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MACs – Some Observations

As credit markets continue to be roiled by the subprime mortgage crisis and the illiquidity of highly leveraged loans, buyers in some high profile M&A transactions have claimed the right to exit deals based on the assertion of a "material adverse change" or "MAC" in the target's business. The reasons driving this development are mostly obvious. The increased cost of previously committed financing has led buyers to search for available avenues to escape from, or renegotiate, otherwise unconditional purchase obligations entered into in frothier times. Also, targets in certain industries, such as mortgage lending, student loan and residential construction, have indeed experienced, and may continue to experience, significant deterioration in their results of operations.

An additional but less obvious factor may be as much to blame as any other for the recent profusion of MAC claims – the reverse termination fee. Introduced by deal makers in recent times as the *quid pro quo* for a buyer's willingness to relinquish the once sacrosanct financing condition to closing, reverse termination fees are sometimes a seller's sole recourse for a buyer's failure to complete an acquisition. This is most often the case in private-equity sponsored buyouts where the purchasers are newly formed entities with little in the way of assets. The typical reverse termination fee is in the range of 3% of the purchase price and, with the downside limited or fixed, buyers that previously would have been loathe to risk a huge adverse judgment in litigation over the MAC clause now have been willing to take the risk. The Harman International deal is a recent example of a situation where the buyers, KKR and Goldman Sachs, initially asserted a MAC, but ultimately negotiated a $400 million investment in Harman convertible securities in exchange for termination of the acquisition agreement and relinquishment of all claims without payment of the $225 million reverse break fee.

Against this backdrop, we thought some reminders about MAC clauses might be useful.

First and foremost, the case law involving MAC clauses is sparse and has remained largely unchanged since Vice Chancellor Leo E. Strine, Jr.'s seminal 2001 IBP v. Tyson decision, in which he determined that the MAC provision in an acquisition agreement is 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." While the broad parameters of a MAC analysis are clear – the event must have been unknown to the buyer, must be very material and must extend for a sustained period – there remain unresolved questions. For example, does the requisite durational significance differ depending on the character of the buyer? Would strategic buyers (as in IBP) be expected to absorb a decline of longer duration than

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financial buyers (who are the source of most of the presently asserted MAC claims)? How much prior knowledge is acceptable for the buyer to claim that the event was "unknown"? Perhaps the pending disputes will clarify these questions.

While careful drafting of a MAC clause is important, equal attention should be paid to how the MAC provision (a representation and warranty) relates to other provisions in the contract. Truly material events that would destroy the value of a deal for a buyer would better be reflected in specific provisions of the agreement based on more objective criteria instead of, or in addition to, a MAC. For example, if an event is known and truly material to a deal, the buyer should include a specific closing condition to cover the event. A major element in the current litigation over alleged MAC events involving Sallie Mae is how much of the negative impact of pending student loan legislation should the buyer be obligated to sustain. The buyer group and Sallie Mae differ over the interpretation of the definition of a MAC for a change in law. A closing condition directly tied to the enactment of any legislation more adverse to Sallie Mae than the previously disclosed legislative proposals might have more clearly avoided the ambiguity that is currently in dispute.

Even if a party believes it has crafted a MAC provision that perfectly suits its situation, a court in litigation will likely look to other provisions of the agreement and possibly to additional evidence outside the four corners of the agreement to divine the parties' intentions. As Chancellor Strine noted in a recent hearing in the Sallie Mae litigation, the parties always argue that the provision is "perfectly clear that it means what I say." More often than not, however, in hindsight it is not as clear as the parties believed and the court needs to examine other evidence. The inclusion of other provisions in the agreement to cover specific concerns would not only provide clarity for the parties, but would also guide the court as to what the parties deemed important for MAC purposes. For instance, the other representations and warranties in the agreement should establish a scope as to what the parties considered material.

While the emergence of reverse break fees has capped the exposure of buyer litigants, the amounts in play nonetheless remain large, *e.g.*, the reverse break fee in Sallie Mae is $900 million. While some of the pending MAC disputes may result in judicial determinations that shed more light on this area of law, the best protections for both buyer and seller are clear thinking and good agreement drafting.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. If you have any questions regarding the foregoing, please contact Paul D. Ginsberg at 212-373-3131, Brad S. Karp at 212-373-3316, Toby S. Myerson at 212-373-3033, Robert B. Schumer at 212-373-3097 or Frances F. Mi at 212-373-3185.