Efficiency and Certainty in Uncertain Times: The Material Adverse Change Clause Revisited

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What role do material adverse change clauses play in merger agreements? This Note analyzes the increasing importance of material adverse change clauses in economic downturns and examines their evolution and judicial interpretation. The Note argues that the vagueness of these clauses leads courts to construe them narrowly and fail to effectuate the intent of contracting parties, ultimately creating uncertainty in merger agreements and failing to accomplish the goals of contracting parties. The Note concludes that replacing material adverse change clauses with reverse termination fees will better serve the parties' goals and uphold contract principles, yielding more efficient outcomes while reducing unnecessary litigation.

I. INTRODUCTION

Material adverse change ("MAC") clauses have long been included in merger agreements and financing commitments.[1] Such provisions allow companies — typically the buyer in the merger context — to exit an agreement in certain instances in which an unanticipated event or trend significantly impacts one of the merging entities. While MAC clauses traditionally were mere

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* J.D. Candidate, 2010, Columbia Law School. The author would like to thank Professor Philip Genty for his advice, guidance and insight, and the staff and editorial board of the *Journal of Law and Social Problems* for their comments and edits.

1. Alan M. Christenfeld & Shepard W. Melzer, *Material Adverse Change Clauses: The Big MAC*, N.Y.L.J., Oct. 3, 2002, at 5.

"boilerplate provisions," they have evolved to heavily negotiated and carefully drafted clauses.[2]

Since the credit crisis, MAC clauses have become tremendously important. Increased financial uncertainty and difficulty in syndicating debt has caused deals to fail more frequently, and buyers have attempted to rely on these clauses to end their commitments to acquire target companies under merger agreements.[3] This Note analyzes the judicial standard for interpreting MAC clauses and argues that courts construe both traditional and complex MAC clauses similarly. The foundational cases in MAC jurisprudence demonstrate the failure of MAC clauses both to effect the parties' intent and to uphold basic contract principles of efficiency and certainty. This Note suggests that replacing these clauses with reverse termination fees will more successfully accomplish the goals of the contracting parties, while reducing unnecessary litigation.

Part II of this Note provides a brief overview of MAC clauses. Part III describes the courts' definitions of materiality in traditional MAC clauses and compares this approach to recent decisions interpreting complex MAC clauses in agreements that have unraveled due to the credit crisis. Part IV examines the failure of these clauses to accord with their goals and with basic contract principles. Finally, Part V of the Note advocates replacing such clauses with reverse termination fees.

II. An Overview of Market MAC and MAE Clauses

This Part provides a brief overview of MAC clauses, which are also called material adverse effect ("MAE") clauses,[4] and their role in merger agreements. The first section defines MACs, describing their evolution from traditional "boilerplate provisions" to complex and heavily negotiated clauses, and raises some potential issues with their interpretation. The second section explores the role of the MAC clause within the merger agreement

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2. Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 865–66 (2002).

3. Kenneth M. Wolff & Cason A. Moore, *In the Wake of the Crunch: Credit Market Turmoil and the Potential Effects on MAC Provisions*, M&A LAW., Nov-Dec. 2007, at 7.

4. For the purposes of this Note, MAC and MAE will be used interchangeably.

as well as the theories supporting its inclusion, including correcting the asymmetries between the positions of buyer and seller.

A. DEFINITION AND EVOLUTION OF MAC CLAUSES

Mergers and acquisitions are among the most significant corporate events, impacting and altering not merely corporate structure and governance, but the lives of numerous people involved in the day-to-day operations of the merging entities.[5] Thus, mergers are generally carefully contemplated; the parties spend substantial time and resources to ensure that their expectations are met.[6] Merger agreements enumerate the parties' legal rights and obligations in four primary components — representations and warranties, covenants, conditions to closing, and indemnification.[7]

MAC clauses are among the myriad provisions found within merger agreements. These clauses are usually included in the conditions to closing portion of an agreement, predicating a party's obligation to complete the deal on the absence of a MAC.[8] At times, however, MAC clauses are found in an agreement's representations and warranties section operating in conjunction with a "bring-down provision," whereby the target is required to represent and warrant that it has not and will not experience a MAC in its conditions, and that such representations and warranties are true as of the time of closing.[9] If such a change occurs

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5. Celia R. Taylor, *When Good Mergers Go Bad: Controlling Corporate Managers Who Suffer a Change of Heart*, 37 U. RICH. L. REV. 577, 577 (2003).

6. *Id.*

7. Richard A. Goldberg & Steve J. Lee, *Negotiating the Purchase Agreement*, *in* MERGERS & ACQUISITIONS 2009: TRENDS & DEVELOPMENTS 11, 19 (Practising L. Inst., 2009).

8. Goldberg & Lee, *supra* note 7, at 43.

9. Joel I. Greenberg & A. Julia Haddad, *The Material Adverse Change Clause: Careful Drafting Key, But Certain Concerns May Need to be Addressed Elsewhere*, N.Y.L.J., Apr. 23, 2001, at 5; *see also* John F. Seegal, *Minimization of Pre-Closing Risk in Private Company Acquisitions*, *in* Acquiring or Selling the Privately Held Company 655, 671 (Practising L. Inst., 2008) (discussing bring-down provisions as a "provision pursuant to which all of the sellers' pre-closing covenants function as closing conditions."). For an example of a bring-down provision, see Brief & Special Appendix for Defendants-Appellants at 46–47, Recticel Foam Corp. v. Bay Indus., Inc., 128 F. App'x 798 (2d Cir. 2005) (No. 04-3413), in which a MAC was included in the agreement's representations and warranties, and coupled with a bring-down provision that "makes the truth of the representations and warranties contained in § 4.9 a condition precedent to closing."

within the clause's specified time period,[10] the buyer is released from its obligations under the agreement.[11]

While the mergers and acquisitions world has used MAE provisions in common practice for a long time, with references to MAC clauses made as early as the 1940s, the form and substance of these provisions has evolved dramatically and continues to vary between agreements.[12] Generally, merger agreements containing MACs will define the term "Material Adverse Effect." An agreement may simply state: "*Material Adverse Effect*' means with respect to any Person, a material adverse effect on the financial condition, properties, operations, business or results of operations of such Person and its Subsidiaries taken as a whole."[13] A MAC definition may contain other elements that the parties agreed upon, most commonly allowing exit when there is a material change to the seller's business, operations, or financial condition, and an adverse effect on either the seller's or buyer's ability to close the transaction.[14] Negotiations concerning what conditions must be met before a buyer can exit the deal are normally limited, except for changes to a company's future "prospects."[15] Sellers generally want to exclude "prospects" because they introduce "the possibility that speculative developments might allow the buyer to walk away from the deal."[16] Acquirers, on the other hand, are concerned about future changes impacting the target company. Developments that can "reasonably be expected to have a Material Adverse Effect" are often included to cross this impasse between seller and buyer demands.[17] Courts,

10. Alana A. Zerbe, Note and Comment, *The Material Adverse Effect Provision: Multiple Interpretations & Surprising Remedies*, 22 J.L. & COM. 17, 18 (2002). The relevant time period is generally that between the signing of the agreement and the deal's close. *Id.*

11. Goldberg & Lee, *supra* note 7, at 19.

12. Andrew C. Elken, Note, *Rethinking the Material Adverse Change Clause in Merger and Acquisition Agreements: Should the United States Consider the British Model?*, 82 S. CAL. L. REV. 291, 292, 307 (2009).

