

Living In a Material World: The Evolution, Purpose, and Future of Material Adverse Change Clauses

Contributed by: Ross B. Bricker, Courtney M. Beemer and Jodi K. Newman, Jenner & Block LLP

When Pan Am went bankrupt in 1994, Delta attempted to help Pan Am out by agreeing to finance Pan Am's restructuring. After Pan Am suffered a 20 to 40 percent decline in bookings over a three-month period, Delta felt there was too much risk involved in the deal and backed out. Pan Am sued, arguing Delta was required to perform its financing commitments. The court rejected Pan Am's claims, ordering it not only to repay the money Delta had advanced under the agreement, but also allowing Delta completely out of the contract.

When IBP and Tyson agreed to join forces in 2001 with the hope of dominating the meat section of American supermarkets, both companies thought it was a merger made in meat heaven. But when IBP incurred a multi-million dollar Federal Trade Commission fine and had to restate certain financials, Tyson got cold feet and tried to cancel the merger. IBP responded with a complaint, alleging that Tyson improperly terminated the merger agreement. The court agreed, ordering Tyson to consummate the merger.

Goldman Sachs and Kohlberg Kravis Roberts (KKR) walked away from an \$8 billion dollar buyout of Harman International Industries in 2007 when Harman's stock value dropped by 20 percent. Goldman Sachs and KKR immediately invested \$400 million into Harman, even though the merger break-up fee was only \$225 million. That was a less risky proposition than litigation over whether Goldman and KKR could properly terminate the buyout.

What is the common thread among these widely divergent results? The answer is a contract clause that keeps transaction lawyers pulling their hair out at night, triggers distrust between potential merger partners, and inspires fear in corporate executives. It is a clause whose words and language have remained relatively consistent for decades, but that has undergone a sea change in judicial approach and interpretation. It is the material adverse change or material adverse effect clause (respectively, MAC or MAE Clause).

What is a MAC Clause?

A MAC Clause is present in one form or another in most merger and purchase agreements. Its purpose is generally to allocate risk among the parties after signing the merger agreement and before closing of the transaction. The clause usually appears as a seller's representation that, as of a date specified in the clause, no material adverse change or effect has occurred in the asset or entity being sold. The representation is typically "brought down" as of the closing date through a closing condition. Depending on the deal dynamics, the buyer may also be subject to a MAC Clause. If a MAC occurs with respect to one party, the other party may invoke the MAC Clause as a means to terminate the merger or purchase agreement.

An ideal MAC Clause has several elements. First, it establishes the parties' benchmark for measuring change and determining materiality. Next, it lays out what types of events the parties consider to be material to their transaction, as well as those events that the parties see as exceptions or "carve outs" and are not to be considered material changes. Finally, the MAC Clause reflects the parties' state of knowledge at signing and/or closing (often in representations and warranties and extensive disclosure schedules) and their expectations for potential future invocation of the MAC Clause.

Because the MAC Clause is one of the parties' primary protections after signing, its parameters are often hotly negotiated. It is difficult, and sometimes impossible, to get a true consensus on

what is material and what future events should permit termination of an agreement. Think of putting a diehard Cubs and White Sox fan in a room and asking them to reach a meeting of the minds on which team better represents Chicago. That probably cannot happen, and like that age-old baseball argument, parties sometimes leave the negotiating table with very different views as to what should and should not constitute a MAC, getting comfort instead in some version of “we have the better argument if there is ever actually a dispute.”

From a seller’s perspective, MAC Clauses generate uncertainty and fear over the fate of the deal. Thus, most sellers want to limit the nature and scope of events that can constitute a MAC, and would prefer more rather than fewer carve-outs.

From the buyer’s perspective, the MAC Clause should be all-encompassing and protect the buyer against any possible change in the company or assets being purchased—even changes that impact a company’s future prospects or could reasonably be found to potentially have such an impact.

With such divergent strategic purposes, it is easy to see why so much time and effort go into drafting an effective MAC Clause - and equally easy to see why efforts to enforce MAC Clauses have lead to threats of termination and litigation, with often unanticipated or unpredictable results.

Everything’s a MAC

For decades—until the Delaware Chancery Court’s seminal 2001 decision in *In re IBP Shareholders Litig.*¹— MAC Clauses were viewed as a protection for buyers because courts adopted an expansive approach to designating an event as a material adverse change. Anything and everything could be a MAC including: a decline in earnings,² operating losses,³ reductions in income,⁴ reduction in sales volumes,⁵ customer losses,⁶ reduction in target audience,⁷ reduction in value of acquired properties,⁸ cancellation of a contract,⁹ general economic or business conditions that have a disparate impact on a company compared to the economy as a whole, and future prospects.¹⁰

In a nutshell, in the pre-*IBP* world, MAC Clauses were buyer-friendly, particularly in the merger context. A review of approximately thirty cases addressing MAC Clauses from 1975 through 2001 reveals that the majority of decisions favored the buyer.¹¹ The courts’ preferential treatment of buyers was even greater outside the context of the sale of securities with courts favoring buyers in 60 percent or more of the cases litigating MAC Clauses.

A number of factors influenced this judicial tendency.

First, MAC Clauses were often treated by contracting parties and their counsel as a kind of catch all, with considerable generality in language, so that any negative event seemed an appropriate trigger for a MAC violation.

Additionally, courts generally applied an objective, “reasonable buyer” type of standard to analyzing MAC Clauses. This effectively downplayed the buyer’s actual prior knowledge of potentially problematic changes and materiality, and emphasized instead simply whether an event was really adverse or not. Indeed, the key judicial question often seemed to be whether the negative development in question would impact a buyer’s decision about pricing or going forward with a transaction. Not surprisingly, the answer was almost always “yes” and the court would find in favor of the aggrieved buyer.

Finally, courts typically did not scrutinize the due diligence and disclosure process, the negotiation of contract terms, or the overall purpose of an investment. Instead, courts just looked at whether there had been a negative or adverse event, and considered a wide range of such changes to be MACs. Because of this judicial approach, threatening to invoke a MAC Clause became an effective negotiating tool for repricing.

