”, an important element of MAC.

The case of *Nirma Industries Ltd. & Anr. v. Securities Exchange Board of India (SEBI)* was originally a case between Nirma Industries with Shree Rama Multi Tech Limited (SRMTL), of which through a promotor Nirma lent SRMTL a sum of fund of Rs. 48,95 crores, with SRMTL’s shares held as collateral. SRMTL then failed to carry out payment of their credits to Nirma. SRMTL’s collateral shares was then going to be executed by Nirma in order to obtain 24.5% of the total shares owned in SRMTL, announced to the public of the decision in accordance to India’s Takeover Regulations of 1997.

An audit carried out to SRMTL found that SRMTL’s promotor was caught in fraudulent transaction, embezzling more than Rs. 350 crores. Based on the audit finding, Nirma then filed a request to Securities Exchange Board of India (SEBI) to invoke their offer of the shares on the grounds of the newfound embezzlement finding. The request was then denied by SEBI and eventually by the Securities Appellate Tribunal.

The MAC clause can be used in this case as the grounds of Nirma’s non-performance and release of their transactional obligations¹⁷, as the embezzlement finding can be used as proof of a material adverse effect happening in SRMTL’s business activities caused by their promotor that affects the shares used as collateral against Nirma. However, in reference to the Article 27(1) of India’s Takeover Regulations of 1997, it is governed that the revocation of a public offer can be granted with the agreement of SEBI, or the passing of the acquirer, or in accordance with SEBI’s appraisal of the revocation. Notwithstanding 13-month of uncertainty between Nirma’s request and SEBI’s response following the embezzlement finding, the lack of legal basis for MAC made it impossible for Nirma to apply for an MAC to release them from their obligations.

1.4. MAC in the Netherlands

The Dutch law acknowledges a contract non-performance, albeit when it comes to MAC, regardless of the familiarity of the concept, the Dutch law has yet to issue a provision to govern the use of MAC and acknowledge it as a contract non-performance alternative clause.

The case between *Municipality of Zutphen v. State of the Netherlands* arose from a property sales and purchase between the municipality of Zutphen and the state of the Netherlands.

¹⁷ Kenneth A. Adams, “A Legal Usage Analysis of Material Adverse Change Provisions”, 10 *Fordham J. Corp & Fin. L.* 9 (2004).

July 2006 saw the Netherland government enter into a contract with Zutphen and its surrounding court and prosecutor office. The contract agreed for the government of the Netherland to purchase a land and built a new building for the local prosecutor office, but then in May 2010, the government informed that the plan to build a new prosecutor office has ceased to exist due to the new regulation to reduce the government budget, which then forfeited the plan of building the new prosecutor office in Zuthpen.

The municipality of Zuthpen argued that the government should have been able to anticipate new the regulation (reorganization plan and the issuance of a new regulation more oftentimes had been preplanned) and pushed for the government to keep their side of the contractual obligation.

The court ruling stated that the government of the Netherlands has the interest of the public, which should take precedence over their obligation abide to the contract with the municipality of Zutphen, especially since a compensation had been offered, thus declined the municipality of Zuthpen's claim for the state of the Netherlands to carry out their contractual obligations. The court found that in the contract between the municipality of Zuthpen and the state of the Netherlands, there is no decisive MAC clause that can exclude a party of its contractual obligations in case of a negative material adverse change, which, in the case that there is a clause stipulates a definitive MAC clause, the regulation amendment that the state of the Netherlands had to comply with could be considered as a material adverse effect, thus the implementation of MAC could be carried out to prevent litigation¹⁸. Furthermore, the State of the Netherlands' nonobligatory to anticipate the regulatory amendment could not be granted as an unforeseen circumstance¹⁹ as the terms of clause was not negotiated between the parties.

