

Material Adverse Change clauses: do they hold any water?

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Material Adverse Change clauses are designed to protect buyers against “Triggers” that negatively affect acquisition targets in the period between signing and closing an agreement. However, it is difficult to give effect to these clauses.

The MAC clause

A Material Adverse Change (MAC) clause enables a buyer to withdraw from a signed deal if certain criteria defined in the clause are met. MAC clauses are intended to protect buyers against any changes, circumstances, developments, events or occurrences (defined as “Triggers”) that have had, or are reasonably likely to have, a material adverse effect on the business (i.e. assets and liabilities), financial condition or operating results of a target and, if appropriate, its subsidiaries, taken as a whole, in the period between the signing of a definitive transactional agreement and the closing of that transaction.

The definition of a MAC is often heavily negotiated because it has the potential to grant a buyer a convenient walk-away right if, after signing a deal, it is struck by “buyer’s remorse”. It is for this reason that targets will argue that buyers should not be able to walk away from a deal if a Trigger arises out of, is caused by, or relates to:

- ▶ changes in general economic or political conditions;

- ▶ changes or downturns in the industry in which the target operates;
- ▶ changes or amendments in accounting principles, laws or regulatory policies;
- ▶ the announcement or consummation of the transaction;
- ▶ the identity of the buyer;
- ▶ compliance with the definitive transactional agreement(s); or
- ▶ any act of terrorism or war, unless the target and, if appropriate, its subsidiaries, taken as a whole, is disproportionately affected by the Trigger when compared with its peers in the same industry or geographic area.

Despite all of the potential carve-outs for which a target will negotiate, many buyers still view some form of MAC clause as a necessity in the light of the very real dangers that have been highlighted by the global recession. In fact, statistics released by the American Bar Association reveal that the agreements in nearly all (i.e. about 97%) public company deals that were signed in 2008 included a MAC clause with a walk-away right.

Of those deals:

- ▶ 98% included a carve-out for changes in economic conditions;
- ▶ 93% included a carve-out for changes in industry conditions;
- ▶ 93% included a carve-out for changes occurring as a result of the announcement of the deal;
- ▶ 86% included a carve-out for changes in law;
- ▶ 83% included a carve-out for changes in accounting principles; and
- ▶ 88% included a carve-out for acts of terrorism or war.

In addition, 92% of the agreements that contained carve-outs included “disproportionate” language as a qualification to those carve-outs, with 53% of those agreements requiring that the disproportionate impact be material or substantial.

Clearly, MAC clauses have become an important part of the machinery driving agreement in most public company deals in the USA. The trend is similar in the UK, Europe and, indeed, in South Africa. But, while these clauses consume a large amount of the negotiation time, it is not yet clear how much protection they grant buyers in practise. The real question is: when, or under what circumstances, will a court find that a MAC has occurred?

Relevant case law

There does not appear to be reported case law on the subject in South Africa. So it is useful to review the way in which the specialist commercial courts of Delaware in the US have interpreted these types of clauses.

In *In re: IBP, Inc. Shareholders Litigation*, 789 A.2d 14 (Del. Ch. 2001), the Delaware Court of Chancery had to determine whether or not the acquirer, Tyson, was permitted to terminate its merger contract with the target, IBP, as a result of an alleged breach by IBP of its representation and warranty that it had not suffered a “Material Adverse Effect” since the “Balance Sheet Date”, except as set out in the “Warranted Financials” or the disclosure schedule to the contract.

The contract defined a “Material Adverse Effect” as, “any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect... on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as a whole”.

Tyson, in essence, argued that a decline in IBP’s performance in two consecutive quarters since the Balance Sheet Date was evidence of the existence of a Material Adverse Effect. In addition, it argued that an unexpectedly-high impairment charge against one of IBP’s subsidiaries constituted a Material Adverse Effect.

In interpreting the definition of a Material Adverse Effect in the merger contract, the Court stated that, “[o]n its face, [it] is a capacious clause that puts IBP at risk for a variety of uncontrollable factors that might materially affect its overall business or results of operations as a whole”. In addition, the definition of Material Adverse Effect did not contain any carve-outs.

The Court held that it could not give meaning to such a broadly-drafted clause unless it read the contractual language in, “the larger context in which the parties were transacting”. According to the Court, this requires a court to understand the motivations of a buyer in acquiring a specific target. In this regard, the Court held that a short-term speculator may regard the failure of a target to meet analysts’ projected earnings for a quarter as material. However, that failure may be less significant to a strategic buyer with long-term prospects for the business combination between it and the target:

“[t]o such an acquirer, 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 earnings power over a commercially reasonable period, which one would think would be measured in years rather than months” (footnote omitted).

This led the Court to hold that a MAC clause: “is best read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquirer” (footnote omitted).

On the question of onus, the Court held that, since merger contracts are heavily negotiated and cover a large number of specific risks explicitly, “a buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close”.

The Court was ultimately unable to conclude that a Material Adverse Effect had occurred. Instead, it found that the decline in IBP’s business since the Balance Sheet Date was due to short-term swings in the cattle industry, which is cyclical in nature, and that Tyson had not considered the subsidiary that had suffered the impairment charge to have been important at the time the parties were negotiating and could not therefore claim that that subsidiary was now important to it. It consequently ordered Tyson to close the transaction and acquire IBP pursuant to the terms of their merger contract.

