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Material Adverse Change Provisions: Mergers and Acquisitions

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This Note looks at the use of material adverse change (MAC) provisions to allocate risk in acquisition transactions and provides an overview of their typical structure and exclusions as well as relevant case law. It also discusses, from a buyer's perspective, potential modifications and supplements to a customary MAC provision.

This Note summarizes the contours of a customary MAC provision, the major MAC-related cases and their impact on the drafting and interpretation of MAC provisions. This Note also examines the contractual alternatives available to buyers to modify or supplement the customary MAC provision to better allocate pre-closing adverse change risk to sellers.

THE BASICS OF RISK ALLOCATION IN ACQUISITION AGREEMENTS

Merger agreements and other types of acquisition agreements (referred to as acquisition agreements) allocate financial and other risks relating to the business and the acquisition transaction between the buyer and the seller. The buyer usually assumes the most significant risk relating to any acquired business: the risk (both upside and downside) of the general financial performance of the business following the closing. However, to allocate to the seller all or a portion of certain other risks relating to the business and the transaction, acquisition agreements typically employ various contractual mechanisms such as:

- Purchase price adjustment provisions.
- Representations and warranties.
- Covenants.
- Closing conditions.
- Indemnification rights.
- Termination rights.

For example, the seller commonly represents and warrants to the accuracy of specified factual statements regarding the business as of the signing and closing of the transaction. If this representation or warranty is materially breached, the buyer generally may refuse to close the transaction or, in a private transaction, assert an indemnity claim against the seller after the closing. Because the seller usually possesses better information about the business than the buyer before signing, these provisions allocate to the seller some of the risk that the information about the business set out in the seller's representations was inaccurate. In addition, acquisition agreements commonly contain covenants requiring the seller to conduct the business in the ordinary course consistent with past practice between signing and closing of the transaction. A material breach of this covenant also generally entitles the buyer to refuse to close the transaction or, in a private transaction, to assert a post-closing indemnity claim. For more information on common provisions in acquisition agreements, see *Practice Notes*:

- *Stock Purchase Agreement Commentary (http://us.practicallaw.com/6-381-0589).*
- *Asset Purchase Agreement Commentary (http://us.practicallaw.com/4-381-0590).*
- *Merger Agreement Commentary: Public Mergers and Acquisitions (http://us.practicallaw.com/3-382-3060).*

SHARING PRE-CLOSING ADVERSE CHANGE RISK VIA THE MAC

The buyer also seeks to allocate to the seller pre-closing adverse change risk, which is the risk of something happening before the closing that has or, at some time in the future, may have a materially adverse effect on the business for reasons other than seller factual misrepresentations or seller covenant breaches. Pre-closing adverse change risk includes, among other examples: changes in consumer tastes or demand; increases in raw material, commodities, labor or other costs; introduction of competitive products and services; changes in financial markets, interest rates, currency exchange rates, unemployment levels or other macroeconomic conditions; changes in law; key employee departures; unwise business judgments; and natural disasters, war or terrorism. Allocation of pre-closing adverse change risk customarily is accomplished through material adverse change (MAC) or material adverse effect (MAE) provisions (used interchangeably for purposes of this Note). MAC provisions generally take one of two forms:

- A closing condition that entitles the buyer not to close if the business suffers a MAC between a specified baseline date (generally the date of signing of the transaction or the date of the last audited or unaudited balance sheet of the business before the signing) and the closing date.
- A seller representation that the business has not suffered a MAC between the specified baseline date and the closing, along with a closing condition that entitles the buyer to walk away if such representation is not true at closing.

Acquisition agreements may include both a closing condition and a representation, both of which reference a negotiated definition of material adverse change (see *What Constitutes a MAC?*).

MAC provisions also are used in acquisition agreements to qualify the seller's representations (for example, a representation that there is no pending or threatened litigation against the business except as would not result in a MAC) and the closing condition relating to the accuracy of the representations at closing. This use of MAC provisions allocates the risk that information regarding the business represented by the seller to the buyer is inaccurate, as opposed to pre-closing adverse change risk.

WHAT CONSTITUTES A MAC?

Because MAC provisions allocate risks that neither party feels comfortable they can know at the time of signing or control between signing and closing, the definition of a MAC and the related provisions generally are negotiated vigorously. For well over a decade, however, this negotiation generally has occurred in the context of a widely shared understanding within the deal community regarding the customary function, structure, scope and language of MAC provisions and the accepted range of such provisions from relatively "pro-seller" to relatively "pro-buyer".