1.5. MAC in Indonesia

The current standing of MAC in Indonesia is that the concept of MAC has been widely used in practice, whereas the understanding and familiarity of MAC is Indonesia has yet to progress, even within legal practitioners. The practice of MAC in Indonesia generally does not explicitly integrating the clause into the contract; the concept of MAC oftentimes integrated into a contract non-performance clause apart from force majeure. The interpretation of MAC itself is still pretty much unheard of, as the implementation of MAC depends on the level of understanding of the legal practitioners on the concept of MAC²⁰.

2. The Implication of the COVID-19 Pandemic to the Practice of Material Adverse Change in Mergers and Acquisitions

Mergers and acquisitions are business transactions that have been impacted by the pandemic. The economic climate change, the ubiquity of the decline of a company's value and revenue, prompted numerous corporations to incorporate themselves through company restructuring, most commonly merger or acquisition. The restructuring was meant to suppress and anticipate potential loss caused by the pandemic and its countermeasures.

¹⁸ Engel V.C., "The Material Adverse Change clause from a Dutch perspective: a solution for the uncertainty caused by unforeseen circumstances?" *Bw-Krant Jaarboek 27*, 103-111, <https://hdl.handle.net/1887/36606>.

¹⁹ The Dutch law acknowledges the term "unforeseen circumstance" to pardon a contract non-performance through termination or amendment of the contract, of which the implementation must be in accordance to the fair and reasonable clause of Section 6: 258 of the Dutch Civil Code. (see <https://ggiforum.com/corporate-finance/m-a/608-material-adverse-change-in-dutch-maa-transactions.html>).

²⁰ Anonymous Legal Counsel of a software company based in Jakarta. Personal interview with the Author, March 2023.

The impact of the pandemic commonly affected merger and acquisition contract agreed upon prior to the declaration of the pandemic by WHO in early 2020. The pandemic and its countermeasures played a significant part in merger and acquisition contract performance, as they directly caused a change in performance cost and transaction value, even after the pandemic has ended. Due diligence standards reformation, postponed transactions due to the unpredictable situation caused by the impact of the pandemic, difficulties in determining prices, deceleration of licensing process as the majority of government employees and civil servants are compelled to work remotely; stricter foreign trades regulations; and contract clauses adjustment following the increased need for transaction security²¹. The impacts of these policies, in some cases, can still be felt even post-pandemic, especially the negotiation process slowdown due to the travel ban policy and due diligence amendment, of which certain companies in certain industries require effort to adjust their company standards to remain compliant with the latest due diligence standard.

The concept of MAC oftentimes can be found in financing contracts agreed upon between a company with a banking institution, the company acting as the debtor and the banking institution acting as the creditor. Financing contract is prevalent as a company's mean to obtain their operational and capital expenditure. The capital expenditure received from the financing contract would then be used to outlay their transactions, among which to fund their obligations in a merger or acquisition contract.

Prior to the signing of financing contract, the creditor of the contract must first analyze the debtor's profile, credibility, and capability to avoid non-performing loan through the implementation of 5C principles (character, capacity, capital, collateral, and condition). *Condition* in 5C principles refers to the business situation and financial condition of the debtor coming forward, including their ability to make payments in accordance to the agreed terms of the contract²². To anticipate the occurrence of NPL ascribed to the dropdown of a debtor's financial condition in the duration of the contract, a financing contract oftentimes set out a clause of breach of contract on the condition that the debtor's financial condition (according to their financial reports) has sunk below the threshold agreed upon in the contract, consequently terminating the agreement and call off the loan. The loan termination and the contract termination caused by the failure of the debtor's financial condition in the duration of the contract period can be used as a proof of a material adverse effect, negatively affecting the company's aptitude to perform their contractual obligations agreed upon in a mergers and acquisitions contract. The impact of COVID-19 from the perspective of corporate finances does not only applies during the pandemic, but pertinent even after the pandemic cease to exist, therefore the termination of the financing agreement exacerbated by a proof of significant decline in the company's revenue and overall financial conditions due to the lingering impact of COVID-19 post pandemic can further proof that there is a material adverse effect happening, thus the implementation of the MAC clause upon a merger and acquisition contract non-performance.

