MACademy: A Round Table Discussion Regarding Material Adverse Change (MAC) Clauses

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Purpose of this CLE

1. Introduce the legal concept of the Material Adverse Change (MAC) clause

2. Benefit from the practical experience of our legal experts

3. Document the practical experience of our legal experts for future reference
A Legal Solution to a Business Problem

→ A MAC clause is a means for the parties to contractually allocate who will bear the risk of adverse events during the time between signing and closing.
The Function of a MAC Clause

- Generally serves to release a buyer from its obligations to complete a transaction without penalty in the event that the seller experiences an unexpected and significant impairment to its business, operations or financial condition prior to the closing of a transaction.

- Includes:
  - the definition of a MAC, and
  - carve-outs or exclusions from this definition
Risk Allocation

- The carve-outs are the principal place in a MAC clause where buyers and sellers allocate risk

- Carve-Outs
  - allocate market and systemic risks to the buyer
  - allocate closing risk to the seller for adverse events that disproportionately affect it
Other Introductory Thoughts

1. Negotiating tool for buyer’s remorse? The MAC strategy
2. Worst case scenario? Buy what you already agreed to
3. Option value for both the buyer and the seller? Form of insurance for both sides?
4. Provides reputational cover to the buyer? Reverse termination fees and the untrustworthy future buyer
5. Does it matter who the buyer is? Strategic vs. financial buyer
Prevalence of MAC Clauses*

*Data Sourced from the 2011 Nixon Peabody MAC Survey.
Anatomy of a MAC Clause

"Material Adverse Change" means any result, occurrence, fact, change, event or effect that has, [or could reasonably be expected to have], a materially adverse effect on the business, assets, liabilities, capitalization, condition (financial or other), results of operations [or prospects] of Target, except to the extent resulting from (A) changes in general local, domestic, foreign, or international economic conditions, (B) changes affecting generally the industries or markets in which Company operates, (C) acts of war, sabotage or terrorism, military actions or the escalation thereof, (D) any changes in applicable laws or accounting rules or principles, including changes in GAAP, (E) any other action required by this Agreement, or (F) the announcement of the Transaction, (provided that such event, change, or action does not affect Company in a substantially disproportionate manner).
Considerations When Defining a MAC

- Sellers seek narrowest possible definition with as many carve-outs as possible; buyer seeks reverse, along with a ‘disproportional effect’ exception to the carve-outs
- Buyers and Sellers may consider:
  - economic conditions, industry specific conditions, and/or company specific conditions
  - magnitude of the impact
  - duration of the effect
- Forward Looking Language
  - ‘could have’ – pro-buyer
  - ‘would have’ – pro-seller
  - ‘are reasonably expected to have’ – middle-ground
MAC clause is a means of protecting against unknown risks (those not identified prior to signing)

MAC clauses can contain specific metrics; however, if a specific risk has been identified in due diligence prior to signing, buyer should rely on a specific, explicit closing condition rather than relying on a general MAC closing condition
MAC Carve-Outs: MAC Clause Exceptions

- Material adverse effect
- Carve-Outs (pro-seller)
- Exception to Carve-Outs (pro-buyer)

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MAC Carve-Outs: MAC Clause Exceptions

- Limit the scope of the MAC “out” for buyer
- Reflection of relative bargaining power
- Often form the bulk of the MAC definition

- A court will analyze carve-outs only after it determines that a MAC has occurred (Hexion)
Seller-Friendly Considerations

- **Strategy**: Weaken the MAC definition by excluding specific events.

- Frequently Used Carve-Outs:
  - Changes in the economy or business in general
  - Changes in general conditions of the specific industry
  - Acts of war and major hostilities
  - Acts of terrorism
  - Changes in laws or regulations
  - Changes in GAAP
  - Failure by the target to meet earnings or revenue projections
Disproportionate Effect Limitation

- Material adverse effect

- Carve-Outs (pro-seller)

- Exception to Carve-Outs (pro-buyer)

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MAC Carve-Outs: Buyer Pushback Strategy

- **Buyer Concern**: Ensure MAC carve-out does not result in moral hazard

- **Buyer Solution**: Limit the scope of the carve-out by including a proportionality analysis with similarly-situated market participants
When MACs Attack:
Strategies and Tactics for Using the MAC Clause

Topics Discussed:
- wielding the MAC clause:
  - “strategic use” vs. “tactical use”
- MAC clause analysis
- demonstrating a MAC:
  - judicial interpretation vs. contractual triggers
Wielding the MAC Clause

- **“Strategic Use”**
  - threatening a MAC as a bargaining tool to re-open negotiations
  - example:
    - Johnson & Johnson v. Guidant Corporation

- **“Tactical Use”**
  - invoke MAC clause to jettison the deal
  - example:
    - Re. IBP Shareholders Litigation
MAC Attacks: Strategies and Tips

- **Limited Guidance:**
  - MAC clauses are rarely litigated in North America
  - dearth of jurisprudence → uncertainty for interpretation and application

- **Issues & Order of Analysis:**
  - has there been a “change”?
  - is the change a “material adverse change”?
  - is the change captured by a carve-out provision?
  - what is the appropriate remedy/result?

- **Interpretation:**
  - construction of contract is the guiding principle

- **Burden of Proof:**
  - party proposing to rely on the MAC clause bears the onus of demonstrating its existence – *(Hexion)*
Demonstrating a Material Adverse Change

- Is the Event a “Material Adverse Change”? 
  - review the definition in the agreement  
    - how has risk been allocated? 
  - apply any statistical triggers built into the contract 
  - other factors: 
    - magnitude of the effect of the change 
    - scope of the effect of the change 
    - duration of the effect from the change 
    - future implications of the change 

- Does it Fall within the Carve-outs as an Exception?