NOTES

RETHINKING THE MATERIAL ADVERSE CHANGE CLAUSE IN MERGER AND ACQUISITION AGREEMENTS: SHOULD THE UNITED STATES CONSIDER THE BRITISH MODEL?

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I. INTRODUCTION

The material adverse change ("MAC")[1] clause is a contract provision that periodically dominates the headlines, usually in the wake of a major financial downturn, and the most recent downturn has not been an

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∗ Class of 2009, University of Southern California Gould School of Law; A.B. Politics and Economics 2004, Princeton University. I owe a sincere debt of gratitude to my advisor, Bryant Danner, for his enthusiasm and criticism, and to the staff and editors of the *Southern California Law Review* for all of their help. I would also like to thank Alan Stephenson, Philip Boeckman, Alan Schwartz, Steven Davidoff, and Adrian Knight for sharing their thoughts on MAC clauses. This Note does not necessarily represent the views of any of the aforementioned, and any errors or omissions are my own. Finally, thank you to my fiancée, Sarah.

1. This Note will use "MAC" to refer to both "material adverse changes" and "material adverse effects," except where the distinction is pertinent. Some agreements choose to use just one of the two possible terms, some agreements use both terms and attempt to define them slightly differently, and some agreements use both terms interchangeably. Although "change" and "effect" have similar everyday meanings, MAC is arguably the more precise term in the context of merger and acquisition agreement drafting. For an in-depth discussion on the distinctions between material adverse change and material adverse effect, see Kenneth A. Adams, *A Legal-Usage Analysis of "Material Adverse Change" Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9, 17–18 (2004).

exception.[2] A MAC clause dispute typically occurs when one side of an agreement no longer wants to complete a merger or acquisition, and often the stakes are high: in the midst of the credit crisis and economic turmoil that began in 2007, MAC disputes erupted in at least thirteen high-profile transactions—the four largest disputes ranging from $1.5 billion to $25.3 billion.[3] As recently as fifteen years ago, the MAC clause was essentially an uncontroversial boilerplate provision, but the clause has since changed dramatically.[4] This Note explores the modern MAC clause in the United States through a comparative analysis with the United Kingdom, which has effectively prohibited a transformation of the traditional MAC clause.

The MAC clause specifies the circumstances under which a purchaser[5] can walk away from a merger and acquisition ("M&A") transaction.[6] The MAC clause exists to address risk in the interim period after the parties have signed the merger agreement but before the transaction has closed.[7] This interim period in a typical transaction is about three months, but it can extend up to a year in some deals, depending on the extent of due diligence and any applicable governmental regulatory approval process.[8] A wide

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2. *See, e.g.*, Michael J. de la Merced, *Wary Buyers May Scuttle Two Deals*, N.Y. TIMES, Sept. 22, 2007, at C1; Posting of Tennille Tracy to Deal Journal, http://blogs.wsj.com/deals/2007/10/18/a-mac-traffic-jam-at-sallie-mae/ (Oct. 18, 2007, 15:33 EST).

3. Finish Line unsuccessfully alleged a MAC in Tennessee Chancery Court after refusing to close a $1.5 billion acquisition of Genesco; the private equity consortium of Bain Capital, the Carlyle Group, and Dubilier & Rice threatened Home Depot with a MAC claim after an agreement to purchase HD Supply for $10.325 billion, which resulted in a renegotiated agreement for nearly $2 billion less; Sallie Mae filed suit against the consortium of J.C. Flowers, JP Morgan Chase, and Bank of America, claiming that the consortium wrongfully asserted that a MAC occurred in refusing to close a $25.3 billion merger; KKR and GS Capital Partners asserted a MAC claim in refusing to close an $8 billion acquisition of Harman International. *See* Wachtell, Lipton, Rosen & Katz, Recent MAE Situations, Address at the National Economic Research Associates Symposium: When Can Buyers Walk? The Material Adverse Change Clause (Dec. 6, 2007) (presentation on file with author).

4. Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 331 (2005).

5. This Note will refer to the purchaser, seller, and target as the parties to the transaction. For the purposes of this Note, use of these definitional terms is not meant to imply that the transaction is a hostile takeover. This Note uses the terms in the context of a friendly, negotiated transaction, including mergers of equals. In some instances, the target may be the same company as the seller, and in other instances, the target may be a subsidiary of the parent seller company. In general, this Note will refer to the seller and the target interchangeably, unless otherwise specified.

6. *See* Nick J. Vizy, *Material Adverse Change Clauses*, *in* 2 CORPORATE COUNSEL'S GUIDE TO ACQUISITIONS & DIVESTITURES §§ 13, 13:2 (Thomson Reuters/West 2008).

7. *See id.*

8. Gilson & Schwartz, *supra* note 4, at 333–34.

> A realistic time frame for deal completion from signing to closing is at least 90 days. This estimate, of course, assumes that other conditions and regulatory review requirements can be satisfied in that period, an assumption that will often prove unrealistic, particularly in the case of mergers requiring regulatory approvals which may take six months or more to obtain.

David M. Silk, James Cole Jr. & Igor Kirman, *Takeover Law and Practice 2004*, *in* DOING DEALS array of events or changes that were unforeseen when the merger agreement was signed may occur during this interim period, and as a result, the purchaser may no longer wish to complete the deal.[9] The MAC, often included in the agreement as a defined term and a closing condition, grants the purchaser the option of walking away from the deal if a change occurs that is sufficient to trigger the clause.[10]

MAC clauses have existed in M&A agreements in the United States for the majority of the twentieth century.[11] Traditionally, the MAC clause was a short boilerplate provision that received little attention in negotiations.[12] In the last fifteen years, however, the MAC clause has transformed dramatically.[13] The typical modern MAC clause is now extraordinarily complex and detailed, as many corporate attorneys attempt to specify nearly all of the elements that could constitute a MAC and all of the carve-outs, or exceptions, to those elements.[14] Faiza Saeed, a corporate partner at Cravath, Swaine & Moore, described the transformed MAC clause as a "10-headed hydra."[15] Yet, no matter how detailed and complex a MAC clause becomes, it is still unlikely to cover the types of events that cause most MAC disputes, which are, by nature, unforeseen.

Serious consequences may stem from this recent transformation from the traditional MAC clause to the modern MAC clause.[16] First, transaction costs are attendant in the contentious negotiation and detailed drafting of the modern MAC clause. Second, the modern MAC clause may stand as one impediment to successfully negotiating a transaction. Third, the modern MAC clause may reduce the certainty that a transaction will close after the agreement is signed. Because even the purchaser and the seller are uncertain as to whether the complex MAC clause in their agreement will allow the purchaser to exit the deal, the modern MAC clause becomes the center of expensive disputes and litigation. Finally, the modern MAC clause may reduce clarity in the securities markets, potentially creating

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2005: UNDERSTANDING THE NUTS & BOLTS OF TRANSACTIONAL PRACTICE 9, 119 (PLI Corporate Law & Practice 2005).

9. *See* Dennis J. Block & Jonathan M. Hoff, *Material Adverse Change Provisions in Merger Agreements*, N.Y.L.J., Aug. 23, 2001, at 5.

10. *See* Adams, *supra* note 1, at 9–11.

11. *See* James J. Fuld, *Some Practical Aspects of a Merger*, 60 HARV. L. REV. 1092, 1105 (1947) (referring to a MAC clause in a closing condition in merger agreements in the 1940s).

12. *See* Gilson & Schwartz, *supra* note 4, at 331.

13. *See id.*

14. *See id.* at 330–31.

15. Redefining the MAC, http://dealbook.blogs.nytimes.com/2008/04/03/redefining-the-mac/ (Apr. 3, 2008, 11:16 EST) (quoting Faiza J. Saeed at the Tulane Corporate Law Institute).

16. *See* discussion *infra* Part IV.A.

arbitrage opportunities and inefficiencies in the functioning of the free market. As the MAC clause becomes increasingly detailed and complex, the market may become less certain as to whether the transaction will actually close. This may create inefficiencies in the ability of the market to accurately price the securities of the purchaser and seller.

This Note attempts to contribute to the existing literature by stepping back and addressing the potential problems with the modern MAC clause in the United States through the lens of a comparative-law analysis.[17] Primarily, the purpose of this Note is to shape the debate on whether the emerging trend in the United States to negotiate an increasingly detailed MAC clause is desirable or efficient. By highlighting a comparison with rules adopted in the United Kingdom, which has considered the issue and decided to prohibit detailed drafting of MAC clauses under certain circumstances, this Note examines the question of whether corporate attorneys in the United States could benefit from adopting practices similar to those in the United Kingdom.

Part II of this Note begins by examining the purpose of a MAC clause. This part then compares the simple traditional structure of a MAC clause to the complex modern structure that has emerged in the last fifteen years or so, emphasizing the factors that may have been driving this transformation. To provide perspective on the MAC clause in the United States, Part III outlines the MAC clause regime in the United Kingdom. Part IV analyzes the potential concerns with the modern MAC clause in the United States and explores whether the net benefits of allowing the freedom to negotiate the modern MAC clause outweigh the net benefits of implementing a form of MAC clause regulation. Finally, this Note underscores the need to initiate a critical investigation of the modern MAC clause in the United States, regardless of whether one ultimately determines that regulation may or may not be beneficial.

II. THE MAC CLAUSE IN THE UNITED STATES

A. PURPOSE OF THE MAC CLAUSE

An examination of the purpose of the MAC clause is a fundamental starting point, as it provides a foundation for critically analyzing the recent transformation from the traditional MAC clause to the modern MAC

17. This Note does not attempt to provide a detailed analysis of any particular judicial opinion or MAC clause dispute, and it does not attempt to provide drafting considerations for practitioners, both of which have been covered in the academic and professional literature.

clause. Several potential explanations of the purpose of the MAC clause exist, and it is possible that the purpose of the MAC clause has changed as it has transformed from the traditional form to the modern form. This section will explain the general purpose of the MAC clause, and then evaluate several theories that have been advanced to explain the purpose of the MAC clause.

1. The General Purpose of the MAC Clause

In general, the purpose of the MAC clause is to provide a means by which the purchaser may unilaterally refuse to close a merger or acquisition under certain circumstances.[18] The MAC clause can be understood primarily as an allocation of risk between the purchaser and the seller in the interim period between signing the agreement and closing the transaction—a term that has been defined by some as "interim risk."[19] Specifically, there is a risk that the value of the seller's firm could change in the time between signing and closing.[20] This interim period is typically one to three months, but in certain transactions it can extend for up to a year.[21] The length of the interim period between signing and closing may be influenced by the extent of the due diligence process or compliance with government regulatory procedures.[22] As the length of the interim period increases, the risk that the seller's value could change also increases. In short, the basic purpose of the MAC clause is to allow the purchaser to walk away from the transaction if the value of the seller changes in a sufficiently material and adverse manner. As discussed below, several theories discuss other aspects and conceptions of the purpose of the MAC clause, most notably in the context of the recent transformation of the MAC clause.

2. Symmetry Theory

The "symmetry theory" has been advanced as an explanation of the general purpose of the MAC clause.[23] In the absence of a MAC clause, the

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18. *See* Joseph B. Alexander, Jr., *The Material Adverse Change Clause*, 51 PRAC. LAW. 11, 11 (2005).

19. Rod J. Howard, *Deal Risk, Announcement Risk and Interim Changes—Allocating Risks in Recent Technology M&A Agreements*, *in* DRAFTING CORPORATE AGREEMENTS 2000–2001, at 217, 221 (PLI Corporate Law & Practice 2000).

20. *Id.*

21. Gilson & Schwartz, *supra* note 4, at 333–34.

22. *Id.* Examples of regulatory procedures include: preparing and filing a proxy statement with the Securities and Exchange Commission ("SEC"); registering securities with the SEC; complying with the filing and waiting period under the Hart-Scott-Rodino Premerger Notification Act; and seeking a revenue ruling from the Internal Revenue Service ("IRS"). *See id.* at 333.

23. *Id.* at 335–37.

risk that the seller's value may change in the interim period is not allocated symmetrically between the seller and the purchaser.[24] If the value of the seller increases in the interim period, the seller may not be bound by the agreement for a number of reasons.[25] For example, under Delaware law,[26] the seller's shareholders could refuse to approve the deal if it is subject to a shareholder vote, and the seller's board of directors could be legally obligated under a fiduciary duty to renegotiate with the purchaser or exit the deal to accept a superior offer.[27] The fiduciary duty of the seller's board of directors to secure the transaction offering the highest value reasonably attainable to the shareholders is triggered when the transaction will create a "change of control" in the seller.[28] Regardless of whether the fiduciary duty of the board of directors is triggered, the seller may be required to obtain shareholder approval of the proposed merger, which allows the seller's shareholders an option to reject the transaction after the merger agreement has been signed.[29] To protect this ability of the seller to seek competing bids if the value of the seller increases during the interim period, the Delaware courts have restricted the use of so-called "no shop" clauses in friendly merger agreements.[30]

If the value of the seller decreases, however, the purchaser likely may still be legally bound by the agreement to close the deal.[31] Thus, in the

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24. *Id.* at 336.

25. *Id.* at 335–36.

26. This Note primarily focuses on Delaware law because of the state's importance in matters of corporate law. In certain sections below, this Note also analyzes jurisprudence from other states, such as New York. This Note does not purport to provide a comprehensive comparative survey of corporate law in all fifty states. It should be noted, however, that certain states do not impose fiduciary duties on boards of directors as Delaware did in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, as discussed below. For example, Indiana, North Carolina, Pennsylvania, and Virginia have passed statutes explicitly stating that the duty of the board of directors in a change-of-control merger is no different than in any other situation. *See* Charles W. Mulaney, Jr., *Selected Issues in Deal Jumping: Bidding for a Target Already Party to a Merger Agreement*, *in* MERGERS & ACQUISITIONS 2006: WHAT YOU NEED TO KNOW NOW 111, 118 (PLI Corporate Law & Practice 2006).

27. *See* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1993); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). *See also* Mulaney, *supra* note 26, at 114–16.

