NOTES

THE MODERN MAC: ALLOCATING DEAL RISK IN THE POST-*IBP V. TYSON* WORLD

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I. INTRODUCTION

The definitive agreement in mergers and acquisitions ("M&A") transactions is one of the most heavily negotiated agreements in the field of commercial contracts.[1] Besides establishing basic terms, such as defining the target and setting the form and amount of consideration, both buyer and seller attempt to allocate risk in order to achieve an acceptable level of deal certainty. Between an agreement's signing and its closing, weeks, if not months, can pass as the purchaser performs due diligence and the parties obtain the necessary voting and regulatory approvals.[2] In the interim, either the purchaser or the target may have a change of heart or a decline in performance. One way of allocating such risk during this period is through the use of a Material Adverse Change ("MAC") or Material Adverse Effect ("MAE") clause.[3] In essence, MAC clauses allow a party to the

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

2. ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE: MERGERS AND ACQUISITIONS § 14.07[B], at 14-438 (Supp. 2015); Alan Schwartz & Ronald Gilson, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 333–34 (2005).

3. The terms Material Adverse Change ("MAC") and Material Adverse Effect ("MAE") are used interchangeably by both the courts and practitioners. I will use the terms interchangeably throughout this Note. David Cheng, *Interpretation of Material Adverse Change Clauses in an Adverse Economy*, COLUM. BUS. L. REV. 564, 568 n.20 (2009).

agreement—most often the purchaser—to walk away free of penalty if the other party experiences an adverse change that is sufficiently material. However, despite the apparent simplicity of such clauses, vague drafting and a dearth of case law have made issues of interpretation exceedingly imprecise and unpredictable.

The failure to adequately define what events will constitute a MAC in a given deal may force the courts to engage in the imprecise act of interpreting the parties' intent. The way in which courts interpret the standard MAC clause can have profound effects on the outcome of deals and should be a primary consideration of those who draft such clauses. The failure to adequately tailor clauses in light of modern courts' default approach to MAC interpretation has resulted in orders of specific performance and uncapped damages for buyers who otherwise may have been able to walk away.[4]

This Note will provide a comprehensive review of the evolution of New York's and Delaware's interpretation of MAC clauses and the clause's ultimate effectiveness as a means of allocating deal risk. Part II will provide general information regarding MAC clauses and other risk-allocating devices, as well as demonstrate the practical implications of invoking such a clause through an evaluation of the deal and subsequent litigation in the seminal *IBP v. Tyson* case. Part III will assess the impact of the *IBP* decision through an evaluation of prominent MAC litigation in New York and Delaware, both pre- and post-*IBP*, ending with a reflection on where the courts' default approach to MAC interpretation stands today. Finally, Part IV will consider explanations for the continued use of MAC clauses in M&A agreements in light of New York and Delaware courts' approach to MAC interpretation.

II. THE MAC CLAUSE & *IBP V. TYSON*

A. DEAL CERTAINTY & MAC BASICS

Following the negotiation and signing of a definitive agreement, there is often a significant period of time before a deal will close.[5] Owing to shareholder voting requirements, proxy statements, security registrations, regulatory approvals, or even just extensive due diligence, delays before closing often extend from a couple of weeks to as long as several months

4. *See, e.g.*, Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 760–62 (Del. Ch. 2008); *IBP*, 789 A.2d at 83–84.

5. *See supra* note 2 and accompanying text.

after initial execution.[6] Given this significant gap in time, both purchaser and seller are incentivized to ensure they receive what they bargained for in the agreement. As was demonstrated by the crash of the financial markets in 2008, a target's value can decline precipitously in a short period of time.[7] Thus, it is in the purchaser's best interest to negotiate terms that allow it to walk away if the target has experienced a fundamental economic change.[8] On the other hand, the seller must ensure that the deal closes given the harsh consequences that a failed deal may have on a target.[9] In practice, purchasers and sellers use a number of contractual devices to allocate risk and ensure that their required level of deal certainty is achieved.

The decision regarding which risk-allocating terms to include in an agreement, including the extent of protection provided by those terms, is the result of a strategic tug of war between the purchaser and target, the outcome of which greatly depends on their respective leveraging power.[10] Common contractual devices used to allocate risk include specific performance clauses,[11] break-up fees and reverse break-up fees,[12] closing conditions,[13] and MAC clauses. For the purpose of this Note, I will focus solely on the role of MAC clauses as a means of allocating risk.

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6. *See id.*

7. 1 COMMERCIAL CONTRACTS: STRATEGIES FOR DRAFTING AND NEGOTIATING § 9.04[F], at 9-63 (Vladimir R. Rossman & Morton Moskin eds., Supp. 2015) [hereinafter STRATEGIES FOR DRAFTING AND NEGOTIATING]. *See also* Robert T. Miller, Hexion v. Huntsman*: Elaborating the Delaware MAC Standard*, 10 ENGAGE: J. FEDERALIST SOC'Y PRAC. GROUPS 20, 20 (2009) ("[A] delay between signing and closing creates the possibility that, during the interim period, the business or financial condition of one of the parties may deteriorate.").

8. While it is most often the purchaser who has the right to walk away upon the occurrence of a target's MAC, MAC clauses can also apply against a purchaser to the benefit of a target. For example, when the consideration for a transaction is the purchaser's stock, the seller may want to reserve the right to walk if the stock's value declines considerably. *See, e.g.*, Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 Del. Ch. LEXIS 57, at *36–37, *88–91 (Apr. 29, 2005).

9. FLEISCHER & SUSSMAN, *supra* note 2, § 14.07[B], at 14-439 (explaining that, for a seller, the failure to close a deal can result in a reputation as "damaged goods"; a potential loss of personnel, customers, and supply arrangements; and forgone alternative opportunities).

10. Factors affecting a party's leveraging power include the competition for the target, the need or desire to complete a deal for each party, the state of the financial markets, the nature of financing commitments, and the target's view of its prospects for comparable transactions. *Id.* at 14-437.

11. Merger agreements should address the availability of specific performance as an available remedy. Although rare, Delaware courts have compelled the merger of two companies even absent a specific performance clause. *Id.* § 4.07[D], at 14-473.

12. Break-up fees are a specified monetary amount that is paid to a prospective buyer if the seller decides not to close. Reverse break-up fees are paid to a seller by the prospective purchaser if it decides not to close. Both types of fee act to incentivize the parties to close and to compensate a non-withdrawing party. *See id.* § 14.07[E], at 14-485.

13. For example, financing conditions allow a prospective purchaser to walk away if it is unable to obtain third-party financing. *Id.* at 14-495.

MAC clauses are not only present in virtually all M&A agreements, but they are also one of the most heavily negotiated terms in those agreements.[14] MAC clauses can take two forms: First, they are often included as a qualifier to a target's representations and warranties.[15] "By qualifying a particular representation or warranty by the absence of an MAE, the seller can shift liability to the buyer for matters that do not rise to the level of an MAE."[16] For example, a warranty may warrant against litigation other than those that would not reasonably be expected to result in a MAC.[17] Thus, a buyer will bear the risk of any potential litigation that does not rise to that level of materiality. When combined with a bringdown condition, the MAC in the representation or warranty provides a walk-away right. Second, MAC clauses are frequently included as a stand-alone closing condition for the buyer.[18] In this case, if the target experiences a MAC between signing and closing, then the purchaser will have the contractual right to terminate the agreement.[19] This allows the purchaser to either walk away without cost or to use the MAC as leverage to cut a new deal.[20] Thus, as a closing condition, a MAC clause shifts the risk of changed circumstances during the interim period from the purchaser to the

14. 2 TIMOTHY R. DONOVAN & JODI A. SIMALA, SUCCESSFUL PARTNERING BETWEEN INSIDE AND OUTSIDE COUNSEL § 41:33 (2014) ("Material adverse effect . . . provisions are among the most heavily negotiated and common provisions in M&A agreements."), *available on* Westlaw; Stephen I. Glover, *The Impact of* Tyson Foods *on "MAC" Outs*, M&A LAW., Nov.–Dec. 2001, at 1, 1 ("MAC outs . . . have always been the subject of vigorous bargaining."); Joseph B. Alexander, Jr., *The Material Adverse Change Clause (With Sample Language)*, 51 PRAC. LAW. 11, 11 (2005) ("The Material Adverse Change Clause . . . as a closing condition has achieved permanent status as one of the most highly negotiated parts of acquisition agreements."). A 2009 merger and acquisition deal study concluded that 98 percent of agreements contain a MAC clause. James R. Griffin, *2009 M&A Deal Point Study: Strategic Buyer/Public Targets*, M&A LAW., Nov.–Dec. 2009, at 1, 5.

15. 2 DONOVAN & SIMALA, *supra* note 14, § 41:33.

16. *Id. See also* Glenn D. West, *Revisiting Material Adverse Change Clauses—Private Equity Buyers Should (But Mostly Can't/Don't) Special Order Their MACs*, WEIL, GOTSHAL & MANGES LLP (July 1, 2006), http://www.weil.com/articles/revisiting-material-adverse-change-clauses--private-equity-buyers-should-but-mostly-cantdont-special-order-their-macs.

17. *See, e.g.*, Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 Del. Ch. LEXIS 57, at *129 (Apr. 29, 2005).

18. Kenneth A. Adams, *Understanding "Material Adverse Change" Provisions*, M&A LAW., June 2006, at 3, 4.

19. NICK J. VIZY, 2 CORPORATE COUNSEL'S GUIDE TO ACQUISITIONS & DIVESTITURES § 13:2 (2014), *available on* Westlaw; Alexander, *supra* note 14, at 17–18.

20. 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-61 ("Parties may turn to these provisions to extricate themselves from a regretted transaction, or to find leverage to better renegotiate its terms."); Dennis J. Block & Jonathan M. Hoff, *Material Adverse Change Provisions in Merger Agreements*, N.Y.L.J., Aug. 23, 2001, at 1, 1 ("When one party seeks to invoke a MAC, the parties can either renegotiate the transaction or agree to terminate; alternatively, either the parties to the agreement or the shareholders of the jilted party may commence litigation.").

seller.[21] While a seller's obligation to close may be contingent on the absence of a MAC in the purchaser,[22] this Note primarily focuses on the more frequent scenario of a purchaser claiming that a target has suffered a MAC.