Great Lakes Chem. Corp. v. Pharmacia Corp. is illustrative.¹² Great Lakes contracted to purchase a subsidiary of Pharmacia. After signing the purchase agreement, Great Lakes discovered that the Pharmacia subsidiary had lost numerous customers, and Great Lakes sued to terminate the agreement. Great Lakes argued that Pharmacia breached its warranty that “there would be no change in the business of the Company which would have a Material Adverse Effect.” The purchase agreement defined a MAE as, “a negative effect or negative change on the operations, results of operations or condition (financial or otherwise) in an amount equal to \$6,500,000 or more.”¹³ Pharmacia moved to dismiss, contending that the customer losses were due to external market factors and that problems at the subsidiary’s customers that were not covered by the agreement’s MAE Clause.¹⁴ The court disagreed, finding that the complaint stated a claim for a MAE Clause violation because the clause contained broad language defining a material adverse event and did not exclude from that definition external events such as market changes and problems at other companies. Consequently, according to the court, Pharmacia subsidiary’s loss of customers could well constitute a MAE.¹⁵

Similarly, in *Pan Am Corp. v. Delta Air Lines Inc.*,¹⁶ an unhappy Delta cited a reduction in sales volume as a ground for the invocation of a MAC Clause in a financing agreement with Pan Am. In the *Pan Am* case, a provision in Pan Am’s bankruptcy work-out agreement provided that there would be no material adverse changes in Pan Am’s “business, financial position, results of operations or prospects.”¹⁷ The agreement’s purpose was to “address the problems raised by Pan Am’s current cash situation and to improve the chances of confirming a Plan of Reorganization”¹⁸ When Pan Am’s advance bookings suffered a decline of between a 20 and 40 percent over a three-month period as compared to the same quarter the prior year, the court found that such decline constituted a MAC, especially in light of Pan Am’s already precarious financial position.¹⁹ The court considered this deterioration in advanced bookings to be a MAC due to both its unexpected and shocking nature and lack of other available funding. As a result, the court ordered Pan Am to repay to the buyer the loans it received under the work-out agreement.²⁰

Cancelled contracts were also proper fodder for MAC litigation, particularly when the contract’s loss was the seller’s fault. In *Coastal Power Int’l, Ltd. v. Transcontinental Capital Corp.*,²¹ the buyer purchased a floating power plant for \$70 million and thereafter learned it needed to spend an additional \$2 million in order to reinstate the plant’s insurance policies.²² The buyer sued the seller and invoked the MAC Clause to recover the money it spent reinstating the policies.²³ The court found that the seller failed to provide the insurance surveyor with information needed to evaluate the coverage and that this failure contributed to the policies’ cancellation.²⁴ The court made the determination that this fact was material by looking at whether it would “assume actual significance in the deliberations of a reasonable purchaser.”²⁵ Because the insurance company’s disapproval—and the ensuing cancellation of policies and the increased premiums necessary to reinstate the policies—constituted “an event likely to have a material adverse effect” on the plant, the court found the seller liable for breach of contract and ordered the seller to compensate the buyer for the cost of reinstating the insurance.²⁶

And Then There Was IBP

Everything changed in 2001 with the Delaware Chancery Court’s decision in *In re IBP Shareholders Litig.*²⁷ Tyson, the U.S.’s leading chicken distributor, agreed to acquire IBP, the nation’s leading beef manufacturer pursuant to a merger agreement signed on January 1, 2001. While the parties were negotiating the terms of the agreement, IBP suffered large first quarter losses and was forced to restate its financial statements due to problems at DFG, one of its subsidiaries. IBP kept Tyson informed of its problems throughout the negotiations. On March 29, 2001, despite having knowledge of these problems for several months and never indicating that it would put a stop to the merger, Tyson pulled out of the deal and filed suit in Arkansas to rescind or terminate the merger agreement, claiming, among other things, that IBP breached the

agreement's MAE Clause warranty. The next day, IBP filed suit in Delaware to specifically enforce Tyson's performance under the merger agreement.

The agreement defined an MAE as "any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as [a] whole."²⁸ The clause did not contain carve-outs for declines in the overall economy or market conditions.²⁹ According to Tyson, IBP had suffered an MAE because of the decline in IBP's performance in the last quarter of 2000 and first quarter of 2001 and the DFG impairment charge. The court, however, was not convinced by Tyson's argument and issued a decision that altered the way buyers, sellers, and courts viewed MAE Clauses. It ordered Tyson to specifically perform its obligations under the merger agreement by analyzing the MAE Clause for the first time from the perspective of the actual buyer rather than the reasonable buyer.

First, the *IBP* decision emphasized that courts would and should carefully scrutinize what the parties reviewed, discussed and ultimately chose to include in, and omit from, the MAC Clause and related provisions. The *IBP* court examined the factual basis behind the claims and the transaction history of each party, rather than simply applying the standard of a reasonable buyer. This change in analysis effectively altered the focus from the reasonable buyer to the actual buyer, making pre-merger knowledge and discussions a key element in determining whether a breach of the agreement occurred, rather than just the words of the MAC clause.

Second, in determining whether Tyson validly rescinded the merger agreement, the court focused heavily on Tyson's actual knowledge of the risks involved in the deal. For example, the court considered whether Tyson had contractually accepted certain known risks, such as the problems with IBP's subsidiary, through the inclusion of specific schedules in the merger agreement.³⁰ The court likewise evaluated evidence showing that (1) IBP informed Tyson there would be potential changes to earnings because of problems at DFG; (2) IBP was just beginning to deal with its accounting problems; (3) Tyson knew that IBP believed certain specific schedules disclosed the DFG problem; and (4) Tyson's executives paid little attention to DFG, urged IBP to restate its financials promptly, and at no time indicated that if IBP restated its financials that it would breach the merger agreement.³¹

Moreover, the court scrutinized Tyson's subjective knowledge in determining whether IBP fraudulently induced Tyson into entering the merger agreement. The court noted that the merger agreement's specificity demonstrated the parties' attentiveness to issues and their recognition that material issues needed to be addressed in writing if they truly posed a concern.³² The court also pointed out that the agreement contained "numerous representations and warranties, with lengthy schedules of carve-outs."³³ This observation was relevant to the court's determination that the parties had conducted due diligence, were aware of the DFG issue, held many discussions concerning the DFG issue, and drafted a specific, detailed merger agreement that did not specifically include the DFG issue as a potential MAE.

