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EXPERT ANALYSIS

Quantifying Material Adverse Changes for Liability and Damage Purposes

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Global mergers and acquisitions deal volume reached $888.9 billion in the third quarter of 2014, up 29 percent from the same quarter in 2013.[1] Deals like Actavis' $66 billion takeover bid for Allergan,[2] Medtronic's $43 billion cash and stock offer for Covidien,[3] and AT&T's $67 billion bid for DirecTV grabbed headlines.[4]

The same trend held true for mid-market transactions (prices under $1 billion), albeit at less eye-popping percentage increases. Through August 2014, total transactions were up 12.8 percent, with deal values up by 16.2 percent.[5]

Thus, it is a good time to take a look at one of the staples of merger and acquisitions and other commercial agreements: "material adverse change" provisions, or MACs, or "material adverse effect" provisions, or MAEs.[6] We propose an alternative way to determine liability and damages for breach of MACs in merger and acquisition, and other financial agreements, should the parties seek to quantify whether a MAC occurred but are unable to agree on the amount.

Using a fair-market-value standard to determine potential liability and damages allows parties to resolve MAC disputes before litigation and is usable by the trier of the facts on motions to dismiss and at a trial or in arbitration.

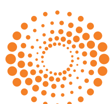
BACKGROUND ON MACS AND PIVOTAL CASES *IBP* AND *HEXION*

MAC provisions allow parties to allocate risk for the period between the date of the subject company's most recent financials and the signing of the transactional agreements, or between contract signing and closing. If a MAC in the subject company[7] occurred in that time period, the buyer, seller or funder can walk away from the transaction without penalty.[8]

Before the *IBP* and *Hexion* cases,[9] courts generally defined MACs through the eyes of an objective purchaser, in which sometimes modest adverse circumstances allowed them to walk away from the transaction.[10]

The tide shifted in Delaware Chancery Court cases with the *IBP* and *Hexion* decisions. These decisions generally support the position that an alleged MAC must be one that materially and adversely affects the subject company's long-term earnings prospects.

In *IBP*, the court rejected a buyer's MAC claim and granted the seller IBP's motion for specific performance. The court, per then-Vice Chancellor Leo E. Strine, said IBP's annual earnings were historically in the black but subject to strong swings in earnings before interest, taxes and net income.



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For example, IBP's 12-month income from operations at the end of the third quarter of 2000 was $462 million, versus $528 million for the full year of 1999. This decline notwithstanding, the court said, "[E]ven where a material-adverse-effect condition is as broadly written as the one in the merger agreement, that provision is best read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner."[11]

Hexion's MAC claim focused on Huntsman Corp.'s weakened financial performance and the misses in its forecasts. The court recognized that Huntsman's first half 2008 earnings before interest, depreciation and amortization had declined by 19.9 percent from its first half results in 2007. In addition, the second half 2007 EBITDA was 22 percent below what Huntsman had presented to bidders in June 2007, and its projected 2008 EBITDA was down 32 percent from its earlier forecast.

In addition to holding that the merger agreement's language did not support Hexion's claims, the court said, "for the purpose of determining whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting. In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. … A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close … [for] such a decline to constitute a material adverse effect, poor earnings must be expected to persist significantly into the future."[12]

Starting with *IBP* and continuing with *Hexion*, three facts were evident:

- In jurisdictions not bound by the tough hurdles facing those seeking to declare a MAC, the decisions went both ways.[13]
- Delaware Chancery has never found a MAC to have occurred, but in one currently pending case, plaintiffs have survived a motion to dismiss.[14]
- In big-money cases, the litigation risks and substantial litigation costs kept parties mostly out of the courthouse.[15] Parties had to consider the re-trading of deals, including assertion of *in terrorem* threats to declare a MAC, or simply paying a termination fee and walking away.

