BENESCH
Attorneys at Law

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Private Equity Bulletin

MATERIAL ADVERSE CHANGE ("MAC") CLAUSES IN TODAY'S ECONOMIC CLIMATE

Today's financial climate is volatile. The country is experiencing the worst financial crisis in seventy years. What started as instability in the housing market has progressed to instability in the financial and stock markets, and buyers and sellers alike worry that a deep recession is looming. Although the current administration is working on various financial rescue packages and there are minor indications that the Emergency Economic Stabilization Act of 2008 is having a positive effect on very short-term lending, it remains difficult to obtain long-term financing.

Understandably, private equity firms are scrutinizing investment opportunities and are being extremely cautious until the moment that the deal is consummated. Since sellers have a minimal amount of leverage in a poor economic climate, buyers have been insisting on agreements that provide the buyer with maximum flexibility to walk away before closing. Until recently, buyers believed a MAC clause would protect the buyer from unforeseen events or circumstances; however, recent decisions by the Delaware courts have shaken this belief.

MAC Clauses and Adverse Conditions

A MAC clause is a tool believed to allocate economic risk among the parties. In general, a MAC clause allows the buyer to terminate an agreement if there is a material adverse change that affects the target company or its assets between the time that the agreement is executed and the closing. Although the parties define a MAC within the agreement, generally a MAC is a change in circumstances or an event that causes a material adverse effect to the business's assets or its financial condition. Some MAC clauses focus not only on consequences that occur prior to the consummation of the transaction but also on consequences that may have an impact on the post-consummation earnings potential of the target company.

A MAC clause typically does not include changes in political, general business, economic, or market conditions unless the change affects the target company disproportionately. And, while theoretically a MAC clause can include or exclude virtually anything to which the parties agree, whether a court will enforce the MAC clause is becoming increasingly questionable.

The Court's Analysis

In analyzing whether a MAC has occurred, a Delaware court will first consider whether the event or circumstances were included under the MAC clause and whether the possibility of the event or circumstances was disclosed at the time that the parties entered into the merger agreement. A court will then strictly construe the MAC clause and make a fact based inquiry focused on the intent of the parties at the time that they entered into the merger agreement. A short-term financial investor would be more concerned with the company meeting quarterly projections, while a strategic investor would focus on the effect being long-term and durational. If a company is in a volatile or cyclical business, the court is unlikely to find a short-term loss or a decline in stock price to be a MAC.

Three cases decided by the Delaware Chancery Court, *In re IBP, Inc. Shareholders Litigation ("IBP")*, *Frontier Oil v. Holly Corp. ("Frontier Oil") and, most recently*, *Hexion Specialty Chemicals, Inc. v. Huntsman Corp. ("Hexion")*, provide buyers with direction regarding judicial review and the court's interpretation of MAC clauses.

The court in *Frontier Oil* was clear that, unless the burden is contractually allocated otherwise, the party that asks for its performance to be excused (usually the buyer) must rebut a strong presumption in favor of closing the transaction. The buyer must demonstrate that a MAC has occurred and that the effect is material. The "materiality" inquiry is highly fact specific and will, of course, depend upon the circumstances of both the transaction and its parties, as well as the language chosen by the parties in the MAC clause. In *Frontier Oil*, the buyer showed that the litigation in question *could* have a material adverse effect on the target business going forward, but the buyer failed to show that the litigation "[did] have, would have, or would reasonably be expected to

have . . ." a material adverse effect. Therefore, the buyer did not prove that the litigation constituted a MAC, and since the buyer did not prove that a MAC occurred, the buyer could not invoke the MAC clause and terminate the agreement.

In *Hexion*, the seller specifically negotiated out of a typical "financing out" clause, so the buyer's only argument for terminating the merger agreement was to rely on a very broad MAC clause. The buyer's board of directors had determined that the combined entity would be insolvent, and the buyer claimed that, based on the anticipated insolvency, a MAC had occurred. However, the court found that the buyer showed a lack of good faith when the buyer failed to consult with the seller, mitigate the risk of insolvency, or to otherwise use its reasonable best efforts to consummate the deal. Further, the court held that the MAC clause did not protect the buyer from a drop in profit, even if it resulted in the combined entity being insolvent, and emphasized that a transaction cannot be terminated simply due to the buyer's remorse.

In *IBP*, Tyson wanted to acquire IBP as a part of their long-term strategy. Since IBP's decline in performance was expected to be short lived, and in fact started to improve just as Tyson terminated the agreement, the court found that Tyson had not demonstrated that a MAC had occurred.

The Reality

After the court's decision in *Hexion*, buyers are understandably skeptical regarding their ability to use a MAC clause to terminate an agreement. In *Hexion*, the value of the target corporation had declined dramatically, and the buyer had obtained a valuation that the combined entity would be insolvent. The buyer was facing significantly higher lending costs while having to pay the price that was originally negotiated for a non-performing business. However, the court held that the MAC clause did not apply and that the buyer had breached the merger agreement. The court seemed to view the situation as a simple case of buyer's remorse.

Ultimately, the economy will recover, and MAC clauses will not be as significant as they are today. In the meantime, a buyer must remember that public policy favors the closing of transactions. Although a MAC clause theoretically provides the buyer with the ability to terminate an agreement, the reality is that it is highly unlikely that a court will permit the buyer to walk away based on such a provision.