Despite intense negotiation and the clause's apparent significance in the world of M&A agreements, the fundamental language of the standard MAC clause has remained unchanged since the 1970s, enshrined by deal custom and tradition.[23] Subject to slight variations, a MAC is generally defined as, "any change, event, occurrence or condition which has had, or would reasonably be expected to have, individually or in the aggregate, a material adverse effect on the business, assets, liabilities, financial condition or results of operations of the target company, taken as a whole."[24] Boiled down to its basic elements, a MAC is a change that has a material adverse effect. This circular definition has minimal descriptive value and makes the clause ripe for dispute. Although most understand the terms "adverse change" or "adverse effect" to mean a change for the worse, the term "material" is ambiguous and rarely defined in a quantifiable sense.[25] In fact, the use of an ambiguous standard is unusual in such a context where most drafters would instead implement a more concrete rule.[26] Yet, there are a few explanations for the use of such a vague standard: Deal professionals may believe it is commonly understood, possibly intending to import the definition from the securities law context; or they simply intend it to mean "significant"; or, more likely, it is left ambiguous intentionally.[27] By using a vague standard, the parties avoid the

21. Cheng, *supra* note 3, at 569.

22. *See, e.g.*, *Frontier*, 2005 Del. Ch. LEXIS at *27 n.38.

23. West, *supra* note 16.

24. 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-61 (citing Howard Spilko & Joshua Little, *Material Adverse Change Trends*, N.Y. L.J., Sept. 14, 2009, at S6–7, 10).

25. Some deals have tried to overcome this vagueness by establishing quantitative guidelines. However, these have some important weaknesses: (1) added transaction costs and arbitrariness; (2) they complicate the negotiation; (3) courts may think indicia are exclusive; (4) MACs are meant to capture the unknown. Because of these weaknesses, the vast majority of deals do not include such qualifiers. Adams, *supra* note 18, at 6; West, *supra* note 16; 1 COMMERCIAL CONTRACTS: STRATEGIES FOR DRAFTING AND NEGOTIATING § 3.03, at 3-8 (Vladimir R. Rossman & Morton Moskin eds., Supp. 2014) ("Possibly the most nettlesome interpretive issue raised by the MAC clause concerns the determination whether a particular adverse change or effect is 'material.'").

26. Schwartz & Gilson, *supra* note 2, at 332.

27. Cheng, *supra* note 3, at 568, 574 (explaining that MAC clauses "are often 'purposely written in an ambiguous fashion.'") ("Other areas of law that deal with materiality, such as federal securities law, fail to provide any guidance for MAC clauses since a reasonable investor and a reasonable acquirer may have different standards for what is important.").

expense of negotiation and also the risk of specifying details that ultimately prove underinclusive when construed by a judge.[28] However, as we will see, the failure to adequately define what constitutes a MAC makes the term particularly prone to dispute, creates difficulties of interpretation for the courts, and ultimately leads to the terms favoring the seller in all but the most unusual circumstances.

Despite the adherence to the standard MAC clause throughout the last several decades, there are a couple common alterations that affect the clause's scope. By including the word "prospects" or other forward-looking language in the MAC definition, the clause's scope widens to include adverse events that will affect the future performance of the target.[29] For example, threatened or pending litigation may not have yet caused a MAC in the target but may be so certain and detrimental as to have a MAC on the "prospects" of the target. While there is a scarcity of case law interpreting the contours of "prospects" in MAC clauses, the courts that have considered forward-looking language have found it to refer to a seller's future earnings potential.[30]

Another modern trend in MAC clauses, which has become increasingly common, is the inclusion of a list of carve-outs or exceptions.[31] Common carve-outs often exclude changes in the general economy or industry, changes in regulation or accounting rules, and terrorism.[32] These exceptions are exclusively seller-friendly because they constrict the universe of possible adverse changes, reducing the likelihood that a buyer will be able to walk away.[33] Then again, the most common exceptions include events that are not within the direct control of the target. As Alan Schwartz and Ronald Gilson point out, the exceptions impose

28. *Delaware Chancery Court Addresses Default Interpretation of Broadly Written Material Adverse Effect Clauses*, 115 HARV. L. REV. 1737 (2002) [hereinafter *Broadly Written MAEs*]; Alexander, *supra* note 14, at 18 ("The law is unsettled, and trying to be too specific can be just as bad as being too general.").

29. Adams, *supra* note 18, at 7.

30. Alexander, *supra* note 14 ("Most courts consider the inclusion of forward-looking language to include a seller's future earnings potential."); Steven Davidoff Solomon, *The MAC is Back, But Does It Kill a Deal?*, N.Y. TIMES (Aug. 23, 2011, 3:45 PM), http://dealbook.nytimes.com/2011/08/23/the-big-mac-is-back-but-does-it-kill-a-deal ("There is not much, if any, case law interpreting what 'prospects' actually means and what future events it is meant to pick up, but it is generally thought to at least cover adverse changes in earnings projections.").

31. Schwartz & Gilson, *supra* note 2, at 330.

32. 2 DONOVAN & SIMALA, *supra* note 14.

33. West, *supra* note 16 ("Although the case law is decidedly on the side of the seller in limiting a buyer's ability to successfully invoke the standard material adverse change clause, deal dynamics have been such that sellers have been able to further erode the limited comfort provided by these clauses by inserting numerous exclusions or carve-outs.").

external risk factors on the purchaser because neither party can affect the risk and the purchaser is the relatively superior risk bearer.[34] The contemporary rise in use of such exceptions can be attributed to the changing nature of deals, which makes the materialization of external risk factors a larger concern.[35] Interestingly enough, the MAC clause in the IBP-Tyson agreement did not include any exclusions, giving the court the task of determining what constitutes "material" under a standard MAC clause.[36]

B. MAC IN PRACTICE: *IBP V. TYSON*

1. The Deal

The IBP-Tyson merger resulted from a bidding contest that began in November 2000.[37] By acquiring IBP, the nation's largest beef producer and second-largest pork producer,[38] Tyson, the nation's largest chicken producer, hoped to create "the world's preeminent meat products company."[39] During the auction process, Tyson received information regarding IBP that raised serious concerns about its financial condition. First, there were indications that its beef business was heading into a cyclical trough.[40] Second, IBP was projected to fall well short of its projections for the fiscal year 2000.[41] Lastly, an accounting fraud at one of IBP's subsidiaries, DFG, resulted in a charge of $30 million to earnings.[42] Despite these "waving red flags," Tyson continued to pursue the deal.[43] At the end of the auction, IBP accepted Tyson's bid, and they entered a merger agreement on January 1, 2001.[44]

34. Schwartz & Gilson, *supra* note 2, at 330.

35. *Id.*

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

37. *Id.* at 28.

38. DORSEY & WHITNEY LLP, *IBP V. TYSON FOODS*: WHERE'S THE BEEF IN BIG MAC? 2 (June 30, 2001) [hereinafter DORSEY], *available at* http://www.dorsey.com/files/tbl_s21Publications%5CPDFUpload141%5C118%5C96.IBP%20v%20Tyson%20010630.pdf.

39. *IBP*, 789 A.2d at 21–22.

40. *Id.* at 45 (John Tyson, Tyson's CEO, "indicated that Tyson was purchasing IBP 'fully aware of the cyclical factors that affect commodity meat products.'" (emphasis omitted)).

41. *Id.* at 22.

42. *Id.* at 34 ("The undisputed facts show that Tyson was apprised of fraud by the highest level executive of DFG and that the business had serious problems."); DORSEY, *supra* note 38, at 2 (explaining that DFG represented "less than 1% of consolidated revenues").

43. *IBP*, 789 A.2d at 38–39.

44. *Id.* at 22, 45 ("Tyson trumpeted the value of the merger to its stockholders and the financial community, and indicated that it was fully aware of the risks that attended the cyclical nature of IBP's business.").

The definitive merger agreement, like most others, contained a MAC clause.[45] Section 5.01, Corporate Existence and Power, and section 5.10, Absence of Certain Changes, found in IBP's representations and warranties, guaranteed that "there has not been: (a) any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect" . . . "on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] [s]ubsidiaries taken as a whole."[46] Interestingly, unlike most merger agreements, this MAC clause did not contain any exclusions or carve-outs for risks such as economic or industry decline. Given the proliferation of seller-friendly carve-outs in MAC clauses, it is possible that either the parties did not deem the exceptions necessary or, perhaps, the absence of exclusions was the intentional result of bargaining with the intent to impose external risk factors on IBP. If the latter scenario is correct, it appears that this MAC clause, more so than most modern MACs, was intended to be protective of Tyson, leaving open economic or industry decline as a justification for walking away.[47] Either way, the clause's unusually broad language would ultimately be narrowed through judicial interpretation.[48]

2. The Dispute

Following the signing of the agreement, Tyson initiated a tender offer for IBP's shares.[49] At the same time, both Tyson and IBP were suffering poor financial results due to an unusually harsh winter that was negatively impacting livestock health and supplies.[50] Tyson's earnings per share were down 50 percent for the first quarter as compared to the previous year, and the second quarter looked even bleaker.[51] At the end of the first quarter, IBP's earnings from operations were off a full 64 percent from the previous year.[52] Additionally, following a Securities and Exchange Commission

45. *Id.* at 42–43.

46. Tyson Foods, Inc., *Agreement and Plan of Merger* 41, 45 (Jan. 1, 2001), *available at* http://corporate.findlaw.com/contracts/planning/agreement-and-plan-of-merger-ibp-inc-and-tyson-foods-inc.html.

47. DORSEY, *supra* note 38, at 1 ("The MAC clause in the IBP merger agreement was very broad and seemingly protective of Tyson, with none of the exclusions frequently negotiated by targets.").

48. *Id.*

49. *IBP*, 789 A.2d at 35.

50. *Id.* at 47–48 (noting that chickens were suffering more than cows).

51. SIMPSON THACHER & BARTLETT LLP, DELAWARE CHANCERY COURT ORDERS SPECIFIC PERFORMANCE OF MERGER AGREEMENT: AN ANALYSIS OF THE IBP-TYSON LITIGATION 3 (Aug. 2, 2001) [hereinafter SIMPSON], *available at* http://www.stblaw.com/content/publications/pub320.pdf.