13. Allegheny Energy, Inc. v. DQE, Inc., 74 F. Supp. 2d 482, 490 (W.D. Pa. 1999).

14. Elken, *supra* note 12, at 302.

15. Paul S. Bird & Colette C. Haider, *On Squeeze-Outs, MAC Clauses and Vote-Buying: Recent Judicial Decisions Affecting M&A Transactions*, *in* THE NEW CLIMATE FOR MERGERS AND ACQUISITIONS — 19TH ANNUAL M&A INSTITUTE, 546, 557 (Glasser LegalWorks 2002).

16. Carole Schiffman, *Current Issues for Private Equity Buyers*, *in* NINTH ANNUAL PRIVATE EQUITY FORUM 107, 131 (Practising L. Inst., 2009).

17. *Id*. at 132.

however, may interpret such language as synonymous with prospects.[18]

The surge in mergers and deal-making preceding the recent credit crunch produced a "seller's market," which caused most deals to omit financing conditions and eliminate most non-MAC bases for withdrawing from a transaction — further enhancing the significance of MAC clauses.[19] MAC provisions have become the object of extensive negotiations, and now commonly contain numerous exceptions ("carve-outs") as well as exclusions from such carve-outs.[20] Carve-outs often include, among other things, changes resulting from general economic or global conditions or conditions in the seller's industry or region, changes in applicable law or regulation, deal-related litigation, changes that the deal's announcement causes, and the results of seller actions that the acquirer requests.[21] Due to the September 11 attacks, parties sometimes insert a provision excluding changes resulting from terrorism or war.[22] The scope of a MAC clause can impact its applicability, typically prompting targets to negotiate for greater specificity and buyers to strive for broader and more inclusive MAC clauses that provide easier exit.[23]

Despite the proliferation of MAC carve-outs and the extensive negotiations surrounding MAC provisions, MAC clauses ultimately fail to define what changes would be deemed material. The definition of "material adverse change" in merger agreements generally invokes the phrase "material adverse change," but "ma-

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18. Galil, *supra* note 2, at 856; *see* Cendant Corp. v. Commonwealth Gen. Corp., No. 98C-10-034 HLA, 2002 WL 31112430, at *6 (Del. Super. Ct. Aug. 28, 2002) ("[T]here are issues of genuine fact surrounding whether" a MAC, defined as "an event or occurrence that has or could reasonably be expected to have a material adverse effect . . . ." includes prospects); *see also* Sherri L. Toub, Note, *"Buyer's Regret" No Longer: Drafting Effective MAC Clauses in a Post-*IBP *Environment*, 24 CARDOZO L. REV. 849, 868 (2003) (stating that "[t]ypically, one focus of Seller's efforts will be to delete any reference in the MAC definition to 'prospects' or to other forward-looking concepts").

19. Alan Goudiss, John Gueli & Stephen Vander Stoep, *Taking Soured M&A Deals to Court*, N.Y.L.J., Aug. 25, 2008, at 8.

20. Galil, *supra* note 2, at 848; Bradley C. Sagraves & Bobak Talebian, Note, *Material Adverse Change Clauses in Tennessee:* Genesco v. Finish Line, 9 TRANSACTIONS: TENN. J. BUS. L. 343, 347 (2008).

21. Galil, *supra* note 2, at 848.

22. David Marcus, *Material Change Clauses Scrutinized After Sept. 11*, N.Y.L.J., Jan. 3, 2002, at 2.

23. Sagraves & Talebian, *supra* note 20, at 347–48.

terial" "is an inherently vague . . . word."[24] Without a definition for materiality, establishing a clear and predictive standard is difficult. Courts often look to evidence regarding parties' intent, which makes their interpretations haphazard.[25] Due to the uncertainty surrounding their interpretation, buyers typically invoke MAC clauses only as a last resort.[26] Further, concerns are often enumerated as distinct closing conditions instead of using a MAC clause.[27]

B. THEORETICAL UNDERPINNINGS OF MAC CLAUSES

MAC clauses attempt to address various negotiations issues, particularly negotiations surrounding corporate mergers and acquisitions. The MAC clause primarily allocates risks following the merger agreement's signing but prior to the closing.[28] While ideally such a lag would not occur, it is often an inevitable consequence of the need to, for example, obtain shareholder and regulatory approvals and deal financing.[29] The agreement's representations and warranties address the uncertainty arising from this interlude, but the MAC clause especially attempts to ensure that the acquirer obtains the company it bargained for and is not bound to close a deal involving dramatically altered circumstances.[30]

A target company's failure to meet initial buyer expectations at closing may stem from inadequate investment in the company's operations in the period between the signing of an agreement and the deal's close.[31] To address the problem of investment incentives and reliance, traditional MAC clauses create a threat of

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24. Kenneth A. Adams, *A Legal-Usage Analysis of "Material Adverse Change" Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9, 23 (2004).

25. Dean S. Kristy & Dennis P. Orr, *Recent Developments in Litigation*, *in* HANDLING HIGH-TECH M&AS IN A COOLING MARKET: ENSURING THAT YOU GET VALUE 825, 849–50 (Practising L. Inst., 2001); Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 331 (2005) (stating that the language of the MAC is "ambiguous with respect to significant issues").

26. Jonathon M. Grech, Comment, *"Opting Out": Defining the Material Adverse Change Clause in a Volatile Economy*, 52 EMORY L.J. 1483, 1491 (2003).

27. Greenberg & Haddad, *supra* note 9.

28. Goldberg & Lee, *supra* note 7, at 20.

29. *Id.*

30. Toub, *supra* note 18, at 852–53.

31. Gilson & Schwartz, *supra* note 25, at 337.

buyer exit, prompting the seller to continue to invest in the target company and to ensure its ongoing profitability during this transition period.[32] The evolution of MAC clauses to include exceptions and carve-outs is consistent with Professor Ronald Gilson's "investment theory," which suggests that these complex MAC clauses attempt to allocate risks to the party that can most adequately bear them and prevent their materialization.[33] Thus, such carve-outs impose endogenous risks on the target, while allocating exogenous risks to the buyer because exogenous risks (that is, changes in general economic conditions) cause the greatest threat to the seller's stand alone value should a deal fail.[34]

MAC clauses may further address various asymmetries in transactions. Again, the signing-closing gap in most M&A transactions causes a symmetry problem between buyers and sellers. While several factors insulate the seller from squandering the increases in its own value that accrued during this stage — such as the courts' frequent refusal to uphold no-shop provisions,[35] fiduciary obligations that may compel a company to exit a deal when the purchase price does not accurately reflect the company's increased value, and the necessity for shareholder approval — in the absence of a MAC clause the buyer bears the entire risk of decreases in the seller's value.[36]

Finally, MAC clauses may correct an information asymmetry by addressing the "lemon problem," where a better-informed seller attempts to convince a less-informed buyer that an item contains no hidden defects.[37] A seller that exposes those defects would obtain a reduced price. Here, the MAC clause functions as a means of protecting the buyer from this possibility while eliminating the need to reduce the purchase price.[38]

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32. *Id.*
33. *Id.* at 338–39.
34. *Id.* at 339.
35. Elken, *supra* note 12, at 296. Merger agreements may sometimes include no-shop provisions, which bar sellers from seeking more favorable bids following negotiation of a sale. The Delaware courts in particular have restricted the use of such clauses in friendly merger agreements. *Id.*
36. Gilson & Schwartz, *supra* note 25, at 337–38.
37. The "lemon problem" comes from the used car context, where prices on used cars are necessarily reduced because a seller cannot convince a buyer that the car is not a lemon.
38. Galil, *supra* note 2, at 849.

