

# Featured Articles

## ***Material Adverse Change Clauses: The Metrics in Delaware, Plus Drafting and Negotiation Advice***

Contributed by:

Cathy L. Reese, Brian M. Rostocki and Kyle Wagner  
Compton, Fish & Richardson P.C., and Joseph W.  
Bartlett, Sonnenschein Nath & Rosenthal LLP

Recent litigation in the Delaware Court of Chancery, including the litigation involving the now-terminated \$25 billion Sallie Mae merger, is a reminder in merger and acquisition (M&A) transactions that care should be given in drafting and negotiating material adverse change (MAC) or material adverse effect (MAE) clauses. These clauses are typically intended to permit a buyer to terminate the agreement upon the happening of an event that has a material impact on the seller after the signing of the agreement but before closing.

MAC clauses can take the form of a closing condition for the contemplated transaction. When used as a closing condition, a MAC clause serves as a means to allocate risk among the parties by allowing one or both to terminate the agreement if an adverse change occurs that has a significant negative impact on one or both of the parties. A MAC clause can also appear as a representation or warranty. In this way, a MAC clause can be renewed and brought down through a condition requiring the continued accuracy of the representation or warranty at closing time.

MAC clauses are important to both buyers and sellers. Buyers seek to utilize MAC clauses as a way to walk away from a contemplated transaction and, therefore, prefer the broadest possible MAC clauses. Sellers seek to utilize MAC clauses to provide greater certainty of consummation and, therefore, prefer the tightest MAC clauses possible. In practice, however, a MAC clause is typically included in the transaction agreement as a closing condition, which provides the buyer with a way out of the transaction should any materially adverse business or economic changes affecting the target company or its assets occur from the time the parties entered into their definitive agreement to the time the transaction is consummated.

Historically, MAC clauses were rarely invoked as a way to back out of the transaction but rather as an opportunity to renegotiate a more favorable deal price. For example, in December of 2004, Johnson & Johnson (J&J) entered into an agreement to acquire Guidant Corporation for \$25.4 billion in stock and cash.<sup>1</sup> The acquisition agreement contained MAC provisions, which J&J later threatened to invoke after certain circumstances (specifically, product recalls and

government investigations) affected Guidant in a manner that J&J considered to be materially adverse. By invoking its MAC clause and threatening to walk away, J&J was able to gain the leverage necessary and renegotiate a lower deal price. Boston Scientific, however, topped J&J's lowered bid and ultimately acquired Guidant.<sup>2</sup>

More recently, however, MAC clauses have been invoked as a reason for terminating transactions. For example, an investor group comprising J.C. Flowers & Company, JPMorgan Chase and Bank of America (the Flowers Group) agreed in April 2007 to acquire SLM Corporation, the parent company of Sallie Mae.<sup>3</sup> Several months later, however, the Flowers Group attempted to lower its offer, from \$60 per share to \$50, by invoking the MAC clause in the merger agreement. The Flowers Group cited the recent credit crunch and the enactment of unfavorable legislation affecting Sallie Mae as constituting MACs. Rather than renegotiate the transaction, SLM brought suit in the Delaware Chancery Court on October 8, 2007 to force the Flowers Group to pay a \$900 million reverse termination fee. SLM argued that the proposed reduction of the purchase price triggered its right to demand the reverse termination fee. At a hearing, Vice Chancellor Strine questioned the parties as to why both sides did not just "all agree to terminate" since the Flowers Group had "no intention of closing this deal."<sup>4</sup> SLM Corporation has since agreed to settle with the Flowers Group, dismissing the lawsuit in the Chancery Court and terminating the merger agreement in exchange for a deal to refinance about \$30 billion in debt.<sup>5</sup>

With MACs now being used increasingly as ammunition for buyers to walk away from deals, lawyers on both sides of the negotiating table should be more mindful of the language of MAC clauses and not treat them as the boilerplate they were once considered to be. Case law yields few strict guidelines in the drafting of MAC clauses, and the leading cases in the area focus more on which party has the burden of proving a MAC.

### **Delaware Chancery Court Jurisprudence**

Two decisions by the Delaware Chancery Court, *IBP, Inc. v. Tyson Foods, Inc. (In re IBP, Inc. S'holders Litig.)*<sup>6</sup> and *Frontier Oil Corp. v. Holly Corp.*,<sup>7</sup> provide guidance on the way courts—at least Delaware courts—might interpret MAC clauses.