28. *Paramount*, 637 A.2d at 45; *Revlon*, 506 A.2d at 182.

29. *See* Mulaney, *supra* note 26, at 118.

30. *See Paramount*, 637 A.2d at 51 ("The No-Shop Provision could not validly define or limit the fiduciary duties of the Paramount directors [as sellers]. To the extent that a contract, or a provision thereof, purports to require a board to act or not to act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable. Despite the arguments of Paramount and Viacom to the contrary, the Paramount directors could not contract away their fiduciary obligations. Since the No-Shop Provision was invalid, Viacom never had any vested contract rights in the provision." (citation omitted)).

31. Gilson & Schwartz, *supra* note 4, at 336.

absence of a MAC clause, the purchaser assumes the risk that the seller's value *decreases* during the interim period between signing the agreement and closing, but the seller may not assume the risk that the seller's value *increases* during that time span. In this context, the symmetry theory proposes that the purpose of the MAC clause can be understood as a contractual readjustment of this asymmetric risk allocation.

The symmetry theory has been rejected as an explanation for the purpose of the MAC clause by some academic commentators.[32] One possible argument against the symmetry theory is that the MAC clause existed well before the development of the Delaware case law in the 1980s, which in certain circumstances imposed a fiduciary duty on sellers to walk away from the agreement if a superior offer was presented.[33] Because the MAC clause predates the seller's option to refuse to close the transaction, some commentators argue that the purpose of the MAC clause cannot be a response to asymmetric risk allocation.[34]

A second possible argument against the symmetry theory is that the trend in M&A agreements since the developments in Delaware law suggests that the typical MAC clause does not actually correct the asymmetric risk allocation.[35] Although Delaware law may insulate sellers from the risk that its value increases above the price before closing the transaction, regardless of the underlying cause of the change in value, the typical MAC clause does not insulate the purchaser from the risk of a decrease in the seller's value due to causes that are exogenous to the seller.[36] For example, roughly 83 percent of MAC clauses include an exception specifying that changes in the "economy or business in general" would not constitute a MAC, and thus the seller could not use the MAC clause to exit the transaction.[37] Under an agreement that contained this common exception, the seller could walk away from the transaction if the seller's value increased before closing due to an upswing in the general economy, but the MAC clause would not allow the purchaser to walk away

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32. *E.g.*, *id.* at 332.

33. *Id.* at 349.

34. *Id.*

35. *See id.* at 349–54.

36. *Id.* Exogenous risk refers to risk that is beyond the control of the seller, such as the risk of a financial market crash.

37. NIXON PEABODY LLP, SIXTH ANNUAL MAC SURVEY 5 (2007) [hereinafter SIXTH SURVEY], *available at* http://www.nixonpeabody.com/linked_media/publications/MAC_survey_2007.pdf (reporting that 83 percent of their sample of 413 asset purchase, stock purchase, and merger agreements between June 1, 2006, and May 31, 2007, contained an exception for changes in the economy or business in general).

from the transaction if the seller's value decreased before closing due to a downswing in the general economy. Thus, in 83 percent of transactions, the MAC clause explicitly maintains a significantly asymmetric risk allocation.[38] Some commentators conclude that the historical existence of MAC clauses before the developments in Delaware law in the 1980s, in addition to the remaining asymmetry in risk allocation, effectively undercut the symmetry theory as a plausible explanation of the purpose of the MAC clause.[39]

3. Investment Theory

Another potential explanation of the purpose of the MAC clause is the "investment theory."[40] The investment theory focuses on the ability of the seller to make investments in itself and in the integration process to begin the realization of synergies during the interim period between signing and closing.[41] Without a MAC clause in the merger agreement, the seller might have less of an incentive to make synergistic investments, especially when those investments would reduce the stand-alone value of the seller.[42] In other words, the seller is subject to a type of moral hazard problem in the interim period.[43] The investment theory posits that the purpose of the MAC clause is to mitigate this moral hazard problem by providing the purchaser with a credible threat to encourage the seller to make investments that could efficiently prevent a decrease of its value in the interim period.[44] The investment theory suggests that an efficient MAC clause should allocate endogenous risk[45] to the seller and exogenous risk to the purchaser.[46] For example, according to the investment theory, an efficient MAC clause would allocate to the seller the risk of a value decrease due to a loss of key customers, and it would allocate to the purchaser the risk of a value decrease due to a market-wide financial crisis. As explained below in Part

38. *See id.*

39. *See, e.g.*, Gilson & Schwartz, *supra* note 4, at 349–54.

40. *Id.* at 337–40.

41. *Id.* at 337.

42. *Id.* at 338. Examples of investment in synergy include the following: integrating the seller's product line with the purchaser's product line, discontinuing or altering research and development strategy, retaining valuable employees, and retaining customers and suppliers. *Id.* at 337.

43. "Moral hazard" generally refers to the concept that if a person is insulated from risk, he may act differently than he otherwise would. Specifically, if a person is protected from the consequences of an undesirable action, then he may be more likely to act badly. Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 238 (1996).

44. Gilson & Schwartz, *supra* note 4, at 338–39.

45. In this context, endogenous risk refers to risk that the seller can control to some extent, such as the risk of losing employees or supplier contracts to competitors.

46. Gilson & Schwartz, *supra* note 4, at 339.

II.C, some commentators argue that the investment theory explains not only the purpose of the MAC clause, but also the transformation from the simple traditional MAC clause to the complex modern MAC clause.[47]

Although the investment theory may make sense on an abstract academic level, it does not seem to be a realistic explanation of the purpose of the MAC clause. It seems questionable that the corporate attorneys who are drafting MAC clauses intend to create an incentive for the seller to make synergistic investments. If the purchaser seeks to encourage the seller to make such investments in the interim period between signing and closing, it is unlikely that they would use the MAC clause to accomplish that purpose. Indeed, the MAC clause would be a circuitous method of encouraging the seller to make investments, especially considering that M&A agreements often include direct and explicit covenants regarding the operation of the business in the interim period.[48] Indeed, the purchaser and the seller typically agree on a covenant regarding the operation of the seller's business, in which the parties specifically agree on the protocol for the seller's investments and strategic decisions during the interim period.[49] It is unlikely that the MAC clause is actually a backdoor method of accomplishing goals that are already addressed directly in other sections of the agreement. Thus, the investment theory ultimately seems unpersuasive as a realistic explanation of the purpose of the MAC clause.

4. Renegotiation Leverage Theory

In practice, the purpose of the MAC clause arguably could be understood as a vehicle to allocate leverage in renegotiating the terms of the merger agreement if an event occurs that could potentially be a MAC. Proponents of the investment theory argue that the threat of the purchaser successfully invoking a MAC clause must be credible to create the proper incentive for the seller to engage in synergistic investments that would increase the value of the merged entity postclosing.[50] Some have suggested, however, that the MAC clause is more of an instrument to gain a bargaining chip in the renegotiation process, rather than a viable method of unilaterally walking away from the deal.[51] One reason why MAC clauses

47. *E.g.*, *id.* at 357–58.

48. *See* AM. BAR ASS'N COMM. ON NEGOTIATED ACQUISITIONS, MODEL ASSET PURCHASE AGREEMENT WITH COMMENTARY §§ 5, 5.2 (2001) (discussing the "Covenants of Seller Prior to Closing" and, specifically, the "Operation of the Business of Seller" covenant).

49. *Id.*

50. *See* Gilson & Schwartz, *supra* note 4, at 356–57.

51. Jessica Hall, *Scuttling Deals? More a Threat than Reality*, REUTERS, Sept. 18, 2007, http://www.reuters.com/article/reutersEdge/idUSN1845894020070918?sp=true.

are used as leverage in renegotiations could be that strategic partners in a merger or acquisition have already invested substantially in the process, and the transaction costs of finding a new strategic partner can be significant.[52] Although difficult to prove empirically, anecdotal evidence suggests that the renegotiation leverage theory explains the MAC clause process to some extent.[53]

5. Rethinking Purpose in the Context of the Modern MAC Clause

As the MAC clause has transformed from its traditional form to its modern form, its purpose has become something of a paradox. The traditional MAC clause was originally designed primarily to address *unforeseen* risks, and it did so in standard boilerplate terms.[54] In what has perhaps been an attempt to reduce uncertainty, the terms of the MAC clause have become more specific, as purchasers and sellers now heavily negotiate an increasingly long and detailed list of MAC elements and exceptions. By definition, however, unforeseen risks cannot be specified. As the MAC clause has become more specific, it potentially departs from the original purpose of covering unforeseen interim risks. As explained in the next section and in Part IV.A below, it is not clear that the modern MAC clause significantly reduces uncertainty among the parties or in the market regarding whether the transaction will actually close.[55] The next section explains how the purpose of the MAC clause is reflected in its structure, and how that structure has changed dramatically in the relatively recent past.

B. STRUCTURE OF THE MAC CLAUSE

To understand whether the modern MAC clause is efficient or desirable, it is first necessary to understand the structure of the typical MAC clause and how that structure has changed. Understanding the structure is also essential because MAC clause regulation, as enacted in the United Kingdom, has been directed in part at controlling the structure of

52. *See The Art of Walking Away from the Deal*, KNOWLEDGE@WHARTON, Jan. 11, 2006, http://knowledge.wharton.upenn.edu/articlepdf/1343.pdf?CFID=1741866&CFTOKEN=26495023&jsessionid=a830a4420d3a1c80e3cb4d30531d244e1b18.

53. *See* Hall, *supra* note 51.

54. *See* Gilson & Schwartz, *supra* note 4, at 331.

55. *See* Paritosh Bansal, *Wall St. Looks for Legal Precedent in Deal Disputes*, REUTERS, Mar. 9, 2008, http://www.reuters.com/article/reutersEdge/idUSN0935434820080310 ("Although MAC clauses are becoming more specific, they can still lead to disputes as people negotiating these contracts cannot anticipate everything.").

the MAC clause.[56] This section will explain *how* the structure of the MAC clause has transformed in the United States, and the following section will explore *why* the MAC clause has transformed.

The basic structure of the traditional MAC clause in an M&A agreement was relatively uncomplicated, but the modern structure is now subject to myriad variations.[57] The main content of the MAC clause is found in the "defined terms" section of an M&A agreement,[58] and nearly every merger agreement now contains a negotiated definition of a MAC.[59] The following is an example of how a MAC might be defined in a merger agreement: *"Material Adverse Change" means any material adverse change in the business, results of operations, assets, liabilities, or financial condition of the Seller, as determined from the perspective of a reasonable person in the Purchaser's position*.[60]

Several elements of the above example may be subject to negotiation. First, the parties may disagree on the appropriate perspective from which to determine whether a MAC has occurred.[61] A relatively common variation of the MAC definition—and one that is more purchaser friendly—is simply to state that a MAC is determined from the purchaser's perspective, rather than from the perspective of a reasonable person in the purchaser's position.[62] Another potential variation on the example above is whether "material" is defined within the definition of a MAC.[63] In some agreements, the parties may attempt to define a MAC by setting a specific dollar-value threshold.[64] For example, in a 2001 agreement between Great Lakes Chemical and Pharmacia, the purchase agreement defined a MAC as "a negative effect or negative change on the operations, results of operations or condition (financial or otherwise) in an amount equal to $6,500,000 or more,"[65] representing about 5 percent of the transaction,

56. *See* discussion *infra* Part III.

57. *See generally* Adams, *supra* note 1 (discussing variations in the structure and provisions of MAC clauses).

58. *See id.* at 10; *Second Annual MAC Survey Reveals Buyer-Friendly Trends*, M&A ADVISOR (Nixon Peabody LLP, New York, N.Y.), July 2003, at 1 [hereinafter *Second Survey*], *available at* http://www.nixonpeabody.com/linked_media/publications/MAAdvisor_07002003.pdf.

59. SIXTH SURVEY, *supra* note 37, at 4 (reporting that only 1 percent of their sample of 413 asset purchase, stock purchase, and merger agreements between June 1, 2006, and May 31, 2007, contained a MAC clause without including MAC or material adverse effect in the defined terms).

60. Adams, *supra* note 1, at 21 (emphasis in original).

61. *Id.* at 24–26.

62. *Id.* at 24–25.

63. *Id.* at 26–27.

64. *See* SIXTH SURVEY, *supra* note 37, at 3.

65. Great Lakes Chem. Corp. v. Pharmacia Corp., 788 A.2d 544, 557 (Del. Ch. 2001).

which was worth approximately $125 million.[66] This type of specific dollar threshold is a rare element in the definition of MAC clauses, but it does appear in approximately 3 to 6 percent of all agreements.[67]

While the definition of a MAC may contain any combination of elements that the parties agree constitutes a MAC, some elements are found in a significant percentage of agreements.[68] The following elements are the most common in MAC definitions: (1) a MAC on the business, operations, or financial condition of the target; (2) a MAC on the seller's ability to close the transaction; and (3) a MAC on the purchaser's ability to close the transaction.[69] Table 1, below, illustrates the prevalence of specific elements in the MAC definitions in asset purchase, stock purchase, and merger agreements from June 2006 to June 2007.[70]

TABLE 1: PREVALENCE OF MAC ELEMENTS, JUNE 2006 TO JUNE 2007.

MAC Element	**Percentage of agreements in which the element occurred**
The business, operations, or financial condition of the target	95%
The seller's ability to close the transaction	49%
The purchaser's ability to close the transaction	24%
A loss over a specified dollar threshold is a MAC	3%
The securities or purchased assets	3%
The validity or enforceability of deal	2%
The purchaser's ability to use the assets as the seller did	2%
The prospects of the target or seller	2%

66. *Id.* at 546.

67. In 2003, a specific dollar threshold appeared in the MAC definition in 6 percent of agreements. *See Second Survey*, *supra* note 58, at Ex. A. In 2006, a specific dollar threshold appeared in the MAC definition in 3 percent of agreements. *Fifth Annual MAC Survey*, M&A ADVISOR (Nixon Peabody LLP, New York, N.Y.), Oct. 2006, at 4 [hereinafter *Fifth Survey*], *available at* http://www.nixonpeabody.com/ linked_media/publications/MAAdvisor_10232006.pdf. In 2007 as well, a specific dollar threshold appeared in the MAC definition in 3 percent of agreements. SIXTH SURVEY, *supra* note 37, at 3.