III. Judicial Interpretation of MAC Clauses

This Part has two sections. The first section summarizes the jurisprudence of traditional MAC clauses, first explaining the courts' general approaches towards the interpretation of MAC clauses and then focusing on the courts' narrow interpretation of materiality, particularly in *IBP v. Tyson*.[39] The second section discusses the jurisprudence of complex MAC clauses, first examining judicial approaches to materiality and then specifically analyzing the judicial analysis of the MAC clause carve-outs in the *Genesco* and *Huntsman* cases.[40]

A. Traditional MAC Jurisprudence

1. *Materiality in light of Contract Principles*

Despite the powerful impact MAC clauses can have on mergers, they are rarely invoked during times of economic stability. Economic downturns, however, tend to foster litigation.[41] In interpreting these clauses, courts first look to general contract principles. Such principles dictate that where contract language is clear and unambiguous, its terms will be dispositive, and the court will not consider parole or extrinsic evidence.[42] This is the fundamental approach of the judiciary in interpreting contracts: upholding the intentions of the contracting parties.[43] In instances of contractual ambiguity, however, parole evidence is used to illuminate the parties' intentions.[44] A court must look to "all relevant circumstances," including "the state of the world" and "the state of the law," as well as "all writings, oral statements, and other conduct by which the parties manifested their assent, to-

39. 789 A.2d 14 (Del. Ch. 2001).

40. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008); Genesco, Inc. v. Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007).

41. Gilson & Schwartz, *supra* note 25, at 331.

42. *IBP, Inc.*, 789 A.2d at 54–55.

43. Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 569 (2003).

44. *IBP, Inc.*, 789 A.2d at 55.

gether with any prior negotiations between them and any applicable course of dealing, course of performance, or usage."[45]

Courts have generally found MAC clauses susceptible to more than one reasonable interpretation and have emphasized that interpreting these provisions and, particularly, defining materiality, should be context specific. Some factors for courts to consider include "the event in light of the size and nature of the transaction and the nature of the parties' business,"[46] applying a "cross-matching of the significance of a fact to the essence of the transaction in question," and "a plausible showing of the potentially adverse effect of the former on the latter."[47] As "[t]he notion of an MAE is imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties,"[48] the definition of materiality is inextricably bound to the specific transaction and its goals.

2. *Materiality Narrowly Defined*

Pacheco v. Cambridge Technology Partners[49] is an example of a court addressing the issue of materiality as it relates specifically to a corporation's declining quarterly revenues.[50] Cambridge Technology Partners ("Cambridge"), a successful systems integration and consulting firm, contracted to acquire Excell Data Corporation ("Excell"). The merger agreement included Cambridge's representation that "since June 30, 1998, there has not been any Material Adverse Change in the Business Condition of Cambridge." The agreement defined business condition as "the business, financial condition, results of operations, assets or prospects," and defined prospects as "events, conditions, facts or developments that are known to Excell and that in the reasonable

45. 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS 275 (2d ed. 1998).
46. Allegheny Energy, Inc. v. DQE, Inc., 74 F. Supp. 2d 482, 517–18 (W.D. Pa. 1999); *see also* Pine State Creamery Co. v. Land-O-Sun Dairies, Inc., No. 98-2441, 1999 WL 1082539, at *4 (4th Cir. Dec. 2, 1999) (finding that "[o]ften, however, it is necessary to resort to extrinsic evidence to ascertain the precise intent of the parties").
47. N. Heel Corp. v. Compo Indus., Inc., 851 F.2d 456, 463 (1st Cir. 1988).
48. Frontier Oil Corp. v. Holly Corp., No. Civ.A. 20502, 2005 WL 1039027, at *34 (Del. Ch. Apr. 29, 2005).
49. 85 F. Supp. 2d 69 (D. Mass. 2000).
50. This is the central issue in *IBP v. Tyson Foods*, 789 A.2d 14, as well.

course of events are expected to have an effect on future operations of the business as presently conducted by Excell."[51]

Former Excell shareholders alleged that Cambridge's failure to meet quarterly predictions and the decline in quarterly revenues constituted a material adverse change.[52] In dismissing both arguments, the court found revenue predictions belonged in the prospects category. It determined that, based on the drafting of the clause, changes concerning prospects only applied to Excell's prospects, not Cambridge's.[53] More significantly, the court held that Excell's invocation of quarterly earnings failed to demonstrate a material change.[54] To be material, quarterly earnings must be compared to earnings in corresponding quarters of previous years, rather than sequentially.[55]

Vice Chancellor Strine of the Delaware Chancery Court addressed the role of quarterly revenues in determining whether a MAC has occurred in the seminal case *IBP v. Tyson Foods.*[56] Tyson, a chicken distributor, and IBP, a beef and pork distributor, signed a contested merger agreement after an active auction for IBP, throughout which Tyson received information about IBP's business and financial conditions.[57] This information disclosed many problems potentially impacting IBP, including a downturn in the beef industry, evidence of accounting fraud in an IBP subsidiary, and IBP's liability for an asset impairment charge of $60.4 million that indicated a reduced cash flow.[58] Tyson, despite receiving this information, ultimately proceeded with an acquisition offer, and the parties signed a merger agreement.[59]

Section 5.10 of this agreement contained a traditional MAC, which required the "Absence of Certain Changes," including "any event, occurrence, or development of a state of circumstances or facts which has had or reasonably could be expected to have a

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51. *Pacheco*, 85 F. Supp. 2d at 71.
52. *Id.* at 74–75.
53. *Id.* at 75. The MAC clause at issue defined a change in prospects as a MAC only if Excell experienced such a change.
54. *Id.*
55. *Id.*
56. 789 A.2d 14 (Del. Ch. 2001).
57. *Id.* at 21–22.
58. *Id.*
59. *Id.* at 22.

Material Adverse Effect."[60] When the deal unraveled and IBP filed suit to enforce the agreement, Tyson pointed to the impairment charge and IBP's disappointing performance in the last quarter of 2000 and the first quarter of 2001 as evidence of a MAC and as grounds for its refusal to consummate the merger.[61]

The *Tyson* court did not adopt the approach of the *Cambridge* court, which found Cambridge's failure to meet sequential quarterly projections irrelevant. Instead, the *Tyson* court looked to the transaction's context to interpret the MAC and to determine the materiality of the failure to meet quarterly projections.[62] The court concluded that when an acquirer is purchasing a company as part of a long-term strategy, the failure to meet projected earnings for one quarter is irrelevant; instead, "the important thing is whether the company has suffered a Material Adverse Effect in its business or results of operations that is consequential to the company's earning power over a commercially reasonable period."[63] While the court did not specifically define a "commercially reasonable period," the court suggested that "one would think [it] would be measured in years rather than months."[64] Thus, although IBP experienced significantly reduced first quarter earnings compared to the previous year (the Cambridge court's metric for materiality of a change), and evidence indicated that IBP's continued performance in this manner would cause its overall performance in 2001 to differ materially from its past performance,[65] the court nevertheless concluded that this reduction in quarterly earnings was not a MAC.[66]

Vice Chancellor Strine's conclusion regarding the absence of a MAC is partially attributable to his skepticism about the expert testimony in the case, and to IBP's emphasis on the cyclical nature of its business.[67] Moreover, Chancellor Strine stressed that his conclusion was heavily influenced by his "temporal perspective, which recognizes that even good businesses do not invaria-

