

Drafting material adverse change clauses

By Jeffrey Rothschild, Nick Azis, Patrice Corbiau, Dennis White and Abigail Reed

Merger and acquisition contracts typically feature a material adverse change or material adverse effect (both abbreviated here to MAC) clause, under which a buyer may exit the deal or renegotiate terms if an unforeseen material adverse business or economic change affecting the target company occurs between executing the acquisition agreement and closing the transaction. A MAC clause also provides the seller with a means of qualifying certain representations and warranties so that immaterial breaches are ignored (at least for purposes of closing). MAC provisions are heavily negotiated, with buyers seeking broad MAC clauses for maximum flexibility to exit the transaction. Not surprisingly, sellers prefer narrow MAC clauses to ensure that the transaction closes at the agreed-upon price. Understanding how courts view these MAC clauses, as well as recent trends in their drafting, is essential in negotiating M&A transactions.

MAC CLAUSES IN THE US

Below are details of a few cases regarding MAC clauses which have been litigated and decided.

In *In Re: IBP, Inc. Shareholders Litigation*, 789 A.2d. 14 (Del. Ch. 2001), the merger agreement contained a broad MAC clause with no carve-outs. Tyson Foods asserted that IBP, the target, had suffered a material adverse effect because its first quarter 2001 earnings were 64 percent behind those for the first quarter of 2000. However, the Delaware Court of Chancery did not regard this downturn as affecting IBP on a long-term basis. In the standard set by the court in IBP, a party seeking to invoke a MAC clause and terminating a deal faces the high burden of proving that the events claimed to be a MAC "substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the [MAC] should be material when viewed from the longer-term perspective of a reasonable acquirer". The court determined that IBP had not suffered a MAC, and, as a result, Tyson Foods was forced to complete the purchase.

Frontier Oil Corp. v. Holly Corp., C.A. No. 20502 (Del. Ch. Apr. 29, 2005), which embraced the standard set forth in IBP as Delaware law, also demonstrated the importance of carefully crafting MAC clauses. The court noted that the phrase 'would have' or 'would reasonably be expected to have' a MAC, as used in the agreement at issue, created an objective test with a significantly higher threshold than the wording

'could' or 'might'. This standard requires a buyer to examine not only current conditions but also the future, and to produce evidence of a long term downturn.

The MAC clauses at issue in *Frontier Oil* and *IBP* were similar in that they both contained a qualifier that a given effect 'would reasonably be expected to' have a MAC, requiring the seller to consider the impact of possible future events. The 'reasonably expected' qualifier continues to make frequent appearances in MAC clauses today. However, the MAC clause in *Frontier Oil* also excluded certain events, such as general economic, regulatory or political conditions or changes; financial market fluctuations; and general changes in the petroleum industry. These carve-outs are also frequently seen.

Recent litigation in Tennessee, in which Genesco filed suit against the Finish Line Inc. and Headwind Inc. (collectively, 'Finish Line') in the Tennessee Chancery Court, also demonstrated the importance of careful drafting. Genesco sought specific performance of a merger agreement under which Finish Line was to acquire Genesco. In December 2007, the court granted specific performance, ordering Finish Line to complete the merger. Although the court found that a MAC had occurred with regard to Genesco's financial condition, the court held that its financial decline fit within a carve-out to the MAC clause contained in the merger agreement, since it was due to "general economic conditions" and was not "disproportionate to the financial decline of others in its industry".

CALLING A MAC AS A BASIS TO RENEGOTIATE

In several recent cases, the declaration of a MAC was the basis for 'busting' a transaction without the dispute even coming to trial. *SLM Corporation v. J.C. Flowers II L.P., et al*, commonly referred to as the Sallie Mae case, was a closely watched and recently settled Delaware Court of Chancery case, which involved a merger agreement for the \$26bn sale of Sallie Mae to a consortium of investors led by J.C. Flowers II L.P. According to Flowers, new federal legislation that reduced federal subsidies to student lenders and impacted on Sallie Mae's earnings amounted to a MAC, and buyers should have been allowed to terminate the deal without paying the agreed-upon \$900m break-up fee. Sallie Mae disagreed and sued for a declaration that no MAC had occurred and that defendants had unlawfully repudiated the merger agreement. The dispute never went to trial. The parties' settlement called for the defendants to refinance \$30bn of Sallie Mae debt. Similarly, Kohlberg, Kravis, Roberts & Co. and Goldman Sachs pulled out of an \$8bn buyout of stereo company Harman International Industries, claiming that Harman's financial condition was unacceptable and a MAC had occurred. However, the litigation was avoided and the acquisition was terminated, when the former buyers agreed to buy \$400m of Harman convertible debt securities.