Finding that Tyson had knowledge of these potential problems prior to signing the agreement, the court held that "[t]o the extent that a contracting party chose not to negotiate for specific language regarding an issue, the most plausible inference is that the issue was simply not fundamental enough to buttress a rescission claim."³⁴ Because Tyson had knowledge of IBP's financial problems, Tyson's fraud and contractual risk claims failed. The lesson of this conclusion is patent: if a party has actual knowledge of a potential problem, and fails to address it specifically and explicitly in an agreement, a court may likely assume the potential problem's fruition was not considered material and therefore does not constitute grounds for relief.

Third, the court looked carefully at the actual purpose of the investment. Was there an expectation of near-term profitability? Did the buyer inform the seller that the merger needed to be accretive or EPS (earnings per share) positive right away? If there was such an expectation,

was it manifested in any way in the parties' contemporaneous actions—in dealing with lenders, internal forecasting, and so on? Were changes in future prospects or performance part of the pricing calculation or properly included as part of the MAC Clause? In *IBP*, Vice Chancellor Strine found that quarterly results were not essential in the transaction, and that a quarterly drop did not constitute a MAE. The court commented that, in the context of the Tyson/*IBP* negotiations and diligence, the MAE clause was “best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.”³⁵ Consequently, in this situation, “[a] short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of this reasonable acquiror.”³⁶

Sorting Through the Rubble: Adjusting To the New IBP Standard

After the *IBP* decision, litigation over MAC Clauses increased dramatically as companies and courts tried to figure out how to deal with Vice Chancellor Strine's opinion. In the first five years after the *IBP* decision, over 25 opinions³⁷ specifically addressed the applicability of MAC Clauses. In Delaware and elsewhere, the courts attempted to look in detail at the subjective intent of the parties, no longer content with the objective pre-*IBP* standard, and the landscape of MAC Clause litigation changed as a result.

This new emphasis led courts to consider certain factors in interpreting any MAC Clause: (1) the buyer's goal for the acquisition—short-term profits, long-term investment, or a combination of both,³⁸ (2) what the parties considered “material” to the transaction,³⁹ (3) what should be considered a material adverse event in the context of the due diligence, negotiations, disclosures and agreement,⁴⁰ (4) whether the allegedly material event could have been handled by a specific contract term,⁴¹ (5) what the parties intended as exceptions to the MAC Clause,⁴² and (6) what was discussed, revealed or could have been discovered during due diligence.⁴³

Three cases—*FleetBoston Fin. Corp. v. Advanta Corp.*, decided in 2003 by the Delaware Chancery Court; *In re Eastern Continuous Forms*, decided by the Pennsylvania Federal Court; and *Cendant Corp. v. Commonwealth Gen. Corp.*, decided by the Delaware Superior Court—are illustrative.

In *Fleet Boston*,⁴⁴ the target company, Advanta, concealed⁴⁴ that it miscoded the interest rates on over \$1 billion of new accounts receivables, and the acquiring company, Fleet, alleged a breach of their contribution agreement's MAE Clause because Advanta had failed to notify Fleet of the problem prior to closing, even though Advanta knew of it. The MAE Clause provided that “no event has occurred or fact or circumstance arisen that, individually or taken together with all other facts, circumstances, and events, has had, or is reasonably likely to have a Material Adverse Effect upon the acquired Business.”⁴⁵ The agreement defined an MAE “as including any effect that is “material and adverse to the assets, liabilities, financial position, business or results of operations of the Business, taken as a whole”⁴⁶ While the court found the withheld facts were material, it noted that “it does not necessarily follow that the miscoding problem constituted a Material Adverse Effect within the meaning of the agreement.”⁴⁷ The court seemed to be suggesting that although a change or effect may generally be a material change, if the agreement does not specifically protect against that type of material change, then it is not a material adverse change for the purpose of the agreement. The court did not explore this issue further due to a finding of liability on other grounds.⁴⁸

In *In re Eastern Continuous Forms*,⁴⁹ an agreement's specific MAC Clause provided the court with the guidance necessary to determine whether a MAC had occurred. Keybis, a business form manufacturer, entered into an agreement to sell itself to a financial buyer. In the purchase agreement's MAC Clause, Keybis represented that it “has not . . . suffered any material adverse change in its working capital, condition, financial or otherwise, assets, liabilities, customer base, business operations or prospects.”⁵⁰ Keybis promised to indemnify the new owners for any breach of this provision. Prior to closing, Keybis found out that one of its biggest customers was

on the verge of bankruptcy. After closing, Keybis lost all business from its bankrupt customer. Keybis' new owners brought suit against the former owners seeking indemnification. The new owners alleged that Keybis failed to disclose information concerning its customer's precarious financial state prior to closing, in violation of the MAC Clause, which specifically referenced changes to Keybis' customer base. The court found that Keybis clearly had knowledge of information that could have a MAC on its customer base and failed to share this information in violation of the MAC Clause's terms.⁵¹ The court was thus able to find liability on the part of the former owners based on the specificity of the agreement's MAC Clause.