60. *Id.* at 42.
61. *Id.* at 52, 65.
62. *Id.* at 66–67.
63. *Id.* at 67.
64. *Id.*
65. *Id.* at 68–69.
66. *Id.* at 71–72.
67. *Id*.

bly perform at consistent levels of profitability," and, absent such an approach, "a contrary conclusion could be reached."[68]

The court's narrow reading of the MAC clause in *Tyson* is particularly interesting in light of the clause's broad drafting. As discussed above, MAC clauses have become increasingly complex, with numerous carve-outs and exceptions.[69] In both *Tyson* and *Cambridge*, events were found to fall outside the purview of the MAC, despite its broad drafting and the absence of specifically delineated exceptions. The *Tyson* opinion specifically addressed the broad nature of the MAC clause, describing it as "a capacious clause that puts IBP at risk for a variety of uncontrollable factors that might materially affect its overall business or results of operation as a whole."[70] The court therefore recognized that the breadth of this clause barred IBP from contending that changes in livestock supply were excluded from the MAC clause as an implicit carve-out.[71] Nevertheless, Strine concluded that "the notion that § 5.10 gave Tyson a right to walk away simply because of a downturn in cattle supply is equally untenable."[72] To prevent such an "untenable" conclusion, the court inferred a temporal element to materiality, reasoning that the "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."[73] Through its interpretation of materiality, the court essentially narrowed the MAC clause's application, despite its the breadth[74]

The *Tyson* ruling has been criticized as failing to establish a widely applicable and predictable standard for the interpretation of MAC clauses[75] The ambiguity of the contract's MAC clause prompted the court to adopt a highly fact-specific approach, with considerable attention paid to extrinsic evidence surrounding the merger.[76] The court particularly looked to Tyson's intensive ef-

68. *Id.* at 71 n.170.
69. *See supra* Part II.A.
70. 789 A.2d at 65.
71. *Id.* at 66.
72. *Id.*
73. *Id.* at 68.
74. *Id.* Strine himself indicates that such an approach would eliminate the need for extensive and involved drafting of carve-outs and qualifiers. *Id.* at n.155.
75. Galil, *supra* note 2, at 860–61.
76. *IBP, Inc.*, 789 A.2d at 65.

forts to acquire IBP, its knowledge of the difficulties facing IBP at signing, Tyson's other attempts to delay the merger, and the post hoc nature of the MAE argument.[77] These facts led Vice Chancellor Strine to conclude that the invocation of the MAE clause was tied to buyer's regret, rather than a belief that an MAE had actually occurred.[78] Moreover, the different burden of proof between New York and Delaware corporate-law doctrine at issue in *Tyson* suggests that the court's ruling would not necessarily control disputes governed by Delaware law.[79]

Despite this critique, and the influence of specific facts in *Tyson*, the Delaware Court of Chancery adopted the *Tyson* approach as Delaware law in *Frontier Oil v. Holly Corp*.[80] *Frontier Oil* involved a long contemplated merger between two midsize petroleum refiners that developments subsequent to the signing of the merger agreement had impeded.[81] The Holly Corp. ("Holly") alleged that impending environmental litigation against Frontier Oil Corp. ("Frontier Oil") constituted an MAE as defined in the merger agreement, releasing it from its obligation to consummate the deal.[82]

In addressing Holly's MAE claim, the court recognized that an MAE is inherently "imprecise" and its application varies with

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77. *Id.*

> [I]t is useful to be mindful that Tyson's publicly expressed reasons for terminating the Merger did not include an assertion that IBP had suffered a Material Adverse Effect. The post-hoc nature of Tyson's arguments bear on what it felt the contract meant when contracting, and suggests that a short-term drop in IBP's performance would not be sufficient to cause a MAE.

Id.

78. *Id.* at 22.

79. *Id.* at 72. The court here applied New York law rather than Delaware law due to choice of law provisions. *Id.* at 54. New York law and Delaware law differed as to the burden of proof, with New York's "preponderance" standard slightly less demanding than Delaware's "clear and convincing" standard. Strine acknowledged that, under the Delaware standard, IBP may not have been entitled to specific performance. *Id.* at n.172.

80. No. Civ.A. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005).

81. *Id.* at *11.

82. *Id.* at *25. Material Adverse Effect was defined in § 8.9(d) of the merger agreement 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 or (B) the ability of the party to consummate the transactions contemplated by this Agreement or fulfill the conditions to closing set forth in Article 6 . . . .

Id. at *10.

each merger.[83] In its analysis of the materiality of the impending litigation, it assumed the *Tyson* court's view on the materiality of a decline in quarterly earnings, finding no reason to adopt a different approach for Delaware law.[84] While rejecting Frontier Oil's contention that litigation can never constitute an MAE because its "results are inherently speculative," and recognizing that the litigation posed "serious risks for Frontier," the court nevertheless found that Holly failed to meet its burden of demonstrating an MAE.[85] In so concluding, it adopted *Tyson*'s high bar for materiality, requiring that the payment of defense costs must have a "significant effect if viewed over a longer term," irrespective of their specific burden such costs imposed in a given year.[86]

B. COMPLEX MAC CLAUSE JURISPRUDENCE

The *Tyson* court's narrow interpretation of a broad MAC, partially driven by a desire to reduce the extensive negotiations surrounding this provision, ironically contributed to the proliferation of MAC carve-outs and exemptions.[87] This phenomenon can be partially attributed to the *Tyson* court's rejection of implicit carve-outs.[88] The 2007 credit crunch brought with it a wave of attempts to renegotiate or terminate deals that had encountered difficulty or were no longer favorable to buyers, and, in turn, a number of these more complex clauses were presented for judicial consideration.[89] While many of these mergers terminated in out-of-court settlements prior to judicial scrutiny of the MAC clauses,[90] the Tennessee court's decision in *Genesco v. Finish Line*[91] and

83. *Id.* at *34.
84. *Id*.
85. *Id.* at *37.
86. *Id.*
87. IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14, 68 n.155 (Del. Ch. 2001) ("A contrary rule will encourage the negotiation of extremely detailed 'MAC' clauses with numerous carve-outs or qualifiers. An approach that reads broad clauses as addressing fundamental events that would materially affect the value of a target to a reasonable acquirer eliminates the need for drafting of that sort.").
88. *See supra* Part III.A2.
89. Goudiss, Gueli & Stoep, *supra* note 19.
90. The proposed $25 billion merger between Sallie Mae Corporation and J.C. Flowers and Company was one such failed merger that settled prior to a judicial decision in a case centering on the merger agreement's MAC. The MAC in this instance included a carve-out for "changes in Applicable Law" unless the changes were "in the aggregate more adverse" than those described in Sallie Mae's previous 10-K. SLM Corp., Proxy State-

the Delaware Chancery Court's later holding in *Hexion v. Huntsman*[92] shed considerable light on the interpretation of these post-*Tyson* clauses.