However, the prevailing MAC understanding has experienced something of a paradigm shift. The 2008 decision of the Delaware Chancery Court in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.* and the 2007 decision of the Tennessee Chancery Court in *Genesco, Inc. v. Finish Line, Inc.* confirmed the previously growing suspicion within the deal community that the customary MAC provision provides little protection to the buyer. As a result, buyers should consider seeking to modify or supplement the customary MAC provision to allocate a greater portion of pre-closing adverse change risk to sellers and to give buyers more leverage in negotiations with sellers to amend or terminate acquisition agreements when the business deteriorates prior to closing.

EXAMINATION OF A CUSTOMARY MAC PROVISION

Before we can examine the courts' analyses of MAC provisions or potential drafting changes, it is helpful to understand the traditional MAC provisions. Set out below is the MAC condition, representation and definition from the *Genesco, Inc./Finish Line Inc.* merger agreement. These are fairly typical examples of negotiated MAC provisions and definitions.

Example of MAC Condition

Material Adverse Effect. Since the date of this Agreement, there shall not have occurred a Company Material Adverse Effect with respect to the Company and the Company Subsidiaries, considered as a whole, that has not been cured prior to the Termination Date.

Example of MAC Representation

Absence of Certain Changes or Events. Since February 3, 2007 through the date hereof, except as specifically contemplated by this Agreement or set forth on Section 3.6 of the Company Disclosure Schedule, (i) there have not been any changes, events or circumstances of which the Company has knowledge that have had, individually or in the aggregate, a Company Material Adverse Effect, and (ii) the Company and each Company Subsidiary has conducted its respective business in the ordinary course of business, except for such actions as have not had, individually or in the aggregate, a Company Material Adverse Effect.

Example of MAC Definition

"*Company Material Adverse Effect*" shall mean any event, circumstance, change or effect that, individually or in the aggregate, is materially adverse to the business, condition (financial or otherwise), assets, liabilities or results of operations of the Company and the Company Subsidiaries, taken as a whole; provided, however, that none of the following shall constitute, or shall be considered in determining whether there has occurred, and no event, circumstance, change or effect resulting from or arising out of any of the following shall constitute, a Company Material Adverse Effect: (A) the announcement of the execution of this Agreement or the pendency of consummation of the merger (including the threatened or actual impact on relationships of the Company and the Company Subsidiaries with customers, vendors, suppliers, distributors, landlords or employees (including the threatened or actual termination, suspension, modification or reduction of such relationships)); (B) changes in the national or world economy or financial markets as a whole or changes in general economic conditions that affect the industries in which the Company and the Company Subsidiaries conduct their business, so long as such changes or conditions do not adversely affect the Company and the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate; (C) any change in applicable Law, rule or regulation or GAAP or interpretation thereof after the date hereof, so long as such changes do not adversely affect the Company and the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate; (D) the failure, in and of itself, of the Company to meet any published or internally prepared estimates of revenues, earnings or other financial projections, performance measures or operating statistics; provided, however, that the facts and circumstances underlying any such failure may, except as may be provided in subsections (A), (B), (C), (E), (F) and (G) of this definition, be considered in determining whether a Company Material Adverse Effect has occurred; (E) a decline in the price, or a change in the trading volume, of the Company Common Stock on the New York Stock Exchange ("NYSE") or the Chicago Stock Exchange ("CHX"); (F) compliance with the terms of, and taking any action required by, this Agreement, or taking or not taking any actions at the request of, or with the consent of, Parent; and (G) acts or omissions of Parent or Merger Sub after the date of this Agreement (other than actions or omissions specifically contemplated by this Agreement).

Analysis of Genesco's MAC Definition

Because the force of both the MAC condition and representation is drawn from the definition of what constitutes a MAC, it is necessary to carefully parse the definition itself. This includes:

- **What is material?** As is typically the case, the word "material" is not defined with reference to magnitude, duration or any other criteria. Four reasons commonly are cited for not defining "material":
  - Even an unbiased draftsperson finds it extremely challenging to construct a comprehensive definition of when an event, occurrence, change or effect is "material".
  - An exercise that is extremely challenging for an unbiased legal draftsperson becomes nearly impossible when committed to negotiation among the seller's and the buyer's lawyers in the context of a deal.
  - In light of the preceding two points, parties often conclude that the best resolution is to forego defining "material" in the acquisition agreement and instead to trust that, if ever a dispute occurs, reviewing judges will know what is "material" when they see it.
  - In the event a MAC is alleged, drafting ambiguity may be beneficial because it may create an incentive for both parties to negotiate reasonably to amend or terminate the agreement.
- **Financial projections are not included.** Note that the litany of "business, condition (financial or otherwise), assets, liabilities, or results of operations" does not include "prospects". Buyers often seek (but overwhelmingly fail) to include "prospects", believing that its inclusion would result in a MAC being determined based on a comparison of the business' actual performance as of closing relative to its projected performance (as opposed to its actual performance) as of the baseline date. Given the "hockey stick" business financial projections (meaning they project significant growth following the closing) that sellers often provide to buyers in connection with acquisition negotiations, buyers' desire to include "prospects" is not surprising. To the contrary, however, the *Genesco* MAC definition not only does not include prospects, but also contains the fairly typical language that the failure to meet any published or internally prepared financial estimates will not constitute, or be considered in determining, whether a MAC has occurred.
- **Timing of the MAC.** The *Genesco* MAC provision favors the seller in allowing the buyer to walk away only if an event, circumstance, change or effect has had a materially adverse effect before the closing. Many buyers are successful in providing that the buyer can walk away if "a pre-closing event, circumstance, change or effect has had prior to the closing, **or is reasonably likely to have after the closing**, a materially adverse effect". There are various formulations of this forward-looking language from the pro-buyer "could have" to the pro-seller "would have" to various middle ground formulations such as "are reasonably likely to have" or "are reasonably expected to have".
- **Carve-outs**. The bulk of the MAC definition is comprised of a lengthy list of what will neither constitute a MAC nor be considered in determining whether a MAC has occurred. The type and language of these exceptions or carve-outs differ somewhat from deal to deal, but some version of these carve-outs is customary. Sellers argue that buyers should not be able to refuse to close if the business suffers a material adverse change due to:
  - the same macroeconomic, industry wide, force majeure or otherwise generally applicable risks that the buyer already faces in its own business and is as capable of evaluating and bearing as is the seller; or
  - risks inherent in announcing and effecting the transaction or arising out of the buyer's actions.

As reflected in the *Genesco* MAC definition, buyers often successfully limit application of one or more of these carve-outs if the changes set out in the relevant carve-out affect the business in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which the business operates.

For other examples of MAC definitions and a discussion of typical exceptions see *Standard Documents, Stock Purchase Agreement (Pro-Buyer Long Form) (http://us.practicallaw.com/4-382-9882)* and *Merger Agreement (Pro-Buyer) (http://us.practicallaw.com/8-383-4693).*

MAC-RELATED CASES

The Delaware Chancery Court (and in the case of *Genesco*, the Tennessee Chancery Court) has issued several important decisions interpreting MAC provisions. Importantly, none of these cases has resulted in a court finding that a MAC has occurred.

IN RE IBP SHAREHOLDERS LITIGATION

In the 2001 Delaware Chancery Court *In re IBP Shareholders Litigation* case, Tyson Foods sought to terminate its New York law-governed merger agreement with IBP (*In Re: IBP, Inc. Shareholders Litigation, 789 A.2d. 14 (Del. Ch. 2001)*). Tyson argued that IBP had breached its representation and warranty that it had not, since the relevant balance sheet date, suffered a MAC, except as set out on the specified schedule to the merger agreement. Tyson pointed to the decline in IBP's performance over the last quarter of 2000 and the first quarter of 2001, taken together with an impairment charge associated with accounting irregularities at DFG Foods, one of IBP's subsidiaries. Vice Chancellor Strine held that IBP had not suffered a MAC. The opinion contains a number of principles relevant to drafting, negotiating and interpreting MAC provisions.

Burden of Proof

In what Vice Chancellor Strine described as a "close" case, the court held that practical reasons favored an approach requiring the buyer to make a strong showing to invoke a MAC exception to its obligation to close.

Transaction Context and Knowledge Establish the Baseline

The court held that the "negotiating realities" bear on the interpretation of the MAC clause and that "the contractual language must be read in the larger context in which the parties were transacting". In establishing a baseline against which to determine whether subsequent developments had the "required materiality", Vice Chancellor Strine looked to the condition of IBP on the relevant balance sheet date ("consistently profitable, but subject to strong swings in annual EBIT and net earnings"), as adjusted by the specific disclosures in its financial statements and the schedules to the merger agreement (which disclosed the accounting issues at DFG). Relatedly, the court noted that merger agreements are heavily negotiated and cover many specific risks explicitly.

Vice Chancellor Strine found that, even where a MAC provision is broadly drafted in favor of the buyer (the MAC clause in IBP lacked even the customary pro-seller carve-outs), it "is best read as a backstop protecting the acquiror from the occurrence of unknown events". The implication is that, if a party has actual knowledge of a potential risk and fails to address it in the agreement, there is a high probability that the court will infer that such risk was not viewed by the buyer as relevant to the determination whether a MAC has occurred.

