INTERPRETATION OF MATERIAL ADVERSE CHANGE CLAUSES IN AN ADVERSE ECONOMY

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I. INTRODUCTION

By all accounts, 2008 was an awful year for the financial markets, and deal-making activity has plummeted.[1] Sellers in particular have had a tough time, and their negotiating power has been quite weak due to current market conditions.[2] Over the last year, credit has been increasingly difficult to obtain, and markets have been full of uncertainty.[3] Some sellers have even resorted to "reverse auctions," where several sellers compete over one buyer.[4] Meanwhile, buyers have found it easier to walk away from deals.[5] Often, buyers who try to renege on previously agreed to deals will argue that the seller has experienced a material

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1 "The entire global financial system almost collapsed, the takeover market shrank by a third as the credit markets dried up, the stock market had one of its worst years in history, and a series of legendary financial institutions disappeared." Steven M. Davidoff, *The Deal Professor's Year-End Review*, N.Y. TIMES DEALBOOK, Dec. 29, 2008, http://dealbook.blogs.nytimes.com/2008/12/29/the-deal-professors-year-end-review.

2 "The overall market conditions have weakened sellers' negotiating options." Steven M. Davidoff, *It's Hard Out There for a Seller*, N.Y. TIMES DEALBOOK, Sept. 24, 2008, http://dealbook.blogs.nytimes.com/2008/09/24/its-hard-out-there-for-a-seller.

3 *Id.* ("Credit has dried up, and markets are volatile on the downward side. The only ones who do want to sell or raise capital in these times are those who need to do so, which provides them with minimum negotiating leverage.").

4 Steven M. Davidoff, *Tough Times for Sellers' Lawyers as Buyers Play Hardball on Deals*, N.Y. TIMES DEALBOOK, Oct. 6, 2008, http://dealbook.blogs.nytimes.com/2008/10/06/tough-times-for-sellers-lawyers-as-Buyers-Play-Hardball-on-deals (citing as one prominent example when Bank of America chose to acquire Merrill Lynch instead of Lehman Brothers).

5 Davidoff, *supra* note 2 ("[B]uyers are insisting on agreements that provide them maximum flexibility to terminate the agreement prior to completion.").

adverse change ("MAC"), sometimes also referred to as a material adverse effect ("MAE").[6]

Seller plaintiffs in recent cases have contended that the real reason for assertion of MAC clauses by buyers is the increased difficulty in obtaining financing and enforcing commitments from lenders during these credit-scarce times.[7] In the Sallie Mae litigation for instance, buyers that included J.C. Flowers, J.P.Morgan, and Bank of America tried to invoke a MAE clause to avoid paying a $900 million breakup fee for dropping the $25 billion deal.[8] The buyers argued that Sallie Mae suffered a MAE due to the subprime mortgage crisis and the September 2007 passage of the federal College Cost Reduction and Access Act that reduced government subsidies to lenders such as Sallie Mae by $19 billion.[9] In seeking to recover the termination fee, Sallie Mae claimed that the Credit Crisis was explicitly excluded from

[6] William Kucera & Charles Wu, *MAE Clauses have their value*, MAYER BROWN IN THE NEWS, June 23, 2008, http://www.mayerbrown.com/news/article.asp?id=5668&nid=20 ("[T]here has lately been a significant increase in buyers attempting to renege on previously announced mergers and acquisitions (M&A) deals . . . many of these arguments are based, in whole or in part, on an assertion that the target business has suffered a material adverse effect (MAE), also referred to as a material adverse change [MAC].").

[7] Press Release, Sallie Mae and Genesco Lawsuits Highlight Need for Clear, Specific MAC/MAE Language in Acquisitions, http://www.bracewellgiuliani.com/index.cfm/fa/news.advisory/item/2ec3ea59-c95c-4a25-bda0-e6939149f0f1/Sallie_Mae_and_Genesco_Lawsuits_Highlight_Need_for_Clear_Specific_MACMAE_Language_in_Acquisitions.cfm (last visited Apr. 26, 2009) (noting that there will be more attention towards the scope of MAE clauses as financing becomes less committed and the business of targets becomes more volatile).

[8] Andrew R. Sorkin & Michael J. de la Merced, *Sallie Mae settles lawsuit over buyout that didn't happen*, INT'L HERALD TRIB. (Jan. 28, 2008) (reporting Sallie Mae's announcement that a settlement had been reached and the merger agreement terminated).

[9] The buyers also said that "Sallie Mae's business revolves around borrowing money from asset-backed securities and asset-backed commercial paper in order to lend money to students." Beth Bar, *Sallie Mae Litigation Raises Issue of Deal 'Adverse Effect,'* N.Y.L.J. (Nov. 14, 2007), *available at* http://www.law.com/jsp/ihc/PubArticleFriendlyIHC.jsp?id=900005495752 (discussing the claims made by both sides).

the MAE clause and that details about the potential legislation had been disclosed in its 10-K filing.[10] Nonetheless, it settled the lawsuit in January 2008 in exchange for a deal to refinance about $30 billion in debt.[11] Just like in other recent deals,[12] the buyers were able to renegotiate without any serious financial penalty merely by asserting a MAE.

Some commentators might expect the recent imbalance of negotiating power between sellers and buyers to result in broader, more buyer-favorable MAC clauses[13] and greater scope given to those clauses by the courts. However, this Note will argue that the current credit crunch is not a MAC and should not be used to loosen MAC standards of materiality. The recent crisis better fits under a carve-out exception, included in 75% of MAC clauses,[14] which excludes events resulting from changes in general economic or business conditions. Part II of this Note defines a MAC clause, identifies some common features, and discusses the standard for materiality. Part III briefly summarizes the two leading Delaware cases on the interpretation of MAC clauses. Part IV examines the role of MAC clauses in the 2001 recession and draws comparisons with today's conditions. Part V analyzes two recent cases that adhere to a strict standard for determining whether a MAC exists. Part VI considers whether courts should continue to maintain this steep hurdle for buyers seeking to prove a MAC. Finally, Part VII concludes.

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[10] *Id.*

[11] Sorkin & de la Merced, *supra* note 8.

[12] Examples include Home Depot having to reduce the selling price of its supply unit in June 2007 and the Harman International acquisition falling through in August 2007. *See* Kucera & Wu, *supra* note 6.

[13] "In light of the credit crisis, we are seeing MAC terms become more buyer-friendly, and we anticipate the market to stay this way through most of 2009." Nixon Peabody LLP, *Seventh Annual MAC Survey* (2008), http://nixonpeabody.com/linked_media/publications/MAC_survey_2008.pdf (last visited Apr. 26, 2009) (surveying 528 asset purchase, stock purchase, and merger agreements from June 1, 2007 to May 31, 2008).

[14] *Id.*

II. MAE/MAC CLAUSES GENERALLY

Almost all merger agreements have a "material adverse effect/change" (MAE/MAC) clause that allows the acquirer to walk away from the deal.[15] These provisions can "vary considerably."[16] They are often "purposely written in an ambiguous fashion"[17] but can feature specific carve-outs or exceptions. In a contract, MAC provisions most commonly appear as a condition to closing: "there shall not have occurred a Material Adverse Change in the company" or as part of the representations or warranties sections, where a party either makes a representation regarding the nonoccurrence of a MAC since a given date or indicates the absence of anything leading to a MAC.[18] Although some writers try to explain why it might be preferable to use "MAC rather than MAE,"[19] the two terms are usually used interchangeably as they will be throughout this Note.[20]

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[15] Out of the 528 agreements surveyed, only 4% had no MAC out. *Id.* at 6.

[16] Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 848 (2002) (noting that some are quite simple, only requiring there be no MAC in the seller's business at closing, while others are complex and specifically define a MAC to exclude or include certain events or circumstances).

[17] Bar, *supra* note 9 ("[T]he notion of [a materially adverse effect] is imprecise and varies both with the context of the transaction and its parties and the words chosen by the parties.") (citing Frontier Oil Corp. v. Holly Corp., 2005 WL 1039027 at *34 (Del. Ch. Apr. 29, 2005)).

[18] Kenneth A. Adams, *A Legal-Usage Analysis of "Material Adverse Change" Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9, 10-11 (2004).

[19] *See id.* at 17-19 (declaring "MAC" to be the better term because it is better suited to absolute representations and in all other contexts should work just as well as "MAE").

[20] "As in Tyson, the parties in Genesco used the terms MAC and MAE interchangeably." Bradley C. Sagraves & Bobak Talebian, *Material Adverse Change Clauses in Tennessee: Genesco v. Finish Line*, 9 TRANSACTIONS: TENN J. BUS. L. 343, 355 (2008). "The terms MAC and MAE are used interchangeably throughout this Comment." Jonathon M. Grech, *"Opting Out": Defining the Material Adverse Change Clause in a Volatile Economy*, 52 EMORY L.J. 1483, 1484 n.10 (Summer 2003).

MAC clauses most commonly appear in the agreements of merger and acquisition ("M&A") deals and address the possibility of something occurring from the signing of the merger agreement up to the consummation of the transaction, the "closing," that adversely affects the value of the seller or target.[21] This length of time varies but is usually a period of at least a few months. In most deals, this time lag will depend on shareholder approval and the right and obligation of the buyer to conduct due diligence.[22] A MAC clause shifts the risks of loss due to particular changed circumstances from the buyer to the seller during this interim period.[23]

A. Purposes

Academics differ slightly on the purposes of the MAC clause, but many agree that it is a way to allocate interim risk between signing and closing in order to "alleviate the 'lemon problem.'"[24] The "lemon problem" describes the

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[21] *See* Jeffrey T. Cicarella, *Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause*, 57 CASE W. RES. L. REV. 423 (2007) (describing the context and role of MAC clauses in M&A agreements). The "time period covered by the MAC provision [is] usually either since the date of the most recent balance sheet or from the execution of the merger agreement to the closing date." Grech, *supra* note 20, at 1486.