In *Cendant*,⁵² Cendant entered into an agreement with Commonwealth to buy all of Commonwealth's stock in Providian. The agreement's MAC Clause contained a warranty that Providian had not suffered "an event or occurrence that has or could reasonably be expected to have a material adverse effect on permits, the business, financial condition or results of operations of the Company and its Subsidiaries taken as a whole."⁵³ After the agreement was signed, Cendant discovered internal accounting fraud and began selling some of its own subsidiaries. Concerned that Cendant may attempt to terminate the agreement, Commonwealth sued for a declaration that no MAC at Providian had occurred, thereby preemptively blocking Cendant from a way out of its obligations under the agreement. The main issue for the court was whether the language of the clause was intended to cover material adverse changes in Providian's "future prospects"—an often hotly contested term in MAC Clause negotiations. While the MAC Clause in question did not include a specific reference to "future prospects," the court reasoned that a reasonable jury could infer that the forward-looking language of the clause—"could reasonably be expected to"—referred to Providian's future prospects.⁵⁴ The court reasoned that "[t]here [were] genuine issues of material fact surrounding whether the drafters intended the forward-looking language to include prospects, as well as whether the current future wording does include prospects. It seems that this will all boil down to whether a reasonable jury could determine, based on the facts as it finds them to be, that the MAC Clause warrants prospects." Accordingly, the court refused to grant summary judgment for Commonwealth.⁵⁵

Frontier Oil Clarifies the Standard Established by IBP

After several years of chaos in the court system, *Frontier Oil Corp. v. Holly Corp.*⁵⁶ helped solidify and clarify the scope of the *IBP* ruling.

The *Frontier Oil* case involved a planned merger between Frontier Oil Corporation and Holly Corporation. Both Frontier and Holly were mid-sized petroleum refiners, with Frontier's market covering the eastern Rocky Mountain area and Holly's covering the Western Rocky Mountains. Holly also owned pipelines that supported the transport of both crude and refined oil. The merger terms were structured so that for each share of Holly common stock, Holly shareholders would receive one share of Frontier and \$11.11 in cash.

Prior to entering into a merger agreement, the parties' negotiations focused on a potential lawsuit against Frontier concerning oil fields located at Beverly Hills High School owned by Frontier's subsidiary Wainoco, which allegedly were causing cancer in high school students. Holly was aware of the potential for this matter to become a very expensive class action and the extent of Frontier's liability was an issue that continuously arose during the negotiations. A schedule to the merger agreement specifically addressed this "threatened litigation":

Wainoco Oil & Gas Company ("Wainoco") owned an interest in an oil field from 1985 until early 1995 in the area where the Beverly Hills High School is located. News articles in February 2003 indicated that the Brockovich and Masry law firm were preparing a lawsuit involving that site. Wainoco sold its interest to Venoco, Inc. by a Purchase and Sale Agreement dated February 9, 1995. Frontier has not been contacted by anyone concerning a possible lawsuit, and does not have any knowledge of any litigation being filed. For avoidance of doubt and only for the limited purpose of the Agreement, Frontier agrees with, and for the sole benefit

of, Holly that this potential litigation will be considered as “threatened” (as such term is used in Section 4.8 of the Agreement) and that the disclosure of the existence of this “threatened” litigation herein is not an exception to Section 4.8, 4.9 or 4.13 of the Agreement and despite being known by Holly, will have no effect with respect to, or have any limitation on, any rights of Holly pursuant to the Agreement.⁵⁷

During the 14 weeks after execution of the merger agreement, two events occurred that eventually led to the agreement's cancellation. One was the filing of litigation regarding the Beverly Hills oil field situation. The second was Lehman Brothers' evaluation of Holly's pipeline assets, which showed that Holly had tremendously undervalued those assets (meaning that Frontier had struck a very good deal).⁵⁸ After these two events occurred, Holly contacted Frontier to discuss the future of the merger, including changing the deal to an all cash deal. Frontier was worried that Holly would attempt to legally back out of the merger. Consequently, during this call, Frontier attempted to trick Holly into repudiating the merger agreement so that Frontier could bring suit for wrongful repudiation. With the assistance of counsel, Frontier asked Holly, among other things, whether Holly's board was willing to do or support the signed deal under the existing terms. When Holly replied no, Frontier alleged that Holly had repudiated the merger agreement.

Frontier filed an action in Delaware Chancery Court on August 20, 2003, arguing that (1) Holly repudiated the merger agreement; (2) Holly breached the covenant of good faith and fair dealing by using the Beverly Hills lawsuit as a pretext for cancelling the merger; and (3) Holly's decision not to proceed with closing entitled Frontier to the break-up fee contained in the agreement.⁵⁹ On August 21, Holly gave Frontier formal notice under the agreement that Holly was terminating the agreement based on a breach of the merger agreement's MAE Clause warranty.⁶⁰

In response to Frontier's repudiation suit, Holly argued that (1) it did not repudiate the agreement, but simply broached the subject of discussing exit options; and (2) the Beverly Hills lawsuit breached Frontier's representations and warranties, as it would reasonably be expected to have an MAE on Frontier's financial situation or profitability as a company.⁶¹ The court rejected Holly's claim that it did not need to go forward with the merger because Frontier suffered a MAC, concluding that Holly based its MAC claim on potential litigation which it knew about at the time of drafting, yet failed to specifically provide for in the MAC Clause.⁶²

As part of its analysis, the court analyzed the parties' subjective intent by referencing the forward-looking language of the MAC Clause:

Except as set forth on Schedule 4.8 of the Frontier Disclosure Letter, there are no actions, suits or proceedings pending against Frontier or any of its Subsidiaries or, to Frontier's knowledge, threatened against Frontier or any of its Subsidiaries, at law or in equity, or by any federal, state or foreign commission, court, board, bureau, agency, or instrumentality, other than those that would not have or **reasonably be expected to have**, individually or in aggregate, a Frontier Material Adverse Effect.⁶³

Holly argued that defense fees that Frontier would incur in defending the Beverly Hills litigation constituted a MAE, however, the court concluded that the defense fees, while potentially large, would only be a short term effect. In the court's opinion, the forward looking language of the MAE Clause was chosen by Frontier and Holly and indicative of their qualitative intent, and therefore, the court could not only look at a limited one year period in evaluating a potential MAE. Consequently, the defense costs, a short term problem, could not constitute an MAE under the terms of this agreement.