52. *Id.*

("SEC") investigation, IBP announced it would have to restate its financial statements to take an additional earnings charge because of DFG.[53] On March 13, 2001, IBP filed its restated financials which included a $60.4 million DFG asset impairment charge on its 2000 10-K.[54]

Meanwhile, Tyson's anxiety about the merger began to grow and stalling tactics were implemented.[55] Although Tyson still believed that the merger made strategic sense, it used the SEC investigation and the subsequent restatement of IBP's financial statements as a negotiation chip in an attempt to extract a better deal.[56] Don Tyson, Tyson Food's founder, former CEO, and controlling shareholder, was having buyer's regret and no longer supported a merger at the agreed-upon price of $30 per share.[57] However, despite growing resistance to the merger, Tyson's investment bank reported in late March that, even with pessimistic assumptions, $30 per share was within the fairness range and that the merger "still [made] tremendous strategic sense."[58] Nevertheless, following a meeting between Don Tyson and the former executives who served under him, the decision was made that Tyson should find a way to back out of the merger.[59] Based on these events, the court believed that the decision to abandon the merger was due to concerns about IBP's and Tyson's poor results for the first quarter, not because of the DFG and SEC issues IBP was dealing with.[60]

Following Tyson's decision to end the merger, the legal team immediately drafted a letter to IBP regarding its withdrawal, citing the financial restatements and failure to disclose the SEC investigation.[61] Interestingly, nowhere in the letter did Tyson claim that the poor performance in the first quarter represented a MAC.[62] Simultaneously with its letter to IBP, Tyson filed suit in Arkansas, seeking a declaratory judgment regarding its grounds for termination.[63] Upon receipt of Tyson's letter, IBP filed suit in Delaware, seeking specific performance.[64] Vice

53. *IBP*, 789 A.2d at 45–47.

54. *Id.* at 49; SIMPSON, *supra* note 51, at 3 (explaining that the charge resulted in an impairment of "roughly $.50 to $.60 per IBP share").

55. *IBP*, 789 A.2d at 47.

56. *Id.*

57. *Id.* at 50.

58. *Id.* (explaining that McKinsey & Company reported there were $250 million in synergies in the deal).

59. *Id.*

60. *Id.*

61. *Id.* at 50–51.

62. *Id.* at 51.

63. *See id.*

64. *Id.*

Chancellor Strine of the Delaware Court of Chancery ruled that litigation could commence in Delaware.[65] The litigation, which was expedited at the request of the parties, involved "massive amounts of discovery and two weeks of trial."[66]

When trial began in May, Tyson argued three grounds for termination: (1) IBP breached its representations and warranties as evidenced by the restatement of its financials; (2) IBP fraudulently induced Tyson to enter into the agreement; and (3) multiple purported MACs resulting from IBP's poor financial performance in the last quarter of 2000 and in the first quarter of 2001, and the asset impairment charges related to DFG.[67] Tyson asserted that it was "virtually indisputable" that these factors, taken together, amounted to a MAC.[68] Conversely, IBP argued that no valid reason for termination existed and that the agreement should be specifically enforced.[69]

3. The Decision

The first issue before the court was establishing the governing law. Despite the fact that both constituent corporations were incorporated under the laws of Delaware, the merger agreement contained a New York choice of law provision, and both parties agreed that the substantive aspects of the contract claim were to be governed by New York law.[70] Given that New York follows traditional contract law principles, the court was to "give great weight to the parties' objective manifestations of their intent in the written language of their agreement."[71]

Vice Chancellor Strine proceeded to deliver a "long and closely reasoned" opinion, which ultimately concluded that there existed no legal grounds for Tyson to terminate the agreement.[72] In his view, Tyson was simply experiencing a case of buyer's regret.[73] To support this view, Vice Chancellor Strine pointed to Tyson's publicized reasons for termination, which did not mention a possible IBP MAC.[74] Nevertheless, despite his clear belief that the MAC argument was a pretext, he acknowledged that

65. DORSEY, *supra* note 38, at 2.
66. *IBP*, 789 A.2d at 23.
67. *Id.* at 51–52.
68. *Id.* at 65.
69. *Id.* at 51.
70. *Id.* at 52.
71. *Id.* at 54.
72. DORSEY, *supra* note 38, at 1.
73. *IBP*, 789 A.2d at 22.
74. *See id.* at 51.

interpreting MAC clauses is "an exercise that is quite imprecise" because the wording, while appearing deceptively simple, is "dauntingly complex" in its application.[75] And although no MAC was found to have occurred in this case, the Vice Chancellor admitted he was torn about the correct outcome and that he reached his conclusion with "less than the optimal amount of confidence."[76]

In reaching its conclusion, the court made several holdings that limited the scope and effectiveness of broadly defined MAC clauses. First, the court held that a general economic or industry decline—in this case, a downturn in cattle supply—could not alone constitute a MAC.[77] Instead, the purchaser must show that the event had the "required materiality of effect" on the target.[78]

Second, the court held that contractual language of MAC clauses must be interpreted in light of the "negotiating realities" and larger context in which the parties were contracting.[79] Here, the court drew a distinction between strategic and financial purchasers.[80] Whereas a target's failure to attain short-term projections may be highly material for a financial buyer, such a failure is far less material when the target is being acquired for long-term strategic reasons, as was the case here.[81] Vice Chancellor Strine posited that "[i]t is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause."[82] Here, Tyson was clearly purchasing IBP for strategic reasons, and a review of IBP's historical financials revealed that it was "consistently profitable" but suffered swings in annual earnings.[83]

Finally, remarking that the decision ultimately boiled down to a question of public policy, the court surmised that a New York court would likely require the purchaser to make a strong showing before allowing it to invoke a MAC exception to its obligation to close.[84] With that policy in mind, the court concluded:

75. *Id.* at 65.
76. *Id.* at 71.
77. *Id.* at 66.
78. *Id.*
79. *Id.* at 67.
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.* at 68.

> [W]here a Material Adverse Effect 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.[85]

Returning to the facts, with its "seller-friendly perspective," the court concluded that Tyson had not carried its burden of showing IBP suffered a MAC despite the 64 percent decline in first quarter earnings and the DFG charge, which the court found to be "insignificant."[86] It was clear from the facts that Tyson knew about the risks and events it later claimed gave rise to the MAC; thus, by failing to specifically allocate these known risks, Tyson presumptively bore the associated risks.[87]

In addition to the MAC argument, the court also concluded that IBP did not breach its representations and warranties, nor did it find any evidence of fraud.[88] In deciding the proper remedy, the court took an unorthodox route and ordered the completion of the merger between Tyson and IBP.[89] This order of specific performance was the first time a Delaware court forced the combination of two public companies.[90]

In reflecting on the court's interpretation, it is evident that simply including a MAC clause in an agreement is not the same as having a get-out-of-jail-free card for a remorseful buyer. Even when the clause is seemingly broad and protective of the purchaser, Vice Chancellor Strine made clear that courts must look well beyond the language when discerning materiality.

III. *IBP V. TYSON*'S IMPACT ON MAC INTERPRETATION

The outcome of *IBP v. Tyson* ultimately boiled down to a policy

85. *Id.* at 68. In the court's opinion, "a contrary rule [would] encourage the negotiation of extremely detailed 'MAC' clauses with numerous carve-outs or qualifiers. An approach that reads broad clauses as addressing fundamental elements that would materially affect the value of a target to a reasonable acquioror eliminates the need for drafting of that sort." *Id.* at 68 n.155. The interesting paradox about this view is that "extremely detailed 'MAC' clauses with numerous carve-outs" are the norm when it comes to drafting MAC clauses. *See supra* notes 31–35 and accompanying text. And although this ruling makes such carve-outs less necessary in theory, it encourages the exact opposite, that is, extremely detailed MAC clauses with numerous inclusions as to what qualifies as a MAC.

86. *Id.* at 68, 70.

87. Cheng, *supra* note 3, at 578 n.70.

88. *IBP*, 789 A.2d at 72, 78.

89. *Id.* at 82.

90. *See supra* note 11 and accompanying text.

decision. The Delaware Court of Chancery decided that a seller-friendly interpretation of broad MAC clauses is preferable because a contrary approach would lead to increased transaction costs through the negotiation and drafting of detailed MAC clauses.[91] Also underlying the decision was the policy goal of preventing purchasers from walking away when they get cold feet, as was readily apparent from the facts of the litigation.

Given the intense publicity that the *IBP* litigation received and the significant attention the court gave to the issue of MAC clause interpretation, the *IBP* decision is still regarded as the seminal case when it comes to judicial interpretation of MAC clauses.[92] While the decision is universally recognized for its significance, opinions are varied on whether it was a departure from the law, and whether the reasoning and outcome was correct or preferable.[93] In this part of the Note, I will address some of these issues through a comprehensive review of pre- and post-*IBP* litigation to determine what, if any, effect *IBP* had on the world of MAC interpretation and where the MAC standard stands today. The scope of my

91. *IBP*, 789 A.2d at 71 n.170.

92. ANTONIO J. MACIAS & THOMAS MOELLER, SIGNALING AND RISK ALLOCATION IN MERGER AGREEMENTS 12 (drft. Sept. 2013), *available at* http://www.baylor.edu/business/finance/doc.php/228011.pdf.