[22] For most mergers, the acquirer will need to conduct due diligence research on the other corporation, and pass all relevant information on to the shareholders so that they can make an informed decision. Due diligence in the context of M&A is the process of identifying and confirming the business reasons for the proposed transaction. It can include strategic, financial, legal, marketing, operations, and human resource considerations. Joe Burke, *Due Diligence in Mergers & Acquisitions*, BNET, Oct. 2000, http://findarticles.com/p/articles/mi_m4153/is_5_57/ai_67590520.

[23] Celia R. Taylor, *When Good Mergers Go Bad: Controlling Corporate Managers Who Suffer a Change of Heart*, 37 U. RICH. L. REV. 577, 586 (January 2003) ("This window of time may be lengthy and cautious parties will try to allocate risk while they wait.").

[24] Galil, *supra* note 16, at 848-49 (acknowledging however that some clauses are forward-looking and require not only the absence of a MAC as of the closing date but also the absence of any development that might

information asymmetry that occurs when a seller knows more about a product than a potential buyer.[25] This can lead to a steep price discount and in some cases may even prevent a mutually beneficial transaction.[26] Although buyers will try to find out as much relevant information about the seller as possible during due diligence, serious problems may still remain uncovered.[27] A MAC clause, by shifting the risk of unexpected MACs from buyer to seller, reduces the discounting that would normally arise from this information

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result in one after closing). Other writers have suggested a theory that is phrased differently but is similarly based on concerns over information asymmetry. The "investment theory" suggests that "an efficient acquisition agreement will impose endogenous risk on the seller and exogenous risk on the buyer." Under this theory, the MAC clause modifies the principle of caveat emptor to the extent the target caused the events leading to the alleged MAE. Cicarella, *supra* note 21, at 429 (quoting Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 339 (2005)).

[25] First explored by George Akerlof in a 1970 economics paper, the lemon problem "concerns how horse traders respond to the natural question: 'if he wants to *sell* that horse, do I really want to *buy* it?' Such questioning is fundamental to the market for horses and used cars, but it is also at least minimally present in every market transaction." George A. Akerlof, *Writing the "The Market for 'Lemons'": A Personal and Interpretive Essay* (Nov. 14, 2003), *available at* http://nobelprize.org/nobel_prizes/economics/articles/akerlof.

[26] Galil, *supra* note 16, at 849 ("Left unallayed, the buyer's doubts will lead to a steep discount in the offered price, perhaps even reducing it below the seller's minimum sale price and scuppering a potentially valuable deal.").

[27] Craig Thornton & Dan Ruskin, *Due Diligence: Learn From the Past, but Look Toward the Future*, 3 UNIVERSAL ADVISOR (2004), *available at* http://www.plantemoran.com/Services/Consulting/StrategyGlobalServices/Resources/Articles/Due+Diligence.htm (finding traditional due diligence "insufficient in predicting the long-term success of a transaction" and noting that due diligence routinely performed when acquiring or selling a business is often done "too quickly or too narrowly"); Gerald Adolph, Simon Gillies & Joerg Krings, *Strategic Due Diligence: A Foundation for M&A Success*, *available at* http://www.strategy-business.com/press/enewsarticle/enews092806 (describing the "strategic" due diligence necessary to determine whether the potential value of a deal is realistic since "even the best financial and legal due diligence practices do not uncover the whole story for any given prospect, and they certainly do not guarantee success").

asymmetry.[28] The existence and terms of a MAC provision thus affect both a deal's purchase price and its likelihood of completion.

Consequently, a MAC clause can be "one of the heavily negotiated parts of a merger agreement."[29] A seller would obviously prefer not to have a MAC clause at all.[30] When one is included, as it is in almost every merger agreement, a seller will want to limit the events that trigger the MAC clause, while a buyer will want a broad clause that gives it flexibility to terminate the deal if the seller's business worsens.[31] In most cases, the buyer tends to win out, and the MAC clause is drafted broadly.[32]

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[28] In the majority of deals, changes in general economic conditions are excluded from the definition of a MAC because there is no information asymmetry associated with such changes. Thus, the buyer still bears the risk of an economic downturn that does not disproportionally affect the seller's business. *See infra* Part II.B ¶ 2.

[29] Kari K. Hall, *How Big is the MAC?: Material Adverse Change Clauses in Today's Acquisition Environment*, 71 U. CIN. L. REV. 1061, 1063 (Spring 2003). *But see MAC the Knife; Breaking Merger Deals*, THE ECONOMIST (Dec. 6, 2001), *available at* http://www.economist.com/business/displaystory.cfm?story_id=E1_RJSSVS ("The awkwardly named material adverse change (MAC) clause has mostly been an ignored get-out in the small print of merger agreements.").

[30] Hall, *supra* note 29, at 1064 ("MAC clauses are normally drafted broadly, as the buyer prefers.").

[31] *Id.* (stating that the seller will "want to limit the outs for the buyer as much as possible" but the buyer will "want to negotiate a broad clause that will enable it to walk away from the deal if the seller's business deteriorates in any way before the closing"). *See also* Cicarella, *supra* note 21, at 426-27 ("The acquirer wants a broad MAC clause so that it has maximum leeway to walk away from the deal . . . the target, on the other hand, prefers a narrow MAC clause to ensure the deal closes at the specified price.").

[32] *See* Hall, *supra* note 29, at 1064. The reasons for this are likely similar to why parties generally prefer to leave the definition of materiality in MAC clauses undefined. In most cases, it will be too impractical or uncertain to narrowly identify all the situations that might give rise to a MAC. *See infra* Part II.C ¶ 1.

B. Common Features

A model Stock Purchase Agreement provided by the American Bar Association contains this broadly drafted MAC provision: "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 circumstance exists that may result in such a material adverse change."[33] MAC provisions such as the one above may also feature forward-looking language addressing "prospects"[34] and the effects of events which may not have fully materialized at the time the acquirer tries to break the deal.[35] Hence, a "typical MAC clause" might define a MAC as "any change that is or would be expected to have a materially adverse effect on the assets, liabilities, operations, financial condition or prospects of the seller."[36] While parties have the option of characterizing a MAC more narrowly, a broad definition gives courts greater discretion when determining whether an event constitutes a MAC.[37]

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[33] Model Stock Purchase Agreement (Prepared by the Committee on Negotiated Acquisitions of the Section of Business Law of the American Bar Association), *in* DOING DEALS 2002: UNDERSTANDING THE NUTS & BOLTS OF TRANSACTIONAL PRACTICE IN AN UNCERTAIN MARKET 626 (PLI Corporate Law & Practice Course, Handbook Series No. B-1295, 2002).

[34] Grech, *supra* note 20, at 1488 ("Some definitions encompass the seller's 'prospects.'").

[35] Cicarella, *supra* note 21, at 428 (describing the function of the MAC).

[36] Owen D. Kurtin, *Mergers and Acquisitions: Material Adverse Change*, http://www.satellitetoday.com/commercial/equities/22060.html (last visited Apr. 26, 2009) (describing the uses and effects of MAC clauses).

[37] Nick J. Vizy, *Material Adverse Change Clauses*, *in* 2 CORPORATE COUNSEL'S GUIDE TO ACQUISITIONS & DIVESTITURES §§ 12.002, 12.003 (William A. Hancock ed., 2002) ("It is impossible for the parties to anticipate and specifically identify every potential event that may affect the companies prior to the closing of the transaction. Therefore, every MAC clause will include some type of catchall provision which, by necessity, must incorporate generalized terms.").

However, parties also regularly exclude certain adverse changes from the definition of a MAC by listing specific exceptions or "carve-outs." "And [MAC] carve-outs can themselves be subject to carve-outs."[38] From June 2007 to May 2008, the most common MAC exceptions tended to fit into four categories: change in markets,[39] changes in legal developments,[40] changes resulting in calamites,[41] and miscellaneous.[42] A survey of 528 agreements during that period by Nixon Peabody found "a decrease in MAC exceptions for all types of 'changes in markets' categories," other than a slight increase in "changes in exchange rates."[43] Although none of the decreases were substantial, they do seem to support a trend towards more buyer-favorable MAC terms.[44]

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[38] Adams, *supra* note 18, at 43.

[39] The most common of these included: change in the economy or business in general (75% of agreements surveyed), change in general conditions of the specific industry (70%), change in securities markets (45%), change in trading price or trading volume of company's stock (33%), change in interest rates (16%), and change in exchange rates (12%). Nixon Peabody LLP, *supra* note 13.

[40] The two most frequent types: change in laws or regulations (63%) and change in interpretation of laws by courts or government entities (27%). *Id.* at 8.

[41] These included: acts of war or major hostilities (60%), terrorism (59%), acts of God (25%), change in political conditions (38%), national calamity (12%), and international calamity involving the United States (7%). *Id.* at 9.

[42] The most widespread remaining exceptions: failure by target to meet revenue or earnings projections (35%), changes in GAAP (60%), changes caused by the taking of any action required, permitted, or arising in connection with the agreement (56%), and effect of announcement of transaction (64%). *Id.* at 11.

[43] *Id.* at 7 (internal quotations added).

[44] *Id.*

C. Materiality

Even if an adverse event is not excluded by an exception, it must still be material to qualify as a MAC.[45] Materiality is often not defined by the parties in the agreement, and even when it is, the definition is often vague.[46] Other areas of law that deal with materiality, such as federal securities law, fail to provide any guidance for MAC clauses since a reasonable investor and a reasonable acquirer may have different standards for what is important.[47] An investor may also have a more short-term perspective than an acquirer.[48] Another possible way of defining materiality would be to quantify the impact necessary to result in a MAC.[49] In most cases, however, attempts by the parties to quantify materiality will be impractical.[50] The buyer will want a low level while the seller will want a high level, and to avoid a standstill the parties may decide to leave the meaning of materiality ambiguous.[51] Thus, the parties, by failing to precisely define materiality, are making a deliberate choice to rely if necessary on the later interpretation of a court.