The uncertain nature of the Coronavirus that caused the pandemic and the happening of the pandemic proved that there is a need for parties to allocate an alternative clause in their contract, in the case that a material adverse effect ensues, yet the condition is deemed to be not in accordance to the characteristics of force majeure and hardship.

Law is a set of regulations applicable to society, with each their own purposes and functions. Darji Darmodihardjo and Sidharta denoted that one of the functions of law is conflict resolution. The declaration of pandemic and its ensuing countermeasures has given immense impact to the economy

²¹ Deloitte Global, "Six Important Legal M&A Considerations During the Global Pandemic", last modified in May 2022.

²² Muhammad Ayub, *Understanding Islamic Finance* (Great Britain: John Wiley and Sons, 2007).

and business activities, resulting in the alteration of contract performance ability, eliciting conflict of contract.

Contract non-performance is usually pardoned through the implementation of force majeure or hardship, the codified contract non-performance clauses. As regulated clauses, the implementation of force majeure and hardship must meet certain characteristics set forth in the related legal instrument. The uncertainty of the pandemic makes it difficult to determine its adherence with force majeure or hardship, thus an alternative clause is needed to resolve conflict of contract rooted from the pandemic and its countermeasures. The need for an alternative clause has significantly growing post pandemic, as some companies might still have to deal with the aftereffect of the pandemic that could jeopardize their ability to perform their contractual obligations.

To resolve a conflict previously unheard of, the law needs to be flexible to accommodate the unfamiliar situation that leads to the conflict. This belief is in line with Roscoe Pound's theory, which stated that the law is a tool of social engineering. The theory signified that the law is ought to be flexible and accommodative to the changes happening in the society. In relation to the conflict of contract, the pandemic, and its function in conflict resolution, the manifestation of law's role as a social engineer in its capacity in conflict resolution, conflict of contracts inflicted by the uncertain condition of pandemic and its countermeasure, which might still be in place post pandemic, on the condition that a party's incapacity to perform its contractual obligations cannot be classified as a force majeure or hardship, the injured party could implement the MAC clause as an alternative clause to release them of their contractual obligations due to the adverse effect of the pandemic, its countermeasure, and the persisting impact lasted through post pandemic.

The objective of MAC implementation is for the clause to act as an alternative to the current codified non-performance clause as a ramification of an unforeseen condition involving the public interest and had not been provisioned prior to outbreak, thus the implementation of MAC in this case can be said as a manifestation of the function of law as a flexible, adaptive, and accommodative conflict resolution.

3. Determining the Compliance of the Practice of Material Adverse Change to the Principles of International Contract

As a part of customary law, the implementation of MAC shall abide to the applicable conventions of customary law practice. The conventions of customary law practice are in adherence with the certain normative requirements pertaining to the related customary law. Principally, the implementation of MAC shall follow the normative requirements applicable within the contract's jurisdiction. Merger and acquisition contracts that chose to adhere to the principles of UPICC must heed to the provisions of contract performance and non-performance expounded in the regulation; conversely, merger and acquisition contracts with the Indonesian contract law chosen as their choice of law should recognize the prerequisite of contract delineated in the *Kitab Undang-Undang Hukum Perdata* (KUH Perdata, Indonesia Civil Code).

3.1. The Practice of MAC According to UNIDROIT Principles of International Commercial Contract (UPICC)

UNIDROIT Principles of International Commercial Contract (UPICC) is a set of codified customary law. It is a soft law instrument issued to harmonize the law of international contract. The validity of UPICC in Indonesia as an instrument of international contract law in Indonesia has been ratified through the Presidential Regulation No. 59 of 2008 of the Ratification of the

Statute of the International Institute for the Civil Law Unification. The legalization of the Presidential Regulation legitimized the Indonesian law to submit the international contract principles of UPICC.

In relation to the use of MAC as an alternative clause, UPICC accommodates the principles salient to an international contract. These principles can be utilized to analyze the validity of MAC as a contract non-performance alternative clause according to the instrument of international contract law.