The Practical Use of a MAC Clause

That said, a prudent buyer will not disregard the MAC clause. Whether in these tough times or when the economy recovers, the MAC clause is an essential source of protection for the buyer. Although Delaware courts have never permitted a buyer to terminate a merger agreement based on a MAC clause, the courts have not completely rejected its use either. The courts have, instead, repeatedly provided suggestions for their effective use.

A properly drafted MAC clause can give a buyer greater flexibility to renegotiate the purchase price. When circumstances trigger a MAC and the parties quietly and successfully renegotiate the terms of an agreement, litigation never ensues and the public never becomes aware of the benefit that a MAC clause provided. Therefore, it is important for the agreement to include a MAC clause that has been carefully drafted based on the court's commentaries and the specific situation that is at hand.

A Modest Amount of Generality

Typically, a buyer wants a broadly drafted MAC clause because the buyer theorizes that the MAC will offer greater protection against the unforeseen. The buyer should negotiate for a MAC clause that sets forth a certain degree of generality so that it encompasses a range of potential unanticipated events, but a court will find an overly broad MAC clause to be ambiguous. In such a case, the court will look at evidence from sources other than the contract itself, such as statements between the parties or the circumstances surrounding the agreement.

Although, at times, certain language is deliberately and strategically left unclear, parties should beware. When the interpretation is left to the courts, the outcome is often unexpected. The court will interpret a broad MAC clause, as well as a general event and its effect, from the perspective of a reasonable buyer in the context of the transaction and the words chosen by the parties.

Recommendations

To avoid an unexpected interpretation by the courts, the parties should, list all of the things that they believe could possibly go awry before the deal closes. Focus on the issues particular to the transaction and address specific risks explicitly in the MAC clause. For the protection of a buyer, consider the following when drafting and negotiating a MAC clause.

1. The MAC should define every substantive term with metrics. What makes an effect disproportionate? What makes an adverse change material? Although the parties may have difficulty reaching an agreement regarding the method of determining or a quantitative amount of materiality, inclusion of a predetermined dollar amount or an earnings percentage threshold will avoid uncertainty should an issue arise.

2. If the parties are relying on projections, forecasts, or other estimates, the MAC clause should reflect this understanding of the parties and set standards for arriving at future projections and minimum performance standards for the deal to be consummated.

3. If, at the time that the agreement is negotiated, the parties are aware of the potential of certain risks, the risks should be specifically included in the MAC definition; otherwise, the court will typically exclude that event or circumstances related to it. The MAC clause should also cover unknown risks

that are "durationally significant."

4. The MAC clause should include *all* potential litigation, including litigation regarding risks unknown at the time that the agreement is reached.

5. To be enforced, certain events outside of the seller's control, such as a downturn of general economic or industry conditions, acts of war or terrorism, changes in or new laws, regulations, or licensing requirements, the impact that the announcement of the deal has on the seller's business, and future prospects of the seller, must be specifically included in the MAC. Otherwise, the court typically finds these events to be outside the scope of the MAC clause. Unfortunately, the seller typically negotiates these types of events from the agreement.

6. The agreement should specifically address the terms of a seller's right to cure a MAC, if the seller has that right at all, whether disputes will be resolved through the courts or arbitration, and clearly state if specific performance is barred as a remedy.

7. Although outside the parameters of a MAC clause, financing should be specifically addressed in the agreement in what is typically known as a "financing out" clause. Since, in a poor economic climate, buyers have more leverage and can insist on terms that only require that the buyer use its reasonable best efforts to obtain the necessary financing, we will likely see a movement toward including such clauses.

Reverse Termination Fee: Terminating the Agreement Due to Any Condition

At one time, the "reverse termination fee" was becoming increasingly more common. A reverse termination fee is negotiated into the agreement and limits the seller's remedies should the buyer choose to exit the deal after closing conditions are satisfied. In such a case, the buyer must pay a set fee, as stated in the agreement. A two-tier reverse termination fee can also be negotiated so that the buyer pays a higher fee if it breaches the agreement and a lower fee if it cannot close the deal due to its inability to obtain financing.

Reverse termination fees are intended to give buyers security in that they can only be liable for a predetermined fee and assure sellers of some compensation should the buyer be unable or unwilling to close. The fee is typically two to three percent of the purchase price. However, a reverse termination fee does not seem to be satisfactory to most sellers, as two to three percent of the purchase price may not be adequate compensation if the agreement is terminated.

If the agreement does include a reverse termination fee, the language is subject to the same judicial standards regarding ambiguity. The reverse termination fee must clearly state that, in the event that the agreement is terminated by the buyer's breach or otherwise, the reverse termination fee is the sole and exclusive remedy and eliminates the remedies of specific performance or contractual damages.

Conclusion

In light of recent economic trends and uncertainties, buyers should not rely on their ability to terminate an agreement based on a MAC clause. The courts favor the closing of transactions and have shown extreme reluctance to enforce a MAC clause. However, these provisions may provide the buyer with sufficient leverage to renegotiate their purchase agreement.

On the other hand, a properly drafted reverse termination fee can provide the buyer with maximum flexibility to walk away. Unfortunately, the seller usually does not regard such a fee as adequate compensation for when the agreement is terminated.

In either case, MAC and reverse termination fee provisions must be carefully scrutinized and must be drafted to accurately reflect the parties' intentions.

Additional Information

Please feel free to contact us to provide any feedback regarding this specific Bulletin or any suggested topics that you would find valuable for us to address in future Bulletins.

www.beneschlaw.com

James M. Hill
(216) 363-4444
jhill@beneschlaw.com

Julie M. Price
(216) 363-4689
jprice@beneschlaw.com

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