Under general theories of contract law, courts then are forced to make a fact-intensive inquiry to determine whether

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[45] Cicarella, *supra* note 21, at 430 ("First, a court must determine whether the MAC provision covers the events in question. Second, a court must determine whether those events are material.").

[46] Hall, *supra* note 29, at 1064 ("Materiality is often not defined by the parties in the agreement . . . . Even if materiality is defined in the MAC clause, the definition is often vague and difficult to apply to a specific set of circumstances.").

[47] Cicarella, *supra* note 21, at 431 (noting that "the current MAC standard is harder to satisfy than mere materiality required under federal securities laws").

[48] *Id.*

[49] One example of quantifying a MAC: "any adverse effect of $1,500,000 or more on the Company or any of its Subsidiaries shall in any event be deemed a Company Material Adverse Effect." Grech, *supra* note 20, at 1498.

[50] Cicarella, *supra* note 21, at 431 (stating that attempts to quantify the impact of a MAE are not practical because parties have difficulty agreeing on a dollar level of adversity).

[51] *Id.*

the MAC clause applies.[52] Due to the rarely unambiguous language of MAC clauses, the plain meaning rule is often unhelpful.[53] Hence, when determining whether a change is material in the face of ambiguous language, courts will turn to parol evidence, which may include drafting history, standards of the industry, or an examination of other economic factors related to the transaction.[54] Given the information asymmetry problem described above, one could argue that MAC clauses should be interpreted broadly in favor of buyers, since sellers are in a better position to assess the interim risks of their business and should bear the costs of nondisclosure. However, courts, in addition to being aware of the buyer's due diligence responsibilities, also tend to strictly enforce the terms of contracts between sophisticated parties who presumably know what to bargain for.[55] Although there is no bright-line test for determining

[52] Taylor, *supra* note 23, at 590 ("If MAE analysis is not clouded by corporate fiduciary duty arguments, contract doctrine provides the proper framework for interpretation."). "Courts apply principles of contract law when interpreting MAC provisions." Grech, *supra* note 20, at 1497-98. *See also*Hall, *supra* note 29 at 1080 (using the *Tyson* case to illustrate that "[d]ecisions involving MAC clauses tend to be very fact intensive").

[53] The "plain meaning rule" states that "if contractual language is unambiguous, a court must give it its ordinary meaning and may not engage in further interpretive inquiry." Taylor, *supra* note 23, at 590.

[54] Grech, *supra* note 20, at 1501 (discussing the role of parol evidence and discussing in turn how courts examine the drafting history, custom of the industry, and economic factors). When making this inquiry, courts should "look to all the relevant circumstances . . . including the state of the world . . . the state of the law . . . all writings, oral statements, and other conduct by which the parties manifested their assent, together with any prior negotiations between the parties and any applicable course of dealings, course of performance, or usage." E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS 275 (2d ed. 1998).

[55] *See In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 72-73 (Del. Ch. 2001) [hereinafter *Tyson*] (stating that *caveat emptor* is still the law of New York and applies with full force given that these were sophisticated parties dealing with each other at arms' length and with the advice of skilled experts).

materiality, two leading Delaware cases provide some guidance.[56]

III. *TYSON* AND *FRONTIER OIL*

Both *Tyson*, which applied New York law, and *Frontier Oil*, which confirmed the basic holding of *Tyson* in Delaware, place a high burden on the buyer to justify termination under a MAC clause.

A. *Tyson* (New York law)

In *Tyson*, the Delaware Chancery Court held that a MAC clause only protects buyers from "unknown events that substantially threaten" the seller's earnings ability in a "durationally-significant manner."[57] The agreement in *Tyson* defined a MAE 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 whole . . . ."[58] The court ruled that the asset impairment at a small subsidiary of the seller[59] and a

[56] "Given the complexity of interpretation, there may be no magic language guaranteed to accomplish a particular goal. However, studying causes such as Tyson can reduce some of the uncertainty." Taylor, *supra* note 23, at 591. "The jurisprudence of MAC clauses is not a model of clarity. Courts have chosen not to derive guidelines for the interpretation of MAC clauses from a probing look at the function of such clauses. Rather, they have mostly preferred to approach each case on the basis of their general experience in business contracts and their judicial instincts." Galil, *supra* note 16, at 864.

[57] Comment, *Delaware Chancery Court Addresses Default Interpretation of Broadly Written Material Adverse Effect Clauses,* 115 HARV. L. REV. 1737, 1738 (Apr. 2002) (quoting *Tyson*, 789 A.2d at 68).

[58] *Tyson*, 789 A.2d at 65 (quoting Agreement § 5.10(a) (specific warranty dealing generally with MAE) and § 5.01 (defining MAE for entire agreement)).

[59] The subsidiary, DFG, had problems with its accounting procedures, which ultimately led to a $60.4 million "Impairment Charge" in its 2000 10-K. *Id.* at 49.

single quarter of poor earnings did not constitute a MAE.[60] The broadly drafted MAE clause did not have an exception for general changes to the economy or to the seller IBP's industry.[61] As the buyer invoking the MAC, Tyson Foods had the burden of proof, one which it did not meet.[62]

In deciding that short-term earning decreases and subsidiary impairment charges were not material, the court held that materiality must be "viewed from the longer-term perspective of a reasonable acquirer."[63] The failure of a company to meet projected earnings for a quarter, while possibly important to a short-term speculator, is less important to a buyer who is acquiring the company as part of a long-term strategy.[64] This was particularly true in this case because Tyson Foods knew or should have known about the cyclical nature of IBP's business based on earnings data disclosed in its 10-K.[65] The court also seemed to find it significant that Tyson's publicly stated reasons for terminating the merger did not include any mention that IBP had suffered a MAE.[66] The "post-hoc" timing of Tyson's

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[60] "On a normalized basis, IBP's first quarter of 2001 earnings from operations ran 64% behind the comparable period in 2000." *Id.* at 69.

[61] The two most common types of MAC exceptions today. *See supra* note 39. At the time, Tyson Foods, Inc. was the nation's leading chicken distributor. IBP, with annual sales of over $15 billion, was the number one beef distributor and second largest pork distributor. *Tyson*, 789 A.2d at 21, 24.

[62] *Tyson*, 789 A.2d at 53 ("Tyson bears the burden to show that a breach of warranty excused its non-performance.").

[63] *Id.* at 68 (stating that a "short-term hiccup in earnings should not suffice").

[64] Grech, *supra* note 20, at 1510 (describing the *Tyson* court's analysis).

[65] IBP suffered a poor quarter in the winter and spring of 2001 "due in large measure to a severe winter, which adversely affected livestock supplies and vitality." *Tyson*, 789 A.2d at 22. "The picture that is revealed from this data is of a company that is consistently profitable, but subject to strong swings in annual EBIT and net earnings." *Id.* at 67.

[66] *Id.* at 65 (commenting on the "post-hoc nature of Tyson's arguments").

assertion made IBP's short-term decline seem more like a justification for buyer's remorse and less like a MAE.[67]

Although not performing as well as it and Tyson had hoped, IBP's business as a whole appeared strong enough to keep up with its past long-term performance.[68] The lackluster performance of one subsidiary did not change this fact. Although the decision was a close one,[69] the court's long-term perspective was consistent with the parties' intentions at the time they signed the merger agreement, and its MAC analysis was consistent with prior interpretations of similarly broad MAC clauses.[70] This standard of analysis was been deemed by later commentators to be "seller-friendly."[71]

B. *Frontier Oil* (Delaware law)

In 2005, *Frontier Oil* extended this seller-friendly standard to Delaware law and to cases asserting a MAC based on litigation. After having entered into a merger agreement with Frontier Oil, Holly Corporation,[72] during due diligence, discovered the possibility of a toxic tort suit

[67] *Id.*

[68] *Id.* at 71 (stating that IBP as a whole seemed "to be in sound enough shape to deliver results of operations in line with the company's recent historical performance").

[69] *Id.* (Judge Strine admitting that he is "confessedly torn about the correct outcome" and that this conclusion was reached "with less than the optimal amount of confidence").

[70] *See* Grech, *supra* note 20, at 1513 (concluding that the court had established that Tyson knew about the events it later claimed gave rise to a MAE and thus, by failing to contract around the cyclical nature of IBP's business and the DFG impairment charge, Tyson also implicitly bore the risks associated with them), 1514 (comparing the *Tyson* court's analysis to that of three previous cases).

[71] "Tyson sets a very 'target-friendly' standard to be applied when interpreting broadly drafted MAC provisions." Sagraves & Talebian, *supra* note 20, at 354.

[72] Frontier, a Wyoming corporation headquartered in Houston, and Holly, a Delaware corporation headquartered in Dallas, were both mid-sized petroleum refiners. Frontier Oil Corp. v. Holly Corp., 2005 Del. Ch. LEXIS 57, at *3 (Apr. 29, 2005).

against a subsidiary of Frontier as well as other parties.[73] The two parties then modified their agreement to add a litigation-specific MAC provision reading in part:

> [T]here are no actions, suits, or proceedings pending against Frontier or any of its Subsidiaries or, to Frontier's knowledge, threatened against Frontier or any of its Subsidiaries . . . other than those that would not *have or reasonably be expected to* have, individually or in the aggregate, a Frontier Material Adverse Effect.[74]

After the modified agreement was approved, a lawsuit was indeed filed against Frontier's subsidiary. To the surprise of both corporations, the complaint alleged, and documents which were not discovered during due diligence revealed, that Frontier would be directly liable for its subsidiary.[75] Although recognizing that litigation could have a "catastrophic" effect on Frontier's business, the court concluded that Holly failed to produce sufficient evidence for a court to make a reasonable and informed judgment of the likelihood of an outcome on the merits.[76] The existence of a lawsuit by itself was not enough to establish the reasonable expectation of a MAE.[77] Estimates of the cost of defending the lawsuit, if viewed from a long-term perspective, were also insufficient to prove that Frontier would suffer a MAE.[78] To rise to the level of a MAE, the threatened effect must be substantial in degree and duration. *Frontier Oil* thus integrated *Tyson*'s high burden of proof for a MAE into the

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[73] *Id.* at *7-8.