The court also analyzed whether the potential impact of the Beverly Hills litigation qualified as an MAE, however, it ultimately rejected the idea that the total potential liability for the suit should be considered as a MAE because Holly failed to develop the merits of the case against Frontier and

the results of the litigation were no more than random speculation. Moreover, the court concluded, the fact that the potential litigation was specifically mentioned in the disclosure schedules to the merger agreement revealed Holly's subjective knowledge of the issue and demonstrated that had Holly wanted this potential litigation to qualify as an MAE, it would have included it specifically in the MAE Clause.

Coming Full Circle: MAC Clauses as Paths Back To Negotiations

A review of MAC Clause activity in the last three years shows that, based on the new judicial standards set forth in *IBP* and *Frontier*, parties are more reluctant to take on the risk and cost of allowing a court to determine whether a MAC has occurred. As a result, the threat of calling a MAC leads more to deal renegotiation than termination. Several examples are instructive.

When the purchase of Home Depot Supply by Bain Capital, the Carlyle Group, and Clayton, Dubilier & Rice started to fall apart, the parties chose to renegotiate the deal when Home Depot became afraid that the financiers would call a MAC and walk away from the deal.⁶⁴ The banks providing financing for the transaction—JP Morgan Chase, Merrill Lynch, and Lehman Brothers—had threatened to walk away from the transaction due to the downward spiral of the credit and housing markets, which negatively affected the seller's business. The MAC Clause in the purchase agreement contained a carve-out for general economic conditions. Based on this carve-out in the MAC Clause, the buyers would have had an uphill battle if they chose to go to court to terminate due to the fact that it would be hard to prove that the decline was not a result of general economic conditions.⁶⁵ The parties, however, renegotiated the terms of the transaction, and Home Depot agreed to lower the original purchase price of \$10.3 billion to \$8.5 billion in order to assure the deal went through.⁶⁶

When Goldman Sachs and KKR walked away from its \$8 billion buyout of Harman International Industries in September 2007, they immediately invested \$400 million into Harman in order to avoid a long, costly legal battle.⁶⁷ Due to adverse changes in Harman's business, KKR and Goldman concluded that Harman's financial condition was unacceptable and invoked the deal's MAC Clause.⁶⁸ Harman disagreed, stating that no MAC had occurred. Although the break-up fee in the merger agreement was only \$225 million, KKR and Goldman apparently found it advisable to pay more on the front end than to let a court decide their fate which would mean paying large legal fees and potentially having the court order specific performance of their obligations under the purchase agreement.⁶⁹

J.C. Flowers, Bank of America, JP Morgan Chase, and several other private equity firms signed an agreement in April 2007 to buy student lender Sallie Mae for \$25 billion, or \$60 per share.⁷⁰ When federal legislation significantly impacted subsidies to student loan lenders, Sallie Mae's stock price dropped dramatically.⁷¹ The buyers informed Sallie Mae that they believed Sallie Mae had suffered a MAC as a result of the drop in stock price and sent a revised proposal to Sallie Mae offering to pay \$21 billion, or \$50 a share.⁷²

Sallie Mae responded by filing a lawsuit seeking \$900 million in damages against J.C. Flowers and its buyout partners in Delaware,⁷³ arguing that, because the MAC Clause specifically excluded contemplated legislation similar to that which Congress subsequently approved, in order to prove a MAC occurred, J.C. Flowers needed to demonstrate that the legislation passed was "materially worse" than the proposed legislation Sallie Mae included in its public filings.⁷⁴ Additionally, Sallie Mae argued that the definition of a MAC specifically excluded problems in the credit market because it contained a carve-out for "general economic, business, regulatory, political, or market conditions."⁷⁵ J.C. Flowers argued that it only needed to demonstrate that the passed legislation was "incrementally worse" than the proposed legislation that Sallie Mae disclosed. Notably, the MAC Clause contained no materiality requirement, and stated that the MAC exclusions did not include "changes in the Applicable Law relating specifically to the education finance industry that are in the aggregate more adverse to the Company and its subsidiaries, taken as a whole, than the legislative and budget proposals."⁷⁶ Trial was tentatively

set for July 2008 but Sallie Mae dropped its lawsuit in January in exchange for a \$31 billion credit line from a group of banks including Bank of America, JPMorgan Chase, Barclays, Deutsche Bank, Credit Suisse, The Royal Bank of Scotland, and UBS.⁷⁷ This replaced the \$30 billion interim financing that was part of the proposed merger.⁷⁸

Sallie Mae exploited the ambiguity in the MAC Clause by playing on J.C. Flowers' fear of having a court decide the ambiguities in the MAC Clause and, consequently, used the clause as leverage to obtain much needed financing. The lack of clarity in the MAC Clause forced J.C. Flowers to assess its hand, rather than simply rely on the language in the MAC Clause itself. The lack of a materiality requirement made it very difficult to predict how a court would interpret events in the context of the MAC Clause's wording. Consequently, Sallie Mae was able to use this ambiguity to force financing from J.C. Flowers' buy-out partners.

Where It Lies: MAC Standards Today

Late last month, the Delaware Chancery Court issued its newest opinion addressing the applicability of MAC clauses, reaffirming that it would still vigorously apply the subjective standards set forth by *IBP*.

The case, *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, involved chemical manufacturers Huntsman and Hexion. In July 2007, Hexion entered into an agreement to acquire Huntsman for \$28 per share of Huntsman common stock.⁷⁹ Hexion planned on funding the merger with debt financing committed by Credit Suisse and Deutsche Bank.⁸⁰ The financing, however, was contingent on the merged company being solvent.⁸¹ When Huntsman's net debt dramatically increased and its financial performance drastically decreased (for example, its EBITDA decreased by 41 percent from its pre-signing forecast for 2008), Hexion determined that the merged company would be insolvent based on a questionably obtained insolvency letter.