68. Vizy, *supra* note 6, § 13:3.

69. SIXTH SURVEY, *supra* note 37, at 3 (reporting the percentage of merger agreements that included certain elements in their sample of 413 agreements between June 1, 2006, and May 31, 2007).

70. *See id.*

The specific elements that constitute a MAC fluctuate from year to year.[71] An increase in the number of elements generally suggests that the purchaser holds more negotiating leverage, as each MAC element expands the set of events that could allow the purchaser to unilaterally exit the deal.[72] Conversely, a MAC definition with fewer elements generally favors the seller.[73]

Although MAC definitions traditionally only included a brief statement of the MAC elements, most agreements now include a list of MAC exceptions that are specifically carved out of the definition.[74] The MAC exceptions in a given agreement will depend on the relative bargaining power of the parties and the external events that are of particular concern at the time the agreement is drafted. In general, more exceptions favor the seller, and fewer exceptions favor the purchaser.[75] Table 2 illustrates the prevalence and range of MAC exceptions from June 2006 to June 2007.[76]

TABLE 2: PREVALENCE OF MAC EXCEPTIONS, JUNE 2006 TO JUNE 2007.

MAC Element	**Percentage of agreements in which the element occurred**
Decline in the economy or business in general	83%
Decline in the general conditions of the specific industry	73%
Changes caused by an announcement of the transaction	71%
Changes caused by acts of terrorism	61%
Changes in GAAP	63%
Change in law or regulations	59%
Change caused by taking of action permitted by the agreement	56%
Decline in the securities markets	51%

71. *Id.* at 2.
72. *See id.* at 1.
73. *Id.*
74. Vizy, *supra* note 6, § 13:8. *See also* Gilson & Schwartz, *supra* note 4, at 350 (reporting that 83 percent of merger agreements contained at least one MAC exception in their sample of 100 merger agreements in 2000).
75. SIXTH SURVEY, *supra* note 37, at 1.
76. *Id.* at 5–10.

Change in political conditions	37%
Decline in the trading price/volume of the target stock	36%
Change in the interpretation of laws by courts or government	32%
Failure by the target to meet revenue or earnings projections	32%
Acts of God	23%
Loss of employees	18%
Change in interest rates	17%
Litigation relating to the deal	16%
National calamity	12%
Change in exchange rates	10%
Developments arising from facts expressly disclosed	9%
Expenses incurred in connection with deal transactions	8%
Change in the target's relationship with labor organizations	6%
Change in applicable taxes	4%
Acts by which the target is bound by law or contract	4%
Delay or cancellation of orders	3%

Although Table 2 demonstrates a wide range of exceptions, it is not exhaustive. The negotiating parties can include any exceptions upon which they agree. For example, in a disputed 2007 agreement between Accredited Home Lenders and private equity fund Lone Star Funds, the MAC clause included eleven different exceptions.[77] The MAC clause drafted in this deal is reproduced in the footnote below to illustrate just how complex the modern MAC clause has become, as compared to the traditional MAC clause.[78]

77. Accredited Home Lenders Holding Co., Agreement and Plan of Merger (Form 8-K, Ex. 2.1), at 5–6 (June 4, 2007) [hereinafter Agreement and Plan of Merger]. For a complete discussion of the dispute between Accredited Home Lenders and Lone Star Funds, see Steven M. Davidoff & Kristen Baiardi, Accredited Home Lenders v. Lone Star Funds*: A MAC Case Study* (Wayne State Univ. Law Sch., Research Paper No. 08-16, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092115.

78. The agreement between Accredited Home Lenders and Lone Star Funds contained this MAC clause:

> "*Material Adverse Effect*" means, with respect to the Company, an effect, event, development or change that is materially adverse to the business, results of operations or financial condition of the Company and the Company Subsidiaries, taken as a whole; *provided*, *however*, that in no event shall any of the following, alone or in combination, be deemed to

The defined MAC term is generally applied within the agreement to the representations and warranties, the covenants, and the closing conditions.[79] The following is a possible example of a MAC clause representation in an agreement: *Since January 1, 2008, no MAC has occurred*.[80] An example of a MAC representation that would potentially give the purchaser more leeway to invoke a MAC could be: *Since January 1, 2008, no events or circumstances have occurred that constitute, individually or in the aggregate, a MAC*.[81] Another type of MAC

> constitute, nor shall any of the following be taken into account in determining whether there has been, a Material Adverse Effect: (a) a decrease in the market price or trading volume of Company Common Shares (but not any effect, event, development or change underlying such decrease to the extent that such effect, event, development or change would otherwise constitute a Material Adverse Effect); (b) (i) changes in conditions in the U.S. or global economy or capital or financial markets generally, including changes in interest or exchange rates; (ii) changes in applicable Law or general legal, tax, regulatory or political conditions of a type and scope that, as of the date of this Agreement, could reasonably be expected to occur, based on information that is generally available to the public or has been Previously Disclosed; or (iii) changes generally affecting the industry in which the Company and the Company Subsidiaries operate; *provided*, in the case of clause (i), (ii) or (iii), that such changes do not disproportionately affect the Company and the Company Subsidiaries as compared to other companies operating in the industry in which the Company and the Company Subsidiaries operate; (c) changes in GAAP; (d) the negotiation, execution, announcement or pendency of this Agreement or the transactions contemplated hereby or the consummation of the transactions contemplated by this Agreement, including the impact thereof on relationships, contractual or otherwise, with customers, suppliers, vendors, lenders, mortgage brokers, investors, venture partners or employees; (e) earthquakes, hurricanes, floods, or other natural disasters; (f) any affirmative action knowingly taken by Parent or Purchaser that could reasonably be expected to give rise to a Material Adverse Effect (without giving effect to this clause (f) in the definition thereof); (g) any action taken by the Company at the request or with the express consent of any of the Buyer Parties; (h) failure by the Company or the Company Subsidiaries to meet any projections, estimates or budgets for any period prior to, on or after the dates of this Agreement (but not any effect, event, development or change underlying such failure to the extent such effect, event, development or change would otherwise constitute a Material Adverse Effect); (i) any deterioration in the business, results of operations, financial condition, liquidity, stockholders' equity and/or prospects of the Company and/or the Company Subsidiaries substantially resulting from circumstances or conditions existing as of the date of this Agreement that were generally publicly known as of the date of this Agreement or that were Previously Disclosed; (j) any litigation or regulatory proceeding set forth in Section 5.09 of the Company Disclosure Schedule (but only to the extent of the specific claims and allegations comprising such litigation or regulatory proceeding existing as of the date of this Agreement; and (k) any action, claim, audit, arbitration, mediation, investigation, proceeding or other legal proceeding (in each case whether threatened, pending or otherwise), or any penalties, sanctions, fines, injunctive relief, remediation or any other civil or criminal sanction solely resulting from, relating to or arising out of the failure by either the Company or the Reporting Subsidiary to file in a timely manner its Annual Report on Form 10-K for the fiscal year ended December 31, 2006, its Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, and/or the Quarterly Report on Form 10-Q for the second and third quarters of 2007.

Agreement and Plan of Merger, *supra* note 77, at 5–6.

79. *See* Adams, *supra* note 1, at 10–13; Block & Hoff, *supra* note 9.

80. *See* Adams, *supra* note 1, at 10.

81. *See id.* As opposed to the first example, this variation would theoretically allow the purchaser to aggregate several smaller adverse events—each insufficient to constitute a MAC alone—to refuse to close the transaction. As discussed later, it may be difficult to enforce this in court, especially in Delaware.

representation could be the following: *Neither the Seller nor the Target is party to any litigation that would reasonably be expected to result in a MAC*.[82] The MAC provision can also be used in a covenant.[83] For example, the merger agreement may include a covenant by which the seller agrees to provide the purchaser with prompt notice of the occurrence of any MAC.[84]

The closing conditions in the merger agreement will often also include or incorporate MAC provisions. This is what allows the purchaser to walk away from the transaction if a MAC occurs. A closing condition may specifically list a MAC provision similar or identical to the MAC provisions in the representations and warranties.[85] A more effective and common method of incorporating the MAC provisions in the other sections of the merger agreement into the closing conditions is to use a "bringdown condition."[86] A typical bringdown condition could be stated as follows: *The Purchaser's obligation to consummate at the Closing the transactions contemplated by this agreement is subject to satisfaction, or waiver by the Purchaser, of the following conditions at or prior to the Closing: The representations of Target contained in this agreement were accurate as of the date of this agreement and are accurate as of the Closing Date*.[87] The bringdown condition allows the purchaser to refuse to close the transaction if one of the representations or covenants becomes inaccurate, which has the effect of applying the MAC clause to the closing provision.[88]

As explained below in Part II.C, the MAC elements and exceptions are becoming more numerous and complex, and the MAC clause is now often heavily negotiated.[89] In general, the seller usually values certainty in closing the deal and, thus, attempts to limit the ability of the purchaser to invoke the MAC clause. To do this, the seller typically seeks to limit the MAC clause by narrowly tailoring the elements that constitute a MAC and by including a range of exceptions.[90] In contrast, the purchaser usually

82. *See id.* at 11.

83. *See id.* at 12.

84. *Id.*

85. *Id.* at 11–12.

86. *Id.*

87. *See id.* at 13.

88. *Id.* at 11–12.

89. SIXTH SURVEY, *supra* note 37, at 1; Block & Hoff, *supra* note 9; *Drafting Material Adverse Change Clauses in Light of Delaware Case Law*, INSIDE M&A (McDermott Will & Emery, Chicago, Ill.), Nov./Dec. 2007, at 1 [hereinafter *Drafting MAC Clauses*], *available at* http://www.mwe.com/info/news/insidem&a1207.pdf (explaining that "MAC clauses are highly negotiated in today's deal environment").

90. *See* Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 849.

values the ability to walk away from the deal and thus seeks to make the MAC clause as broadly applicable as possible.[91]

C. Transformation from the Traditional MAC to the Modern MAC

The preceding section explained the fundamentals of the structure of the MAC clause and *how* the typical MAC clause has changed from a simple structure to a complex structure in the United States. This section will explore and evaluate potential explanations of *why* this transformation has occurred. This transformation prompted one prominent M&A attorney to state: "I do think that it's fair to ask, and I have gone back and looked at definitions, does anyone understand what's being carved out here?"[92] Why did this happen?

From what was once a boilerplate provision in an M&A agreement, the MAC clause has dramatically transformed into a highly negotiated provision with an increasing number of complex elements and exceptions.[93] The transformation of the MAC clause is a relatively recent development.[94] The traditional MAC clause has been used—in some basic form—in merger agreements since at least 1947,[95] but the elements that constitute a MAC and the exceptions that are carved out of the MAC have expanded tremendously since the early 1990s. In 1993, roughly 18 percent of MAC clauses contained a specific exception to the traditional elements of a MAC, and the average MAC clause in 1995 included less than one exception.[96] By 2000, approximately 83 percent of MAC clauses contained at least one exception, and the average MAC clause included nearly four exceptions.[97] The trend has continued throughout this decade, as MAC clauses are being defined with increasing specificity and include an expanding number of exceptions.[98] As noted above, the widely publicized MAC clause from the 2007 agreement between Accredited Home Lenders

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91. *Id.*

92. Redefining the MAC, *supra* note 15 (quoting Faiza J. Saeed at the Tulane Corporate Law Institute).

93. *See* Gilson & Schwartz, *supra* note 4, at 331; Howard, *supra* note 19, at 230–32.

94. *See* Gilson & Schwartz, *supra* note 4, at 331; Howard, *supra* note 19, at 248.

95. Fuld, *supra* note 11, at 1105 (explaining that a condition upon closing may include the following language: "There has been no material adverse change in the conditions of the Company from that set forth in its Proxy Statement, other than changes arising in the ordinary and normal course of business.").

96. Gilson & Schwartz, *supra* note 4, at 350.

97. *Id.*

98. *See* SIXTH SURVEY, *supra* note 37, at 1.

and Lone Star Funds included eleven separate exceptions.[99] In addition, the elements that constitute a MAC are being defined with increasing specificity.[100] This increased specificity in drafting has been accompanied by increased conflict and negotiation difficulties in drafting merger agreements.[101] In short, the traditional MAC clause has transformed into a complex and contentious focal point of M&A agreement negotiations.

What has been driving the transformation from the traditional MAC clause to the modern MAC clause? A definitive explanation—if one exists—is beyond the scope of this Note. Instead, as a prelude to evaluating whether the traditional or the modern MAC clause is preferable, this Note will briefly evaluate several explanations for the transformation, and suggest the extent to which these explanations may be competing or complementary. The goal is to shed some light on whether the modern MAC clause is an improvement on the traditional MAC clause. This section will explore several potential factors that may, in the aggregate, help to explain the transformation to the modern MAC clause. The first potential driving factor is external events, such as financial crises, terrorist attacks, and natural disasters. Second, the transformation may have begun as a response to the unique nature of high-technology transactions in Silicon Valley in the 1990s, and the modern MAC clause may have spread to the rest of the economy through a process of sociological diffusion. Third, judicial opinions, especially in the Delaware Chancery Court, may help to explain the transformation. Finally, the level of volatility of the economy may also be a driving factor.

1. Unprecedented and Unforeseen External Events

One potential driving factor in the transformation of the traditional MAC clause to the modern MAC clause could be the occurrence of unprecedented and unforeseen external events, such as financial crises, terrorist attacks, or natural disasters. It is apparent that specific MAC exceptions seem to appear in M&A agreements in the wake of significant external events.[102] For example, in the year following the terrorist attacks of September 11, 2001, the percentage of agreements that included a MAC exception for "acts of terrorism" more than doubled.[103] Similarly, in the

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99. Agreement and Plan of Merger, *supra* note 77, at 5–6.

100. *See* SIXTH SURVEY, *supra* note 37, at 3.

101. *See* Block & Hoff, *supra* note 9; *Drafting MAC Clauses*, *supra* note 89, at 1.