[74] *Id.* at *15 (quoting § 4.8 of the merger agreement).

[75] *Id.* at *40-44 (describing the litigation and Frontier's role as guarantor and indemnitor for its subsidiary Wainoco).

[76] *Id.* at *136.

[77] "In assessing whether the risk of litigation . . . may have a Material Adverse Effect, the mere existence of a lawsuit cannot be determinative." *Id.* at *137 n.224.

[78] *See id.* at *138-42 (evaluating Holly's projections of defense costs); "Holly, however, has not shown that Frontier could not pay them or that their payment would have had a significant effect if viewed over a longer term." *Id.* at *142.

law of Delaware, the forum where most MAE litigation occurs because so many companies are incorporated there.[79]

IV. COMPARISONS TO 2001 RECESSION

Tyson and *Frontier* are still considered seminal cases for MAC interpretation.[80] *Tyson*'s standard for materiality was established in the midst of the 2001 recession.[81] Similar to the downturn in 2008, the economy in 2001 experienced a deteriorating stock market and a slowdown in economic activity, as evidenced by a decline in new M&A agreements and an increase in the termination of existing ones.[82] The bursting of the Dot-com bubble, a number of corporate fraud scandals, and the terrorist attacks of September 11 all contributed to the increased uncertainty and volatility of the business environment in the early 2000s.[83]

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[79] Cicarella, *supra* note 21, at 435 & n.80 (also pointing out that even when the law of another state applies, that state may not have case law on point and thus may look to Delaware for persuasive authority).

[80] "Notwithstanding the prevalence of MAE clauses in M&A agreements, [*Tyson* and *Frontier Oil*] have been [the] only two significant court decisions on this topic." Kucera & Wu, *supra* note 6.

[81] According to the National Bureau of Economic Research, a private, nonprofit, nonpartisan organization charged with determining economic recessions, the 2001 recession lasted from March to November. *The NBER's Recession Dating Procedure*, *available at* http://www.nber.org/cycles/recessions.html (last visited Apr. 26, 2009).

[82] Galil, *supra* note 16, at 846 (noting that the "dollar value of announced M&A deals" fell from $3.5 trillion in 2000 to $1.7 trillion in 2001, and the "value of cancelled deals . . . was $68.8 billion from 242 deals in 2001, compared to $40.2 billion from 205 deals in 2000"). "We are living in volatile times politically and economically. Uncertainty plagues the United States economy and scandals rock the corporate world . . . . The recent downturn in the United States and world economies caused many merger parties to reconsider their plans." Taylor, *supra* note 23, at 577.

[83] The Dot-com crash wiped out $5 trillion in market value of technology companies on NASDAQ from March 2000 to October 2002. *Will Dotcom Bubble Burst Again?*, L.A. TIMES, July 16, 2006, *available at* http://www.qctimes.com/articles/2006/07/17/news/business/doc44bb0a1ab97ce159604273.txt. The New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and NASDAQ did not open on September 11 and remained closed until September 17. When the stock markets reopened,

A. Growing Importance of MAC Clauses

MAC clauses unsurprisingly took on greater prominence during this period.[84] The number of MAC cases filed increases when the economy is experiencing a slowdown and companies are concerned about their future performance.[85] Some of these events, such as the 9/11 terrorist attacks, resulted in new MAC definitions and exceptions.[86] More broadly, as noted by a 2002 article in this publication, a weak and anxious economy led to greater use of MAC clauses to justify deal terminations.[87] As mentioned at the beginning of this Note, current conditions have similarly caused more buyers to invoke, or threaten to invoke, a MAC clause in order to walk away from a deal due to economic uncertainty or lack of credit.[88] Despite these somewhat comparable conditions, the situations of buyers during the two periods are not as analogous as they might first appear.

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the Dow Jones Industrial Average (DJIA) stock market index fell 684 points, or 7.1%, to 8921, a record-setting one-day point decline. Bill Barnhart, *Markets Reopen, Plunge*, CHI. TRIB. (Sept. 17, 2001), *available at* http://www.chicagotribune.com/business/chi-010917markets,0,5287650.story.

[84] "Uncertain economic times provide strong incentive to reexamine corporate behavior and the laws that govern it." Taylor, *supra* note 23, at 610.

[85] "Cases involving MAC clauses seem to come in waves depending on the economic environment." Hall, *supra* note 29, at 1065 (noting that a wave of cases involving MAC clauses began in the late 1990s and continued into 2003).

[86] Referred to by some as Osama Bin Laden ("OBL") clauses, these can take several forms. Some include terrorist related events as a MAC, while others exclude such events in a carve-out provision. *See* Galil, *supra* note 16, at 863-64.

[87] "As a weakening economy has highlighted issues of uncertainty and risk-allocation, while delivering material adverse changes with a more generous hand than hitherto, MAC clauses have increasingly been used for attempts to break a deal rather than merely renegotiate its terms." Galil, *supra* note 16, at 864.

[88] "Economic uncertainty makes buyers nervous." Davidoff, *supra* note 4.

B. Availability of Credit

Unlike in 2008, credit in 2001 was much easier to obtain than in earlier recessions. A 2002 FDIC analysis of bank trends pointed out that commercial credit during the 2001 recession was more readily available than in previous recessions despite a decline in commercial and industrial ("C&I") loans.[89] Greater access to capital markets, particularly for large borrowers, meant that fewer C&I loans had less of an effect on the overall availability of credit than in the past.[90] In the case of smaller companies with less ability to raise corporate debt, commercial banks remained relatively well capitalized and willing to lend to credit-worthy borrowers.[91] Most small businesses did not experience much difficulty in obtaining credit in 2001.[92]

[89] Lisa Ryu, *FDIC: Bank Trends Business Credit in 2001: More Available than in Past Recessions*, http://www.fdic.gov/bank/analytical/bank/bt_0202.html (last visited Apr. 26, 2009) (finding that in spite of weaker commercial and industrial lending by banks, overall commercial credit remains more available than in other recent recessions).

[90] "As of September 2001, nearly 55 percent of the credit market liabilities of nonfarm nonfinancial corporate businesses were in the form of commercial paper and corporate bonds, up from about 45 percent in 1990." *Id.* (noting the rising importance of capital market debt instruments in corporate finance).

[91] "As of September 2001, just one half of one percent of FDIC-insured institutions had a ratio of equity and reserves to assets of less than 6 percent. By comparison, over 10 percent of insured institutions had an equity and reserve to asset ratio of less than 6 percent as of June 1990 when the last recession began." *Id.* (noting that despite recent tightening of lending standards, most FDIC-insured banks will be able to expand their loan portfolios in 2002).

[92] "[D]ata from the Quarterly Financial Reports of Manufacturing, Mining, and Trade Firms (QFR) show that outstanding bank loans to manufacturers with less than $25 million in total assets actually increased moderately in 2001." *Recent Economic Developments and the Availability of Credit to Small Businesses: Hearing Before the H. Small Buss. Comm,* (statement of Roger W. Ferguson, Jr., Vice Chairman of the Federal Reserve), *available at* http://www.federalreserve.gov/boarddocs/testimony/2002/20020424/default.htm (updating the Small Business Committee of the U.S. House of Representatives on economic conditions and noting that since the start of 2001, the percentage of small businesses who have found

During the 2001 recession, total commercial credit grew more than in any of the past three recessions.[93] This led many to conclude by early 2002 that "there is little evidence of a credit crunch."[94]

In 2008, almost no one would doubt the existence and effects of a credit crunch.[95] The collapse of Lehman Brothers at a time when no one would loan it money,[96] and a number of other well-known firms, such as AIG, Citigroup, and GM, trying to obtain bailout money from the U.S. government, the "lender of last resort," all seem to confirm a general freezing of credit.[97] In contrast to 2001, smaller businesses have also suffered. During August 2008, 67% of small-business owners complained of having been affected by the credit crunch, as compared to 55% in February.[98] In recent months, in addition to the supply of credit, demand for new

credit more difficult to obtain has remained moderate and well below the levels witnessed in previous downturns).

[93] Ryu, *supra* note 89 ("Adjusted for inflation, growth in total commercial credit during the recession that began in April 2001 has been substantially higher than during any of the past three recessions.").

[94] *Id.*

[95] "It was once an arcane term only known to economists, but the phrase "credit crunch" has been so widely used over the past year that it has been added to the latest edition of the Oxford English Dictionary." David Budworth, *The Credit Crunch Explained*, TIMES ONLINE, Aug. 12, 2008, http://www.timesonline.co.uk/tol/money/reader_guides/article4530072.ece.

[96] Lehman's attempts in the summer of 2008 to raise $6 billion in fresh capital from investors faltered. Lehman Brothers Holdings, Inc., N.Y. TIMES, *available at* http://topics.nytimes.com/topics/news/business/companies/lehman_brothers_holdings_inc/index.html (briefly chronicling Lehman's slow collapse).

[97] *See* Barbara Kiviat, *Is There Really a Credit Crunch?*, TIME (Dec. 24, 2008), *available at* http://www.time.com/time/business/article/0,8599,1868392,00.html?iid=sphere-inline-sidebar (collecting evidence from both sides regarding the availability or unavailability of credit).

[98] *See* Barbara Kiviat, *The Credit Crunch: Where is it Happening?*, TIME (Sept. 30, 2008), *available at* http://www.time.com/time/business/article/0,8599,1845818,00.html (describing surveys by the National Small Business Association).

loans has also shrunk.[99] Even with reduced demand, most economists agree that credit markets at present are abnormally tight.[100] Buyout firms in particular have had to cut back on the number and size of deals as compared to 2006 and the first half of 2007.[101] Private equity firms in 2007 were not able to sustain their traditional returns by borrowing money to buy companies as they have done in the last two decades.[102] Due to the greater scarcity of credit, acquirers today may be even more desperate than their counterparts in 2001 to back out of deals. Nonetheless, buyers still face an almost impossibly high burden to establish a MAC under Delaware law.