This paper will analyze the legality of MAC through six general principles of UPICC essential to all periods of contract. Each principles contains its own purpose as well as limitations, of which every party looking to bind themselves into a contract have to consider, otherwise the contract, whether or not it has been signed by both parties, will be declared null and void.

3.1.1. Freedom of Contract

Article 1.1. UPICC stipulates that every party are given the freedom to bind themselves to a contract and determine the contents of the contract. Exceptions for this principle are the laws of anti-trust, currency, pricing, and other mandatory law of national, international, and supranational origin, applicable to the relevant private international law.

This principle allows the use of MAC as it reflects the nature of the principle to give the parties involved in a contract the right to determine the contents of their contract, including the clauses provisioning their agreed transaction with considerations to the limitations and restrictions of the principle.

3.1.2. Pacta Sunt Servanda

Pacta sunt servanda is a contract principle attributable to the binding power of a contract towards the parties involved. The principle of pacta sunt servanda allows a contract to bind its parties as is the legislations. Article 1.3. UPICC in its substance stipulates that a signed contract legally binds its parties and modification can be done through a mutual agreement between the parties bound to the contract, thus a modification or even termination of a contract is allowed as long as the action is taken within the consensus of the parties.

In its relation to the practice of MAC as a contract non-performance alternative clause, the authoritative nature of the principle permits the parties to determine the definition and terms of MAC, consequently granting the use of MAC on the condition of a contract non-performance, therefore any legal actions taken on the grounds of material adverse effect is valid as long as it follows the definition and terms of MAC previously agreed in the contract.

3.1.3. Good Faith and Fair Dealing

Good faith and fair dealing is a principal impetus of every commercial transaction. This principle is governed in Article 1.7. UPICC, which stipulates that parties of a contract are obliged to act in accordance to the good faith and fair dealing principle in international trade without exceptions and restrictions. The good faith and fair dealing principle shall be respected and considered in all stages of contract, from the pre-contractual negotiations, contract drafting, contract performance, and contract expiration or termination.

This principle recognizes the use of MAC as an alternative clause to contract non-performance provided that the use of MAC does not recalcitrate the good faith and fair dealing principle. The use of MAC should take into account the interest of all parties

involved as opposed to the interest of a single party. On the condition that the use of MAC appertain to non-compliance to the principle, the injured party is given the right to request for material compensation from the cost of negotiation and immaterial compensation for the lost prospect of entering into a different contract or a contract with a third party.

3.1.4. Trade Usage

Trade usage is a part of customary law abiding to certain normative requirements upon implementation to international commercial contract. The practice of trade usage shall be done within the knowledge of the parties involved, fulfillment of the trade usage shall remain orderly, and reasonable²³.

UPICC governs the use of trade usage through Article 1.9., which envisages that the trade usage employed in a contract has to be widely known and regularly observed within the scope of international trade by parties that are particularly concerned, except where the application of such the trade usage would be deemed unreasonable.

MAC as a part of customary law can be categorized as a manifestation of trade usage, as it is widely known and regularly observed within the scope of merger and acquisition and credits contract. As such, the use of MAC is in accordance of the trade usage principle as long is it subsequently follows the principles of international contract with considerations to the exceptions of the principles.

3.1.5. Force Majeure

Force majeure is a term used to define the concept of “non-performance” provisioned in Article 7.1.1. UPICC. Article 7.1.7. UPICC defines force majeure as failure of contract performance due to the ramification of an impediment unforeseen and could not be reasonably expected or avoided at the time of the conclusion of the contract. The effects of the force majeure clause exonerate the injured party of the consequences of non-performance, and to suspend the performance when the impediment is only temporary, while other rights of the oblige are not affected.