The facts of *IBP* are quite lengthy. Put simply, IBP and Tyson Foods entered into a merger agreement whereby Tyson agreed to acquire IBP in a cash-out merger. During the due diligence process, Tyson learned that there may be issues with IBP's future prospects, including a downturn in IBP's beef business and accounting issues at one of IBP's subsidiaries. Tyson entered into the agreement to acquire IBP notwithstanding

these red flags. After signing the agreement, Tyson sought to withdraw from the merger with IBP, partially in reliance upon a MAC clause.<sup>9</sup> Tyson asserted that IBP's one-time financial impairment charge associated with IBP's acquisition of one of its subsidiaries and declines in IBP's quarterly earnings entitled Tyson to back out of the merger pursuant to the MAC clause in the merger agreement.<sup>9</sup> IBP resisted Tyson's efforts to withdraw and the parties became entrenched in litigation.<sup>10</sup>

As an initial matter, Vice Chancellor Strine held that the party seeking to terminate an agreement based on a MAC has the burden of proving that a MAC occurred.<sup>11</sup> Vice Chancellor Strine determined that the broadly written MAC clause at issue was "best read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner . . . ."<sup>12</sup> The MAC "should be material when viewed from the longer-term perspective of a reasonable acquirer"; a "short term hiccup in earnings should not suffice."<sup>13</sup> The court went on to find that IBP had not suffered a MAC. The court focused on the "post-hoc" nature of Tyson's arguments, noting the fact that Tyson's initial public disclosures for terminating the merger did not claim that a MAC occurred based on IBP's impairment charge or earnings decline.<sup>14</sup> Vice Chancellor Strine explained the significance of this fact as follows: "The post-hoc nature of Tyson's arguments bear on what it felt the contract meant when contracting . . . and suggests that a short-term drop in IBP's performance would not be sufficient to cause a [MAC]."<sup>15</sup> With respect to the one-time impairment, Vice Chancellor Strine reasoned that a one-time impairment charge was not material because the IBP subsidiary at issue was only a small portion of IBP's business and would have little impact on the merged company.<sup>16</sup> With respect to the declines in IBP's quarterly earnings, the Vice Chancellor observed that, before entering into the merger agreement, Tyson knew that IBP was consistently profitable, but that IBP had erratic earnings and would not meet certain earnings projections.<sup>17</sup> The court also focused on the fact that stock market analysts anticipated that IBP's earnings for the next two years would return to their historical performance, and Tyson's own investment banker believed that the merger made sense for Tyson.<sup>18</sup> Accordingly, Vice Chancellor Strine rejected Tyson's reliance on the MAC clause.

The *IBP* case illustrates two important concepts. First, the party seeking to terminate must show that the event in question is a "substantial threat" and "durationally significant" to the other party for the event to constitute a MAC. Second, if such party loses, it may be compelled to complete the transaction. In *IBP*, the court ordered specific performance, requiring Tyson to consummate the merger. The court reasoned that the merger between Tyson and IBP represented a unique

business opportunity, for which monetary damages would be difficult to calculate, and the merger made strategic sense.<sup>19</sup>

Although the Chancery Court in *IBP* applied New York law, it held in *Frontier* that the same standard should apply under Delaware law.<sup>20</sup> In *Frontier*, Vice Chancellor Noble addressed claims of repudiation and breach of the covenant of good faith and fair dealing in the context of a merger agreement entered into between Frontier Oil Corporation and Holly Corporation, which was signed after four months of negotiations. Immediately prior to signing the merger agreement, Holly became aware of an environmental class action threatened by activist Erin Brockovich involving one of Frontier's subsidiaries.<sup>21</sup> Holly nonetheless signed the merger agreement, but only after Frontier agreed to give a strong representation about outstanding and threatened litigation. The representation, however, was qualified by a MAC clause.<sup>22</sup> Following the parties' signing of the merger agreement, the class action litigation was commenced. It became clear during the litigation that Frontier had guaranteed its subsidiary's obligations and therefore Frontier would be liable for the environmental claims.<sup>23</sup> After unsuccessful negotiations, Frontier sued Holly for repudiating the merger agreement and claimed damages. Holly disputed the repudiation claim, arguing that the environmental class action constituted a MAC. Holly also countered with its own claims of breach of representations and warranties and wrongful repudiation, and sought damages.<sup>24</sup>