As some cases demonstrate (see table), the mere act of asserting a MAC claim can cause a sharp decline of the target's stock price, which could later serve as a basis to re-trade the deal down.[16]

HOW TO PREVAIL ON A MAC CLAIM AFTER *IBP* AND *HEXION*

The high MAC threshold resulting from *IBP* and *Hexion* is likely the reason there have been so few post-*Hexion* decisions, as well as the fact that Delaware Chancery has never, after trial, found a MAC to have occurred. There could, however, be any number of circumstances responsible for a company's long-term earnings decline while a MAC provision is in effect, such as:

- The acquisition of a startup company for its intellectual property (evidenced by one or more patents), only to discover that some or all of the intellectual property embodied in a seller's patent is alleged to be owned by a third party.
- A massive company fraud.
- A catastrophic environmental event.
- A product liability exposure resulting in injury and deaths from harmful components of the product.[17]

Assume that, prior to disclosing such problems, each of these hypothetical companies had signed agreements with purchasers of their shares or with lenders, based on the modest MAC provision contained in Section 3.12 of the American Bar Association's "model stock agreement." That provision reads as follows:

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> 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.

Further assume that the issues in each of these examples was disclosed by the seller, borrower or third parties in the relevant time period at a level of detail sufficient for a reasonable person to assess the risks. Could the purchaser or lender walk away without penalty, say from a reverse termination fee?

The answer should be "yes," because each of these circumstances is likely to materially and adversely affect the "prospects, assets or conditions" in the ABA's MAC language, thereby constituting a MAC, despite the high threshold established by *IBP* and *Hexion*. To date, there has been no case to test the correctness of this observation.

QUANTIFYING MACS

Determining whether a MAC took place typically occurs after construing the MAC language in the operative agreements and matching the drafters' language to the facts of the deal. It seems, despite the drafters' best intentions (and often feverish negotiations on the wording of MAC provisions), serious battles on whether a MAC occurred are inevitable after the bad facts on the subject company are revealed.

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In two cases, we found the MACs described a dollar amount decline that could determine whether a MAC had occurred. In *Great Lakes Chemical Corp. v. Pharmacia Corp.,* Great Lakes contracted to buy a Pharmacia subsidiary and then sued to terminate the agreement because the subsidiary was suffering customer losses.[18] Pharmacia moved to dismiss the complaint, saying the customer losses stemmed from external factors.

The MAC clause was defined as "a negative change on the operations, results of operations or condition (financial or otherwise) in an amount equal to $6,500,000 or more."

The court decided the allegation by Great Lakes that it suffered damages in excess of $50 million created an issue of fact sufficient to deny Pharmacia's motion.

While *Great Lakes* was a decision only in motion practice, *Nip v. Checkpoint Systems Inc.* was not.[19] *Nip* arose from Checkpoint Systems' purchase of A.W. Printing from sellers Richard Nip and Nip Lung Kwan.

Checkpoint sought to recover damages resulting from the sellers' alleged failure to disclose customer losses prior to closing. The trial court held for Checkpoint, and a jury awarded Checkpoint over $2.5 million, relying in part on the dollar-denominated MAC definition:

> A change (or effect) in the condition (financial or otherwise), properties, assets, liabilities, rights, obligations, operations, business or prospects which change (or effect), individually or in the aggregate, adversely affects, or could reasonably be expected to adversely affect, such condition, properties, assets, liabilities, rights, obligations, operations, business or prospects in an amount equal to or greater than $50,000.[20]

The appellate court affirmed, saying such customer losses "could reasonably be expected to exceed the amount of $50,000."[21]

The attempted acquisition of amusement park operator Cedar Fair by an affiliate of Apollo Global Management in 2009 is an example of a buyer setting an EBITDA threshold below which it could terminate the transaction.