102. *See Second Survey*, *supra* note 58, at 2.

103. *Id*. (reporting that the percentage of MAC clauses that included an exception for "acts of terrorism" increased from 7 percent to 15 percent).

two years following the disastrous 2005 hurricane season that included hurricane Katrina, the percentage of agreements that included an exception for "events of weather or other acts of God" increased from 3 percent to 23 percent.[104] These examples, however, better explain the *nature* of the modern MAC clause, rather than explaining the *cause* of the transformation. In other words, drafters of the modern MAC clause will now respond to significant external events by including them in the agreements, but the external events themselves do not seem to explain what started this practice. This is evinced in part by the simple fact that many significant external events occurred well before the MAC clause transformation began in the early 1990s.[105]

2. Contractual Innovation in Silicon Valley M&A

A second potential driving factor for the MAC clause transformation relates to the development of technology M&A transactions in Silicon Valley in the 1990s. Some have explained that the trend of increasing the specificity of the MAC clause and increasing the number of MAC exceptions was started by Silicon Valley M&A attorneys.[106] Those attorneys altered the MAC clause in response to the unique features of the technology business and transactions between technology companies.[107] These features included the following: unusually rapid change in competition; overwhelming importance of human assets; extraordinarily short product cycles; and higher volatility in stock.[108] Rod Howard, co-head of M&A at the Silicon Valley law firm of Brobeck, Phleger & Harrison LLP, explained that the technology industry in the 1990s presented several unusual characteristics and novel risks,[109] and Silicon Valley attorneys responded in part by changing the MAC clause.[110]

104. SIXTH SURVEY, *supra* note 37, at 7 (reporting that 23 percent of MAC clauses contained an exception for "events of weather or other acts of God"); *Fourth Annual MAC Survey*, M&A ADVISOR (Nixon Peabody LLP, New York, N.Y.), Oct. 2005, at 4, *available at* http://www.nixonpeabody.com/linked_media/publications/MAAdvisor_ 10172005.pdf (reporting that 3.1 percent of MAC clauses contained an exception for "Events of weather or other acts of God" in 2005). The attorneys at Nixon Peabody speculated that the dramatic increase "may reflect heightened concerns in the wake of recent catastrophic weather events, such as the Southeast Asia tsunami in 2004 and Hurricane Katrina in 2005." *Fourth Annual MAC Survey*, *supra*.

105. For example, external events such as World War II, the Vietnam War, and the 1970s oil crisis did not result in a transformation of the MAC clause.

106. Howard, *supra* note 19, at 224–32.

107. *Id.* at 224–27. The author, Howard stated that he is partially responsible for the developments in the MAC clause. *Id.* at 217 n.2.

108. *Id.* at 226–30.

109. *Id.*

110. *Id.* at 226.

In 2000, Howard stated that "[i]ncreasingly, the question in technology M&A is not whether or not to have carve-outs to the MAC[] clause, but how far to go."[111] Howard further explained that "[w]hile broad MAC[] carve-outs appear to have been a Silicon Valley innovation, they have increasingly spread to deals involving technology companies outside Silicon Valley."[112] When the article was written in 2000, it was still true that "broad MAC[] carve-outs remain more common in mergers involving at least one Silicon Valley company or Silicon Valley legal or financial advisers."[113] The trend of expanding the MAC clause has continued since the article was written in 2000, and today the modern MAC clause has spread to M&A transactions across virtually all industries and geographical regions in the United States.[114]

Assuming the modern MAC clause was in fact an innovation of Silicon Valley law firms in response to the technology transactions of the 1990s, the question remains as to why the modern MAC clause has become so prevalent in virtually all other types of M&A agreements in the United States. One possible explanation could be that transactional attorneys expected that courts may consider the specific drafting of MAC clauses in technology agreements when interpreting MAC clauses in other industries.[115] Specifically, transactional attorneys in various fields may have been concerned that a court would view the ambiguity in the traditional MAC clause differently after some parties in the technology—or any other—industry began drafting specific and explicit MAC clauses.[116] Related elements of momentum and inertia may partially explain the widespread diffusion of the modern MAC clause. For example, sociology literature has explored the diffusion of corporate legal instruments, such as poison pills, resulting from repeated interactions among a network of corporate executives and attorneys.[117] In sum, there appears to be some support for the hypothesis that the MAC clause transformation is a product of contractual innovation in response to technology M&A in Silicon Valley in the 1990s.

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111. *Id.* at 230.

112. *Id.*

113. *Id.* at 232.

114. *See* Gilson & Schwartz, *supra* note 4, at 354–55.

115. *See id.* at 354.

116. *Id.*

117. *See, e.g.*, Gerald F. Davis & Henrich R. Greve, *Corporate Elite Networks and Governance Changes in the 1980s*, 103 AM. J. SOC. 1, 1 (1997).

3. Response to Judicial Opinions

Another potential driving factor in the MAC clause transformation could be the effect of certain judicial opinions. Specifically, some commentators have suggested that a New York Supreme Court decision in 1988 caused transactional attorneys to reconsider the nature and structure of the traditional MAC clause.[118] In the highly publicized case of *Bear Stearns v. Jardine*,[119] Bear Stearns sued the Hong Kong brokerage house, Jardine Strategic Holdings, for withdrawing from an agreement to purchase a 20 percent stake in Bear Stearns for $400 million.[120] Jardine agreed to pay $23 per share, but withdrew from the agreement after the Bear Stearns stock fell to under $10 per share following the stock market crash on Black Monday—October 19, 1987.[121] In addition to the drop in stock price, Bear Stearns suffered an $18.3 million loss in October—the first monthly loss in the history of the company.[122] Moreover, Bear Stearns also suffered an immediate $100 million loss as a result of transactions in its arbitrage and clearance departments.[123]

Despite all of the deleterious effects that Bear Stearns suffered on Black Monday, the New York Supreme Court rejected arguments by the purchaser, Jardine, based on a traditionally broad MAC clause, that a MAC had occurred.[124] The court held that a MAC could not be established as a matter of law, in part because (1) Jardine had been advised that the market was at a peak, (2) Jardine understood the risk involved in the transaction, and (3) Bear Stearns' short-term and long-term prospects were arguably improved by Black Monday relative to its industry peers.[125] As noted above, some commentators have suggested that this judicial decision was a catalyst in the transformation from the traditional MAC clause to a more

118. *See, e.g.*, Gilson & Schwartz, *supra* note 4, at 354.

119. *Court Decisions: Bear Stearns Cos. v. Jardine Strategic Holdings Ltd.*, N.Y.L.J., June 13, 1990, at 22 [hereinafter *Bear Stearns Cos. v. Jardine Strategic Holdings Ltd.*] (citing Bear Stearns Cos. v. Jardine Strategic Holdings Ltd., No. 31371187, slip op. (N.Y. Sup. Ct. June 17, 1988), *aff'd mem.*, 533 N.Y.S.2d 167 (App. Div. 1988)); *Bear Stearns Sues Jardine*, N.Y. TIMES, Dec. 11, 1987, at D3.

120. *Bear Stearns Cos. v. Jardine Strategic Holdings Ltd.*, *supra* note 119. Bear Stearns sought $200 million in the law suit. *Id.*

121. *See id.* On Sept. 30, 1987—the day that the deal was announced—Bear Stearns' stock closed at $17.28. *See* Historical Prices: The Bear Stearns Companies Inc., http://finance.google.com/finance/historical?cid=4167&startdate=Sept+30%2C+1987&enddate=Oct.+20%2C+1987&histperiod=daily (last visited Nov. 4, 2008). On Oct. 20, 1987, the stock closed at $8.64. *See id.*

122. *Bear Stearns Cos. v. Jardine Strategic Holdings Ltd.*, *supra* note 119.

123. *Id.*

124. *Id.*

125. *Id.*

extensively and specifically drafted modern MAC clause, as corporate counsel for sellers attempted to avoid Jardine's fate.[126]

While the 1988 *Jardine* decision may have inadvertently sparked the transformation to the modern MAC clause, the Delaware Chancery Court in 2001 implicitly attempted to prevent specific negotiation of complex MAC clauses. The Delaware Chancery Court case of *In re IBP, Inc. Shareholders Litigation* involved an agreement by Tyson, the nation's largest chicken distributor, to purchase IBP, the nation's largest beef and second-largest pork distributor.[127] Tyson agreed to pay approximately $3.2 billion for IBP stock and to assume about $1.5 billion in IBP debt.[128] In the interim period between signing and closing, both companies suffered livestock supply losses and IBP also restated earnings as a result of an accounting impropriety.[129] Tyson withdrew from the merger and sued IBP for fraudulently inducing Tyson into the deal; IBP countersued to enforce the agreement, and Tyson claimed that the traditional MAC clause granted it the right to withdraw.[130]

In what is widely considered to be the seminal MAC clause case in the United States, the Delaware Chancery Court found that a MAC had not occurred and ordered specific performance of the merger agreement.[131] Vice Chancellor Leo E. Strine Jr. held that

> [m]erger contracts are heavily negotiated and cover a large number of specific risks explicitly. As a result, even where a [MAC] condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror.[132]

Vice Chancellor Strine reasoned that a "*contrary rule will encourage the negotiation of extremely detailed 'MAC' clauses with numerous carve-outs or qualifiers*. An approach that reads broad clauses as addressing fundamental events that would materially affect the value of a target to a

126. *See* Gilson & Schwartz, *supra* note 4, at 354.
127. *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 21 (Del. Ch. 2001).
128. David Barboza & Andrew Ross Sorkin, *Tyson to Acquire IBP in $3.2 Billion Deal*, N.Y. TIMES, Jan. 2, 2001, at A13.
129. *In re IBP*, 789 A.2d at 47–49.
130. *Id.* at 50–52.
131. *Id.* at 71, 84.
132. *Id.* at 68 (footnote omitted).

reasonable acquiror eliminates the need for drafting of that sort."[133]

It seems apparent that Vice Chancellor Strine framed the default rule with the goal of reversing or preventing the transformation of the traditional MAC clause into the modern MAC clause. In creating a high threshold for successfully invoking a MAC clause, the *IBP* decision strongly suggests that Vice Chancellor Strine intended to encourage practitioners to draft simple MAC clauses. Despite Vice Chancellor Strine's apparent intentions, the decision has failed to discourage "extremely detailed" drafting in the modern MAC clause, perhaps due to some combination of factors discussed below.

The Delaware Chancery Court followed the *IBP* decision in another important MAC clause decision in 2005.[134] In *Frontier Oil Corp. v. Holly Corp.*, the merger of the two oil companies became derailed before closing when a wholly-owned subsidiary of the seller, Frontier Oil, became the target of a series of toxic tort lawsuits that were initiated by environmental activist Erin Brockovich.[135] The Delaware Chancery Court adopted the *IBP* standard—which had interpreted New York law—as Delaware law,[136] and held that the pending environmental mass tort litigation was not sufficient to constitute a MAC.[137] The opinion explained that "[t]he notion of [a MAC] is imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties."[138] The *Frontier Oil* decision potentially had the effect of encouraging practitioners to make MAC clauses even more specific, more complex, and more negotiated.[139] Some practitioners apparently believed

> [t]he most obvious lesson [from *Frontier Oil*] relates to the definition of [a MAC] . . . .
>
> [Attorneys] should carefully draft the [MAC] provisions in the acquisition documents to specifically identify these types of [risks] as something that would constitute a [MAC]. Furthermore, one may want to include some industry-specific terms and risks in a [MAC] clause.[140]

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133. *Id.* at 68 n.155 (emphasis added).

134. Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 Del. Ch. LEXIS 57, at *7–8 (Del. Ch. Apr. 29, 2005).

135. *Id.*

136. *Id.* at *128 ("Although *IBP* involved application of New York law, I see no reason why the law of Delaware should prescribe a different perspective.").

137. *Id.* at *143.

138. *Id.* at *127.

139. *See Fifth Survey*, *supra* note 67, at 2 (speculating that the increase in MAC elements is linked to "the admonition of the Delaware Chancery Court in *Frontier Oil* . . . that buyers specifically identify factors that may give rise to a MAC").

140. Suellen W. Bergman, *Once upon an M&A: Litigation . . . a Deal Falls Apart . . . Lessons Are*

Thus, although the *Frontier Oil* decision did not start the transformation from the traditional MAC clause to the modern MAC clause, it likely has served as a driving factor in encouraging the trend toward more complex and more specific drafting.

There have been two additional MAC clause cases in the wake of the most recent economic downturn. The first was *Genesco, Inc. v. The Finish Line, Inc.*, which was decided at the trial level in the Tennessee Chancery Court under Tennessee law.[141] The case was brought by Genesco, a footwear retailer, to compel The Finish Line, another footwear retailer, and UBS, The Finish Line's investment bank, to complete their $1.5 billion acquisition of Genesco before the termination date of December 31, 2007.[142] The Finish Line and UBS asserted several defenses, including a contract defense that Genesco's poor performance in the third quarter of 2007 constituted a MAC as defined in their agreement, allowing The Finish Line and UBS to refuse to close the deal.[143] The MAC clause in this dispute included seven exceptions.[144] The Tennessee Chancellor agreed with The Finish Line and UBS that a MAC had occurred,[145] but found that it fell within the second exception in the agreement's MAC definition, which excluded changes in the economy as a whole or in the seller's industry, as long as the changes were not materially disproportionate to others in the industry.[146] Given the relatively small number of transactions

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Learned, BUS. L. TODAY, Sept./Oct. 2005, at 59, 61, *available at* http://www.abanet.org/buslaw/blt/2005-09-10/bergman.shtml.

141. Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III) (Tenn. Ch. Dec. 27, 2007), *available at* http://www.genesco.com/images/litigation_library/genesco-pdf.pdf.

142. *Id.* at *1–2.

143. *Id.* at *30. Genesco missed its third quarter projection of $23.6 million by $10 million. *Id.* at *10.