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[99] *See* Mark Trumbull, *Credit Crunch Shows Little Sign of Easing*, CHRISTIAN SCI. MONITOR (Jan. 6, 2009), *available at* http://www.csmonitor.com/2009/0106/p01s04-usec.html (also noting how, according to the Fed's quarterly survey of bank loan officers, the percentage of banks tightening their credit terms is much higher today than in the past two recessions).

[100] *Id.* ("'We were obviously at one extreme a couple of years ago. Credit was too easy,' says Nariman Behravesh, chief economist at IHS Global Insight in Lexington, Mass. Now 'the pendulum swung way over in the other direction.'").

[101] Steven M. Davidoff, *A Requiem for Private Equity*, N.Y. TIMES DEALBOOK, Dec. 17, 2008, http://dealbook.blogs.nytimes.com/2008/12/ 17/a-requiem-for-private-equity/ (detailing how four large buyouts agreed to before the Credit Crisis failed because banks were no longer willing to finance them and the prices could no longer be justified).

[102] "The bread-and-butter buyout business in which private-equity firms borrowed money to buy companies, then repaired the companies or broke them up for a profit, are unlikely to sustain the 30 percent annual returns that investors have demanded in the past two decades." Thomas Heath, *Private Equity's Loss of Leverage*, WASH. POST, Jan. 2, 2008, at D08 (describing how the credit crunch lowered the number of private equity deals). *But see* Nicholas Rummell, *Blackstone CEO: Good times Ahead for Private Equity*, CRAIN'S N.Y. BUS. (Nov. 11, 2008), *available at* http://www.crainsnewyork.com/apps/pbcs.dll/article?AID=/20081111/FREE/8111 19977 (citing Blackstone CEO Stephen Schwarzman who argued that private equity firms do particularly well during recessions and are poised to outperform most other financial services firms).

V. RECENT CASES AFFIRM STRICT STANDARD FOR MAC

In two recent cases, courts have continued to apply a strict standard when interpreting MAC clauses. The buyers in these cases invoked MACs based on changes that were largely caused by deteriorating economic conditions. *Genesco* and *Hexion* both relied heavily on *Tyson* and *Frontier Oil* to decide against the buyers.

A. *Genesco* (Tennessee law)

In *Genesco*, a Tennessee[103] opinion, the seller Genesco's quarterly earnings were falling significantly short of projections, and the buyer Finish Line claimed a MAC to avoid a highly leveraged deal "that no longer looked financially viable."[104] On June 18, 2007, Finish Line and Genesco, both footwear retailers, announced the execution of their merger under which Genesco would merge into a subsidiary of Finish Line, the smaller company in terms of revenue and operations, in exchange for $54.50 per outstanding share of Genesco common stock.[105] On August 30, 2007, Genesco reported a $0.13 loss per share for the second quarter, its largest dollar decline in operating income in ten years.[106] Due to concerns voiced by Finish Line's

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[103] The merger agreement contained a Tennessee choice of law provision. Complaint for Specific Performance of Obligation Under Agreement and Plan of Merger at 1-2, *Genesco, Inc. v. The Finish Line, Inc.*, No. 07-2137-II(III) (Tenn. Ch. Ct. filed Sept. 21, 2007) [hereinafter *Genesco* complaint], *available at* http://www.genesco.com/?g=litigation_lib rary.litigation_library (follow "01 Complaint Filed by Genesco" hyperlink).

[104] Steven M. Davidoff, *Finish Line's Road Map*, N.Y. TIMES DEALBOOK, Jan. 28, 2008 (commenting on Finish Line's answer to the lawsuit against it by UBS to terminate obligations to finance the acquisition of Genesco).

[105] Sagraves & Talebian, *supra* note 20, at 344 (describing the terms of the merger).

[106] *Id.* (quoting from Memorandum and Order at 13, *Genesco*, No. 07-2137-II(III) (Tenn. Ch. Ct. filed Dec. 27, 2007) [hereinafter *Genesco* Memorandum and Order], *available at* http://www.genesco.com/?g=liti

investment bank, UBS, in reaction to this news, Genesco feared that UBS "was attempting to renege on its commitments" and filed suit for specific performance.[107] The outcome of the lawsuit turned on whether the court would find that a MAC had occurred.[108]

Relying on *Tyson*, the Tennessee court found that a MAC had occurred but was excluded by the exceptions for changes in general economic conditions and industry-wide conditions.[109] The merger agreement defined "Company Material Adverse Effect" in § 3.1(a) as "any event, circumstance, change, or effect that individually or in the aggregate, is materially adverse to the business condition (financial or otherwise), assets, liabilities, or results of operations of the Company and the Company Subsidiaries, taken as a whole . . . ."[110] Similar to *Tyson*, the merger agreement did not define "material." The court, citing *Tyson* and *Frontier Oil*, required that "the change in the target company's business . . . be significant" and took into consideration: (1) the change's duration, (2) its measure, and (3) its relation to the purposes the parties sought to achieve by entering into the merger.[111]

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[107] *Genesco* Complaint, *supra* note 103, at 20.

[108] "[F]rom the outset of the lawsuit, all parties recognized that a ruling on whether a MAC had occurred was determinative of Genesco's claim of specific performance and Finish Line's and UBS's defense to that claim." [Pretrial] Memorandum and Order at 3, *Genesco*, No. 07-2137-II(III) (Tenn. Ch. Ct. filed Nov. 29, 2007) *available at* http://www.genesco.com/?g=litigation_library.litigation_library (follow "51 Memorandum and Order" hyperlink).

[109] Steven M. Davidoff, *Genesco v. Finish Line: The Opinion*, M&A LAW PROF BLOG, http://lawprofessors.typepad.com/mergers/2007/12/genesco-the-opi.html (last visited Apr. 26, 2009) (analyzing Chancellor Lyle's discussion of general MAC claims).

[110] Genesco Inc., Current Report (Form 8-K), Ex. 2.1, at 8 (June 18, 2007), *available at* http://www.sec.gov/edgar.shtml.

[111] *Genesco* Memorandum and Order, *supra* note 106, at 34 (outlining the essential elements of a MAE as provided in the parties' merger agreement).

All three factors were deemed satisfied by the court in determining that a MAE had occurred. Section 7.2(b) of the merger agreement stated that "[s]ince the date of this Agreement, there shall not have occurred a Company Material Adverse Effect . . . that has not been cured prior to the Termination Date."[112] The court viewed this provision as an acknowledgement by the parties that a MAE can occur within three or four months.[113] Given that sales and earnings declines in May and June made 2007 one of the worst performances in Genesco's last ten years, the court concluded that the changes were of "sufficient durational significance."[114] In terms of the "measure or quantification of the change," the poor performance of 2007 taken as a whole was enough for the court to find that the change was material.[115] Finally, the court found that Finish Line's purpose for entering into the merger was to satisfy "long-term strategic goals . . . such as diversification, synergies from reduced costs and opportunity for growth."[116] Although the decline in Genesco's earnings did not affect the merger benefits of diversification and synergy, it did result in less money being available to pay for the financing of the merger and to grow the merged company.[117] Finish Line had planned on the Genesco part of the merged business, in light of its historical earnings, to contribute 70% of the finance

[112] *Id.* at 35 (emphasis omitted) (quoting from the merger agreement).

[113] *Id.*

[114] *Id.* at 36. This short-term perspective appears to deviate from the approach taken by *Tyson*. At least one commentator has expressed uncertainty that a Delaware court would have adopted the same time period. *See* Davidoff, *supra* note 109.

[115] *Genesco* Memorandum and Order, *supra* note 106, at 34 (acknowledging that "parties and their experts have depicted Genesco's performance and earnings for 2007 in a variety of ways and methods," but focusing on the fact that the earning declines over two quarters were not sufficiently mitigated by later increases).

[116] *Id.* at 36.

[117] *Id.*

payments.[118] Given the decline's duration, its measure or significance, and its effect on the purposes of the merger, the court concluded that a MAE had occurred.[119]

The preceding MAE discussion, however, is moot since the court, earlier in its opinion, already determined that the MAE is excluded by the carve-out for changes in general economic conditions.[120] During its analysis, the court's reliance on expert testimony was consistent with the facts and circumstances approach used in *Tyson*.[121] Based on the testimony of competing experts, the court found that Genesco's poor 2007 performance was "due to general economic conditions such as higher gasoline, heating oil and food prices, housing and mortgage issues, and increased consumer debt loads."[122] Furthermore, the decline was not

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[118] *Id.* at 37 (noting that although "paying the financing costs" was "a secondary purpose" it does affect how much cash is available to grow the company).

[119] *Id.* (rejecting however the claim that an investigation of Genesco for securities violations and a class action lawsuit also constitute a MAE since there has not yet been a finding that fraud occurred or enough shown to give rise to an inference of wrongdoing).

[120] Found in § 3.1(a) of the merger agreement, exception (B) excludes from the definition of a MAE:

> [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.

Id. at 29.

[121] Sagraves & Talebian, *supra* note 20, at 360 (discussing court's analysis of whether the MAE carve-outs applied). "Both courts focused on an intense examination of the parties' intentions and gave great deference to the language of the negotiated merger agreements." *Id.* at 364 (comparing *Genesco*'s approach to *Tyson*'s).

[122] *Genesco* Memorandum and Order, *supra* note 106, at 31. In making this finding, the court relied in great part on the expert testimony of Duane Cantrell, who has twenty-six years of experience in the retail

disproportionate to others in its industry.[123] Since the exclusion prevents Finish Line and UBS from calling a MAE to excuse performance, the court ordered specific performance pending a determination by a New York court that the merger would result in a solvent entity.[124] Prior to the New York trial and before the Tennessee court could issue a final decision, the parties settled in March 2008.[125]

Partly due to not being a final decision, it is unclear how much influence *Genesco* will have on the interpretation of MAC provisions.[126] The opinion may have limited

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industry and is the former president and director of retail footwear company Payless Shoe Stores, Mr. Estepa, who is Genesco's Senior Vice President of Journeys, and Professor Saunders. *See id.* at 31-32.