Apollo, presumably chastened by its adverse *Hexion* experience a year earlier, insisted it could terminate the deal if Cedar Fair's EBITDA for the four quarters ending Dec. 31, 2009, was less than

Incidents of MAC Claims Leading to Extra-Judicial Settlements	
Accredited Home Lenders	*Accredited Home Lenders Holding Co. v. Lone Star Fund V (U.S.) et al.*, No. 3160-VCL (Del. Ch. 2007)
In 2007, private-equity firm Lone Star agreed to purchase Accredited Home Lenders for $400 million. As an originator of subprime residential mortgages, AHL faced an uncertain future when the housing market began to unravel in the summer of 2007 and received a "going concern" qualification, causing Lone Star to assert a MAC claim. AHL sued for specific performance in Delaware Chancery Court, seeking specific performance of the transaction. The parties settled the dispute out of court by agreeing to a 22 percent price reduction conditioned on Lone Star's agreement to provide AHL with $49 million in additional financing.	
Sallie Mae	*SLM Corp. v. J.C. Flowers II et al.*, No. 3279-VCS (Del. Ch. 2007)
In 2007, J.C. Flowers & Co., JPMorgan Chase and Bank of America agreed to a $25 billion buyout of student loan originator SLM Corp., commonly known as Sallie Mae. In response to pending legislation thought to affect Sallie Mae's long-term earnings, the buyers sought to walk away from the deal and avoid paying the $900 million termination fee by asserting a MAC claim. Sallie Mae sued in the Delaware Chancery Court, seeking to recover the $900 termination fee. The MAC claim ultimately served as a bargaining chip for the buyers who settled with Sallie Mae, allowing them to walk away from the purchase in exchange for an agreement to refinance $30 billion of Sallie Mae's short-term debt.	
HD Supply	
In an attempt to finance a share buyback, cash-strapped Home Depot pursued the sale of its business unit, HD Supply, in June 2007. Originally priced at over $10 billion, Home Depot lowered its price as its profitability was negatively affected by the collapse of the housing market. Home Depot's repricing resulted from the buyers' threat of termination pursuant to the agreement's MAC clause. Despite the agreement's explicit carve-out provision that ruled out market conditions as a MAC, some speculated that Home Depot lacked sufficient leverage to call the buyers' bluff in the midst of such trying financial circumstances. The deal was subsequently consummated in August 2007 at an adjusted price of $8.5 billion.	
Acxiom	
Buyers Silver Lake and ValueAct initially proposed a purchase price of over $2 billion but got cold feet when learning that Acxiom, a data management company, had suffered a net loss of $11.5 million in the quarter ending in June 2007. The buyers adopted a novel negotiating approach. Rather than assert a MAC claim in court, the buyers used their bargaining power to lower the termination fee from $110 million to $65 million, leaving them with a less expensive means of escape.	
Harman International Industries	
In April 2007, Kohlberg Kravis Roberts & Co. and Goldman Sachs Group Inc. reached a deal with audio manufacturer Harman International Industries Inc. to purchase its stock for $120 per share — a 17 percent premium to its most recent closing price — or $7.8 billion in total. Months later, the buyers announced that they were not satisfied with Harman's financial condition and invoked the agreement's MAC clause in order to walk away from the deal. Investors responded negatively to the MAC claim, and Harman shares declined by 24 percent. The buyers took advantage of this decline by renegotiating the terms of the purchase the following month. By returning to the negotiating table, they avoided paying a termination fee. Instead of acquiring Harman, they invested $400 million in Harman notes, convertible into stock priced at $104. If converted, the buyers would control about 5.6 percent of outstanding common stock at the time of the purchase.	
Solutia	*Solutia Inc. v. Citigroup Global Markets Inc. et al.*, No. 08-01057 (Bankr. S.D.N.Y)
Solutia, the product of a 1997 spin-off by Monsanto Corp., filed for bankruptcy protection in 2003. By August 2007, the company had a reorganization plan and sought financing. In October 2007, Citigroup, Goldman Sachs and Deutsche Bank agreed to provide $2 billion in financing to Solutia. In January 2008, the lenders sought to be released from their commitment on the ground that a MAC had taken place. Solutia sued for specific performance, and the lenders counterclaimed for a declaratory judgment, asserting that because of the MAC, they were not in breach of their commitment. The case settled mid-trial with the lenders agreeing to waive the MAC claim and increase the original revolving credit facility by an additional $50 million. In return, Solutia agreed to pay a higher interest rate on its $1.2 billion senior secured loan and dismiss the lawsuit with prejudice.	
Pep Boys	
Pep Boys agreed to sell to Gores after struggling to compete for several years. The deal fell apart after Pep Boys announced weak quarterly results in the first quarter of 2012. Rather than contest the occurrence of a MAC in court, Gores agreed to pay the $50 million termination fee and walk away.	