In hindsight, the COVID-19 pandemic might fulfill the definition of a force majeure, as the outbreak of the virus was unforeseen and could not be mitigated at the time. The pandemic and its subsequent countermeasures, with their unpredictability affects the majority of contract performance. However, implementation of force majeure does not end in the similarity between the impediment and the principles; it should be ascertained that whether the performance has been impeded, and the impeded party has to proof the conformity of the situation with the requirements of force majeure, analyzed through the congruence of the non-performance with the characteristics of impediment legally associated with force majeure: whether or not the impediment is beyond the obligor’s control; whether or not the situation could not be reasonably foreseen at the time of the conclusion of the contract; and whether or not the consequences of the impediment can reasonable be expected, avoided, or overcome. The Note of the UNIDROIT Secretariat on the UNIDROIT Principles of International Commercial Contracts and the COVID-19 Health Crisis noted that to determine whether the outbreak of the pandemic and its countermeasures, it is detrimental to analyze the adherence of the conditions prompted by the pandemic meets the requirements of force majeure from Article 7.1.7 of UPICC.

²³ Fabrizio Cafaggi, *Loc. Cit.*

Should the obligor failed to substantiate the congruency of their non-performance with the requirements of force majeure from 7.1.7. UPICC, the obligor can not be exonerated from the repercussions of their non-performance, notwithstanding the existence of an encumbrance.

Provided that there is indeed a material adverse effect affecting the obligor's capacity to perform their contractual obligations, but is found to be incongruent with the force majeure requirements, a previously agreed MAC can be used as clause to acquit their non-performance consequences, thus the contract can be terminated accordingly without penalties for non-performance. The key difference between force majeure and MAC is that, MAC enables the termination of contract, liberating the parties involved off of their contractual rights and obligations; inversely, force majeure generally only enables the postponement of contract performance rather than terminating it completely, thus making MAC an alternative to force majeure to pardon a contract non-performance.

3.1.6. Hardship

Hardship is a non-performance concept prevailed upon the occurrence of events fundamentally alters the equilibrium of the contract, either because of the increase of performance cost or the decrease of performance value. Events that can be classified as a hardship are events that occur or become known to the injured party after the conclusion of the contract, could not reasonably have been taken into account at the time of the conclusion of the contract, beyond the control of the injured party, and the risk of the events was not assumed by the injured party.

The occurrence of hardship grants the injured party to request for a negotiation, bearing into mind that the request shall be made without delay. Failure to reach an agreement during negotiation (in which the injured party is not entitled to withhold their performance), either party could resort to the court, which ultimately allows them to terminate the contract or adapt the contract to restore the equilibrium of the contract.

The predominant requirement for a condition to be considered a hardship is that the condition fundamentally alters the equilibrium of the contract, resulting in the change of performance cost or performance value.

The value of a party is one of the major economic reasons for two or more party to enter into a merger and acquisition contract; the merged company is expected to have a greater value in comparison with the merging company.

The onset of the pandemic and the implementation of its countermeasures are known to have affected the business activities through the implementation of regulations limiting the mobility of its subject. Consequently, the impact of said countermeasures affected the prices of commodities and value of certain products or services. The outcome of the consequences is that there was a significant increase in prices, affecting contract performance and the value of contract performance thereafter.

Determining the commencement of a hardship corresponds with that of force majeure, of which it needs a thorough analysis to correlate the non-performance with the requirements of hardship according to the precondition set forth in UPICC, especially the substantial alteration of the contract's equilibrium.

Uncertain conformity between a non-performance with the preconditions of hardship brings up MAC as an alternative non-performance clause. Contrary to the codified hardship, the flexibility of MAC allows the parties to decide the definition of

MAC and specify the terms and exceptions of MAC accordingly, with the considerations of other principles of international commercial contract and their exceptions.

3.2. The Practice of MAC According to Indonesia Civil Code (Kitab Undang-Undang Hukum Perdata / KUH Perdata)

Indonesian contract law historically originated from the European Continental Law, that according to Article 2 Transition Act of the Constitution of the Republic of Indonesia 1945 (Aturan Peralihan Undang-Undang Dasar 1945), declared to remain in effect in accordance to the principles of concordance, as long as there is no amendment in place, through the Indonesia Civil Code or *Kitab Undang-Undang Hukum Perdata* (KUH Perdata).