144. Genesco, Inc., Agreement and Plan of Merger (Form 8-K, Ex. 2.1), at 8–9 (June 17, 2007).

145. *Genesco, Inc.*, No. 07-2137-II(III), at *33–37. The Tennessee Chancellor cited the *IBP* and *Frontier Oil* decisions from Delaware in support of the proposition that a MAC must be more than a mere blip in earnings and it must be durationally significant. The Tennessee Chancellor, however, seemingly adopted a unique interpretation of durationally significant. She referred to a clause in the agreement that allowed the parties to cure breaches before the termination date of December 31, 2007, and explained that durationally significant should be in reference to this termination date. Thus, she found that the poor performance in the third quarter was sufficiently durationally significant to constitute a MAC. *Id.* at *35–36. This is not how Vice Chancellor Strine interpreted durational significance in *IBP*. *See In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 67–68 (2001).

146. *Genesco, Inc.*, No. 07-2137-II(III), at *31–33. The MAC in the agreement stated:

> "Company Material Adverse Effect" shall mean any event, circumstance, change or effect that, individually or in the aggregate, is materially adverse to the business, condition (financial or otherwise), assets, liabilities or results of operations of the Company and the Company Subsidiaries, taken as a whole; provided, however, that none of the following shall constitute, or shall be considered in determining whether there has occurred, and no event, circumstance, change or effect resulting from or arising out of any of the following shall constitute, a Company Material Adverse Effect . . . . (B) changes in the national or world

that are decided under Tennessee law, and the general criticism of the reasoning of the *Genesco* opinion, it seems relatively unlikely that this judicial opinion will have a significant long-term effect on the drafting of MAC clauses.

The second case decided in the wake of the most recent economic downturn was *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, which was decided in the Delaware Chancery Court in September 2008.[147] Hexion, a chemical company that is 92 percent owned by the private equity firm Apollo Global Management, agreed to acquire another chemical company, Huntsman, in July 2007.[148] In the interim period between signing and closing, the economy deteriorated significantly and Hexion claimed that Huntsman suffered a MAC, which would allow Hexion to walk away from the transaction without paying the $325 million break-up fee.[149] Huntsman sought specific performance of the transaction.[150] Vice Chancellor Stephen P. Lamb found that Hexion's MAC claim failed.[151] Vice Chancellor Lamb's opinion stated that "[a] buyer faces a heavy burden when it attempts to invoke a material adverse change clause in order to avoid its obligation to close."[152] He continued by noting that the Delaware Chancery Court has never found a MAC to have occurred and "this is not a coincidence."[153] The clear message from the *Hexion* opinion is that it will be very difficult for a buyer to successfully invoke a MAC clause to refuse to close a transaction. Because there is still a possibility of successfully invoking a MAC clause under the right set of facts, which in turn also provides the buyer some leverage in renegotiating transactions, the MAC clause certainly remains an important provision in M&A agreements. It remains to be seen, however, how this most recent and influential decision from the Delaware Chancery Court will shape the ongoing evolution of the MAC clause.

> economy or financial markets as a whole or changes in general economic conditions that affect the industries in which the Company and the Company Subsidiaries conduct their business, so long as such changes or conditions do not adversely affect the Company and the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate.

Id. at *29.

147. Hexion Specialty Chems., Inc. v. Huntsman Corp., No. 3841-VCL, slip op. (Del. Ch. Sept. 29, 2008).

148. *Id.* at 1.

149. *Id.* at 1–3.

150. *Id.* at 3.

151. *Id.* at 36.

152. *Id.* at 39–40.

153. *Id.* at 40.

4. Volatility in the Economy

Another potential driving factor in the transformation to the modern MAC clause could be an increasingly volatile economy that has made exogenous risk a more serious danger.[154] Specifically, as the capital markets are subject to greater fluctuations, the risk that factors beyond the control of the seller may decrease the seller's value in the interim period between signing and closing the deal also increases. In a prominent article on the MAC clause, Ronald Gilson and Alan Schwartz argued that increasing volatility helps to explain the existence of the modern MAC clause.[155] Gilson and Schwartz argue that "[t]he need to make explicit the exogenous risk allocation should become more pressing as exogenous risks become more severe. The increased volatility of capital and product markets in the 1990s thus suggests that explicit MAC exceptions should become more prevalent over the course of that decade."[156]

Gilson and Schwartz look to the volatility index of the Chicago Board Options Exchange, which measures near-term volatility through stock option index pricing.[157] In general, Figure 1 below depicts the volatility of the securities markets in the United States from 1990 to 2008. Increases in the volatility price index means that the capital markets are subject to greater fluctuations. The upward sloping sections thus represent time periods in which the markets were becoming increasingly volatile. Similarly, the downward sloping sections represent time periods in which the markets were becoming less volatile. Gilson and Schwartz note that the volatility index demonstrates that volatility "increased substantially over the period from 1994 to 2003, the period during which MAC exceptions became part of acquisition practice,"[158] which is generally true, as Figure 1 illustrates.

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154. *See* Gilson & Schwartz, *supra* note 4, at 339.

155. *Id.*

156. *Id.*

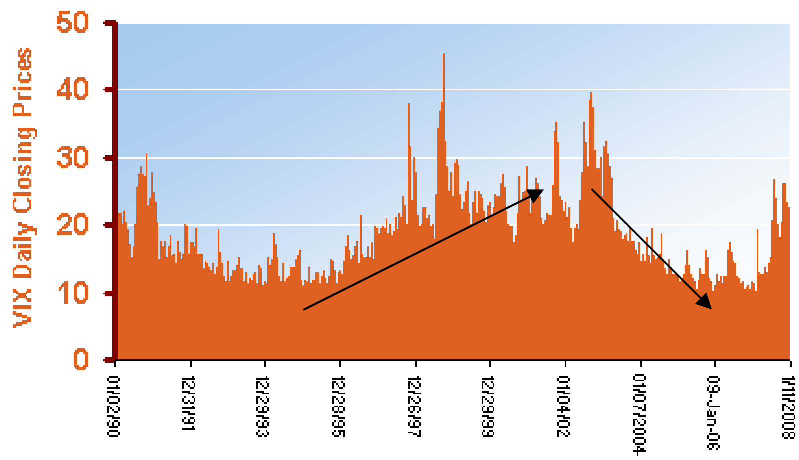
157. *Id.* at 339 n.21.

> In 1993, the Chicago Board Options Exchange® (CBOE®) introduced the CBOE Volatility Index®, VIX®, and it quickly became the benchmark for stock market volatility. It is widely followed and has been cited in hundreds of news articles in the Wall Street Journal, Barron's and other leading financial publications.
>
> VIX measures market expectation of near term volatility conveyed by stock index option prices.

Chicago Board Options Exchange, Frequently Asked Questions About the New VIX, http://www.cboe.com /micro/vix/faq. aspx (last visited Dec. 18, 2008).

158. Gilson & Schwartz, *supra* note 4, at 339 n.21.

FIGURE 1. CBOE VOLATILITY INDEX.[159]



One major problem with the volatility hypothesis as an explanation for increased MAC exceptions is that it appears to be refuted by the data after 2003. As Figure 1 illustrates, volatility decreased substantially from 2003 until around the start of the credit crisis in August 2007.[160] The *New York Times* reported in February 2007 that "in recent years . . . volatility has largely evaporated from the market."[161] If increased volatility leads to greater prevalence of MAC exceptions, then one might expect the number of MAC exceptions to become less prevalent as volatility decreases.[162] To the contrary, MAC exceptions became more prevalent. In a survey of 425 asset purchase, stock purchase, and merger agreements from June 2005 until June 2006, the firm reported that "MAC exceptions increased across the board."[163] In a survey of 413 agreements from June 2006 until June 2007, again there were "increases across the board in MAC exceptions."[164] So despite the downward trend in volatility after 2003, MAC exceptions have continued to become even more prevalent.

This recent negative correlation—decreasing volatility and increasing MAC exceptions—raises several possible conclusions about the volatility hypothesis. The first is that the recent trend undermines or disproves this

159. Chicago Board Options Exchange, Price Charts, http://www.cboe.com/micro/vix/pricecharts.aspx (last visited Dec. 18, 2008) (modifications made to original).

160. *Id.*

161. Floyd Norris & Jeremy W. Peters, *Wall St. Tumble Adds to Worries About Economies*, N.Y. TIMES, Feb. 28, 2007, at A1.

162. *See* Gilson & Schwartz, *supra* note 4, at 339 n.21.

163. *Fifth Survey*, *supra* note 67, at 2.

164. SIXTH SURVEY, *supra* note 37, at 3.

hypothesis. Specifically, one could conclude that although Gilson and Schwartz correctly recognized a positive *correlation*—increased volatility and increased MAC exceptions—from 1994 to 2003, they mistakenly concluded that increased volatility was a *cause* of increased MAC exceptions. This conclusion raises the question of whether there is any logical reason why the causal connection between increased volatility and increased exceptions would not also mean that decreased volatility should lead to decreased exceptions. In other words, it is possible that volatility was indeed a causal factor in increasing MAC exceptions from 1994 to 2003, as Gilson and Schwartz concluded, but other countervailing factors caused MAC exceptions to continue to increase from 2003 to 2007, despite decreasing volatility during that period. For example, there may be a type of ratchet effect in which it is relatively easy to increase the complexity and number of MAC exceptions, but relatively difficult to decrease them. In other words, the modern MAC clause may have taken on a life of its own once attorneys started the trend toward more complex drafting.

Having seen the purpose, structure, and transformation of the MAC clause in the United States, it is instructive to compare it to the MAC clause in the United Kingdom. As explained in Part III below, the United Kingdom has taken a regulated approach to the MAC clause, and thus, the modern MAC clause in its American form does not exist in the United Kingdom for certain types of transactions.[165] This comparative analysis of the United Kingdom's regulation of MAC clauses provides a perspective on the relative benefits and costs of the modern MAC clause in the United States.

III. THE MAC CLAUSE IN THE UNITED KINGDOM

In the United Kingdom, the content and structure of the MAC clause can be quite different, depending on whether the transaction is private or public.[166] Whether a transaction is considered private or public in the United Kingdom depends on the nature of the target company.[167] In general, the difference between a public transaction and a private transaction turns on whether the target company has any securities that are

165. *See* discussion *infra* Part III.

166. *Use of Material Adverse Change Clauses in the United Kingdom*, INSIDE M&A (McDermott Will & Emery, Chicago, Ill.), Nov./Dec. 2007, at 4 [hereinafter *Use of MAC Clauses*], *available at* http://www.mwe.com/info/news/inside m&a 1207.pdf.

167. *See* PANEL ON TAKEOVERS AND MERGERS (U.K.), THE TAKEOVER CODE, at A3–A7 (2006) [hereinafter CITY CODE], *available at* http://www.thetakeoverpanel.org.uk/new/codesars/DATA%5C code.pdf.

admitted to trade on a regulated market in the United Kingdom.[168] In a private transaction—that is, one in which the target company's securities are not traded on a regulated market—the content and structure of the MAC clause is similar to a MAC clause in the United States.[169] In a private transaction in the United Kingdom, as in all transactions in the United States, the purchaser and the seller are free to negotiate the MAC elements and the MAC exceptions.[170] In the event of a dispute, the courts will interpret the MAC in accordance with English contract principles.[171]

By contrast, in a public transaction—that is, one in which the target company's securities are traded on a regulated market—the content and structure of the MAC is entirely different than in a private transaction.[172] This is because public transactions in the United Kingdom are regulated by

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168. *Id.* at A3. The City Code does extend to some private transactions in limited circumstances in which the target company is a resident of the United Kingdom. The complete definition of a company over which the City Code maintains jurisdiction in mergers and acquisitions includes the following:

> (i) UK, Channel Islands and Isle of Man registered and traded companies
>
> The Code applies to all offers (not falling within paragraph (iii) below) for companies and Societas Europaea (and, where appropriate, statutory and chartered companies) which have their registered offices in the United Kingdom, the Channel Islands or the Isle of Man if any of their securities are admitted to trading on a regulated market in the United Kingdom or on any stock exchange in the Channel Islands or the Isle of Man.
>
> (ii) Other companies
>
> The Code also applies to all offers (not falling within paragraph (i) above or paragraph (iii) below) for public and private companies and Societas Europaea (and, where appropriate, statutory and chartered companies) which have their registered offices in the United Kingdom, the Channel Islands or the Isle of Man and which are considered by the Panel to have their place of central management and control in the United Kingdom, the Channel Islands or the Isle of Man, but in relation to private companies only when: (A) any of their securities have been admitted to the Official List at any time during the 10 years prior to the relevant date; or (B) dealings and/or prices at which persons were willing to deal in any of their securities have been published on a regular basis for a continuous period of at least six months in the 10 years prior to the relevant date, whether via a newspaper, electronic price quotation system or otherwise; or (C) any of their securities have been subject to a marketing arrangement as described in section 163(2)(b) of the Companies Act 1985 at any time during the 10 years prior to the relevant date; or (D) they were required to file a prospectus for the issue of securities with the registrar of companies or any other relevant authority in the United Kingdom, the Channel Islands or the Isle of Man or to have a prospectus approved by the UKLA at any time during the 10 years prior to the relevant date.
>
> In each case, the relevant date is the date on which an announcement is made of a proposed or possible offer for the company or the date on which some other event occurs in relation to the company which has significance under the Code.
>
> The Panel appreciates that the provisions of the Code may not be appropriate to all statutory and chartered companies referred to in paragraphs (i) and (ii) above or to all private companies falling within the categories listed in paragraph (ii) above and may accordingly apply the Code with a degree of flexibility in suitable cases.

Id. at A3–A4 (footnote omitted) (Section (iii) on shared jurisdiction omitted).

169. *Use of MAC Clauses*, *supra* note 166, at 4.