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$311.8 million.[22] While separate and distinct from the MAC language, it nonetheless provided an out to which the buyer might avail itself.

While the use of EBITDA thresholds is more empirical than conventional MAC language, a single EBITDA or other earnings-based threshold is merely evidentiary and not dispositive of the magnitude of the decline in a business.

USING FAIR-MARKET-VALUE PERCENTAGE DECLINE TO DEFINE A MAC

Parties otherwise disposed to determine a liquidated sum to define a MAC may have difficulty in arriving at that figure because of the buyer/lender's incentives to opt for the lowest possible number and the seller/borrower the highest. This may explain why it is uncommon for merger and acquisitions or other contracts to include an agreed upon liquidated sum above which a MAC could be declared.[23]

To move parties in that direction, a fair-market-value standard can be used as part of a MAC clause if the parties cannot negotiate a liquidated sum. Thus, a decline in the subject company's fair market value in the relevant time period, by a percentage negotiated by the parties, would give the counterparty the right to abandon the transaction without penalty.[24] In doing so, there would be no need to try to match the drafters' words (or such parol evidence as would survive an integration clause battle) to the adverse circumstance.

Take, for example, the purchase by J. Rettenmaier & Sohne of the chemical excipient business of Penwest Pharmaceuticals. Section 21(d) of their purchase and sale agreement defined a "material adverse change" as one allowing the buyer to terminate if the change "would reduce the fair market value of the Business by ten percent (10%) or more, where 'fair market value' has the meaning set forth in Revenue Ruling 59-60."[25]

If a MAC in the subject company occurred in that time period, the buyer, seller or funder can walk away from the transaction without penalty.

This fair market value proposal responds to the challenges of *IBP* and *Hexion* that bar MAC proponents from prevailing, except for matters constituting long-term impairments of the subject company's earning power. We suggest measuring whether the subject company's long-term earnings power was materially compromised by the event alleged to constitute a MAC.

Determining the change in the subject company's fair market value for the period before and after the alleged MAC will establish whether the difference exceeded the percentage decline specified in the transactional agreement. Such an analysis would likely be a discounted cash-flow approach, which could more fairly measure the long-term effect of the adverse event than a current-year decline as measured by static revenue, EBITDA or EBIT multiples.[26]

The simplest way to accomplish the task would be for the parties to agree on a neutral party to provide the computation or each side could appoint an expert with the results averaged.[27] Either way, the parties would have a useful basis on which to re-trade the deal, and the trier of fact would be better able to decide motions to dismiss or at trial. In the process, the fair-market-value standard addresses both the liability question of whether a MAC took place and the damages, if any, to the party declaring it.

NOTES

[1] Bloomberg Finance, *Global M&A Market Review: Financial Rankings, 1st 3Q 2014*, at 3.

[2] David Gelles, *Valeant and Pershing Square to Raise Offer for Botox Maker Allergan*, N.Y. Times, Oct. 7, 2014.

[3] Foo Yun Chee, *Medtronic Offers EU Concessions in $43 Bln Covidien Deal*, Reuters, Nov. 11, 2014.

[4] Liana B. Baker, Soyoung Kim & Marina Lopes, *AT&T Makes Best on Video With $48.5 Billion DirecTV Bid*, Reuters, May 19, 2014.