Materiality

The court held that to be material an event must "substantially threaten the overall earnings potential of the target". It did not specify whether earnings before deduction of interest, taxes, depreciation and amortization (EBITDA), earnings before interest and taxes (EBIT), earnings per share (EPS) or some other income statement measure is the best measure of earnings potential. In addition, the court did not quantify what percentage or absolute dollar decrease in such measure is required to "substantially threaten" overall earnings power.

Duration of the Effect

Vice Chancellor Strine remarked that a strategic buyer who contracts to acquire a business as part of a long-term strategy should not consider a short-term blip in earnings to constitute a MAC. Consequently, the court held that the determination of whether a MAC has occurred requires consideration of the impact of the alleged MAC on the overall earnings potential of the target over a "commercially reasonable period". To constitute a MAC, the event must threaten the target's earnings potential in a manner that is "durationally-significant". Vice Chancellor Strine suggested the relevant period would be measured in years rather than months. This aspect of the opinion is particularly important because a period of years generally will not have elapsed by the time a buyer determines to invoke a MAC provision to refuse to close or before the parties' MAC dispute reaches court. Therefore, any buyer invoking a MAC bears the uphill burden of convincing the court that the business' financial condition not only already has suffered, **but will continue to suffer**, a MAC for the full "commercially reasonable" period.

FRONTIER OIL CORPORATION V. HOLLY CORPORATION

The 2005 Delaware Chancery Court *Frontier Oil* case reinforced the *IBP* ruling (*Frontier Oil Corp. v. Holly Corp., C.A. No. 20502 (Del. Ch. Apr. 29, 2005)*). In its merger agreement, Frontier represented that it was not subject to any pending or threatened litigation except as would not have or reasonably be expected to have a MAC. In the schedules to the merger agreement, the parties specified that a specific potential toxic tort suit against Frontier would be considered "threatened" for purposes of the representation but would not be considered as having been scheduled as an exception to the representation. The toxic tort suit was filed after the execution of the agreement and the parties tried, ultimately unsuccessfully, to renegotiate the deal. Frontier filed suit claiming that Holly had repudiated the merger agreement and Holly argued that Frontier had breached its litigation representation because the toxic tort suit would reasonably be expected to result in a MAC.

Vice Chancellor Noble held that Holly had not met its burden of showing that a MAC had occurred or would reasonably be expected to occur. The principles listed below emerged from the opinion.

Burden of Proof

The court followed *IBP* in finding that the burden of proof falls on the party asserting that a MAC has occurred or would reasonably be expected to occur. The court noted that, in the face of *IBP*, the parties could have allocated expressly the burden of proof as a matter of contract, but they did not do so.

Adoption of IBP

Noting that *IBP* applied New York law, the court followed the decision and quoted with approval from *IBP* that a MAC 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".

Language Still Matters

The court focused on several specific features of the particular MAC definition and its drafting history, including the addition of "would . . . reasonably be expected" and the inclusion of "prospects". Although the court ultimately decided that Holly had not proved that a MAC had occurred or would reasonably be expected to occur, it examined the MAC using the forward-looking language provided for in the merger agreement.

HEXION SPECIALTY CHEMICALS, INC. V. HUNTSMAN CORP.

In the 2008 Delaware Chancery Court *Huntsman* case, Hexion, an affiliate of Apollo Global Management LLC, argued that it was not obligated to close its acquisition of Huntsman because Huntsman had suffered a MAC (*Hexion Specialty Chemicals v. Huntsman Corp., 2008 WL 4457544 (Del. Ch. Sept. 29, 2008)*). Hexion pointed to Huntsman's failure to achieve its financial projections, but the court found that Hexion had not met its burden of proof. Confirming the pro-seller bias of Delaware judges reviewing MAC provisions, the court noted that it was "not a coincidence" that the Delaware courts have never found a MAC to have occurred in the context of an acquisition agreement. In delivering the judgment of the court, Vice Chancellor Lamb enunciated the principles set out below.

Burden of Proof

The court refused to distinguish between a MAC clause drafted in the form of a condition precedent as opposed to a representation or warranty. The court followed *IBP* and held that the burden of proof rests on the party seeking to excuse its performance under the contract absent clear language to the contrary (again acknowledging that the parties could contract explicitly on the subject).

Duration of the Effect

The court followed *IBP* in holding that a MAC must be assessed over "a commercially reasonable period, which one would expect to be measured in years rather than months."

Carve-Outs Considered Only if MAC Exists

The court would not address the carve-outs in the MAC definition (see *Analysis of Genesco's MAC Definition*). The MAC definition in the merger agreement included the following carve-out:

> "(A) any . . . change . . . resulting from . . . changes in general economic or financial market conditions, except . . . [changes that have] had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the chemical industry; [or] (B) any . . . change . . . that affects the chemical industry generally . . ."