The court determined, among other things, that there had been no breach of representation by Frontier because no MAC occurred.<sup>25</sup> As an initial matter, Vice Chancellor Noble, like Vice Chancellor Strine in *IBP*, found that Holly had the burden of establishing a MAC with respect to Frontier.<sup>26</sup> Vice Chancellor Noble then found that Holly had not satisfied its burden. Holly had not established that the environmental class action was likely to be "catastrophic" for Frontier such that Frontier would suffer a MAC.<sup>27</sup> Holly also failed to establish that the costs of defending the class action litigation would itself constitute a MAC because Holly did not show that Frontier would be unable to pay the costs associated with that litigation or that the payment of such costs would have a significant impact on Frontier over the long term.<sup>28</sup>

The significance of *Frontier* is two-fold. First, the *Frontier* decision extended the holding in *IBP*, which applied New York law, to Delaware, where a number of MAC cases are litigated. Second, the *Frontier* decision reinforces the ultimate lesson from *IBP*—that M&A lawyers should be wary about relying on a MAC clause as a means of walking away from the transaction, particularly when they knew or should have known of the event claimed to have caused the MAC before concluding the agreement.

## MAC Clauses in Practice

Buy-side deal makers face the following dilemma: their client needs certainty that, on closing day, it will get what it paid for. Yet, the types of impairments to value typically relegated to coverage by MAC clauses, as opposed to explicit representations and warranties demanded of the seller, are often by their nature either unknown or unknowable. How might acquirers effectively draft MAC clauses to provide a walk-away right triggered by unforeseeable contingencies?

In practice, MAC clauses are often drafted with the apparent aim of achieving great breadth through lack of specificity. The “change” is often defined not by occurrence of an enumerated event or class of events, but by any event that may have a material adverse change or effect on the business, operations, or financial condition of one or both parties. Definitions of materiality are typically qualitative rather than quantitative. For example, MACs are often defined as “changes having a disproportionate effect on the target as compared to other companies in the same line of business,” or “changes that would reasonably be expected to have a material adverse effect.” To the extent that events or classes of events are explicitly identified in MAC clauses, they are usually included as enumerated carve-outs that cannot constitute a material adverse change. Common examples include general changes in the economy, general changes in the target’s industry, changes in applicable laws or regulations, or changes attributable to the announcement of the deal.

The almost universal reliance on general language in MAC clauses most likely results from an understandable abundance of caution. Draftsmen tend to shy away from precise definition. There is incipient danger in identifying, for example, ten events that will constitute a material adverse change—by virtue of Murphy’s Law, the contingency which in fact arises, and which is, in fact, both material and adverse, will be contingency number eleven. Because that contingency is not listed, a court may find, by negative implication, that it was not part of the bargain.

The question, then, is whether a cautious lack of specificity puts the acquirer in a better position than an enumerated list might. In the few cases where MAC clauses have been put to the test, it appears that the cautious approach has not paid off. In both *IBP* and *Frontier*, such general MAC clauses were found not to encompass the contingencies alleged as having material adverse effects. More recently, in the Sallie Mae case, Vice Chancellor Strine criticized the MAC clause at issue for its vagueness, because it did not clearly support either party’s position: “[The defendants’] position . . . is not the most intuitively obvious reading of this . . . . On the other hand, the plaintiff’s position could have been much more clearly drafted . . . . I’m not sure that this is the greatest example of

clear scrivenering from either side.”<sup>29</sup> The irony is that in each of these cases, the acquirer was aware of the contingency that ultimately occurred before it inked the deal. Tyson Foods knew of the potential accounting issues facing the IBP subsidiary; Holly knew of the potential class action facing the Frontier subsidiary; Flowers knew of the pending legislation that proved less favorable to Sallie Mae as signed than as proposed. In each of these cases, the acquirer seemingly could have drafted a MAC clause that explicitly included the contingency that it later complained of.

While generally-worded or vague MAC clauses are the norm, Delaware case law suggests that the use of intentionally non-specific MAC clauses is, at best, likely to be unhelpful to the acquirer. And although the case law is admittedly limited, it is easy to see the predictive value of what it teaches. Although MAC clauses differ from other types of representations and warranties or conditions precedent to closing in that they attempt to account for unknowable contingencies, they are still contractual provisions, subject to the same canons of contract interpretation as all other contractual provisions. Any party claiming the existence of a contract provision not explicitly contained within the four corners of the contract itself necessarily faces a stiff burden of proving that such a provision was, in fact, part of the bargain. That the Delaware Chancery Court has placed the burden of demonstrating the occurrence of an unenumerated material adverse change on the party claiming its occurrence is unsurprising.