[123] *Id.* at 33. To justify this finding, the court excludes results of Genesco's teen footwear line, Journeys, despite the fact that 50-60% of Genesco's business is in this sector. Davidoff, *supra* note 109 (commenting that the justification for finding Genesco's decline was not disproportionate to others in the industry is not that clear).

[124] After ordering specific performance, the court noted that the issue of insolvency "has been reserved and carved out of this litigation for the New York Court to decide. If the combined companies would result in an insolvent entity, the New York lawsuit by UBS will halt the merger." *Genesco* Memorandum and Order, *supra* note 106, at 42.

[125] The agreement settled all outstanding litigation and released all claims against Finish Line, Genesco, and UBS. Finish Line and UBS agreed to pay Genesco $175 million and to distribute 12% of Finish Line's shares to Genesco's shareholders. Sagraves & Talebian, *supra* note 20, at 362-363 (citing Genesco, Inc., Current Report (Form 8-K), Exhibit 10.1, at 2 (Mar. 4, 2008), *available at* http://phx.corporate-ir.net/preview/phoenix.zhtml?c=75042&p=irol-sec&secCat01.1_rs=11&secCat01.1_rc=10 (follow "3/4/08 8-K" hyperlink)); "Genesco will get $175 million—$136 million of it from UBS, the rest from Finish Line—as well as 6.5 milion shares of Finish Line stock." Steven M. Davidoff, *Lessons From the Genesco Fight*, N.Y. TIMES DEALBOOK, Mar. 4, 2008, http://dealbook.blogs.nytimes.com/2008/03/04/lessons-from-the-genesco-fight.

[126] "The precedential weight of the Genesco decision may be limited beyond the fact that it is not a final decision. Specifically, it may be limited by the express language of the Merger Agreement relied upon by the court . . . ." Sagraves & Talebian, *supra* note 20, at 363 (discussing potential future impact of the opinion). "Ultimately, I'm not sure the opinion will have much precedential power for MAC cases though it does support a very broad interpretation of the general industry condition that

precedential value for future MAC cases because it came from Tennessee and not Delaware.[127] In addition, the express MAE language in the merger agreement differed from prior cases. Based on the wording of the agreement, the court took a shorter-term view of when a MAC could occur than the *Tyson* court did.[128] Future MAC clauses may eliminate or modify this language. The rest of *Genesco*'s MAC analysis bears many similarities to that of *Tyson*, but it is still too early to tell how much the decision will be relied upon in the future. It was not mentioned in the case that follows.[129]

B. *Hexion* (Delaware law)

On July 12, 2007, Hexion Specialty Chemicals, Inc. entered into a merger agreement for the leveraged cash acquisition of Huntsman Corporation at $28 per share for 100% of Huntsman's shares.[130] The total value of the deal, including assumed debt, was approximately $10.6 billion.[131] The merger would have created the world's largest specialty

drafters should be aware of." Davidoff, *supra* note 109 (listing final thoughts on the case).

[127] Davidoff, *supra* note 125 (explaining that no one is a winner in the settlement because of its limited precedential value).

[128] Sagraves & Talebian, *supra* note 20, at 364-65 (discussing the *Genesco* court's reliance on the "drop dead" date termination provision in the merger agreement). The court also reasoned that the intentions and expectations of the parties contained a shorter-term view because repaying the debt out of Genesco's profits was a material purpose of the merger. *Id.* at 364.

[129] "[T]he Genesco/Finish Line opinion was not even cited in this one, confirming its status as an outlier." Steven M. Davidoff, *Lessons From Huntsman v. Hexion*, N.Y. TIMES DEALBOOK, Oct. 2, 2008, http://dealbook.blogs.nytimes.com/2008/10/02/lessons-from-huntsman-v-hexion.

[130] Huntsman, a Delaware corporation, and Hexion, a New Jersey corporation, are both large chemical companies. Hexion is privately held and 92% owned by Apollo Global Management, a Delaware limited liability company and a large private equity group. Apollo was not a party to the merger agreement. Hexion Specialty Chems., Inc. v. Huntsman Corp., 2008 Del. Ch. LEXIS 134, at *7-9 (Del. Ch. Sept. 19, 2008).

[131] *Id.* at *8.

chemical company.[132] While in the process of obtaining regulatory approvals, the seller Huntsman reported several disappointing quarterly results and missed the numbers it had projected at the time the deal was signed.[133] In the middle of 2008, the buyer Hexion, after obtaining an "insolvency" opinion,[134] filed suit and claimed that the merger could not be completed because financing would not be available due to the prospective insolvency of the combined entity and because the seller had suffered a MAE.[135] The court declined to rule on whether the combined entity would be solvent.[136] Since the "stringent deal terms" originally agreed to by Hexion did not include a "financing out,"[137] Hexion was not excused from performance if financing was not available at closing.[138] The MAE clause was one of the few ways Hexion could walk away without paying Huntsman at least $325 million in liquidated damages.[139]

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[132] *Id.* at *13.

[133] *Id.* at *3.

[134] The court found the insolvency opinion unreliable because it was prepared with the knowledge that it could be used in litigation, was based on skewed numbers provided by Apollo, and was produced without consultation with Huntsman. *Id.* at *19-20.

[135] *Id.* at *4.

[136] Instead of "referee[ing] a battle of experts in which there is no clear answer and no possibility of splitting the difference," the court decided not to reach the issue of solvency because that issue will not arise unless and until banks refuse to fund the transaction. *Id.* at *111-12.

[137] A "financing out" is a provision that gives the buyer the right to not complete the transaction if it is unable to secure financing for the transaction. They have appeared mostly in transactions involving public companies being taken private. *See Why "Financing Outs" May be Back In*, CAPITALEYES, BANK OF AMERICA BUSINESS CAPITAL, http://corp.bankofamerica.com/public/public.portal?_pd_page_label=products/abf/capeyes/archive_index&dcCapEyes=indCE&id=374 (last visited Apr. 26, 2009) (arguing that "financing outs" will become more common if credit continues to dry up).

[138] Due to a pre-existing signed agreement with a competing bidder and Apollo's "intense desire" for the deal, Huntsman had significant negotiating leverage, and "the merger agreement is more than usually favorable to Huntsman." *Hexion*, 2008 Del. Ch. LEXIS 134, at *12.

[139] If there is no MAE, then the issue will be whether Hexion's liability for failing to close is limited to $325 million by contract or is uncapped.

The Delaware Court of Chancery on September 29, 2008 ruled against Hexion's MAE claim. Relying heavily on *Tyson*, the court emphasized that a buyer faces a heavy burden when attempting to invoke a MAE clause and noted that no Delaware court had ever found for a buyer on a MAC claim.[140] Section 6.2(e) of the merger agreement conditions Hexion's obligation to close on the absence of "any event, change, effect or development that has had or is reasonably expected to have individually or in the aggregate," a MAE.[141] MAE is defined in § 3.1(a)(ii) to be: "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."[142]

In accordance with *Tyson,* a buyer seeking to prove a MAC still had to show a significantly durational adverse event expected to impact future results and based on the business as a whole, not just on declines in one subsidiary or branch.[143] Absent language to the contrary, the burden of proof is on the buyer asserting the MAE.[144] The court followed *Tyson*'s example of examining the change in the context in which the parties were transacting and assuming, absent evidence to the contrary, that the acquisition is part of a long-term strategy.[145] The "commercially reasonable

The merger agreement "expressly provides for uncapped damages in the case of a 'knowing and intentional breach of any covenant' by Hexion and for liquidated damages of $325 million in cases of other enumerated breaches." *Id.* at *13.

[140] Davidoff, *supra* note 129 ("A material adverse change, or MAC, is tough to prove.").

[141] *Hexion*, 2008 Del. Ch. LEXIS 134, at *47.

[142] *Id.* (listing several carve-outs, which are not analyzed in detail because the court, without taking exclusions into account, already found that no MAC had occurred).

[143] Davidoff, *supra* note 129 (highlighting noteworthy points from the decision).

[144] *Hexion*, 2008 Del. Ch. LEXIS 134, at *55 (For the "same practical reasons" cited by the *Tyson* court, "the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract.").

[145] *Id.* at *51-52.

period" should be measured in years rather than months.[146] For a decline to constitute a MAE, "poor earnings results must be expected to persist significantly into the future."[147] The court next decided that a more appropriate benchmark for evaluating claims was Earnings Before Interest, Tax, Depreciation and Amortization ("EBITDA"), rather than earnings per share, because EBITDA is independent of capital structure and thus a better measure of the operational results of the business.[148] This choice of benchmark was the first judicial pronouncement on the subject.[149] The court then turned to each of Hexion's three arguments for why Huntsman had suffered a MAE.

1. Disappointing Earning Performance from July 2007 to Present

While the court acknowledged that Huntsman's results were disappointing,[150] it rejected Hexion's contention that a MAE analysis should focus on Huntsman repeatedly missing

[146] *Id.* at *52 (quoting *Tyson*, 789 A.2d 14, 68 (Del. Ch. 2001), for the proposition that a MAE clause provides 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 [an adverse change] should be material when viewed from the longer-term perspective of a reasonable acquirer.").

[147] *Id.* at *53.

[148] *Hexion*, 2008 Del. Ch. LEXIS 134, at *58 (stating that earnings per share "is very much a function of the capital structure of a company" and not necessarily very relevant when the acquirer for cash is replacing the capital structure of the target). EBITDA was also the metric the parties relied on most when negotiating and modeling the transaction. *Id.*

[149] Owen C. Pell & Paul Carberry, *Delaware Court Interprets Material Adverse Effect Clause to Bar Hexion and Apollo From Abandoning Huntsman Deal*, White & Case Alerts, Oct. 2, 2008, http://www.whitecase.com/alert_litigation_100208.