The court refused to analyze whether industry-wide changes had affected Huntsman disproportionately compared to other companies in the chemical industry. In the court's view, unless as a threshold matter it determines that a MAC has occurred under the definition read without regard to carve-outs, it need not consider the application of pro-seller carve-outs to the definition of MAC or any pro-buyer carve-outs to such pro-seller carve-outs.

Taken as a Whole

The court refused to focus on two divisions of Huntsman that had been particularly troubled, stating that the merger agreement required a MAC to be determined based on an examination of Huntsman and its subsidiaries, taken as a whole.

Specific Disclaimers Trump MAC

The court analyzed whether a MAC had occurred based on a comparison of Huntsman's actual and projected post-signing results as of the time of the litigation versus its actual pre-signing results. The court rejected Hexion's argument that the court should analyze whether a MAC had occurred based on a comparison of Huntman's actual and projected post-signing results as of the time of the litigation versus its projected post-signing results as of the time of signing. In reaching this result, the court noted that in the merger agreement Huntsman expressly disclaimed any representation or warranty with respect to projections.

Benchmark for Measurement

The court held that, in a cash acquisition, EBITDA is a better measure of changes in the results of operations than EPS. It reasoned that EPS, because it is a function of the capital structure of a company, including leverage, is largely irrelevant to a cash buyer who intends to replace the capital structure of the target business. The court also noted that EBITDA was "the metric the parties relied on most heavily in negotiating and modeling the transaction". (Notably, in *IBP*, the court examined both EPS and EBIT in a deal that offered a choice between cash or a combination of cash and stock.)

Financial Period Comparisons

The court held that "the terms financial condition, business or results of operation are terms of art, to be understood with reference to their meaning in Regulation S-K and 'Management's Discussion and Analysis of Financial Condition and Results of Operations' section of the financial statements that public companies are required to file with the SEC". This requires a comparison of each year and quarter to the previous year's equivalent period. The court found that the decline in Huntsman's EBITDA, measured on this basis, did not support a MAC. The court rejected Hexion's comparison of consecutive quarters noting that Huntsman's results historically were down in the third and fourth quarters given the cyclical nature of the business.

Forward-Looking Analysis

The court acknowledged that an analysis of the expected future performance of the target company was mandated by the "is reasonably expected to have" language of the MAC clause. It reviewed the parties' respective projections for this purpose and determined that, consistent with analysts' estimates, Huntsman's 2009 EBITDA likely would be somewhere between the parties' respective projections. The court found that those estimates did not demonstrate that Huntsman had suffered or would reasonably be expected to suffer a MAC.

For more information on the Hexion case, see *Practice Note, In Dispute: Hexion/Huntsman (http://us.practicallaw.com/5-384-1893).*

GENESCO, INC. V. FINISH LINE, INC.

In the 2007 Tennessee Chancery Court *Genesco* case, Finish Line argued that it was excused from closing its acquisition of Genesco because Genesco had suffered a MAC (*Genesco Inc. v. The Finish Line, Inc., Case No. 07-2137-II(III) (Tenn. Ch. 2007)*). The court found that Genesco's financial performance had declined, but the decline was due to general economic conditions and thus carved-out from the MAC definition under the agreement. While the court noted that it therefore was unnecessary to analyze whether a MAC would have occurred absent the application of the carve-outs, it included such analysis "for completeness", citing *IBP* and *Frontier Oil*, among others, and listing certain "common-sense considerations" in determining whether a change was significant within the context and circumstances of the merger. These common-sense considerations include the items listed below.

Duration of the Change

The court found that a provision in the merger agreement that contemplated that a MAC could be cured before the drop dead date constituted an acknowledgement by the parties that, in the context of that particular merger, a MAC could occur in three or four months.

Measure of the Change

In concluding that a MAC would have occurred but for the application of the carve-outs, the court noted that Genesco's 2007 earnings were among its lowest annual earnings in the previous ten years.

Impact of the Change on an Essential Purpose

The court discussed the impact of Genesco's 2007 earnings on the ability of the merged entity to repay its financing and have money left over to grow the company (the strategy sought to be achieved by Finish Line when it entered into the transaction).

For more information on the *Genesco* case, see *Practice Note, In Dispute: Genesco/Finish Line (http://us.practicallaw.com/0-385-3647).*

MODIFYING THE MAC DEFINITION

Case law and deal practice suggest several possible modifications to the customary MAC provision that buyers could advance to shift more of the pre-closing adverse change risk to the seller.