## A Burden-Shifting Approach

*IBP* and *Frontier* suggest an alternative approach to drafting MAC clauses that focuses not on specificity, but on burden. Those cases place the burden of demonstrating the occurrence of a material adverse change on the party alleging its occurrence—typically, the acquirer. Where the seller contests the occurrence of a MAC, the acquirer must carry the burden of proving that the contested event was a MAC as contemplated by both parties at the time the deal was signed. In most cases, absent a specific definition within the four corners of the contract, allocation of the burden would be dispositive.

One approach that might be preferable to both a generally worded MAC clause and an enumerated list of MAC events might focus on burden-shifting. Acquirer and seller could negotiate, and build into a MAC clause, an agreement on the presumptions and the burden of proof. The parties might reverse or modify the presumption, for example, by specifying that once the acquirer makes a plausible case of the occurrence of a material adverse change, the burden shifts to the seller to rebut that prima facie case. One advantage of this approach is that it allows the parties to negotiate the presumptions up front, providing a future judge, arbitrator, or

other referee with greater confidence that treatment of any later-occurring contingency was within the contemplation of the parties as part of the bargain, and not buyer's remorse cloaked in hindsight justification. A second advantage is that the parties can negotiate the value of such burden-shifting and build that value into the deal price. But, while potentially preferable in the eyes of the acquirer, the burden-shifting approach may be less than attractive to a seller focused on deal certainty, for whom no premium would justify granting the acquirer *carte blanche* to assert any unforeseen contingency as a basis for walking away from the deal. Moreover, the seller may find it difficult to place a value on the possible occurrence of unforeseen deal-breaking events.

Another alternative approach—one that has the potential to better optimize both deal value and deal certainty—would capitalize on both specificity and burden-shifting. As noted above, it is often the case that acquirers are aware of potentially material contingencies before their occurrence, and before an agreement is signed. A MAC clause could be drafted enumerating contemplated contingencies and shifting the burden to the seller for only those contingencies. That is, the seller bears the ultimate burden of demonstrating that an enumerated event—an anticipated but uncertain contingency at the time of signing—is not a MAC, should that event later occur. The acquirer, however, would retain the burden of demonstrating that the occurrence of any unenumerated event constitutes a MAC.

Although acquirers may justifiably resist enumerating such contingencies in a MAC clause for fear of creating any negative implication that an unenumerated contingency cannot also constitute a MAC, enumeration might make more sense when coupled with a burden-shifting provision applicable only to enumerated events. Negative implication is avoided by acknowledgement that the parties contemplate other unforeseen events which may also constitute MACs, and the parties agree that a different allocation of the burden of proof applies to such unforeseen events. Sellers would benefit from knowing exactly what anticipated contingencies are at issue, and may be better able to value their assumption of the burden as to those contingencies based on the probability of their occurrence. Further, sellers would benefit from greater deal certainty knowing that only a defined subset of possible contingencies could likely be successfully asserted as a basis for the acquirer's walking away from the table.

This approach would also elevate MAC clauses from *pro forma* boilerplate to negotiable, value-adding provisions more akin to representations and warranties. The fact that contingencies addressed in MAC clauses are generally not under the control of either party does not mean that they are

not quantifiable. To the extent that the acquirer knows that a given, material contingency may occur, it makes sense to address its occurrence up-front at the negotiating table, rather than retrospectively in a court room. To the extent that the likelihood of occurrence of such contingencies can be quantified, it makes sense for the seller to extract value in exchange for assuming the risk of its occurrence. Both parties will benefit from deal certainty, knowing at the outset which contingencies, beyond the control of either party, will nevertheless threaten the deal.

Finally, whatever option is elected, the parties, and particularly their counsel, must understand that words make a difference in the ultimate result. One obvious outcome-determinative drafting choice is saying that a particular occurrence "could" have a material adverse effect versus "would" have a material adverse effect. In both *IBP* and *Frontier*, the wording of the MAC clause was critical to the court's analysis. In *Frontier*, the court noted, "'would' connotes a greater degree . . . of likelihood than 'could' or 'might,' which would have suggested a stronger element of speculation (or a lesser probability of adverse consequences.)"<sup>30</sup>

The precise words used can have tremendous consequences in this context, and should reflect the allocation of risk actually contemplated and negotiated by the parties. Actively negotiate the language so as to eliminate as much of the mystery as possible on the outcome in court (or, better, before reaching court). Set up ground rules, illustrations and examples and, once the likely results of future contingencies are known, build the price of the issues negotiated into the overall economics. Leaving the issue up in the air is not consistent with the core thesis in American contract law—that a contract is a meeting of the minds.