170. *See id.*

171. *Id.* There is, however, very little case law on interpreting MAC clauses in the British courts, so they may tend to look to the decisions of the Panel on Takeovers and Mergers in the public transaction context for guidance. *Id.*

172. *See id.*

the Panel on Takeovers and Mergers ("Takeover Panel").[173] The Takeover Panel is an independent body that was established in 1968.[174] As of May 20, 2006, the Takeover Panel has statutory authority under the Companies Act 2006.[175] The Takeover Panel consists of up to thirty-four members who are drawn from a series of financial and business organizations.[176] The main function of the Takeover Panel is to issue and administer the City Code on Takeovers and Mergers ("City Code").[177] The general purpose of the City Code is to provide a framework for takeovers and to promote the integrity of the financial markets.[178] The City Code is based on a set of six general principles, the spirit of which explicitly overrides the specific language of the thirty-seven City Code rules.[179] In other words, the Takeover Panel will not give credence to a narrow reading of the verbiage in the rules if that reading conflicts with one of the general principles.[180] The fourth general principle is the most pertinent to the Takeover Panel's position on MAC clauses:

> False markets must not be created in the securities of the offeree company, of the offeror company or of any other company concerned by the bid in such a way that the rise or fall of the prices of the securities becomes artificial and the normal functioning of the markets is distorted.[181]

In general, the Takeover Panel is concerned that uncertainty surrounding the ability of the purchaser to exit the transaction will have a detrimental effect on the market.[182] In other words, the market benefits from clarity

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173. CITY CODE, *supra* note 167, at A1.

174. *Id.*

175. Companies Act, 2006, c. 46, §§ 942–65 (Eng.).

176. CITY CODE, *supra* note 167, at A7–A8.The City Code states:

> The Panel comprises up to 34 members: (i) the Chairman, who is appointed by the Panel; (ii) up to two Deputy Chairmen, who are appointed by the Panel; (iii) up to twenty other members, who are appointed by the Panel; and (iv) individuals appointed by each of the following bodies: The Association of British Insurers; The Association of Investment Companies; The Association of Private Client Investment Managers and Stockbrokers; The British Bankers' Association; The Confederation of British Industry; The Institute of Chartered Accountants in England and Wales; Investment Management Association; The London Investment Banking Association (with separate representation also for its Corporate Finance Committee and Securities Trading Committee); The National Association of Pension Funds.

Id. at A8.

177. *Id.* at A1. "The City" is a common metonym in the United Kingdom for the financial sector, similar to the usage of "Wall Street" in the United States. *See* ROY S. FREEDMAN, INTRODUCTION TO FINANCIAL TECHNOLOGY 29 (2006).

178. CITY CODE, *supra* note 167, at A1.

179. *See id.* at A2, B1 (general principles in B1).

180. *See id.*

181. *Id.* at B1.

182. *See* CODE COMM., PANEL ON TAKEOVERS AND MERGERS, REVISION PROPOSALS RELATING

regarding the chances that the announced transaction will close, and the Takeover Panel highly values this market clarity.

In addition to the general principles, the City Code includes specific rules that relate to the MAC clause.[183] Rule 13 of the City Code applies to the conditions in an M&A agreement.[184] There are two subsections in rule 13 that apply directly to MAC provisions in the conditions of a merger agreement: First, rule 13.1 prohibits conditions that depend solely on subjective judgments of the board of directors of either the purchaser or the seller.[185] This subsection, for example, would not allow the parties in a public M&A transaction to draft a closing condition that allowed the purchaser to exit the transaction by subjectively deciding that a MAC has occurred.[186] In addition to rule 13.1, the main subsection that applies to MAC clauses is rule 13.4, which states:

> An offeror should not invoke any condition or pre-condition so as to cause the offer not to proceed, to lapse or to be withdrawn unless the circumstances which give rise to the right to invoke the condition or pre-condition are of material significance to the offeror in the context of the offer.[187]

Rule 13.4 is powerful because it authorizes the Takeover Panel to determine when a purchaser may or may not invoke a MAC clause to exit a transaction.[188]

Perhaps the most significant characteristic of the MAC clause regime under the Takeover Panel is that, unlike in the United States, MAC clauses in public transactions in the United Kingdom may not contain MAC exceptions.[189] Instead, the Takeover Panel prescribes when a condition may

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TO RULE 13 OF THE TAKEOVER CODE 4 (2003), *available at* http://www.thetakeoverpanel.org.uk/new/consultation/DATA%5CPCP15.pdf.

183. *See* CITY CODE, *supra* note 167, at G15–G16.

184. *Id.* The full title of Rule 13 is "Pre-Conditions in Firm Offer Announcements and Offer Conditions." *Id.* at G15.

185. *Id.* at G15. Rule 13.1 states:

> An offer must not normally be subject to conditions or pre-conditions which depend solely on subjective judgements by the directors of the offeror or of the offeree company (as the case may be) or the fulfillment of which is in their hands. The Panel may be prepared to accept an element of subjectivity in certain circumstances where it is not practicable to specify all the factors on which satisfaction of a particular condition or pre-condition may depend, especially in cases involving official authorisations or regulatory clearances, the granting of which may be subject to additional material obligations for the offeror or the offeree company (as the case may be).

Id.

186. *See Use of MAC Clauses*, *supra* note 166, at 4.

187. CITY CODE, *supra* note 167, at G16.

188. *See Use of MAC Clauses*, *supra* note 166, at 4–5.

189. *Id.* at 4.

or may not be invoked.[190] The result of the City Code rules is that the MAC clause in public transactions in the United Kingdom is generally standardized.[191] An example of a MAC clause in a merger agreement condition in a public transaction in the United Kingdom usually takes the following general form: *no adverse change or deterioration having occurred in the business, assets, financial or trading position or profits or prospects or operational performance of any member of the Group which in any case is material in the context of the wider Group taken as a whole*.[192] This typical U.K. MAC clause is similar to the typical traditional MAC clause in the United States.

The seminal interpretation of a MAC clause by the Takeover Panel occurred in 2001 when the advertising firm of WPP attempted to invoke a MAC clause to avoid closing an acquisition with the advertising firm of Tempus.[193] Tempus was a publicly listed company and WPP owned approximately 25 percent of Tempus stock.[194] On September 10, 2001, WPP posted an offer to purchase the remaining outstanding stock.[195] Following the terrorist attacks on September 11, WPP sought a ruling from the Takeover Panel as to whether WPP was entitled under the City Code to invoke the MAC clause in the purchase agreement.[196] The Takeover Panel ruled that WPP could not invoke the MAC clause due to the events and consequences of September 11, stating that invoking a MAC clause "requires an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous . . . to something that would justify frustration of a legal contract."[197] The Takeover Panel agreed that September 11 was indeed exceptional and unforeseen, but to successfully invoke the MAC clause WPP needed to prove that the effects on Tempus's prospects were distinguishable from the

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190. *See id.* at 4–5.

191. *Id.* at 4.

192. *Id.* (emphasis added).

193. *See* Panel on Takeovers and Mergers, Offer by WPP Group PLC ("WPP") for Tempus Group PLC ("Tempus"), Statement 2001/15, at ¶ 1 (Nov. 6, 2001), *available at* http://www.thetakeoverpanel.org.uk/Statements/200115.pdf [hereinafter Offer by WPP for Tempus Group].

194. *Id.* ¶ 5.

195. *Id.*

196. *Id.* ¶ 7. The MAC clause was contained in one of the conditions. It stated:

> "[S]ince 31 December 2000 and save as disclosed in the accounts then ended and save as publicly announced in accordance with the Listing Rules by Tempus prior to 20 August 2001 and save as disclosed in this document or as otherwise fairly disclosed in writing by Tempus to WPP: (i) no material adverse change or deterioration having occurred in the business, assets, financial or trading position or profits or prospects of any member of the wider Tempus Group."

Id. ¶ 8 (emphasis removed).

197. *Id.* ¶ 16.

decline in the general economy and the advertising sector.[198] The Takeover Panel received criticism that it had essentially rendered the MAC clause meaningless by requiring something analogous to frustration of contract, because if that condition is satisfied, traditional common law precedent likely would not bind the purchaser under the contract.[199] In 2004, the Takeover Panel clarified the MAC clause standard by stating that the effect did not have to amount to actual legal frustration of the contract to constitute a MAC.[200] Nevertheless, the standard required for invoking a MAC clause condition "is a high one" and the effect or change must still be of "very considerable significance striking at the heart of the purpose of the transaction."[201]

The Takeover Panel has articulated several policy justifications for the rules limiting the ability of the purchaser to invoke a MAC clause to exit the transaction. First, the Takeover Panel is concerned with providing protection to the target's shareholders by ensuring that the purchaser is not able to withdraw or lapse an offer under most circumstances.[202] Second, the Takeover Panel seeks to maintain an efficient market and to avoid the creation of false markets in the securities of the target or purchaser by preventing the purchaser from withdrawing or lapsing an offer except in appropriate circumstances.[203] The adoption and implementation of the rules on MAC clauses are intended to provide a high level of certainty, clarity, and predictability following the announcement of a firm offer for a merger or takeover.[204]

There is a somewhat subtle, but important, difference between the policy goals of encouraging (1) clarity regarding the chances that the deal will close, and (2) certainty that the deal will close. The former reflects the goal of ensuring that the market has clear information on the probability that the deal will close, whether that probability is 10 percent or 90 percent. The latter reflects the goal of maximizing the probability that an announced

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198. *Id.* ¶ 19.

199. *Some Differences in Law and Practice Between U.K. and U.S. Stock Purchase Agreements*, JONES DAY COMMENTARY (Jones Day, Cleveland, Ohio), Apr. 2007, at 8, *available at* http://jonesday.com/files/Publication/780146b3-acb8-4d32-9c62203981cc7df8/Presentation/PublicationAttachment/f4bbc492-0161-4520-9f40-23dcc3318089/Some%20Differences.pdf.

200. PANEL ON TAKEOVERS AND MERGERS, NOTE 2 ON RULE 13—INVOCATION OF CONDITIONS, PRACTICE STATEMENT NO. 5, at 2 (2004), *available at* http://www.thetakeoverpanel.org.uk/new/practiceStatements/DATA/PS05.pdf.

201. *Id.* at 3.

202. *See* REVISION PROPOSALS RELATING TO RULE 13 OF THE TAKEOVER CODE, *supra* note 182, at 4.

203. *See id.*

204. *See id.*

deal will close. The Takeover Panel exhibits evidence that it is incorporating elements of both policy goals. In terms of clarity, the fourth general principle guides the Takeover Panel in attempting to maximize clarity in the market regarding the probability that the transaction will close. In terms of certainty, the *WPP* decision demonstrates that the Takeover Panel has established a very high threshold to invoke a MAC clause, which effectively increases the probability that announced transactions will close. Note, however, that the Takeover Panel has not officially decided that *all* announced transactions should close—the Takeover Panel could achieve total certainty by prohibiting MAC clauses from public transactions entirely, which it has not done.

The Takeover Panel has also articulated policy reasons justifying the limitation of MAC exceptions in public M&A agreements. In 2004, in rejecting a proposal to allow more negotiated MAC conditions, the Takeover Panel gave credence to several arguments.[205] First, the Takeover Panel considered the potential arbitrage opportunities that would result from the detailed drafting of MAC conditions.[206] For example, concern existed that complex and detailed MAC conditions would be difficult for most in the market to analyze, and only the most sophisticated shareholders would be in a position to meaningfully assess the risk of the purchaser exiting the deal.[207]

Second, the Takeover Panel considered that it might be unrealistic to expect that the seller would be able to exact a higher bid price from the purchaser as a quid pro quo for agreeing to a more purchaser-friendly MAC clause.[208] One of the main reasons supporting this assertion is that, in practice, the bid price is generally agreed on separately from the negotiation of the conditions.[209]

The Takeover Panel did not fail to consider the benefits of the freedom to negotiate.[210] The Takeover Panel even recognized that there may be circumstances in which the purchaser may not make an offer for a public seller in the United Kingdom if it cannot specifically negotiate the drafting and invocation of conditions like the MAC clause without being

205. *See* CODE COMM., PANEL ON TAKEOVERS AND MERGERS, REVISION PROPOSALS RELATING TO RULES 2.4, 2.5, 2.7, 9.3, 13, 23, 24.6, 34, 35.1 AND 38.3 OF THE TAKEOVER CODE 7–11 (2004), *available at* http://www.thetakeoverpanel.org.uk/new/consultation/DATA%5CPCP200404.pdf.

206. *See id.* at 8–9.

207. *Id.* at 9.

208. *Id.*

209. *Id.*

210. *Id.* at 7–8.

overridden by the Takeover Panel.[211] The Panel concluded, however, that despite the legitimate benefits of allowing the parties freedom to negotiate, the overriding concern was that a transaction would fail to close—contrary to the reasonable expectations of the seller's shareholders and the market as a whole.[212] Consequently, the Takeover Panel decided not to amend the City Code's high threshold for invoking MAC clause conditions or its prohibition of specific negotiation and contracting with regard to such conditions.[213]

IV. SHOULD THE UNITED STATES ADOPT THE BRITISH MODEL?

Having seen how the Takeover Panel has prohibited the development of a modern MAC clause in the United Kingdom in an effort to protect investors and maintain market integrity, this section returns to the United States to evaluate whether a similar form of MAC clause regulation would be beneficial. The first section explores several concerns with the modern MAC clause. The second section makes policy recommendations regarding MAC clause regulation.

A. POTENTIAL CONCERNS WITH THE MODERN MAC CLAUSE IN THE UNITED STATES

In the seminal MAC clause opinion in the United States, *IBP*, Vice Chancellor Strine supported his decision to reject the invocation of a traditional MAC clause by reasoning that a "contrary rule will encourage the negotiation of extremely detailed 'MAC' clauses with numerous carve-outs or qualifiers."[214] The *IBP* opinion clearly implied that the modern MAC clause is undesirable.[215] The similarities between the *IBP* decision by the Delaware Chancery Court in the United States and the *WPP* decision by the Takeover Panel in the United Kingdom are clear. Both seek to limit the successful invocation of a MAC clause to truly long-term changes that strike at the underlying purpose of the transaction. Both the Chancery Court in *IBP* and the Takeover Panel have disfavored the negotiation of extremely detailed MAC clauses that contain numerous exceptions. Yet contrary to the implicit intent of the Delaware Chancery Court in *IBP* and the policy decision of the Takeover Panel in the United Kingdom, the

211. *Id.* at 9.
212. *Id.* at 9–10.
213. *Id.*
214. *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 68 n.155 (Del. Ch. 2001).
215. *See id.*

modern MAC clause with numerous exceptions persists in the vast majority of agreements in the United States.[216] This section will explore four potential consequences of the modern MAC clause and the counterarguments to each.