ALLOCATE THE BURDEN OF PROOF TO SELLER

The agreement could provide expressly that the seller bears the burden of proving the absence of a MAC regardless of whether the buyer asserts that a MAC has occurred or the seller asserts the absence of a MAC as a defense. Alternatively, where the MAC definition expressly contemplates various pro-seller carve-outs, the parties might compromise to allocate the burden of proof to the seller only with respect to the application of such carve-outs.

OVERCOME KNOWN EVENTS PRESUMPTION

The agreement could provide expressly that all events, circumstances, changes or effects relating to the business, whether known or unknown at the time of execution of the agreement and regardless of the course of dealing between the parties in connection with the transaction, will be considered in determining whether a MAC has occurred, unless otherwise provided in an express carve-out.

INCLUDE "PROSPECTS"

The agreement could include prospects in the MAC definition. Even better from a buyer's perspective, the agreement could expressly provide that the determination of the occurrence of a MAC be by reference to a comparison of the business's actual performance for the period after signing relative to the seller's financial projections for the period following signing, rather than to the business's actual performance for the period before signing. Relatedly, the agreement would not include any MAC carve-out for failure to meet projections or any statement disclaiming any seller representation as to projections.

FORWARD-LOOKING STANDARD

The agreement could provide that the post-closing effects of a pre-closing event, circumstance, change or effect will be considered in the MAC determination if the event or circumstance "could have" or "is reasonably likely to have" a MAC, as opposed to "would have" a MAC.

ELIMINATE OR SCALE BACK THE PRO-SELLER CARVE-OUTS

The agreement could eliminate or scale back the pro-seller MAC carve-outs for macroeconomic, industry wide, force majeure, otherwise generally applicable or deal-related risks. Arguments supporting this position include:

- The standards imposed by the courts in determining initially whether a MAC has occurred, even absent application of the carve-outs, are so seller-friendly that eliminating the carve-outs is appropriate.
- The buyer cares about the financial condition of the business at closing and is indifferent regarding the cause of any deterioration.
- In the case of acquisitions involving cash consideration, the logic for the buyer assuming these risks is not as persuasive as in the case of a fixed exchange ratio stock-for-stock merger involving two companies in the same industry.

TIGHTEN DISPROPORTIONATE MANNER CARVE-OUT

Buyers typically negotiate a limitation to the seller's carve-outs for changes or conditions that adversely affect the business in a disproportionate manner relative to similarly situated companies. This limitation could be tightened by providing that the pro-buyer carve-out:

- Is not qualified by materiality.
- Negates the application of the underlying carve-out "**if** the business is disproportionately affected" rather than "**to the extent** the business is disproportionately affected".
- Defines the peer group to which the seller's performance will be compared where the clarity is helpful to the buyer.
- Applies to all pro-seller carve-outs that are not specific to the business or transaction.

INCLUDE SHORT-TERM EFFECTS

The MAC definition could state expressly that an effect need not be "durationally-significant" to be the basis of a MAC. Even better from a buyer's perspective, the agreement could specify the income statement periods and balance sheet dates that the parties agree to reference in applying the MAC.

ADD SPECIFIC NON-EXCLUSIVE FINANCIAL MILESTONES

The MAC definition could include specific, non-exclusive financial milestones that if not achieved would constitute a MAC. For example, the parties could provide that, without limiting the generality of the MAC definition, the failure of the business to achieve a specified amount of EBITDA in the trailing 12-month period before closing constitutes a MAC. The financial milestone requirement could be incorporated into the MAC definition or, as discussed below, formulated as a separate closing condition.

SUPPLEMENTING THE MAC PROVISION

Buyers can also seek to supplement MAC provisions by employing or expanding on alternative contractual levers to allocate to the seller more of the pre-closing adverse change risk. The following is a review of some of these possible alternatives.

INTERIM OPERATING COVENANTS

Buyers may mitigate pre-closing adverse change risk somewhat by expanding the covenant delineating those actions relating to the business that cannot be taken between signing and closing without the buyer's consent (known as the interim operating covenant). While this alternative has some theoretical appeal, it offers little practical benefit because there are antitrust limitations on the buyer's control of the seller's business before closing, and sellers are reluctant to give up operational control to the buyer pre-closing if there is any chance of the deal not closing.

ADDITIONAL AND TIGHTER REPRESENTATIONS AND WARRANTIES

Parties to an acquisition transaction frequently spend significant time negotiating representations and warranties, including the materiality, temporal, knowledge and other qualifications to the representations. However, it is common for the condition precedent requiring such representations and warranties to be true and correct at closing (known as the representations and warranty bring down) to include a "materiality scrape" (a provision that requires all materiality qualifiers to be disregarded for purposes of determining whether a particular representation or warranty is breached) and, for closing condition purposes, to subject the accuracy of most such representations and warranties, in the aggregate, to a MAC standard. Customarily certain representations and warranties are carved out of this approach and instead are required individually to be true and correct in all respects (for example, the MAC representation itself) or in all material respects (for example, the representation as to due incorporation).

