

MATERIAL ADVERSE CHANGE CLAUSES IN MERGERS & ACQUISITIONS: DEAL POINTS

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I. Overview.

“Material Adverse Change” or “MAC” clauses in merger or acquisition agreements are one of many kinds of deal protections that parties build into their transactions. In the case of MAC clauses, the purpose of the provision is to allocate risk between Buyer and Seller (or Target), for changes or events affecting the enterprise being sold, its market, or other external conditions between the date of the signing of the Agreement and the closing of the transaction, a period that can sometimes extend to over a year when financing or regulatory approvals must be obtained. A variation is the “Material Adverse Event” or “MAE” clause.

II. Practical Guidance.

The MAC clause usually incorporates a defined term for “Material Adverse Change” in the definitional section of the Agreement. The MAC definition is then “brought down” into the body of the Agreement, usually as at least a Condition to Buyer’s obligation to close, stating that Buyer’s obligation to close is conditioned on no MAC, as defined, having occurred in the period between signing and closing. The MAC is often also brought down into the Agreement in the form of a Representation and Warranty, and/or a Covenant, and sometimes as a standalone provision, and then incorporated into the Termination section of the Agreement, giving rise to a right (not an obligation) of Buyer to terminate the Agreement and not to close the transaction if a MAC, as defined, has occurred. In some cases, the occurrence of a MAC also gives Buyer a right of renegotiation short of termination, either at the Buyer’s election, or for certain kinds of defined MACs, with others giving rise to the right of termination only. MAC clauses even show up in some very high value non-M&A commercial agreements such as sale, lease, license, distribution and others. The threat of invoking a MAC clause also gives Buyer leverage to renegotiate its deal with a motivated Seller.

While the general MAC definition is relatively standard in most agreements, Carve-outs – exceptions – to what constitutes a MAC are often heavily negotiated. The effect of a Carve-out’s applicability is to deny Buyer the benefit of what would otherwise be a MAC - based right to terminate the Agreement and not close the transaction. There are even often negotiated exceptions to MAC carve-outs, the applicability of which would put the Buyer back in the position of having a right to terminate and not to close. Illustrations of a general MAC definition, carve-outs, and exceptions to the carve-outs; along with the MAC definition’s use in Conditions to Closing, and Representations and Warranties sections, are given below.

A. *Sample General Material Adverse Change Provision*

“No Material Adverse Change. Since the date of this Agreement, there has not been any material adverse change in the business, financial condition, capitalization, assets, liabilities, operations, results of operations or prospects of the Target or its Subsidiaries.”

B. *Sample General Material Adverse Change Definition with Carve-outs and Exceptions to Carve-outs (Carve-outs italicized; Exceptions to Carve-outs italicized and boldfaced)*

"MATERIAL ADVERSE CHANGE/EFFECT" means, when used in connection with the Target, any change, event, violation, inaccuracy, circumstance or effect that is materially adverse to the business, assets, liabilities, financial condition, results of operations or prospects of the Target and its Subsidiaries taken as a whole, *other than as a result of: (i) changes adversely affecting the United States economy (so long as the Target is not disproportionately affected thereby); (ii) changes adversely affecting the industry in which the Target operates (so long as the Target is not disproportionately affected thereby); (iii) the announcement or pendency of the transactions contemplated by this Agreement; (iv) the failure to meet analyst projections, in and of itself; (v) changes in laws; (vi) changes in accounting principles; or (vii) acts of war or terrorism.*"

In the example above, subsection (i) carves out from the MAC events giving rise to a right of termination “changes adversely affecting the United States economy” but excepts from the carve-out changes to the U.S. economy that that disproportionately affect Target. In other words, a change to the U.S. economy would not give rise to a Buyer’s right of termination under the general MAC provision, but if it could be argued that the change to the U.S. economy disproportionately affected Target, the MAC clause would apply notwithstanding the carve-out, and Buyer would have the right of termination to excuse closing.