[150] "Huntsman's first-half 2008 EBITDA was down 19.9% year-over-year from its first-half 2007 EBITDA. And its second-half 2007 EBITDA was 22% below the projections Huntsman presented to bidders in June 2007 for the rest of the year." *Hexion*, 2008 Del. Ch. LEXIS 134, at *59.

forecasted earning targets.[151] Section 5.11(b) of the merger agreement explicitly disclaimed any representation or warranty by Huntsman with respect to:

> any projections, forecasts or other estimates, plans or budgets of future revenues, expenses or expenditures, future results of operations . . . future cash flows . . . or future financial condition . . . of [Huntsman] or any of its Subsidiaries . . . heretofore or hereinafter delivered to or made available to [Hexion or its affiliates] . . . .[152]

The court took this provision as evidence that the two parties had allocated the risk to Hexion that Huntsman's performance would not live up to management's expectations.[153] Jordan Zaken, an Apollo partner involved in negotiating the deal for Hexion, even admitted on cross-examination that Hexion and Apollo never fully believed Huntsman's forecasts.[154]

Instead, the court determined the "proper benchmark" for analyzing these changes would be to compare each year and quarter to the prior year's equivalent period.[155] Under this year-to-year analysis, Huntsman's 2007 EBITDA was only 3% below its 2006 EBITDA, and 2008 EBITDA would be 7%-11% below 2007 EBITDA, depending on whose forecasts are used.[156] Based on these comparisons, the court concluded that no MAE had yet occurred.[157]

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[151] As of August 2008, Huntsman's projection for consolidated EBITDA was $879 million, a 32% decrease from the forecast the year before of $1.289 billion. *Id.* at *60.

[152] *Id.*

[153] "If Hexion wanted the short-term forecasts of Huntsman warranted by Huntsman, it could have negotiated for that." *Id.* at *60-61.

[154] *Id.* at *62.

[155] *Id.* at *65.

[156] *Id.* (pointing out that 2008 EBITDA will be 7% lower than 2007 EBITDA according to Huntsman management's forecasts, but according to Hexion's lower estimates, 2008 will be 11% lower).

[157] *Id.* ("Through this lens, it becomes clear that no MAE has occurred.").

In terms of whether the disappointing results can be "reasonably expected to have" a MAE,[158] the court decided that the anticipated effects do not add up to a MAE.[159] Its conclusion is based on "the likely outcome for Huntsman's 2009 EBITDA [being] somewhere in the middle" of Huntsman's and Hexion's projections.[160] This seemed to be confirmed by the estimates of financial analysts.[161] Based on such estimates, EBITDA from 2006 to 2009 would only drop 3.6%. Only two of Apollo's four original deal models, produced in June of 2007 to justify its $28 per share offer, expected Huntsman's projected 2009 EBITDA to be significantly below this estimate.[162] In other words, the calculations Apollo used to arrive at its price recognized the likelihood of the poor results. The court concluded that the impact of such results can not reasonably be expected to lead to a MAE.

2. Huntsman's Increase in Net Debt since Signing

Hexion, however, urged that Huntsman's results should be examined together with its increase in debt. At the end of June 2007, Huntsman forecasted that its net debt would decrease from $4.116 billion to $2.953 billion by the end of

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[158] *Id.* at *47 (quoting MAE language in § 6.2 of the merger agreement).

[159] *Id.* at *69.

[160] *Id.* Huntsman projected that it will generate $1.12 billion of EBITDA in 2009 while Hexion projected that Huntsman's EBITDA in 2009 will be $809 million. Huntsman's projections are backed by its CEO, CFO, and division managers, who each described in detail how target earnings for next year will be reached and how the reversal of macroeconomic effects, such as sharp increases in crude oil and natural gas prices and the weakening of the dollar, are also expected to positively change future EBITDA. The court recognized that Huntsman management's expectations may be overly optimistic but ultimately concluded Hexion, which offered little detail on how its projections were arrived at, was too pessimistic. *Id.* at *67-68.

[161] Current analysts estimate Huntsman's 2009 EBITDA will average around $924 million. *Id.*

[162] It is at $833 million in one model and $364 million in the "recession case" model. The other two models are essentially the same.

2008.[163] Rather than shrinking by a billion dollars, Huntsman's net debt since signing had expanded by over a quarter of a billion dollars.[164] Again, the court looked to Apollo's deal models and noticed that in all four modeled cases, Apollo/Hexion assumed Huntsman's net debt at closing would be around $4.1 billion.[165] Hence, a significant decrease in Huntsman net debt would have been "simply an added attraction."[166] Even combined with reduced earnings, an increase in net debt that was only 5% different from Hexion's expectations in valuing the deal can not constitute a MAE.[167]

3. Underperformance in Huntsman's Textile Effects and Pigments

Hexion at trial also focused on two Huntsman divisions that had experienced trouble since the signing, but which the court dismissed as "only tangentially related to the issue."[168] The Pigments and Textile Effects divisions were only anticipated to generate one fourth of Huntsman's EBITDA in 2008.[169] In addition, the court found evidence, based on testimony from both sides, that the problems were "short-term in nature."[170] The Textile Effects business was acquired by Huntsman in June 2006 and had to be restructured due to an inflated cost structure that was worsened by

[163] *Id.* at *70.

[164] Increases in the prices of inputs and growth in accounts receivables caused working capital to expand by $265 million, while foreign exchange effects resulted in the notional value of the debt to increase by $178 million. *Id.* (noting that "[t]hings did not go according to plan").

[165] *Id.* at *71-72.

[166] *Id.* (explaining that Hexion's assumptions while making the deal were predicated on Huntsman net debt of close to the current level).

[167] *Id.*

[168] *Id.* at *72-73 ("Little space need be spent on this argument as it falls on its own weight.").

[169] 14% of adjusted 2008 EBITDA is expected to come from Pigments and 11% from Textile Effects. *Id.* at *72-73 (noting that Huntsman as a whole is not materially impaired by the two divisions).

[170] *Id.* at *74.

macroeconomic effects, such as the weakening of the dollar and the increase in the price of crude oil.[171] Pigments involves titanium dioxide, "a notoriously cyclical business, which Apollo well knew at the time of bidding."[172] Similar to the reasoning in *Tyson*, the short-term poor performance of a small part of the target company was not deemed to have a MAE on the business as a whole.

After dismissing Hexion's MAE claim, the court concluded that Hexion had engaged in a knowing and intentional breach, and therefore damages would not be capped at $325 million.[173] Due to the language of the agreement, Hexion could not be forced to close the deal but was ordered to specifically perform all other covenants and obligations associated with it.[174] In other words, Hexion had to complete all the agreed-to steps in an attempt to complete the merger but could decide at the end not to.[175]

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[171] *Id.* at *74-75 (noting that Textile Effects faced a "perfect storm" of macroeconomic challenges in the first-half of 2008," but most of these have been reversing since the end of the second quarter of 2008 and Huntsman has been able to pass some price increases onto the market since July 2008).

[172] *Id.* at *75-76 (explaining that prior to this deal, Apollo had been in negotiations with one of Huntsman's competitors in the titanium dioxide business to acquire their pigments division and was therefore "familiar with the cyclicality that business is known to face"). While most of its competitors use the chlorine process for manufacturing titanium dioxide, Huntsman predominantly uses the sulfate process and has suffered from increased prices of sulfuric acid. However, the financial distress of Tronox, a major competitor in the pigments business and a user of the chlorine process, shows that current difficulties in the pigments industry is not restricted to manufacturers like Hunstman who use the sulfate process. *Id.* at *76.

[173] *Id.* at *77.

[174] *Id.* at *117 (finding that under the agreement Huntsman can not force Hexion to consummate the merger).

[175] If it decides not to close or is unable to, Hexion would then be liable to Huntsman for uncapped damages.

C. Impact on Future MAC Cases

Although it is still too early to precisely gauge the precedential value of *Genesco* and *Hexion*, commentators have been quick to point out that after *Hexion* a buyer seeking to establish a MAC has an even higher burden to meet.[176] Based on Vice Chancellor Lamb's acknowledgement in the opinion that no buyer has ever successfully proved a MAC in Delaware and the court's continued reliance on *Tyson*'s seller-friendly standards, buyers should now be even more cautious about their ability to establish a MAC under Delaware law.[177]

Attempts to account for these decisions by rephrasing MAC clauses or adopting fewer exclusions are unlikely to make a significant difference. The language of MAC provisions is too established. When negotiating deals, lawyers rely on past practice and rarely attempt to significantly reword key provisions.[178] More time and more cases are needed before the wording of MAC clauses are changed enough to significantly improve the chances of a buyer proving a MAC. Despite a decrease in MAC exceptions over the last year, an indication that MAC terms are becoming more "buyer-friendly,[179] a MAC first needs to be proved before looking to the exceptions. Cutting back on

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[176] A buyer "has an even bigger hill to climb before an MAC is . . . established." Steven M. Davidoff, *The State of the MAC*, N.Y. TIMES DEALBOOK, Nov. 7, 2008, http://dealbook.blogs.bytimes.com/2008/11/07/the-state-of-the-mac (noting that *Hexion* "reaffirmed the high bar Delaware law sets for a buyer to prove a material adverse effect occurred").

[177] "Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence." *Hexion*, 2008 Del. Ch. LEXIS 134, at 52.

[178] This has been so far confirmed by "the few deals announced in a post-Huntsman world—they look remarkably like previous MACs, with perhaps fewer exclusions." Davidoff, *supra* note 176.

[179] Nixon Peabody LLP, *supra* note 13.

exclusions will not make a MAC any easier to prove under *Hexion* and *Tyson*.[180]

VI. COURTS SHOULD CONTINUE TO UPHOLD *TYSON*

For the reasons set out below, courts have been correct in upholding a strict MAC standard during these troubled times. Past practice upon which parties have relied on during their negotiations should not be abandoned due to new economic conditions. Given that MAC provisions are even more likely during today's Credit Crisis to be used as an excuse for buyers to renege on or renegotiate deals, courts should continue to view MAC assertions just as, if not even more, distrustfully.[181] Since sellers for the most part have relatively weak bargaining power in the current business environment, buyers already have plenty of alternatives for wiggling out of deals.