1. *Materiality Defined*

In September 2007, Finish Line approached Genesco, a Tennessee based footwear retailer, with an offer to acquire the company. The combination would produce a three billion dollar entity with a varied customer and product base. Finish Line attempted to acquire Genesco primarily to diversify the company, capitalizing on the synergies and opportunities for growth that would result from the deal.[93] In June, following Finish Line's successful bid for Genesco, the companies executed a highly leveraged merger agreement.[94] As the smaller of the two companies, Finish Line financed the deal with considerable debt, investing only $11 million dollars of its own cash in the acquisition. UBS would finance the remaining $1.5 billion under a commitment letter executed by Finish Line and UBS. The merger agreement demanded that Finish Line exercise "reasonable best efforts" to obtain this financing, while the commitment letter obligated UBS to finance the deal, subject to certain conditions.[95]

Included among the merger agreement's conditions precedent to closing was an MAE clause that required the absence of a "Company Material Adverse Effect with respect to the Company and the Company Subsidiaries."[96] Specifically, the MAE was defined as "any event, circumstance, change or effect that, individually or in the aggregate, is materially adverse to the business,

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ment, at A-3 (Aug. 17, 2007), *available at* http://www.sec.gov/Archives/edgar/data/1032033/000095013307002968/w35116dfdefm14a.htm#101. After filing suit for enforcement of the agreement in Delaware Chancery Court, Sallie Mae dropped its suit against J.C. Flowers in exchange for a deal to refinance $30 billion in debt due the following month. Andrew Ross Sorkin & Michael J. de la Merced, *Sallie Mae Settles Suit Over Buyout that Fizzled*, N.Y. TIMES, Jan. 28, 2008, at C1.

91. No. 07-2137-II(III) (Tenn. Ch. Dec. 27, 2007).

92. 965 A.2d 715 (Del. Ch. 2008).

93. Genesco, Inc. v. Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007).

94. Genesco Inc., Proxy Statement, at 24–25 (Aug. 13, 2007), *available at* http://www.sec.gov/Archives/edgar/data/18498/000095014407007746/g08095dmdefm14a.htm.

95. *Id.* at 5, 40–41.

96. *Id.* at A-39.

condition (financial or otherwise), assets, liabilities or results of operations of the Company and the Company Subsidiaries, taken as a whole."[97] However, the agreement continued beyond this traditional definition, detailing an extensive list of exceptions. The agreement stated "none of the following shall constitute, or shall be considered in determining whether there has occurred, and no event, circumstance, change or effect arising from or arising out of any of the following shall constitute, a Company Material Adverse Effect."[98] These exceptions included many frequently found in recent MAC clauses,[99] such as the announcement of the agreement, any change in applicable law, a decline in the target's stock price, or acts of the acquirer or its parent. Of particular importance was the exclusion detailed in § 3.1(a)(B):

> [C]hanges 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 . . . .[100]

This exclusion later became an issue for the parties, given the economic changes wrought by the credit crisis.

Finish Line eventually attempted to withdraw from the deal, citing as evidence of an MAE Genesco's failure to meet its June earning projections, its overall missed projections for 2007, and the 61% decline in its second and third quarter earnings as compared to the previous year.[101] While Genesco's revenues had similarly missed projections during certain periods of 2006, revenues rebounded later in the year; however, there was no corresponding rebound for 2007.[102]

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97. *Id.* at A-6.
98. *Id.* at A-6 to A-7.
99. *See supra* Part II.A.
100. *See* Genesco Inc., Proxy Statement, *supra* note 94, at A-7.
101. Genesco, Inc. v. Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007).
102. *Id.*

Looking to decisions in other jurisdictions, including *Tyson*, for guidance, the court concluded that "[c]ommon sense considerations" necessitated the evaluation of three aspects of the decreased revenue: duration, measure, and relationship to the essential purpose of the merger.[103] Following the *Tyson* court's approach and basic contract principles,[104] the *Genesco* court further stated that "in deciding whether a business change is significant a court must not do so in a vacuum but with reference to the context and circumstances of the merger."[105]

However, the *Genesco* court concluded that while a change may be short in duration it may still constitute an MAE, as the parties contemplated in the merger agreement.[106] This conclusion differed from the *Tyson* court's, which emphasized that a decrease in quarterly earnings, even when compared on a yearly basis rather than sequentially, is a short-term "blip" rather than a long term change. According to § 7.2 of the agreement, sufficient cause to terminate the merger exists where an MAE had occurred since the agreement's signing date and was not cured prior to the agreement's closing date.[107] The court pointed to this provision as "an acknowledgment by the parties that in the context of this merger an MAE can occur in three or four months."[108] Therefore, the court reasoned that the combination of lower second and third quarter earnings constituted a significantly adverse change.[109]

In analyzing Finish Line's purpose in executing this merger, the court focused on the growth opportunities that it sought. The court found that while Genesco's decreased earnings would not impact its pursuit of diversification and synergies, such decreases would materially impact the growth of the company because the transaction was highly leveraged.[110] Given that Finish Line intended to finance this acquisition primarily through debt, with the vast majority of debt payments coming from Genesco's revenue subsequent to the merger, Genesco's decline in earnings im-

103. *Id.*
104. *See supra* Part III.A.
105. *Genesco, Inc.*, 2007 WL 4698244.
106. *Id.* at 20.
107. *Id.*
108. *Id.*
109. *Id.*
110. *Id*. at 36–37.

pacted "the ability of the merged entity to pay its financing and have money left over to grow the company."[111] Thus, the court concluded that because Genesco's decline in earnings affected the merged entity's ability to repay its financing obligations, the decline was material.[112]

In reaching its conclusion regarding materiality, the *Genesco* court looked to the *Tyson* ruling for guidance. It suggested that a more nuanced approach towards materiality may be needed in today's world of mergers and acquisitions. *Genesco* shows that *Tyson* should not be interpreted as a bar on finding materiality for short-term changes.

While the *Genesco* court's approach to materiality represented a qualified departure from the *Tyson* decision, the Delaware Chancery Court reaffirmed and further bolstered Tyson's ruling in its recent *Hexion v. Huntsman* decision.[113] The Hexion-Huntsman merger was factually similar to Genesco-Finish Line. Hexion is the world's largest producer of binder, adhesive, and ink resins for industrial applications. Apollo Global Management through its majority ownership in Hexion's holding company is the primary owner. It bid for the acquisition of Huntsman — a global manufacturer and marketer of chemical products.[114] Like the Finish Line-Genesco deal, Hexion's acquisition of Huntsman was highly leveraged.[115] Following the signing of the merger agreement, as the parties sought regulatory approvals, Huntsman released disappointing quarterly results, failing to meet the company's earlier predictions.[116] Hexion brought suit in the Delaware Court of Chancery seeking a declaratory judgment abrogating its obligations under the merger agreement because of, among other reasons, the occurrence of an MAE.[117]

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111. *Id.*

112. While the *Genesco* court found that a decline in earnings could be material, it nevertheless found that an MAE did not occur in this instance. *See infra* Part III.B2.

113. 965 A.2d 715 (Del. Ch. 2008).

114. *Id.* at 722–23.

115. Hexion Specialty Chems., Inc., Agreement and Plan of Merger among Hexion Specialty Chemicals, Inc., Nimbus Merger Sub Inc. and Huntsman Corporation, at 27 (July 12, 2007), *available at* http://www.sec.gov/Archives/edgar/data/13239/0001193125071 56392/dex21.htm (according to the terms of the Merger Agreement, Credit Suisse and Deutsche Bank committed to provide financing for the deal in a July 12, 2007 Commitment Letter).

116. *Hexion Specialty Chems., Inc.*, 965 A.2d at 721.

117. *Id.* at 723.