Article 1319 defines the contract law as all agreement, both *nominaat* or *innominaat* and joint or non-mutual agreement, adheres to the general provisions of KUH Perdata, specified in Book III of KUH Perdata.

Non-performance clause in Indonesia acknowledges force majeure, as envisaged in Article 1244 and 1245 KUH Perdata. Force majeure in Indonesia has promulgated elements that is prerequisite to the applications, which governs that a non-performance can be classified as force majeure should the cause was not foreseeable, ensues impossibility in fulfilling the contract terms, is not a fallacy and oversight of either party, and that the burden of performance can not be imposed to the party or parties involved. Failure to fulfill the preconditions resulting in inapplicability of force majeure to pardon the non-performance, regardless of an impediment ensued. Such preconditions apply to the non-performance caused by the onset of the pandemic and the implementation of its countermeasures as well as the perennial impact of the pandemic.

MAC as an alternative clause commonly found in credits and merger and acquisition contracts. The use of MAC in Indonesia is familiar in concept, although the knowledge of the terms and definition of the clause are still very limited between Indonesian legal practitioners.

As a clause of a contract, MAC can be used in Indonesia as long as the contract in question conforms the prerequisite of Indonesian contract according to Article 1320 KUH Perdata. The article stipulates that the applicability of a contract depends on its compliance to the prerequisite interconnected with one another: that a contract is in effect as long as the contract was agreed and acknowledged by the legally capable parties and applies to an object of the contract due to a lawful cause. On the condition that a contract failed to meet the prerequisite, the contract will be declared null and void.

Additionally, the Indonesian contract law acknowledges the principles of contract law, stipulated by the KUH Perdata; a set of principles required for a contract to be deemed legally binding according to the Indonesian law, interconnected with the prerequisite of contract in Article 1320 KUH Perdata.

3.2.1. Freedom of Contract

The freedom of contract according to KUH Perdata has similar principle to the freedom of contract according to UPICC. This principle grants the freedom for the parties to choose whether they want to: 1) enter into a contract; 2) draw a contract with anyone; 3) determine the contents, performance, and requirements of the contract; and 4) to determine the content of the contract: verbal or written.

Exception of the freedom of contract follows the provision of Article 1337 KUH Perdata, which governs the limitations of the freedom of contract in consideration with the

prohibition of contradictory contract with the applicable laws and regulations, propriety/morality, and public order.

As is with the freedom of contract provisioned by UPICC, the freedom of contract principle in KUH Perdata allows the implementation of MAC through the freedom of determining the contents and performance of the contract, including dispute settlement clause as a result of an impediment, by taking into considerations the exceptions of the principle stipulated in Article 1337 KUH Perdata.

3.2.2. Good Faith

The principle of good faith is a contract principle governed in Article 1338(3) KUH Perdata. The article set forth for the parties of a contract to enter into the contract with good faith and perform their obligations in accordance to their belief and for the interest of the parties involved.

The principle of good faith allows the practice of MAC according to Indonesian law by practicing the principle of good faith throughout the period of pre-contractual to contract performance to the termination or expiration of the contract.

3.2.3. Pacta Sunt Servanda

Pacta sunt servanda in Indonesian law has a similar conduct to the principle of pacta sunt servanda in UPICC. Both principles in nature declared that a contract is binding to the parties involved as is the applicable laws and regulations. Pacta sunt servanda in Indonesia is based on the stipulation of Article 1338(1) KUH Perdata. The binding force of a contract given to it by this article subsequently forced the involved party to abide to the contents of the contract, and for the court or other third party to respect the terms of a contract as is the governing law and regulations, and is not permitted to intervene in determining and performing of the contract²⁴.

As an alternative contract clause, the principle of MAC makes it possible for the injured party of a contract to request a material adverse effect that puts their contractual performance at risk. As a trade usage, the practice of MAC in Indonesia can only be applied if the clause had previously acknowledged and agreed upon between the parties prior to when the material adverse effect takes place.

