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Material Adverse Clauses: Practice in an Uncertain World

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Recent court decisions addressing the meaning of Material Adverse Effect ("MAE")[1] involved situations where a strategic buyer of a publicly traded target sought to invoke an MAE clause to justify terminating the deal. These decisions establish a high threshold for finding an MAE and adopt a facts and circumstances test that provides only general guidance about the meaning of MAE in any particular circumstance. In the context of private mergers and acquisitions, this uncertainty can have even greater significance because the definition of MAE affects not only the "walk away" rights of the purchaser, but may affect post-closing indemnification rights as well. The cases are particularly important for financial buyers who typically have different expectations than strategic purchasers.

The first part of this article will describe how MAE clauses are used in merger and acquisition agreements. The second part of this article will describe how courts have enforced MAE clauses in the context of acquisitions of publicly traded targets by strategic buyers and discusses the possibility that courts might reach different outcomes in other contexts. Finally, this article will discuss how practitioners have responded to the case law, particularly in the context of private mergers and acquisition transactions by financial buyers.

The Contractual Context

In general, from the purchaser's point of view, the MAE clause creates uncertainty because it permits the value of the business it is acquiring to deviate from the Purchaser's expectations by some degree. From the seller's point of view, the MAE clause produces greater certainty because it creates a range of deviation from expectations before the seller suffers a consequence. The tug of war occurs because sellers desire a greater degree of tolerance while purchasers prefer the certainty produced by a narrower concept.

In practice, the MAE clause is found in a variety of sections of an acquisition agreement and this struggle over the degree of certainty plays out in a number of ways:

- The MAE clause, particularly in the public context, may serve as a stand-alone closing condition requiring that since a specified date, typically the date of execution of the acquisition agreement, the target has not suffered an MAE. The purchaser accepts the risk that some event or change causes the value of the target to be less than expected, until the consequences are of such significance that an MAE occurs, at which point the purchaser is allowed to terminate or "walk away" from the deal.

- The MAE clause may also affect a "bring-down" closing condition that states that the representations and warranties must be true and correct as of the closing. This condition may require that some or all of the representations must be absolutely true and correct "in all material respects" or that they are true and correct except for breaches that would not cause an MAE.
- The MAE concept also may appear in specific representations. Many acquisition agreements contain a stand-alone representation that since a certain date, typically the date of the most recent audited or unaudited balance sheet, the target has not suffered an MAE. In addition, specific representations and warranties may be qualified by MAE thereby limiting the representation to factual matters that "have not had and would not reasonably be expected to have, individually or in the aggregate, an MAE."
- Where the target company is not publicly traded, the MAE clause may also affect whether a purchaser may be entitled to receive post-closing indemnification for breaches of representations and warranties. As stated above, an MAE clause may be used to qualify specific representations and warranties thereby shifting the risk of inaccuracies to the purchaser before the MAE level is reached. In some instances a seller will not be required to indemnify a purchaser until an MAE has occurred, although most often this MAE requirement is replaced by a "basket" of an exact dollar threshold or deductible.

The language of the MAE definition may be subject to a number of variations. In general, a well-drafted clause should cover a variety of specified "changes" and "effects" that, individually or in the aggregate, have had a material adverse effect on the target's assets, properties, results of operations or condition (financial or otherwise). One area of discussion between the parties typically involves the degree to which changes that have occurred but which have not yet had an impact on the target may constitute an MAE. Purchasers frequently expect some degree of "forward looking" impact either through the inclusion of the term "prospects" or having the MAE cover matters that "would have" or "would reasonably be expected to have" an MAE. Often, sellers will attempt to negotiate for carve-outs to the definition of MAE that exclude events such as terrorism, war, announcement risk, market price fluctuations, changes in laws or regulations or general or industry-wide economic or business conditions. This, in turn, may lead the purchaser to insist that the carve-outs be limited to matters that do not disproportionately affect the target.

Judicial Interpretation

Practitioners seeking guidance about the judicial interpretation of the MAE clause will find that the number of cases is sparse. The landmark case attempting to interpret the meaning of materiality is *TSC Industries, Inc. v. Northway, Inc.*,[2] which stated that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[3] The cases are clear that MAE means something more than the word "material."

Courts that have tackled the meaning of MAE have adopted interpretations that are highly factual and context specific and which establish a high bar before determining that an MAE has occurred. Judicial interpretations of MAE clauses offer a poor guide to business people who seek certainty and quantification of risk because practitioners have difficulty quantifying MAEs and, to the extent an MAE is quantifiable, it may be significantly larger than a businessperson might expect. The most recent cases discussed below demonstrate that the courts view MAE as a difficult burden to overcome and if the parties have not created a more exacting definition of MAE, the courts are reluctant to create one for them.