In *Hexion Speciality Chemicals, Inc. et al., v. Huntsman Corp.*, the Court was faced with a MAC clause containing a standard industry carve-out. It had to determine whether or not the relevant standard for judging if a MAC had occurred was to compare the target’s performance from the date of signing the merger agreement and its expected future performance with the performance of its peers in the industry over the same period. The Court held that, “[t]he plain meaning of the carve-outs found in the proviso is to prevent certain occurrences which would otherwise be MAE’s being found to be so”. It went on to state that:

“[i]f a catastrophe were to befall the chemical industry and cause a material adverse effect in Huntsman’s business, the carve-outs would prevent this from qualifying as an MAE under the Agreement. But the converse is not true – Huntsman’s performance being disproportionately worse than the chemical industry in general does not, in itself, constitute an MAE. Thus, unless the court concludes that the company has suffered an MAE as defined in the language coming before the proviso, the court need not consider the application of the chemical industry carve-outs”.

Following these statements, the Court in *Hexion* went on to reaffirm the holdings in *IBP*. But it also made a number of other important points.

First, it stated that it is no coincidence that Delaware courts have never found a MAC to have occurred in the context of a merger agreement. In so doing, it reiterated the heavy burden that a buyer must bear if it seeks to terminate its deal with the target.

Second, the Court noted that, although it should affect a target’s, “long-term earning power over a commercially reasonable period, which one would expect to be measured in

years rather than months”, a MAC can occur in the period between signing and closing, provided that any substantial decline in earnings during that period is, “expected to persist significantly into the future”.

Third, the Court held that the form that a MAC clause takes (e.g.: a warranty, a representation or a condition to closing) should not determine the allocation of the burden of proof in the absence of any evidence regarding the intention of the parties on this point.

Finally, it held that, in the context of a cash acquisition where a buyer is acquiring both the debt and equity of a target, the use of earnings per share (EPS) as a benchmark for examining changes in the results of a company’s operations is problematic because EPS is, “very much a function of the capital structure of a company, reflecting the effects of leverage”.

Since an acquirer for cash may replace the capital structure of the target with one of its own choosing, the capital structure of the target prior to closing is largely irrelevant. In these circumstances, a court should look to the results of operations of the target’s business, which is best measured using earnings before interest, taxes, depreciation and amortisation (EBITDA) data because this is independent of the capital structure of the target.

Lessons learned from the US

South African lawyers can learn the following lessons from the US cases referred to above:

- ▶ A MAC clause is a “backstop” provision that is analysed and interpreted against the backdrop of negotiations between the parties. As a result, the parties should

not be able to rely on the MAC for issues that were specifically contemplated during negotiations; these issues should be covered by specific warranties and indemnities. Although South Africa has strict rules regarding the admission of parol evidence for the purposes of interpreting a contract, the typically broad and ambiguous drafting of these clauses should provide any party seeking to admit the parol evidence with a sufficiently strong foothold for its admission.

- ▶ If a buyer wishes a MAC clause to include any short-term declines in the business, financial condition or results of operations of a target, then it should contract for this specifically, either by:
 - ▶ acknowledging, in the preamble or otherwise, that the buyer is, say, acquiring the target as part of its short-term investment strategy; or
 - ▶ providing that a MAC shall occur if, say, the target fails to meet stated business goals, financial targets or projections in the period between signing and closing.
- ▶ It is not clear whether the South African courts would follow the example of the US courts in placing the onus of proving a MAC on the buyer. This is the most likely outcome since it will usually be the buyer who is asserting a MAC as a defence to an allegation by the target of repudiation of the definitive transactional agreement(s). But the parties should avoid any risk in this regard by allocating the onus explicitly in their agreement.
- ▶ The parties should explicitly provide for the valuation method to be used in determining whether or not a MAC has occurred (e.g.: EPS or EBITDA), especially

where the MAC contains an economic or industry carve-out. As the Hexion case indicates, a court will be inclined to use EBITDA since this will provide it with the most objective measure of the earnings performance of a target relative to its peers. The valuation method used by the buyer or its financial advisers in valuing the target will probably be the standard against which the parties seek to pin the determination of a MAC.

- ▶ The parties and their financial and legal advisers should consider all possible Triggers that are likely to impact on the performance or value of a target when drafting the definition of a MAC and its carve-outs. This is especially important where the target’s business is cyclical or subject to short-term swings in fortune.
- ▶ If a buyer wishes to assert a MAC, it should tread very carefully, especially in its dealings with the target’s management. As the Delaware cases suggest, courts are reluctant to find that a MAC has occurred. Consequently, a court may force the buyer to specifically perform its obligations under the definitive transactional agreement(s). Although specific performance may seem like a drastic remedy on its face, the IBP decision indicates that it is likely to be less drastic than allowing the buyer to walk away from the deal (which would make the target appear like “damaged goods” in the eyes of the marketplace) with only an award of damages against its name (which would be almost impossible to calculate and, in any event, staggeringly high in the case of a public company).

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