Hexion filed suit against Huntsman on June 16, 2008 in the Delaware Chancery Court, asking for a ruling that it need not go forward with the proposed acquisition due to Huntsman's deteriorating financial condition. Hexion asked the court to find that (1) Huntsman had suffered a MAC, and (2) Hexion's liability would be limited to the \$325 million termination fee if it did not consummate the transaction due to Huntsman's insolvency.⁸²

Five days later, in response to Hexion's suit, Huntsman went on the offensive, filing suit in Texas against Hexion's parent, Apollo, as well as Apollo's founders.⁸³ Huntsman has requested \$3 billion in damages for fraud and tortious interference under the theory that Apollo and Apollo's founders fraudulently induced Huntsman to sign the merger agreement with Hexion and break a \$9.6 billion dollar deal to be acquired by Dutch company Basell Holdings NV so that Apollo would not have stiffer competition from its Dutch competitor.⁸⁴

In Hexion's Delaware suit, the court granted a motion by Hexion for an expedited proceeding, leading to a six-day trial. One of the first issues the court addressed was how it should interpret certain carve-outs in the context of the broader MAE Clause. The agreement's MAE Clause provided that Hexion's obligation to close was conditioned on the absence of "any event, change, effect or development that has had or is reasonably expected to have, individually or in the aggregate," an MAE. The agreement defined an MAE as:

. . . [A]ny occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of the Company and its Subsidiaries, taken as a whole; provided, however, that in no event shall any of the following constitute a Company Material Adverse Effect: (A) any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions, except in the event, and only to the extent, that such occurrence, condition, change, event or effect has had a disproportionate effect on the Company and its Subsidiaries, taken as

a whole, as compared to other Persons engaged in the chemical industry; (B) any occurrence, condition, change, event or effect that affects the chemical industry generally (including changes in commodity prices, general market prices and regulatory changes affecting the chemical industry generally) except in the event, and only to the extent, that such occurrence, condition, change, event or effect has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the chemical industry

The MAE Clause therefore contained a carve-out for changes in the industry as a whole. Hexion argued that the relevant standard to apply was to compare Huntsman's performance since the signing of the merger agreement, and its expected future performance, to the rest of the chemical manufacturing industry. Huntsman argued that there was no need to look at the industry as a whole unless the court first determined that Huntsman had indeed suffered an MAE. The court agreed with Huntsman, finding that the carve-out applied only once the court found an MAE had actually occurred. Once an MAE was established, then, the court said, the event may be compared for proportionality to changes in the industry to see whether the MAE should be carved out.

The court then turned to whether a MAE had occurred. Reiterating *IBP*, the court stated that "For purposes of whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting."⁸⁵ Deciding that Hexion was a long-term acquirer without near-term expectations or needs, the court clarified that in this circumstance, in order for the decline to constitute a MAE, the decline must be expected to last well into the future.

The court then looked to what the proper benchmark was for examining whether the changes in the business operation post-signing constituted an MAE, ultimately deciding that EBITDA changes were the correct measure for examining MAEs based on operational results of a business. Looking at the fall in projections, the court found that the projection decline, although sizable, could not be a basis for an MAE because representations with respect to Huntsman's projections and forecasts were specifically disclaimed and because the parties failed to include prospects in the MAE Clause. As a result, there was no representation or warranty with respect to Huntsman's forecasts.

Rather, the court analyzed the financial results with the results for the same period the previous year. Looking at the quarter-by-quarter comparison along with a trailing-twelve-month comparison, the court decided that the changes (which ranged from a three to seven percent decrease) were not MAEs. The court also concluded that many of the problems in certain Huntsman divisions were expected to be short term due to the cyclical nature of the industry, and consequently, in this context, did not have a MAE.

The court found that Hexion had knowingly and intentionally breached its obligations under the merger agreement by failing to use its best efforts to close the transaction, and ordered Hexion to fulfill all of its covenants and obligations under the merger agreement, except for its obligation to close. The court limited its ruling because while the agreement did contain a specific performance provision, the awkwardness of the drafting appeared to exclude the obligation to close from the provision. The court went on to say that after specifically performing its obligations under the merger agreement (besides closing), the parties and financiers would need to revisit the solvency issue at which point Hexion must determine if it had indeed used its best efforts to close. If Hexion simply chose to close the transaction, this issue would be moot. If not, the solvency issue would be ripe and the court would revisit that problem, but the court declined to cap potential damages at the amount of the termination fee, and instead stated it would consider the issue without a damages cap to the extent that the damages related to Hexion's knowing and intentional breach of the agreement.

Conclusion

MAC Clause analysis has taken a long, twisting journey. While the type of language included in MAC Clauses has not changed to a great degree, the manner in which it is reviewed by courts has altered significantly. Once viewed under the objective prism of a reasonable buyer, analysis of the MAC Clause has evolved into a deep dive into parties' negotiations, diligence, knowledge and intent. As a result, careful and strategic documenting of a transaction and its MAC Clause provision remain central to avoiding disputes and to each party achieving its goals and objectives.

Mr. Bricker is a partner in Jenner & Block's litigation department and a member of the Firm's Litigation Executive and Strategy Committee. Ms. Beemer is a former associate of Jenner & Block. She is currently completing a judicial clerkship in Chicago. Ms. Newman is an associate in Jenner & Block's litigation department.

¹ 789 A.2d 14 (Del. Ch. 2001).

² See, e.g., *Raskin v. Birmingham Steel Corp.*, 1990 WL 193326, Fed. Sec. L. Rep. ¶ 95,668 (Del. Ch. Dec. 4, 1990) (denying approval of a proposed settlement between a company and its shareholders because the court found that a 50 percent decline in a merger target's earnings constituted a MAC and thus, contrary to the shareholders' allegations, the company was entitled to abandon the planned merger); *Gordon v. Diagnostek, Inc.*, 812 F. Supp. 57, 59-60 (E.D. Pa. 1993) (granting company's motion to dismiss target's shareholders' suit against it, finding that it company was justified in terminating a merger because the target inflated its quarterly earnings).

