The Material Adverse Change Clause

(With Sample Language)

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THE MATERIAL ADVERSE CHANGE CLAUSE (MAC) as a closing condition has achieved permanent status as one of the most highly negotiated parts of acquisition agreements. The basic premise underlying a MAC is that the purchaser should receive the benefit of the bargain. In practice, a MAC included within the closing conditions of an acquisition agreement provides purchasers with an “out” in the event of unforeseen material adverse business or economic changes affecting or involving the target company or assets between the execution of the definitive acquisition agreement and the consummation of the transaction. Some acquisition agreements include forward-looking language (usually with the inclusion of the word

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"prospects"), which requires not only the absence of an event or set of circumstances which causes materially adverse consequences when such consequences occur before the consummation of the transaction, but also the absence of any event that may result in a material adverse effect on the future earnings potential or prospects of a target company following the consummation of the transaction.

When parties litigate the meaning of a MAC within an acquisition agreement, courts have weighed the specific facts involved and have, unfortunately, often used a fragmented and complex approach in reaching an opinion. Nonetheless, courts have often addressed similar issues and concerns in their interpretation of MACs, and these issues and concerns should be kept in mind when negotiating such clauses. The goal of this article is to provide practical suggestions for transactional lawyers drafting and negotiating MACs. Although no set of guidelines will yield a flawless MAC, there are several considerations that may limit the potential for unexpected results in the event of litigation.

MAC OVERVIEW• As with everything we do, lawyers have taken varied approaches with respect to the drafting of MACs. Traditionally, those representing purchasers prefer broadly drafted MACs under the theory that broad language will expand the field of eligible MAC events, thus providing greater protection against the unforeseen. The ABA’s model Stock Purchase Agreement contains an example of the basic broadly worded MAC:

No Material Adverse Change. Since the date of the Balance Sheet, there has not been any material adverse change in the business, operations, properties, prospects, assets or condition of any Acquired Company, and no event has occurred or circumstances exist that may result in such material adverse effect.

As an alternative approach to the broadly drafted MAC, counsel may attempt to craft a narrowly defined MAC, which may include dollar thresholds or numerous carveouts. Legal jurisprudence interpreting MACs suggests that either approach may expose the contracting parties to unintended results. Although courts may determine that a broadly drafted MAC is ambiguous and open to interpretation, leading to the examination of extrinsic evidence and often unanticipated outcomes, courts generally are unwilling to loosely interpret narrowly drafted MACs, which is contrary to the purchaser’s basic interest in obtaining protection against unforeseen events.

Limitations Of The Broadly Drafted MAC
To avoid narrow interpretation of a MAC, counsel for purchasers often negotiate for broad language under the theory that the definition may be interpreted to include unknown or unanticipated adverse events. Unfortunately, broadly drafted MACs succumb to their own interpretational pitfalls, namely ambiguity. Inclusion of words such as “material,” “prospects,” and “business” often lead to the courts determining the proper application of a MAC. In accordance with well-settled case law, ambiguous language within a contract gives rise to a question of fact to be interpreted by available extrinsic evidence. Accordingly, courts often examine extrinsic evidence in an attempt to determine the intent of the contracting parties. Such use of extrinsic evidence combined with the broad power of interpretation left to the courts often leads to unexpected results. The following section discusses issues that should be kept in mind when drafting MACs. Because courts tend to examine MACs with a strong emphasis on the particular facts of the case, it is critical that counsel not take a formulaic approach to drafting MACs. To effectively represent clients, you must focus on the issues particular to the particular transaction.
Materiality

When contracting parties litigate a MAC, courts are generally asked to determine whether:

- The event constituted an “adverse event” in light of the definition of the MAC; and
- The adverse event was “material.”

Though determining whether an adverse event has occurred is relatively straightforward, determining whether such adverse event is material is not and, unfortunately (or fortunately depending on one’s perspective), contracting parties often fail to provide specific language to define the meaning of “material.”

Objective Standard

In determining whether an adverse event is material, courts generally adopt the objective standard of what a reasonable purchaser would view as being material. See, e.g., Parnes v. Gateway 2000, Inc. 122 F.3d 539 (8th Cir. 1997). In reaching a conclusion, courts also examine extrinsic evidence to determine what the purchaser and seller deemed to be material with respect to other matters under the acquisition agreement and may also look to the parties’ prior conduct to determine what events should be considered material.

Determining Intent

As previously discussed, the presence of undefined terms contained within the acquisition agreement requires courts to determine the intent of the contracting parties. This determination process can often result in unforeseen results. One option for practitioners seeking to avoid uncertainty is to carefully consider a deal-specific definition of materiality. For example, the inclusion of a predetermined dollar amount or an earnings percentage threshold may be used to avoid the uncertainty inherent in failing to define materiality. Here is an example of a MAC I used when representing the seller:

For purposes of this Agreement, a “Material Adverse Effect” shall mean any event, occurrence, change in facts, conditions or other change or effect which has resulted or could reasonably be expected to be materially adverse to any of the following: the Company, its business, its prospects, operations or results of operations, the condition (financial or otherwise) of the Company or any material asset (including, without limitation, any Material Contract). For purposes hereof, an event, occurrence, change in facts, conditions or other change or effect which has resulted or could reasonably be expected to result in a suit, action, charge, claim, demand, cost, damage, penalty, fine, liability or other adverse consequence of at least $150,000 shall be deemed to constitute a Material Adverse Effect.

The practical disadvantage of attempting to set predetermined thresholds is that the contracting parties may have difficulty reaching agreement about what method or quantitative amount should be used as the threshold.

Known Events

In IBP v. Tyson Foods, Inc. (789 A.2d 14 (Del. Ch. 2001)), the Delaware Chancery Court granted a request for specific performance of a proposed merger of Tyson and IBP. In reviewing the broadly drafted MAC contained in the acquisition agreement, the court restricted material adverse effects to “unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner.” In finding that no material adverse event occurred, the court noted that because Tyson had knowledge of the volatility of IBP’s earnings, a drop in short-term earnings at IBP did not constitute a material adverse effect. Hence, when purchasers are aware of certain potential events, especially those events that may affect earnings, the purchaser should negotiate to have such known events specifically included within the MAC definition.