Probably the leading case interpreting MAE is *IBP, Inc. v. Tyson Foods Inc.*,[4] in which the Delaware Chancery Court, interpreting New York law, examined Tyson's attempt to justify the termination of its agreement to acquire IBP on the basis of an MAE. Tyson argued that a sharp earnings decline, particularly when coupled with accounting irregularities at one of IBP's business units that required a restatement of IBP's financials, constituted an MAE. IBP had experienced an earnings decline in its first fiscal quarter of 64% from the comparable prior year period, which represented a 32% decline in last twelve month's earnings over a six-month period.

The Court granted specific performance to IBP and rejected Tyson's arguments that the declines in financial performance constituted an MAE. The court examined the facts closely and considered the facts from the broad point of view of the parties' expectations. The court started from the premise that an MAE condition serves 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."[5] The court viewed the earnings downturn as a cyclical event that did not affect the long-term prospects of IBP in the hands of a strategic buyer like Tyson. The court examined the five-year earning history of IBP and concluded that the fluctuation was within the range of volatility of IBP's earnings during the period. The court hinted that if Tyson was concerned about the short-term earnings prospects of IBP that it should have addressed this concern specifically in the merger agreement.[6]

In *Frontier Oil v. Holly Corp.*,[7] the Delaware Chancery Court, interpreting Delaware law, examined whether a threatened toxic tort litigation would reasonably be expected to have an MAE. Holly was seeking to justify its termination of an agreement to merge with Frontier on the basis that the litigation constituted a breach of the litigation representation in the merger agreement in which Frontier had represented the absence of litigation other than those "that would not have or reasonably be expected to have, individually or in the aggregate" an MAE.[8]

The Court undertook an extensive examination of the facts and the history of the negotiations. Although the Court noted that Holly had established some possibility that the litigation could be "catastrophic," it held that Holly had not established the requisite likelihood of such a result in order to establish that the litigation constituted an MAE.[9] The Court also ruled that potential costs of litigation, estimated by the court at between $15 million and $20, did not constitute an MAE in the context of the purchase of a company worth $338 million.

The lesson of the *IBP* and the *Frontier Oil* cases as well as a number of other cases that have examined the question is that the determination of whether an event constitutes an MAE is highly fact specific and will be measured in view of the reasonable expectations of the purchasing party. [10] These cases are cited for the proposition that only events that are found to be significant in terms of the long-term value of the target company are likely to be found to constitute an MAE. The key cases and literature regarding MAE focus on the interpretation of MAE clauses in the context of public M&A transactions where an industry participant is acquiring the target for the long-term strategic and synergistic benefits inherent in the acquisition. In such a context, it makes sense that courts might take a longer-term view of the concept of MAE and try to examine whether the events claimed to constitute an MAE really affect the fundamentals of the underlying business proposition.

But what of the financial buyer? Such a buyer is likely examining the target company in a different manner than the strategic buyer. Such a buyer typically is considering the earnings potential of the target company in the absence of synergy, often relying on healthy doses of leverage which makes the tolerance for error much smaller. The conduct of such buyers often reveals their own view of materiality given the exhaustive and detailed diligence such buyers typically perform. For such buyers, who are driven by the notion of short to medium term financial return on investment, the recent decisions applying MAE clauses provide a yardstick that is crude at best.

Most of the cases and literature regarding MAE focus on the interpretation of MAE clauses in the context of closing conditions and termination rights. In the private context, questions regarding MAE may also arise when determining a purchaser's right to seek indemnification for breaches. A decision not to close a signed deal can lead to a drastic reduction in value for a target such that the certainty of close is always a fundamental concern for a seller. The potentially disproportionate effect that the failure to close has on the seller as opposed to the purchaser may explain the courts' reluctance to declare that an MAE has occurred. In the context of post-closing indemnification, perhaps the equities shift. A purchaser that has consummated the transaction would be asserting that the measure of materiality ought to be different when attempting to be made whole as opposed to seeking to avoid the contract in its entirety.

This point of view might be made with particular force by a financial buyer. The courts when examining MAE have looked closely at the purchaser's expectations, and a financial buyer purchases with a different set of expectations than a strategic buyer. For example, the court in *IBP* examined the five-year earning cycle of IBP and found that the determination of profitability was within the expectations for a cyclical business. Perhaps this is a just result when considering the decision of a strategic buyer who presumably buys for the strategic benefits of ownership and with a view to indefinite ownership. But to a buyer that purchases with an expectation of holding for perhaps three years, seeking only a financial return in the face of significant leverage, that decline might be of significantly greater materiality—especially in the context of seeking an indemnification payment as opposed to seeking to avoid the transaction.

The cases suggest that the criteria by which MAE will be measured "is imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties."[11] Accordingly, in the proper context, MAE might not be quite the significant hurdle suggested by *IBP* and *Frontier Oil* and in some of the literature. Nevertheless, the precedents are out there and testing the boundaries of the case law is not likely an attractive idea for most purchasers.