93. *See Broadly Written MAEs*, *supra* note 28, at 1741 ("The court's failure to offer a clearer default interpretation for general MAE provisions is regrettable. A default interpretation that imposed on buyers the risk of events not specifically included in the parties' definition of an MAE would have produced the same result and would have been permissible under New York precedent. A clear default also would have provided valuable certainty, helping to promote efficient levels of terms negotiation and merger activity."); DORSEY, *supra* note 38, at 1, 4 ("The *IBP* case does not mark a departure in the law. It received attention in the press because of the size of the deal, the industry dominance of the parties, Tyson's unusual attempt to back out and the remedy ordered by the court.") ("The crucial lesson of *IBP* is that courts appear quite willing (and even eager) to look at the overall context of a negotiation and the long-term strategic aspects of the businesses involved in order to add interpretive meaning to a MAC clause instead of simply reading its breadth and vagueness in favor of a buyer looking for escape."); Glover, *supra* note 14, at 1, 3 ("Practitioners suggested that because the somewhat murky test applied by *Tyson Foods* puts a heavy burden on the party seeking to terminate, merger parties would begin to negotiate provisions that defined MACs in a more precise way. . . . This review suggests that *Tyson Foods* has not significantly changed the content of MAC provisions."); Block & Hoff, *supra* note 20 ("While the IBP decision reflects a thoughtful analysis of complex issues, it is not clear, notwithstanding its high-profile focus in the media, whether it represents a watershed decision with respect to MACs. This is particularly the case given the detailed and fact-specific analysis of the contract at issue, as well as the somewhat uncertain guidance in light of the court's continued references to conflicting policy and choice-of-law concerns.") ("[T]he IBP decision suggests that the disclosure of possible adverse events in the agreement, disclosure schedules or in diligence will limit a terminating party's ability to rely on a MAC."); SIMPSON, *supra* note 51, at 2, 9 ("While the remedy ordered by Vice Chancellor Strine has limited precedent, the IBP-Tyson decision confirms the view of most practitioners that a buyer has a high burden in persuading a court that a MAC has occurred. . . . While the IBP decision is the most significant decision in recent years concerning a MAC, the precedential impact should not be overstated.").

analysis is limited to cases from New York and Delaware not only because of their preeminence in the world of M&A and corporate law, but also because *IBP* and its successors have created a common and unified approach in the judicial interpretation of MAC clauses in those jurisdictions. The following cases were chosen because their outcomes are not only representative of the time in which they were decided, but the opinions also offer the most thorough insight into the courts' default MAC interpretation. While the following cases are not exhaustive of MAC litigation in Delaware and New York, they are frequently cited and are of important precedential value.

A. PRE-*IBP* JUDICIAL INTERPRETATION

1. *Bear Stearns Co. v. Jardine Strategic Holdings* (New York, 1988)

On September 30, 1987, Bear Stearns, a publicly-held New York stockbroker and securities firm, entered an agreement with Jardine Holdings, a Hong-Kong based company whose principal business was holding significant minority equity positions in a wide range of companies.[94] Under the agreement, Jardine was to complete a tender offer for 20 percent of Bear Stearns's outstanding common stock as well as 20 percent each of two series of preferred stock.[95] The agreement was subject to a number of conditions, one of which was a MAC clause:

> Notwithstanding any other provisions of the Offer, the purchaser . . . may terminate or amend the Offer if at any time on or after September 30, 1987 and prior to the time of payment of any such Shares any of the following events shall occur and remain in effect: (a) any change shall have occurred or been threatened, other than as contemplated in the Transaction Agreement in the business, properties, assets, liabilities, condition (financial or otherwise), operations or results of operations of the Company or any of its subsidiaries taken as a whole . . . [that] has material adverse significance with respect to the value of the Shares to the Purchaser.[96]

Jardine began its tender offer at the beginning of October, but within two weeks, the crash of October 19th, 1987 occurred.[97] Also known as

94. Bear Stearns Cos. v. Jardine Strategic Holdings, Ltd., No. 31731/87, 1988 N.Y. Misc. LEXIS 892, at *2–3 (June 17, 1988), *aff'd* 1988 N.Y. App. Div. LEXIS 11406 (Oct. 14, 1988). Bear Stearns consisted of Bear Stearns Companies, Inc. and Bear Stearns & Company, a partnership consisting of the executives.

95. *Id.* at *3.

96. *Id.* at *4.

97. *Id.* at *5.

Black Monday, October 19th marked a five-hundred-point drop in the Dow Jones Industrial Average and a loss of a trillion dollars in shareholder equity.[98] Unsurprisingly, the market crash had significant adverse effects on Bear Stearns.[99] First, Bear Stearns suffered a $100 million loss between its risk arbitrage and security clearance departments.[100] Second, despite slashing discretionary bonuses by $39.5 million and accruing tax benefits worth $5.2 million, Bear Stearns experienced a 99.2 percent drop in net profit as compared to the prior year's corresponding quarter. Notably, this was the first quarterly loss since Bear Stearns became a public company.[101] Finally, Bear Stearns's performance continued to lag in the following quarter, with operating income down 56.3 percent, net income down 38.3 percent, and earnings per share down 42.9 percent, all compared to the prior year's corresponding quarter.[102]

Immediately following the crash, both parties met to discuss Black Monday's impact.[103] Despite the significant losses, Bear Stearns officials reported that the company was in good shape overall and still had promising future prospects.[104] Nevertheless, Jardine's management decided to terminate the transaction, claiming that Bear Stearns had suffered a MAC in its results of operations because of the $100 million loss over two days and unprecedented quarterly losses.[105] Bear Stearns filed a complaint for breach of contract with the Supreme Court of New York, to which Jardine filed a motion to dismiss.[106] Bear Stearns argued that notwithstanding the $100 million loss over two days, its overall situation had not been impaired.[107] Even more, Bear Stearns argued that Jardine was well aware that it was a "highly volatile and risky business."[108]

The court, in addition to considering Jardine's motion to dismiss, also treated it as a motion for summary judgment since both parties had put

98. *Id.* at *1.
99. *See id.* at *5–6.
100. *See id.* at *7.
101. *Id.* at *7.
102. *Id.* at *8.
103. *Id.* at *5.
104. *Id.* at *5–6.
105. *Id.* at *6, *9.
106. *Id.* at *1.
107. *Id.* at *10.
108. *Id.* at *11–12 ("Indeed, this very point was specifically articulated in the many prospectuses issued by Bear Stearns in connection with the sale of its obligations, as well as in Bear Stearns's filings with the Security [*sic*] and Exchange Commission. . . . [T]hese documents make clear risks involved in Bear Stearns's arbitrage and clearance operations, the very two activities which accounted for the One Hundred Million dollar loss suffered by Bear Stearns, immediately after the 'crash.'").

forth their evidence.[109] Ultimately the court denied both motions because it could not conclude that the terms of the agreement were sufficiently clear and unambiguous to be decided as a matter of law, concluding that a trial based on extrinsic evidence was necessary in order to determine the parties' intent.[110] Nevertheless, the court remarked that "[i]f indeed Jardine understood and *knew* the volatility and riskiness of the securities business, then it cannot fairly be said . . . that a quarter downturn, albeit significant . . . gave rise to a right to terminate the agreement as a matter of law."[111]

The court's conclusion in *Bear Stearns* seems in line with the *IBP* decision. Both transactions were upset by external risks that significantly affected the target's short-term performance, but otherwise did not preclude future profitability. In these situations, the courts seem eager to prevent the attempted withdrawal. In both cases, the courts reasoned that the purchasers' knowledge of the specific risks faced by the targets is of the utmost importance in assessing a MAC. Additionally, neither court seemed particularly receptive or intrigued by quantitative data surrounding the adverse effects.

Although similar, however, *IBP* elaborated extensively on the approach taken in *Bear Stearns*. The *Bear Stearns* court seemingly began and ended with the purchaser's knowledge of the risks. No consideration was given to the "negotiating realities," such as whether Jardine was a strategic or financial purchaser. While on a fuller record the court may have provided a more in-depth analysis, the court apparently viewed a party's knowledge of risk as dispositive. Thus, while *IBP* provides for a more thorough framework, it seems, at least at this point, to be a natural extension of New York law. However, as illustrated by the next two cases, courts of the pre-*IBP* era were not completely aligned in the seller-friendly approach to MAC clauses.

2. *Raskin v. Birmingham Steel Corp.* (Delaware, 1990)

Birmingham Steel announced that it was merging with Harbert Corporation in September of 1989.[112] Financing for the merger was to be provided in part by The Bear Stearns Companies and Continental Bank

109. *Id.* at *2.

110. *Id.* at *14.

111. *Id.* (emphasis added) ("Here one can fairly assume that Jardine was fully apprised of the risks inherent in the business in which it sought to make a substantial investment.").

112. Raskin v. Birmingham Steel Corp., No. 11365, 1990 Del. Ch. LEXIS 194, at *3 (Dec. 4, 1990).

along with an equity contribution from Harbert Corporation.[113] Both the financing commitments and the merger agreement were subject to conditions, including the absence of the occurrence of a MAC in Birmingham's financial condition.[114] In October, it became clear that Birmingham's financial condition was deteriorating. By January, earnings for the first half of the fiscal year (July to December) had declined by 50 percent as compared to the same period for the previous year.[115] With that information in hand, Continental communicated to Harbert that it believed a MAC had occurred and encouraged a mutual termination of the financing commitment.[116] Harbert communicated to Birmingham that it was in agreement with Continental and that Bear Stearns did not believe the deal was financeable given the circumstances.[117]

Birmingham's shareholders filed a class action lawsuit that claimed the financing commitments and merger agreement had been breached by defendants and sought specific performance of those agreements, or in the alternative, damages for the loss in value of Birmingham stock.[118] Ultimately, the Birmingham shareholders reached an agreement with Harbert and sought court approval of the proposed settlement.[119] The court, in considering the motion to approve the settlement, reviewed the probable merits of each claim.[120] In reviewing the breach of contract claim, the court noted that the record strongly supported the occurrence of a MAC in Birmingham's financial performance. The court concluded that "[w]hile it is possible that on a full record and placed in a larger context one might conclude that a reported 50% decline in earnings over two consecutive quarters might not be held to constitute a material adverse development, it is, I believe unlikely to think that might happen."[121]

Although the court did not definitively conclude that a MAC had occurred in Birmingham's performance, its confidence that a short-term decline in Birmingham's performance was material is telling. While the court did admit that the larger context may impact its conclusion, there was no inquiry into whether the downturn was due to larger economic or industry forces or whether the purchaser and banks were aware of such a

113. *Id.* at *3–4.
114. *Id.* at *4.
115. *Id.* at *6.
116. *Id.*
117. *Id.*
118. *Id.* at *1.
119. *Id.* at *2.
120. *Id.* at *14.
121. *Id.* at *14–15.

risk. At the very least, this case indicates that prior to *IBP*, a short-term decline—even one that is relatively small—could satisfy the materiality standard under Delaware law.