The Hexion-Huntsman merger agreement is a paradigmatic example of an agreement in a "seller's market."[118] Hexion's eagerness to acquire Huntsman during the bidding process caused it to rely upon a narrowly tailored MAE clause. According to the terms of the clause, the absence of an MAE — defined in the agreement's representations and warranties — constituted a condition to closing and the only basis for exiting the deal.[119] According to § 3.1(a)(ii) of the agreement

> [A] "*Company Material Adverse Effect*" means 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; *provided*, *however*, that in no event shall any of the following constitute a Company Material Adverse Effect . . . ."[120]

Similar to those found in the Genesco-Finish Line deal, the agreement then delineated events that would not constitute an MAE, including an exception for conditions affecting the industry generally, and a carve-out to that exception for an "event or effect [that] has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the chemical industry."[121]

While the agreement's MAE definition was extensive, as is typical of such clauses, it did not elucidate a standard for determining the materiality of a change. The Delaware Chancery Court therefore adopted the *Tyson* approach[122] and looked to the transaction's context. The court concluded that the assumption in corporate acquisitions is that they are part of a long-term strategy, and that it therefore must look to whether there has been an adverse change in business that affects a "company's long-term earning power over a commercially reasonable pe-

118. *See supra* Part II.A.
119. *Hexion Specialty Chems., Inc.*, 965 A.2d at 738.
120. *Id.* at 10.
121. *Id.*
122. *See supra* Part III.A2.

riod."[123] Such a period, the court found, should be "measured in years rather than months."[124]

Unlike the court in *Genesco*, the *Huntsman* court concluded that while 2007 was clearly a difficult year for Huntsman, such difficulty did not constitute an MAE. To rise to the level of an MAE, "poor earnings results must be expected to persist significantly into the future."[125] The court furthermore rejected the argument that a failure to meet forecasted earnings should be examined when determining whether a change was material; instead, it defined the terms "financial condition, business, or results of operations" as "terms of art" that indicate the only change that should be evaluated is between the previous year's matching quarterly results and expected future performance.[126] The court held that this language constituted an implicit exclusion of discrepancies between forecasted earnings and actual earnings, which is "natural given the role of a material adverse effect clause as a backstop provision."[127]

Vice Chancellor Lamb's opinion differs from the *Genesco* court's regarding *Tyson*'s view that a short-term decrease in quarterly earnings is immaterial in corporate acquisitions. Moreover, unlike the *Genesco* court, the *Huntsman* court restricted its contextual analysis for determining materiality to the long-term focus of corporate acquisitions, seemingly finding the extensive debt financing of the merger irrelevant to materiality. This decision thereby signifies the Delaware Chancery Court's continued upholding of *Tyson*'s narrow approach to the applicability of MACs despite new financing realities and the possible significance of a short-term decline in earnings — as the *Genesco* court articulated.

2. *The Role of MAC Exceptions*

Both the Genesco-Finish Line and Huntsman-Hexion agreements contained complex MACs that enumerated many instances

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123. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008).
124. *Id*.
125. *Id.*
126. *Id.* at 742.
127. *Id.* at 741 n.70.

where an event would not constitute a MAC, and several exceptions to those circumstances. Both parties relied on these exceptions and carve-outs in their arguments regarding the applicability of the MAC provision. The two cases illustrate somewhat different approaches to interpreting and applying modern, narrowly tailored MAC clauses.[128]

While the *Genesco* court analyzed the materiality of the changes in *Genesco*'s quarterly earnings, it was not essential to the court's holding. The *Genesco* court rejected Finish Line's MAE argument even prior to examining the materiality of these changes, finding that this decline in quarterly earnings resulted from a shift in general economic conditions rather than intra-industry changes. The court furthermore accepted Genesco's testimony that the changes in general economic conditions did not disproportionately affect Genesco compared to other companies in the industry.[129] The court therefore held, without looking to materiality, that the drop in quarterly earnings resulted from a condition that the MAC provision explicitly excluded.[130] While the court concluded that the drop in quarterly earnings was indeed material, it ultimately found that Finish Line was obliged to consummate the merger due to the cause of this material change.[131]

The Delaware court's approach to the Hexion-Huntsman MAE clause was markedly different. Unlike the Genesco-Finish Line agreement, the parties had bargained for carve-outs for changes within the chemical industry in addition to changes in general economic conditions, excepting those changes disproportionately affecting the target (Huntsman).[132] Based upon this provision, Hexion asked the court to compare Huntsman's performance from the time of the merger agreement's signing to the whole industry to determine whether changes affecting the industry had dispro-

128. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008); Genesco, Inc. v. Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007).

129. *SLM Corp. v. J.C. Flowers* also partially centered on the disproportionate effect of general economic conditions (the 2007 credit crisis) on Sallie Mae as compared to other institutions of similar size. However, this case does not provide guidance on this issue because the parites reached an out of court settlement. Sorkin & Merced, *supra* note 90, at C1.

130. *Genesco, Inc.*, 2007 WL 4698244.

131. *Id.* at 22–23.

132. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 736–37.

portionately impacted Huntsman's performance.[133] While the Tennessee Chancery Court adopted this approach, examining the merits of the parties' arguments concerning the cause and relative effect of these changes, Vice Chancellor Lamb rejected the applicability of these carve-outs. He instead concluded that such exceptions and carve outs need only be examined after determining the materiality of the change.[134]

3. *Implications of the Genesco and Huntsman Decisions*

While the *Genesco* court's approach to the MAC clause diverged from the *Tyson* court's approach, the *Huntsman* court reaffirmed *Tyson* both in its approach to materiality and its attempts to render complex MAC provisions unnecessary and irrelevant.[135] The *Genesco* decision points out the difficulties in ascertaining what constitutes a material change and in interpreting the MAC carve-outs, which are connected with the typical drafting of the clauses as well as changing market realities. Ultimately, however, the *Huntsman* decision signals continued adherence to the long-term approach in *Tyson* and continued judicial reluctance to define materiality broadly.[136] Given the Delaware Chancery Court's role as the leading court on corporate standards, the *Huntsman* decision will likely have greater precedential value than the Tennessee Chancery Court's decision.[137]

Despite the differences in reasoning among these courts, each concluded that a MAC had not occurred. Both courts ordered specific performance of the merger agreements, with the court in *Huntsman* limiting its order to all aspects of the merger agree-

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133. *Id.* at 737.

134. *Id.*

135. *See supra* Part III.A.2.

136. At the beginning of its discussion of Hexion's MAE argument, the court noted that "[a] buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close" and further that "[m]any commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement." Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008).

137. Omari Scott Simmons, *Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. RICH. L. REV. 1129, 1129 (2008) (quoting Vice Chancellor Leo Strine on the Delaware courts: "Here, corporate law is an industry that is important unto itself, and we know that if we are perceived as unfair, it matters"); *see also* Maureen Milford, *New Home for Delaware's Noted Chancery Court*, N.Y. TIMES, Feb. 4, 2001, at 117.

ment aside from the obligation to close and imposing uncapped damages as a remedy for failure to consummate the merger.[138] However, the financing banks contested the solvency of the proposed combined entity in both cases.[139] This parallel litigation ended in the termination of the mergers, with Finish Line and Hexion obtaining favorable settlements.[140] The targets' recognition and fear that they would not succeed in litigation against the financing banks drove the settlements, leaving both to attempt to collect payment from corporations with limited capital.[141]

IV. MAC JURISPRUDENCE IN LIGHT OF MAC GOALS AND CONTRACT PRINCIPLES

This Section examines the relationship between the MAC clause, as courts have interpreted it, and the goals of MAC provisions and contracts generally. This section is broken down into two parts. The first part argues that, given MAC jurisprudence, both traditional and complex MAC clauses fail to accomplish their purposes in merger agreements. The second part examines the tension between the current, narrow judicial interpretation of MAC clauses and contract principles of certainty, finality, and efficiency.