A buyer can seek to make this materiality scrape or aggregate MAC standard more buyer-favorable in two ways by:

- Tightening the definition of MAC in the ways described above (see *Modifying the MAC definition*).
- Insisting that some or all of the representations that otherwise would be subject to the materiality scrape or aggregate MAC standard instead:
  - contain no materiality standards or contain materiality standards tighter than a MAC within the language of such representations; and
  - be required, for closing condition purposes, to be true and correct or true and correct in all material respects.

This tightening of materiality qualifiers would make the acquisition agreement more buyer- favorable. In addition, it allocates more risk to the seller for adverse changes in the business between the baseline date and closing. However, by definition, the bring-down condition does not address pre-closing adverse change risk (the risk of the occurrence before closing of an event or change that has had or may have had a material adverse effect on the business for reasons other than seller factual misrepresentation or seller covenant breaches). For example, tightening the language in the bring-down might help the buyer if the pre-closing adverse effect on the business is due to the filing of a lawsuit or the initiation of a regulatory enforcement action after signing, which was not disclosed by the seller in connection with the relevant litigation or compliance with laws representations. However, this approach would not help the buyer if the pre-closing adverse effect on the business is due to any of the long list of events and circumstances not covered by traditional seller representations.

Sellers' representations can be modified to reduce pre-closing adverse change risk only by expanding their scope in order to narrow the scope of pre-closing adverse change risk, not by tightening their materiality qualifiers. Sellers are unlikely to agree to a broad expansion of traditional representations, particularly to encompass unknown and uncontrollable risks.

INDEMNIFICATION

In the context of private acquisition transactions, the indemnification provisions also commonly include a materiality scrape providing for materiality to be read out of all representations and warranties (except certain specified representations such as the MAC representation) in determining when a representation has been breached for indemnification purposes. This approach requires the parties also to specify an aggregate deductible or threshold (the amount, often a percentage of the transaction value, that all claims, when aggregated, must exceed before the buyer is entitled to indemnification) and possibly a *de minimis* threshold (the amount that an individual claim must exceed to qualify for indemnification). The amounts of these deductibles and thresholds generally are well below amounts that typically would be thought to constitute a MAC. They thus offer a mechanism for buyers to recover losses for pre-closing adverse effects on the business well below a MAC level. However, as with the tighter-than-MAC materiality qualifiers to seller representations for closing condition purposes discussed above, tighter-than-MAC indemnification thresholds for breaches of representations do not allocate to the seller any additional pre-closing adverse change risk.

PURCHASE PRICE ADJUSTMENTS

Acquisition agreements in private deals often include a provision that adjusts the purchase price based on working capital or net asset changes between a specified pre-signing balance sheet and the closing balance sheet (see *Standard Clause, Stock Purchase Agreement: Working Capital Purchase Price Adjustment Provision (http://us.practicallaw.com/6-383-9979)*). These balance sheet-based purchase price adjustments allocate to the seller some pre-closing adverse change risk. However, such adjustments have two significant shortcomings from the buyer's perspective:

- The adjustments only make the seller bear the adverse effects of pre-closing events to the extent these effects actually flow through the business's balance sheet by closing.
- Because these adjustments capture only one-time, dollar-for-dollar balance sheet reductions, these adjustments do not compensate the buyer for the lost capitalized value to the business resulting from a reduction in EBITDA, net income or any other income statement measure.

Consequently, a theoretically more useful mechanism to shift to a seller pre-closing adverse change risk is a purchase price adjustment based on a multiple of EBITDA, net income or some other income statement measure for a defined period beginning before the closing date and ending on the closing date or a date following the closing. This type of provision effectively borrows the mechanics of post-closing earn-outs, which are used to adjust the purchase price based on performance of the business during a specified post-closing period. However, there are several difficulties involved in negotiating and drafting an earn-out based entirely or partly on a pre-closing period:

- A pre-closing earn-out effectively reprices the transaction based on business performance during the prescribed period. Very few sellers or buyers are willing to enter into a transaction with significant uncertainty about the ultimate purchase price.
- Many sellers and buyers likely would be uncomfortable determining purchase price entirely or largely on earnings performance for a quarter or year because earnings for those periods may turn out to be aberrational relative to long-term earnings results of the business.
- An earn-out based entirely or partly on income statement results for the pre-closing period incentivizes the seller to operate the business outside the ordinary course before closing to artificially and unsustainably inflate pre-closing income statement results.
- An earn-out based on income statement results for a pre-closing period would fail to capture the post-closing income statement effects of pre-closing adverse events.
- An earn-out based on income statement results for a period that begins pre-closing and ends post-closing would capture, to some degree, post-closing results unrelated to pre-closing events and also would raise all the control and business segregation issues that plague post-closing earn-out negotiations.
- A pre-closing earn-out, like a post-closing earn-out, is very difficult to achieve in the context of a public company acquisition given the large number of stockholders and stockholder vote and disclosure requirements. Public company acquisitions occasionally involve contingent value rights (CVRs), but these rights generally are tied to resolution of specified contingent assets or liabilities, or achievement of specified milestones, not income statement-based earn-out formulas.

