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Material Adverse Effect

How It "Affects" M&A Transactions

BY T. TED MOTHERAL

In most corporate transactions, not everything is going to go as planned. Hence, the attorneys on both sides have to provide for unexpected happenings. Such is even the case when certain business, economic and government situations occur during the period between the signing and the closing of a transaction (also known as the gap period). On one hand, sellers would argue that little, if anything, should happen, meaning that the deal should still close at the previously agreed-upon purchase price and under the agreed-upon circumstances. Buyers, on the other hand, would counter that they shouldn't bear the risk of adverse developments during this time period, particularly because sellers remain responsible for day-to-day operations of the target throughout the gap period between signing and closing.

Like in most circumstances throughout the negotiation of a transaction, the buyer and the seller usually find a middle ground, which is achieved through indemnification and termination provisions in the main transaction agreements. However, another important component to allocate risk between the parties is the concept of Material Adverse Change or Material Adverse Effect (MAC or MAE).

This article will provide an overview of MAE, including (1) an introduction to MAE, (2) examples of buyer and seller MAE definitions and uses, and (3) a brief analysis of some key MAE cases.

FUNCTIONS OF MAE PROVISIONS

MAE serves two primary functions in a transaction agreement. First, it limits various seller representations, warranties and covenants, establishing a relatively high threshold for disclosure or compliance relating to risks associated with changes in the target's business. Second, MAE is operative in the conditions to be satisfied or waived before the buyer is required to consummate the deal. Specifically, an MAE must not have occurred during the gap period. Otherwise, the buyer may terminate the acquisition agreement. This is often referred to as an MAE out. In contrast with its use in reps, warranties and covenants, this application of the MAE concept favors the buyer by presenting it with the option to walk away from a deal after its anticipated value has changed. In both contexts, however, the seller will want to minimize the likelihood of occurrence of an MAE by narrowing which events and circumstances will satisfy the definition, and the buyer will seek to achieve the opposite.

MAE DEFINITION

Virtually all acquisition agreements include a formal definition of MAE in the definitions section. Here's a pro-buyer example, intended to cast a wide net:

> "Material Adverse Effect" means any event, change, circumstance, effect or other matter that has, or could reasonably be expected to have, either individually or in the aggregate with all other events, changes, circumstances, effects or other matters, with or without notice, lapse of time or both, a material adverse effect on (a) the business, assets, liabilities, properties, condition (financial or otherwise), operating results, operations or prospects of the acquired companies, taken as a whole, or (b) the ability of the company or the seller to perform its obligations under this Agreement or to consummate timely the transactions contemplated by this Agreement.

By contrast, a relatively pro-seller definition intended to be difficult to satisfy might provide:

> "Material Adverse Effect" means any event, change, circumstance, effect or other matter that has a material adverse effect on (a) the business, financial condition or results of operations of the acquired companies, taken as a whole, or (b) the ability of the seller to consummate timely the transactions contemplated by this Agreement; provided, however, that none of the following, either alone or in combination, will constitute, or be considered in determining whether there has been, a Material Adverse Effect: any event, change, circumstance, effect or other matter resulting from or related to (i) any outbreak or escalation of war or major hostilities or any act of terrorism, (ii) changes in Laws, GAAP or enforcement or interpretation thereof, (iii) changes that generally affect the industries and markets in which any acquired company operates, (iv) changes in financial markets, general economic conditions (including prevailing interest rates, exchange rates, commodity prices and fuel costs) or political conditions, (v) any failure, in and of itself, of any Acquired Company to meet any published or internally prepared projections, budgets, plans or forecasts of revenues, earnings or other financial performance measures or operating statistics (it being understood that the facts and circumstances underlying any such failure that are not otherwise excluded from the definition of a "Material Adverse Effect" may be considered in determining whether there has been a Material Adverse Effect), (vi) any action taken or failed to be taken pursuant to or in accordance with this Agreement or at the request of, or consented to by, the purchaser, or (vii) the execution or delivery of this Agreement, the consummation of the transactions contemplated by this Agreement or the public announcement or other publicity with respect to any of the foregoing.

Broadly speaking, there are three differences between the definitions, which are (1) forward-looking language, (2) the list of direct objects, and (3) the long list of exceptions in the pro-seller definition.

