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Revisiting the MAC Clause in Transaction

What Can Counsel Learn from the Credit Crisis?

By Andrew M. Herman and Bernardo L. Piereck

Counsel to mergers and acquisitions transactions can learn from the challenges posed by the credit crisis to reassess the use of "Material Adverse Change," or "MAC," clauses to allocate pre-closing risk between the parties.

Before the onset of the economic crisis, few practitioners and market participants could have foreseen the speed with which financial titans fell and the systemic impact of their failure. The events of 2007, 2008, and 2009, including the collapse of Bear Stearns and Lehman Brothers and the government's increased role in economic activity, demonstrated how quickly parties' basic assumptions concerning market and political risk and financing conditions can change and negatively impact the operations, financial conditions, and expected performance of acquisition targets (and buyers) in M&A transactions. As conditions deteriorated, several buyers, including most notably Apollo Global Management (in the highly publicized Huntsman deal), sought unsuccessfully to claim that a "material adverse change" had occurred in the target's business that resulted in the failure of a closing condition under the merger agreement. Instead of successfully avoiding their obligations under their merger agreements, panicked buyers provided the Delaware Court of Chancery an opportunity to reaffirm the significant burden buyers face in walking away from a deal by claiming that a material adverse change occurred. As we progress out of the crisis, buyers must understand that unless they expressly bargain for different risk allocation among the parties, they assume virtually all market and systemic risks affecting a target's business and assets at signing under current Delaware law. In view of this recent history, this may not be a desirable or appropriate risk allocation for the future.

To better understand whether buyers and sellers are now focused on negotiating the material adverse change (or MAC) language to allocate risk in their transactions, we compared the closing conditions and MAC definitions in merger agreements that were entered into shortly before the onset of the financial crisis with post–financial crisis agreements. Our review highlighted that although some parties have incorporated objective concepts into the MAC definition, most transactions continue to use the same MAC definition that existed prior to the financial crisis. We believe that as the markets stabilize and buyers have greater leverage in their negotiations, buyer's counsel should consider whether they can successfully shift the risk of systemic failure in a manner that allows their clients to walk away from a transaction with little to no cost (and assuming a seller is willing to accept this allocation). Below we summarize the current Delaware approach to MAC interpretation and offer practical suggestions for buyer's counsel to consider in drafting transaction documents.

Typical MAC Structure

Virtually all merger agreements include "material adverse effect" or "material adverse change" clauses that allocate the interim risk of adverse changes affecting the target (and sometimes the buyer) among the parties. The MAC concept is used throughout the merger agreements to qualify representations and warranties, in some form to qualify covenants that operate between signing and closing, and as a condition to the buyer's obligation to consummate the deal. Because the buyer's closing obligations are typically conditioned on the absence of a MAC––whether through the representation and warranty bring-down or a stand-alone MAC condition––buyers have the ability to terminate or renegotiate the terms of a transaction by claiming the occurrence of a MAC following events that adversely affect the target's business between signing and closing.

MAC clauses typically follow a virtually identical structure and use similar language to define the conditions that would excuse the buyer from its obligation to close. A MAC definition usually includes a general description of events that constitute a material adverse change followed by several exceptions that detail specific events that are carved out from the definition and not considered by the parties (or a court) in a MAC analysis.

A typical agreement first defines a MAC as any event, circumstance, fact, change, development, condition, or effect that, either individually or in the aggregate, has had or could reasonably be expected to have a material adverse effect on the business, financial condition, results of operations, or other aspects of the business of the target and its subsidiaries, taken as a whole. The parties generally do not further define the meaning of a "material adverse effect" and rely instead on a court to determine when an event has risen to this level. The second part of the definition generally contains a number of exceptions to the definition to make clear what events are not intended to qualify as a MAC. The effect of these exclusions is to shift from the seller to the buyer the risk of certain events that may otherwise be interpreted as a MAC. While the MAC definition is fairly uniform across merger agreements, the carve-outs are subject to heavy negotiation by the parties and tend to contain the majority of deal-specific customization. This approach, as will become apparent, is inherently seller-friendly and may expose the buyer to unintended risk allocation.

Huntsman/Hexion

In September 2008, at the height of the financial crisis, Vice Chancellor Lamb of the Delaware Chancery Court issued the opinion in *Hexion Specialty Chems. Inc. v. Huntsman Corp*, 965 A.2d 715 (Del. Ch. 2008). *Huntsman* and *In Re IBP, Inc. Shareholders Litigation v. Tyson Foods*,

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789 A.2d 14 (Del. Ch. 2001) (interpreting New York law), are the seminal cases governing Delaware's construction of MAC clauses. The more recent Huntsman decision is a cautionary tale to buyers to carefully consider the language assigning risk among the transacting parties.