*Ms. Reese is a Principal in the Delaware office of Fish & Richardson P.C. and heads the firm's Corporate and Chancery Litigation practice. She is an established trial attorney with extensive experience in corporate and Chancery litigation, as well as corporate counseling and Delaware corporate opinions. Ms. Reese is one of a small group of lawyers ranked by Chambers USA, America's Leading Lawyers for Business; Delaware Superlawyers, and Delaware Today Magazine as the leading litigators in Delaware in the areas of business litigation and the handling of matters before the Delaware Court of Chancery. Ms. Reese represents and counsels corporations, their boards of directors, special committees of the board, officers, managers, stockholders, and investors. Ms. Reese's litigation practice includes: breach of fiduciary duty claims, corporate governance and election disputes, securities issues and statutory proceedings under the Delaware General Corporation Law. Ms. Reese's counseling practice*

advises corporations, management, boards of directors and board committees regarding their duties in connection with fundamental corporate transactions, including mergers and acquisitions, asset sales, and dissolutions.

Mr. Rostocki and Mr. Compton are attorneys resident in the Delaware office of Fish & Richardson P.C. Mr. Rostocki is a former Judicial Law Clerk to the Honorable Henry duPont Ridgely, Justice of the Supreme Court of Delaware, and Myron T. Steele, Chief Justice of the Supreme Court of Delaware. Mr. Compton is a former Judicial Law Clerk to Vice Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery.

Mr. Bartlett is Of Counsel at Sonnenschein Nath & Rosenthal LLP, where he is a member of the Corporate Practice Group. He has extensive experience in alternative investments, venture capital, emerging companies, initial public offerings, corporate restructurings, private equity and buyouts. Mr. Bartlett has acted as counsel to, director of, and shareholder in, a number of development stage companies during his 47-year career in the venture capital business. Mr. Bartlett has also served as trustee of a series of public mutual funds, chair of a public REIT, and as counsel to asset managers throughout his career, including the managers of public and private equity funds. He has been a limited partner in a number of pooled investment vehicles, including Bain Capital and Needham Emerging Growth Partners. Prior to joining Sonnenschein, Mr. Bartlett was Of Counsel at Fish & Richardson P.C.

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<sup>1</sup> See Vanessa Grant and Sven O. Milelli, *When a Good Deal Goes Bad: Recent Market Turmoil Puts Spotlight on 'Material Adverse Change' Clauses in M&A Transactions* (Nov. 30, 2007), [http://www.mccarthy.ca/article\\_detail.aspx?id=3776](http://www.mccarthy.ca/article_detail.aspx?id=3776) (last visited May 2, 2008).

<sup>2</sup> *Id.*

<sup>3</sup> See Andrew Ross Sorkin and Michael J. de la Merced, *Sallie Mae Settles Suit Over Buyout That Fizzled*, *The New York Times* (Jan. 28, 2008), <http://www.nytimes.com/2008/01/28/business/28deal.html> (last visited May 2, 2008).

<sup>4</sup> *SLM Corporation v. J.C. Flowers II, L.P.*, No. 3279 (Del. Ch.), Scheduling Conference Transcript (Oct. 22, 2007).

<sup>5</sup> See Sorkin and de la Merced, *supra* note 3.

<sup>6</sup> 789 A.2d 14 (Del. Ch. 2001).

<sup>7</sup> No. 20502 (Del. Ch. Apr. 29, 2005).

<sup>8</sup> *IBP*, *supra* note 6, at 21–23.

<sup>9</sup> *Id.* at 23, 52.

<sup>10</sup> See *id.* at 23 n.1.

<sup>11</sup> See *id.* at 53.

<sup>12</sup> *Id.* at 68.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 65.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at 70–71.

<sup>17</sup> *Id.* at 71.

<sup>18</sup> See *id.* at 71, 84.

<sup>19</sup> See *id.* at 82–84.

<sup>20</sup> *Frontier*, *supra* note 7, at 93.

<sup>21</sup> *Id.* at 5–6.

<sup>22</sup> *Id.* at 10–11.

<sup>23</sup> *Id.* at 26–27.

<sup>24</sup> *Id.* at 67–68.

<sup>25</sup> *Id.* at 104–105.

<sup>26</sup> *Id.* at 96–97.

<sup>27</sup> *Id.* at 98–100.

<sup>28</sup> *Id.* at 101–105.

<sup>29</sup> See *SLM*, *supra* note 4.

<sup>30</sup> See *Frontier*, *supra* note 7, at 92 n.209.