3. *Pan Am Corp. v. Delta Air Lines, Inc.* (New York, 1994)

In January of 1991, Pan Am and its subsidiaries filed for bankruptcy protection.[122] In March, Delta Air Lines approached Pan Am and expressed interest in a possible acquisition of two of its operating divisions.[123] Not wanting to sell off its assets piecemeal, Pan Am made any asset sale contingent on an agreement to a combined plan of reorganization.[124] On August 11, Delta presented Pan Am with a letter that included a proposal for an Asset Purchase Agreement and a plan of reorganization.[125] The plan of reorganization included an investment of $305 million in a reorganized Pan Am ("Pan Am II"), which would serve Latin America and the Caribbean.[126] Delta made its Pan Am II commitment conditioned on the completion of the asset purchase agreement; completion of legal, financial, and environmental due diligence; and confirmation of a plan of reorganization that was satisfactory to Delta.[127] Pan Am accepted Delta's August 11 proposal, and the next day, Delta and Pan Am entered into a definitive agreement regarding the asset purchase and the provision of up to $80 million in debtor in possession ("DIP") financing.[128] The Bankruptcy Court approved the transaction.[129]

By October it became clear that Pan Am would need additional operating funds, so negotiations began to obtain more DIP financing.[130] After days of negotiation, the parties reached an agreement, which required Delta to provide up to an additional $140 million in new DIP financing and to increase its proposed financing of Pan Am II to $205 million.[131] This revised agreement was contingent upon, among other things, the nonexistence of MACs.[132] The MAC clause required that:

122. Pan Am Corp. v. Delta Air Lines, Inc., 175 B.R. 438, 445 (Bankr. S.D.N.Y. 1994).
123. *Id.*
124. *See id.*
125. *Id.* at 446.
126. *Id.*
127. *Id.* at 447.
128. *Id.*
129. *Id.*
130. *Id.* at 447–48.
131. *Id.* at 449.
132. *Id.* at 450.

> Since August 12, 1991 there shall have been no material adverse change in the business, financial position, results of operations or prospects of the Retained Assets, except for any change resulting from conditions or circumstances disclosed to Delta on or prior to such date, and except that any change in results of operations (whether before or after September 24, 1991) resulting from conditions or circumstances in effect on September 24, 1991 shall not constitute such a material adverse change.[133]

Failure to satisfy a contingency would require the immediate repayment on December 5, 1991 of any amounts advanced.[134]

By November, Pan Am's revenue projections began to deteriorate and projected expenses began to swell.[135] At an end-of-the-month meeting, Pan Am revealed that they expected revenue shortfalls of $60 million from December through the first half of 1992.[136] At the same time, projected expenses for the Pan Am II investment had risen by $64 million, resulting in an overall expected loss of $76.2 million during the business plan.[137] Ultimately, due to the poor financial projections and poor condition of the market, Delta decided against providing additional DIP financing to Pan Am and also chose to withhold funding for Pan Am II until the plan's effective date.[138] Pan Am sued, claiming that Delta's failure to invest in Pan Am II represented a repudiation of the August and October agreements.[139]

The U.S. District Court for the Southern District of New York quickly extinguished Pan Am's claims, finding no evidence in support of its claim of repudiation and a failure of Pan Am to satisfy the conditions precedent to Delta's obligations.[140] One of the conditions that Pan Am failed to satisfy was the nonexistence of a MAC.[141] In reaching its conclusion that Pan Am had experienced a MAC, the court focused heavily on the quantifiable deterioration in Pan Am's business performance as compared to the previous year and forecasts made by a Pan Am vice president.[142] Of particular interest to the court was a $23 million shortfall from projections

133. *Id.* at 450 n.7.
134. *Id.* at 450.
135. *Id.* at 452–56.
136. *Id.* at 458.
137. *Id.* at 459.
138. *Id.* at 463–64.
139. *Id.* at 467.
140. *Id.* at 467–94.
141. *Id.* at 492–93.
142. *Id.*

for the month of November 1991, as well as the declines in advanced bookings on Pan Am's remaining divisions for the months of January and February 1992, which ranged from 19.1 percent to 43.5 percent below the previous year.[143] The court concluded that "[t]hese statistics reflect a material adverse change to Pan Am's business . . . and . . . business prospects."[144]

Interestingly, the court noted that the business deterioration "came as a surprise" to both parties.[145] This suggests that there was some continuity between *Bear Stearns*, *Pan Am*, and *IBP* under New York law in that all three decisions considered the purchaser's knowledge when interpreting the MAC clauses. Then again, while the *Pan Am* court claimed that the deterioration "came as a surprise," it is hard to believe that business difficulties were unforeseeable given that Pan Am had declared bankruptcy only months prior. At the same time, *Pan Am* suggests that prior to *IBP*, New York courts were willing to find a MAC solely as the result of a short-term financial downturn. Most of the court's analysis focused on the statistics, and the statistics alone. The court was not focused on the overall negotiating realities; in fact, no attention was paid to Delta's motives. On the other hand, the context of *Pan Am* is unique and significant in that Delta was providing funds in a workout from bankruptcy, which suggests that a steep and further deterioration in performance may be more significant or "material" than a short-term decline in performance of an otherwise profitable and stable target.

B. POST-*IBP* JUDICIAL INTERPRETATION

1. *Frontier Oil Co. v. Holly Co.* (Delaware, 2005)

Frontier and Holly, both mid-sized oil refiners, began negotiating a merger agreement in March 2003, under which Frontier would acquire Holly in exchange for a mix of cash and Frontier stock.[146] Days before the

143. *Id.* at 493 ("The percentage of non-revenue passengers (per flight) in Pan Am's traffic mix increased in the period August through October 1991, indicating that Pan Am's advanced bookings for December 1991 and January and February 1992 also overstated the actual revenues that Pan Am II would realize from those bookings."); 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-63 ("In the larger context of the case, Saddam Hussein's invasion of Kuwait had driven down Pan Am's advanced bookings significantly, because of widespread perceptions that the airline would face terrorist threats. The court, however, refrained from opining on geopolitical effects on consumer perceptions, instead focusing on the core carve-out in the MAC provision.").

144. *Pan Am*, 175 B.R. at 493.

145. *Id.*

146. Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 Del. Ch. LEXIS 57, at *6 (Apr. 29, 2005).

definitive agreement was to be signed, Holly learned of a potential mass toxic tort lawsuit against a Frontier subsidiary stemming from oil extraction adjacent to Beverly Hills High School that was alleged to have caused cancer in a number of students.[147] This development ultimately led to the renegotiation of the merger agreement and modification of the MAC clause.[148] Section 4.8 of the Merger Agreement read as follows:

> *Except as set forth on Schedule 4.8 of the Frontier Disclosure Letter*, there are no actions, suits or proceedings pending against Frontier or any of its Subsidiaries or, to Frontier's knowledge, threatened against Frontier or any of its Subsidiaries . . . other than those that would not *have or reasonably be expected to* have, individually or in the aggregate, a Frontier Material Adverse Effect.[149]

The agreement went on to define Material Adverse Effect as "a material adverse effect with respect to (A) the business, assets and liabilities (taken together), *results of operations*, condition (*financial or otherwise*) *or prospects* of a party and its Subsidiaries on a consolidated basis . . . ."[150] Notably, the definition of a Material Adverse Effect goes on to exclude from its definition "results from (i) general economic, regulatory or political conditions . . . (ii) financial or securities market fluctuations . . . [or] (iii) changes in, or events or conditions affecting, the petroleum refining industry generally . . . ."[151] Finally, Frontier's Disclosure Letter read in part as follows:

> Frontier agrees with, and for the sole benefit of, Holly that [the Beverly Hills] litigation will be considered as 'threatened' . . . and that the disclosure of the existence of this 'threatened' litigation herein is not an exception to Section 4.8 . . . and despite being known by Holly, will have no effect with respect to, or have any limitation on, any rights of Holly pursuant to the Agreement.[152]

Thus, in effect, through renegotiating the agreement, Holly allocated

147. *Id.* at *7–8. Interestingly, the suit was brought by activist Erin Brockovich and the famous plaintiffs firm associated with her.

148. *Id.* at *15.

149. *Id.* Italics represent additions after the renegotiation. *Id.* at *15 n.15.

150. *Id.* at *16. Italics represent additions after the renegotiation. *Id.* at *15 n.15.

151. *Id.* at *36–37. Thus, unlike the broad MAC clause used in *IBP*, which did not contain any carve-outs or exclusions, this clause had been narrowed by the parties to exclude certain events. Nonetheless, "none of these exceptions was relevant, and so the sole issue was whether the Beverly Hills litigation, which was admittedly adverse to Frontier, was of sufficient magnitude to constitute a 'Material Adverse Effect' under the agreement. This pattern—carefully drafted exceptions for systematic risks [that] turn out to be irrelevant while the dispute centers on whether an admittedly adverse event is sufficiently material—is common in MAC disputes." Miller, *supra* note 7, at 23.

152. *Frontier*, 2005 Del. Ch. LEXIS 57, at *17.

the risk of the potential Beverly Hills litigation by having Frontier warrant that it would not have, nor reasonably be expected to have, a MAE on Frontier.[153] Both boards adopted this modified agreement.[154]

Within the fourteen weeks that followed the signing, but before closing, the threatened Beverly Hills litigation became a reality.[155] The lawsuit, filed on behalf twenty-one plaintiffs, two of whom were deceased, named not only Frontier's subsidiary, but also Frontier.[156] Unbeknownst to both Frontier and Holly up to this point, Frontier had guarantee and indemnity obligations stemming from its subsidiary's assumption of the original Beverly Hills School District lease.[157] This revelation took both parties by surprise, and the Holly Board considered noticing a MAC.[158] It became clear to Frontier that Holly would not close the deal unless it was renegotiated.[159] Nevertheless, despite considering several proposals that would insulate Holly shareholders from the negative effects the litigation may have had on Frontier's stock price, the parties failed to strike a new deal and Frontier filed suit, claiming Holly had repudiated its obligation under the Merger Agreement.[160] The next day, Holly sent a letter to Frontier claiming the Beverley Hills litigation constituted a Frontier MAC.[161] By this time, the Beverly Hills litigation had expanded into three separate lawsuits on behalf of over 400 plaintiffs, with estimated defense costs in the $40 to $50 million range and potential liability in the $500 million to $1 billion range.[162]

Vice Chancellor Noble of the Delaware Court of Chancery addressed whether the Beverly Hills litigation had or would reasonably be expected to have a MAE.[163] In reviewing the language of the agreement the Vice Chancellor synthesized the basic substance of section 4.8 and schedule 4.8: "Frontier represented to Holly that the Beverly Hills Litigation *would not*

153. In addition to allocating risk through a MAC clause, section 7.5 also included a $15 million break-up fee from the terminating party in addition to a $1 million reimbursement fee for expenses incurred. *Id.* at *32–33.