³ See, e.g., *Katz v. NVF Co.*, 473 N.Y.S.2d 786 (N.Y. App. Div. 1984) (denying class certification in a case involving a MAC claim based on a net annual loss of over \$6.3 million compared to net earnings of \$2.1 million for the prior fiscal year); *Peoria Sav. & Loan Assoc. v. American Sav. Assoc.*, 441 N.E. 2d 853, 109 Ill.App.3d 1043 (Ill. App. Ct. 3d Dist. 1982) (upholding a preliminary injunction to halt a merger based on a MAC claim concerning a party's additional net loss of \$700,000); *Sale v. Contran*, 486 S.W.2d 60 (6 Ark. Ct. App. 1982) (granting summary judgment to the proposed purchaser based on a MAC occurring when a seller suffered a \$500,000 loss instead of a projected \$500,000 profit).

⁴ *In re Digital Resource, LLC*, 246 B.R. 357 (B.A.P. 8th Cir. 2000).

⁵ See, e.g., *Pan Am Corp. v. Delta Air Lines, Inc.*, 175 B.R. 438 (S.D.N.Y. 1994).

⁶ See *Great Lakes Chem. Corp. v. Pharmacia Corp.*, 788 A.2d 544, 556 (Del. Ch. 2001) (summarized *infra*); see also *Gordon v. Dolin*, 434 N.E. 2d 341, 105 Ill. App.3d 319 (Ill. App. Ct. 1st Dist. 1982)

⁷ *Borders v. KRLB, Inc.*, 727 S.W.2d 357 (Tex. App. 1987).

⁸ *Esplanade Oil & Gas, Inc. v. Templeton Energy Income Corp.*, 889 F.2d 621, 623 (5th Cir. 1989).

⁹ *Coastal Power Int'l, Ltd. v. Transcontinental Capital Corp.*, 10 F. Supp. 2d 345, 369 (S.D.N.Y. 1998).

¹⁰ *Allegheny Energy, Inc. v. DQE, Inc.*, 74 F. Supp. 2d 482, 486 (W.D. Penn. 1999), *aff'd* 216 F.3d 1075 (3d Cir. 2000).

¹¹ See *id.* (finding for buyer in a case concerning a MAC based on changes in the industry/economy); see also, e.g., *In re Apex Auto Warehouse*, 205 B.R. 547 (N.D. Ill. 1997) (finding for buyer in a case concerning a MAC based on a reduction in the seller's sales volume); *Coastal Power Int'l Ltd. v. Transcontinental Capital Corp.*, 10 F. Supp. 2d 345 (S.D.N.Y. 1998) (finding for buyer in a case concerning a MAC based on a cancellation of a contract); *KLRA, Inc. v. Long*, 639 S.W.2d 60 (Ark. Ct. App. 1982) (finding for buyer in a case concerning a decline in the seller's profits).

¹² *Great Lakes Chem. Corp.*, 788 A.2d at 556.

¹³ *Id.* at 557.

¹⁴ *Id.* at 556.

¹⁵ *Id.* at 557.

¹⁶ 175 B.R. 438 (S.D.N.Y. 1994).

¹⁷ *Id.* at 450 n.7

¹⁸ *Id.* at 449-50.

¹⁹ *Id.* at 492-93.

²⁰ *Id.* at 517.

²¹ *Coastal Power Int'l, Ltd. v. Transcontinental Capital Corp.*, 10 F. Supp. 2d 345 (S.D.N.Y. 1998).

²² *Id.* at 369.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 362.

²⁶ *Id.* at 369.

²⁷ *In re IBP Shareholders Litig.*, 789 A.2d 14, 23 (Del. Ch. 2001).

²⁸ *Id.* at 65.

²⁹ *Id.*

³⁰ *Id.* at 55.

³¹ *Id.* at 60-61.

³² *Id.* at 73-74.

³³ *Id.* at 74.

³⁴ *Id.* at 74.

³⁵ *Id.* at 68.

³⁶ *Id.*

³⁷ *Able Cartage v. Strategic Outsourcing, Inc.*, 2005 WL 2333924 (W.D. Tenn. Sept. 6, 2005); *Benchmark Elecs., Inc. v. J.M. Huber Corp.*, 343 F.3d 719 (5th Cir. 2003); *BP Amoco Chem. Co. v. Sun Oil Co.*, 166 F. Supp. 2d 984 (D. Del. 2001); *Cendant Corp. v. Commonwealth Gen. Corp.*, No. 98C-10-034 (Del. Super. Ct. 2002); *Citrus Trading Corp. v. Duke Energy LNG Sales, Inc.*, 2005 WL 2045206 (S.D. Tex. Aug. 23, 2005); *Consol. Edison, Inc. v. Northeast Utils.*, 249 F. Supp. 2d 387 (S.D.N.Y. 2003); *Faulkner v. Verizon Communications, Inc.*, 156 F. Supp. 2d 384 (S.D.N.Y. 2001); *First Republic Bank v. Brand*, 2005 WL 2649499 (Pa. Ct. Cm. Pl. Oct. 7, 2005); *FleetBoston Fin. Corp. v. Advanta Corp.*, 2003 WL 240885 (Del Ch. Jan. 22, 2003); *Golub v. Hilb, Rogal & Hobbs Co.*, 379 F. Supp. 2d 639 (D. Del. 2005); *Heights Driving School, Inc. v. Top Driver, Inc.*, 51 Fed. Appx. 932 (6th Cir. 2002); *Herring v. Teradyne, Inc.*, 2002 WL 32068316 (S.D. Cal. Feb. 22, 2002); *In re Eastern Continuous Forms, Inc.*, 2004 WL 2418285 (E.D. Pa. Oct. 28, 2004); *In re Enron*, 292 B.R. 507 (S.D.N.Y. 2002); *In re Foundry Networks, Inc. Sec. Litig.*, 2003 WL 22077729 (N.D.Cal. Aug. 29, 2003); *In re InaCom Corp.*, 2001 Bank. LEXIS 1297 (D. Del. Aug. 7, 2001); *International Paper Co. v. Androscoggin Energy LLC*, 2002 WL 31870169 (N.D. Ill. Dec. 19, 2002); *Media General, Inc. v. Tomlin*, 387 F.3d 865 (D.C. Cir. 2004); *Nip v. Checkpoint Systems, Inc.*, 154 S.W.3d 767 (Tex. Ct. App. 2004); *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920 (9th Cir. 2003); *Pfizer, Inc. v. Stryker Corp.*, 348 F. Supp. 2d 131 (S.D.N.Y. 2004); *Powell v. First Republic Bank*, 274 F. Supp. 2d 660 (E.D. Pa. 2003); *River Terrace Association v. Bank of New York*, No. 2005 WL 3134228 (N.Y. Sup. Apr. 13, 2005); *Rus, Inc. v. Bay Industries*, 322 F. Supp. 2d 302 (S.D.N.Y. 2003); *S.C. Johnson & Son, Inc. v. DowBrands, Inc.*, 167 F. Supp. 2d 657 (D. Del. 2001); *Stafford v. Bakke*, 2005 WL 165855 (S.D. Ind. 2005).