The forward-looking language sought by buyers is intended to capture events or circumstances that have not yet, but may in the future, result in a materially adverse effect. Without this language, it's conceivable that an eventuality that would certainly reduce a target company's future value without having any impact on its current operations and earnings would not qualify as an MAE. An example would be a failure to obtain government approval on a new product or service.

The second difference between the pro-buyer and pro-seller versions of MAE relates to the

object of the effect. The buyer version looks to include assets, liabilities, properties and non-financial condition, all of which were omitted from the seller version. The buyer's objective in this case is to reduce the size of the denominator in assessing materiality. What may qualify as a material adverse effect on, say, a company's liabilities or properties alone may not be material to the company as a whole, particularly where the target company didn't have a lot of liabilities or properties to begin with. Once again, the buyer looks to make a given event or circumstance more likely to constitute an MAE.

The final material variation between the two MAE definitions is the seller's proposed inclusion of a long list of exceptions. Despite being omitted from the buyer favorable draft, virtually all MAE definitions include such lists in one form or another, though they may differ in their specifics. Some of the more common exceptions are those relating to:

- changes in the economy or business in general,
- changes in general conditions of the specific industry,
- acts of war or major hostilities,
- Acts of God,
- changes in political conditions.

KEY MATERIAL ADVERSE EFFECT CASE LAW

Even though definitive case law on MAE is somewhat sparse, these Delaware cases stand out as particularly important, including:

IBP vs. Tyson

In *In Re: IBP, Inc. Shareholders Litigation,* 789 A.2d. 14 (Del. Ch. 2001), the merger agreement contained a broad MAC clause with no carve-outs. Tyson Foods asserted that IBP, the target, had suffered a material adverse effect because its first quarter 2001 earnings were 64 percent behind those for the first quarter of 2000. However, the Delaware Court of Chancery did not regard this downturn as affecting IBP on a long-term basis. In the standard set by the court in IBP, a party seeking to invoke a MAC clause and terminating a deal faces the high burden of proving that the events claimed to be a MAC "substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the [MAC] should be material when viewed from the longer-term perspective of a reasonable acquirer." The court determined that IBP had not suffered a MAC, and, as a result, Tyson Foods was forced to complete the purchase.

Hexion v. Huntsman

In this case, Hexion Specialty Chemicals attempted to exercise a MAC out under its agreement with Huntsman on the basis of a deterioration in Huntsman's business during the period between signing and closing. Hexion focused its arguments on Huntsman's repeated failure to achieve its forecasts as well as an increase in Huntsman's net debt as compared to its projected decrease and the underperformance of two of Huntsman's operating divisions.

The court concluded that, because Huntsman had specifically disclaimed any representations regarding projections, the failure to achieve targets could not be the basis of an MAE. The court also concluded that the proper way to determine the existence of an MAE is to compare current results against the prior historical period and found only a small decline (3-6%) over annual periods. In addition, the increase in net debt had been small (5%), and the Huntsman business units affected by the downturn contributed only 25% of overall EBITDA. Thus, all considered, no MAE had occurred.

The court then ruled that Hexion was obligated to consummate the acquisition, a transaction for which financing was no longer available.

The decision reaffirms the holding in *IBP v. Tyson* that parties seeking to invoke MAC outs bear a "heavy burden" to demonstrate that an MAE has occurred. The court noted that, as of the date of the opinion (2008), Delaware courts had never found a material adverse effect to have occurred in the context of a merger agreement. The court further noted that an MAE ordinarily will be "measured in years rather than months" and, thus, an MAE will not be found unless an adverse change is "consequential" to the target's long-term earning power, rather than a "short-term hiccup." The case is a cautionary tale to buyers and suggests that buyers may wish to include specific metrics and benchmarks in their agreements because reliance on generalized MAE definitions to terminate will be difficult. Additionally, the opinion indirectly states to buyers that MAE clauses will not be read in isolation, but will be viewed in the context of the entire agreement and the overall transaction.

T. Ted Motheral is a partner in the corporate transactions practice group of Walter | Haverfield, LLP. He has been a CMBA member since 2016. He can be reached at (216) 928-2967 or tmotheral@walterhav.com.