154. *Id.* at *6.

155. *Id.* at *40.

156. *Id.*

157. *Id.* at *39–40, *45 ("[I]t is also clear that Frontier's management did not know about the indemnities—or had forgotten about them—when the Merger Agreement was signed.").

158. *Id.* at *109.

159. *Id.* at *63–64.

160. *Id.* at *86–87.

161. *Id.* at *88–89.

162. *Id.* at *76–77.

163. *Id.* at *122–43.

have an MAE and *would not reasonably be expected to have* an MAE."[164] In the court's view, this was an objective test that required forward-looking analysis because of the amended language.[165] The court then reiterated the standard for MAC interpretation set out by the same court only four years prior in *IBP*. But in that case, the court was considering New York law; here, the court was to settle the dispute under Delaware law.[166] Nonetheless, the court explicitly adopted the *IBP* standard, saying, "I see no reason why the law of Delaware should prescribe a different perspective."[167] In characterizing the standard, the court said "it may be more useful to consider the standard drawn from *IBP* as one designed to protect a merger partner from the existence of unknown (or undisclosed) factors that would justify an exit from the transaction."[168] Yet, the analysis of IBP's earnings impairment was not readily adaptable to the facts at hand given that the Beverly Hills litigation had not yet caused any adverse effects on Frontier.[169]

The first issue the court addressed was the burden of proof in a MAC claim.[170] Since the parties did not allocate the burden of proof contractually, the court relied on presumed expectations and case law to conclude that the burden of demonstrating that the Beverly Hills litigation constituted a MAC fell on Holly.[171] Next, the court addressed whether litigation can ever qualify as a MAC.[172] Despite Frontier's argument that litigation is too speculative to ever constitute a MAC, the court stated that "threatened litigation can be so certain, the outcome so predictable, and the likely consequences (*i.e.*, 'prospects') so negative, that an observer could readily conclude that the impact that one would reasonably expect to result from the litigation would be material and adverse."[173] However, despite recognizing the "serious risks" to Frontier and the possible "catastrophic" outcome, the court refused to consider the possibility of an adverse

164. *Id.* at *124 & n.209 ("The parties used 'would,' not 'could' or 'might.' 'Would' connotes a greater degree (although quantification is difficult) of likelihood than 'could' or 'might,' which would have suggested a stronger element of speculation (or a lesser probability of adverse consequences)."). The court noted that "[i]t would be neither original nor perceptive to observe that defining a 'Material Adverse Effect' as a "material adverse effect' is not especially helpful." *Id.* at *126.

165. *Id.* at *126–27. (explaining that the use of "would reasonably be expected to have" and the use of "prospects" necessitated a forward-looking analysis).

166. *Id.* at *127–28.

167. *Id.* at *128.

168. *Id.* at *129.

169. Miller, *supra* note 7, at 23.

170. *Frontier*, 2005 Del. Ch. LEXIS at *129–31.

171. *Id.* at *131–32.

172. *Id.* at *132.

173. *Id.*

judgment in its MAC analysis because Holly had failed to provide facts or testimony that would give the court a "basis to make a reasonable and an informed judgment of the probability of an outcome on the merits."[174] Thus, the issue boiled down to whether the expected cost of defense would have, or would reasonably be expected to have, a MAE on Frontier.[175] Both parties proffered estimated costs ranging from $10 million to $50 million, but the court concluded that the evidence pointed to a reasonable estimate of $15 million to $20 million.[176] The court compared these estimated costs with the enterprise value of Frontier, which experts had testified was approximately $338 million.[177] With those figures in mind, the court concluded that these costs could be absorbed without causing a significant effect over the long term.[178] Thus, Holly had not carried its burden of proving the Beverly Hills litigation would have, or would reasonably be expected to have, a MAC.[179] Nevertheless, the court concluded in the end that Frontier had breached the Merger Agreement by claiming Holly had repudiated, allowing Holly to walk away without having to pay the break-up fee.[180]

The significance of the *Frontier* decision is twofold. First, it represents the unification of New York and Delaware law under the *IBP* standard. Second, it sheds light on how seller-friendly the *IBP* standard really is. Here, unlike *IBP*, Holly not only knew about the risk of litigation, but also attempted to allocate that risk in the agreement. Thus, *Frontier* goes to show that even when the burden of a risk has been specifically allocated in the contract—and thereby addressing the "knowledge" prong of the analysis—courts are still reluctant to find a MAC when that risk materializes.

2. *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.* (Delaware, 2008)

Following the adoption of the *IBP* standard by the Delaware courts in *Frontier*, the MAC standard was put to the test again in a case reminiscent

174. *Id.* at *133, *136.

175. *Id.* at *138.

176. *Id.* at *141.

177. *Id.* at *142 n.230. The court acknowledged that "[t]he question of whether a particular 'problem' would have an MAE has both quantitative and qualitative aspects." *Id.* at *142. Market capitalization in this case was calculated with a discounted cash flow analysis and concluded that the net present value on a going-forward, stand-alone basis was approximately $338 million. *Id. See also* Miller, *supra* note 7, at 23 ("The teaching of *Frontier Oil* seems to be . . . that a diminution in earnings capacity of about 5% is not a MAC in Delaware.").

178. *Frontier*, 2005 Del. Ch. LEXIS at *142.

179. *Id.* at *143.

180. *Id.* at *157–58.

of *IBP*. In July 2007, following a bidding process, Hexion entered a merger agreement under which Huntsman would be acquired in a leveraged cash acquisition.[181] Due to the competitive bidding process, the terms of the agreement significantly favored Huntsman.[182] Not only did Hexion offer a substantially higher price than the competition, but it also agreed to close regardless of its ability to obtain financing.[183] The agreement provided for uncapped damages in the case of a "knowing and intentional breach" by Hexion and liquidated damages of $325 million for other breaches.[184] The only provision that would allow Hexion to escape the agreement without paying damages was the MAC clause.[185] Section 6.2(e) of the agreement provided that "Hexion's obligation to close is conditioned on the absence of 'any event, change, effect or development that has had or is reasonably expected to have, individually or in the aggregate,' an MAE."[186] An MAE was defined as "any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of the Company and its Subsidiaries, taken as a whole . . . ."[187] The definition continued, excluding from its meaning any adverse changes in general economic or financial market conditions, as well as adverse changes in the chemical industry generally, so long as the changes did not affect Huntsman disproportionately.[188]

In line with the recurring theme of the previously discussed cases, in April 2008, prior to closing, Huntsman reported first quarter returns much lower than projected, causing Hexion's management to question the

181. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 720–21 (Del. Ch. 2008). This agreement occurred almost immediately before the onset of the national and international credit crisis.

182. *See id.* at 721.

183. *Id.* Usually, a deal that is highly leveraged will contain a "financing condition" or "financing out," which allows the purchaser to walk away without penalty if it is unable to obtain proper financing by closing. Here, the terms of the financing agreements did not mirror the terms of the merger agreement, creating a situation where the financing could fall through but still obligate the purchaser to close. Miller, *supra* note 7, at 23 ("Hexion had received commitment letters from Credit Suisse and Deutsche Bank to provide the needed financing, but the obligations of the banks under these letters was contingent in various ways that Hexion's obligation to complete the merger was not. Hence, if the time came to close the deal and Hexion had not obtained the necessary financing under the bank commitment letters or otherwise, Hexion would still be obligated to pay the purchase price and consummate the merger, and it would be in breach if it did not do so.").

184. *Hexion*, 965 A.2d at 724.

185. *Id.*

186. *Id.* at 736.

187. *Id.*

188. *Id.* at 736–37. As was the case in *Frontier*, these exclusions or carve-outs, once again, turned out to be inconsequential to the outcome of the case. *See supra* note 151.

occurrence of a MAC.[189] Nevertheless, instead of immediately crying MAC, Hexion began a "carefully designed plan" to frustrate the financing.[190] As part of the larger plan to escape the deal, Hexion eventually filed suit, claiming, in part, that Huntsman had experienced a MAC.[191]

In addressing the issue of whether Huntsman suffered a MAC, Vice Chancellor Lamb first addressed the applicability of the carve-outs.[192] Since the plain meaning of the carve-outs "is to prevent certain occurrences which would *otherwise* be MAE's being found to be so," a court need not consider the application of the carve-outs unless the court first concludes that the company has suffered a MAC.[193] Thus, the court would not consider Hexion's argument that Huntsman's poor performance relative to other chemical companies signifies a MAC falling outside the chemical industry carve-out without first establishing that Huntsman had indeed suffered a MAC.[194]

Next, before methodically dispelling Hexion's argument that Huntsman had suffered a MAC, Vice Chancellor Lamb carefully laid out the evolved MAC standard.[195] Proceeding from the presumption that "[i]n the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy," the court emphasized that the important consideration in the MAC analysis is "whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months."[196] Thus, if poor performance in the short-term is to constitute a MAC, the adverse effects "must be expected to persist significantly into the future."[197]

189. *Id.* at 725.

190. *See id.* at 725–30. Hexion's plan involved obtaining an insolvency opinion, publishing it, which it knew, or reasonably should have known, would frustrate the financing, and then claim it did not "knowingly and intentionally" breach its obligation to close. This plan still would not have relieved them of their obligation to close because of the absence of a financing out; however, it may have limited liability to the capped liquidated damages amount.

191. *Id.* at 730.

192. *Id.* at 736–38.

193. *Id.* at 737.

194. *See id.* at 737–38 ("However, because . . . Huntsman has not suffered an MAE, the court need not reach the question of whether Huntsman's performance has been disproportionately worse than the chemical industry taken as a whole.").

195. *Id.* at 738–46.

196. *Id.* at 738.