The Huntsman saga began in the pre-crisis buyout boom, when credit was readily available and the risk of economic collapse was not readily apparent. In late 2005, Hexion, a company 92 percent owned by the Apollo Management private equity group, first entered into negotiations to acquire Huntsman, but negotiations soon died after Huntsman missed its earnings targets. In early 2007, Huntsman engaged an investment bank to solicit bids for the sale of the company. Bassel and Hexion emerged as the main contenders to acquire the company. Although Huntsman initially agreed to a transaction with Bassel, the company quickly backed out of that deal and executed a leveraged cash acquisition with Hexion after Hexion increased its original offer above Bassel's price. The Huntsman/Hexion deal was structured as a leveraged cash acquisition for 100 percent of Huntsman Corporation stock for a total consideration of approximately $10.6 billion including the assumption of debt.

After the parties signed the merger agreement, Huntsman suffered several consecutive quarters of poor financial performance, repeatedly missing the numbers it had projected at the time the deal was signed. Hexion, led by Apollo, reevaluated the economics of the transaction and declared that Huntsman had suffered a MAC. Hexion argued that Huntsman had suffered a MAC because Huntsman's financial results not only failed to meet the company's own estimates but were also disproportionately worse that those of competing firms affected by the economic downturn.

The Huntsman merger agreement contained a standard MAC definition, defining a MAC as "any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of [Huntsman] and its Subsidiaries, taken as a whole[.]" The general definition is followed by several carve-outs, excluding from the MAC definition any changes in general economic and financial market conditions and changes affecting the chemical industry generally, unless these changes have a disproportionate effect on Huntsman and its subsidiaries.

Lamb rejected Hexion's arguments in holding that Huntsman did not suffer a MAC, noting that it was not a coincidence that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement." The court relied upon its 2001 decision in *Tyson Foods* to find that a buyer seeking to avoid its obligations by claiming the occurrence of a MAC must show that "there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." Thus, the court held that a few awful quarters of performance are not enough to trigger a MAC, without more.

The court also rejected Hexion's argument that Huntsman's disproportionately poor results in comparison to its peers constituted a MAC, noting that the proportionality qualifier in the MAC's carve-outs are only relevant where the buyer can show the existence of a MAC in the first place. This part of the *Huntsman* holding is important because transacting parties often focus on negotiating the terms of the various MAC carve-outs. *Huntsman* cautions buyers that the carve-outs are simply that––exceptions to a MAC––and cannot be used to prove the existence of a MAC.

The *Huntsman* case confirmed that the standard for successfully claiming a "MAC carve-out" in Delaware is a high standard that no buyer has ever successfully asserted as an excuse to avoid closing. This begs the question, if the conditions of the worst economic crisis since the Great Depression did not produce a single set of facts sufficiently egregious to allow a buyer to claim a MAC, what is the value of this provision going forward? The old approach in most cases will not provide a clear path to walking away from a transaction when the target business has deteriorated between signing and closing. However, as we propose below, deal lawyers can bolster the effectiveness of the MAC to better address risk allocation between the seller and buyer by adding objective criteria into their MAC definitions.

Drafting MAC Clauses After the Crisis

As we come out of the crisis, buyers must remember Lamb's taunt in *Huntsman*: it is not a coincidence that no Delaware court has ever found that a MAC has occurred in the context of a merger agreement. The message here is clear––write into the document the mechanisms for allocating the risks among the parties. Below we provide a few tips to assist drafters in improving their odds of successfully defending a MAC carve-out.

1. Employ Objective Criteria

If a particular risk or metric is important to the buyer's valuation of the target or the economics of the transaction, the buyer should seek to incorporate an objective measure of this item into the MAC definition or as a separate closing condition. Lamb warned Apollo and Hexion in the *Huntsman* opinion in denying the use of Huntsman's financial forecasts from the MAC analysis that "[c]reative investment bankers and deal lawyers could have structured, at the agreement of the parties, any number of potential terms to shift to Huntsman some or all of the risk that Huntsman would fail to hit its forecast targets."

In fact, Apollo seems to have heeded Lamb's warning and instructed its counsel to add an objective closing condition into its December 16, 2009, merger agreement to acquire Cedar Fair, the amusement park operator. The agreement conditions Apollo's obligation to close on the absence of a MAC and further conditions Apollo's obligation to close on Cedar Fair meeting a specified minimum EBITDA target for the four fiscal quarters ended December 31, 2009, subject to a right of Apollo to review the calculation. Had Apollo followed this approach in its courting of Huntsman, the fact question would have been much simpler: was the EBITDA target met or not?

Adding objective criteria provides buyers with a bright-line test for walking away from the deal. In addition to EBITDA, the buyer may seek to raise other metrics that materially impact the buyer's economic assessment of the target and its business. Material customers, cost of goods sold, renewal of material agreements, revenue, cash flow, gross margin, and any number of other factors can provide greater certainty to a buyer that they will not be required to consummate a transaction that is outside the bounds of their economic model.

However, buyers face certain new risks if they choose to define MAC conditions solely with reference to bright-line metrics. A bright-line test is by its nature binary––the triggering event either occurs or it doesn't. While this may be helpful in allowing buyers to walk away from a transaction, it can shift the target management's focus away from the operation of the company's business to monitoring and massaging the specified criteria. This shift may get the target to the closing but could have an adverse effect on

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the long-term prospects of the combined company.