1. Increased Transaction Costs

One potential disadvantage associated with an extremely detailed and complex modern MAC clause is the increased transaction costs of deals. Given that corporate law firms charge hourly rates in the hundreds or thousands of dollars,[217] and negotiation of the modern MAC clause can require teams of attorneys on behalf of both the purchaser and the seller, the transformation from the traditional MAC clause to the modern MAC clause has likely been expensive for clients.

Clients in M&A transactions may or may not be sensitive to either monetary or temporal costs, depending on the particular circumstances. In terms of temporal cost, the additional time that it takes to draft and negotiate the modern MAC clause may be significant in transactions that are highly time sensitive. Clients may prefer to avoid the additional attorneys' fees associated with drafting and negotiating the modern MAC clause if there is a more efficient alternative. On the other hand, depending on the overall magnitude of the transaction, the incremental monetary cost of drafting and negotiating the modern MAC clause is likely to be relatively insignificant. Moreover, from a purely economic perspective, this type of wealth transfer from clients to attorneys is less problematic at the societal level. In economic terms, the specific allocation of wealth among different parties—for example, clients and attorneys—within society is less important than maximizing the total wealth of the society. Thus, while clients of M&A transactions may rightfully be concerned by the increased attorneys' fees associated with the modern MAC clause, this aspect of the MAC clause is not per se economically inefficient because it transfers wealth in a consensual manner, rather than decreasing the total wealth of society.

216. *See* SIXTH SURVEY, *supra* note 37 (finding that in a sample of 413 agreements ranging from $100 million to $32.9 billion, at least nine distinct categories of MAC exceptions were present in more than 50 percent of the agreements).

217. *See* Nathan Koppel, *Lawyers Gear up Grand New Fees*, WALL ST. J., Aug. 22, 2007, at B1 (reporting in 2007 that hourly fees can exceed $1000 at several of the top law firms in the United States).

2. Increased Impediments to Transactions

The modern MAC clause in the United States potentially has more economically significant costs than just additional attorneys' fees. The modern MAC clause may create true economic inefficiencies by decreasing the total wealth of society. This decrease in total potential societal wealth could stem from the loss of M&A transactions that would occur but for the existence of the modern MAC clause. Modern MAC clause negotiation in the United States appears to be contentious and time-consuming at best, and deal breaking at worst. The head of M&A at the law firm of Sullivan & Cromwell explained in the *Economist* that "creating a detailed MAC clause gets in the way of completing the deal."[218] A corporate M&A partner at the law firm of Allen & Overy explained in the *Financial Times* that "[t]he snag is that insisting on such specific [MAC clause] terms can be a deal-breaker."[219] These comments from leading M&A attorneys suggest that there may be some otherwise economically efficient transactions that have been thwarted by the modern MAC clause. Given that the Takeover Panel in the United Kingdom prevents this type of detailed MAC clause negotiation in public transactions, it is possible that these transactions that have been lost in the United States may have been completed successfully under a British system of regulation. Even if there are *currently* no transactions that are lost in the United States as a result of modern MAC clause negotiation, there may be transactions that will be lost in the future if the modern MAC clause continues on the same trajectory toward further complexity and even more contentious negotiation. Note that the modern MAC clause evolved from the traditional MAC clause in just the last fifteen years or so.[220]

Even if the MAC clause transformation has created a potential impediment to some transactions in the United States, there is a legitimate question about whether this is a positive or negative development. Assuming—without debating for purposes of this Note—that increasing total societal wealth is an important and valid objective, if the modern MAC clause prevents economically efficient transactions that would increase total societal wealth, then this aspect of the development of the modern MAC clause is detrimental. As noted above, the modern MAC clause has been described as "get[ting] in the way of . . . the deal"[221] and "a

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218. *MAC the Knife*, ECONOMIST, Dec. 8, 2001, at 69.

219. David Morley, *Opt-Out Sections of Big Financial Deals Are Highly Unpredictable, Warns David Morley*, FIN. TIMES (London), Mar. 4, 2002, at 16.

220. *See supra* Part II.C.

221. *MAC the Knife*, *supra* note 218.

deal-breaker."[222] Given that the drafting and negotiation of the modern MAC clause is contentious and complex, some transactions may be lost due to the additional time required to agree on the MAC clause, some transactions may be lost because the modern MAC clause negotiations contribute to an impasse between the purchaser and the seller on the agreement as a whole, and some transactions may be lost if a MAC clause is invoked and attempts to renegotiate fail.

Considering what is at stake in negotiating the modern MAC clause, it is not surprising that it could potentially be a deal breaker. Specifically, from the seller's perspective, a purchaser who seeks to limit the MAC exceptions in the agreement is attempting to expand the universe of events that would allow the purchaser to walk away from the transaction without paying any termination fee that may have been specified in the agreement. If the purchaser successfully invokes a MAC clause and terminates the transaction, then the seller could suffer significant harm: the seller has wasted the time and money spent on the merger process to that point, and a failed merger could leave the seller with the stigma of being "damaged goods" in the market for future mergers.[223] From the purchaser's perspective, a seller who seeks to include a litany of MAC exceptions in the agreement is attempting to ensure that the purchaser must be obligated to close the deal—or pay a termination fee—even in the event that the seller's value decreases substantially between signing and closing the agreement. Given the contentious opposing positions and the financial implications at stake, it is unsurprising that the negotiation of the modern MAC clause is—or may soon be—a deal breaker in some transactions.

If, however, the modern MAC clause does not prevent any transactions—and will not prevent any for the foreseeable future—or if it does not prevent *economically efficient* transactions, then the modern MAC clause in the United States may provide an advantage over the MAC clause regime in the United Kingdom. Indeed, it could be possible that the modern MAC clause provides a type of filtering function by separating efficient transactions from transactions that are flawed in some respect.

For example, suppose a purchaser and a seller are negotiating the definition of a MAC in an acquisition agreement, and the seller insists on including a MAC exception that carves out "a failure of the target to meet

222. Morley, *supra* note 219, at 16.

223. Hall, *supra* note 51 ("If you're the target, your options are limited . . . . Accepting a lower price is better than having no deal at all and being tainted as damaged goods and having your stock fall below the pre-deal value.").

revenue or earnings projections"[224] without including language that qualifies it as a long-term failure. This would be an interesting exception for a seller to request because the Delaware Chancery Court in *IBP* held that a MAC requires a substantial threat to "the overall earnings potential of the target in a durationally-significant manner"[225] and a "short-term hiccup in earnings should not suffice"[226] to constitute a MAC. A MAC exception carving out "a failure by the target to meet revenue or earnings projections" is superfluous because it excludes an event that clearly will not constitute a MAC under Delaware or New York law, *unless* the failure is related to a long-term earnings problem.[227] Therefore, the seller who insists on this exception may signal to the purchaser a potential concern regarding the target's long-term earnings. The purchaser—after recognizing this signal in the course of MAC clause negotiations—may reevaluate the financial projections of the target and determine that the transaction is actually less valuable. In this hypothetical example, if the transaction would not have increased total social wealth, the detailed drafting and contentious negotiation of the modern MAC clause provided a positive function in separating an efficient transaction from an inefficient transaction.

It is difficult to empirically evaluate whether the potential function of the modern MAC clause as a deal breaker is positive or negative. Such an empirical analysis would require inside information from the negotiations of potential transactions that ultimately never occurred, which is not available to the public. Because this information is unavailable, it is unclear whether the modern MAC clause acts more as a filter to separate sound transactions from those that are flawed, or whether the modern MAC clause acts more as an impediment to wealth-maximizing transactions.

Nevertheless, assuming that the modern MAC clause sometimes acts as a positive filter and sometimes as a negative impediment in the process of negotiating a transaction, one could argue that the relative value of each role is not necessarily symmetric. In terms of filtering sound transactions from flawed transactions, the MAC clause negotiation is probably a relatively small part of the negotiation process. Purchasers likely do not rely heavily on the MAC clause negotiation to recognize the merits of a transaction, given the extensive due diligence process and consultation with

224. This type of MAC exception was included in approximately one-third of M&A agreements from June 2006 to June 2007. *See supra* table accompanying note 76.

225. *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 68 (Del. Ch. 2001).

226. *Id.*

227. *Id.*

experts such as investment bankers and corporate attorneys. In other words, if parties to an M&A transaction were prohibited from specifically negotiating the detailed modern MAC clause—as they are in the United Kingdom—the benefits that would be lost from the filtering function would either be de minimis, or the other methods of evaluating potential transactions could compensate for the loss. Conversely, any economically efficient M&A transaction that is lost as a result of the contentious modern MAC negotiations has a substantial impact on total social wealth. Thus, one could argue that the benefits of prohibiting specific negotiation of the modern MAC clause—as in the United Kingdom—could be significant, even if only a relatively small amount of transactions that would have been lost are completed.

Nevertheless, despite the anecdotal descriptions of the MAC clause as a deal breaker—perhaps used as hyperbole—and the hypothetical academic arguments discussed above, there is little else to suggest that the negotiation of the modern MAC clause alone is sufficient to derail an otherwise economically efficient transaction. It seems unlikely that the relatively small amount of incremental time and cost of negotiating and drafting the modern MAC clause would be sufficient to undermine the entire deal. With the scant evidence available, this seems to be an insufficient justification for regulation.

3. Reduced Certainty that Transactions Will Close

Another potential concern with the modern MAC clause in the United States, in addition to reduced *clarity* in the securities markets, as discussed below, is that it may reduce *certainty* that the transaction will actually close. As explained above in Part II.C.3, the Delaware Chancery Court set a high threshold for invoking a MAC clause.[228] This high threshold for invoking a MAC clause increases the certainty that the transaction will close. The numerous exceptions in the typical modern MAC clause may raise this threshold for invoking a MAC clause beyond what was envisioned by the Delaware Chancery Court in *IBP*. In other words, as the parties to a transaction specifically negotiate carve-outs that otherwise would have constituted a MAC clause, they reduce the universe of potential events that would allow the purchaser to walk away from the transaction, thus making the transaction more certain to close.

One could argue that the typical modern MAC clause with numerous

228. *See* Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 Del. Ch. LEXIS 57, at *127–29 (Del. Ch. Apr. 29, 2005); *In re IBP*, 789 A.2d at 68.

exceptions may actually reduce the likelihood that the transaction will close. So long as the interpretation and effect of the modern MAC clause remains undecided in major corporate states like Delaware and New York, disputing parties have been more likely to use the MAC clause in renegotiations or settlement.[229] Of the high-profile MAC clause disputes in 2007, most of the disputed transactions were terminated as part of a settlement, a few transactions actually closed after being renegotiated at a lower price, and one disputed transaction went to a determinative judicial judgment.[230] It is possible that the uncertainty surrounding the modern MAC clause provides leverage for the purchaser in threatening to walk away from the transaction, which ultimately may result in more settlements, fewer completed transactions, and less certainty that a given transaction will actually close.

Compare the current situation in the United States to the situation in the United Kingdom. The Takeover Panel in the United Kingdom also set a high threshold for invoking a MAC clause in the *WPP* decision.[231] As explored above in Part III, the Takeover Panel pursues the related goals of increasing both clarity in the securities markets and certainty that announced transactions will close.[232] Note, however, that neither the Delaware Chancery Court in *IBP* nor the Takeover Panel prohibited MAC clauses altogether, which demonstrates that neither decided to pursue *complete certainty* that an announced transaction will close. Both recognized that there will be some transactions in which a true MAC has occurred, and in those rare cases, it is desirable to give the purchaser an option to walk away from the transaction.

4. Reduced Clarity in the Securities Markets

Perhaps the most serious concern is that the modern MAC clause may reduce clarity in public securities markets. As noted above, *clarity* as to the probability that a transaction will close is distinct from *certainty* that a

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229. *See* The Big MAC, http://dealbook.blogs.nytimes.com/2008/03/10/the-big-mac/ (Mar. 10, 2008, 11:00 EST).

230. *Id.* The one disputed transaction that reached a judicial judgment was the suit by Genesco against The Finish Line, which is discussed above. *See* Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III) (Tenn. Ch. Dec. 27, 2007), *available at* http://www.genesco.com/images/litigation_library/genesco-pdf.pdf.

231. *See* Offer by WPP for Tempus Group, *supra* note 193, at ¶ 16 (explaining that the legal standard for invoking a MAC clause "requires an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous . . . to something that would justify frustration of a legal contract").

232. *See* discussion *supra* Part III.

transaction will close—clarity refers to knowing the level of certainty that the deal will close. This concern is reflected in the "preserving the integrity of the markets" policy that underlies the MAC clause regime in the United Kingdom with respect to public M&A.[233] The Takeover Panel determined that a detailed and complex MAC clause creates undesirable uncertainty about whether the announced transaction will actually close.[234] This uncertainty, in turn, creates market inefficiency for the entire period between signing and closing, as investors cannot accurately price the securities of the merging parties.

The concerns regarding reduced clarity in the securities markets relate primarily to public transactions in which the seller has publicly traded securities on a market exchange. As discussed above in Part III, the Takeover Panel's regulation of the MAC clause relates only to public transactions—it does not regulate private transactions in which the seller does not have securities that are traded on a market exchange.

Reduced clarity in the securities markets may be a negative externality of the negotiation goals and practices of some corporate attorneys who draft complex modern MAC clauses. It may be rational for both sides of an M&A contract negotiation to agree on intentionally ambiguous terms.[235] One reason why an ambiguous contract term may benefit both parties is if the parties cannot reach a compromise.[236] Both parties may also prefer an ambiguous contract term because they may benefit from the term's vagueness in the course of renegotiations, including invoking the threat of litigation.[237] The fact that only about 3 percent of agreements identify a specific quantitative dollar threshold for what constitutes a MAC[238] may be evidence that M&A contract drafters prefer ambiguity in the modern MAC clause.[239] As the modern MAC clause increases in length and complexity, the ambiguity as to the ultimate effect of the MAC clause likely also increases. While this practice of drafting a complex and ambiguous MAC

233. *See* REVISION PROPOSALS RELATING TO RULE 13 OF THE TAKEOVER CODE, *supra* note 182, at 4.