197. *Id.*

The court then further clarified the burden of proof regarding MAC clauses.[198] In the court's view, it is irrelevant whether a MAC clause takes the form of a representation, a warranty, or a condition to closing: absent contrary intent, the burden of proof falls squarely on the party attempting to excuse itself from the contract.[199] Elaborating further, the court established that the proper measure of a target's business operations is EBITDA, not earnings per share, which is highly dependent on a target's capital structure and is largely irrelevant in an acquisition.[200]

The court then evaluated each of the three grounds that Hexion claimed constituted a MAC.[201] The first ground was Huntsman's poor performance in the year following the signing.[202] Not only was EBITDA for the first half of 2008 nearly 20 percent below the prior year's, but EBITDA for the second half of 2007, and 2008 as a whole, fell short of projections by 22 percent and 32 percent respectively.[203] The court refused to consider the failure to meet projections in this case because not only did "the merger agreement[] explicitly disclaim any representation or warranty with respect to 'any projections, forecasts or other estimates,'" but a Hexion executive also testified that Hexion knew Huntsman would not reach its projections.[204] In comparing actual results from prior years, the court thought it clear that a 3 percent decline in EBITDA from 2006 to 2007, a 7 to 11 percent decline in EBITDA from 2007 to 2008, and a historic annual trend of declining earnings throughout the fiscal year were evidence enough that a MAC had not been suffered.[205] EBITDA from the time of signing until Hexion claimed a MAC was only down 6 percent.[206] Next, in recognizing that expected future performance is a relevant

198. *Id.* at 738–40.

199. *Id.* at 739–40 ("[M]aterial adverse effect clauses are strange animals, *sui generis* among their contract clause brethren.").

200. *Id.* at 740. ("Because EBITDA is independent of capital structure, it is a better measure of the operational results of the business."). EBITDA is the acronym for Earnings Before Interest, Taxes, Depreciation and Amortization, which is a common indicator of a company's financial performance. *Definition of "Earnings Before Interest, Taxes, Depreciation and Amortization—EBITDA"*, INVESTOPEDIA, http://www.investopedia.com/terms/e/ebitda.asp (last visited Jan. 28, 2015).

201. *Hexion*, 965 A.2d at 740–46.

202. *Id.* at 740.

203. *Id.*

204. *Id.* at 740–42.

205. *Id.* at 742. ("And although Huntsman's fourth quarter 2007 EBITDA was 19% below its third quarter 2007 results, which were in turn 3% below its second quarter 2007 results, Huntsman has historically been down on a quarter-over-quarter basis in each of the third and fourth quarters of the year.").

206. *See id.* at 742 ("[C]omparing the trailing-twelve-month EBITDA for second quarter 2007 to second quarter 2008, the 2008 result is only down 6% from 2007.").

consideration to a MAC evaluation, the court acknowledged the impreciseness of such an assessment.[207] Nevertheless, in light of then-current analyst projections of a 3.6 percent decrease in EBITDA for 2009, the court concluded that Hexion had not carried its burden, particularly given the macroeconomic challenges Huntsman was facing.[208]

In support of its argument regarding Huntsman's poor results from operations, Hexion also pointed to a rise in Huntsman's net debt.[209] Originally, Huntsman had projected decreasing its debt by the end of 2008 by $1.163 billion through the divestiture of three divisions.[210] This, however, did not go as planned and Huntsman ended up increasing its debt by $178 million.[211] Nevertheless, after studying Hexion's models for the deal, all of which assumed net debt at closing would be $4.1 billion, which was only 5 percent below Huntsman's actual net debt, the court was not swayed.[212] The nominal decrease in earnings combined with a 5 percent increase from expected debt was simply not sufficiently material to claim Huntsman had suffered a MAC.[213]

Lastly, Hexion argued that poor performance at two of Huntsman's divisions, which when combined were expected to comprise 25 percent of total EBITDA, resulted in a MAC.[214] The court, in giving minimal credence to the argument, noted that even if the divisions were materially impaired, such fact would be only tangentially related to the larger question of Huntsman's business as a whole, especially given the relatively small percentage of EBITDA at issue.[215] In dismissing this argument, the court reflected on the fact that the poor performance was likely the result of macroeconomic factors that were probably short-term in nature.[216]

The court ultimately concluded that Huntsman had not suffered a

207. *Id.* at 743.

208. *Id.*

209. *Id.* at 743–44.

210. *See id.* at 744 ("As of the end of June 2007, Huntsman forecast that its net debt at the end of 2008 would be $2.953 billion. At the time, its net debt stood at $4.116 billion.").

211. *Id.* at 744. Once again, both parties offered points of view that made the increase in debt appear favorable. From Huntsman's point of view, this increase represented only a 5 percent to 6 percent increase, which is a "far cry" from an MAE based on financial condition. From Hexion's perspective, Huntsman failed to account for the fact that Huntsman received $794 million for the three divisions, which was supposed to go towards paying off debt. Thus, Hexion argued that the increase in debt actually represented a 32 percent increase.

212. *Id.*

213. *Id.*

214. *Id.* at 744–45.

215. *Id.* at 745.

216. *Id.*

MAC and that Hexion knowingly and intentionally breached several covenants.[217] As a result, the court specifically enforced Hexion's obligations to the extent permitted by the agreement.[218]

C. WHERE DOES THIS LEAVE THE MODERN MAC STANDARD?

IBP v. Tyson is hailed as the seminal case on the topic of MAC clause interpretation for good reason.[219] Given the dearth of case law on the topic, Vice Chancellor Strine's thoughtful and thorough opinion established the general framework for contemporary MAC clause interpretation in New York and Delaware. The lasting precedential value of the *IBP* decision is its decisive shift to a seller-friendly interpretation of MAC clauses. Prior to *IBP*, as was demonstrated in *Bear Stearns*, *Pan Am*, and *Birmingham Steel*, the New York and Delaware courts were sending mixed signals regarding what properly constituted materiality and whether a short-term decline in performance was sufficient to ever constitute a MAC. The Court in *IBP*, charged with interpreting a MAC clause that was seemingly protective of the purchaser, settled the confusion, making it clear that MAC clauses are not escape hatches for remorseful buyers. Anthony Niblett points to *IBP* as an example of how a decision in the early evolution of the law can settle a standard at one end of the spectrum so as to avoid future litigation.[220] This assessment holds true over a decade after the *IBP* decision. Not only is MAC litigation exceedingly rare in both New York and Delaware, but also when it has occurred, most notably in *Frontier Oil* and *Hexion*, the courts have entrenched the seller-friendly standard.

Taken together, *IBP*, *Frontier Oil*, and *Hexion* reveal that MAC clause interpretation involves a highly fact-specific, case-by-case determination of materiality. They also make it exceedingly clear that a party claiming the occurrence of a MAC—most often a purchaser—bears a very heavy burden.[221] In fact, this burden of proof is so great that "no Delaware court

217. *Id.* at 722.

218. *Id.*

219. Cheng, *supra* note 3, at 580; Bradley C. Sagraves & Bobak Talebian, *Material Adverse Change Clauses in Tennessee:* Genesco v. Finish Line, 9 TRANSACTIONS: TENN. J. BUS. L. 343, 349 (2008).

220. ANTHONY NIBLETT, CASE-BY-CASE ADJUDICATION AND THE PATH OF THE LAW 20–21 (Mar. 2011), *available at* http://works.bepress.com/anthony_niblett/1 ("[*IBP*] represents an example of an early case in the evolution of law being decided narrowly, and implicitly resolved most potential disputes. . . . The *IBP* decision was seen by commentators as surprising. Commentators suggested that the interpretation of the materiality standard is 'so demanding that—absent a cataclysm of biblical proportions—it cannot be met.' The benchmark was set 'impossibly high,' ensuring that the MAC clause will almost certainly not be invoked.").

221. 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-63 ("[C]ourts

has ever found a MAC . . . in the acquisition context."[222] Although the courts have made it abundantly evident that they are not inclined to allow a party to walk away on the grounds of a MAC, the courts have not developed any clear guidelines nor quantitative data points for discerning when an adverse change is sufficiently material.[223] The lack of precision inherent in the judicial decisions creates difficulties for practitioners in offering guidance to businesspersons who seek predictability and certainty in allocating deal risk.[224] Nevertheless, some important lessons can be learned from this line of cases that provide purchasers with realistic expectations about the clause's utility for allocating risk.[225]

One of the first lessons learned from this line of cases is which party bears the burden of proof. While the earlier cases provided that the burden of proof lies with the party seeking to excuse its performance under the contract, *Hexion* made it clear that this is the presumption only "absent clear language to the contrary."[226] Thus, the parties—presumably when there is a huge disparity of bargaining power in favor of the purchaser—can negotiate such that the seller would bear the burden of proving the nonexistence of a MAC.

Another important takeaway from this line of decisions is the courts' willingness to look beyond the clear meaning of the language to the unique facts and negotiating realities of the parties in order to discern intent. This factually intensive approach has led to seemingly broad clauses being read very narrowly, and, additionally, it has provided some concrete guidance that practitioners must keep in mind. First, courts presume that parties have allocated risks that were foreseen or foreseeable at the time of signing. For example, Jardine knew of the volatile nature of the stock market, Tyson knew of the cyclical nature of the beef industry, and Hexion knew that

engage in a case-by-case, highly fact-specific materiality inquiry, paying particular attention to the size of the transaction and the parties involved. This effectively elevates a claimant's burden in larger and more sophisticated transactions.").

222. FLEISCHER & SUSSMAN, *supra* note 2, § 14.07[E], at 14-493.

223. 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-62 ("Courts appear to perceive such claims as the business equivalent of sour grapes, or as an attempt of a party . . . to obtain through the courts what it did not get at the bargaining table."). *See also* TABLE 1.

224. Carl L. Reisner, Gary J. Pagano & Joseph Rose, *Material Adverse Clauses: Practice in an Uncertain World*, M&A LAW., Apr. 2006, at 1, 3.

225. FLEISCHER & SUSSMAN, *supra* note 2, § 14.07[B], at 14-461 ("The most critical point expressed is the need for acquirors to appreciate that deals cannot be terminated for 'technicalities' or insignificant reasons.").

226. *See In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 53 (Del. Ch. 2001); Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 Del. Ch. LEXIS 57, at *131 (Apr. 29, 2005); Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 739 (Del. Ch. 2008).