³⁸ *Frontier Oil Corp. v. Holly Corp.*, C.A. No. 20502 (Del. Ch. Apr. 29, 2005).

³⁹ *Citrus Trading Corp. v. Duke Energy LNG Sales, Inc.*, 2005 WL 2045206 (S.D. Tex. Aug. 23, 2005) (asking what the parties considered a material event).

⁴⁰ *FleetBoston Fin. Corp. v. Advanta Corp.*, 2003 WL 240885 (Del. Ch. Jan 22, 2003) (determining whether a material event was a material adverse event under the agreement).

⁴¹ *In re Eastern Continuous Forms, Inc.*, 2004 WL 2418285 (E.D. Pa. Oct. 28, 2004) (looking at specific contract terms to determine if the event should be considered an MAE).

⁴² *First Republic Bank v. Brand*, 2005 WL 2649499 (Pa. Comm. Pl. Oct. 7, 2005) (looking at the exceptions to a MAE Clause).

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- ⁴³ *Frontier Oil Corp. v. Holly Corp.*, C.A. No. 20502 (Del. Ch. Apr. 29, 2005).
- ⁴⁴ *FleetBoston Fin. Corp. v. Advanta Corp.*, 2003 WL 240885 (Del. Ch. Jan 22, 2003).
- ⁴⁵ *Id.* at *5.
- ⁴⁶ *Id.* at *5 n.11.
- ⁴⁷ *Id.* at *11 n.42.
- ⁴⁸ *Id.* at *11 n.42.
- ⁴⁹ *In re Eastern Continuous Forms, Inc.*, 2004 WL 2418285 (E.D. Pa. Oct. 28, 2004).
- ⁵⁰ *Id.* at *1
- ⁵¹ *Id.* at *3.
- ⁵² *Cendant Corp. v. Commonwealth Gen. Corp.*, 2002 WL 31112430 (Del. Super. Ct. Aug. 28, 2002)
- ⁵³ *Id.* at *1.
- ⁵⁴ *Id.* at *5.
- ⁵⁵ *Id.* at *6.
- ⁵⁶ C.A. No. 20502 (Del. Ch. Apr. 29, 2005).
- ⁵⁷ *Id.* at 11.
- ⁵⁸ *Id.* at 26-27.
- ⁵⁹ *Id.* at 67-68.
- ⁶⁰ *Id.* at 64.
- ⁶¹ *Id.* at 68-69.
- ⁶² *Id.* at 96.
- ⁶³ *Id.* at 10 (emphasis added).
- ⁶⁴ Michael J. de la Merced, *Dealbook: Home Depot: A Script for Renegotiations?*, N.Y. Times, Aug. 27, 2007, available at <http://dealbook.blogs.nytimes.com/2007/08/27/home-depot-a-script-for-deal-renegotiations/> (last visited Nov. 7, 2008).
- ⁶⁵ *Id.*
- ⁶⁶ *Id.*
- ⁶⁷ *KKR, Goldman in Compromise with Harman*, Reuters, available at <http://uk.reuters.com/article/partiesNews/idUKWNAS721320071022> (Oct. 22, 2007) (last visited Nov. 7, 2008).
- ⁶⁸ Dana Cimiluca & Dennis K. Berman, *KKR, Goldman Cancel \$8 Billion Harman Deal*, The Wall Street Journal, Sept. 22-23, 2007, at A3.
- ⁶⁹ *KKR, Goldman in Compromise with Harman*, *supra* note 67.
- ⁷⁰ Mark McSherry, *Sallie Mae seeks \$900 million damages in takeover lawsuit*, Reuters, available at <http://www.reuters.com/article/businessNews/idUSN0835889020071009> (Oct. 9, 2007) (last visited Nov. 7, 2008).
- ⁷¹ *Id.*
- ⁷² *Id.*
- ⁷³ *Id.*
- ⁷⁴ Jeffrey Rothschild & Abigail Reed, *Drafting Material Adverse Change Clauses in Light of Delaware Case Law*, McDermott Will & Emery Inside M&A, available at http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/906e3d64-aab3-401c-a2e8-12c7c4f23986.cfm (Nov./Dec. 2007) (last visited Nov. 7, 2008).
- ⁷⁵ *Id.*
- ⁷⁶ *Id.*
- ⁷⁷ Tucker Echols, *Sallie Mae settles buyout lawsuit*, Washington Business Journal, available at <http://sanantonio.bizjournals.com/washington/stories/2008/01/28/daily1.html> (Jan. 28, 2008) (last visited Nov. 7, 2008).
- ⁷⁸ *Id.*

⁷⁹ Complaint, public version ¶1, *Hexion Specialty Chemicals Inc. v. Huntsman Corp.*, No. 3841-VCL, 2008 BL 222908 (Del. Ch. Sept. 29, 2008).

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.* at ¶¶ 2-8.

⁸³ John E. Morris, *Huntsman fires back at Apollo*, The Deal.com, available at http://www.thedeal.com/dealscape/2008/06/huntsman_fires_back_at_apollo.php (last visited Nov. 7, 2008)

⁸⁴ *Id.*

⁸⁵ *Hexion* at 39.