FINANCING CONDITION

A financing condition subjects the buyer's obligation to close on its ability to obtain its financing (see *Standard Clause, Purchase Agreement: Financing Condition (http://us.practicallaw.com/5-383-6603)*). In leveraged acquisitions, buyers typically prefer a financing condition because it best protects the buyer from financing risk, that is the risk of gaps between the lenders' funding conditions under the financing commitment and the buyer's closing conditions under the acquisition agreement.

Financing conditions permit a buyer not to close the acquisition agreement if the lenders do not fund due to the buyer's failure to satisfy any of the conditions to the lenders' funding obligation under the financing commitment. As a result, any conditions to the lenders' funding commitment that relate to pre-closing adverse change risk become back-door modifications or supplements to the MAC provisions in the acquisition agreement. For example, conditions to the lenders funding commitment may include:

- Absence of a business MAC.
- Absence of a market MAC.
- Successful loan syndication.
- Achievement of a specified business milestone.

ADDITIONAL FINANCIAL MILESTONE CLOSING CONDITIONS

As noted above, a possible modification to MAC provisions is the inclusion of specific, non-exclusive financial milestones that will constitute a MAC if not achieved. Also, as noted above, these milestones can be included as stand-alone closing conditions instead of as part of the MAC definition. Because including this type of milestone in the MAC definition may limit a court's interpretation of the broader MAC definition, buyers may instead prefer to include milestones as stand-alone closing conditions. This means that unless the seller (or the target company) achieves the specified milestone, the buyer is under no obligation to close. Milestone closing conditions could include, among others:

- Solvency of the business.
- Solvency of the buyer after giving pro forma effect to the acquisition and the contemplated debt and equity financing for the acquisition.
- Achievement by the business of specified minimum EBITDA, EPS, revenue or other income statement results for specified pre-closing periods.
- Achievement by the business of a specified minimum working capital or cash amount at closing.
- Absence of the loss of a specified number or percentage of customers or clients.
- Maintenance of specified minimum debt ratings.
- Achievement of a specified operational milestone event with financial implications (such as the receipt of FDA approval for a new drug).

REVERSE BREAK-UP FEES

Another tool for addressing pre-closing adverse change risk is a buyer termination right coupled with a related termination fee paid by the buyer to the seller, commonly referred to as a "reverse break-up fee". In their broadest form, these provisions allow the buyer to pay the reverse break-up fee and terminate the deal in the buyer's sole discretion. In their narrower form, these provisions allow the buyer to pay the reverse break-up fee and terminate the deal only if financing is not obtained or a specified financial milestone is not satisfied. In any form, to some degree they permit a buyer to walk away from a deal where the business has suffered a pre-closing adverse change, although falling short of a MAC, for the price of the reverse break-up fee. For further discussion of reverse break-up fees, see *Practice Note, Reverse Break-up Fees and Specific Performance (http://us.practicallaw.com/8-386-5095)* and *Practice Note, Drafting and Negotiating Reverse Break-up Fee and Specific Performance Provisions (http://us.practicallaw.com/6-386-5096)*.

A buyer's right to terminate by paying a specified reverse break-up fee, coupled with a customary MAC condition, are powerful tools for a buyer to allocate, perhaps ultimately for little or no cost to the buyer, pre-closing adverse change risk to the seller. If pre-closing events that adversely affect the business make purchasing the business undesirable to the buyer at closing or result in the buyer being unable to obtain financing, as applicable, the buyer can claim that a MAC has occurred and refuse to close the transaction. The buyer is confident that its maximum exposure is the amount of the reverse break-up fee. This leaves the seller with the following choices:

- Pursue MAC litigation against the buyer during which the business may continue to deteriorate.
- Negotiate a lower purchase price with the buyer.
- Negotiate with the buyer to terminate the deal for a portion of the reverse break-up fee or some other negotiated settlement.

For information on current market trends in the use of reverse break-up fees to allocate risk, see *Reverse Break-up Fees and Specific Performance: A Survey of Remedies in Public Deals (http://us.practicallaw.com/7-502-1268)*.

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