Huntsman would not meet its projections. Conversely, Delta was surprised by the sudden downturn in Pan Am. The clear message to potential purchasers is that they must negotiate to have known risks and potential events specifically included within their MAC definition if they want MAC protection from those risks.[227] Then again, even when known risks are specifically allocated, as was the case with the Beverly Hills litigation in *Frontier*, the party attempting to excuse its performance still bears a heavy burden. While it is not clear when the courts will consider a risk or event to be "known," it is clear that they will not allow a purchaser to claim ex post that an event or change is material when they testified that they were aware of the risk.[228]

Additionally, the courts' assumption that corporate purchasers have strategic motives leads to the requirement that adverse changes affect the long-term earnings potential of the target over a commercially reasonable period, which is measured in years, not months.[229] Thus, a purchaser attempting to prove a MAC should be prepared to proffer evidence and expert testimony that the adverse change is not a short-term hiccup but will instead have long-term material effects.[230] Conversely, targets should be prepared to defend against a MAC claim by showing that the adverse change is outside the norm or part of a cyclical change.[231] Also, when assessing whether the long-term earnings potential of a target is materially impacted, it should be assessed in terms of EBITDA.[232] While the courts have not established any clear guidelines with regard to how significant a decline in EBITDA must be before it is material, it is possible that further judicial interpretation will provide greater guidance.[233]

227. 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-65 ("[C]ourts pay close attention to the parties' knowledge and conduct during negotiations to discern the details of the risk allocation at the time of signing. MACs shift the *unforeseeable* changes only; they do not protect buyers from risks foreseeable at the time of signing, which parties are presumed to have allocated.").

228. *Broadly Written MAEs*, *supra* note 28, at 1742.

229. *Hexion*, 965 A.2d at 738. *See also supra* notes 79–83 and accompanying text.

230. 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-64–9-65.

231. *Id.*

232. Miller, *supra* note 7, at 24–25 ("Reviewing the essential legal developments in these cases, we see that the Delaware courts first glossed the phrase [MAC] to mean a change or event that substantially threatens the subject company's long-term earnings capacity and then set out to explicate this gloss in a financially sophisticated and essentially quantitative way. As the cases progress, the phrase *earnings capacity* comes to mean power to produce EBITDA, thus incorporating into the legal standard all the [generally accepted accounting principles] needed to compute EBITDA as well as the generally accepted practices of finance professionals who routinely rely on EBITDA . . . .").

233. *Id.* at 25 ("Judicial commonsense is used, on a case-by-case basis, to establish how much of a decline in EBITDA thus measured will count as a MAC. In this perspective, the individual MAC

In *IBP*, Vice Chancellor Strine opined that the seller-friendly approach to MAC interpretation avoids the need for extensive negotiation over carve-outs and exceptions, thereby saving on transaction costs. While it indeed seems to have obviated the need for extensive carve-outs protective of the seller,[234] this approach has also escalated the need for buyers to bargain for greater specificity. Thus, in essence, the court has merely shifted the burden of negotiation. Instead of sellers negotiating narrowness into MAC clauses, purchasers must now negotiate breadth into the clauses. For example, MAC clauses must now be explicitly defined to include declines in general trends, short-term "hiccups," and known risks, if a buyer intends to have its MAC clause protect against those outcomes. This shift in the burden of negotiation falls in line with the court's general aversion to allowing purchasers to treat MAC clauses as get-out-of-jail-free cards. Whether purchasers will be able to effectively incorporate "inclusions" into their MAC definitions remains to be seen, but what is clear is that *IBP* and its successors have not reduced the prevalence of carve-outs in MACs.[235]

litigations should be seen as plotting out data points: in *IBP*, we learn that a diminution in earnings capacity from relevant fiscal period to relevant fiscal period of 45% or more is likely a MAC, but a diminution of up to 2% is not. In *Frontier Oil*, a diminution of about 5% is not a MAC, and in *Hexion* a diminution of even 10% is not a MAC.").

234. *See* West, *supra* note 16 ("Even in the absence of these specific exclusions, courts have been reluctant in the past to read a material adverse change clause such that it would cover external factors that did not directly relate to the conduct of the target company's business.").

235. 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-61.

TABLE 1: Summary of Delaware & New York MAC Clause Case Law

Case	*Adverse Change(s)*	*Sufficiently Material?*
Bear Stearns v. Jardine (New York, 1988)	$100 million loss in two days 99.2% drop in quarterly revenue (first quarterly loss in history)	Likely No. Defendant knew of volatility inherent within industry.
Raskin v. Birmingham Steel (Delaware, 1990)	50% decline in earnings for first half of fiscal year	Likely Yes.
Pan Am v. Delta Air Lines (New York, 1994)	20% to 40% declines in advanced bookings $23 million shortfall from projected revenue for one month	Yes. "These statistics reflect a material adverse change to . . . business . . . and business prospects."
IBP v. Tyson (New York, 2001)	Missed short-term earnings projections 64% decline in earnings from operations as compared to same quarter in year prior $60 million earnings charge due to fraud	No. Defendant knew of cyclical nature and not significant from long-term perspective.
Frontier Oil v. Holly (Delaware, 2005)	$15–$20 million defense cost in company with $338 million enterprise value	No. Cost can be absorbed in company of that size without long-term effect.
Hexion v. Huntsman (Delaware, 2008)	Falling short of projections by 22% and 32% for two prior years 20% decrease in EBITDA for first half of fiscal year Increased net debt by $178 million when intended to decrease by $1.163 billion	No. Purchaser anticipated shortfall in projections. Decline in EBITDA followed historical trend. Purchaser anticipated failure to decrease net debt.

IV. WHY MAC IN THE MODERN WORLD?

The foregoing analysis of New York and Delaware MAC clause interpretation gives rise to a basic question: given the low, if not nonexistent, likelihood that a MAC clause will effectively extricate a party from a deal, what explains the clause's continued prevalence in M&A agreements, especially in light of alternatively available risk-allocating provisions? Part IV attempts to answer this question through an exploration of several possible explanations.

The first, and least strategic, explanation for the continued use of MAC clauses stems from their enshrinement in deal custom and tradition.[236] Having remained practically unchanged and almost universally used for four decades of deal practice, the MAC clause has become entrenched as standard practice. Because of this special stature and the relatively minimal cost of negotiation, there is little incentive for deal professionals to omit the clause. While including a MAC results in some added cost, the potential downside of not including one would be tremendous if events warranting a MAC materialize. Not only would this result in costs to the party that is unable to withdraw, but it may also result in liability for the professional who broke from industry practice. Thus, in all likelihood, deal professionals will continue to include MAC clauses in agreements regardless of how the courts are interpreting them because they have become a common fixture in M&A agreements.

Another explanation for the continued use and viability of MAC clauses is the ability to have their interpretation governed by the law of different states. While the narrow interpretation adopted by New York and Delaware in the wake of *IBP v. Tyson* has not resulted in a successful MAC claim, at least one court in the post-*IBP* era has dealt with adverse effects sufficient to warrant a MAC claim. In *Genesco v. The Finish Line*, the Chancery Court of Tennessee found that a retailer's 54 percent decline over three consecutive quarters, which also represented its lowest earnings in a decade, constituted a MAC.[237] Thus, a careful choice of law provision may effectively increase a party's ability to walk away upon the occurrence of an adverse change.

Third, while a MAC clause may not result in the right to walk away, the inclusion of a MAC may reduce the likelihood of adverse changes in

236. West, *supra* note 16.

237. Despite finding a MAC, the court concluded that it fit within a carve-out for general economic conditions, which prevented the buyer from using the MAC to walk away. Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III) 1, 33 (Tenn. Ch. Ct. Dec. 27, 2007).

the first place. As Gilson and Schwartz explain, the buyer's potential walk-away right created by a MAC clause incentivizes the seller to invest at an optimal level to ensure the continued performance of its business during the interim between signing and closing.[238] Without the walk-away right, the seller has less incentive to guard against less-than-optimal outcomes in its business and financial performance.[239] While this explanation is only relevant to internal risk factors given that a seller's investment cannot affect external risks, this explanation remains satisfactory since the courts have read clauses narrowly, excluding from adverse effects external risk factors that were not explicitly bargained for.[240]

Fourth, the MAC clause still plays an important role as a residual safety clause.[241] Despite the fact that Delaware has not yet found an adverse change that was sufficiently material to warrant rescission, MAC clauses are important back-up protection against truly significant and unforeseen risks.[242] For this reason alone, the incremental cost of including a MAC is likely justified given the probability of the target experiencing a truly significant adverse change. Nevertheless, while MACs should not be ignored or eliminated, it is equally important that deal professionals not overestimate their effectiveness.

Finally, the threat of MAC litigation alone provides significant leverage to a party wanting to renegotiate the deal.[243] Litigation is expensive and uncertain, and while sellers can take some comfort in the courts' seller-friendly MAC interpretation, the risk of litigation is often not worth the reward. Sellers would rather accept a lower selling price than incur the expense of litigation or risk an adverse judgment resulting in no deal at all.[244] At the same time, buyers also have an incentive to settle instead of risking a loss in court and being bound to the original purchase price.[245] In this way, MACs act as a renegotiation tool for parties no longer satisfied with the terms of the deal.[246]

238. Schwartz & Gilson, *supra* note 2, at 345.

239. *See id.* ("The MAC permits the buyer to exit in the event of a low realization, and this exit right motivates the seller to invest to reduce the likelihood of these realizations.").

240. *Id.*

241. 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-61.

242. West, *supra* note 16.

243. 2 DONOVAN & SIMALA, *supra* note 14; Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 869 (2010) ("Several buyers have publicly invoked the MAC, and either threatened or initiated litigation, to terminate deals or restructure them along different lines.").

244. Solomon, *supra* note 30.

245. *Id.*

246. *Id.*

In closing, while New York and Delaware courts have weakened the effectiveness of MAC clauses from a purchaser's perspective, the modern MAC still has teeth. MAC clauses still incentivize sellers to invest in their continued performance, they still provide leverage to a party wanting to renegotiate, and they provide a last defense against truly substantial adverse changes.

V. CONCLUSION

The use of MAC clauses in M&A agreements has a long history that will continue to develop. Although deal risk cannot be completely mitigated through the use of MAC clauses alone, they serve an important function in protecting parties' blind spots from the unknown. And while limited case law in New York and Delaware has made use of MAC clauses somewhat unpredictable in the years of late, the previously discussed decisions have made it clear that absent a long-term demise in a target's continued earnings capacity, which was both unforeseeable and unforeseen at the time of signing, MAC clauses cannot be relied on to excuse a buyer from closing.[247]

247. 1 STRATEGIES FOR DRAFTING AND NEGOTIATING, *supra* note 7, § 9.04[F], at 9-61–9-65.