A. Risk Allocation

Business cycles have always existed. These exogenous risks should be allocated to the acquirer.[182] As previously discussed, the purpose of a MAC clause is to reduce the information asymmetry between seller and buyer on the endogenous risks associated with the seller's business. Exogenous risks that affect the entire industry or the national economy are equally capable of being identified by both seller and buyer. Consequently, MAC clauses have

[180] "It would behoove buyers to realize that cutting back on exclusions probably does not make up for the Huntsman [*Hexion*] and IBP [*Tyson*] judicial opinions. An MAC is a very limited remedy these days, at best." Davidoff, *supra* note 176. The "Current MAC Standard . . . makes succeeding on a MAC argument virtually impossible." Cicarella, *supra* note 21, at 447.

[181] It is appropriate then that "MACs actually became more target-favorable this year, but by virtue of a judicial opinion, not through negotiating leverage." Davidoff, *supra* note 176.

[182] Cicarella, *supra* note 21, at 429 (proposing that an efficient merger agreement should impose endogenous risk on the seller and exogenous risk on the buyer).

been seen as covering the endogenous risks which were not disclosed to the buyer, while the purchase price has reflected the exogenous risks of economic cycles. In the same way that Tyson and Hexion knew or should have known about the cyclical nature of their targets' industries, private equity firms who have reneged on deals made in the latter half of 2007 arguably should have known the credit freeze was likely to happen. Perhaps these buyers should have seen it coming.[183]

However, some argue that the economic downturn in 2007 and 2008 was impossible to predict. Many commentators claim that the freeze in credit is unprecedented and that this recession could lead to the biggest slowdown since the Great Depression.[184] To the extent that MAC cases rely on the degree and predictability of the change based on the expectations and intentions of the parties, a massive change in economic conditions, even if exogenous, might be considered unpredictable enough to be a mutual mistake, one that neither buyer or seller could anticipate.[185] Moreover, the effects of tightening credit markets and weakening economies are somewhat endogenous in that they affect the credit and performance of an individual seller's business.[186] Hence, remorseful buyers

[183] "[I]f that possibility wasn't baked into the firms' models—then shame on them." Andrew Ross Sorkin, *If Buyout Firms are So Smart, Why Are They So Wrong?*, N.Y. TIMES, (Nov. 18, 2007), http://www.nytimes.com/2007/11/18/business/18deal.html.

[184] The World Bank's chief economist stated: "[t]he financial crisis is now likely to result in the most serious recession since the 1930s." *World Bank Predicts Worst Recession Since Great Depression*, INDO-ASIAN NEWS SERV., Dec. 10, 2008, http://newsx.com/story/37792.

[185] "A mutual mistake is an incorrect belief shared by both parties. The conventional wisdom is that the contract is more likely to be voidable if the mistake is mutual, a distinction emphasized by courts for over a century." Eric Rasmusen & Ian Ayres, *Mutual and Unilateral Mistake in Contract Law,* 22 J. LEGAL STUD. 309, 310 (1993).

[186] These endogenous effects arguably cut the other way as well in that they affect the buyer's ability to acquire financing to get the deal done.

have attempted to characterize the effects of the Credit Crisis as a MAC due to its scope and unforeseeability.

This ignores the fact that sellers did not have any more insight into the future than buyers. If recent economic changes and their effects were truly unpredictable by both sides, then no justification exists for imposing the risk of such changes on the seller rather than the buyer. Rather, the opposite has been the established custom in business deals. As evidenced by the extensive due diligence typically conducted by buyers, the principle of caveat emptor is well established in the M&A context.[187] The unanticipated credit shortage and market volatility in 2008 should not be used as excuses to invoke a MAC clause.

Nonetheless, in recent years, buyers such as Hexion have continued to assert MACs by claiming the impossibility of financing. They attempt to characterize the potential insolvency of the merged entity as a MAC issue by blaming the non-disclosure or inaccuracy of the seller's forecasts. As seen in the *Hexion* case, however, the possibility of negative industry conditions is often already accounted for, or at least should have been, in the buyer's pricing models. Standard contract rules of interpretation should apply.[188] The parties' original intentions, defined by *Tyson* and other cases as the parties' purposes for entering into the merger, and the

[187] "Caveat emptor" literally translates to "let the buyer beware" and stands for the notion that the law assumes equal bargaining power between seller and buyer and therefore offers little or no statutory protection for the latter. The allocation of risk between the two parties is thus left largely to negotiation. PHILIP MARTINIUS, M&A: PROTECTING THE PURCHASER 18 (2005) (explaining the concept of caveat emptor in common law countries). "No one's taking short cuts with due diligence." Michael Sisk, *Regulations Add Wrinkle to M&A*, U.S. BANKER, Apr. 2005, http://www.americanbanker.com/usb_article.html?id=20050401lJ77ACH2 ("Caveat Emptor is the name of the game more than ever.").

[188] *See* Taylor, *supra* note 23, at 605-11 (reading *Tyson* as "notice . . . when the merger process breaks down after an agreement has been reached, contract law is just as important as corporate law in determining the proper resolution").

language of the merger agreement should still control.[189] From this perspective, financing difficulties should not allow a buyer to avoid paying a termination fee or damages in the event that the deal does not go through.[190]

B. Other Options for Remorseful Buyers

In practice, even without courts loosening the MAC standard, buyers have not had any difficulty "bullying" their way out of deals. "Material adverse change" are "magic words that usually permit a buyer to walk away without a financial penalty."[191] Just like other types of litigation, MAC cases are often settled before reaching a courtroom. Both sides want to avoid the expense and delay of litigation involving extensive fact finding and discovery. Even if a court is unlikely to rule for the buyer, the seller may not have the funds to support a drawn out trial that requires hiring expensive expert witnesses, or it may simply decide that a legal fight is not worth it.[192]

Recent cases have proven illustrative. In *Genesco*, for instance, even though Genesco succeeded in denying Finish Line's MAC claim, it may have lost money by not settling the

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[189] "If Tyson is applied, as this article argues it should be, parties will be held to their original intentions and great weight will be placed on the language of the merger agreement . . . Tyson emphasizes the importance of contract doctrine in this area without minimizing corporate directors' fiduciary duties." *Id.*

[190] In addition, the buyer could always negotiate for a "financing out" provision. *See supra* note 137.

[191] Sorkin, *supra* note 183 ("Even though, based on the precedent, it may ultimately be difficult for a buyer to establish that a target business suffered a MAE in a fully litigated case, in many instances the mere claim by a buyer that an MAE has occurred may provide the buyer with sufficient leverage and instill in the seller sufficient uncertainty that the parties come to a negotiated resolution . . . ."); Kucera & Wu, *supra* note 6 (providing a couple of recent examples).

[192] As discussed at the start of this Note, many sellers in 2008 were desperate and had little negotiating power with buyers.

dispute earlier for a higher price.[193] Instead, "as Genesco went deeper into this litigation morass more roadblocks came up."[194] A MAC was invoked in *Hexion* because the deal terms were so favorable to the seller that the buyer had few other options for escaping without paying a significant penalty. This is certainly not the case in the vast majority of other deals being approved in the present economic environment.[195] Both buyers and sellers will tend to explore other options before rushing to litigate a MAC claim.[196]

Buyers who are wary of being compelled to close a no longer attractive deal can bargain for numerous other devices besides the MAC clause. These include reverse termination fees, non-binding letters of intent rather than formal merger agreements, post-agreement due diligence conditions, shareholder approval as a closing requirement, asset purchases, and toxic convert rights that automatically reset the per share price if there is a decline in the seller's stock after the purchase.[197] All of these allow buyers to maintain greater flexibility to walk away from or renegotiate a deal without asserting a MAC.

VII. CONCLUSION

Given the incentives for both sides to avoid litigation and the availability of other tactics for remorseful buyers, the scarcity of decided MAC cases is not surprising. This may

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[193] Davidoff, *supra* note 125 (speculating that Genesco may have been able to settle earlier for a higher price and noting that "loss aversion is one reason why most material adverse change cases settle").

[194] *Id.*

[195] *See* Davidoff, *supra* note 2.

[196] "Due to the uncertainty of the outcome of litigation, a party will most likely invoke the MAC clause only as a last resort." Grech, *supra* note 20, at 1491 (explaining what happens when a party decides to terminate a merger). "Not all conflicts regarding this key clause necessitate a move towards litigation." Alana A. Zerbe, *The Material Adverse Effect Provision: Multiple Interpretations & Surprising Remedies*, 22 J.L. & COM. 17, 34 (Fall 2002) (summarizing a case in which a press release detailed two conflicting interpretations of the MAC clause but no litigation resulted).

[197] Davidoff, *supra* note 4 (citing recent examples for many of these devices).

imply, however, that the failure of most buyers to successfully litigate MAC claims is not as significant as commentators believe. The handful of MAC cases that actually result in a court decision each year may not be representative of the overall success rate of MAC claims. Although a Delaware court has never ruled for a buyer in a MAC case,[198] the number of claims that are successfully settled out of court ensure that these clauses remain tremendously useful for buyers.[199] The *Hexion* court's affirmation of *Tyson*'s heavy burden for buyers invoking a MAC is consistent with the purpose of the MAC clause and does not substantially diminish its effectiveness.

It will be interesting to see how MAC clauses evolve over the next few years. If the wording and intentions behind these clauses remain largely unchanged, then their interpretation by courts should remain stable as well. Based on the current language of MAC clauses and past cases, the drying up of credit and current economic volatility should not fall under the definition of a MAC.

198 *See supra* note 178.

199 Presumably this is part of the reason commentators have not argued that MAC clauses should be drastically changed or done away with altogether.