Responses to Uncertainty

Practitioners have been responding to the recent case law. In the public M&A arena the response is easier to observe, and practice tends to vary less as it is easier for practitioners to point to "market precedent." Private M&A is clearly subject to greater variation, and views about what is "market" are clearly more subjective and likely to be influenced by which side of the transaction the lawyer is representing. Although there have been a number of attempts to catalog market practice, such studies need to be relied upon with care because there is a wide degree of variation depending upon a variety of factors such as the size of the transaction, the industry, whether the transaction is the result of a competitive auction process and the length of the intervening period between signing and closing.

Purchasers should heed the lessons of *IBP* and consider addressing specific concerns in the acquisition agreement. The purchaser's advisors should help their client prioritize the subject matters of greatest concern and quantify the degree of risk the purchaser is willing to accept. Potential solutions include qualifying individual representations and warranties with specific dollar thresholds rather than materiality or MAE, and providing for closing conditions that the target must meet particular financial targets, such as calling for the target to achieve certain levels of earnings during a time period before the closing. Alternatively, the use of earn-outs and contingent purchase price mechanisms can provide a method for protecting against uncertainty and sharing the risks. The use of a liquidated damage clause is another method by which parties can limit the uncertainties the parties face in relying on MAE clauses because the costs of wrongfully terminating an acquisition agreement are known in advance.

The inclusion of the MAE clause in the "bring-down" condition or the inclusion of a basket concept in an indemnity provision when materiality or MAE is also used in specific representations raises issues about the possibility of "double materiality." Purchasers frequently require that for purposes of the "bring-down" condition and for determining indemnification liability that materiality qualifiers should be disregarded. In the context of indemnification claims, the parties may agree that the materiality or MAE qualifier will be completely disregarded for purposes of determining indemnification claims. Sometimes, the qualifiers are ignored solely for purposes of determining the amount of indemnifiable losses, but not for purposes of determining whether a breach of an individual representation has occurred.

Practitioners are also paying close attention to the definition of MAE. Purchasers are seeking to have all effects aggregated together so that even unrelated circumstances are viewed as an entirety. In addition, the exceptions to the definition are being carefully negotiated.

The task of bringing precision to the balancing of risks between sellers and purchasers can be arduous and it is tempting for the parties to ignore certain risks by reverting to an MAE standard. Nevertheless, purchasers, especially financial buyers, as well as sellers, need to be aware of the uncertainties this course of action entails. The approaches can be as varied as deals themselves and while practitioners and their clients may search for what is "market," the most important consideration is ensuring that the parties have a clear understanding and are comfortable with the risks that they are assuming.

Notes

1. Note many agreements use the term "Material Adverse Change" ("MAC") although practitioners sometimes perceive that there is a difference between MAC and MAE the courts have repeatedly used the terms interchangeably. For ease of reference, we use the term MAE but the term MAC should be considered to be included in the discussion.
2. 426 U.S. 438 (1976).
3. *See also* Allegheny Energy, Inc. v. DQE, Inc., 74 F.Supp.2d 482 (W.D. PA. 1999), *aff'd* 216 F.3d 1075 (3d Cir. 2000) (material means "having real importance or great consequences").
4. In re IBP, Inc. Shareholders Litigation, 789 A.2d 14 (Del. Ch. 2001).
5. *Id*. at 68.
6. As Chancellor Leo Strine points out, Tyson entered into the agreement "without demanding any representation that IBP meet its projections for future earnings, or any escrow tied to those projections." *Id*. at 22.
7. Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 WL 1039027 (Del. Ch. 2005).
8. *Id*. at *4.
9. *Id*. at *36.
10. *See, e.g., Pine State Creamery v. Land-o-Sun Dairies*, 201 F.3d 437 (4d Cir. 1999) (a shift from a small monthly and year-to-date operating profit to an operating loss of $400,000 in two succeeding months was a question for the jury because the business was seasonal); *Pan Am Corp. v. Delta Air Line*, 175 B.R. 438 (S.D.N.Y. 1994) (workout context impacts expectations regarding MAC clauses); *Bear Stearns Co. v. Jardine Strategic Holdings*, no. 31371187, slip. op. (N.Y. Supr. 1988) *aff'd mem*., 533 N.Y.S.2d 167 (1988) (tender offeror for 20% of Bear Stearns could not withdraw after severe losses on Black Monday, October 19, 1997, in view of known volatile and cyclical nature of business); *Katz v. NVG Co*., 100 A.D.2d 420 (1984) (MAC occurred where one merger partner suffered a net loss of over $6.3 million compared to $2.1 million of profits in the same period the year before); and *Raskin v. Birmingham Steel*, 1990 WL 193325 (Del Ch. 1990) (a 50% decline in reported earnings over two consecutive quarters created a "strong record" of a MAC but it was "possible" with a "full record" and a "larger context" the decline was not a MAC).
11. *Frontier Oil Corp*., 2005 WL 1039027 at *34 (Del. Ch. 2005).