As stated, a variation on MAC provisions are “Material Adverse Effect,” or “MAE” clauses, which operate in a similar manner; as in this sample:

C. *Sample General Material Adverse Effect Definition “Brought Down” to Representations and Warranties and Conditions Precedent to Closing Provisions*

Definition

“**Material Adverse Effect**” means any of (i) a material and adverse effect on the legality, validity or enforceability of any Transaction Document, (ii) a material and adverse effect on the results of operations, assets, prospects, business or financial condition of the Company and the Subsidiary, taken as a whole, or (iii) a material and adverse impairment to the Company’s ability to perform on a timely basis its obligations under any Transaction Document.

Representations and Warranties

Adverse Changes. Since the date of execution of this Agreement, no event or series of events shall have occurred that reasonably could have or result in a Material Adverse Effect;

Conditions Precedent to Closing

Adverse Changes. Since the date of execution of this Agreement, no event or series of events shall have occurred that reasonably could have or result in a Material Adverse Effect.”

III. MAC Clauses in the Courts.

MAC clauses came into greater prominence, and greater scrutiny, during the “Great Recession” of 2007 - 2008, when several buyers tried to use them to avoid closing in the face of the credit crunch. The results in ensuing litigation give important guidance in how to draft and negotiate MAC clauses to give meaningful deal protection and be something more than boilerplate.

In *In Re IBP, Inc. Shareholders Litigation v. Tyson Foods*, 789 A.2d 14 (Del. Ch. 2001), the Delaware Court of Chancery, interpreting New York law, stated that a MAC clause should be analyzed in terms of the Target company’s earnings potential over a commercially reasonable period, meaning years, not months, in order to determine whether the adverse change was material enough to excuse performance by the Buyer.

In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp*, 965 A.2d 715 (Del. Ch. 2008), a Great Recession-era decision, Hexion, a subsidiary of private equity group Apollo Management, sought to use a MAC clause to terminate its pending merger acquisition of Target Huntsman, which had suffered from poor performance after the merger agreement was signed. The MAC clause definition included any occurrence materially adverse to Huntsman’s “financial condition, business, or results.” A carve-out excluded from the MAC definition changes in economic conditions affecting the chemical industry generally. An exception to the carve-out provided that it would not apply if the changes in the economic conditions affecting the chemical industry generally affected Huntsman disproportionately.

The Delaware Court of Chancery, relying on the prior IBP decision, held that, as a general matter, a few quarters of bad performance would not be enough to trigger the MAC clause, that Huntsman’s disproportionately bad performance compared to the chemical industry as a whole fell into the MAC carve-out exception, and that a MAC carve-out and exception thereto only become relevant to apply if the MAC has occurred in the first place. The Chancery Court also stated that EBITDA was a better measure of determining materiality than earnings per share, which might be affected by Target’s capital structure. The Court finally noted that a MAC had never been held by the Delaware courts to excuse a Buyer’s performance.

The lesson of *Hexion* is that, for a MAC provision, its carve-outs and exceptions to the carve-outs to apply, they must be expressly set forth with great specificity. Presumably, had Hexion stated in the merger agreement how

many quarters of financial performance, and at what numbers, constituted the material adverse change, the Court would have had no choice but to give effect to the MAC clause.

Also, in 2009, Bank of America used a MAC clause as leverage to pressure the U.S. Government to increase the available bailout funds for the acquisition of investment bank Merrill Lynch.

IV. Drafting a Material Adverse Change Definition and Clauses

The yield from this litigation history is that MAC clauses, their carve-outs and exceptions to the carve-outs must be expressly set forth with great specificity and objectivity, or the parties should not count on their applicability. The decisions go far to explain why, post-crisis, MAC clauses are negotiated as heavily as they are. However, it is conversely important to understand that establishing highly specific, “bright line” MAC events in the Agreement may aid their enforceability when they occur, but also decrease the frequency with which the MAC will be understood by both parties to have occurred at a level to be enforceable in court. By decreasing subjectivity, the Buyer decreases applicability, and loses bargaining leverage with the Target when an event close to, but not clearly meeting, the MAC criteria occurs. Buyers may wish particularly to identify known risks, like an adverse result in a pending or threatened litigation, or a regulatory change, as exceptions to a MAC carve-out that would otherwise operate to Target’s benefit. Identifying the time frame in which MACs, carve-outs, and exceptions occur is also important to their enforceability.

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