A. FAILURE OF THE MAE CLAUSE TO ACHIEVE ITS GOALS

Given the Delaware Chancery Court's interpretation of traditional and complex MAC clauses, it seems that these provisions do not accomplish their goal of symmetrically allocating risk be-

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138. *Hexion Specialty Chems., Inc.*, 965 A.2d at 756–57, 762; Genesco, Inc. v. Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007).

139. *See* Credit Suisse Sec. (USA) LLC v. Huntsman Corp., 269 S.W.3d 722, 724 (Tex. App. 2008); UBS Sec. LLC v. Finish Line, Inc., No. 07 Civ. 10382, 2008 WL 536616 (S.D.N.Y. Feb. 22, 2008). Solvency was a condition precedent to financing according to the respective commitment letters in each transaction.

140. *Hexion, Huntsman Kill Deal*, HOUS. BUS. J., Dec. 15, 2008; Lessons From the Genesco Fight, http://dealbook.blogs.nytimes.com/2008/03/04/lessons-from-the-genesco-fight/ (Mar. 4, 2008, 10:05 EST). Genesco's settlement provided for payments of $175 million from both UBS and Finish Line, and 6.5 million shares of Finish Line stock. *Id.*

141. Lessons from the Genesco Fight, *supra* note 140; Why Dow-Rohm Is No Huntsman-Hexion, http://dealbook.blogs.nytimes.com/2008/12/30/why-dow-rohm-is-no-huntsman-hexion/ (Dec. 30, 2008, 16:54 EST).

tween buyers and sellers from the merger's execution to closing.[142] Courts in Delaware and elsewhere are hesitant to find a MAC, creating an almost insurmountably high bar for establishing materiality.[143] This approach renders the clause ineffectual. Moreover, the high threshold persists even with exceptions and carve-outs to these exceptions. For example, the Chancery Court in *Huntsman* made materiality a necessary condition antecedent to the consideration of such exceptions.[144] The *Huntsman* decision thus casts some doubt on Gilson's investment theory, which posited that complex MACs allocate risks efficiently to the parties best suited to bear them.[145] While the *Genesco* court did interpret the MAC carve-out as allocating exogenous risks to the buyer, it ultimately failed to protect the target.

B. CONTRACT PRINCIPLES AND MAC CLAUSES

1. *Contract Principles*

A primary goal of contract law, particularly in transactions involving the sale of one firm to another, is to facilitate the contracting parties' maximization of joint gains through two complementary means: efficient trade and efficient investment.[146] Efficient trade is accomplished when the value of the exchange to the buyer exceeds the cost of performance to the seller, while efficient investment involves maximizing a deal's surplus through the parties' actions.[147] When the cost of performance exceeds the benefits to all parties, efficiency will dictate a contract's breach.[148]

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142. *See supra* Part II.B.

143. *See* David Cheng, Note, *Interpretation of Material Adverse Change Clauses in an Adverse Economy*, 2009 COLUM. BUS. L. REV. 564, 599–602 (concluding that a high bar for materiality is both settled precedent and justified as such).

144. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 737 (Del. Ch. 2008).

145. *See supra* Part II.B.

146. Schwartz & Scott, *supra* note 43, at 544–45.

147. *Id.*

148. Jordan A. Goldstein, *The Efficiency of Specific Performance in Stock-for-Stock Mergers*, 29 DEL. J. CORP. L. 747, 755 (2004). Expectation damages are often seen as the ideal remedy for breach, partially because expectation damages approximate actual economic loss and thereby provide an incentive for promisors to breach efficiently. *Id.*

While contract law aims at efficiency, merger agreements are directed at attaining finality.[149] Parties draft such agreements to create a binding commitment with significantly fewer representations and warranties and with a focus on compromise over lengthy negotiations.[150] Certainty that a deal will close is particularly important in a strategic transaction. Otherwise, parties will hesitate to share confidential information.[151] In the United Kingdom, the Panel on Takeovers and Mergers regulates mergers in public transactions.

> [T]he Takeover Panel is concerned that uncertainty surrounding the ability of the purchaser to exit the transaction will have a detrimental effect on the market. In other words, the market benefits from clarity regarding the chances that the announced transaction will close, and the Takeover Panel highly values this market clarity.[152]

Moreover, in the merger context, some argue that specific performance is the only remedy for breach because damages are inadequate.[153] Perhaps this argument stems from the focus on certainty and finality in the merger context, which impedes courts from adequately compensating parties for a deal's failure.

2. *MAC Jurisprudence and Contract Principles*

Inclusion of MAC clauses in merger agreements threatens the finality of these agreements. As the case law discussed above indicates, the language of these clauses poses an interpretational challenge, introducing uncertainty into the agreement related to the definition of materiality.[154] While seemingly an attempt at ex ante allocation of specific risks to each of the contracting parties, complex MAC exceptions heighten this lack of clarity, prompting

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149. JAMES C. FREUND, A TURBULENT DECADE FOR DEALS: ANATOMY OF A MERGER REVISITED 7 (1987).

150. *Id.*

151. Derek M. Winokur & Stephen Leitzell, *Deal Protection Measures in Public M&A*, *in* MERGERS & ACQUISITIONS 2009: TRENDS & DEVELOPMENTS 539, 544 (Practising L. Inst., 2009).

152. Elken, *supra* note 12, at 320–21 (footnote omitted).

153. Goldstein, *supra* note 148, at 759.

154. *See supra* Part II.A.

lawyers to ask: "does anyone understand what's being carved out here?"[155] This uncertainty causes extensive litigation and, frequently, the failure of the deal irrespective of the MAC litigation results.[156]

Moreover, litigation surrounding MAC clauses often exposes the tension between the goals of agreement finality and efficiency. Both the Genesco and Huntsman agreements provide examples of this conflict: while the agreements are aimed at finality a consummation of the merger would not necessarily produce an efficient outcome due to a decline in earnings and changes in the credit market. Traditionally, MAC clause uncertainty has served as a tool for renegotiation to a more efficient outcome,[157] with buyers threatening invocation of the MAC as leverage in the negotiation process.[158] However in economic downturns, MAC clauses have more often been invoked to terminate the merger rather than to renegotiate for more efficient outcomes.[159] Such a desire operates in tension with the court's obligation to interpret the contract in accordance with the parties' intentions (including the finality goal that govern all mergers), preventing the court from reaching a more efficient conclusion.

V. Reverse Termination Fees as an Alternative to MAC Clauses

Contracts generally, and mergers and acquisitions particularly, face challenges that MAC clauses try to address. But MAC jurisprudence highlights how MAC clauses have failed to alleviate these problems, instead fostering extensive and perhaps unnecessary litigation. The clauses' ineffectiveness is due to their ambiguity. Courts have looked to context to define mate-

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155. Redefining the MAC, http://dealbook.blogs.nytimes.com/2008/04/03/redefining-the-mac/ (Apr. 3, 2008 11:16 EST).

156. *See supra* Part III.B.3.

157. Such renegotiation has been cited generally as the goal of a court order of specific performance, which usually results in the parties agreeing to new terms of the deal based on market factors rather than judicial determination. Goldstein, *supra* note 148, at 759–60.