234. *See id.*

235. Both Jeffrey Lipshaw and Steven Davidoff have stated that this contract drafting practice may be rational. *See* The Dog Bites: Coda, M&A Law Prof Blog, http://lawprofessors.typepad.com/mergers/litigation/ index.html (Dec. 24, 2007) [hereinafter Davidoff] (blog of Steven Davidoff); Posting of Jeffrey Lipshaw to Concurring Opinions, http://www.concurringopinions.com/archives/2007/12/the_ cerberus_ca.html (Dec. 22, 2007, 9:57 EST).

236. *See* Davidoff, *supra* note 235.

237. *Id.*

238. SIXTH SURVEY, *supra* note 37, at 3.

239. *See* Davidoff, *supra* note 235.

clause may be rational from the standpoint of the purchaser and the seller—and their attorneys—it potentially creates a negative externality effect on the rest of the market. The reduced clarity of the modern MAC clause may benefit the parties to the M&A transaction, but it makes it more difficult for the market to gauge the likelihood that the transaction will actually close, and thus, the market cannot accurately price the implicated securities.

The increasingly detailed drafting of the modern MAC clause may have another unintended consequence related to clarity. Consider the situation in which corporate attorneys, following the trend of increasingly detailed MAC clause drafting, carve out an exception for an event that never would have qualified as a MAC clause under *IBP*. This event, were it to occur, would not allow the purchaser to walk away from the deal, even if the parties decided not to include it in the list of exceptions to what constitutes a MAC clause. The parties, however, include the exception anyway in the spirit of detailed drafting, just to be thorough. This agreement, with the exception that never would have qualified as a MAC under *IBP*, is used as a precedent for other deals, and soon this superfluous exception is found in many agreements. Now consider the parties who decide to omit the superfluous exception. Assume that the event covered by the superfluous exception occurs, and the seller attempts to invoke the MAC clause. The seller may have omitted the exception with the goal of concise drafting and relying on *IBP*. The purchaser, however, may now argue that including the exception is the market standard and specifically omitting the exception implies that the intention of the parties was to allocate that particular risk to the seller. Thus, an event that was previously not sufficient to trigger a MAC clause may become sufficient as a direct result of the increasingly detailed drafting of the modern MAC clause.

B. Policy Recommendations for the United States

The fundamental issue that the United States must consider is whether the net benefits of the modern MAC clause outweigh the net benefits of implementing a form of MAC clause regulation. This is a difficult balancing analysis, which is resistant to quantitative investigation. In the United Kingdom, the Takeover Panel examined the question and determined that—in public M&A transactions—the net benefits of limiting freedom to negotiate the MAC clause outweighed the net benefits of allowing unlimited negotiation. Of course, broad philosophical and structural differences exist between the United States and the United Kingdom in their respective approaches to regulating M&A. The United Kingdom generally takes a more regulated approach to many facets of public M&A issues, including MAC clauses, termination rights, conditions, litigation, and takeover defenses. Nevertheless, formal analysis of the MAC clause question has been mostly absent in the United States to date.

Classic economic and legal arguments support the abstract freedom of parties to negotiate the MAC clause in M&A agreements. Indeed, a fundamental basis of contract law is that "a régime in which contracts are freely made and generally enforced gives greater scope to individual initiative and thus promotes the greatest wealth of a nation."[240] Moreover, as Richard Posner and Anthony Kronman explained, "[a]n important function of contract law is to enforce the parties' agreed-upon allocation of risk,"[241] which presumably would include the MAC clause. The argument in favor of individual negotiation is that each contracting party to an M&A transaction is in the best position to judge its own risk preferences and allocate those risks accordingly.[242] As a result of negotiation, each separate transaction allocates risk in the most efficient manner possible.[243] Moreover, each M&A transaction has a unique set of potential risks, and the contracting parties are in the best position to understand these risks and bargain an efficient allocation.

Assuming that the transformation from the traditional MAC clause to the modern MAC clause reflects a careful and nuanced determination by corporate attorneys and contracting parties seeking to realize efficiency gains by specifically negotiating the detailed allocation of risk through the MAC clause, it stands to reason that the modern MAC clause increases efficiency and "promotes the greatest wealth of a nation."[244] If so, implementing MAC clause regulation that limits the freedom to negotiate would be inefficient and would reduce the "wealth of the nation."[245] The arguments in favor of allowing full freedom to negotiate the modern MAC clause are weighty. Indeed, great deference should be given to the functioning of the free market, especially in the case of the MAC clause where the contracting parties are usually sophisticated and negotiating the agreement on an arms-length basis.

Nevertheless, the practical consequences of the modern MAC clause

240. Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553, 562–63 (1933).

241. ANTHONY T. KRONMAN & RICHARD A. POSNER, THE ECONOMICS OF CONTRACT LAW 4 (1979).

242. *See* HUGH COLLINS, REGULATING CONTRACTS 161–65 (1999); MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 127–40 (1993); James Gordley, *Contract Law in the Aristotelian Tradition*, *in* THE THEORY OF CONTRACT LAW 265, 318–20 (Peter Benson ed., 2001).

243. *See* Gordley, *supra* note 242, at 319.

244. *See* Cohen, *supra* note 240, at 562–63.

245. *See id.*

should not be ignored, especially in M&A transactions involving a company with publicly traded securities. This section considers each of the four consequences of the modern MAC clause discussed above in Part IV.A.

1. Increased Transaction Costs

The increased transaction costs of drafting and negotiating the modern MAC clause do not support implementing a form of regulation. These increased transaction costs are a form of wealth transfer from clients to attorneys, rather than a loss of societal wealth. This type of wealth transfer, however, is not traditionally a strong argument in support of government regulation, especially since the clients and their attorneys in M&A transactions are relatively sophisticated parties. Although government regulation is not warranted based on this wealth transfer, clients may wish to undertake a more critical balancing analysis of the increased transaction costs versus the benefits of drafting and negotiating a detailed modern MAC clause, depending on the relative monetary value and time sensitivity of the transaction.

2. Increased Impediments to Transactions

As discussed above, the modern MAC clause may be an impediment to completing a transaction. And if the modern MAC clause does—or soon may—stand in the way of completing transactions, this could be viewed as either a positive or a negative function of the MAC clause, depending on whether it serves as a positive filter separating sound transactions from flawed transactions, or whether it acts as an impediment to otherwise efficient transactions. Again, if the modern MAC clause results in a combination of both the positive and the negative functions, the costs may not be symmetric and the negative function likely outweighs the positive function.[246] Assuming that the modern MAC clause does not serve primarily as a negative impediment to otherwise efficient transactions, then implementing a form of regulation appears unjustified.

3. Reduced Certainty that Transactions Will Close

As discussed above in Part IV.A, the advent of the modern MAC clause in the United States may increase or decrease the certainty that transactions will actually close. On one hand, the additional MAC exceptions can be seen as an attempt to raise the already high threshold for

246. *See* discussion *supra* Part IV.A.

invoking a MAC clause established by the Delaware Chancery Court in *IBP*. On the other hand, there is likely increasing uncertainty surrounding the effect of the burgeoning MAC exceptions in the typical clause, especially given the current absence of any determinative judicial opinions interpreting a modern MAC clause. It is therefore an open question as to whether the modern MAC clause in the United States increases or decreases the certainty that a transaction will close. Both the Delaware Chancery Court and the Takeover Panel in the United Kingdom have implied that greater certainty that an announced deal will close is desirable.[247] Although greater certainty is desirable, neither the Delaware Chancery Court in *IBP* nor the Takeover Panel in the United Kingdom have endorsed requiring that *all* announced transactions close under *all* circumstances—which could be accomplished in part by prohibiting MAC clauses altogether. Assuming that a transaction is more certain to close under the regulated system in the United Kingdom than under the unregulated system of specific negotiation in the United States, and assuming that greater certainty is desirable—short of the upper limit of total certainty—this suggests that implementing a form of MAC regulation in the United States could be beneficial. The benefits reaped from additional certainty, however, would have to be balanced against the costs of regulation and the benefits of allowing sophisticated parties to negotiate the terms of their own deals. From an abstract perspective, it seems unlikely that the benefits of incrementally increased certainty resulting from regulation would outweigh the costs.

4. Reduced Clarity in the Securities Markets

Perhaps the strongest argument in favor of regulating the modern MAC clause stems from the concern that it reduces clarity in the pricing of the public securities involved in M&A agreements. The Takeover Panel in the United Kingdom determined that a detailed and complex MAC clause creates undesirable uncertainty about whether the announced transaction will actually close, which consequently creates market inefficiency for the interim period between signing and closing. Indeed, this "preserving the integrity of the markets" policy is the primary justification for MAC clause regulation in the United Kingdom.[248] If the parties are publicly traded, the

247. *Id.*

248. *See* REVISION PROPOSALS RELATING TO RULE 13 OF THE TAKEOVER CODE, *supra* note 182, at 4 ("[O]ne of the purposes of Rule 13 is to avoid the creation of false markets in the securities of an offeror or the offeree company by preventing an offeror from withdrawing or lapsing an offer except in appropriate circumstances."). *See also* discussion *supra* Part III.

market will react to an announced transaction in pricing securities. As a result, there is a public policy interest in ensuring that the market can reasonably rely on the announcement of the transaction. The market is less efficient without clarity as to whether the invocation of a MAC clause will prevent the announced transaction from being completed.

Moreover, the preference of many M&A parties to intentionally draft ambiguous MAC clauses may impose a negative externality on the United States securities markets in the form of reduced clarity and uncertain pricing. Investors in the British securities markets avoid this externality because the purchaser and seller are prohibited from negotiating additional complexity into the MAC clause.[249] Thus, the inefficiencies and externalities resulting from the modern MAC clause may support implementing a form of MAC regulation in the United States in public M&A transactions.[250]

The question is whether the incremental benefits of specifically negotiating the MAC clause outweigh the costs—in the form of market inefficiencies and externalities—resulting from reduced clarity as to whether a transaction with a modern MAC clause will actually close. Again, the benefits and costs on each side of this balancing analysis resist quantitative calculation. The Takeover Panel in the United Kingdom, however, decided that the cost of reduced clarity in the securities market was a sufficient policy concern to justify regulating MAC clauses in public M&A transactions. Although the United Kingdom generally takes a more regulated approach to M&A, the United States has a strong commitment to clarity, transparency, and full information in the securities markets and, thus, American policymakers must carefully consider the costs of leaving the burgeoning MAC clause unregulated.[251]

5. Policy Recommendations

This Note is primarily intended to initiate a policy debate and catalyze discussion and research regarding the rise of the modern MAC clause. Thus, the most important policy recommendation is for the United States to

249. *See Use of MAC Clauses*, *supra* note 166, at 4–5.

250. This argument only applies to public M&A transactions since it focuses on the effects and costs borne by investors in the securities markets.

251. Although the United States government is generally less prone to regulating than the United Kingdom—and much of Europe—restriction of the freedom to contract in the transactional setting is not unprecedented in the United States. For example, the United States has promulgated rules under the Securities Exchange Act of 1934 governing tender offers in friendly takeovers and proxy requirements. Indeed, these regulations were implemented to protect investors and maintain market integrity. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78 (2000).

begin the process of evaluating the costs and benefits of the current MAC clause trend. In terms of ultimately determining whether to regulate or not, the potential consequences of the modern MAC clause discussed above suggest several initial policy conclusions.

In private transactions, MAC clause regulation is not yet warranted. Private transactions do not implicate publicly traded securities, so there is no justification to regulate MAC clauses based on reduced clarity in the markets as to whether the transaction will actually close. The remaining danger, however, is that otherwise efficient private transactions may be lost as a consequence of the modern MAC clause. The mere anecdotal evidence that the modern MAC clause may undermine some transactions is insufficient to justify MAC clause regulation. Nevertheless, if the trend toward increasing MAC clause complexity continues, there may come a point in the future when MAC clause regulation will be necessary to preserve the economic wealth that is destroyed when private M&A transactions are lost.

In public transactions, one justification for MAC clause regulation is to remedy the decreased social wealth that results from lost transactions. As discussed above, this justification is merely anecdotal at this point, which alone would be insufficient to warrant governmental intervention. Public transactions, however, invoke the justification of protecting investors and the integrity of the securities markets. The modern MAC clause may reduce clarity in the securities markets during the interim period between signing and closing. In addition, when M&A parties rationally agree to draft intentionally ambiguous and complex MAC clauses, they may present a negative externality on the securities market in the form of even further uncertainty. These potential consequences of the modern MAC clause are the types of market failures that government regulation is intended to prevent. The Takeover Panel in the United Kingdom has determined that the consequences of a highly complex MAC clause outweigh the benefits of allowing M&A parties to freely negotiate the MAC clause. It would be prudent for the United States to undertake the same analysis.

V. CONCLUSION

This Note seeks to stimulate a policy debate regarding the modern MAC clause in the United States. The academic and professional literature in the United States to date has not critically examined the relative advantages and disadvantages associated with regulation of the MAC clause versus allowing merging parties the freedom to negotiate the MAC clause. This debate has existed in much of the rest of the world—including the United Kingdom—but it has not yet occurred in the United States. The evidence of the consequences of the modern MAC clause, in concert with the precedent set in the United Kingdom, suggests that MAC clause regulation may have some benefits in public M&A transactions in the United States. At this point, given that the costs of the modern MAC clause are primarily hypothetical or anecdotal, it seems that the costs of regulation and the benefits of allowing sophisticated parties to negotiate the terms of their own transactions would suggest that MAC clause regulation would not be positive in the United States. Regardless of whether one ultimately determines that regulation is or is not appropriate in the United States, the issue deserves close attention.