MAC CLAUSES UNDER UK LAW

MAC clauses are frequently used in UK M&A transactions, but their structure and content differ, depending on whether the transaction is of private or public nature.

In private company M&A, a MAC clause may take the form of either a condition to completion or, more likely, a warranty that no MAC has occurred since a specified date. The buyer will try to negotiate that the warranty is repeated at completion so as to have a termination right exercisable if the warranty, when repeated at completion, is not true. A typical private company MAC clause will contain similar exceptions as in a US transaction.

In public company M&A, it is standard practice for a UK offer document to contain a MAC clause (expressed as a condition to the offer), the wording of which is largely standardised, as follows: "[save as publicly disclosed] no adverse change or deterioration having occurred in the business, assets, financial or trading position or profits or prospects or operational performance of any member of the Group which in any case is material in the context of the wider Group taken as a whole". However, unlike in the private company context, there are no negotiated exceptions since the UK regulation prescribes the circumstances when a condition may or may not be invoked.

The most significant case law regarding a MAC clause in the public company context was the Takeover Panel's ruling on WPP plc's offer for Tempus Group plc. WPP plc's offer had been announced in August 2001, and WPP argued that following the events of September 11, 2001, a material adverse change had occurred. The Takeover Panel took the view that those events, although exceptional, unforeseeable and a contributor to the decline that had already affected the advertising industry, did not undermine the rationale for the terms and the price of WPP's offer, which were Tempus' long-term prospects. The Takeover Panel stated in this instance that to meet the material significance test "requires an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous to something that would justify frustration of a legal contract". As a result, the Takeover Panel held WPP to its offer. More recently, the Panel has stated that a bidder need not demonstrate legal frustration, but it must demonstrate the events are of considerable significance, striking at the heart of the purpose of the transaction.

MAC CLAUSES UNDER BELGIAN LAW

Although MAC clauses were only recently introduced in Belgium, their use has now become quite common. It is premature to generalise any Belgian trends related to MAC clauses. However, it is interesting to note that, in Belgium, as in the US, parties will often claim a MAC as the basis for a renegotiation of the contract, rather than an immediate termination. If one of the parties to the transaction wishes to protect itself

from a specific event, that should be provided in a separate contractual clause, rather than relying on a general MAC clause.

DRAFTING MAC CLAUSES IN LIGHT OF CASE LAW AND RECENT DISPUTES

Following the *IBP* and *Frontier Oil* decisions, in which buyers were unsuccessful in invoking a MAC to exit a deal, M&A practitioners began drafting agreements where a 'material change' was defined more precisely (for example, a material change would occur if a target's revenues dropped 10 percent). The generally seller-friendly environment of the last several years has seen more frequent utilisation of exceptions to MAC clauses. For example, it was common for a buyer not be able to claim a MAC for changes resulting from general economic, financial, regulatory or market conditions, so long as the changes have not affected the target in a 'materially disproportionate' manner as compared to other similarly situated companies.

However, given the expected downturn in M&A activity and tightening of credit markets, the trend in deal terms generally and MAC clauses specifically may be starting to shift in favour of buyers as they seek more flexibility in terminating transactions. If a buyer has identified certain concerns regarding a target, those concerns should be addressed specifically, either in a tailored MAC clause or as a separately stated closing condition.

Regardless of the relative bargaining power of buyers and sellers in the marketplace generally, or in the context of a particular deal, MAC clauses remain important mechanisms for terminating a transaction and special care should be taken drafting them with precision.

As published in Financier Worldwide's 2008 International M&A e-book.