158. Toub, *supra* note 18, at 858; The Big MAC, http://dealbook.blogs.nytimes.com/2008/03/10/the-big-mac/ (Mar. 10, 2008, 11:00 EST).

159. Toub, *supra* note 18, at 858–59 (discussing the downturn in 2001); Lessons from the Genesco Fight, *supra* note 140 (discussing the current economic downturn).

riality, but their interpretations have often restricted a MAC clause's application and at times have been contrary to the parties' intent.

Given the connection between MAC clauses' unpredictable interpretations and their ambiguity, some have suggested including specific thresholds for a material change.[160] While merger agreements do occasionally enumerate quantitative guidelines for determining materiality, such definitions are rare.[161] Choosing particular indicia for measuring materiality raises several concerns. Numerous measures exist, and the selection of specific measures will often be arbitrary, while setting a threshold for each possible index is impractical.[162] Moreover, while such indicia may be intended as illustrative, courts may interpret them as exclusive and fail to consider other changes that may have a material effect on the merging entities.[163]

Incorporating these standards is undesirable due to the difficulty of negotiating them prior to the merger,[164] and the difficulty of insuring against unanticipated changes that specific standards negotiated beforehand do not easily capture.[165] The inclusion of such indicia does not alleviate the difficulties in interpreting carve-outs, which the *Genesco* court struggled with,[166] and the current turmoil in the global economy exacerbates such difficulties.

Reverse termination fee provisions allow a buyer to pay the seller a fixed and often high price to exit an agreement. These can perhaps be used to achieve the intended function of MAC clauses. Merger agreements have included termination fees for quite some time, allowing the seller to terminate a deal for a fixed

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160. Galil, *supra* note 2, at 865.

161. Kenneth A. Adams, *A Legal-Usage Analysis of "Material Adverse Change" Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9, 28–29 (2004).

162. *Id.*

163. *Id.*

164. George Foussianes, Managing Director of Goldman Sachs, has noted that:

> The dynamic that we have experienced in negotiations is that when the parties start to talk about this kind of thing, somebody may throw out a number saying, "Let's define a material adverse change as a situation where EBIT-DA drops by X amount of dollars." That starts down a path that gets very, very difficult. The first thing that the buyer thinks is, "Why did he or she choose that number? Do they know something I don't know?"

Galil, *supra* note 2, at 865.

165. Schiffman, *supra* note 16, at 132–33.

166. *See supra* Part III.B.2.

price, usually between 1% and 3.5% of the deal's value but ranging as high as 11.4%. Courts generally uphold these fees if they are reasonable relative to the size of the entire transaction.[167] While not as prevalent as termination fees, reverse termination fees have become increasingly popular.[168] Merger agreements typically value such fees at 1% to 3% of the deal.[169] These provisions appear in various forms: some allow for withdrawal from the agreement upon payment of the fee in all circumstances,[170] while some are ambiguities regarding applicability when included alongside specific performance clauses.[171]

Research surrounding the efficacy of reverse termination fee clauses indicates that they are often found in deals involving a significant degree of information asymmetry between buyers and sellers, as well as in deals with complex offers.[172] Reverse termination fees have also become increasingly pervasive in mergers involving private equity firms,[173] which use these provisions to secure exit if there is a failure to obtain financing.[174] These findings indicate that reverse termination fee provisions perform a function similar to that which MAC clauses are intended to perform in two ways. First, they grant the buyer a legitimate exit recourse — protecting it from the lemon problem and maintain-

167. Goldberg & Lee, *supra* note 7, at 38.

168. *Id.* at 39.

169. *Id.*; *see also* Vipal Monga, *Turning the Tide*, DEAL MAG., Aug. 29, 2008, http://www.thedeal.com/newsweekly/features/turning-the-tide.php.

170. *See* SLM Corp., Proxy Statement, *supra* note 90, at A-36 (In § 11.05(c), the agreement provided that "[i]n the event that the Company shall terminate this Agreement pursuant to [§ 10.01(d)(ii)] and at the time of such termination there is no state of facts or circumstances that would reasonably be expected to cause the conditions in [§§ 9.01, 9.02(a)(i) or 9.02(a)(ii)] not to be satisfied on the End Date . . . as a result of Parent or its Affiliates failing to Satisfy the HSR Act condition to closing as set forth in [§ 9.01(c)], then, in any such event, Parent shall pay to the Company a termination fee of $900,000,000 in cash (the 'Parent Termination Fee')").

171. United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810 (Del. Ch. 2007). Here, litigation arose because two seemingly conflicting provisions were included in the merger agreement — a reverse termination fee clause and a requirement for specific performance in the case of breach.

172. Thomas W. Bates & Michael L. Lemmon, *Breaking Up Is Hard To Do? An Analysis of Termination Fee Provisions and Merger Outcomes*, 69 J. FIN. ECON. 469, 502 (2003).

173. Goldberg & Lee, *supra* note 7, at 38–39. In United Rentals' merger with Ram Holdings, Inc., an acquisition vehicle of Cerberus Capital Management, RAM insisted on including a reverse break-up fee, "which was indicative of the increased willingness of private equity firms to agree to (or insist upon) a reverse break-up fee provision." *Id.* at 40.

174. Winokur & Leitzell, *supra* note 151, at 553.

ing of a sufficiently high purchase price. Second, reverse termination fees provide an incentive for the seller to take profit maximizing actions that will maintain the value of the company and will prevent the seller from exiting the agreement.[175] Moreover, reverse termination fees are legitimate leverage for an agreement's renegotiation (or termination) when performance is no longer economically efficient.[176]

Incorporating reverse termination fees in lieu of MAC clauses may raise similar issues in negotiations as attempting to define a change's materiality. Such clauses, however, have already been successfully incorporated into agreements, indicating that their inclusion did not necessarily disrupt the negotiation process. With MACs, negotiations regarding the materiality of a change may raise concerns that the seller is anticipating some undisclosed change. However, this concern is irrelevant with termination fee provisions, which generally mirror the amount of the standard termination fee payable to the acquirer.[177]

Lawyers and dealmakers have not yet definitively concluded how such reverse termination fees should be valued in a deal. Some, particularly those who are confident that a deal will succeed, argue that they are merely a part of the cost of doing business. However, those who recognize that such termination fees may play a key role if the deal sours contend that such fees should be valued as an option.[178] Thus, while including reverse termination fees has not yet become general practice, and the precise means by which they should be incorporated into agreements and valued has yet to be determined, they present a possible solution to the issues that MAC clauses have unsuccessfully tried to resolve.

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175. *See supra* Part II.B.

176. Indeed, RAM Holdings, Inc. relied upon the reverse termination fee provision in its merger agreement with United Rentals, Inc. to exit the agreement following its determination that payment of this fee would result in greater economic efficiency than consummating the merger. Monga, *supra* note 169.

177. Winokur & Leitzell, *supra* note 151, at 553.

178. Monga, *supra* note 169.

VI. Conclusion

While MAC clauses have evolved since the *Tyson* decision, their ambiguity has forced the judiciary to consider external factors to determine their applicability, causing a highly restrictive reading of these clauses. Attempts to create a more carefully tailored escape clause by using more specific carve-outs have failed to promote predictability in litigation. These decisions indicate that, in recent years, MAC clauses have merely created greater uncertainty in an unstable economic environment and have proven unsuccessful at allocating risks or alleviating the lemon problem. Replacing such clauses with reverse termination fee provisions will better serve these goals, while according with contract principles.