3.2.4. Principle of Consensualism

The principle of consensualism according to Article 1338 jo. Article 1320 KUH Perdata requires a contract to reach a consensus before the closing of the contract. An exception to the principle of consensualism happens to the condition that an agreed contract was drafted without considering other preconditions and requirements of a contract in relation to the subject and object of the contract.

In relation to the implementation of MAC, the principle of consensualism allows the use of MAC; of which the practice should be acknowledged and agreed between the parties and the terms and definitions of MAC agreed upon in the contract do not contradict the preconditions and requirements of a contract in relation to the subject and object of the contract.

3.2.5. Principle of Personality

Article 1315 KUH Perdata gives a definition to the principle of personality. This principle stipulates that a contract agreed between the parties only applies to those who

²⁴ Salim H.S., *Hukum Kontrak Teori dan Penyusunan Kontrak* (Jakarta: Sinar Grafika, 2009), p.10

entered themselves into the contract. The exception of this principle applies to the condition that contract was made to attain the interest of a third party.

In relation to the implementation of MAC, this principle allows the use of the alternative contract non-performance clause, as long as the aim of the MAC usage is not to achieve a third party's interest.

For instance, if a party received their capital expenditure to carry out their merger and acquisition contract from a banking institution through a financing agreement, and afterwards losing their ability to perform their contractual obligation on one or both contracts, or experiences a material adverse condition that changes the cost of performance over the threshold of the capital expenditure, or a non-performing loan take place, resulting in the calling off of the financing agreement, the party could not use the termination of the financing agreement as MAC to pardon their merger and acquisition contract non-performance, in order to acquire the banking institution's interest. The termination of the financing agreement should only act as a proof of material adverse effect additional to their financial report and not as the motivating force behind the claim of material adverse effect.

3.2.6. Principle of Equilibrium

The principle of equilibrium is an Indonesian contract law principle of a strict provisioning of the rights and obligations of the parties in the contract in all periods of contract. The provision shall include the guarantee of the right of the parties to protect themselves from potential loss appears from a material adverse condition that could affect their contract performance.

The drafting of MAC in Indonesia according to the principle of equilibrium means that the parties involved are obligated to make sure that there is a strict and definite definition and terms of MAC and the implementation of the clause that can be practiced should there happen a material adverse effect imperils their contract performance.

IV. CONCLUSIONS

Contingent to the analysis above, it can be concluded that: 1) the implications of the implementation of the MAC clause pertaining to the pandemic and the aftereffects of the pandemic validates the possibility of a company entering into a contract to draft and agree on the MAC clause as an alternative to a contract non-performance clause (force majeure and hardship) to anticipate and as a risk mitigation to overcome a conflict of contract emanated from the persisting, unforeseeable effect of the pandemic and its countermeasures post pandemic resulting in a contract non-performance; and 2) the use of the MAC clause by companies preparing to enter into a merger and acquisition contract to anticipate the risk of the perennial effect of the pandemic and its countermeasures post pandemic has to take into consideration the principles of international contract governed by the UNIDROIT Principles of International Commercial Contract (UPICC), the preconditions and principles of contract in accordance to Article 1315, Article 1320, AND Article 1338 Book III of KUH Perdata (Indonesia Civil Code) for contracts under the jurisdiction of Indonesian law, and the exceptions pertaining to the preconditions and principles set forth in the related contract law instrument as well as other requirements correlated to the subject and object of contract.

Therefore, companies that are about to bind themselves into a mergers of acquisitions contract are henceforth able to use the clause of MAC as an alternative to pardon a contract non-performance

due to a material adverse effect that failed to attest the conformity of the non-performance with the requirements of force majeure or hardship.

The absence of promulgated legal basis compels the parties wished to implement MAC as a clause in their contract to follow the regulations of trade usage and the principles of contract of national (within the jurisdiction), international, and supranational origin chosen in the contract, taking into account the exceptions of the requirements and the principles stipulated within the contract law and the corresponding requirements of the subject and object of the contract.

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