[5] Robert W. Baird & Co., Global M&A Monthly: A Middle-Market Perspective on the Global Mergers & Acquisitions Environment (September 2014), at 2.

[6] These terms appear to be used interchangeably in merger and acquisitions and other agreements. In this article, we refer to MACs and MAEs simply as MACs.

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Whether the subject company's long-term earnings power was aterially compromised by the alleged event should also be measured to constitute a MAC

[7] Typically, the seller in a merger-and-acquisition setting, or the borrower in a financing, but arguably the funder in a merger setting where the funder was required to fund over an extended time period, or the buyer in a transaction in which the buyer's shares formed the transaction's consideration.

[8] *See* Ross B. Bricker, Courtney M. Breeman & Jodi K. Newman, *Living In a Material World: The Evolution, Purpose and Future of Material Adverse Change Clauses*, Bloomberg Finance LP (2008); Jeffrey Rothschild, Nick Azis, Patrice Corbiau, Dennis White & Abigail Reed, *Drafting Material Adverse Change Clauses,* McDermott Will & Emery, Financier Worldwide International M&A Review (2008); Paxton Law Group, *Material Adverse Effect Clauses in Public Company Merger Agreements* (Mar. 4, 2014).

[9] *See In re IBP S'holder Litig.,* 789 A.2d 14 (Del. Ch. 2001), and *Hexion Specialty Chems. v. Huntsman Corp.*, 959 A. 2d 47 (Del. Ch. 2008).

[10] *See* Bricker, *supra* note 8, at 2. For example, *see KLRA Inc. v. Long et al.,* 6 Ark. App. 125 (Ark. Ct. App. 1982), in which the court ruled in favor of the buyer of a radio station seeking to terminate the purchase agreement after the court determined a 48 percent decline in the station's profits in one year constituted a material adverse change; *Pan Am Corp. v. Delta Air Lines Inc.*, 175 B.R. 438 (Bankr. S.D.N.Y. 1994), in which the court ordered Pam Am to repay funds loaned by Delta during the course of Pan Am's restructuring, after determining that Pan Am's passenger and revenue projections had undergone significant adverse changes; and *Coastal Power International v. Transcontinental Capital,* 10 F. Supp. 2d 345 (S.D.N.Y. 1998), in which the court determined that a MAE had occurred after the seller of a barge allowed its insurance coverage to expire days before closing.

[11] *In re IBP S'holder Litig.,* 789 A.2d 14, 154 (Del. Ch. 2001).

[12] *Hexion Specialty Chems. v. Huntsman Corp.,* 965 A.2d 715, 738 (2008).

[13] Buyers prevailed in, for example, *International Paper Co. v. Androscoggin Energy LLC,* No. 00-CV-6215, Mem. Op. (N.D. Ill. 2000); *Nip et al. v. Checkpoint Systems,* No. 2001-39671 (Tex. Dist. Ct., 281st Dist. Harris County 2003), *aff'd* 154 S.W.3d 767 (2004); *In re Eastern Continuous Forms*, 302 B.R. 320 (Bankr. E.D. Pa. 2003); and *Osram Sylvania Inc. v. Townsend Ventures,* No. 8123-VCP (Del. Ch. 2013). Sellers prevailed in, for example, *S.C. Johnson & Son v. DowBrands Inc.,* 167 F. Supp. 2d 657 (D. Del. 2001); *Rus Inc. v. Bay Industries,* 322 F. Supp. 2d 302 (S.D.N.Y. 2003); *Media General v. Tomlin,* 387 F. 3d 865 (D.C. Cir. 2004); and *Frontier Oil Corp. v. Holly Corp.,* No. 20502 (Del. Ch. 2005). *See* also Chad Bray, *Finish Line, Genesco Settlement Terminates $1.5 Billion Merger,* Wall St. J., Mar. 3, 2008).

[14] *See Osram,* No. 8123-VCP.