Additionally, blind reliance on pure objective criteria would eliminate from the buyer's arsenal its most powerful bargaining chip––the subjective MAC. Although no Delaware court has ever found that a buyer has successfully declared a MAC, numerous deals have been renegotiated by the parties following the buyer's declaration or threatened declaration of a MAC. MAC litigation is fact intensive and expensive, and a buyer may use the threat of litigation to recut a deal before closing. J. C. Flowers & Company successfully leveraged a standard subjective MAC to renegotiate its highly publicized failed $25 billion acquisition of Sallie Mae (and avoid a $900 million breakup fee) after the federal government cut subsidies to certain student lenders.

Depending on the deal dynamics, it may be appropriate to retain elements of a subjective definition but also include objective, concrete examples of when a MAC would occur. This provides greater certainty of protection from anticipated business, legal, and market risks while retaining the buyer's flexibility to leverage the subjective MAC in further negotiations with the seller.

2. Carve Out the Carve Outs

Once the criteria to determine when a MAC would exist have been agreed, it is time to focus again on the exceptions. Sellers have traditionally been successful at negotiating very specific carve-outs to the general MAC definition. A buyer and their counsel should carefully review these seller carve-outs to determine whether there are any specific risks that are captured by the general carve-outs that the seller does not want to assume. If any risks are identified, these should be excluded from the seller's carve out.

A recent example of this approach is present in ExxonMobil's pending acquisition of XTO Energy, Inc. for approximately $29 billion. XTO is a major Texas energy company that extracts natural gas through the use of hydraulic fracturing, a process by which substances are injected into the ground to increase production by elevating well pressure. At the time the parties signed their agreement in December 2009, Congress was mulling plans to regulate hydraulic fracturing.

Because of the uncertain future regulatory framework created by congressional action, Exxon successfully negotiated a change in law carve-out to the MAC definition that is significant in that it effectively assigns the risk of changes in laws among the parties. Exxon would bear the risk of unforeseen changes in laws affecting the business, while XTO would assume the risk of hydraulic fracturing–specific legislation. This thought-out provision defines a MAC as "a material adverse effect on the . . . business . . . of [XTO] and its Subsidiaries, taken as a whole, excluding any effect resulting from, arising out of or relating to . . . (B) other than with respect to changes to Applicable Laws related to hydraulic fracturing or similar processes that would reasonably be expected to have the effect of making illegal or commercially impracticable such hydraulic fracturing or similar processes (which changes may be taken into account in determining whether there has been a [MAC]), changes or conditions generally affecting the oil and gas exploration, development and/or production industry or industries (including changes in oil, gas or other commodity prices)[.]" Here, careful drafting assigned to XTO the known risks of changes in laws, while assigning to ExxonMobil unknown risks that could negatively affect the acquired business.

3. Specify the Time Frame for Measuring a MAC

Delaware courts have repeatedly stated, first in *Tyson* and more recently in *Huntsman*, that unless the merger agreement states otherwise, the time frame for analyzing whether a MAC has occurred is a "commercially reasonable period," which the court expects is measured in "years rather than months." Although this long-term horizon is likely accurate from a strategic buyer's perspective, it may not be a realistic framework to judge whether closing should proceed, when the typical period from sign to close is month, not years.

Here again, careful drafting and consideration by counsel can focus the court's analysis on the time frame of relevance to the buyer. As you negotiate and draft the transaction agreement, you should address the relevant time period for determining the existence of a MAC. Thus, the agreement could define a MAC as any "event . . . that, either individually or in the aggregate, has had or could reasonably be expected to have a material adverse effect on the business, financial condition, results of operations or other aspects of the business of the target and its subsidiaries, taken as a whole during the [one year/six month] period immediately preceding or immediately following the Closing." Alternatively, the agreement can state that a MAC is any "event . . . that . . . has had or could reasonably be expected to have *either a short-term or long-term* material adverse effect on the business[.]" The specificity of the time horizon will depend on the buyer's need and the parties' negotiations.

Conclusion

As deal volume picks up, buyers and their counsel should not forget our recent history. In the past, buyers may have taken for granted that a subjective MAC provided sufficient insurance in case of unexpected changes or events between signing and closing. But as history has shown, entrenched sellers have successfully argued that even catastrophic changes in market conditions are insufficient to establish the existence of a MAC. As the result of the Delaware court reminding us of the very high threshold to successfully invoke a MAC carve-out, the subjective MAC can result in frustrated buyers accepting risks they did not expect and pointing fingers at their lawyers. It is now clearly incumbent on buyer's counsel to put on any issues list the allocation of loss between signing and closing. This requires a substantive discussion with your client, and perhaps a "gloves off" negotiation with a seller. As we have seen, some buyers are successfully moving the needle to address the outcome of the past few years. We look forward to seeing the solution that parties and their counsel devise going forward to deal with this critical issue.

Andrew M. Herman is a partner and Bernardo L. Piereck is an associate in the Washington, D.C., office of Kirkland & Ellis LLP. Mr. Herman and Mr. Piereck specialize in private equity financings, mergers and acquisitions, and general corporate matters.

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