[15] *See* Bricker, *supra* note 8, at 8-9, and Adam B. Chertok, *Rethinking the U.S. Approach to Material Adverse Change Clauses in Merger Agreements*, 19 U. Miami Int'l & Comp. L. Rev. 99, 124-128 (2011-2012).

[16] For examples, *see Accredited Home Lenders Holding Co. v. Lone Star Fund V (U.S.) et al.,* No. 3160-VCL (Del. Ch. 2007), or *SLM Corp. v. J.C. Flowers II et al.*, No. 3279-VCS (Del. Ch. 2007).

[17] Each of these circumstances might trigger liability or, in some cases, walk-away rights, even if the MAC's language or the carve-outs precluded such a walk-away. *Frontier v. Holly* (*supra* note 12) establishes the Delaware Chancery's standard that a party asserting a MAC claim must prove by a preponderance of the evidence that the magnitude of the seller's or borrower's projected liability from pending litigation is material.

[18] *See Great Lakes Chem. Corp. v. Pharmacia Corp. et al.*, 788 A.2d 544 (Del. Ch. 2001). In considering whether an MAE had occurred, the court also noted the absence of a MAC carve-out in the purchase agreement.

[19] *See Nip,* 154 S.W.3d 767.

[20] *Id.* at 769.

[21] *Id.* at 770. *See* also Rothschild, *supra* note 8, at 4; Andrew M. Herman & Bernardo L. Piereck, *Revisiting the MAC Clause in Transactions,* Business Law Today, Aug. 2, 2010; and DealBook, *The Big MAC*, N.Y. Times, Mar. 10, 2008.

[22] *See* the Dec. 16, 2009, merger agreement between Cedar Holdco Ltd., an Apollo affiliate, and Cedar Fair LP, *available at* https://www.sec.gov/Archives/edgar/data/811532/000119312510027243/ddefm14a.htm. Note that the transaction failed because Cedar Fair was unable to secure the consent of the required two-thirds vote of its unit holders at the $11.50-per-unit deal price.

[23] The American Bar Association found no merger agreement in its 2012 study sample that included a reference to specific dollar amount thresholds. Only 8 percent and 2 percent included such language in its 2010 study and 2008 study, respectively. *See* Am. Bar Ass'n, *Private Target Mergers & Acquisitions Deal Points Study* (Dec. 30, 2013). Also, a Nixon Peabody study found no examples of dollar-denominated threshold language in its sample. Nixon Peabody, *Nixon Peabody MAC Survey* (2014), at 6.

[24] One of the authors suggested such a provision in the acquisition by J. Rettenmaier & Sohne, of the chemical excipient business of Penwest Pharmaceuticals Co. in 2003. *See* Penwest Pharmaceuticals Co.,

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Preliminary Proxy Statement (Nov. 1, 2002), at § 21(d), *available at* https://www.sec.gov/Archives/edgar/data/1047188/000095013503000132/b44818a1prer14a.htm.

[25] Revenue Ruling 59-60 sets forth techniques to determine fair market value. The comparative-company approach most favored in Revenue Ruling 59-60 was dramatically expanded by the Delaware Chancery' Courts landmark ruling in *Weinberger v. UOP Inc.,* 457 A.2d 701 (1983).

[26] The full disclosure of the adverse event might be at a date substantially later than its initial disclosure, thus delaying the closing. To avoid a long-term deadlock in such a circumstance, the parties might negotiate a provision stating that if the change in fair market value could not be determined by a certain date, the buyer or lender would have a walk-away right, subject to its paying a termination fee.

[27] Should the parties agree to a two-appraiser approach to determine any fair-market-value decline between contract signing and closing, wildly disparate results can be minimized by instructing the experts to use agreed-upon metrics in their analyses. These might include which cash-flow projections to use, elements associated with weighted average cost of capital estimations (*e.g.* what equity risk premia should be included) and how terminal value should be calculated (*i.e.* exit multiples or perpetuity growth models).

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